SPECTRUM PHARMACEUTICALS INC
Form 10-Q
May 08, 2015

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

FORM 10-Q

ý QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

For the quarterly period ended March 31, 2015

¨ 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: 001-35006

SPECTRUM PHARMACEUTICALS, INC.
(Exact name of registrant as specified in its charter)

Delaware (State or other jurisdiction of incorporation or organization)	93-0979187 (I.R.S. Employer Identification No.)
11500 South Eastern Avenue, Suite 240 Henderson, Nevada	89052
(Address of principal executive offices)	(Zip Code)

(702) 835-6300
(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 (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. Yes ý 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). Yes ý 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. (Check one):

Large accelerated filer	¨	Accelerated filer	ý
Non-accelerated filer	¨ (Do not check if a smaller reporting company)	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 ý

As of April 30, 2015, 66,995,054 shares of the registrant’s common stock were outstanding.

Table of Contents

SPECTRUM PHARMACEUTICALS, INC.
QUARTERLY REPORT ON FORM 10-Q
FOR THE THREE MONTHS ENDED MARCH 31, 2015
TABLE OF CONTENTS

Item 2 through 5 of Part II have been omitted because they are not applicable with respect to the current reporting period.

Table of Contents

PART I: FINANCIAL INFORMATION
ITEM 1: CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
SPECTRUM PHARMACEUTICALS, INC.
CONDENSED CONSOLIDATED BALANCE SHEETS
(In thousands, except share and par value amounts)
(Unaudited)

	March 31, 2015	December 31, 2014
ASSETS		
Current assets:		
Cash and cash equivalents	$123,365	$129,942
Marketable securities	3,308	3,306
Accounts receivable, net of allowance for doubtful accounts of $164 and $120, respectively	68,755	70,758
Other receivables	7,914	5,489
Inventories	9,079	9,200
Prepaid expenses	3,375	3,774
Deferred tax assets	170	—
Total current assets	215,966	222,469
Property and equipment, net of accumulated depreciation	1,313	1,405
Intangible assets, net of accumulated amortization	214,606	230,100
Goodwill	17,949	18,195
Other assets	18,808	17,864
Total assets	$468,642	$490,033
LIABILITIES AND STOCKHOLDERS' EQUITY		
Current liabilities:		
Accounts payable and other accrued liabilities	$82,153	$84,994
Accrued payroll and benefits	4,378	8,444
Deferred revenue	17,045	9,959
Drug development liability	1,141	1,141
Acquisition-related contingent obligations	5,091	4,901
Total current liabilities	109,808	109,439
Drug development liability, less current portion	13,978	14,644
Deferred revenue, less current portion	416	—
Acquisition-related contingent obligations, less current portion	2,751	2,441
Deferred tax liability	6,808	6,569
Other long-term liabilities	6,944	6,088
Convertible senior notes	97,568	96,298
Total liabilities	238,273	235,479
Commitments and contingencies		
Stockholders' equity:		
Preferred stock, $0.001 par value; 5,000,000 shares authorized:		
Series B junior participating preferred stock, $0.001 par value; 1,500,000 shares authorized; no shares issued and outstanding	—	—
Series E Convertible Voting Preferred Stock, $0.001 par value and $10,000 stated value; 2,000 shares authorized; 20 shares issued and outstanding at March 31, 2015 and December 31, 2014, respectively (convertible into 40,000 shares of common stock, with aggregate liquidation value of $240)	123	123

Common stock, $0.001 par value; 175,000,000 shares authorized; 66,905,839 and 65,969,699 shares issued and outstanding at March 31, 2015 and December 31, 2014, respectively	66	66
Additional paid-in capital	541,157	538,553
Accumulated other comprehensive loss	(2,077)	(850)
Accumulated deficit	(308,900)	(283,338)
Total stockholders' equity	230,369	254,554
TOTAL LIABILITIES AND STOCKHOLDERS' EQUITY	$468,642	$490,033

See accompanying notes to these unaudited condensed consolidated financial statements.

3

Table of Contents

SPECTRUM PHARMACEUTICALS, INC.
CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS
(In thousands, except share and per share amounts)
(Unaudited)

	Three Months Ended March 31, 2015	2014
Revenues:		
Product sales, net	$38,413	$40,096
License fees and service revenue	205	28
Total revenues	$38,618	$40,124
Operating costs and expenses:		
Cost of product sales (excludes amortization of intangible assets)	7,071	6,278
Selling, general and administrative	23,335	23,403
Research and development	15,851	29,497
Amortization and impairment of intangible assets	14,022	5,360
Total costs and operating expenses	60,279	64,538
Loss from operations	(21,661)	(24,414)
Other expenses:		
Interest expense, net	(2,228)	(2,067)
Change in fair value of contingent consideration related to acquisitions	(500)	(724)
Other expense, net	(1,035)	(358)
Total other expenses	(3,763)	(3,149)
Loss before income taxes	(25,424)	(27,563)
Provision for income taxes	(138)	(78)
Net loss	$(25,562)	$(27,641)
Net loss per share:		
Basic and diluted	$(0.39)	$(0.44)
Weighted average shares outstanding:		
Basic and diluted	64,880,677	63,447,309

See accompanying notes to these unaudited condensed consolidated financial statements.

Table of Contents

SPECTRUM PHARMACEUTICALS, INC.
CONDENSED CONSOLIDATED STATEMENTS OF COMPREHENSIVE LOSS
(In thousands)
(Unaudited)

	Three Months Ended March 31,	
	2015	2014
Net loss	$(25,562)	$(27,641)
Other comprehensive (loss) income, net of income tax:		
Unrealized gain on available-for-sale securities	779	314
Adjustment for realized loss on available-for-sale securities, and included in net income	—	(118)
Foreign currency translation adjustments	(2,006)	88
Other comprehensive (loss) income	(1,227)	284
Total comprehensive loss	$(26,789)	$(27,357)

See accompanying notes to these unaudited condensed consolidated financial statements.

Table of Contents

SPECTRUM PHARMACEUTICALS, INC.

CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS
(In thousands)
(Unaudited)

	Three Months Ended March 31, 2015	2014
Cash Flows From Operating Activities:		
Net loss	$(25,562)	$(27,641)
Adjustments to reconcile net loss to net cash used in operating activities:		
Depreciation and amortization	7,017	5,980
Stock-based compensation	2,462	2,571
Accretion of debt discount to interest expense on 2018 Convertible Notes (Note 11)	1,270	1,147
Amortization of deferred financing costs to interest expense on 2018 Convertible Notes (Note 11)	162	131
Bad debt (recovery) expense	44	(70)
Impairment of intangible assets (Note 3(e))	7,160	—
Non-cash foreign currency exchange loss	1,128	(364)
Research and development expense for the value of stock issued to TopoTarget in connection with milestone achievement	—	7,790
Change in fair value of contingent consideration related to acquisitions (Note 9)	500	724
Changes in operating assets and liabilities:		
Accounts receivable, net	1,864	(4,454)
Other receivables	(2,399)	(647)
Inventories	121	600
Prepaid expenses	436	(14,484)
Deferred tax assets	(235)	(2)
Other assets	(404)	(861)
Accounts payable and other accrued obligations	(2,778)	(8,424)
Accrued payroll and benefits	(4,056)	(2,464)
Drug development liability	(666)	(236)
Deferred revenue	7,555	302
Deferred tax liability	239	955
Other long-term liabilities	855	(542)
Net cash used in operating activities	(5,287)	(39,989)
Cash Flows From Investing Activities:		
Purchases of property and equipment	(78)	(320)
Net cash used in investing activities	(78)	(320)
Cash Flows From Financing Activities:		
Proceeds from exercise of stock options	404	1,241
Purchase and retirement of restricted stock to satisfy employee tax liability at vesting	(262)	—
Net cash provided by financing activities	142	1,241
Effect of exchange rates on cash and equivalents	(1,354)	496
Net decrease in cash and cash equivalents	(6,577)	(38,572)
Cash and cash equivalents—beginning of period	$129,942	$156,306
Cash and cash equivalents—end of period	$123,365	$117,734
Supplemental disclosure of cash flow information:		
Cash paid for income taxes	$331	$—

Cash paid for interest	$—	$—

See accompanying notes to these unaudited condensed consolidated financial statements.

Table of Contents

Spectrum Pharmaceuticals, Inc.

Notes to Condensed Consolidated Financial Statements
(all tabular amounts presented in thousands, except share, per share, per unit, and number of years)
(Unaudited)

1. DESCRIPTION OF BUSINESS, BASIS OF PRESENTATION, AND OPERATING SEGMENT
(a) Description of Business
Spectrum Pharmaceuticals, Inc. ("Spectrum", the "Company", "we", "our", or "us") is a biotechnology company, with a prima focus on oncology and hematology. Our strategy is comprised of the (i) commercialization of cancer therapeutics through our U.S. direct sales force and international distributors, (ii) completion of studies for new indications of our marketed products, and (iii) acquisition, development and marketing of a broad and diverse pipeline of late-stage clinical and commercial drug compounds.
We currently market five drugs for the treatment of cancer:

- FUSILEV® injection for patients with advanced metastatic colorectal cancer and to counteract certain effects of methotrexate therapy;
- ZEVALIN® injection for patients with follicular non-Hodgkin's lymphoma;
- FOLOTYN® injection for patients with relapsed or refractory peripheral T-cell lymphoma ("PTCL");
- MARQIBO® injection for patients with Philadelphia chromosome–negative acute lymphoblastic leukemia; and
- BELEODAQ® injection for patients with relapsed or refractory PTCL.

We also have ongoing indication expansion studies with several of our marketed products, and a diversified pipeline of product candidates in Phase 2 and Phase 3 clinical studies.
(b) Basis of Presentation
Interim Financial Statements
The interim financial data as of March 31, 2015 and 2014 is unaudited and is not necessarily indicative of our results for a full year. In the opinion of our management, the interim data includes normal and recurring adjustments necessary for a fair presentation of our financial results for the three months ended March 31, 2015 and 2014. Certain information and footnote disclosures normally included in annual financial statements prepared in accordance with generally accepted accounting principles in the United States of America ("GAAP") have been condensed or omitted pursuant to U.S. Securities and Exchange Commission ("SEC") rules and regulations relating to interim financial statements. The December 31, 2014 balances reported herein are derived from the audited Consolidated Financial Statements included in our Annual Report on Form 10-K for the year ended December 31, 2014. The accompanying Condensed Consolidated Financial Statements should be read in conjunction with our audited Consolidated Financial Statements and Notes thereto included in our Annual Report on Form 10-K for the fiscal year ended December 31, 2014, filed with the SEC on March 13, 2015.
Principles of Consolidation
The accompanying Condensed Consolidated Financial Statements have been prepared in accordance with GAAP in the United States of America and with the rules and regulations of the SEC. These financial statements include the financial position, results of operations, and cash flows of Spectrum and its subsidiaries, all of which are wholly-owned (except for SPC, as discussed below). All inter-company accounts and transactions among the consolidated entities have been eliminated in consolidation.
Variable Interest Entity
We own fifty-percent of Spectrum Pharma Canada ("SPC"), organized in Quebec, Canada in January 2008. Certain of our drug clinical studies are conducted through this "variable interest entity" (as defined under applicable GAAP) and we fund all

of SPC's operating costs. Since we carry the full risks and rewards of SPC, we meet the applicable GAAP criteria as being its "primary beneficiary." Accordingly, SPC's balance sheets and statements of operations are included in our Condensed Consolidated Financial Statements as if it were a wholly-owned subsidiary for all periods presented.

(c) Operating Segment

We operate in one reportable operating segment that is focused exclusively on developing and commercializing oncology and hematology drug products. For the three months ended March 31, 2015 and 2014, all of our revenue and related expenses were solely attributable to these activities. Substantially all of our assets (excluding certain of our bank accounts and intangible asset rights held by our wholly-owned foreign subsidiaries) are located in the U.S.

2. USE OF ESTIMATES AND SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

The preparation of financial statements in conformity with GAAP requires our management to make informed estimates and assumptions that affect the reported amounts of assets, liabilities, revenues, and expenses. On an on-going basis, our management evaluates its estimates, including those related to (i) gross-to-net revenue adjustments; (ii) the timing of revenue recognition; (iii) the collectability of customer accounts; (iv) whether the cost of inventories can be recovered; (v) the fair value of goodwill and intangible assets; (vi) the realization of tax assets and estimates of tax liabilities; (vii) the likelihood of payment and value of contingent liabilities; (viii) the fair value of investments; (ix) assumptions used in reporting stock-based compensation; and (x) the potential outcome of ongoing or threatened litigation.

Our estimates are based on our management's professional judgment which involves their experience and consideration of all available facts. Actual results may materially differ from management's estimates. In our judgment, the accounting policies, estimates, and assumptions described below have the greatest potential to significantly impact the accompanying Condensed Consolidated Financial Statements:

(i) Revenue Recognition

(a) Product Sales: We sell our products to wholesalers or distributors (i.e., our customers), except for our U.S. sales of ZEVALIN in which case the end-user (i.e. clinic or hospital) is our customer. Our wholesalers and distributors in turn sell our products directly to clinics, hospitals, and private oncology-based practices. Revenue from product sales is recognized when title and risk of loss have transferred to our customer, and the following additional criteria are met:

(1) appropriate evidence of a binding arrangement exists with our customer;
(2) price is substantially fixed and determinable;
(3) collection from our customer is reasonably assured;
(4) our customer's obligation to pay us is not contingent on resale of the product;
(5) we do not have significant obligations for future performance to directly bring about the resale of our product; and
(6) we have a reasonable basis to estimate returns.

Our gross revenue is reduced by our gross-to-net ("GTN") estimates each period, resulting in our reported "product sales, net" in the accompanying Condensed Consolidated Statements of Operations. We defer revenue recognition in full if these estimates are not reasonably determinable at the time of sale. These estimates are based upon information received from external sources, in combination with management's judgments and estimates. Such external information includes written and oral information obtained from our wholesalers with respect to their period-end inventory levels, and their sales to end-users during the period. Due to the inherent uncertainty of the inputs that these estimates are based upon, the actual amount we incur may be prospectively reported by us as a revenue adjustment in periods after the initial sale is recorded, and could be materially different from our initial estimates.

Our GTN estimates include the following major categories:

Table of Contents

Notes to Condensed Consolidated Financial Statements
(all tabular amounts presented in thousands, except share, per share, per unit, and number of years)
(Unaudited)

Product Returns Allowances: Our FUSILEV, MARQIBO, and BELEODAQ customers are permitted to return purchased product beginning at its expiration date, and within six months thereafter. Returned product is generally not resold. Returns for expiry of ZEVALIN and FOLOTYN are not contractually, or customarily, allowed. We estimate potential returns based on historical rates of return.

Government Chargebacks: Our products are subject to pricing limits under certain federal government programs. Qualifying entities (i.e., end-users) purchase product from our wholesalers at their qualifying discounted price. The chargeback amount we incur represents the difference between our original sales price to the wholesaler, and the end-user's applicable discounted purchase price. There may be significant lag time between our original sale to the wholesaler and our receipt of the corresponding government chargeback claims from our wholesalers.

Prompt Pay Discounts: Discounts for prompt payment are estimated at the time of sale, based on our eligible customers' prompt payment history and the contractual discount percentage.

Commercial Rebates: Rebates are based on (i) our estimates of purchases by end-users through a group purchasing organization ("GPO"), (ii) the corresponding contractual rebate tier we expect each GPO to achieve, and (iii) our estimates of prospective rebate program changes.

Medicaid Rebates: Our products are subject to state government-managed Medicaid programs, whereby rebates for purchases are issued to participating state governments. These rebates arise when the patient treated with our products is covered under Medicaid. Our calculations related to these Medicaid rebate accruals require us to estimate end-user and patient mix to determine which of our sales will likely be subject to these rebates. There is a significant time lag in us receiving these rebate notices (generally several months after our sale is made). Our estimates are based on our historical claims, as supplemented by management's judgment.

Distribution, Data, and GPO Administrative Fees: Distribution, data, and GPO administrative fees are paid to authorized wholesalers of our products (except for U.S. sales of ZEVALIN) for various services, including: contract administration, inventory management, end-user sales data, and product returns processing. These fees are based on a contractually-determined percentage of applicable sales.

(b) License Fees: We recognize revenue for our licensing of intellectual property to third parties (i.e., out-licenses), based on the contractual terms of each agreement and our application of pertinent GAAP. This revenue may be associated with upfront license fees, milestone payments from our licensees' sales or regulatory achievements, and royalties from our licensees' sales in applicable territories.

(c) Service Revenue: We receive fees under certain arrangements for research and development activities, clinical trial management, and supply chain services. Payment may be triggered by the successful completion of a phase of development, results from a clinical trial, regulatory approval events, or completion of product delivery in our capacity as an agent in such arrangement. We recognize revenue when the corresponding milestone is achieved, or the revenue is otherwise earned through our on-going activities.

(d) New Revenue Recognition Standard: On April 1, 2015, the FASB voted for a one-year deferral of the effective date of the new revenue recognition standard, ASU No. 2014-09, Revenue from Contracts with Customers (Topic 606) ("ASU 2014-09"). If these proposed changes are finalized, this standard would require public entities to apply the amendments in ASU 2014-09 for annual reporting beginning after December 15, 2017. ASU 2014-09 requires an entity to 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 or services. To achieve this core principle, the guidance provides that an entity should apply the following steps: (1) identify the contract(s) with a customer; (2) identify the performance obligations in the contract; (3) determine the transaction price; (4) allocate the transaction price to the performance obligations in the contract; and (5) recognize revenue when, or as, the entity satisfies a performance obligation.

We continue to evaluate the impact of ASU 2014-09 to our current revenue recognition models for product sales, license fees, and service revenue, as described above.

(ii) Cash and Equivalents

Our cash and equivalents consist of bank deposits and highly liquid investments with maturities of three months or less from the purchase date.

(iii) Marketable Securities

Our marketable securities consist of our holdings in mutual funds and bank certificates of deposit. Since we classify these securities as “available-for-sale” under applicable GAAP, any unrealized gains or losses from their change in value is reflected in “unrealized gain on available-for-sale securities” on the accompanying Condensed Consolidated Statements of Comprehensive Loss. Realized gains and losses on available-for-sale securities are included in “other expense, net” on the accompanying Condensed Consolidated Statements of Operations.

(iv) Accounts Receivable

Our accounts receivables are derived from our product sales, license fees, and service revenue, and do not bear interest. The allowance for doubtful accounts is management’s best estimate of the amount of probable credit losses in existing accounts receivable. Account balances are charged off against the allowance after appropriate collection efforts are exhausted.

(v) Inventories

We value our inventory at the lower of (i) the actual cost to purchase or manufacture it, or (ii) its current market value. Inventory cost is determined on the first-in, first-out method (FIFO). We regularly review our inventory quantities in process of manufacture and on hand, and when appropriate, record a provision for obsolete and excess inventory to derive its new cost basis, which takes into account our sales forecast by product and corresponding expiry dates. Direct and indirect manufacturing costs related to the production of inventory prior to FDA approval are expensed through “research and development,” rather than being capitalized to inventory cost.

(vi) Property and Equipment

Our property and equipment is stated at historical cost, and is depreciated on a straight-line basis over an estimated useful life that corresponds with its designated asset category. We evaluate the recoverability of “long-lived assets” (which includes property and equipment) whenever events or changes in circumstances in our business indicate that the asset’s carrying amount may not be recoverable through on-going operations.

(vii) Goodwill and Intangible Assets

Our goodwill represents the excess of our business acquisition cost over the estimated fair value of the net assets acquired in the corresponding transaction. Goodwill has an indefinite accounting life and is therefore not amortized. Instead, goodwill is evaluated for impairment on an annual basis (as of each October 1st), unless we identify impairment indicators that would require earlier testing.

We evaluate the recoverability of indefinite-lived intangible assets at least annually, or whenever events or changes in our business indicate that an intangible asset’s (whether indefinite or definite-lived) carrying amount may not be recoverable. Such circumstances could include, but are not limited to the following:

(a) a significant decrease in the market value of an asset;
(b) a significant adverse change in the extent or manner in which an asset is used; or
(c) an accumulation of costs significantly in excess of the amount originally expected for the acquisition of an asset.

Intangible assets with finite useful lives are amortized over their estimated useful lives on a straight-line basis. We review these assets for potential impairment if/when facts or circumstances suggest that the carrying value of these assets may not be recoverable.

Notes to Condensed Consolidated Financial Statements
(all tabular amounts presented in thousands, except share, per share, per unit, and number of years)
(Unaudited)

(viii) Stock-Based Compensation

Stock-based compensation expense for equity awards granted to our employees and members of our board of directors is recognized on a straight-line basis over the award's vesting period. Recognized compensation expense is net of an estimated forfeiture rate, which estimates those shares expected to be forfeited prior to vesting. We use the Black-Scholes option pricing model to determine the fair value of stock options (as of the date of grant) which carry service conditions for vesting. We use the Monte Carlo valuation model to value equity awards (as of the date of grant) which carry combined market conditions and service conditions for vesting.

Calculating stock-based compensation expense requires the input of highly subjective assumptions, including the pre-vesting forfeiture rate, expected term of the stock-based awards, stock price volatility, and risk-free interest rates. We estimate the expected term of options granted based on our employees' historical exercise patterns, which we believe will be representative of their future behavior. We estimate the volatility of our common stock on the date of grant based on historical volatility of our common stock for a look-back period that corresponds with the expected term. We estimate the risk-free interest rate based upon the U.S. Treasury yields in effect at award grant, for a period equaling the stock options' expected term.

(ix) Foreign Currency Transactions and Translation

We translate the assets and liabilities of our foreign subsidiaries that are stated in their functional currencies (i.e., local operating currencies), to U.S. dollars at the rates of exchange in effect at the reported balance sheet date. Revenues and expenses are translated using the monthly average exchange rates during the reported period. Unrealized gains and losses from the translation of our subsidiaries' financial statements (that are initially denominated in the corresponding functional currency) are included as a separate component of "accumulated other comprehensive loss" in the Condensed Consolidated Balance Sheets.

We record foreign currency transactions, when initially denominated in a currency other than the respective functional currency of our subsidiary, at the prevailing exchange rate on the date of the transaction. Resulting unrealized foreign exchange gains and losses (including those associated with intercompany loans with our subsidiaries, whose functional currency is not the U.S. dollar) are included in "accumulated other comprehensive loss" in the Condensed Consolidated Balance Sheets. Beginning January 1, 2015, the unrealized foreign exchange gains and losses for certain of our intercompany loans were included in "accumulated other comprehensive loss" as they are no longer expected to be settled in the foreseeable future. In periods prior to January 1, 2015, unrealized foreign exchange gains and losses associated with intercompany loans were included in "other expense, net" in the Condensed Consolidated Statements of Operations.

(x) Basic and Diluted Net (Loss) Income per Share

We calculate basic and diluted net (loss) income per share using the weighted average number of common shares outstanding during the periods presented. In periods of a net loss, basic and diluted loss per share are the same. For the diluted earnings per share calculation, we adjust the weighted average number of common shares outstanding to include only dilutive stock options, warrants, and other common stock equivalents outstanding during the period.

(xi) Income Taxes

Deferred tax assets and liabilities are recorded based on the estimated future tax effects of temporary differences between the tax basis of assets and liabilities and amounts reported in the financial statements, as well as operating losses and tax credit carry forwards using enacted tax rates and laws that are expected to be in effect when the differences are expected to reverse. Realization of deferred tax assets is dependent upon future earnings, the timing and amount of which are uncertain.

We have recorded a valuation allowance to reduce our deferred tax assets, because we believe that, based upon a weighting of positive and negative factors, it is more likely than not that these deferred tax assets will not be realized. If/when we determine that our deferred tax assets are realizable, an adjustment to the corresponding valuation allowance would increase our net income in the period that such determination was made.

In the event that we are assessed interest and/or penalties from taxing authorities that have not been previously accrued, such amounts would be included in "provision for income taxes" within the Condensed Consolidated Statements of Operations in the period the notice was received.

Table of Contents
Notes to Condensed Consolidated Financial Statements
(all tabular amounts presented in thousands, except share, per share, per unit, and number of years)
(Unaudited)

(xii) Research and Development Costs
Our research and development costs are expensed as incurred, or as certain milestone payments become due, generally triggered by clinical or regulatory events.
(xiii) Fair Value Measurements
We determine measurement-date fair value based on the proceeds that would be received through the sale of the asset, or that we would pay to settle or transfer the liability, in an orderly transaction between market participants. We utilize valuation techniques that maximize the use of observable inputs and minimize the use of unobservable inputs to the extent possible. Fair value measurements are based on a three-tier hierarchy that prioritizes the inputs used to measure fair value. These tiers include the following:
Level 1: Quoted prices (unadjusted) in active markets for identical assets or liabilities that are publicly accessible at the measurement date.
Level 2: Observable prices that are based on inputs not quoted on active markets, but that are corroborated by market data. These inputs may include quoted prices for similar assets or liabilities or quoted market prices in markets that are not active to the general public.
Level 3: Unobservable inputs are used when little or no market data is available. The fair value hierarchy gives the lowest priority to Level 3 inputs.
“Cash and cash equivalents” within our accompanying Condensed Consolidated Balance Sheets include certificates of deposit and money market funds that are valued utilizing Level 2 inputs. “Marketable securities” consist of mutual funds that are valued utilizing Level 2 inputs.
The fair value of our “drug development liability” within our accompanying Condensed Consolidated Balance Sheets was estimated using the discounted income approach model. The unobservable inputs (i.e., Level 3 inputs) in this valuation model that have the most significant effect on these liabilities include (i) estimates of research and development personnel costs needed to perform the research and development services, (ii) estimates of expected cash outflows to third parties for services and supplies over the expected period that the services will be performed, and (iii) an appropriate discount rate for these expenditures. These inputs are reviewed for reasonableness by management on at least on a quarterly basis.
“Acquisition-related contingent obligations” within our accompanying Condensed Consolidated Balance Sheets represent future amounts we may be required to pay in conjunction with our business combinations. See Note 9(a) for a discussion of contingent value rights granted as part of our acquisition of Talon, and Note 9(b) for the fair value of the liability associated with FDA approval of EVOMELA. These liabilities are valued using Level 3 inputs and include probabilities and assumptions related to the timing and likelihood of achievement of regulatory and sales milestones.

3. BALANCE SHEET ACCOUNT DETAIL
The composition of selected financial statement captions that comprise the accompanying Condensed Consolidated Balance Sheets are summarized below:
(a) Cash and Cash Equivalents and Marketable Securities
As of March 31, 2015 and December 31, 2014, our holdings included within “cash and cash equivalents” and “marketable securities” were at major financial institutions.
Our investment policy requires that investments in marketable securities be in only highly-rated instruments, which are primarily U.S. treasury bills or U.S. treasury-backed securities, and limited investments in securities of any single issuer. We maintain cash balances in excess of federally insured limits with reputable financial institutions. To a limited degree, the Federal Deposit Insurance Corporation (FDIC) and other third parties insure these investments. However, these investments are not insured against the possibility of a complete loss of earnings or principal and are inherently subject to the credit risk related to the continued credit worthiness of the underlying issuer and general

credit market risks. We manage such risks on our portfolio by investing in highly liquid, highly rated instruments, and limit investing in long-term maturity instruments.

Table of Contents
Notes to Condensed Consolidated Financial Statements
(all tabular amounts presented in thousands, except share, per share, per unit, and number of years)
(Unaudited)

The carrying amount of our equity securities, money market funds, bank certificate of deposits ("Bank CDs"), and mutual funds approximates their fair value (utilizing Level 1 or Level 2 inputs – see Note 2(xiii)) because of our ability to immediately convert these instruments into cash with minimal expected change in value.
The following is a summary of our "cash and cash equivalents" and "marketable securities":

	Cost	Gross Unrealized Gains	Gross Unrealized Losses	Estimated fair Value	Cash and cash equivalents	Marketable Securities Current	Marketable Securities Long Term
March 31, 2015							
Bank deposits	$56,395	$—	$—	$56,395	$56,395	$—	$—
Money market funds	66,970	—	—	66,970	66,970	—	—
Bank CDs	246	—	—	246	—	246	—
Mutual funds	3,062	—	—	3,062	—	3,062	—
Total cash and equivalents and marketable securities	$126,673	$—	$—	$126,673	$123,365	$3,308	$—
December 31, 2014							
Bank deposits	$62,997	$—	$—	$62,997	$62,997	$—	$—
Money market funds	66,945	—	—	66,945	66,945	—	—
Bank CDs	244	—	—	244	—	244	—
Mutual funds	3,062	—	—	3,062	—	3,062	—
Total cash and equivalents and marketable securities	$133,248	$—	$—	$133,248	$129,942	$3,306	$—

As of March 31, 2015, none of these securities had been in a continuous unrealized loss position longer than one year.
(b) Property and Equipment
"Property and equipment, net of accumulated depreciation" consist of the following:

	March 31, 2015	December 31, 2014
Computer hardware and software	$3,705	$3,616
Laboratory equipment	657	643
Office furniture	347	344
Leasehold improvements	2,860	2,847
Property and equipment, at cost	7,569	7,450
(Less): Accumulated depreciation	(6,256)	(6,045)
Property and equipment, net of accumulated depreciation	$1,313	$1,405

Depreciation expense (included within "operating costs and expenses" in the accompanying Condensed Consolidated Statements of Operations) for the three months ended March 31, 2015 and 2014, was $0.2 million and $0.3 million in each period.

(c) Inventories
"Inventories" consist of the following:

	March 31, 2015	December 31, 2014
Raw materials	$1,054	$1,507
Work-in-process*	5,018	3,979
Finished goods	3,007	3,714
Inventories	$9,079	$9,200

13

Notes to Condensed Consolidated Financial Statements
(all tabular amounts presented in thousands, except share, per share, per unit, and number of years)
(Unaudited)

*We have contractual commitments to receive $6.4 million of raw materials for the future manufacture of ZEVALIN (representing strategic long-term supply), with expected delivery in the fourth quarter of 2015. Inventory at March 31, 2015 includes $0.8 million of ZEVALIN work-in-progress inventory (representing packaged, but unlabeled vials) with expiry in December 2017. We expect to sell this existing and committed ZEVALIN inventory over the next few years. However, if our forecasted ZEVALIN sales or production strategy changes, it could result in a charge in that period to “cost of product sales (excludes amortization of intangible assets)” within the Condensed Consolidated Statements of Operations.

(d) Other receivables

“Other receivables” consist of the (i) amounts we expect to be refunded from taxing authorities for our income taxes paid, primarily relating to fiscal year 2012, (ii) amounts we expect to be reimbursed from certain third-parties for incurred research and development expenses, and (iii) legal expenses to be reimbursed from our insurance carrier.

	March 31, 2015	December 31, 2014
Income tax receivable	$1,658	$1,387
Reimbursements due from insurance carrier (see Note 15)	1,746	—
Research and development expenses - reimbursements due	4,510	4,102
Other receivables	$7,914	$5,489

(e) Intangible Assets and Goodwill

“Intangible assets, net of accumulated amortization” consist of the following:

	March 31, 2015						
	Historical Cost	Accumulated Amortization	Foreign Currency Translation	Impairment	Net Amount	Full Amortization Period (months)	Remaining Amortization Period (months)
MARQIBO IPR&D (NHL indication)	$17,600	$—	$—	$—	$17,600	n/a	n/a
EVOMELA IPR&D	7,700	—	—	—	7,700	n/a	n/a
BELEODAQ distribution rights	25,000	(1,407)	—	—	23,593	160	151
MARQIBO distribution rights	26,900	(5,304)	—	—	21,596	81	60
FOLOTYN distribution rights	118,400	(22,391)	—	—	96,009	152	122
ZEVALIN distribution rights – U.S.	41,900	(28,002)					
Net income	$ 588	$ (23)	$ 3	$ 4	$ 572		
Net income attributable to noncontrolling interests	(6)				(6)		
Net income attributable to L-3	$ 582	$ (23)	$ 3	$ 4	$ 566		

Earnings per share attributable to L-3 Holdings common shareholders:										
Basic	$	6.47	$	(0.25)	$	0.04	$	0.04	$	6.30
Diluted	$	6.37	$	(0.25)	$	0.04	$	0.04	$	6.20
Cash dividends paid per common share	$	1.65	$		$		$		$	1.65
L-3 Holdings weighted average common shares outstanding:										
Basic		89.9								89.9
Diluted		91.3								91.3

(1) Includes rounding of $1 million.

Table of Contents

L-3 COMMUNICATIONS HOLDINGS, INC.

AND L-3 COMMUNICATIONS CORPORATION

NOTES TO UNAUDITED CONDENSED CONSOLIDATED

FINANCIAL STATEMENTS (continued)

	As Previously Reported	Net Adjustments (in millions)	As Revised
Unaudited Consolidated Statement of Cash Flows for the Year-to-Date Period Ended September 27, 2013:			
Operating activities:			
Net income	$ 588	$ (16)	$ 572
Depreciation of property, plant and equipment	122		122
Amortization of intangibles and other assets	36		36
Deferred income tax provision	45	(7)	38
Stock-based employee compensation expense	42		42
Contributions to employee savings plans in L-3 Holdings common stock	90		90
Amortization of pension and postretirement benefit plans net loss and prior service cost	63		63
Amortization of bond discounts and deferred debt issue costs (included in interest expense)	5		5
Other non-cash items	1		1
Changes in operating assets and liabilities, excluding amounts from acquisitions and divestitures:			
Billed receivables	(117)		(117)
Contracts in process	(36)	(34)	(70)
Inventories	(55)	(5)	(60)
Other assets	(45)	(3)	(48)
Accounts payable, trade	65	(11)	54
Accrued employment costs	27	10	37
Accrued expenses	(41)	(4)	(45)
Advance payments and billings in excess of costs incurred	(109)	48	(61)
Income taxes	32	(1)	31
Excess income tax benefits related to share-based payment arrangements	(3)		(3)
Other current liabilities	(8)	3	(5)
Pension and postretirement benefits	(23)		(23)
All other operating activities	(62)	20	(42)
Net cash from operating activities	$ 617	$	$ 617

4. Recently Issued Accounting Standards

Effective January 1, 2014, the Company adopted Financial Accounting Standards Board (FASB) issued amendments to an accounting standard that require an unrecognized tax benefit or portion of an unrecognized tax benefit to be presented as a reduction to a deferred tax asset for a net operating loss carryforward, a similar tax loss, or a tax credit carryforward, except when certain conditions exist. The adoption of this standard did not impact the Company s financial position, results of operations or cash flows.

In June 2014, the FASB issued Accounting Standard Update (ASU) 2014-12, which provides new guidance on accounting for share-based payments when the terms of an award provide that a performance target could be achieved after the requisite service period. The update requires a reporting entity to treat a performance target

Table of Contents

L-3 COMMUNICATIONS HOLDINGS, INC.

AND L-3 COMMUNICATIONS CORPORATION

NOTES TO UNAUDITED CONDENSED CONSOLIDATED

FINANCIAL STATEMENTS (continued)

that affects vesting and that could be achieved after the requisite service period as a performance condition under ASC 718 *Compensation Stock Compensation*, and apply existing guidance as it relates to awards with performance conditions that affect vesting to account for such awards. The update is effective for the Company for the interim and annual periods beginning after December 15, 2015. The Company is currently evaluating the impact of the adoption of this standard, if any, on our consolidated financial statements.

In May 2014, the FASB issued ASU 2014-09, *Revenue from Contracts with Customers*, which will replace numerous requirements in U.S. GAAP, including industry-specific requirements, and provide companies with a single revenue recognition model for recognizing revenue from contracts with customers. One of the core principles of the new standard is that a company should recognize revenue based on the satisfaction of performance obligations, which depicts the transfer of promised goods or services to customers in an amount that reflects the consideration to which the company expects to be entitled in exchange for those goods or services. The new standard will be effective for the Company for interim and annual reporting periods beginning January 1, 2017. The two permitted transition methods under the new standard are the full retrospective method, in which case the standard would be applied to each prior reporting period presented, or the modified retrospective method, in which case the cumulative effect of applying the standard would be recognized at the date of initial application. The Company is currently evaluating the expected impact of the adoption of this standard on its consolidated financial statements and the transition alternatives available.

In April 2014, the FASB issued an accounting standards update that provides new guidance on the accounting and reporting of discontinued operations. Under the new guidance, only disposals representing a strategic shift in operations should be presented as discontinued operations. Those strategic shifts should have a major effect on the organization s operations and financial results. Additionally, the new guidance requires additional disclosures about discontinued operations. The update is effective for the Company for interim and annual periods beginning January 1, 2015. The adoption of this standard is not expected to impact the Company s financial position, results of operations or cash flows and will only affect the treatment of future discontinued operations.

5. Acquisitions

The business acquisitions discussed below are included in the Company s results of operations from their respective dates of acquisition.

2014 Business Acquisition

On March 4, 2014, the Company acquired Data Tactics Corporation, renamed L-3 Data Tactics, for a purchase price of $57 million, which was financed with cash on hand. The purchase price is subject to adjustment based on closing date net working capital. L-3 Data Tactics is a specialized provider of large-scale data analytics, cybersecurity and cloud computing solution services, primarily to the DoD. Based on the preliminary purchase price, the aggregate goodwill recognized for this business was $39 million, most of which is expected to be deductible for income tax purposes. The goodwill was assigned to the NSS reportable segment. The final purchase price allocation, which is expected to be completed in the fourth quarter of 2014, will be based on the final purchase price and final appraisals and other analysis of fair values of acquired assets and liabilities. The Company does not expect that differences between the preliminary and final purchase price allocations will have a material impact on its results of operations or financial position.

Table of Contents

L-3 COMMUNICATIONS HOLDINGS, INC.

AND L-3 COMMUNICATIONS CORPORATION

NOTES TO UNAUDITED CONDENSED CONSOLIDATED

FINANCIAL STATEMENTS (continued)

2013 Business Acquisition

On December 19, 2013, the Company acquired Mustang Technology Group, L.P. (Mustang) business for a purchase price of $54 million, which was financed with cash on hand. The purchase price and purchase price allocation for Mustang was finalized as of June 27, 2014, with no significant changes from preliminary amounts. Mustang develops and manufactures radar-based sensors and systems used in precision-guided weapons, electronic warfare, unmanned systems and other military applications. Based on the final purchase price allocation, the aggregate goodwill recognized for this business was $41 million, most of which is expected to be deductible for income tax purposes. The goodwill was assigned to the Electronic Systems reportable segment.

Unaudited Pro Forma Statements of Operations Data

The following unaudited pro forma Statements of Operations data present the combined results of the Company and its business acquisitions completed during the year-to-date period ended September 26, 2014 and the year ended December 31, 2013, in each case assuming that the business acquisitions completed during these periods had occurred on January 1, 2013.

	Third Quarter Ended		Year-to-Date Ended	
	September 26, 2014	September 27, 2013	September 26, 2014	September 27, 2013
	(in millions, except per share data)			
Pro forma net sales	$ 2,940	$ 3,025	$ 8,923	$ 9,450
Pro forma net income attributable to L-3	$ 154	$ 200	$ 460	$ 567
Pro forma diluted earnings per share	$ 1.78	$ 2.19	$ 5.20	$ 6.21

The unaudited pro forma results disclosed in the table above are based on various assumptions and are not necessarily indicative of the results of operations that would have occurred had the Company completed these acquisitions on January 1, 2013.

6. Contracts in Process

The components of contracts in process are presented in the table below.

	September 26, 2014	December 31, 2013

	(in millions)	
Unbilled contract receivables, gross	$ 2,449	$ 2,502
Unliquidated progress payments	(900)	(1,035)
Unbilled contract receivables, net	1,549	1,467
Inventoried contract costs, gross	1,069	1,044
Unliquidated progress payments	(72)	(80)
Inventoried contract costs, net	997	964
Total contracts in process	$ 2,546	$ 2,431

Inventoried Contract Costs. In accordance with contract accounting standards, the Company s U.S. Government contractor businesses account for the portion of their general and administrative (G&A),

17

Table of Contents

L-3 COMMUNICATIONS HOLDINGS, INC.

AND L-3 COMMUNICATIONS CORPORATION

NOTES TO UNAUDITED CONDENSED CONSOLIDATED

FINANCIAL STATEMENTS (continued)

independent research and development (IRAD) and bids and proposal (B&P) costs that are allowable and reimbursable indirect contract costs under U.S. Government procurement regulations on their U.S. Government contracts (revenue arrangements) as inventoried contract costs. G&A, IRAD and B&P costs are allocated to contracts for which the U.S. Government is the end customer and are charged to costs of sales when sales on the related contracts are recognized. The Company s U.S. Government contractor businesses record the unallowable portion of their G&A, IRAD and B&P costs to expense as incurred, and do not include them in inventoried contract costs.

The table below presents a summary of G&A, IRAD and B&P costs included in inventoried contract costs and the changes to them, including amounts charged to cost of sales by the Company s U.S. Government contractor businesses for the periods presented.

	Third Quarter Ended		Year-to-Date Ended	
	September 26, 2014	September 27, 2013	September 26, 2014	September 27, 2013
	(in millions)			
Amounts included in inventoried contract costs at beginning of the period:	$ 151	$ 115	$ 138	$ 110
IRAD and B&P costs	70	66	215	219
Other G&A costs	239	216	658	653
Total contract costs incurred	309	282	873	872
Amounts charged to cost of sales	(309)	(271)	(860)	(856)
Amounts included in inventoried contract costs at end of the period	$ 151	$ 126	$ 151	$ 126

The table below presents a summary of selling, general and administrative expenses and research and development expenses for the Company s commercial businesses, which are expensed as incurred and not included in inventoried contract costs.

	Third Quarter Ended		Year-to-Date Ended	
	September 26, 2014	September 27, 2013	September 26, 2014	September 27, 2013

		(in millions)		
Selling, general and administrative expenses	$ 70	$ 70	$ 213	$ 214
Research and development expenses	14	17	48	62
Total	$ 84	$ 87	$ 261	$ 276

Table of Contents

L-3 COMMUNICATIONS HOLDINGS, INC.

AND L-3 COMMUNICATIONS CORPORATION

NOTES TO UNAUDITED CONDENSED CONSOLIDATED

FINANCIAL STATEMENTS (continued)

7. Inventories

Inventories at Lower of Cost or Market. The table below presents the components of inventories at the lower of cost (first-in, first-out or average cost) or realizable value.

	September 26, 2014	December 31, 2013
	(in millions)	
Raw materials, components and sub-assemblies	$ 156	$ 160
Work in process	137	125
Finished goods	78	74
Total	$ 371	$ 359

8. Goodwill and Identifiable Intangible Assets

Goodwill. In accordance with the accounting standards for business combinations, the Company records the assets acquired and liabilities assumed based on their estimated fair values at the date of acquisition (commonly referred to as the purchase price allocation). The table below presents the changes in goodwill by segment for the year-to-date period ended September 26, 2014.

	Electronic Systems	Aerospace Systems	Communication Systems	NSS	Consolidated Total
			(in millions)		
Balance at December 31, 2013	$ 4,085	$ 1,751	$ 992	$ 968	$ 7,796
Business acquisition[1]	(3)			39	36
Foreign currency translation adjustments[2]	(39)	(9)			(48)
Balance at September 26, 2014	$ 4,043	$ 1,742	$ 992	$ 1,007	$ 7,784

(1)

The decrease in goodwill for the Electronic Systems segment was due to the final purchase price allocation for the Mustang business acquisition. The increase in goodwill for the NSS segment was due to the L-3 Data Tactics business acquisition.

(2) The decrease in goodwill presented in the Electronic Systems segment was primarily due to the strengthening of the U.S. dollar against the Euro, the Canadian dollar and the British pound during the year-to-date period ended September 26, 2014. The decrease in goodwill presented in the Aerospace Systems segment was due to the strengthening of the U.S. dollar against the Canadian dollar during the year-to-date period ended September 26, 2014.

The Company s accumulated goodwill impairment losses were $58 million at September 26, 2014 and December 31, 2013, of which $43 million and $15 million were recorded in the Electronic Systems and Communication Systems segments, respectively.

Table of Contents

L-3 COMMUNICATIONS HOLDINGS, INC.

AND L-3 COMMUNICATIONS CORPORATION

NOTES TO UNAUDITED CONDENSED CONSOLIDATED

FINANCIAL STATEMENTS (continued)

Identifiable Intangible Assets. The table below presents information for the Company s identifiable intangible assets that are subject to amortization.

		September 26, 2014			December 31, 2013		
	Weighted Average Amortization Period (in years)	Gross Carrying Amount	Accumulated Amortization	Net Carrying Amount	Gross Carrying Amount	Accumulated Amortization	Net Carrying Amount
				(in millions)			
Customer contractual relationships	19	$ 474	$ 275	$ 199	$ 466	$ 253	$ 213
Technology	11	168	115	53	168	108	60
Other	18	27	16	11	27	15	12
Total	17	$ 669	$ 406	$ 263	$ 661	$ 376	$ 285

The table below presents amortization expense recorded by the Company for its identifiable intangible assets.

	Third Quarter Ended		Year-to-Date Ended	
	(in millions)			
	September 26, 2014	September 27, 2013	September 26, 2014	September 27, 2013
Amortization Expense	$ 11	$ 10	$ 32	$ 29

Based on gross carrying amounts at September 26, 2014, the Company s estimate of amortization expense for identifiable intangible assets for the years ending December 31, 2014 through 2018 is presented in the table below.

	Year Ending December 31,				
	2014	2015	2016	2017	2018
	(in millions)				
Estimated amortization expense	$ 42	$ 41	$ 34	$ 32	$ 26

9. Other Current Liabilities and Other Liabilities

The table below presents the components of other current liabilities.

	September 26, 2014	December 31, 2013
	(in millions)	
Other Current Liabilities:		
Accruals for pending and threatened litigation (see Note 18)	$ 7	$ 6
Accrued product warranty costs	79	75
Estimated costs in excess of estimated contract value to complete contracts in process in a loss position	71	78
Accrued interest	52	52
Deferred revenues	36	35
Notes payable and capital lease obligation	16	10
Other	105	127
Total other current liabilities	$ 366	$ 383

20

Table of Contents

L-3 COMMUNICATIONS HOLDINGS, INC.

AND L-3 COMMUNICATIONS CORPORATION

NOTES TO UNAUDITED CONDENSED CONSOLIDATED

FINANCIAL STATEMENTS (continued)

The table below presents the components of other liabilities.

	September 26, 2014	December 31, 2013
	(in millions)	
Other Liabilities:		
Non-current income taxes payable (see Note 11)	$ 193	$ 177
Deferred compensation	46	45
Accrued workers compensation	40	46
Accrued product warranty costs	26	24
Notes payable and capital lease obligations	2	15
Other	92	99
Total other liabilities	$ 399	$ 406

The table below presents the changes in the Company s accrued product warranty costs.

	Year-to-Date Ended	
	September 26, 2014	September 27, 2013
	(in millions)	
Accrued product warranty costs:[1]		
Balance at January 1	$ 99	$ 99
Accruals for product warranties issued during the period	53	56
Settlements made during the period	(46)	(56)
Foreign currency translation adjustments	(1)	
Balance at end of period	$ 105	$ 99

(1) Warranty obligations incurred in connection with long-term production contracts that are accounted for under the POC cost-to-cost method are included within the contract estimates at completion and are excluded from the above amounts. The balances above include both the current and non-current amounts.

21

Table of Contents

L-3 COMMUNICATIONS HOLDINGS, INC.

AND L-3 COMMUNICATIONS CORPORATION

NOTES TO UNAUDITED CONDENSED CONSOLIDATED

FINANCIAL STATEMENTS (continued)

10. Debt

The components of debt and a reconciliation to the carrying amount of long-term debt is presented in the table below.

	September 26, 2014	December 31, 2013
	(in millions)	
L-3 Communications:		
Borrowings under Amended and Restated Revolving Credit Facility[1]	$	$
3.95% Senior Notes due 2016	500	500
1.50% Senior Notes due 2017	350	
5.20% Senior Notes due 2019	1,000	1,000
4.75% Senior Notes due 2020	800	800
4.95% Senior Notes due 2021	650	650
3.95% Senior Notes due 2024	650	
Subtotal	3,950	2,950
L-3 Holdings:		
3% Convertible Contingent Debt Securities due 2035 (CODES)		689
Principal amount of long-term debt	3,950	3,639
Unamortized discounts	(12)	(9)
Carrying amount of long-term debt	$ 3,938	$ 3,630

[1] During the year-to-date period ended September 26, 2014, L-3 Communications aggregate borrowings and repayments under the Amended and Restated Revolving Credit Facility were $1,367 million. At September 26, 2014, L-3 Communications had the availability of all of its $1 billion Amended and Restated Revolving Credit Facility, which expires on February 3, 2017.

L-3 Communications

Senior Notes: On May 28, 2014, L-3 Communications issued two series of Senior Notes, which are unsecured senior obligations of L-3 Communications. The terms of each series of Senior Notes are presented in the table below.

Note	Date of Issuance	Amount Issued	Bond Discount[1]	Net Cash Proceeds[2]	Effective Interest Rate	Redemption at Treasury Rate[3][4]
		(in millions)				
1.50% Senior Notes due May 28, 2017 (2017 Notes)	May 28, 2014	$ 350	$ 1	$ 347	1.55%	10 bps
3.95% Senior Notes due May 28, 2024 (2024 Notes)	May 28, 2014	$ 650	$ 3	$ 641	4.02%	20 bps

(1) Bond discounts are recorded as a reduction to the principal amount of the notes and are amortized as interest expense over the term of the notes.

(2) The net cash proceeds of $988 million (after deduction of the bond discount, underwriting expenses and commissions and other related expenses) were used primarily to fund the CODES Retirement as discussed below. The remaining net proceeds are available for general corporate purposes.

Table of Contents

L-3 COMMUNICATIONS HOLDINGS, INC.

AND L-3 COMMUNICATIONS CORPORATION

NOTES TO UNAUDITED CONDENSED CONSOLIDATED

FINANCIAL STATEMENTS (continued)

(3) The 2017 Senior Notes may be redeemed at any time prior to their maturity and the 2024 Notes may be redeemed at any time prior to February 28, 2024 (three months prior to their maturity) at the option of L-3 Communications, in whole or in part, at a redemption price equal to the greater of (1) 100% of the principal amount, or (2) the present value of the remaining principal and interest payments discounted to the date of redemption, on a semi-annual basis, at the Treasury Rate (as defined in the Indentures governing the Senior Notes), plus the spread indicated in the table above. In addition, if the 2024 Senior Notes are redeemed at any time on or after February 28, 2024, the redemption price would be equal to 100% of the principal amount.

(4) Upon the occurrence of a change in control (as defined in the Indentures governing the Senior Notes), each holder of the notes will have the right to require L-3 Communications to repurchase all or any part of such holder s notes at a price in cash equal to 101% of the aggregate principal amount plus accrued and unpaid interest, if any, but not including, the date of purchase.

L-3 Holdings

On May 13, 2014, the Company called for full the redemption of all of its outstanding CODES effective on June 2, 2014 (the Redemption Date). The redemption price for the CODES was $1,000 per $1,000 principal amount of the CODES, plus accrued and unpaid interest to, but excluding, the Redemption Date. Holders of the CODES were entitled to convert all or a portion thereof (in integral multiples of $1,000) at any time prior to the close of business on the business day immediately preceding the Redemption Date (the Redemption Conversion Period). The conversion value of CODES of $935 million was calculated in accordance with the indenture governing the CODES based on the closing sales price of L-3 Holdings common stock and the conversion rate for each trading day in the 20 trading day period as follows: (1) for conversion notices received by May 16, 2014 (5 p.m.), the 20 trading day conversion period began on the third trading day following receipt of the conversion notice and (2) for conversion notices received after that time, the 20 trading day conversion period began on May 2, 2014 and ended on May 30, 2014, the trading day immediately preceding the Redemption Date. The Company settled the entire conversion value with respect to converted CODES in cash. As of June 27, 2014, the CODES were retired. As a result of the conversion, the Company recorded a reduction to shareholders equity of $160 million related to the excess conversion value over the fair value of the debt component of the CODES, net of deferred tax liability.

Interest expense recognized for the CODES was $2 million for the year-to-date period ended September 26, 2014 and $5 million and $15 million for the quarterly and year-to-date periods ended September 27, 2013.

11. Income Taxes

The Company and its subsidiaries file income tax returns in the U.S. Federal jurisdiction and various state and foreign jurisdictions. As of September 26, 2014, the statutes of limitations for the Company s U.S. Federal income tax returns for the years ended December 31, 2010 through 2013 were open. The U.S. Internal Revenue Service (IRS) commenced audits of the Company s U.S. Federal income tax returns for 2011 and 2010. The Company cannot predict the outcome of the audits at this time.

The effective tax rate for the year-to-date period ended September 26, 2014 increased to 29.5% from 27.5% for the year-to-date period ended September 27, 2013. The increase was primarily due to a tax benefit in the year-to-date period ended September 27, 2013 of $28 million related to the retroactive reinstatement in January 2013 of the U.S. Federal research and experimentation tax credit for 2012 and 2013, which did not recur in 2014 and the reversal of previously accrued amounts of $10 million in the quarterly period ended September 27, 2013 for the expiration of the statutes of limitations for several tax returns.

Table of Contents

L-3 COMMUNICATIONS HOLDINGS, INC.

AND L-3 COMMUNICATIONS CORPORATION

NOTES TO UNAUDITED CONDENSED CONSOLIDATED

FINANCIAL STATEMENTS (continued)

As of September 26, 2014, the Company anticipates that unrecognized tax benefits will decrease by approximately $20 million over the next 12 months due to the potential resolution of unrecognized tax benefits involving several jurisdictions and tax periods. The actual amount of the decrease over the next 12 months could vary significantly depending on the ultimate timing and nature of any settlement.

Non-current income taxes payable include accrued potential interest of $14 million ($8 million after income taxes) at September 26, 2014 and $11 million ($7 million after income taxes) at December 31, 2013, and potential penalties of $8 million at both September 26, 2014 and December 31, 2013.

12. Amounts Reclassified Out of Accumulated Other Comprehensive (Loss) Income

The amounts reclassified from Accumulated Other Comprehensive (Loss) Income (AOCI) for the year-to-date periods ended September 26, 2014 and September 27, 2013 are presented in the table below.

	Foreign currency translation	Unrealized gains (losses) on hedging instruments	Unrecognized (losses) and prior service cost, net	Total accumulated other comprehensive (loss) income
		(in millions)		
Balance at December 31, 2012	$ 167	$ 3	$ (720)	$ (550)
Other comprehensive loss before reclassifications, net of tax	(18)	(2)		(20)
Amounts reclassified from other comprehensive income, net of tax		1	40	41
Net current period other comprehensive (loss) income	$ (18)	$ (1)	$ 40	$ 21
Balance at September 27, 2013	$ 149	$ 2	$ (680)	$ (529)
Balance at December 31, 2013	$ 142	$ 1	$ (253)	$ (110)
Other comprehensive income before reclassifications, net of tax	(57)	5		(52)
		(5)	7	2

Amounts reclassified from other comprehensive (loss) income, net of tax				
Net current period other comprehensive income	(57)		7	(50)
Balance at September 26, 2014	$ 85	$ 1	$ (246)	$ (160)

24

Table of Contents

L-3 COMMUNICATIONS HOLDINGS, INC.

AND L-3 COMMUNICATIONS CORPORATION

NOTES TO UNAUDITED CONDENSED CONSOLIDATED

FINANCIAL STATEMENTS (continued)

Further details regarding the amounts reclassified from AOCI for the quarterly and year-to-date periods ended September 26, 2014 and September 27, 2013 are presented in the table below.

Details About AOCI Components	Amount Reclassified from AOCI: Third Quarter Ended September 26, 2014	Third Quarter Ended September 27, 2013	Year-to-Date Ended September 26, 2014	Year-to-Date Ended September 27, 2013	Affected Line Item in the Unaudited Condensed Consolidated Statements of Operations
	(in millions)				
Gain (loss) on hedging instruments	$ 1	$	$ (6)	$ 1	Cost of sales-products
	1		(6)	1	Income before income taxes
	(1)		1		Benefit (Provision) for income taxes
	$	$	$ (5)	$ 1	Net income
Amortization of defined benefit pension items:					
Net loss	$ 3	$ 20	$ 11	$ 63	(a)
	3	20	11	63	Income before income taxes
	(1)	(7)	(4)	(23)	Provision for income taxes
	$ 2	$ 13	$ 7	$ 40	Net Income
Total reclassification for the period	$ 2	$ 13	$ 2	$ 41	Net Income

(a) Amounts related to pension and postretirement benefit plans were reclassified from AOCI and recorded as a component of net periodic benefit cost (see Note 19 for additional information).

13. Equity

On February 5, 2013, L-3 Holdings Board of Directors approved a share repurchase program that authorizes L-3 Holdings to repurchase up to $1.5 billion of its common stock through June 30, 2015. Repurchases of L-3 Holdings common stock under the share repurchase program are made at management s discretion in accordance with applicable U.S. Federal securities laws in the open market or otherwise. The timing and actual number of shares to be repurchased in the future will depend on a variety of factors, including, but not limited to, the Company s financial position, earnings, legal requirements, other investment opportunities (including acquisitions) and market conditions. L-3 Holdings repurchased 3.6 million shares of its common stock at an average price of $115.91 per share for an aggregate amount of $413 million from January 1, 2014 through September 26, 2014. All share repurchases of L-3 Holdings common stock have been recorded as treasury shares.

At September 26, 2014, the remaining dollar value of authorization under the share repurchase program was $455 million.

On June 24, 2014, L-3 Holdings Board of Directors declared a cash dividend of $0.60 per share, which resulted in the Company paying total cash dividends of $51 million on September 15, 2014. Also, on October 20, 2014, L-3 Holdings Board of Directors declared a quarterly cash dividend of $0.60 per share, payable on December 15, 2014, to shareholders of record at the close of business on November 17, 2014.

Table of Contents

L-3 COMMUNICATIONS HOLDINGS, INC.

AND L-3 COMMUNICATIONS CORPORATION

NOTES TO UNAUDITED CONDENSED CONSOLIDATED

FINANCIAL STATEMENTS (continued)

14. L-3 Holdings Earnings Per Common Share

A reconciliation of basic and diluted earnings per share (EPS) is presented in the table below.

	Third Quarter Ended		Year-to-Date Ended	
	September 26, 2014	September 27, 2013	September 26, 2014	September 27, 2013
	(in millions, except per share data)			
Reconciliation of net income:				
Net income	$ 157	$ 204	$ 470	$ 572
Net income attributable to noncontrolling interests	(3)	(4)	(9)	(6)
Net income attributable to L-3 Holdings common shareholders	$ 154	$ 200	$ 461	$ 566
Earnings per share attributable to L-3 Holdings common shareholders:				
Basic:				
Weighted average common shares outstanding	85.1	89.6	85.7	89.9
Basic earnings per share:				
Net income	$ 1.81	$ 2.23	$ 5.38	$ 6.30
Diluted:				
Common and potential common shares:				
Weighted average common shares outstanding	85.1	89.6	85.7	89.9
Assumed exercise of stock options	2.8	4.7	3.0	3.9
Unvested restricted stock awards	1.5	1.8	1.6	1.8
Employee stock purchase plan contributions		0.2	0.1	0.2
Performance unit awards	0.1	0.1	0.1	0.1
Assumed purchase of common shares for treasury	(2.9)	(5.2)	(3.2)	(4.7)

Assumed conversion of the CODES[1]		0.1	1.1	0.1
Common and potential common shares	86.6	91.3	88.4	91.3
Diluted earnings per share:				
Net income	$ 1.78	$ 2.19	$ 5.21	$ 6.20

[1] As of June 18, 2014, the final date of conversion, the conversion price during the year-to-date period ended June 27, 2014 was $88.71. Although the CODES were retired during the year-to-date period ended June 27, 2014, they were dilutive for the year-to-date period ended September 26, 2014 as the average market price of L-3 Holdings common stock during the period that the CODES were outstanding was greater than the price at which the CODES would have been convertible into L-3 Holdings common stock. See Note 10 regarding the retirement of the CODES.

26

Table of Contents

L-3 COMMUNICATIONS HOLDINGS, INC.

AND L-3 COMMUNICATIONS CORPORATION

NOTES TO UNAUDITED CONDENSED CONSOLIDATED

FINANCIAL STATEMENTS (continued)

The computation of diluted EPS excluded shares for stock options and employee stock purchase plan contributions of 0.6 million and 0.5 million for the quarterly and year-to-date periods ended September 26, 2014, respectively, and shares for stock options of 1.2 million for the year-to-date period ended September 27, 2013, as they were anti-dilutive.

15. Fair Value Measurements

The following table presents the fair value hierarchy level for each of the Company s assets and liabilities that are measured and recorded at fair value on a recurring basis.

Description	September 26, 2014			December 31, 2013		
	Level 1[(1)]	Level 2[(2)]	Level 3[(3)]	Level 1[(1)]	Level 2[(2)]	Level 3[(3)]
	(in millions)					
Assets						
Cash equivalents	$ 359	$	$	$ 299	$	$
Derivatives (foreign currency forward contracts)		5			6	
Total assets	$ 359	$ 5	$	$ 299	$ 6	$
Liabilities						
Derivatives (foreign currency forward contracts)	$	$ 4	$	$	$ 5	$

(1) Level 1 is based on quoted market prices available in active markets for identical assets or liabilities as of the reporting date. Cash equivalents are primarily held in registered money market funds, which are valued using quoted market prices.

(2) Level 2 is based on pricing inputs other than quoted prices in active markets, which are either directly or indirectly observable. The fair value is determined using a valuation model based on observable market inputs, including quoted foreign currency forward exchange rates and consideration of non-performance risk.

(3)

Level 3 is based on pricing inputs that are not observable and not corroborated by market data. The Company has no Level 3 assets or liabilities.

16. Financial Instruments

At September 26, 2014 and December 31, 2013, the Company s financial instruments consisted primarily of cash and cash equivalents, billed receivables, trade accounts payable, Senior Notes, CODES and foreign currency forward contracts. The carrying amounts of cash and cash equivalents, billed receivables and trade accounts payable are representative of their respective fair values because of their short-term maturities or the expected settlement dates of these instruments. The carrying amounts and estimated fair values of the Company s other financial instruments are presented in the table below.

	September 26, 2014		December 31, 2013	
	Carrying Amount	Estimated Fair Value	Carrying Amount	Estimated Fair Value
		(in millions)		
Senior Notes[1]	$ 3,938	$ 4,181	$ 2,941	$ 3,121
CODES[1]			689	830
Foreign currency forward contracts[2]	1	1	1	1

(1) The Company measures the fair value of its Senior Notes (and its CODES prior to their redemption) using Level 2 inputs based primarily on current market yields for its existing debt traded in the secondary market.

(2) See Note 17 for additional disclosures regarding the notional amounts and fair values of foreign currency forward contracts.

L-3 COMMUNICATIONS HOLDINGS, INC.

AND L-3 COMMUNICATIONS CORPORATION

NOTES TO UNAUDITED CONDENSED CONSOLIDATED

FINANCIAL STATEMENTS (continued)

17. Derivative Financial Instruments

The Company s derivative financial instruments include foreign currency forward contracts, which are entered into for risk management purposes, and an embedded derivative, at December 31, 2013, representing the contingent interest payment provision related to the CODES.

Foreign Currency Forward Contracts. The Company s U.S. and foreign businesses enter into contracts with customers, subcontractors or vendors that are denominated in currencies other than their functional currencies. To protect the functional currency equivalent cash flows associated with certain of these contracts, the Company enters into foreign currency forward contracts. The Company s activities involving foreign currency forward contracts are designed to hedge the changes in the functional currency equivalent cash flows due to movements in foreign exchange rates compared to the functional currency. The foreign currencies hedged are primarily the Canadian dollar, the U.S. dollar, the Euro, and the British pound. The Company manages exposure to counterparty non-performance credit risk by entering into foreign currency forward contracts with major financial institutions that are expected to fully perform under the terms of such contracts. Foreign currency forward contracts are recorded in the Company s condensed consolidated balance sheets at fair value and are generally designated and accounted for as cash flow hedges in accordance with the accounting standards for derivative instruments and hedging activities. Gains and losses on designated foreign currency forward contracts that are highly effective in offsetting the corresponding change in the cash flows of the hedged transactions are recorded net of income taxes in AOCI and then recognized in income when the underlying hedged transaction affects income. Gains and losses on foreign currency forward contracts that do not meet hedge accounting criteria are recognized in income immediately. Notional amounts are used to measure the volume of foreign currency forward contracts and do not represent exposure to foreign currency losses. The table below presents the notional amounts of the Company s outstanding foreign currency forward contracts by currency at September 26, 2014.

Currency	**Notional Amounts (in millions)**	
Canadian dollar	$	161
U.S. dollar		101
Euro		66
British pound		9
Total	$	337

At September 26, 2014, the Company s foreign currency forward contracts had maturities through 2018.

28

L-3 COMMUNICATIONS HOLDINGS, INC.

AND L-3 COMMUNICATIONS CORPORATION

NOTES TO UNAUDITED CONDENSED CONSOLIDATED

FINANCIAL STATEMENTS (continued)

The table below presents the location of the Company s derivative instruments recorded at fair value on the condensed consolidated balance sheets.

	September 26, 2014				December 31, 2013			
	Other Current Assets	Other Assets	Other Current Liabilities	Other Liabilities	Other Current Assets	Other Assets	Other Current Liabilities	Other Liabilities
				(in millions)				
Derivatives designated as hedging instruments:								
Foreign currency forward contracts[1]	$ 4	$ 1	$ 3	$ 1	$ 5	$ 1	$ 3	$ 2
Derivatives not designated as hedging instruments:								
Foreign currency forward contracts[1]								
Embedded derivative related to the CODES[2]								
Total derivative instruments	$ 4	$ 1	$ 3	$ 1	$ 5	$ 1	$ 3	$ 2

(1) See Note 15 for a description of the fair value hierarchy related to the Company s foreign currency forward contracts.

(2) See Note 10 for a description of the CODES Retirement.

The effect of gains or losses from foreign currency forward contracts was not material to the unaudited condensed consolidated statements of operations for the quarterly or year-to-date periods ended September 26, 2014 and September 27, 2013. At September 26, 2014, the estimated amount of existing losses that are expected to be reclassified into income within the next 12 months is less than $1 million.

18. Commitments and Contingencies

Guarantees

In connection with the spin-off of Engility Holdings, Inc. (Engility), L-3 entered into a Distribution Agreement and several other agreements that govern certain aspects of L-3 s relationship with Engility, including employee matters, tax matters, transition services, and the future supplier/customer relationship between L-3 and Engility. These agreements generally provide cross-indemnities that, except as otherwise provided, are principally designed to place the financial responsibility for the obligations and liabilities of each entity with that respective entity. Engility has joint and several liability with L-3 to the U.S. Internal Revenue Service (IRS) for the consolidated U.S. Federal income taxes of L-3 s consolidated group for taxable periods in which Engility was a part of that group. However, the Tax Matters Agreement specifies the portion of this tax liability for which L-3 and Engility will each bear responsibility, and L-3 and Engility have agreed to indemnify each other against any amounts for which the other is not responsible. The Tax Matters Agreement also allocates responsibility between L-3 and Engility for other taxes, including special rules for allocating tax liabilities in the event that the spin-off is determined not to be tax-free. Though valid as between the parties, the Tax Matters Agreement is not binding on the IRS.

Procurement Regulations

A substantial majority of the Company s revenues are generated from providing products and services under legally binding agreements or contracts with U.S. Government and international government customers. U.S.

Table of Contents

L-3 COMMUNICATIONS HOLDINGS, INC.

AND L-3 COMMUNICATIONS CORPORATION

NOTES TO UNAUDITED CONDENSED CONSOLIDATED

FINANCIAL STATEMENTS (continued)

Government contracts are subject to extensive legal and regulatory requirements, and, from time to time, agencies of the U.S. Government investigate whether such contracts were and are being conducted in accordance with these requirements. The Company is currently cooperating with the U.S. Government on several investigations from which civil, criminal or administrative proceedings have or could result and give rise to fines, penalties, compensatory and treble damages, restitution and/or forfeitures. The Company does not currently anticipate that any of these investigations will have a material adverse effect, individually or in the aggregate, on its consolidated financial position, results of operations or cash flows. However, under U.S. Government regulations, an indictment of the Company by a federal grand jury, or an administrative finding against the Company as to its present responsibility to be a U.S. Government contractor or subcontractor, could result in the Company being suspended for a period of time from eligibility for awards of new government contracts or task orders or in a loss of export privileges. A conviction, or an administrative finding against the Company that satisfies the requisite level of seriousness, could result in debarment from contracting with the federal government for a specified term. In addition, all of the Company s U.S. Government contracts: (1) are subject to audit and various pricing and cost controls, (2) include standard provisions for termination for the convenience of the U.S. Government or for default, and (3) are subject to cancellation if funds for contracts become unavailable. International government contracts generally include comparable provisions relating to terminations for convenience or default, as well as other procurement clauses relevant to the international government.

Litigation Matters

The Company is also subject to litigation, proceedings, claims or assessments and various contingent liabilities incidental to its businesses, including those specified below. Furthermore, in connection with certain business acquisitions, the Company has assumed some or all claims against, and liabilities of, such acquired businesses, including both asserted and unasserted claims and liabilities.

In accordance with the accounting standard for contingencies, the Company records a liability when management believes that it is both probable that a liability has been incurred and the Company can reasonably estimate the amount of the loss. Generally, the loss is recorded at the amount the Company expects to resolve the liability. The estimated amounts of liabilities recorded for pending and threatened litigation are disclosed in Note 9. Amounts recoverable from insurance contracts or third parties are recorded as assets when deemed probable. At September 26, 2014, the Company did not record any amounts for recoveries from insurance contracts or third parties in connection with the amount of liabilities recorded for pending and threatened litigation. Legal defense costs are expensed as incurred. The Company believes it has recorded adequate provisions for its litigation matters. The Company reviews these provisions quarterly and adjusts these provisions to reflect the impact of negotiations, settlements, rulings, advice of legal counsel and other information and events pertaining to a particular matter. While it is reasonably possible that an unfavorable outcome may occur in one or more of the following matters, unless otherwise stated below, the Company believes that it is not probable that a loss has been incurred in any of these matters. With respect to the litigation matters below for which it is reasonably possible that an unfavorable outcome may occur, an estimate of loss or range of loss is disclosed when such amount or amounts can be reasonably estimated. Although the Company believes that it has valid defenses with respect to legal matters and investigations pending against it, the results of litigation can be difficult to predict, particularly those involving jury trials. Accordingly, our current judgment as to the likelihood of our loss (or our current estimate as to the potential range of loss, if applicable) with respect to any particular litigation matter may turn out to be wrong. Therefore, it is possible that the financial position, results of operations or cash flows of the Company could be materially adversely affected in any particular period by the unfavorable resolution of one or more of these or other contingencies.

L-3 COMMUNICATIONS HOLDINGS, INC.

AND L-3 COMMUNICATIONS CORPORATION

NOTES TO UNAUDITED CONDENSED CONSOLIDATED

FINANCIAL STATEMENTS (continued)

Class Action. In August 2014, Zubair Patel, Alan Nguyen and Carmen Valentino filed separate, putative class action complaints in the United States District Court for the Southern District of New York against the Company and certain of its officers. Each complaint alleges violations of federal securities laws related to misconduct and accounting errors identified by the Company at its Aerospace Systems segment, and seeks monetary damages, pre- and post-judgment interest, and fees and expenses. On October 20, 2014, these cases were consolidated into a single, putative class action in the United States District Court for the Southern District of New York. The Company believes the action lacks merit and intends to defend against it vigorously. The Company is unable to reasonably estimate any amount or range of loss, if any, that may be incurred in connection with this matter because the proceedings are in their early stages. For a discussion of the Company s internal review relating to the accounting matters at issue, see Note 3.

Government Inquiries. On July 30, 2014, the Company voluntarily contacted the SEC to report information concerning its internal review related to misconduct and accounting errors identified by the Company at its Aerospace Systems segment. The Company is in contact with the SEC and the U.S. Department of Justice, has received subpoenas for documents and other materials from both agencies concerning these self-reported matters, and is fully cooperating. The Company is unable to reasonably estimate any amount or range of loss, if any, that may be incurred in connection with these inquiries because they are in their early stages.

Bashkirian Airways. On July 1, 2004, lawsuits were filed on behalf of the estates of 31 Russian children in the state courts of Washington, Arizona, California, Florida, New York and New Jersey against Honeywell, Honeywell TCAS, Thales USA, Thales France, the Company and Aviation Communications & Surveillance Systems (ACSS), which is a joint venture of L-3 and Thales. The suits relate to the crash over southern Germany of a Bashkirian Airways Tupelov TU 154M aircraft and a DHL Boeing 757 cargo aircraft. On-board the Tupelov aircraft were 9 crew members and 60 passengers, including 45 children. The Boeing aircraft carried a crew of two. Both aircraft were equipped with Honeywell/ACSS Model 2000, Change 7 Traffic Collision and Avoidance Systems (TCAS). Sensing the other aircraft, the on-board DHL TCAS instructed the DHL pilot to descend, and the Tupelov on-board TCAS instructed the Tupelov pilot to climb. However, the Swiss air traffic controller ordered the Tupelov pilot to descend. The Tupelov pilot disregarded the on-board TCAS and put the Tupelov aircraft into a descent striking the DHL aircraft in midair at approximately 35,000 feet. All crew and passengers of both planes were lost. Investigations by the National Transportation Safety Board after the crash revealed that both TCAS units were performing as designed. The suits allege negligence and strict product liability based upon the design of the units and the training provided to resolve conflicting commands and seek approximately $315 million in damages, including $150 million in punitive damages. The Company s insurers have accepted defense of this matter and have retained counsel. The matters were consolidated in the U.S. District Court for the District of New Jersey, which then dismissed the actions on the basis of forum non conveniens. Plaintiffs representing 30 of the estates re-filed their complaint against ACSS on April 23, 2007 with the Barcelona Court s Registry in Spain. On March 9, 2010, the court ruled in favor of the plaintiffs and entered judgment against ACSS in the amount of approximately $6.7 million, all of which represented compensatory damages. Both ACSS and the plaintiffs appealed the judgment. In May 2012, the appellate court ruled in favor of the plaintiffs and entered judgment against ACSS in the amount of $48 million. ACSS filed an appeal of the judgment with the Supreme Court of Spain on September 28, 2012. On July 1, 2013, the Supreme Court agreed to consider the appeal, and the parties are awaiting the Supreme Court s decision. The Company believes that the ruling and the damages awarded are inconsistent with the law and evidence presented and, accordingly, that it is not probable that the Company has incurred a loss with respect to this matter. As of the date of this filing, 18 out of the 30 plaintiffs have released their claims against ACSS in consideration for payments made by the Company s insurance carriers.

Table of Contents

L-3 COMMUNICATIONS HOLDINGS, INC.

AND L-3 COMMUNICATIONS CORPORATION

NOTES TO UNAUDITED CONDENSED CONSOLIDATED

FINANCIAL STATEMENTS (continued)

HVC Alkmaar. On July 23, 2014, a notice of claim was received by our JovyAtlas business unit. The notice relates to losses resulting from a fire that occurred at an HVC Alkmaar bio-energy plant on July 21, 2013. The notice states that the fire resulted from the failure of an uninterruptible power supply (UPS) to provide sufficient power to act as a back-up energy supply, alleges that JovyAtlas was the manufacturer and service provider for the UPS and claims 11 million in estimated property damages and 35 million in estimated business interruption damages. The Company has tendered the notice of claim to its insurance carriers, who have commenced their own investigation.

19. Pension and Other Postretirement Benefits

The following table summarizes the components of net periodic benefit cost for the Company s pension and other postretirement benefit plans.

	Pension Plans				Postretirement Benefit Plans			
	Third Quarter Ended		Year-to-Date Ended		Third Quarter Ended		Year-to-Date Ended	
	September 26, 2014	September 27, 2013	September 26, 2014	September 27, 2013	September 26, 2014	September 27, 2013	September 26, 2014	September 27, 2013
	(in millions)							
Components of net periodic benefit cost:								
Service cost	$ 26	$ 30	$ 80	$ 95	$ (2)	$ 1	$	$ 3
Interest cost	37	33	110	99	4	2	8	5
Expected return on plan assets	(48)	(41)	(145)	(124)	(1)		(3)	(2)
Amortization of prior service costs (credits)		1	1	1		(1)	(1)	(2)
Amortization of net loss (gain)	4	20	13	63	(1)		(2)	1
Curtailment loss		2	1	2	(1)		(1)	
Net periodic benefit cost	$ 19	$ 45	$ 60	$ 136	$ (1)	$ 2	$ 1	$ 5

Contributions. The Company contributed cash of $85 million to its pension plans and $5 million to its other postretirement benefit plans during the year-to-date period ended September 26, 2014. The Company expects to contribute an additional $12 million to its pension plans and $5 million to its other postretirement benefit plans during the remainder of 2014.

20. Stock-Based Compensation

During the year-to-date period ended September 26, 2014, the Company granted stock-based compensation under the Amended and Restated 2008 Long Term Performance Plan (2008 LTPP) in the form of stock options, restricted stock units and performance units further discussed below.

Stock Options. The Company granted 472,992 stock options with an exercise price of $113.67 per option, which was equal to the closing price of L-3 Holdings common stock on the date of grant. The options expire after 10 years from the date of grant and vest ratably over a three-year period on the annual anniversary of the

Table of Contents

L-3 COMMUNICATIONS HOLDINGS, INC.

AND L-3 COMMUNICATIONS CORPORATION

NOTES TO UNAUDITED CONDENSED CONSOLIDATED

FINANCIAL STATEMENTS (continued)

date of grant. The options granted to our Chairman, President and Chief Executive Officer are also subject to performance-based vesting conditions. The weighted average grant date fair value for the options of $20.02 per option was estimated using the Black-Scholes option-pricing model. The weighted average assumptions used in the valuation model for this grant are presented in the table below.

Expected holding period (in years)	5.5
Expected volatility	24.4%
Expected dividend yield	2.7%
Risk-free interest rate	1.7%

Restricted Stock Units. The Company granted 414,694 restricted stock units with a weighted average grant date fair value of $113.69 per share. Restricted stock units automatically convert into shares of L-3 Holdings common stock upon vesting, and are subject to forfeiture until certain restrictions have lapsed, including a three year cliff vesting period for employees and a one year cliff vesting period for non-employee directors, in each case starting on the date of grant.

Performance Units. The Company granted 47,467 performance units with a weighted average grant date fair value per unit of $113.67. The final payout for these units is based on the achievement of pre-determined EPS goals established by the compensation committee of the Company s Board of Directors for the three-year period ending December 31, 2016. The payout can range from zero to 200% of the original number of units awarded, which are converted into shares of L-3 Holdings common stock based on the then existing closing price at the end of the performance period.

21. Supplemental Cash Flow Information

	Year-to-Date Ended	
	September 26, 2014	September 27, 2013
	(in millions)	
Interest paid on outstanding debt	$ 123	$ 133
Income tax payments	116	168
Income tax refunds	8	20

22. Segment Information

The Company has four reportable segments, as described in Note 1. The Company evaluates the performance of its operating segments and reportable segments based on their sales and operating income. All corporate expenses are allocated to the Company s operating segments using an allocation methodology prescribed by U.S. Government regulations for government contractors. Accordingly, all costs and expenses are included in the Company s measure of segment profitability.

L-3 COMMUNICATIONS HOLDINGS, INC.

AND L-3 COMMUNICATIONS CORPORATION

NOTES TO UNAUDITED CONDENSED CONSOLIDATED

FINANCIAL STATEMENTS (continued)

The tables below present net sales, operating income, depreciation and amortization and total assets by reportable segment.

	Third Quarter Ended		Year-to-Date Ended	
	September 26, 2014	September 27, 2013	September 26, 2014	September 27, 2013
	(in millions)			
Net Sales:				
Electronic Systems	$ 1,128	$ 1,139	$ 3,349	$ 3,438
Aerospace Systems	1,037	1,092	3,173	3,416
Communication Systems	507	486	1,562	1,667
NSS	307	323	948	987
Elimination of intercompany sales	(39)	(38)	(116)	(120)
Consolidated total	$ 2,940	$ 3,002	$ 8,916	$ 9,388
Operating Income:				
Electronic Systems	$ 125	$ 144	$ 383	$ 388
Aerospace Systems	64	105	196	336
Communication Systems	49	31	147	116
NSS	19	26	56	66
Consolidated total	$ 257	$ 306	$ 782	$ 906
Depreciation and amortization:				
Electronic Systems	$ 30	$ 28	$ 89	$ 87
Aerospace Systems	11	10	30	28
Communication Systems	13	12	38	35
NSS	2	2	8	8
Consolidated total	$ 56	$ 52	$ 165	$ 158

	September 26, 2014	December 31, 2013

	(in millions)	
Total Assets:		
Electronic Systems	$ 6,998	$ 6,928
Aerospace Systems	2,961	3,087
Communication Systems	2,076	2,130
NSS	1,312	1,247
Corporate	694	596
Consolidated total	$ 14,041	$ 13,988

23. Employee Severance and Termination Costs

Consistent with the Company s strategy to continuously improve its cost structure and right-size its businesses, especially in view of sequestration and other DoD budget reductions, L-3 is completing employment reduction actions across several of its businesses to reduce both direct and indirect costs, including overhead and general and administrative costs. As a result of these initiatives and due to the impact of sequestration at certain

Table of Contents

L-3 COMMUNICATIONS HOLDINGS, INC.

AND L-3 COMMUNICATIONS CORPORATION

NOTES TO UNAUDITED CONDENSED CONSOLIDATED

FINANCIAL STATEMENTS (continued)

affected business units, the Company recorded $23 million in employee severance and other termination costs with respect to approximately 1,500 employees during the year-to-date period ended September 26, 2014. During the year ended December 31, 2013, the Company recorded a total of $29 million in employee severance and other termination costs with respect to approximately 2,000 employees. Employee severance and other termination costs are reported within cost of sales on the unaudited condensed consolidated statement of operations. The remaining balance to be paid in connection with these initiatives was $11 million at September 26, 2014 and December 31, 2013. Employee severance and other termination costs incurred by reportable segment for the year-to-date periods ended September 26, 2014 and September 27, 2013 are presented in the table below.

	Year-to-Date Ended	
	September 26, 2014	September 27, 2013
	(in millions)	
Reportable Segment		
Electronic Systems	$ 14	$ 11
Aerospace Systems	3	1
Communication Systems	5	6
NSS	1	1
Consolidated	$ 23	$ 19

24. Condensed Combining Financial Information of L-3 Communications and Its Subsidiaries

L-3 Communications is a 100% owned subsidiary of L-3 Holdings. The debt of L-3 Communications, including the Senior Notes and borrowings under amounts drawn against the Amended and Restated Revolving Credit Facility is guaranteed, on a joint and several, full and unconditional basis, by certain of its domestic subsidiaries (the Guarantor Subsidiaries) and, in the case of the Amended and Restated Revolving Credit Facility, by L-3 Holdings. The CODES, prior to the CODES Retirement, were guaranteed on a joint and several, full and unconditional basis, by L-3 Communications and the Guarantor Subsidiaries. See Note 11 to the audited consolidated financial statements for the year ended December 31, 2013, included in the Company s Form 10-K/A. The foreign subsidiaries and certain domestic subsidiaries of L-3 Communications (the Non-Guarantor Subsidiaries) do not guarantee the debt of L-3 Communications or L-3 Holdings. None of the debt of L-3 Communications has been issued by its subsidiaries. There are no restrictions on the payment of dividends from the Guarantor Subsidiaries to L-3 Communications or from L-3 Communications to L-3 Holdings.

Under the terms of the indentures governing the Senior Notes, the guarantees of the Senior Notes will automatically and unconditionally be released and discharged: (1) upon the release of all guarantees of all other outstanding indebtedness of L-3 Communications Corporation, or (2) upon the determination that such guarantor is no longer a domestic subsidiary. In addition, the guarantees of the Senior Notes will be automatically and unconditionally released and discharged in the event of a sale or other disposition of all of the assets of any guarantor, by way of merger, consolidation or otherwise, or a sale of all of the capital stock of such guarantor.

The following unaudited condensed combining financial information presents the results of operations, financial position and cash flows of: (1) L-3 Holdings, excluding L-3 Communications and its consolidated subsidiaries (the Parent), (2) L-3 Communications, excluding its consolidated subsidiaries, (3) the Guarantor Subsidiaries, (4) the Non-Guarantor Subsidiaries, and (5) the eliminations to arrive at the information for L-3 on a consolidated basis.

Table of Contents

L-3 COMMUNICATIONS HOLDINGS, INC.

AND L-3 COMMUNICATIONS CORPORATION

NOTES TO UNAUDITED CONDENSED CONSOLIDATED

FINANCIAL STATEMENTS (continued)

As discussed in Note 3, the Company is revising its previously issued financial statements. As part of that revision, the Company has revised the accompanying condensed combining financial statements contained herein. The adjustments related to the internal review of the Aerospace Systems segment, excluding certain adjustments related to the Platform Systems segment, were recorded as adjustments to the Guarantor Subsidiaries financial statement amounts. Adjustments from the internal review that related to a foreign subsidiary of the Platform Systems segment, with a cumulative operating impact through September 26, 2014 of $28 million, were recorded to the Non-Guarantor Subsidiaries financial statement amounts. The adjustments for the accounting related to a sales-type lease transaction for flight simulator systems within its Electronic Systems segment have been recorded as adjustments to the L-3 Communications financial statement amounts. The adjustments for the previously identified immaterial errors were recorded as adjustments to the Guarantor Subsidiaries financial statement amounts.

Table of Contents

L-3 COMMUNICATIONS HOLDINGS, INC.

AND L-3 COMMUNICATIONS CORPORATION

NOTES TO UNAUDITED CONDENSED CONSOLIDATED

FINANCIAL STATEMENTS (continued)

	L-3 Holdings (Parent)	L-3 Communications	Guarantor Subsidiaries	Non-Guarantor Subsidiaries	Eliminations	Consolidated L-3
			(in millions)			
Condensed Combining Balance Sheets:						
At September 26, 2014:						
Current assets:						
Cash and cash equivalents	$	$ 330	$ 1	$ 239	$ (62)	$ 508
Billed receivables, net		296	348	227		871
Contracts in process		994	1,165	387		2,546
Other current assets		410	145	176		731
Total current assets		2,030	1,659	1,029	(62)	4,656
Goodwill		2,324	4,320	1,140		7,784
Other assets		800	568	233		1,601
Investment in and amounts due from consolidated subsidiaries	5,903	6,993	4,049		(16,945)	
Total assets	$ 5,903	$ 12,147	$ 10,596	$ 2,402	$ (17,007)	$ 14,041
Current liabilities	$	$ 872	$ 999	$ 583	$ (62)	$ 2,392
Amounts due to consolidated subsidiaries				366	(366)	
Other long-term liabilities		1,434	187	111		1,732
Long-term debt		3,938				3,938
Total liabilities		6,244	1,186	1,060	(428)	8,062
L-3 shareholders equity	5,903	5,903	9,410	1,342	(16,655)	5,903
Noncontrolling interests					76	76
Total equity	5,903	5,903	9,410	1,342	(16,579)	5,979
Total liabilities and equity	$ 5,903	$ 12,147	$ 10,596	$ 2,402	$ (17,007)	$ 14,041
At December 31, 2013:						
Current assets:						

Cash and cash equivalents	$	$ 258	$	$ 261	$ (19)	$ 500
Billed receivables, net		364	401	226		991
Contracts in process		925	1,152	354		2,431
Other current assets		344	159	169		672
Total current assets		1,891	1,712	1,010	(19)	4,594
Goodwill		2,324	4,320	1,152		7,796
Other assets		838	532	228		1,598
Investment in and amounts due from consolidated subsidiaries	6,670	6,923	3,750		(17,343)	
Total assets	$ 6,670	$ 11,976	$ 10,314	$ 2,390	$ (17,362)	$ 13,988
Current liabilities	$	$ 914	$ 1,011	$ 628	$ (19)	$ 2,534
Amounts due to consolidated subsidiaries				259	(259)	
Other long-term liabilities		1,451	193	124		1,768
Long-term debt	689	3,630			(689)	3,630
Total liabilities	689	5,995	1,204	1,011	(967)	7,932
L-3 shareholders equity	5,981	5,981	9,110	1,379	(16,470)	5,981
Noncontrolling interests					75	75
Total equity	5,981	5,981	9,110	1,379	(16,395)	6,056
Total liabilities and equity	$ 6,670	$ 11,976	$ 10,314	$ 2,390	$ (17,362)	$ 13,988

Table of Contents

L-3 COMMUNICATIONS HOLDINGS, INC.

AND L-3 COMMUNICATIONS CORPORATION

NOTES TO UNAUDITED CONDENSED CONSOLIDATED

FINANCIAL STATEMENTS (continued)

	L-3 Holdings (Parent)	L-3 Communications	Guarantor Subsidiaries	Non-Guarantor Subsidiaries	Eliminations	Consolidated L-3
			(in millions)			
Condensed Combining Statements of Operations:						
For the quarter ended September 26, 2014:						
Total net sales	$	$ 860	$ 1,628	$ 525	$ (73)	$ 2,940
Total cost of sales	(10)	(787)	(1,500)	(469)	83	(2,683)
Operating (loss) income	(10)	73	128	56	10	257
Interest expense		(46)	(2)	1		(47)
Interest and other income, net		4		1		5
(Loss) income before income taxes	(10)	31	126	58	10	215
Benefit (provision) for income taxes	3	(8)	(34)	(16)	(3)	(58)
Equity in net income of consolidated subsidiaries	161	131			(292)	
Net income	154	154	92	42	(285)	157
Net income attributable to noncontrolling interests					(3)	(3)
Net income attributable to L-3	$ 154	$ 154	$ 92	$ 42	$ (288)	$ 154
Comprehensive income attributable to L-3	$ 90	$ 90	$ 89	$ (22)	$ (157)	$ 90
For the quarter ended September 27, 2013:						
Total net sales	$	$ 912	$ 1,646	$ 543	$ (99)	$ 3,002
Total cost of sales	(14)	(854)	(1,458)	(483)	113	(2,696)
Operating (loss) income	(14)	58	188	60	14	306

Interest expense	(5)	(43)		(1)	5	(44)
Interest and other income, net		3	1			4
(Loss) income before income taxes	(19)	18	189	59	19	266
Benefit (provision) for income taxes	5	(3)	(45)	(14)	(5)	(62)
Equity in net income of consolidated subsidiaries	214	185			(399)	
Net income	200	200	144	45	(385)	204
Net income attributable to noncontrolling interests					(4)	(4)
Net income attributable to L-3	$ 200	$ 200	$ 144	$ 45	$ (389)	$ 200
Comprehensive income attributable to L-3	$ 250	$ 250	$ 145	$ 77	$ (472)	$ 250

Table of Contents

L-3 COMMUNICATIONS HOLDINGS, INC.

AND L-3 COMMUNICATIONS CORPORATION

NOTES TO UNAUDITED CONDENSED CONSOLIDATED

FINANCIAL STATEMENTS (continued)

	L-3 Holdings (Parent)	L-3 Communications	Guarantor Subsidiaries	Non-Guarantor Subsidiaries	Eliminations	Consolidated L-3
				(in millions)		
Condensed Combining Statements of Operations:						
For the Year-to-Date Period Ended September 26, 2014:						
Total net sales	$	$ 2,606	$ 4,908	$ 1,623	$ (221)	$ 8,916
Total cost of sales	(39)	(2,354)	(4,533)	(1,468)	260	(8,134)
Operating (loss) income	(39)	252	375	155	39	782
Interest expense	(2)	(127)	(2)		2	(129)
Interest and other income, net		12		2		