HARRIS CORP /DE/
Form 10-Q
October 31, 2017

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549
FORM 10-Q
(Mark One)

þ QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934
For the quarterly period ended September 29, 2017
or
o TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934
For the transition period from to

Commission File Number: 1-3863
HARRIS CORPORATION
(Exact name of registrant as specified in its charter)

| | |
|---|---|
| Delaware | 34-0276860 |
| (State or other jurisdiction of incorporation or organization) | (I.R.S. Employer Identification No.) |
| 1025 West NASA Boulevard Melbourne, Florida | 32919 |
| (Address of principal executive offices) | (Zip Code) |

(321) 727-9100
(Registrant's telephone number, including area code)

No changes
(Former name, former address and former fiscal year, if changed since last report)

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 (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. þ Yes p 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 during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). þ Yes p No

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, a smaller reporting company, or an emerging growth company. See the definitions of "large accelerated filer," "accelerated filer," "smaller reporting company" and "emerging growth company" in Rule 12b-2 of the Exchange Act.

| | | | | |
|---|---|---|---|---|
| Large accelerated filer | þ | | Accelerated filer | o |
| Non-accelerated filer | o | (Do not check if a smaller reporting company) | Smaller reporting company | o |
| Emerging growth company | o | | | |

If an emerging growth company, indicate by check mark if the registrant has elected not to use the extended transition period for complying with any new or revised financial accounting standards provided pursuant to Section 13(a) of the Exchange Act. p

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act). þ Yes þ No

The number of shares outstanding of the registrant’s common stock as of October 27, 2017 was 119,200,550 shares.

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FORM 10-Q
For the Quarter Ended September 29, 2017
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This Quarterly Report on Form 10-Q contains trademarks, service marks and registered marks of Harris Corporation and its subsidiaries.

PART I. FINANCIAL INFORMATION
Item 1. Financial Statements.
HARRIS CORPORATION AND SUBSIDIARIES
CONDENSED CONSOLIDATED STATEMENT OF INCOME
(Unaudited)

| | Quarter Ended | |
|---|---|---|
| | September 29, 2017 | September 30, 2016 |
| | (In millions, except per share amounts) | |
| Revenue from product sales and services | $1,413 | $ 1,420 |
| Cost of product sales and services | (898 ) | (897 ) |
| Engineering, selling and administrative expenses | (243 ) | (277 ) |
| Operating income | 272 | 246 |
| Non-operating income | — | 1 |
| Interest expense | (41 ) | (44 ) |
| Income from continuing operations before income taxes | 231 | 203 |
| Income taxes | (64 ) | (58 ) |
| Income from continuing operations | 167 | 145 |
| Discontinued operations, net of income taxes | (6 ) | 15 |
| Net income | $161 | $ 160 |
| | | |
| Net income per common share | | |
| Basic | | |
| Continuing operations | $1.40 | $ 1.17 |
| Discontinued operations | (0.05 ) | 0.12 |
| | $1.35 | $ 1.29 |
| Diluted | | |
| Continuing operations | $1.38 | $ 1.16 |
| Discontinued operations | (0.06 ) | 0.11 |
| | $1.32 | $ 1.27 |
| | | |
| Cash dividends paid per common share | $0.57 | $ 0.53 |
| Basic weighted average common shares outstanding | 119.1 | 123.9 |
| Diluted weighted average common shares outstanding | 121.2 | 125.5 |

See accompanying Notes to Condensed Consolidated Financial Statements (Unaudited).

HARRIS CORPORATION AND SUBSIDIARIES
CONDENSED CONSOLIDATED STATEMENT OF COMPREHENSIVE INCOME
(Unaudited)

| | Quarter Ended September 29, 2017 | | September 30, 2016 | |
|---|---|---|---|---|
| | (In millions) | | | |
| Net income | $ | 161 | $ | 160 |
| Other comprehensive income (loss): | | | | |
| Foreign currency translation gain (loss), net of income taxes | 25 | | (3 | ) |
| Net unrealized gain on hedging derivatives, net of income taxes | 1 | | — | |
| Net unrecognized gain on postretirement obligations, net of income taxes | — | | 1 | |
| Other comprehensive income (loss), net of income taxes | 26 | | (2 | ) |
| Total comprehensive income | $ | 187 | $ | 158 |

See accompanying Notes to Condensed Consolidated Financial Statements (Unaudited).

HARRIS CORPORATION AND SUBSIDIARIES
CONDENSED CONSOLIDATED BALANCE SHEET
(Unaudited)

| | September 29, 2017 | June 30, 2017 |
|---|---|---|
| | (In millions, except shares) | |
| Assets | | |
| Current Assets | | |
| Cash and cash equivalents | $ 388 | $ 484 |
| Receivables | 706 | 623 |
| Inventories | 896 | 841 |
| Income taxes receivable | 24 | 24 |
| Other current assets | 113 | 101 |
| Total current assets | 2,127 | 2,073 |
| Non-current Assets | | |
| Property, plant and equipment | 890 | 904 |
| Goodwill | 5,376 | 5,366 |
| Other intangible assets | 1,077 | 1,104 |
| Non-current deferred income taxes | 409 | 409 |
| Other non-current assets | 220 | 234 |
| Total non-current assets | 7,972 | 8,017 |
| | $ 10,099 | $ 10,090 |
| Liabilities and Equity | | |
| Current Liabilities | | |
| Short-term debt | $ 80 | $ 80 |
| Accounts payable | 452 | 540 |
| Compensation and benefits | 130 | 140 |
| Other accrued items | 342 | 329 |
| Advance payments and unearned income | 264 | 252 |
| Income taxes payable | 128 | 31 |
| Current portion of long-term debt | 522 | 554 |
| Total current liabilities | 1,918 | 1,926 |
| Non-current Liabilities | | |
| Defined benefit plans | 1,237 | 1,278 |
| Long-term debt, net | 3,395 | 3,396 |
| Non-current deferred income taxes | 35 | 34 |
| Other long-term liabilities | 527 | 528 |
| Total non-current liabilities | 5,194 | 5,236 |
| Equity | | |
| Shareholders’ Equity: | | |
| Preferred stock, without par value; 1,000,000 shares authorized; none issued | — | — |
| Common stock, $1.00 par value; 500,000,000 shares authorized; issued and outstanding 119,045,836 shares at September 29, 2017 and 119,628,884 shares at June 30, 2017 | 119 | 120 |
| Other capital | 1,731 | 1,741 |
| Retained earnings | 1,387 | 1,343 |
| Accumulated other comprehensive loss | (250) | (276) |
| Total shareholders’ equity | 2,987 | 2,928 |
| | $ 10,099 | $ 10,090 |

See accompanying Notes to Condensed Consolidated Financial Statements (Unaudited).

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HARRIS CORPORATION AND SUBSIDIARIES
CONDENSED CONSOLIDATED STATEMENT OF CASH FLOWS
(Unaudited)

| | Quarter Ended | |
|---|---|---|
| | September 29, 2017 | September 30, 2016 |
| | (In millions) | |
| Operating Activities | | |
| Net income | $161 | $ 160 |
| Adjustments to reconcile net income to net cash provided by operating activities: | | |
| Depreciation and amortization | 40 | 53 |
| Amortization of intangible assets from Exelis Inc. acquisition | 25 | 33 |
| Share-based compensation | 11 | 11 |
| Qualified pension plan contributions | — | (64) |
| Pension income | (34) | (24) |
| (Increase) decrease in: | | |
| Accounts receivable | (83) | (39) |
| Inventories | (56) | 2 |
| Increase (decrease) in: | | |
| Accounts payable | (88) | (90) |
| Advance payments and unearned income | 12 | (31) |
| Income taxes | 126 | 63 |
| Other | (19) | (31) |
| Net cash provided by operating activities | 95 | 43 |
| Investing Activities | | |
| Net additions of property, plant and equipment | (23) | (21) |
| Adjustment to proceeds from sale of business | — | (25) |
| Net cash used in investing activities | (23) | (46) |
| Financing Activities | | |
| Proceeds from borrowings | — | 8 |
| Repayments of borrowings | (35) | (38) |
| Proceeds from exercises of employee stock options | 14 | 15 |
| Repurchases of common stock | (75) | (100) |
| Cash dividends | (69) | (68) |
| Other financing activities | (9) | (18) |
| Net cash used in financing activities | (174) | (201) |
| Effect of exchange rate changes on cash and cash equivalents | 6 | 1 |
| Net decrease in cash and cash equivalents | (96) | (203) |
| Cash and cash equivalents, beginning of year | 484 | 487 |
| Cash and cash equivalents, end of quarter | $388 | $ 284 |

See accompanying Notes to Condensed Consolidated Financial Statements (Unaudited).

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

Note A — Significant Accounting Policies and Recent Accounting Standards

Basis of Presentation

The accompanying Condensed Consolidated Financial Statements (Unaudited) include the accounts of Harris Corporation and its consolidated subsidiaries. As used in these Notes to Condensed Consolidated Financial Statements (Unaudited) (these "Notes"), the terms "Harris," "Company," "we," "our" and "us" refer to Harris Corporation and its consolid subsidiaries. Intracompany transactions and accounts have been eliminated in consolidation. The accompanying Condensed Consolidated Financial Statements (Unaudited) have been prepared by Harris, without an audit, in accordance with U.S. generally accepted accounting principles ("GAAP") for interim financial information and with the rules and regulations of the Securities and Exchange Commission ("SEC"). Accordingly, such interim financial statements do not include all information and footnotes necessary for a complete presentation of financial position, results of operations and cash flows in conformity with GAAP for annual financial statements. In the opinion of management, such interim financial statements reflect all adjustments (consisting of normal recurring adjustments) considered necessary for a fair presentation of our financial position, results of operations and cash flows for the periods presented therein. The results for the first quarter of fiscal 2018 are not necessarily indicative of the results that may be expected for the full fiscal year or any subsequent period. The balance sheet at June 30, 2017 has been derived from our audited financial statements, but does not include all of the information and footnotes required by GAAP for annual financial statements. We provide complete, audited financial statements in our Annual Report on Form 10-K, which includes information and footnotes required by the rules and regulations of the SEC. The information included in this Quarterly Report on Form 10-Q (this "Report") should be read in conjunction with the Management's Discussion and Analysis of Financial Condition and Results of Operations and the Consolidated Financial Statements and accompanying Notes to Consolidated Financial Statements included in our Annual Report on Form 10-K for the fiscal year ended June 30, 2017 (our "Fiscal 2017 Form 10-K").

In connection with our divestitures in fiscal 2017 of two significant businesses that were part of our former Critical Networks segment, our remaining operations that had been part of our former Critical Networks segment were integrated with our Electronic Systems segment effective for the third quarter of fiscal 2017, and our Critical Networks segment was eliminated. The historical results, discussion and presentation of our business segments as set forth in our Condensed Consolidated Financial Statements (Unaudited) and these Notes reflect the impact of these changes for all periods presented in order to present all segment information on a comparable basis. There is no impact on our previously reported consolidated statements of income, balance sheets or statements of cash flows resulting from these segment changes. See Note B: Discontinued Operations in these Notes and Note 3: "Discontinued Operations and Divestitures" in the Notes to Consolidated Financial Statements in our Fiscal 2017 Form 10-K for additional information. Our historical results for all periods presented have been restated to account for businesses reported as discontinued operations in our Condensed Consolidated Financial Statements (Unaudited) and these Notes. Except for disclosures related to our cash flows, or unless otherwise specified, disclosures in our Condensed Consolidated Financial Statements (Unaudited) and these Notes relate solely to our continuing operations.

Amounts contained in this Report may not always add to totals due to rounding.

Reclassifications

Certain prior-year amounts have been reclassified in our Condensed Consolidated Financial Statements (Unaudited) to conform with current-year classifications. Reclassifications include certain human resources and information technology ("IT") costs from the "Cost of product sales and services" line item to the "Engineering, selling and administrative expenses" line item in our Condensed Consolidated Statement of Income (Unaudited) and in these Notes.

Use of Estimates

The preparation of financial statements in accordance with GAAP requires us to make estimates and assumptions that affect the amounts reported in the accompanying Condensed Consolidated Financial Statements (Unaudited) and these Notes and related disclosures. These estimates and assumptions are based on experience and other information available prior to issuance of the accompanying Condensed Consolidated Financial Statements (Unaudited) and these Notes. Materially different results can occur as circumstances change and additional information becomes known.

Restructuring, Exelis Acquisition-Related Integration and Other Charges

We record restructuring charges for sales or terminations of product lines, closures or relocations of business activities, changes in management structure, and fundamental reorganizations that affect the nature and focus of operations. Such charges include termination benefits, contract termination costs and costs to consolidate facilities or relocate employees. We record these charges at their fair value when incurred. In cases where employees are required to render service until they are

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terminated in order to receive the termination benefits and will be retained beyond the minimum retention period, we record the expense ratably over the future service period. These charges are included as a component of the “Cost of product sales and services” and “Engineering, selling and administrative expenses” line items in our Condensed Consolidated Statement of Income (Unaudited).

In fiscal 2017, we recorded $58 million of charges for integration and other costs in connection with our acquisition of Exelis Inc. (collectively with its subsidiaries, “Exelis”), substantially all of which were included as a component of the “Engineering, selling and administrative expenses” line item in our Consolidated Statement of Income in our Fiscal 2017 Form 10-K. We had liabilities of $39 million at September 29, 2017 and $43 million at June 30, 2017 associated with this integration activity and with previous restructuring actions. The majority of the remaining liabilities as of September 29, 2017 will be paid within the next twelve months.

Adoption of New Accounting Standards

In the first quarter of fiscal 2018, we adopted an accounting standards update issued by the Financial Accounting Standards Board (“FASB”) that requires recognition of the income tax consequences of intra-entity transfers of assets other than inventory when the transfer occurs. Consequently, this update eliminates the exception to the recognition of current and deferred income taxes for intra-entity transfers of assets other than for inventory until the assets have been sold to an outside party. This update requires entities to apply a modified retrospective approach with a cumulative catch-up adjustment to beginning retained earnings in the period of adoption. In addition, entities are required to record deferred tax balances with an offset to retained earnings for unrecognized amounts that will be recognized under this update. We applied all changes required by this update using the modified retrospective approach from the beginning of fiscal 2018. Adopting this update resulted in a $27 million reduction of prepaid income tax assets from the “Other current assets” and “Other non-current assets” line items and a $27 million increase in the “Non-current deferred income taxes” line item in our Condensed Consolidated Balance Sheet (Unaudited).

Accounting Standards Issued But Not Yet Effective

In May 2014, the FASB issued a comprehensive new revenue recognition standard that supersedes nearly all revenue recognition guidance under GAAP and International Financial Reporting Standards and supersedes some cost guidance for construction-type and production-type contracts. The guidance in this standard is principles-based and, consequently, entities will be required to use more judgment and make more estimates than under prior guidance, including identifying contract performance obligations, estimating variable consideration to include in the contract price and allocating the transaction price to separate performance obligations. The core principle of this standard is that entities should recognize revenue to depict the transfer of promised goods or services to customers in an amount that reflects the consideration to which the entity expects to be entitled in exchange for those goods and services. To help financial statement users better understand the nature, amount, timing and potential uncertainty of the revenue that is recognized, this standard requires significantly more interim and annual disclosures. This standard allows for either “full retrospective” adoption (application to all periods presented) or “modified retrospective” adoption (application to only the most current period presented in the financial statements, with certain additional required footnote disclosures). In August 2015, the FASB issued an accounting standards update that deferred the effective date of the standard by one year, while continuing to permit entities to elect to adopt the standard as early as the original effective date. As a result, this standard is now effective for fiscal years, and interim reporting periods within those years, beginning after December 15, 2017, which for us is our fiscal 2019.

In preparation for the adoption of this standard, the project team we formed has made progress against the detailed implementation plan we developed, including in the following areas:

- Completing an accounting guidance gap analysis, consisting of a review of significant revenue streams and representative contracts to determine potential changes to our existing accounting policies and potential impacts to our consolidated financial statements;
- Completing an inventory of our outstanding contracts and revenue streams;
- Drafting a Company-wide revenue recognition policy reflecting the requirements of this standard and tailored to our businesses;
- Providing Company-wide training to affected employees, including in the areas of accounting, finance, contracts, tax and segment management;
- 

Applying the five-step model of this standard to our contracts and revenue streams to evaluate the quantitative and qualitative impacts this standard will have on our consolidated financial statements, accounting and operating policies, accounting systems, internal control structure and business practices; and

- Initiating the process of reviewing the additional disclosure requirements of this standard and the potential impact on our accounting systems and internal control structure.

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Although we are still in the process of evaluating and quantifying the impact of this standard as described above, we have identified certain changes we expect this standard to have on our consolidated financial statements. A significant portion of our revenue is derived from contracts with the U.S. Government, with revenue recognized using the percentage-of-completion ("POC") method. We expect to recognize revenue on an "over time" basis for most of these contracts by using cost inputs to measure progress toward the completion of our performance obligations, which is similar to the POC cost-to-cost method currently used on the majority of these contracts. Consequently, we expect the adoption of this standard primarily to impact certain of these contracts that recognize revenue using the POC units-of-delivery or milestone methods, resulting in recognition of revenue (and costs) earlier in the performance period as costs are incurred, as opposed to when units are delivered or milestones are achieved. We also are continuing to evaluate the impact of this standard in other areas, including:

- The number of distinct performance obligations within our contractual arrangements;
- Contract modifications;
- The potential impact to timing of revenue recognition for certain non-U.S. Government contracts based on existing contractual language; and
- Estimation and recognition of variable consideration for contracts to provide services.

Because of the broad scope of this standard, it could impact revenue and cost recognition across all of our business segments as well as related business processes and IT systems. As a result, our evaluation of the impact of this standard will continue over future periods. We also have not yet made a determination regarding the use of a full retrospective or modified retrospective adoption approach for this standard, as this determination is primarily dependent on the completion of our analysis.

In February 2016, the FASB issued a new lease standard that supersedes existing lease guidance under GAAP. This standard requires lessees to record most leases on their balance sheets but recognize expenses on their income statements in a manner similar to existing lease guidance under GAAP. Entities are required to use a modified retrospective approach for leases that exist or are entered into after the beginning of the earliest comparative period in the financial statements, with the option to use certain relief. Full retrospective application is prohibited. This standard is effective for fiscal years, and interim reporting periods within those years, beginning after December 15, 2018, which for us is our fiscal 2020. We are currently evaluating the impact this standard will have on our financial position, results of operations and cash flows.

In March 2017, the FASB issued an accounting standards update to improve the presentation of net periodic pension cost and net periodic postretirement benefit cost. This update requires that entities present components of net periodic pension cost and net periodic postretirement benefit cost other than the service cost component separately from the service cost component and outside the subtotal of income from operations. This update must be applied retrospectively and is effective for fiscal years beginning after December 15, 2017, which for us is our fiscal 2019. Adopting this update will result in a decrease in operating income and an increase in the net non-operating components of income from continuing operations of $164 million and $183 million for fiscal 2017 and 2018, respectively. We do not expect that adopting this update will have a material impact on our financial position or cash flows.

## Note B — Discontinued Operations

We completed two significant divestitures during fiscal 2017, the divestiture of our government IT services business ("IT Services") and the divestiture of our Harris CapRock Communications commercial business ("CapRock"), which are described in more detail below. These divestitures individually and collectively represented a strategic shift away from non-core markets (for example, energy, maritime and government IT services). The decision to divest these businesses was part of our strategy to simplify our operating model to focus on technology-differentiated, high-margin businesses, and had a major effect on our operations and financial results.

As a result, IT Services and CapRock are reported as discontinued operations in the accompanying Condensed Consolidated Financial Statements (Unaudited) and these Notes, and our historical financial results have been restated to account for IT Services and CapRock as discontinued operations for all periods presented in the accompanying Condensed Consolidated Financial Statements (Unaudited) and these Notes. Except for disclosures related to our cash flows, or unless otherwise specified, disclosures in the accompanying Condensed Consolidated Financial Statements (Unaudited) and these Notes relate solely to our continuing operations.

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The major components of discontinued operations in our Condensed Consolidated Statement of Income (Unaudited) included the following:

| | Quarter Ended | |
|---|---|---|
| | September 29, 2017 | September 30, 2016 |
| | (In millions) | |
| Revenue from product sales and services | $ — | $ 351 |
| Cost of product sales and services | — | (289 ) |
| Engineering, selling and administrative expenses | — | (38 ) |
| Non-operating loss | (3 ) | — |
| Income (loss) before income taxes | (3 ) | 24 |
| Loss on sale of discontinued operations (1) | — | (2 ) |
| Income tax expense | (3 ) | (7 ) |
| Discontinued operations, net of income taxes | $ (6 ) | $ 15 |

(1) Loss on sale of discontinued operations in the quarter ended September 30, 2016 consisted of transaction costs associated with the divestiture of IT Services.

Depreciation and amortization and capital expenditures of discontinued operations in our Condensed Consolidated Statement of Income (Unaudited) included the following:

| | Quarter Ended September 30, 2016 |
|---|---|
| | (In millions) |
| Depreciation and amortization | $ 17 |
| Capital expenditures | 3 |

IT Services

On April 28, 2017, we completed the divestiture to an affiliate of Veritas Capital Fund Management, L.L.C. (“Veritas”) of IT Services, which primarily provided IT and engineering managed services to U.S. Government customers, for net cash proceeds of $646 million, after estimated transaction expenses and estimated purchase price adjustments in respect of net cash and working capital, and subject to post-closing finalization of those adjustments as set forth in the definitive sales agreement entered into January 26, 2017. We recognized a pre-tax loss of $28 million on the sale of IT Services (a gain of $55 million after certain tax benefits related to the transaction or $.44 per diluted share). The decision to divest IT Services was part of our strategy to simplify our operating model to focus on technology-differentiated, high-margin businesses. IT Services was part of our former Critical Networks segment and in connection with the definitive agreement to sell IT Services, as described above, the remaining operations that had been part of the Critical Networks segment, including our air traffic management (“ATM”) business, primarily serving the Federal Aviation Administration (“FAA”), were integrated with our Electronic Systems segment effective for the third quarter of fiscal 2017, and our Critical Networks segment was eliminated. We agreed to provide various transition services to Veritas for a period of up to 18 months following the closing of the transaction pursuant to a separate agreement.

The following table presents the key financial results of IT Services included in “Discontinued operations, net of income taxes” in our Condensed Consolidated Statement of Income (Unaudited):

| | Quarter Ended | |
|---|---|---|
| | September 29, 2017 | September 30, 2016 |
| | (In millions) | |
| Revenue from product sales and services | $ — | $ 275 |
| Cost of product sales and services | — | (234) |
| Engineering, selling and administrative expenses | — | (24) |
| Non-operating loss | (2) | — |
| Income (loss) before income taxes | (2) | 17 |
| Loss on sale of discontinued operation | — | (2) |
| Income tax expense | (3) | (6) |
| Discontinued operations, net of income taxes | $ (5) | $ 9 |

CapRock

On January 1, 2017, we completed the divestiture to SpeedCast International Ltd. (“SpeedCast”) of CapRock, which provided wireless, terrestrial and satellite communications services to energy and maritime customers, for net cash proceeds of $370 million, after transaction expenses and purchase price adjustments in respect of net cash and working capital as set forth in the definitive sales agreement entered into November 1, 2016. We recognized a pre-tax gain of $14 million on the sale of CapRock (a gain of $61 million after certain tax benefits related to the transaction, including reversal of valuation allowances on capital losses and net operating losses, or $.49 per diluted share). We agreed to provide various transition services to SpeedCast for a period of up to 12 months following the closing of the transaction pursuant to a separate agreement.

The following table presents the key financial results of CapRock included in “Discontinued operations, net of income taxes” in our Condensed Consolidated Statement of Income (Unaudited):

| | Quarter Ended | |
|---|---|---|
| | September 29, 2017 | September 30, 2016 |
| | (In millions) | |
| Revenue from product sales and services | $ — | $ 76 |
| Cost of product sales and services | — | (55) |
| Engineering, selling and administrative expenses | — | (14) |
| Non-operating loss | (1) | — |
| Income (loss) before income taxes | (1) | 7 |
| Income tax expense | — | (1) |
| Discontinued operations, net of income taxes | $ (1) | $ 6 |

Note C — Stock Options and Other Share-Based Compensation

During the quarter ended September 29, 2017, we had options or other share-based compensation outstanding under two shareholder-approved employee stock incentive plans (“SIPs”), the Harris Corporation 2005 Equity Incentive Plan (As Amended and Restated Effective August 27, 2010) and the Harris Corporation 2015 Equity Incentive Plan (the “2015 EIP”). Grants of share-based awards after October 23, 2015 were made under our 2015 EIP. We believe that share-based awards more closely align the interests of participants with those of shareholders. Certain share-based awards provide for accelerated vesting if there is a change in control (as defined under our SIPs). The compensation cost related to our share-based awards that was charged against income was $11 million and $10 million for the quarters ended September 29, 2017 and September 30, 2016, respectively.

The aggregate number of shares of our common stock that we issued under the terms of our SIPs, net of shares withheld for tax purposes and inclusive of both continuing and discontinued operations, was 331,215 and 542,213 during the quarters ended September 29, 2017 and September 30, 2016, respectively. Awards granted to participants

under our 2015 EIP during the quarter ended September 29, 2017 consisted of 411,587 stock options, 713,919 restricted shares and restricted units and 173,407 performance units. The fair value as of the grant date of each stock option award was determined using the Black-

Scholes-Merton option-pricing model and the following assumptions: expected dividend yield of 1.82 percent; expected volatility of 19.32 percent; risk-free interest rates averaging 1.77 percent; and expected term in years of 5.00. The fair value as of the grant date of each restricted share award and restricted unit award was based on the closing price of our common stock on the grant date. The fair value as of the grant date of each performance unit award was determined based on the fair value from a multifactor Monte Carlo valuation model that simulates our stock price and total shareholder return ("TSR") relative to companies in our TSR peer group, less a discount to reflect the delay in payments of cash dividend-equivalents that are made only upon vesting.

Note D — Accumulated Other Comprehensive Loss

The components of accumulated other comprehensive loss are summarized below:

| | September 29, 2017 | June 30, 2017[1] |
|---|---|---|
| | (In millions) | |
| Foreign currency translation, net of income taxes of $2 million and $1 million at September 29, 2017 and June 30, 2017, respectively | $(88) | $(113) |
| Net unrealized loss on hedging derivatives, net of income taxes of $11 million | (16) | (17) |

| | | |
|---|---|---|
| at September 29, 2017 and June 30, 2017 Unrecognized postretirement obligations, net of income taxes of $89 million at September 29, 2017 and June 30, 2017 | (146 ) | (146 ) |
| | $(250) | $(276 ) |

(1) Accumulated foreign currency translation losses of $52 million (net of income taxes of $14 million) were reclassified to earnings in fiscal 2017 as a result of the divestitures of IT Services and CapRock and are included in "Discontinued operations, net of income taxes" in our Consolidated Statement of Income in our Fiscal 2017 Form 10-K.

Note E — Receivables

Receivables are summarized below:

| | September 29, 2017 | June 30, 2017 |
|---|---|---|
| | (In millions) | |
| Accounts receivable | $422 | $ 368 |
| Unbilled costs and accrued earnings on cost-plus contracts | 287 | 258 |
| | 709 | 626 |
| Less allowances for collection losses | (3 ) | (3 ) |
| | $706 | $ 623 |

Note F — Inventories

Inventories are summarized below:

| | September 29, 2017 | June 30, 2017 |
|---|---|---|
| | (In millions) | |
| Unbilled costs and accrued earnings on fixed-price contracts | $ 483 | $ 454 |
| Finished products | 100 | 96 |

| | | |
|---|---|---|
| Work in process | 106 | 96 |
| Raw materials and supplies | 207 | 195 |
| | $ 896 | $ 841 |

Unbilled costs and accrued earnings on fixed-price contracts were net of progress payments of $107 million and $90 million at September 29, 2017 and June 30, 2017, respectively.

Note G — Property, Plant and Equipment

Property, plant and equipment are summarized below:

| | September 29, 2017 | June 30, 2017 |
|---|---|---|
| | (In millions) | |
| Land | $ 43 | $ 43 |
| Software capitalized for internal use | 160 | 155 |
| Buildings | 619 | 617 |
| Machinery and equipment | 1,275 | 1,256 |
| | 2,097 | 2,071 |
| Less accumulated depreciation and amortization | (1,207) | (1,167) |
| | $ 890 | $ 904 |

Depreciation and amortization expense related to property, plant and equipment was $37 million and $39 million for the quarters ended September 29, 2017 and September 30, 2016, respectively.

Note H — Accrued Warranties

Changes in our liability for standard product warranties, which is included as a component of the "Other accrued items" and "Other long-term liabilities" line items in our Condensed Consolidated Balance Sheet (Unaudited), during the quarter ended September 29, 2017 were as follows:

| | (In millions) |
|---|---|
| Balance at June 30, 2017 | $ 26 |
| Warranty provision for sales | 3 |
| Settlements | (4) |
| Balance at September 29, 2017 | $ 25 |

We also sell extended product warranties and recognize revenue from these arrangements over the warranty period. Costs of warranty services under these arrangements are recognized as incurred. Deferred revenue associated with extended product warranties was $21 million at September 29, 2017 and $23 million at June 30, 2017 and is included as a component of the "Advance payments and unearned income" and "Other long-term liabilities" line items in our Condensed Consolidated Balance Sheet (Unaudited).

Note I — Postretirement Benefit Plans

The following tables provide the components of our net periodic benefit income for our defined benefit plans, including defined benefit pension plans and other postretirement defined benefit plans:

| | Quarter Ended September 29, 2017 | | |
|---|---|---|---|
| | Pension | Other Benefits | Total |
| | (In millions) | | |
| Net periodic benefit income | | | |
| Service cost | $10 | $ — | $10 |
| Interest cost | 48 | 2 | 50 |
| Expected return on plan assets | (92 ) | (4 ) | (96 ) |
| Total net periodic benefit income | $(34) | $ (2 ) | $(36) |

| | Quarter Ended September 30, 2016 | | |
|---|---|---|---|
| | Pension | Other Benefits | Total |
| | (In millions) | | |
| Net periodic benefit income | | | |
| Service cost (1) | $15 | $ — | $15 |
| Interest cost | 46 | 2 | 48 |
| Expected return on plan assets | (85 ) | (4 ) | (89 ) |
| Total net periodic | $(24) | $ (2 ) | $(26) |

benefit
income

(1) $1 million of the service cost component of net periodic benefit income is included as a component of the "Discontinued operations, net of income taxes" line item in our Condensed Consolidated Statement of Income (Unaudited) for the quarter ended September 30, 2016.

We made a $400 million voluntary contribution to our U.S. qualified pension plans during fiscal 2017. As a result, we made no contributions to our U.S. qualified defined benefit pension plans during the quarter ended September 29, 2017 and minor contributions to a non-U.S. pension plan. We currently anticipate making no contributions to our U.S. qualified defined benefit pension plans and contributions of approximately $1 million to a non-U.S. pension plan during the remainder of fiscal 2018. We contributed $64 million to our qualified pension plans during the quarter ended September 30, 2016.

The U.S. Salaried Retirement Plan ("U.S. SRP"), a U.S. qualified pension plan, is our largest defined benefit pension plan, with assets valued at $4.4 billion and a projected benefit obligation of $5.6 billion as of June 30, 2017. Effective December 31, 2016, future benefit accruals under the U.S. SRP benefit formula were frozen for all employees and replaced with a 1% cash balance defined benefit formula for certain non-highly compensated employees.

Note J — Income From Continuing Operations Per Common Share

The computations of income from continuing operations per common share are as follows:

| | Quarter Ended | |
|---|---|---|
| | September 29, 2017 | September 30, 2016 |
| | (In millions, except per share amounts) | |
| Income from continuing operations (A) | $ 167 | $ 145 |
| Basic weighted average common shares outstanding (B) | 119.1 | 123.9 |
| Impact of dilutive share-based awards | 2.1 | 1.6 |
| Diluted weighted average common shares outstanding (C) | 121.2 | 125.5 |
| Income from continuing operations per basic common share (A)/(B) | $ 1.40 | $ 1.17 |
| Income from continuing operations per diluted common share (A)/(C) | $ 1.38 | $ 1.16 |

Potential dilutive common shares primarily consist of employee stock options and performance unit awards. Employee stock options to purchase approximately 162,770 and 485,321 shares of our common stock were outstanding at September 29,

2017 and September 30, 2016, respectively, but were not included as dilutive stock options in the computations of income from continuing operations per diluted common share because the effect would have been antidilutive.

Note K — Income Taxes

Our effective tax rate (income taxes as a percentage of income from continuing operations before income taxes) was 27.7 percent in the quarter ended September 29, 2017 compared with 28.6 percent in the quarter ended September 30, 2016. In the quarters ended September 29, 2017 and September 30, 2016, our effective tax rate benefited from the favorable impact of excess tax benefits related to equity-based compensation, and of several differences in GAAP and tax accounting related to investments.

Note L — Fair Value Measurements

Fair value is defined as the price that would be received to sell an asset or paid to transfer a liability in the principal market (or most advantageous market, in the absence of a principal market) for the asset or liability in an orderly transaction between market participants at the measurement date. Entities are required to maximize the use of observable inputs and minimize the use of unobservable inputs in measuring fair value, and to utilize a three-level fair value hierarchy that prioritizes the inputs used to measure fair value. The three levels of inputs used to measure fair value are as follows:

- Level 1 — Quoted prices in active markets for identical assets or liabilities.
- Level 2 — Observable inputs other than quoted prices included within Level 1, including quoted prices for similar assets or liabilities in active markets; quoted prices for identical or similar assets or liabilities in markets that are not active; and inputs other than quoted prices that are observable or are derived principally from, or corroborated by, observable market data by correlation or other means.
- Level 3 — Unobservable inputs that are supported by little or no market activity, are significant to the fair value of the assets or liabilities, and reflect our own assumptions about the assumptions market participants would use in pricing the asset or liability developed using the best information available in the circumstances.

In certain instances, fair value is estimated using quoted market prices obtained from external pricing services. In obtaining such data from the external pricing services, we have evaluated the methodologies used to develop the estimate of fair value in order to assess whether such valuations are representative of fair value, including net asset value ("NAV"). Additionally, in certain circumstances, the NAV reported by an asset manager may be adjusted when sufficient evidence indicates NAV is not representative of fair value.

The following table presents assets and liabilities measured at fair value on a recurring basis (at least annually) as of September 29, 2017 and June 30, 2017:

| | September 29, 2017 | | June 30, 2017 | |
|---|---|---|---|---|
| | Total | Level 1 | Total | Level 1 |
| | (In millions) | | | |
| Assets | | | | |
| Deferred compensation plan investments:(1) | | | | |
| Equity security | $49 | $ 49 | $37 | $ 37 |
| Investments Measured at NAV: | | | | |
| | 25 | | 25 | |

| | | | | |
|---|---|---|---|---|
| Corporate-owned life insurance | | | | |
| Equity fund | 49 | | 50 | |
| Total | 74 | | 75 | |
| Total fair value of deferred compensation plan assets | $123 | | $112 | |
| Liabilities | | | | |
| Deferred compensation plan liabilities: (2) | | | | |
| Equity securities and mutual funds | $56 | $ 56 | $46 | $ 46 |
| Investments Measured at NAV: | | | | |
| Common/collective trusts and guaranteed investment contracts | 86 | | 80 | |
| Total fair value of deferred compensation plan liabilities | $142 | | $126 | |

(1) Represents investments held in a "rabbi trust" associated with our non-qualified deferred compensation plans, which we include in the "Other current assets" and "Other non-current assets" line items in our Condensed Consolidated Balance Sheet (Unaudited).

(2) Primarily represents obligations to pay benefits under certain non-qualified deferred compensation plans, which we include in the "Compensation and benefits" and "Other long-term liabilities" line items in our Condensed Consolidated Balance Sheet (Unaudited). Under these plans, participants designate investment options (including money market,

stock and fixed-income funds), which serve as the basis for measurement of the notional value of their accounts.

The following table presents the carrying amounts and estimated fair values of our significant financial instruments that were not measured at fair value (carrying amounts of other financial instruments not listed in the table below approximate fair value due to the short-term nature of those items):

| | September 29, 2017 | | June 30, 2017 | |
|---|---|---|---|---|
| | Carrying Amount | Fair Value | Carrying Amount | Fair Value |
| | (In millions) | | | |
| Long-term debt (including current portion) (1) | $3,917 | $4,235 | $3,950 | $4,252 |

(1) The fair value was estimated using a market approach based on quoted market prices for our debt traded in the secondary market. If our long-term debt in our balance sheet were measured at fair value, it would be categorized in Level 2 of the fair value hierarchy.

## Note M — Derivative Instruments and Hedging Activities

In the normal course of business, we are exposed to global market risks, including the effect of changes in foreign currency exchange rates. We use derivative instruments to manage our exposure to such risks and formally document all relationships between hedging instruments and hedged items, as well as the risk-management objective and strategy for undertaking hedge transactions. We recognize all derivatives in our Condensed Consolidated Balance Sheet (Unaudited) at fair value. We do not hold or issue derivatives for speculative purposes.

At September 29, 2017, we had open foreign currency forward contracts with an aggregate notional amount of $41 million, of which $5 million were classified as fair value hedges and $36 million were classified as cash flow hedges. This compares with open foreign currency forward contracts with an aggregate notional amount of $33 million at June 30, 2017, of which $2 million were classified as fair value hedges and $31 million were classified as cash flow hedges. At September 29, 2017, contract expiration dates ranged from 3 days to approximately 9 months with a weighted average contract life of 4 months.

### Fair Value Hedges

We use foreign currency forward contracts and options to hedge certain balance sheet items, including foreign currency denominated accounts receivable and inventory. As of September 29, 2017, we had outstanding foreign currency forward contracts denominated in the Australian Dollar and Canadian Dollar to hedge certain balance sheet items. The net gains or losses on foreign currency forward contracts designated as fair value hedges were not material in the quarter ended September 29, 2017 or in the quarter ended September 30, 2016. In addition, no amounts were recognized in earnings in the quarter ended September 29, 2017 or in the quarter ended September 30, 2016 related to hedged firm commitments that no longer qualify as fair value hedges.

### Cash Flow Hedges

We use foreign currency forward contracts and options to hedge off-balance sheet future foreign currency commitments and also have hedged U.S. Dollar payments to suppliers to maintain our anticipated profit margins in our international operations. As of September 29, 2017, we had outstanding foreign currency forward contracts denominated in the Euro, British Pound and Australian Dollar to hedge certain forecasted transactions. The net gains or losses from cash flow hedges recognized in earnings or recorded in other comprehensive income, including gains or losses related to hedge ineffectiveness, were not material in the quarter ended September 29, 2017 or in the quarter ended September 30, 2016.

## Note N — Changes in Estimates

Estimates and assumptions, and changes therein, are important in connection with, among others, our segments' revenue recognition policies related to development and production contracts. Revenue and profit related to

development and production contracts are recognized using the POC method, generally based on the ratio of costs incurred to estimated total costs at completion under the contract (i.e., the "cost-to-cost" method) or the ratio of actual units delivered to estimated total units to be delivered under the contract (i.e., the "units-of-delivery" method) with consideration given for risk of performance and estimated profit. Revenue and profit on cost-reimbursable development and production contracts are recognized as allowable costs are incurred on the contract and become billable to the customer, in an amount equal to the allowable costs plus the profit on those costs.

Development and production contracts are combined when specific aggregation criteria are met. Criteria generally include closely interrelated activities performed for a single customer within the same economic environment. Development and production contracts are generally not segmented. If development and production contracts are segmented, we have determined that they meet specific segmenting criteria. Change orders, claims or other items that may change the scope of a development or production contract are included in contract value only when the value can be reliably estimated and realization

is probable. Possible incentives or penalties and award fees applicable to performance on development and production contracts are considered in estimating contract value and profit rates and are recorded when there is sufficient information to assess anticipated contract performance. Incentive provisions that increase earnings based solely on a single significant event are generally not recognized until the event occurs. We are party to certain contracts with incentive provisions or award fees that are subject to uncertainty until the conclusion of the contract, and our customers may be entitled to reclaim and receive previous award fee payments.

Under the POC method of accounting, a single estimated total profit margin is used to recognize profit for each development and production contract over its period of performance. Recognition of profit on a fixed-price development or production contract requires estimates of the total cost at completion and the measurement of progress toward completion. The estimated profit or loss on a development or production contract is equal to the difference between the estimated contract value and the estimated total cost at completion. Due to the long-term nature of many of our programs, developing the estimated total cost at completion often requires judgment. Factors that must be considered in estimating the cost of the work to be completed include the nature and complexity of the work to be performed, subcontractor performance, the risk and impact of delayed performance, availability and timing of funding from the customer and the recoverability of any claims outside the original development or production contract included in the estimate to complete. At the outset of each contract, we gauge its complexity and perceived risks and establish an estimated total cost at completion in line with these expectations. After establishing the estimated total cost at completion, we follow a standard Estimate at Completion ("EAC") process in which we review the progress and performance on our ongoing development and production contracts at least quarterly and, in many cases, more frequently. If we successfully retire risks associated with the technical, schedule and cost aspects of a contract, we may lower our estimated total cost at completion commensurate with the retirement of these risks. Conversely, if we are not successful in retiring these risks, we may increase our estimated total cost at completion. Additionally, at the outset of a cost-reimbursable contract (for example, contracts containing award or incentive fees), we establish an estimate of total contract value, or revenue, based on our expectation of performance on the contract. As the cost-reimbursable contract progresses, our estimates of total contract value may increase or decrease if, for example, we receive higher or lower than expected award fees. When adjustments in estimated total costs at completion or in estimated total contract value are determined, the related impact to operating income is recognized using the cumulative catch-up method, which recognizes in the current period the cumulative effect of such adjustments for all prior periods. Anticipated losses on development and production contracts or programs in progress are charged to operating income when identified. Net EAC adjustments resulting from changes in estimates impacted our operating income favorably by $11 million ($6 million after-tax or $.05 per diluted share) in the quarter ended September 29, 2017 and favorably by $13 million ($8 million after-tax or $.06 per diluted share) in the quarter ended September 30, 2016.

Note O — Business Segments

We structure our operations primarily around the products, systems and services we sell and the markets we serve, and we report the financial results of our continuing operations in the following three reportable segments, which are also referred to as our business segments:

- Communication Systems, serving markets in tactical communications and defense products, including tactical ground and airborne radio communications solutions and night vision technology, and in public safety networks;
- Electronic Systems, providing electronic warfare, avionics, and command, control, communications, computers, intelligence, surveillance and reconnaissance ("C4ISR") solutions for the defense industry and ATM solutions for the civil aviation industry; and
- Space and Intelligence Systems, providing intelligence, space protection, geospatial, complete Earth observation, universe exploration, positioning, navigation and timing ("PNT"), and environmental solutions for national security, defense, civil and commercial customers, using advanced sensors, antennas and payloads, as well as ground processing and information analytics.

As described in more detail in "Basis of Presentation" in Note A — Significant Accounting Policies and Recent Accounting Standards and Note B — Discontinued Operations in these Notes, in connection with our divestiture of CapRock and entering into the definitive agreement to sell IT Services in the third quarter of fiscal 2017, our other remaining operations that had been part of our former Critical Networks segment, including our ATM business

primarily serving the FAA, were integrated with our Electronic Systems segment effective for the third quarter of fiscal 2017, and our Critical Networks segment was eliminated. The historical results, discussion and presentation of our business segments as set forth in our Condensed Consolidated Financial Statements (Unaudited) and these Notes reflect the impact of these changes for all periods presented in order to present all segment information on a comparable basis. There is no impact on our previously reported consolidated statements of income, balance sheets or statements of cash flows resulting from these segment changes. Our historical results and discussion for all periods presented have been restated to account for businesses reported as discontinued operations in our Condensed Consolidated Financial Statements (Unaudited) and these Notes.

The accounting policies of our business segments are the same as those described in Note 1: "Significant Accounting Policies" in our Notes to Consolidated Financial Statements in our Fiscal 2017 Form 10-K. We evaluate each segment's performance based on its operating income or loss, which we define as profit or loss from operations before income taxes excluding interest income and expense, royalties and related intellectual property expenses, equity method investment income or loss and gains or losses from securities and other investments. Intersegment sales are generally transferred at cost to the buying segment, and the sourcing segment recognizes a profit that is eliminated. The "Corporate eliminations" line items in the tables below represent the elimination of intersegment sales and their related profits. The "Unallocated corporate expense" line item in the tables below represents the portion of corporate expenses not allocated to our business segments.

Total assets by business segment are summarized below:

| | September 29, 2017 | June 30, 2017 |
|---|---|---|
| | (In millions) | |
| Total Assets | | |
| Communication Systems | $1,588 | $1,534 |
| Electronic Systems | 4,123 | 4,094 |
| Space and Intelligence Systems | 2,159 | 2,117 |
| Corporate (1) | 2,229 | 2,345 |
| | $10,099 | $10,090 |

(1) Identifiable intangible assets acquired in connection with our acquisition of Exelis in the fourth quarter of fiscal 2015 were recorded as Corporate assets because they benefit the entire Company as opposed to any individual segment. Exelis identifiable intangible asset balances recorded as Corporate assets were approximately $1.1 billion as of September 29, 2017 and June 30, 2017. Corporate assets also consisted of cash, income taxes receivable, deferred income taxes, deferred compensation plan investments and buildings and equipment.

Segment revenue, segment operating income and a reconciliation of segment operating income to total income from continuing operations before income taxes are as follows:

| | Quarter Ended | |
|---|---|---|
| | September 29, 2017 | September 30, 2016 |
| | (In millions) | |
| Revenue | | |
| Communication Systems | $410 | $ 430 |