GENERAL DYNAMICS CORP
Form 10-Q
October 22, 2014

UNITED STATES SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

FORM 10-Q

(Mark One)
[X] QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d)
OF THE SECURITIES EXCHANGE ACT OF 1934

For the quarterly period ended September 28, 2014
OR
[ ] TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d)
OF THE SECURITIES EXCHANGE ACT OF 1934

Commission File Number 1-3671

GENERAL DYNAMICS CORPORATION
(Exact name of registrant as specified in its charter)

Delaware	13-1673581
State or other jurisdiction of incorporation or organization	I.R.S. employer identification no.
2941 Fairview Park Drive, Suite 100 Falls Church, Virginia	22042-4513
Address of principal executive offices	Zip code
	(703) 876-3000

Registrant's telephone number, including area code

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months and (2) has been subject to such filing requirements for the past 90 days. Yes ü No ___
Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes ü No ___
Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company. See the definitions of "large accelerated filer," "accelerated filer" and "smaller reporting company" in Rule 12b-2 of the Exchange Act.
Large Accelerated Filer ü Accelerated Filer __ Non-Accelerated Filer __ Smaller Reporting Company ___
Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act). Yes No ü
331,389,741 shares of the registrant's common stock, $1 par value per share, were outstanding on September 28, 2014.

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PART I – FINANCIAL INFORMATION

ITEM 1. UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS

CONSOLIDATED STATEMENTS OF EARNINGS (UNAUDITED)

(Dollars in millions, except per-share amounts)	Three Months Ended September 29, 2013	September 28, 2014
Revenues:		
Products	$4,752	$4,909
Services	2,983	2,842
	7,735	7,751
Operating costs and expenses:		
Products	3,700	3,866
Services	2,577	2,408
General and administrative (G&A)	497	478
	6,774	6,752
Operating earnings	961	999
Interest, net	(22)	(21)
Other, net	4	1
Earnings from continuing operations before income tax	943	979
Provision for income tax, net	291	285
Earnings from continuing operations	652	694
Discontinued operations, net of tax of ($2) in 2013 and $1 in 2014	(1)	2
Net earnings	$651	$696
Earnings per share		
Basic:		
Continuing operations	$1.86	$2.09
Discontinued operations	—	0.01
Net earnings	$1.86	$2.10
Diluted:		
Continuing operations	$1.84	$2.05
Discontinued operations	—	0.01
Net earnings	$1.84	$2.06

The accompanying Notes to Unaudited Consolidated Financial Statements are an integral part of these statements.

CONSOLIDATED STATEMENTS OF EARNINGS (UNAUDITED)

(Dollars in millions, except per-share amounts)	Nine Months Ended September 29, 2013	September 28, 2014
Revenues:		
Products	$13,981	$14,005
Services	8,902	8,485
	22,883	22,490
Operating costs and expenses:		
Products	10,979	10,967
Services	7,633	7,246
G&A	1,506	1,455
	20,118	19,668
Operating earnings	2,765	2,822
Interest, net	(63)	(67)
Other, net	4	2
Earnings from continuing operations before income tax	2,706	2,757
Provision for income tax, net	844	821
Earnings from continuing operations	1,862	1,936
Discontinued operations, net of tax of $1 in 2013 and ($38) in 2014	—	(104)
Net earnings	$1,862	$1,832
Earnings per share		
Basic:		
Continuing operations	$5.31	$5.75
Discontinued operations	—	(0.31)
Net earnings	$5.31	$5.44
Diluted:		
Continuing operations	$5.27	$5.64
Discontinued operations	—	(0.30)
Net earnings	$5.27	$5.34

The accompanying Notes to Unaudited Consolidated Financial Statements are an integral part of these statements.

CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME (UNAUDITED)

(Dollars in millions)	Three Months Ended September 29, 2013	Three Months Ended September 28, 2014	Nine Months Ended September 29, 2013	Nine Months Ended September 28, 2014
Net earnings	$651	$696	$1,862	$ 1,832
Gains (losses) on cash flow hedges	12	(60)	—	(69)
Unrealized gains on securities	—	1	7	7
Foreign currency translation adjustments	152	(235)	(92)	(226)
Change in retirement plans' funded status	95	61	299	177
Other comprehensive income (loss), pretax	259	(233)	214	(111)
Provision for income tax, net	39	—	108	41
Other comprehensive income (loss), net of tax	220	(233)	106	(152)
Comprehensive income	$871	$463	$1,968	$ 1,680

The accompanying Notes to Unaudited Consolidated Financial Statements are an integral part of these statements.

CONSOLIDATED BALANCE SHEETS (UNAUDITED)

(Dollars in millions)	December 31, 2013	September 28, 2014
ASSETS		
Current assets:		
Cash and equivalents	$5,301	$5,105
Accounts receivable	4,370	4,181
Contracts in process	4,780	4,436
Inventories	2,890	3,139
Other current assets	821	1,308
Total current assets	18,162	18,169
Noncurrent assets:		
Property, plant and equipment, net	3,359	3,322
Intangible assets, net	1,044	929
Goodwill	11,932	11,756
Other assets	997	1,135
Total noncurrent assets	17,332	17,142
Total assets	$35,494	$35,311
LIABILITIES AND SHAREHOLDERS' EQUITY		
Current liabilities:		
Short-term debt and current portion of long-term debt	$1	$501
Accounts payable	2,216	2,390
Customer advances and deposits	6,584	7,990
Other current liabilities	3,458	3,789
Total current liabilities	12,259	14,670
Noncurrent liabilities:		
Long-term debt	3,908	3,410
Other liabilities	4,826	4,221
Commitments and contingencies (See Note L)		
Total noncurrent liabilities	8,734	7,631
Shareholders' equity:		
Common stock	482	482
Surplus	2,226	2,467
Retained earnings	19,428	20,631
Treasury stock	(6,450)	(9,233)
Accumulated other comprehensive loss	(1,185)	(1,337)
Total shareholders' equity	14,501	13,010
Total liabilities and shareholders' equity	$35,494	$35,311

The accompanying Notes to Unaudited Consolidated Financial Statements are an integral part of these statements.

CONSOLIDATED STATEMENTS OF CASH FLOWS (UNAUDITED)

	Nine Months Ended	
(Dollars in millions)	September 29, 2013	September 28, 2014
Cash flows from operating activities - continuing operations:		
Net earnings	$1,862	$1,832
Adjustments to reconcile net earnings to net cash provided by operating activities:		
Depreciation of property, plant and equipment	280	285
Amortization of intangible assets	112	91
Stock-based compensation expense	90	94
Excess tax benefit from stock-based compensation	(19)	(66)
Deferred income tax provision	51	94
Discontinued operations, net of tax	—	104
(Increase) decrease in assets, net of effects of business acquisitions:		
Accounts receivable	(181)	189
Contracts in process	(119)	380
Inventories	(212)	(259)
Increase (decrease) in liabilities, net of effects of business acquisitions:		
Accounts payable	(1)	174
Customer advances and deposits	16	1,231
Income taxes payable	80	148
Other current and noncurrent liabilities	(183)	(238)
Other, net	(223)	(261)
Net cash provided by operating activities	1,553	3,798
Cash flows from investing activities - continuing operations:		
Purchases of held-to-maturity securities	—	(500)
Capital expenditures	(267)	(337)
Other, net	55	11
Net cash used by investing activities	(212)	(826)
Cash flows from financing activities - continuing operations:		
Purchases of common stock	(696)	(3,117)
Dividends paid	(394)	(618)
Proceeds from option exercises	484	475
Other	46	66
Net cash used by financing activities	(560)	(3,194)
Net cash (used) provided by discontinued operations	(12)	26
Net increase (decrease) in cash and equivalents	769	(196)
Cash and equivalents at beginning of period	3,296	5,301
Cash and equivalents at end of period	$4,065	$5,105
Supplemental cash flow information:		
Cash payments for:		
Income taxes	$713	$573
Interest	$66	$65

The accompanying Notes to Unaudited Consolidated Financial Statements are an integral part of these statements.

CONSOLIDATED STATEMENTS OF SHAREHOLDERS' EQUITY (UNAUDITED)

	Common Stock		Retained	Treasury	Accumulated Other Comprehensive	Total Shareholders'
(Dollars in millions)	Par	Surplus	Earnings	Stock	Loss	Equity
Balance, December 31, 2012	$482	$1,988	$17,860	$(6,165)	$(2,775)	$11,390
Net earnings	—	—	1,862	—	—	1,862
Cash dividends declared	—	—	(591)	—	—	(591)
Stock-based awards	—	173	—	383	—	556
Shares purchased	—	—	—	(718)	—	(718)
Other comprehensive income	—	—	—	—	106	106
Balance, September 29, 2013	$482	$2,161	$19,131	$(6,500)	$(2,669)	$12,605
Balance, December 31, 2013	$482	$2,226	$19,428	$(6,450)	$(1,185)	$14,501
Net earnings	—	—	1,832	—	—	1,832
Cash dividends declared	—	—	(629)	—	—	(629)
Stock-based awards	—	241	—	377	—	618
Shares purchased	—	—	—	(3,160)	—	(3,160)
Other comprehensive loss	—	—	—	—	(152)	(152)
Balance, September 28, 2014	$482	$2,467	$20,631	$(9,233)	$(1,337)	$13,010

The accompanying Notes to Consolidated Financial Statements are an integral part of these statements.

NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS

(Dollars in millions, except per-share amounts or unless otherwise noted)
A. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES
Basis of Consolidation and Classification. The unaudited Consolidated Financial Statements include the accounts of General Dynamics Corporation and our wholly owned and majority-owned subsidiaries. We eliminate all inter-company balances and transactions in the unaudited Consolidated Financial Statements.
Consistent with defense industry practice, we classify assets and liabilities related to long-term production contracts as current, even though some of these amounts may not be realized within one year.
Interim Financial Statements. The unaudited Consolidated Financial Statements have been prepared pursuant to the rules and regulations of the Securities and Exchange Commission. These rules and regulations permit some of the information and footnote disclosures normally included in financial statements prepared in accordance with U.S. generally accepted accounting principles (GAAP) to be condensed or omitted.
Our fiscal quarters are 13 weeks in length. Because our fiscal year ends on December 31, the number of days in our first and fourth quarters varies slightly from year to year. Operating results for the three- and nine-month periods ended September 28, 2014, are not necessarily indicative of the results that may be expected for the year ending December 31, 2014.
The unaudited Consolidated Financial Statements contain all adjustments that are of a normal recurring nature necessary for a fair presentation of our results of operations and financial condition for the three- and nine-month periods ended September 29, 2013, and September 28, 2014.
These unaudited Consolidated Financial Statements should be read in conjunction with the Consolidated Financial Statements and notes thereto included in our Annual Report on Form 10-K for the year ended December 31, 2013.
The unaudited Consolidated Financial Statements have been restated to reflect the results of operations of our axle business in discontinued operations (see further discussion below).
Revenue Recognition. We account for revenues and earnings using the percentage-of-completion method. Under this method, contract costs and revenues are recognized as the work progresses, either as the products are produced or as services are rendered. We estimate the profit on a contract as the difference between the total estimated revenue and costs to complete a contract and recognize that profit over the life of the contract. If at any time the estimate of contract profitability indicates an anticipated loss on the contract, we recognize the loss in the quarter it is identified. We review and update our contract estimates regularly. We recognize changes in estimated profit on contracts under the reallocation method. Under the reallocation method, the impact of a revision in estimate is recognized prospectively over the remaining contract term. The net increase in our operating earnings (and on a per-share basis) from the favorable impact of revisions in contract estimates totaled $105 ($0.19) and $296 ($0.54) for the three- and nine-month periods ended September 29, 2013, and $13 ($0.02) and $103 ($0.20) for the three- and nine-month periods ended September 28, 2014, respectively. While no revisions on any one contract were material to our unaudited Consolidated Financial Statements in the third quarter and first nine months of 2014, the amount decreased compared with the prior-year periods as 2013 included higher favorable revisions in contract estimates on several programs that neared completion in the Combat Systems and Information Systems and Technology groups.

In the second quarter of 2014, the Financial Accounting Standards Board (FASB) issued Accounting Standards Update (ASU) 2014-09, Revenue from Contracts with Customers. ASU 2014-09 prescribes a single, common revenue standard that replaces most existing revenue recognition guidance in GAAP. The standard outlines a five-step model, whereby revenue is recognized as performance obligations within a contract are satisfied. The standard also requires new, expanded disclosures regarding revenue recognition. ASU 2014-09 is effective in the first quarter of 2017. Early application is not permitted. The standard permits the use of either the retrospective or cumulative effect transition method. We have not yet selected a transition method nor have we determined the effect of the standard on our consolidated financial statements.
The required adoption of the ASU in 2017 will preclude our use of the reallocation method of recognizing revisions in estimated profit on contracts discussed above. Because changes in estimated profit will be recognized in the period they are identified (cumulative catch-up method), rather than prospectively over the remaining contract term, we expect that the impact of revisions of contract estimates may be larger and potentially more variable from period to period. Anticipated losses on contracts will continue to be recognized in the quarter they are identified.
Discontinued Operations. In June 2014, we committed to a plan to sell our axle business in the Combat Systems group. Accordingly, the assets and liabilities of the business, including an allocation of goodwill, were reported as held for sale and included in other current assets and liabilities on the unaudited Consolidated Balance Sheets. When a business is held for sale, management is required to evaluate the net assets of the business for impairment based on its fair value less cost to sell. Based on this analysis, we recognized a $106 after-tax loss in the second quarter.
In late 2013, we settled our litigation with the U.S. Navy related to a terminated contract in the company's discontinued tactical military aircraft business. Under the terms of the settlement agreement, the Navy received a $198 credit that will be utilized over several years as the company renders design and construction services on the DDG-1000 program. This activity is reported in net cash from discontinued operations on the Consolidated Statements of Cash Flows.
Subsequent Events. We have evaluated material events and transactions that have occurred after September 28, 2014, and concluded that no subsequent events have occurred that require adjustment to or disclosure in this Form 10-Q.

B. ACQUISITIONS, INTANGIBLE ASSETS AND GOODWILL
We did not acquire any businesses in 2013 or the first nine months of 2014.

The changes in the carrying amount of goodwill by reporting unit for the nine months ended September 28, 2014, were as follows:

	Aerospace	Combat Systems	Marine Systems	Information Systems and Technology	Total Goodwill
December 31, 2013 (a)	$2,741	$2,849	$289	$6,053	$11,932
Other (b)	(104)	(59)	—	(13)	(176)
September 28, 2014	$2,637	$2,790	$289	$6,040	$11,756

(a)Goodwill on December 31, 2013, in the Information Systems and Technology reporting unit is net of $1,994 of accumulated impairment losses.
(b)Consists primarily of adjustments for foreign currency translation.

Intangible assets consisted of the following:

	Gross Carrying Amount	Accumulated Amortization	Net Carrying Amount	Gross Carrying Amount	Accumulated Amortization	Net Carrying Amount
	December 31, 2013			September 28, 2014		
Contract and program intangible assets*	$1,790	$(1,189)	$601	$1,626	$(1,102)	$524
Trade names and trademarks	507	(103)	404	487	(118)	369
Technology and software	130	(92)	38	129	(94)	35
Other intangible assets	155	(154)	1	155	(154)	1
Total intangible assets	$2,582	$(1,538)	$1,044	$2,397	$(1,468)	$929

* Consists of acquired backlog and probable follow-on work and related customer relationships.

The decrease in the gross carrying amount and accumulated amortization of contract and program intangible assets from December 31, 2013, to September 28, 2014, is primarily due to the write-off of fully amortized assets in the Information Systems and Technology group. Amortization expense was $33 and $112 for the three- and nine-month periods ended September 29, 2013, and $30 and $91 for the three- and nine-month periods ended September 28, 2014, respectively.

C. EARNINGS PER SHARE

Earnings per Share. We compute basic earnings per share (EPS) using net earnings for the period and the weighted average number of common shares outstanding during the period. Basic weighted average shares outstanding have decreased throughout 2013 and 2014 due to share repurchases. Diluted EPS incorporates the additional shares issuable upon the assumed exercise of stock options and the release of restricted shares and restricted stock units (RSUs). Diluted EPS in 2014 also includes contingently issuable shares associated with the settlement of our accelerated share repurchase (ASR) program that expires in the fourth quarter of 2014. See Note J for additional details of our share repurchases and the ASR.

Basic and diluted weighted average shares outstanding were as follows (in thousands):

	Three Months Ended		Nine Months Ended	
	September 29, 2013	September 28, 2014	September 29, 2013	September 28, 2014
Basic weighted average shares outstanding	349,337	331,811	350,774	336,911
Dilutive effect of other securities*	3,581	6,370	2,348	6,203
Diluted weighted average shares outstanding	352,918	338,181	353,122	343,114

* Excludes the following outstanding options to purchase shares of common stock and nonvested restricted stock/RSUs because the effect of including these securities would be antidilutive: 2013 - 10,992 and 2014 - 3,446.

D. FAIR VALUE

Fair value is defined as the price that would be received to sell an asset or paid to transfer a liability in the principal or most advantageous market in an orderly transaction between marketplace participants. Various valuation approaches can be used to determine fair value, each requiring different valuation inputs. The following hierarchy classifies the inputs used to determine fair value into three levels:

- Level 1 – quoted prices in active markets for identical assets or liabilities;
- Level 2 – inputs, other than quoted prices, observable by a marketplace participant either directly or indirectly; and
- Level 3 – unobservable inputs significant to the fair value measurement.

We did not have any significant non-financial assets or liabilities measured at fair value on December 31, 2013, or September 28, 2014, except for our assets held for sale (discussed in Note A) that were measured at fair value using Level 3 inputs. Our estimate of fair value considered the discounted projected cash flows of the underlying operations and an evaluation of market prices for similar assets.

Our financial instruments include cash and equivalents, marketable securities and other investments; accounts receivable and accounts payable; short- and long-term debt; and derivative financial instruments. The carrying values of cash and equivalents, accounts receivable and accounts payable on the Consolidated Balance Sheets approximate their fair value. The following tables present the fair values of our other financial assets and liabilities on December 31, 2013, and September 28, 2014, and the basis for determining their fair values:

	Carrying Value	Fair Value	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2) (a)
Financial assets (liabilities) (b)	December 31, 2013			
Other investments	$183	$183	$134	$49
Derivatives	10	10	—	10
Long-term debt, including current portion	(3,909)	(3,758)	—	(3,758)
	September 28, 2014			
Held-to-maturity marketable securities	$500	$500	$10	$490
Other investments	170	170	106	64
Derivatives	(61)	(61)	—	(61)
Long-term debt, including current portion	(3,911)	(3,879)	—	(3,879)

(a)Determined under a market approach using valuation models that incorporate observable inputs such as interest rates, bond yields and quoted prices for similar assets and liabilities.
(b)We had no Level 3 financial instruments on December 31, 2013, or September 28, 2014.

E. INCOME TAXES

Deferred Taxes. Our net deferred tax asset (liability) was included on the Consolidated Balance Sheets in other assets and liabilities as follows:

	December 31, 2013	September 28, 2014
Current deferred tax asset	$35	$32
Current deferred tax liability	(300)	(563)
Noncurrent deferred tax asset	462	597
Noncurrent deferred tax liability	(135)	(92)
Net deferred tax asset (liability)	$62	$(26)

Tax Uncertainties. For all periods open to examination by tax authorities, we periodically assess our liabilities and contingencies based on the latest available information. Where we believe there is more than a 50 percent chance that our tax position will not be sustained, we record our best estimate of the resulting tax liability, including interest, in the Consolidated Financial Statements. We include any interest or penalties incurred in connection with income taxes as part of income tax expense.

We participate in the Internal Revenue Service (IRS) Compliance Assurance Process, a real-time audit of our consolidated corporate federal income tax return. The IRS has examined our consolidated federal income tax returns through 2012. We do not expect the resolution of tax matters for open years to have a material impact on our results of operations, financial condition, cash flows or effective tax rate.

Based on all known facts and circumstances and current tax law, the total amount of unrecognized tax benefits on September 28, 2014, is not material to our results of operations, financial condition or cash flows, and if recognized, would not have a material impact on our effective tax rate. In addition, there are no tax positions for which it is reasonably possible that the unrecognized tax benefits will significantly vary over the next 12 months, producing, individually or in the aggregate, a material effect on our results of operations, financial condition or cash flows.

F. CONTRACTS IN PROCESS

Contracts in process represent recoverable costs and, where applicable, accrued profit related to long-term contracts that have been inventoried until the customer is billed, and consisted of the following:

	December 31, 2013	September 28, 2014
Contract costs and estimated profits	$7,961	$7,209
Other contract costs	1,178	1,073
	9,139	8,282
Advances and progress payments	(4,359)	(3,846)
Total contracts in process	$4,780	$4,436

Contract costs consist primarily of labor, material, overhead and G&A expenses. Other contract costs represent amounts that are not currently allocable to government contracts, such as a portion of our estimated workers' compensation obligations, other insurance-related assessments, pension and other post-retirement benefits and environmental expenses. These costs will become allocable to contracts generally after they are paid. We expect to recover these costs through ongoing business, including existing backlog and probable follow-on contracts. If the backlog in the future does not support the continued deferral of these costs, the profitability of our remaining contracts could be adversely affected.

G. INVENTORIES

Our inventories represent primarily business-jet components and are stated at the lower of cost or net realizable value. Work-in-process represents largely labor, material and overhead costs associated with aircraft in the manufacturing process and is based primarily on the estimated average unit cost of the units in a production lot. Raw materials are valued primarily on the first-in, first-out method. We record pre-owned aircraft acquired in connection with the sale of new aircraft at the lower of the trade-in value or the estimated net realizable value.

Inventories consisted of the following:

	December 31, 2013	September 28, 2014
Work in process	$1,633	$1,843
Raw materials	1,210	1,244
Finished goods	29	23
Pre-owned aircraft	18	29
Total inventories	$2,890	$3,139

H. DEBT

Debt consisted of the following:

		December 31, 2013	September 28, 2014
Fixed-rate notes due:	Interest Rate		
January 2015	1.375%	$500	$500
July 2016	2.250%	500	500
November 2017	1.000%	896	897
July 2021	3.875%	499	499
November 2022	2.250%	991	992
November 2042	3.600%	498	498
Other	Various	25	25
Total debt		3,909	3,911
Less current portion		1	501
Long-term debt		$3,908	$3,410

Our fixed-rate notes are fully and unconditionally guaranteed by several of our 100-percent-owned subsidiaries (see Note O for condensed consolidating financial statements). We have the option to redeem the notes prior to their maturity in whole or part for the principal plus any accrued but unpaid interest and applicable make-whole amounts. As we approach the maturity date of the fixed-rate notes due in January 2015, we will determine whether to repay these notes with cash on hand or refinance the obligation.

On September 28, 2014, we had no commercial paper outstanding, but we maintain the ability to access the commercial paper market in the future. We have $2 billion in committed bank credit facilities that provide backup liquidity to our commercial paper program. These credit facilities include a $1 billion multi-year facility expiring in July 2016 and a $1 billion multi-year facility expiring in July 2018. These facilities are required by rating agencies to support our commercial paper issuances. We may renew or replace, in whole or part, these credit facilities at or prior to their expiration dates. Our commercial paper issuances and the bank credit facilities are guaranteed by several of our 100-percent-owned subsidiaries. In addition, we have approximately $265 in committed bank credit facilities to provide backup liquidity to our European businesses.

Our financing arrangements contain a number of customary covenants and restrictions. We were in compliance with all material covenants on September 28, 2014.

I. OTHER LIABILITIES

A summary of significant other liabilities by balance sheet caption follows:

	December 31, 2013	September 28, 2014
Salaries and wages	$801	$720
Workers' compensation	497	466
Retirement benefits	303	301
Deferred income taxes	300	563
Income taxes payable	36	115
Other (a)	1,521	1,624
Total other current liabilities	$3,458	$3,789
Retirement benefits	$3,064	$2,612
Customer deposits on commercial contracts	677	502
Deferred income taxes	135	92
Other (b)	950	1,015
Total other liabilities	$4,826	$4,221

(a)Consists primarily of dividends payable, environmental remediation reserves, warranty reserves, liabilities of discontinued operations and insurance-related costs.

(b)Consists primarily of liabilities for warranty reserves and workers' compensation and liabilities of discontinued operations.

J. SHAREHOLDERS' EQUITY

Dividends per Share. Dividends declared per share were $0.56 and $1.68 for the three- and nine-month periods ended September 29, 2013, and $0.62 and $1.86 for the three- and nine-month periods ended September 28, 2014, respectively. Cash dividends paid were $196 and $394 for the three- and nine-month periods ended September 29, 2013, and $207 and $618 for the three- and nine-month periods ended September 28, 2014. In advance of possible tax increases, we accelerated our first quarter 2013 dividend payments to December 2012.

Share Repurchases. In the first nine months of 2014, we repurchased approximately 28.8 million of our outstanding shares. Of this amount, 11.4 million shares were repurchased on January 24, 2014, for $1.2 billion under an ASR program facilitated through a financial institution. Our final cost of the ASR program will be determined based on the weighted-average daily market price of our stock during the term of the agreement, which expires in the fourth quarter of 2014. On February 5, 2014, with shares from the prior authorization largely exhausted by the ASR program, the board of directors authorized management to repurchase 20 million additional shares of common stock on the open market. Subsequently, we repurchased an additional 17.4 million shares for approximately $2 billion. On September 28, 2014, 2.6 million shares remained authorized by our board of directors for repurchase, approximately 1 percent of our total shares outstanding. We repurchased 9.2 million shares for a total of approximately $700 in the first nine months of 2013.

Accumulated Other Comprehensive Loss. The changes, pretax and net of tax, in each component of accumulated other comprehensive loss (AOCL) consisted of the following:

	Gains on Cash Flow Hedges	Unrealized Gains on Securities	Foreign Currency Translation Adjustments	Changes in Retirement Plans' Funded Status	AOCL
Balance, December 31, 2012	$6	$7	$1,092	$(3,880)	$(2,775)
Other comprehensive (loss) income, pretax	—	7	(92)	299	214
(Benefit) provision for income tax, net	(1)	2	(1)	108	108
Other comprehensive (loss) income, net of tax	1	5	(91)	191	106
Balance, September 29, 2013	$7	$12	$1,001	$(3,689)	$(2,669)

	Gains (Losses) on Cash Flow Hedges	Unrealized Gains on Securities	Foreign Currency Translation Adjustments	Changes in Retirement Plans' Funded Status	AOCL
Balance, December 31, 2013	$9	$15	$974	$(2,183)	$(1,185)
Other comprehensive (loss) income, pretax	(69)	7	(226)	177	(111)
(Benefit) provision for income tax, net	(18)	3	(5)	61	41
Other comprehensive (loss) income, net of tax	(51)	4	(221)	116	(152)
Balance, September 28, 2014	$(42)	$19	$753	$(2,067)	$(1,337)

Amounts reclassified out of AOCL related primarily to changes in retirement plans' funded status and consisted of pretax recognized net actuarial losses of $336 and $228 for the nine-month periods ended September 29, 2013, and September 28, 2014, respectively. This was partially offset by pretax amortization of prior service credit of $40 and $51 for the nine-month periods ended September 29, 2013, and September 28, 2014, respectively. These AOCL components are included in our net periodic pension and other post-retirement benefit cost. See Note M for additional details.

K. DERIVATIVE INSTRUMENTS AND HEDGING ACTIVITIES

We are exposed to market risk, primarily from foreign currency exchange rates, interest rates, commodity prices and investments. We may use derivative financial instruments to hedge some of these risks as described below. We do not use derivatives for trading or speculative purposes.

Foreign Currency Risk and Hedging Activities. Our foreign currency exchange rate risk related to receipts from customers, payments to suppliers and inter-company transactions denominated in foreign currencies. To the extent possible, we include terms in our contracts that are designed to protect us from this risk. Otherwise, we enter into derivative financial instruments, principally foreign currency forward purchase and sale contracts, designed to offset and minimize our risk. The two-year average maturity of these instruments matches the duration of the activities that are at risk. We had $1.7 billion in notional forward exchange contracts outstanding on December 31, 2013, and $5 billion on September 28, 2014. The increase in the amount of outstanding foreign currency forward contracts is due to significant international contract awards in 2014. We recognize derivative financial instruments on the Consolidated Balance Sheets at fair value (see Note D).

We record changes in the fair value of derivative financial instruments in operating costs and expenses in the Consolidated Statements of Earnings or in other comprehensive loss (OCL) within the

Consolidated Statements of Comprehensive Income depending on whether the derivative is designated and qualifies for hedge accounting. Gains and losses related to derivatives that qualify as cash flow hedges are deferred in OCL until the underlying transaction is reflected in earnings. We adjust derivative financial instruments not designated as cash flow hedges to market value each period and record the gain or loss in the Consolidated Statements of Earnings. The gains and losses on these instruments generally offset losses and gains on the assets, liabilities and other transactions being hedged. Gains and losses resulting from hedge ineffectiveness are recognized in the Consolidated Statements of Earnings for all derivative financial instruments, regardless of designation.

Net gains and losses recognized in earnings, including gains and losses related to hedge ineffectiveness, were not material to our results of operations for the three- and nine-month periods ended September 29, 2013, and September 28, 2014. Net gains and losses reclassified to earnings from OCL were not material to our results of operations for the three- and nine-month periods ended September 29, 2013, and September 28, 2014, and we do not expect the amount of these gains and losses that will be reclassified to earnings during the next 12 months to be material.

We had no material derivative financial instruments designated as fair value or net investment hedges on December 31, 2013, or September 28, 2014.

Interest Rate Risk. Our financial instruments subject to interest rate risk include fixed-rate long-term debt obligations and variable-rate commercial paper. However, the risk associated with these instruments is not material.

Commodity Price Risk. We are subject to risk of rising labor and commodity prices, primarily on long-term fixed-price contracts. To the extent possible, we include terms in our contracts that are designed to protect us from this risk. Some of the protective terms included in our contracts are considered derivatives but are not accounted for separately because they are clearly and closely related to the host contract. We have not entered into any material commodity hedging contracts but may do so as circumstances warrant. We do not believe that changes in labor or commodity prices will have a material impact on our results of operations or cash flows.

Investment Risk. Our investment policy allows for purchases of fixed-income securities with an investment-grade rating and a maximum maturity of up to five years. On September 28, 2014, we held $5.1 billion in cash and equivalents and $500 of marketable securities reported in other current assets. Our marketable securities had an average duration of four months and an average credit rating of AA-. Historically, we have not experienced material gains or losses on these instruments due to changes in interest rates or market values.

Foreign Currency Financial Statement Translation. We translate foreign currency balance sheets from our international businesses' functional currency (generally the respective local currency) to U.S. dollars at the end-of-period exchange rates, and statements of earnings at the average exchange rates for each period. The resulting foreign currency translation adjustments are a component of OCL.

We do not hedge the fluctuation in reported revenues and earnings resulting from the translation of these international operations' results into U.S. dollars. The impact of translating our international operations’ revenues and earnings into U.S. dollars was not material to our results of operations for the three- and nine-month periods ended September 29, 2013, or September 28, 2014. In addition, the effect of changes in foreign exchange rates on non-U.S. cash balances was not material in the first nine months of either 2013 or 2014.

L. COMMITMENTS AND CONTINGENCIES

Litigation

Various claims and other legal proceedings incidental to the normal course of business are pending or threatened against us. These matters relate to such issues as government investigations and claims, the protection of the environment, asbestos-related claims and employee-related matters. The nature of litigation is such that we cannot predict the outcome of these matters. However, based on information currently available, we believe any potential liabilities in these proceedings, individually or in the aggregate, will not have a material impact on our results of operations, financial condition or cash flows.

Environmental

We are subject to and affected by a variety of federal, state, local and foreign environmental laws and regulations. We are directly or indirectly involved in environmental investigations or remediation at some of our current and former facilities and third-party sites that we do not own but where we have been designated a Potentially Responsible Party (PRP) by the U.S. Environmental Protection Agency or a state environmental agency. Based on historical experience, we expect that a significant percentage of the total remediation and compliance costs associated with these facilities will continue to be allowable contract costs and, therefore, recoverable under U.S. government contracts.

As required, we provide financial assurance for certain sites undergoing or subject to investigation or remediation. We accrue environmental costs when it is probable that a liability has been incurred and the amount can be reasonably estimated. Where applicable, we seek insurance recovery for costs related to environmental liabilities. We do not record insurance recoveries before collection is considered probable. Based on all known facts and analyses, we do not believe that our liability at any individual site, or in the aggregate, arising from such environmental conditions, will be material to our results of operations, financial condition or cash flows. We also do not believe that the range of reasonably possible additional loss beyond what has been recorded would be material to our results of operations, financial condition or cash flows.

Other

Portugal Program. In the third quarter of 2014, we reached a settlement with the Portuguese Ministry of National Defense and Ministry of Economy relating to a dispute arising from a contract in our Combat Systems group’s European Land Systems business to provide armored vehicles. The settlement provides for the delivery of vehicles and a significant reduction in our offset obligations and related bank guarantees. The settlement did not have a material impact on our results of operations, financial condition or cash flows.

Government Contracts. As a government contractor, we are subject to U.S. government audits and investigations relating to our operations, including claims for fines, penalties, and compensatory and treble damages. We believe the outcome of such ongoing government audits and investigations will not have a material impact on our results of operations, financial condition or cash flows.

In the performance of our contracts, we routinely request contract modifications that require additional funding from the customer. Most often, these requests are due to customer-directed changes in scope of work. While we are entitled to recovery of these costs under our contracts, the administrative process with our customer may be protracted. Based upon the circumstances, we periodically file claims or requests for equitable adjustment (REAs). In some cases, these requests are disputed by our customer. We believe our outstanding modifications and other claims will be resolved without material impact to our results of operations, financial condition or cash flows.

Letters of Credit and Guarantees. In the ordinary course of business, we have entered into letters of credit, bank guarantees, surety bonds and other similar arrangements with financial institutions and insurance carriers totaling approximately $1.2 billion on September 28, 2014. In addition, from time to time and in the ordinary course of business, we contractually guarantee the payment or performance obligations of our subsidiaries arising under certain contracts.

Aircraft Trade-ins. In connection with orders for new aircraft in funded contract backlog, our Aerospace group has outstanding options with some customers to trade in aircraft as partial consideration in their new-aircraft transaction. These trade-in commitments are structured to establish the fair market value of the trade-in aircraft at a date generally 120 or fewer days preceding delivery of the new aircraft to the customer. At that time, the customer is required to either exercise the option or allow its expiration. Any excess of the pre-established trade-in price above the fair market value at the time the new aircraft is delivered is treated as a reduction of revenue in the new-aircraft sales transaction.

Product Warranties. We provide warranties to our customers associated with certain product sales. We record estimated warranty costs in the period in which the related products are delivered. The warranty liability recorded at each balance sheet date is generally based on the number of months of warranty coverage remaining for products delivered and the average historical monthly warranty payments. Warranty obligations incurred in connection with long-term production contracts are accounted for within the contract estimates at completion. Our other warranty obligations, primarily for business-jet aircraft, are included in other current and noncurrent liabilities on the Consolidated Balance Sheets.

The changes in the carrying amount of warranty liabilities for the nine-month periods ended September 29, 2013, and September 28, 2014, were as follows:

Nine Months Ended	September 29, 2013	September 28, 2014
Beginning balance	$316	$354
Warranty expense	84	108
Payments	(50)	(54)
Adjustments	(4)	6
Ending balance	$346	$414

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M. RETIREMENT PLANS

We provide defined-contribution benefits, as well as defined-benefit pension and other post-retirement benefits, to eligible employees.

Net periodic cost associated with our defined-benefit pension and other post-retirement benefit plans for the three- and nine-month periods ended September 29, 2013, and September 28, 2014, consisted of the following:

	Pension Benefits		Other Post-retirement Benefits	
Three Months Ended	September 29, 2013	September 28, 2014	September 29, 2013	September 28, 2014
Service cost	$80	$49	$4	$3
Interest cost	124	133	13	13
Expected return on plan assets	(148)	(164)	(7)	(8)
Recognized net actuarial loss	106	73	6	2
Amortization of prior service (credit) cost	(16)	(16)	2	—
Net periodic cost	$146	$75	$18	$10

	Pension Benefits		Other Post-retirement Benefits	
Nine Months Ended	September 29, 2013	September 28, 2014	September 29, 2013	September 28, 2014
Service cost	$240	$145	$12	$9
Interest cost	372	399	39	39
Expected return on plan assets	(444)	(492)	(21)	(24)
Recognized net actuarial loss	318	221	18	7
Amortization of prior service (credit) cost	(46)	(50)	6	(1)
Net periodic cost	$440	$223	$54	$30

Our contractual arrangements with the U.S. government provide for the recovery of contributions to our pension and other post-retirement benefit plans covering employees working in our defense business groups. For non-funded plans, our government contracts allow us to recover claims paid. Following payment, these recoverable amounts are allocated to contracts and billed to the customer in accordance with the Cost Accounting Standards (CAS) and specific contractual terms. For some of these plans, the cumulative pension and post-retirement benefit cost exceeds the amount currently allocable to contracts. To the extent recovery of the cost is considered probable based on our backlog and probable follow-on contracts, we defer the excess in contracts in process on the Consolidated Balance Sheets until the cost is allocable to contracts. See Note F for discussion of our deferred contract costs. For other plans, the amount allocated to contracts and included in revenues has exceeded the plans' cumulative benefit cost. We have deferred recognition of these excess earnings to provide a better matching of revenues and expenses. These deferrals have been classified against the plan assets on the Consolidated Balance Sheets.

In 2011, changes were made to the CAS to harmonize the regulations with the Pension Protection Act of 2006 (PPA). For certain contracts awarded prior to February 27, 2012, we are entitled to recover additional pension costs from our customers resulting from the CAS harmonization with the PPA. We submitted REAs of approximately $165 for these contracts in 2012. These REAs remained outstanding on September 28, 2014, and are subject to negotiation with our customer, the U.S. Department of Defense.

N. BUSINESS GROUP INFORMATION

We operate in four business groups: Aerospace, Combat Systems, Marine Systems and Information Systems and Technology. We organize our business groups in accordance with the nature of products and services offered. These business groups derive their revenues from business aviation; combat vehicles, weapons systems and munitions; military and commercial shipbuilding and related services; and communication and information technology systems and solutions, respectively. We measure each group's profit based on operating earnings. As a result, we do not allocate net interest, other income and expense items, and income taxes to our business groups.

Summary financial information for each of our business groups follows:

	Revenues		Operating Earnings	
Three Months Ended	September 29, 2013	September 28, 2014	September 29, 2013	September 28, 2014
Aerospace	$2,152	$2,289	$369	$411
Combat Systems	1,306	1,395	228	232
Marine Systems	1,697	1,820	170	170
Information Systems and Technology	2,580	2,247	216	202
Corporate*	—	—	(22)	(16)
	$7,735	$7,751	$961	$999

	Revenues		Operating Earnings	
Nine Months Ended	September 29, 2013	September 28, 2014	September 29, 2013	September 28, 2014
Aerospace	$5,983	$6,409	$1,068	$1,199
Combat Systems	4,241	4,118	658	591
Marine Systems	5,082	5,272	507	510
Information Systems and Technology	7,577	6,691	599	573
Corporate*	—	—	(67)	(51)
	$22,883	$22,490	$2,765	$2,822

*Corporate operating results consist primarily of stock option expense.

O. CONDENSED CONSOLIDATING FINANCIAL STATEMENTS

The fixed-rate notes described in Note H are fully and unconditionally guaranteed on an unsecured, joint and several basis by certain of our 100-percent-owned subsidiaries (the guarantors). The following condensed consolidating financial statements illustrate the composition of the parent, the guarantors on a combined basis (each guarantor together with its majority-owned subsidiaries) and all other subsidiaries on a combined basis.

CONDENSED CONSOLIDATING STATEMENTS OF EARNINGS (UNAUDITED)

Three Months Ended September 29, 2013	Parent	Guarantors on a Combined Basis	Other Subsidiaries on a Combined Basis	Consolidating Adjustments	Total Consolidated
Revenues	$—	$6,925	$810	$—	$7,735
Cost of sales	2	5,629	646	—	6,277
G&A	19	410	68	—	497
Operating earnings	(21)	886	96	—	961
Interest, net	(23)	1	—	—	(22)
Other, net	1	—	3	—	4
Earnings before income tax	(43)	887	99	—	943
Provision for income tax, net	(15)	290	16	—	291
Discontinued operations, net of tax	(1)	—	—	—	(1)
Equity in net earnings of subsidiaries	680	—	—	(680)	—
Net earnings	$651	$597	$83	$(680)	$651
Comprehensive income	$871	$611	$236	$(847)	$871
Three Months Ended September 28, 2014					
Revenues	$—	$6,761	$990	$—	$7,751
Cost of sales	(1)	5,512	763	—	6,274
G&A	16	397	65	—	478
Operating earnings	(15)	852	162	—	999
Interest, net	(21)	(4)	4	—	(21)
Other, net	(2)	2	1	—	1
Earnings before income tax	(38)	850	167	—	979
Provision for income tax, net	(8)	268	25	—	285
Discontinued operations, net of tax	2	—	—	—	2
Equity in net earnings of subsidiaries	724	—	—	(724)	—
Net earnings	$696	$582	$142	$(724)	$696
Comprehensive income	$463	$570	$(120)	$(450)	$463

CONDENSED CONSOLIDATING STATEMENTS OF EARNINGS (UNAUDITED)

Nine Months Ended September 29, 2013	Parent	Guarantors on a Combined Basis	Other Subsidiaries on a Combined Basis	Consolidating Adjustments	Total Consolidated
Revenues	$—	$20,244	$2,639	$—	$22,883
Cost of sales	10	16,454	2,148	—	18,612
G&A	56	1,229	221	—	1,506
Operating earnings	(66)	2,561	270	—	2,765
Interest, net	(69)	4	2	—	(63)
Other, net	—	—	4	—	4
Earnings before income tax	(135)	2,565	276	—	2,706
Provision for income tax, net	(35)	804	75	—	844
Discontinued operations, net of tax	—	—	—	—	—
Equity in net earnings of subsidiaries	1,962	—	—	(1,962)	—
Net earnings	$1,862	$1,761	$201	$(1,962)	$1,862
Comprehensive income	$1,968	$1,794	$95	$(1,889)	$1,968
Nine Months Ended September 28, 2014					
Revenues	$—	$19,592	$2,898	$—	$22,490
Cost of sales	8	15,943	2,262	—	18,213
G&A	44	1,165	246	—	1,455
Operating earnings	(52)	2,484	390	—	2,822
Interest, net	(68)	(4)	5	—	(67)
Other, net	(4)	5	1	—	2
Earnings before income tax	(124)	2,485	396	—	2,757
Provision for income tax, net	(31)	788	64	—	821
Discontinued operations, net of tax	(104)	—	—	—	(104)
Equity in net earnings of subsidiaries	2,029	—	—	(2,029)	—
Net earnings	$1,832	$1,697	$332	$(2,029)	$1,832
Comprehensive income	$1,680	$1,680	$86	$(1,766)	$1,680

CONDENSED CONSOLIDATING BALANCE SHEETS (UNAUDITED)

December 31, 2013	Parent	Guarantors on a Combined Basis	Other Subsidiaries on a Combined Basis	Consolidating Adjustments	Total Consolidated
ASSETS					
Current assets:					
Cash and equivalents	$4,179	$—	$1,122	$—	$5,301
Accounts receivable	—	1,451	2,919	—	4,370
Contracts in process	571	3,124	1,085	—	4,780
Inventories					
Work in process	—	1,623	10	—	1,633
Raw materials	—	1,172	38	—	1,210
Finished goods	—	24	5	—	29
Pre-owned aircraft	—	18	—	—	18
Other current assets	424	203	194	—	821
Total current assets	5,174	7,615	5,373	—	18,162
Noncurrent assets:					
Property, plant and equipment	156	5,827	1,169	—	7,152
Accumulated depreciation of PP&E	(64)	(3,062)	(667)	—	(3,793)
Intangible assets	—	1,614	968	—	2,582
Accumulated amortization of intangible assets	—	(1,111)	(427)	—	(1,538)
Goodwill	—	8,041	3,891	—	11,932
Other assets	600	483	398	(484)	997
Investment in subsidiaries	35,071	—	—	(35,071)	—
Total noncurrent assets	35,763	11,792	5,332	(35,555)	17,332
Total assets	$40,937	$19,407	$10,705	$(35,555)	$35,494
LIABILITIES AND SHAREHOLDERS' EQUITY					
Current liabilities:					
Customer advances and deposits	$—	$3,493	$3,091	$—	$6,584
Other current liabilities	868	3,644	1,163	—	5,675
Total current liabilities	868	7,137	4,254	—	12,259
Noncurrent liabilities:					
Long-term debt	3,883	25	—	—	3,908
Other liabilities	2,333	2,007	486	—	4,826
Total noncurrent liabilities	6,216	2,032	486	—	8,734
Intercompany	19,352	(19,697)	345	—	—
Shareholders' equity:					
Common stock	482	6	3,570	(3,576)	482
Other shareholders' equity	14,019	29,929	2,050	(31,979)	14,019
Total shareholders' equity	14,501	29,935	5,620	(35,555)	14,501
Total liabilities and shareholders' equity	$40,937	$19,407	$10,705	$(35,555)	$35,494

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CONDENSED CONSOLIDATING BALANCE SHEETS (UNAUDITED)

September 28, 2014	Parent	Guarantors on a Combined Basis	Other Subsidiaries on a Combined Basis	Consolidating Adjustments	Total Consolidated
ASSETS					
Current assets:					
Cash and equivalents	$2,257	$—	$2,848	$ —	$5,105
Accounts receivable	—	1,404	2,777	—	4,181
Contracts in process	516	2,911	1,009	—	4,436
Inventories					
Work in process	—	1,832	11	—	1,843
Raw materials	—	1,212	32	—	1,244
Finished goods	—	15	8	—	23
Pre-owned aircraft	—	29	—	—	29
Other current assets	753	394	161	—	1,308
Total current assets	3,526	7,797	6,846	—	18,169
Noncurrent assets:					
Property, plant and equipment	209	5,947	1,151	—	7,307
Accumulated depreciation of PP&E	(69)	(3,228)	(688)	—	(3,985)
Intangible assets	—	1,452	945	—	2,397
Accumulated amortization of intangible assets	—	(1,019)	(449)	—	(1,468)
Goodwill	—	7,991	3,765	—	11,756
Other assets	474	400	337	(76)	1,135
Investment in subsidiaries	37,270	—	—	(37,270)	—
Total noncurrent assets	37,884	11,543	5,061	(37,346)	17,142
Total assets	$41,410	$19,340	$11,907	$ (37,346)	$35,311
LIABILITIES AND SHAREHOLDERS' EQUITY					
Current liabilities:					
Short-term debt	$500	$1	$—	$ —	$501
Customer advances and deposits	—	3,614	4,376	—	7,990
Other current liabilities	1,268	3,664	1,247	—	6,179
Total current liabilities	1,768	7,279	5,623	—	14,670
Noncurrent liabilities:					
Long-term debt	3,386	24	—	—	3,410
Other liabilities	1,797	1,988	436	—	4,221
Total noncurrent liabilities	5,183	2,012	436	—	7,631
Intercompany	21,449	(21,573)	124	—	—
Shareholders' equity:					
Common stock	482	6	2,043	(2,049)	482
Other shareholders' equity	12,528	31,616	3,681	(35,297)	12,528
Total shareholders' equity	13,010	31,622	5,724	(37,346)	13,010
Total liabilities and shareholders' equity	$41,410	$19,340	$11,907	$ (37,346)	$35,311

CONDENSED CONSOLIDATING STATEMENTS OF CASH FLOWS (UNAUDITED)

Nine Months Ended September 29, 2013	Parent	Guarantors on a Combined Basis	Other Subsidiaries on a Combined Basis	Consolidating Adjustments	Total Consolidated
Net cash provided by operating activities *	$(445)	$1,983	$15	$—	$1,553
Net cash used by investing activities *	1	(188)	(25)	—	(212)
Cash flows from financing activities:					
Purchases of common stock	(696)	—	—	—	(696)
Proceeds from option exercises	484	—	—	—	484
Dividends paid	(394)	—	—	—	(394)
Other, net	19	—	27	—	46
Net cash used by financing activities *	(587)	—	27	—	(560)
Net cash used by discontinued operations	(12)	—	—	—	(12)
Cash sweep/funding by parent	1,801	(1,795)	(6)	—	—
Net increase in cash and equivalents	758	—	11	—	769
Cash and equivalents at beginning of period	2,300	—	996	—	3,296
Cash and equivalents at end of period	$3,058	$—	$1,007	$—	$4,065
Nine Months Ended September 28, 2014					
Net cash provided by operating activities *	$(237)	$2,140	$1,895	$—	$3,798
Cash flows from investing activities:					
Purchases of held-to-maturity securities	(500)	—	—	—	(500)
Capital expenditures	(54)	(257)	(26)	—	(337)
Other, net	2	19	(10)	—	11
Net cash used by investing activities *	(552)	(238)	(36)	—	(826)
Cash flows from financing activities:					
Purchases of common stock	(3,117)	—	—	—	(3,117)
Dividends paid	(618)	—	—	—	(618)
Proceeds from option exercises	475	—	—	—	475
Other, net	66	—	—	—	66
Net cash used by financing activities *	(3,194)	—	—	—	(3,194)
Net cash provided by discontinued operations	26	—	—	—	26
Cash sweep/funding by parent	2,035	(1,902)	(133)	—	—
Net decrease in cash and equivalents	(1,922)	—	1,726	—	(196)
Cash and equivalents at beginning of period	4,179	—	1,122	—	5,301
Cash and equivalents at end of period	$2,257	$—	$2,848	$—	$5,105

* Continuing operations only

(Dollars in millions, except per-share amounts or unless otherwise noted)

ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

BUSINESS OVERVIEW

General Dynamics is an aerospace and defense company that offers a broad portfolio of products and services in business aviation; combat vehicles, weapons systems and munitions; shipbuilding; and communication and information technology systems and solutions. We operate globally through four business groups: Aerospace, Combat Systems, Marine Systems and Information Systems and Technology. Our primary customers are the U.S. government, including the Department of Defense, intelligence community and other U.S. government customers; international governments; and a wide range of corporate and individual customers for business jets. The following discussion should be read in conjunction with our 2013 Annual Report on Form 10-K and with the unaudited Consolidated Financial Statements included in this Form 10-Q. The unaudited Consolidated Financial Statements have been restated to reflect the results of operations of our axle business in discontinued operations (for further discussion, see Note A to the unaudited Consolidated Financial Statements).

DEFENSE BUSINESS ENVIRONMENT

With approximately 60 percent of our revenues from the U.S. government, our financial performance is impacted by U.S. government spending levels, particularly defense spending. When the U.S. government's new fiscal year began on October 1, 2014, the President's fiscal year (FY) 2015 budget request had not been approved by the Congress. Subsequently, a continuing resolution (CR), which prescribes defense funding at prior-year levels, was approved through December 11, 2014. Since the FY15 budget request is relatively consistent with the FY14 appropriation and our backlog supports our expected revenues, we do not expect that the CR will have a material impact on our operating results during the fourth quarter of 2014.

RESULTS OF OPERATIONS

INTRODUCTION

An understanding of our accounting practices is important in the evaluation of our operating results. We recognize the majority of our revenues using the percentage-of-completion method of accounting. The following paragraphs explain how this method is applied in recognizing revenues and operating costs in our Aerospace and defense groups.

In the Aerospace group, contracts for new aircraft have two major phases: the manufacture of the "green" aircraft and the aircraft's outfitting, which includes exterior painting and installation of customer-selected interiors. We record revenues on these contracts at the completion of these two phases: when green aircraft are delivered to and accepted by the customer, and when the customer accepts final delivery of the outfitted aircraft. Revenues associated with the group's completions of other original equipment manufacturers' (OEMs) aircraft and the group's services businesses are recognized as work progresses or upon delivery of services. Fluctuations in revenues from period to period result from the number and mix of new aircraft deliveries (green and outfitted), progress on aircraft completions and the level of aircraft service activity during the period.

The majority of the Aerospace group's operating costs relates to new aircraft production for firm orders and consists of labor, material, subcontractor and overhead costs. The costs are accumulated in production lots and recognized as operating costs at green aircraft delivery based on the estimated average unit cost in a production lot. While changes in the estimated average unit cost for a production lot impact the level of operating costs, the amount of operating costs reported in a given period is based largely on the number and type of aircraft delivered. Operating costs in the Aerospace group's completions and services businesses are generally recognized as incurred.

For new aircraft, operating earnings and margins are a function of the prices of our aircraft, our operational efficiency in manufacturing and outfitting the aircraft, and the mix of aircraft deliveries between the higher-margin large-cabin and lower-margin mid-cabin aircraft. Additional factors affecting the group's earnings and margins include the volume, mix and profitability of completions and services work performed, the market for pre-owned aircraft, and the level of general and administrative (G&A) and net research and development (R&D) costs incurred by the group.

In the defense groups, revenue on long-term government contracts is recognized as work progresses, either as products are produced or services are rendered. As a result, variations in revenues are discussed generally in terms of volume, typically measured by the level of activity on individual contracts or programs. Year-over-year variances attributed to volume are due to changes in production or service levels and delivery schedules.

Operating costs for the defense groups consist of labor, material, subcontractor, overhead and G&A costs and are recognized generally as incurred. Variances in costs recognized from period to period primarily reflect increases and decreases in production or activity levels on individual contracts and, therefore, result largely from the same factors that drive variances in revenues.

Operating earnings and margins in the defense groups are driven by changes in volume, performance or contract mix. Performance refers to changes in profitability based on revisions to estimates at completion on individual contracts. These revisions result from increases or decreases to the estimated value of the contract, the estimated costs to complete or both. Therefore, changes in costs incurred in the period compared with prior periods do not necessarily impact profitability. It is only when total estimated costs at completion on a given contract change without a corresponding change in the value of that contract that the profitability of that contract may be impacted. Contract mix refers to changes in the volume of higher- vs. lower-margin work. Additionally, higher or lower margins can be inherent in the contract type (e.g., fixed-price/cost-reimbursable) or type of work (e.g., development/production).

CONSOLIDATED OVERVIEW

Three Months Ended	September 29, 2013		September 28, 2014		Variance			
Revenues	$7,735		$7,751		$16		0.2	%
Operating costs and expenses	6,774		6,752		22		0.3	%
Operating earnings	961		999		38		4.0	%
Operating margins	12.4	%	12.9	%				
Nine Months Ended	September 29, 2013		September 28, 2014		Variance			
Revenues	$22,883		$22,490		$(393	)	(1.7	)%
Operating costs and expenses	20,118		19,668		450		2.2	%
Operating earnings	2,765		2,822		57		2.1	%
Operating margins	12.1	%	12.5	%				

Our revenues increased in the third quarter of 2014 compared with the prior-year period due to higher revenues in our Aerospace, Combat Systems and Marine Systems groups from increased aircraft deliveries, the start of an international vehicle program and higher ship construction activity, respectively. These increases were partially offset by lower volume in our Information Systems and Technology group, primarily associated with several mobile communication systems programs. Revenues were lower in the first nine months of 2014 compared with the prior-year period. Decreased U.S. Army spending negatively affected our Combat Systems and Information Systems and Technology groups, though to a lesser degree than expected in the Information Systems and Technology group. Aerospace and Marine Systems revenues grew year over year through the first nine months of 2014 due to the factors described above.

Operating costs and expenses decreased, and operating earnings were up in 2014, resulting in an increase in operating margins of 50 basis points in the third quarter and 40 basis points in the first nine months of 2014 compared with the prior-year periods. The increased margins in 2014 were due to improved performance in aircraft manufacturing and outfitting activities in the Aerospace group and significant cost reductions in the Information Systems and Technology group. Third quarter operating margins of 12.9 percent were the highest quarterly margins the company has generated in six years.

REVIEW OF BUSINESS GROUPS

Following is a discussion of operating results and outlook for each of our business groups. For the Aerospace group, results are analyzed for specific lines of products and services, consistent with how the group is managed. For the defense groups, the discussion is based on the types of products and services each group offers with a supplemental discussion of specific contracts and programs when significant to the groups’ results. Information regarding our business groups also can be found in Note N to the unaudited Consolidated Financial Statements.

AEROSPACE

Three Months Ended	September 29, 2013	September 28, 2014	Variance	
Revenues	$2,152	$2,289	$137	6.4 %
Operating earnings	369	411	42	11.4 %
Operating margin	17.1 %	18.0 %		
Gulfstream aircraft deliveries (in units):				
Green	34	38	4	11.8 %
Outfitted	38	31	(7)	(18.4)%

Nine Months Ended	September 29, 2013	September 28, 2014	Variance	
Revenues	$5,983	$6,409	$426	7.1 %
Operating earnings	1,068	1,199	131	12.3 %
Operating margin	17.9 %	18.7 %		
Gulfstream aircraft deliveries (in units):				
Green	99	106	7	7.1 %
Outfitted	103	108	5	4.9 %

Operating Results

The increase in the Aerospace group's revenues in the third quarter and first nine months of 2014 compared with the prior-year periods consisted of the following:

	Third Quarter	Nine Months
Aircraft manufacturing, outfitting and completions	$175	$474
Pre-owned aircraft	(27)	(110)
Aircraft services	(11)	62
Total increase	$137	$426

Aircraft manufacturing, outfitting and completions revenues increased in 2014 primarily due to additional deliveries of large-cabin aircraft. We have experienced reduced aircraft trade-in activity in 2014 leading to lower pre-owned aircraft sales. We had three sales in the third quarter and first nine months of 2014 compared to four sales in the third quarter and nine in the first nine months of 2013. Although aircraft services activity was slightly lower in the third quarter of 2014 compared to the third quarter of 2013, revenues in the first nine months of 2014 exceeded the prior-year period due to growth in the number of aircraft in service and the resulting increased demand for maintenance work.

The increase in the group's operating earnings in the third quarter and first nine months of 2014 compared with the prior-year periods consisted of the following:

	Third Quarter	Nine Months
Aircraft manufacturing, outfitting and completions	$39	$179
Pre-owned aircraft	(1)	3
Aircraft services	9	13
G&A/R&D/other expenses	(5)	(64)
Total increase	$42	$131

Aircraft manufacturing, outfitting and completions earnings grew in the third quarter and first nine months of 2014 due to improved operating performance on our large- and mid-cabin aircraft production. Partially offsetting these increases were higher net R&D expenses associated with ongoing product-development efforts. Overall, the Aerospace group's operating margins increased 90 basis points in the third quarter and 80 basis points in the first nine months of 2014 compared with the prior-year periods primarily due to additional higher-margin aircraft deliveries and favorable cost performance in manufacturing and outfitting activities.

Outlook

We expect an increase of approximately 8 percent in the group's full-year revenues in 2014 compared with 2013 as a result of increased deliveries of Gulfstream aircraft. Operating margins are expected to be in the mid-18 percent range.

COMBAT SYSTEMS