

TEXTRON INC
Form 10-Q
October 27, 2016
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UNITED STATES
SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

Form 10-Q

(Mark One)

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

For the quarterly period ended October 1, 2016

OR

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

For the transition period from ____ to ____.

Commission File Number 1-5480

Textron Inc.

(Exact name of registrant as specified in its charter)

Delaware

(State or other jurisdiction of incorporation or organization)

05-0315468

(I.R.S. Employer Identification No.)

40 Westminster Street, Providence, RI

(Address of principal executive offices)

02903

(Zip code)

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(401) 421-2800

(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 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 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 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 Non-accelerated filer Smaller reporting company

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

As of October 14, 2016, there were 270,208,112 shares of common stock outstanding.

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Table of Contents**PART I. FINANCIAL INFORMATION****Item 1. FINANCIAL STATEMENTS****TEXTRON INC.****Consolidated Statements of Operations (Unaudited)**

| | Three Months Ended | | Nine Months Ended | |
|--|----------------------------|----------------------------|----------------------------|----------------------------|
| | October 1, 2016 | October 3, 2015 | October 1, 2016 | October 3, 2015 |
| <i>(In millions, except per share amounts)</i> | | | | |
| Revenues | | | | |
| Manufacturing revenues | \$ 3,231 | \$ 3,163 | \$ 9,903 | \$ 9,437 |
| Finance revenues | 20 | 17 | 60 | 63 |
| Total revenues | 3,251 | 3,180 | 9,963 | 9,500 |
| Costs, expenses and other | | | | |
| Cost of sales | 2,661 | 2,584 | 8,185 | 7,728 |
| Selling and administrative expense | 323 | 303 | 949 | 969 |
| Interest expense | 45 | 41 | 132 | 126 |
| Special charges | 115 | | 115 | |
| Total costs, expenses and other | 3,144 | 2,928 | 9,381 | 8,823 |
| Income from continuing operations before income taxes | 107 | 252 | 582 | 677 |
| Income tax benefit (expense) | 192 | (76) | 46 | (204) |
| Income from continuing operations | 299 | 176 | 628 | 473 |
| Income (loss) from discontinued operations, net of income taxes* | 122 | | 120 | (2) |
| Net income | \$ 421 | \$ 176 | \$ 748 | \$ 471 |
| Basic earnings per share | | | | |
| Continuing operations | \$ 1.11 | \$ 0.64 | \$ 2.32 | \$ 1.71 |
| Discontinued operations | 0.45 | | 0.44 | (0.01) |
| Basic earnings per share | \$ 1.56 | \$ 0.64 | \$ 2.76 | \$ 1.70 |
| Diluted earnings per share | | | | |
| Continuing operations | \$ 1.10 | \$ 0.63 | \$ 2.31 | \$ 1.69 |
| Discontinued operations | 0.45 | | 0.44 | (0.01) |
| Diluted earnings per share | \$ 1.55 | \$ 0.63 | \$ 2.75 | \$ 1.68 |
| Dividends per share | | | | |
| Common stock | \$ 0.02 | \$ 0.02 | \$ 0.06 | \$ 0.06 |

*Income from discontinued operations, net of income taxes for the three and nine months ended October 1, 2016 primarily includes the settlement of a U.S. federal income tax audit. See Note 13 for additional information.

See Notes to the Consolidated Financial Statements.

Table of Contents**TEXTRON INC.****Consolidated Statements of Comprehensive Income (Unaudited)**

| <i>(In millions)</i> | Three Months Ended | | Nine Months Ended | |
|---|----------------------------|----------------------------|----------------------------|----------------------------|
| | October 1, 2016 | October 3, 2015 | October 1, 2016 | October 3, 2015 |
| Net income | \$ 421\$ | 176\$ | 748\$ | 471 |
| Other comprehensive income, net of tax: | | | | |
| Pension and postretirement benefits adjustments, net of reclassifications | 16 | 22 | 52 | 133 |
| Deferred gains (losses) on hedge contracts, net of reclassifications | (2) | (1) | 23 | (9) |
| Foreign currency translation adjustments | 4 | 1 | 8 | (45) |
| Other comprehensive income | 18 | 22 | 83 | 79 |
| Comprehensive income | \$ 439\$ | 198\$ | 831\$ | 550 |

See Notes to the Consolidated Financial Statements.

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TEXTRON INC.

Consolidated Balance Sheets (Unaudited)

| | October 1, 2016 | January 2, 2016 |
|--|--------------------|--------------------|
| <i>(Dollars in millions)</i> | | |
| Assets | | |
| Manufacturing group | | |
| Cash and equivalents | \$ 589 | 946 |
| Accounts receivable, net | 1,139 | 1,047 |
| Inventories | 4,791 | 4,144 |
| Other current assets | 348 | 341 |
| Total current assets | 6,867 | 6,478 |
| Property, plant and equipment, less accumulated depreciation and amortization of \$4,107 and \$3,915 | 2,568 | 2,492 |
| Goodwill | 2,121 | 2,023 |
| Other assets | 2,318 | 2,399 |
| Total Manufacturing group assets | 13,874 | 13,392 |
| Finance group | | |
| Cash and equivalents | 150 | 59 |
| Finance receivables, net | 969 | 1,087 |
| Other assets | 174 | 170 |
| Total Finance group assets | 1,293 | 1,316 |
| Total assets | \$ 15,167 | \$ 14,708 |
| Liabilities and shareholders equity | | |
| Liabilities | | |
| Manufacturing group | | |
| Short-term debt and current portion of long-term debt | \$ 126 | 262 |
| Accounts payable | 1,216 | 1,063 |
| Accrued liabilities | 2,278 | 2,467 |
| Total current liabilities | 3,620 | 3,792 |
| Other liabilities | 1,987 | 2,376 |
| Long-term debt | 2,777 | 2,435 |
| Total Manufacturing group liabilities | 8,384 | 8,603 |
| Finance group | | |
| Other liabilities | 213 | 228 |
| Debt | 919 | 913 |
| Total Finance group liabilities | 1,132 | 1,141 |
| Total liabilities | 9,516 | 9,744 |
| Shareholders equity | | |
| Common stock | 36 | 36 |
| Capital surplus | 1,674 | 1,587 |
| Treasury stock | (774) | (559) |
| Retained earnings | 6,030 | 5,298 |
| Accumulated other comprehensive loss | (1,315) | (1,398) |
| Total shareholders equity | 5,651 | 4,964 |
| Total liabilities and shareholders equity | \$ 15,167 | \$ 14,708 |
| Common shares outstanding (in thousands) | 270,134 | 274,228 |

See Notes to the Consolidated Financial Statements.

Table of Contents**TEXTRON INC.****Consolidated Statements of Cash Flows (Unaudited)**

For the Nine Months Ended October 1, 2016 and October 3, 2015, respectively

| <i>(In millions)</i> | | Consolidated 2016 | 2015 |
|---|----|------------------------------|-------------|
| Cash flows from operating activities | | | |
| Net income | \$ | 748\$ | 471 |
| Less: Income (loss) from discontinued operations | | 120 | (2) |
| Income from continuing operations | | 628 | 473 |
| Adjustments to reconcile income from continuing operations to net cash provided by operating activities: | | | |
| Non-cash items: | | | |
| Depreciation and amortization | | 331 | 332 |
| Asset impairments | | 36 | |
| Deferred income taxes | | 30 | (11) |
| Other, net | | 76 | 78 |
| Changes in assets and liabilities: | | | |
| Accounts receivable, net | | (92) | (122) |
| Inventories | | (637) | (654) |
| Other assets | | 56 | 6 |
| Accounts payable | | 146 | 156 |
| Accrued and other liabilities | | (290) | (18) |
| Income taxes, net | | (216) | 64 |
| Pension, net | | 21 | 61 |
| Captive finance receivables, net | | 54 | 58 |
| Other operating activities, net | | 2 | (4) |
| Net cash provided by operating activities of continuing operations | | 145 | 419 |
| Net cash used in operating activities of discontinued operations | | (2) | (4) |
| Net cash provided by operating activities | | 143 | 415 |
| Cash flows from investing activities | | | |
| Capital expenditures | | (306) | (286) |
| Net cash used in acquisitions | | (179) | (81) |
| Finance receivables repaid | | 40 | 66 |
| Other investing activities, net | | 53 | 31 |
| Net cash used in investing activities | | (392) | (270) |
| Cash flows from financing activities | | | |
| Proceeds from long-term debt | | 520 | 55 |
| Increase in short-term debt | | 110 | |
| Principal payments on long-term debt and nonrecourse debt | | (433) | (196) |
| Purchases of Textron common stock | | (215) | (211) |
| Dividends paid | | (16) | (17) |
| Other financing activities, net | | 20 | 25 |
| Net cash used in financing activities | | (14) | (344) |
| Effect of exchange rate changes on cash and equivalents | | (3) | (9) |
| Net decrease in cash and equivalents | | (266) | (208) |
| Cash and equivalents at beginning of period | | 1,005 | 822 |
| Cash and equivalents at end of period | \$ | 739\$ | 614 |

See Notes to the Consolidated Financial Statements.

Table of Contents**TEXTRON INC.****Consolidated Statements of Cash Flows (Unaudited) (Continued)**

For the Nine Months Ended October 1, 2016 and October 3, 2015, respectively

| <i>(In millions)</i> | Manufacturing Group | | Finance Group | |
|--|----------------------------|-------------|----------------------|-------------|
| | 2016 | 2015 | 2016 | 2015 |
| Cash flows from operating activities | | | | |
| Net income | \$ 733 | \$ 458 | \$ 15 | \$ 13 |
| Less: Income (loss) from discontinued operations | 120 | (2) | | |
| Income from continuing operations | 613 | 460 | 15 | 13 |
| Adjustments to reconcile income from continuing operations to net cash provided by operating activities: | | | | |
| Non-cash items: | | | | |
| Depreciation and amortization | 322 | 324 | 9 | 8 |
| Asset impairments | 36 | | | |
| Deferred income taxes | 35 | (3) | (5) | (8) |
| Other, net | 74 | 74 | 2 | 4 |
| Changes in assets and liabilities: | | | | |
| Accounts receivable, net | (92) | (122) | | |
| Inventories | (639) | (661) | | |
| Other assets | 85 | (6) | (3) | 12 |
| Accounts payable | 146 | 156 | | |
| Accrued and other liabilities | (283) | (10) | (7) | (8) |
| Income taxes, net | (212) | 58 | (4) | 6 |
| Pension, net | 21 | 61 | | |
| Dividends received from Finance group | 29 | 20 | | |
| Other operating activities, net | 2 | (4) | | |
| Net cash provided by operating activities of continuing operations | 137 | 347 | 7 | 27 |
| Net cash used in operating activities of discontinued operations | (2) | (4) | | |
| Net cash provided by operating activities | 135 | 343 | 7 | 27 |
| Cash flows from investing activities | | | | |
| Capital expenditures | (306) | (286) | | |
| Net cash used in acquisitions | (179) | (81) | | |
| Finance receivables repaid | | | 220 | 269 |
| Finance receivables originated | | | (126) | (145) |
| Other investing activities, net | 5 | 2 | 24 | 36 |
| Net cash provided by (used in) investing activities | (480) | (365) | 118 | 160 |
| Cash flows from financing activities | | | | |
| Proceeds from long-term debt | 345 | | 175 | 55 |
| Increase in short-term debt | 110 | | | |
| Principal payments on long-term debt and nonrecourse debt | (253) | | (180) | (196) |
| Purchases of Textron common stock | (215) | (211) | | |
| Dividends paid | (16) | (17) | (29) | (20) |
| Other financing activities, net | 20 | 25 | | |
| Net cash used in financing activities | (9) | (203) | (34) | (161) |
| Effect of exchange rate changes on cash and equivalents | (3) | (9) | | |
| Net increase (decrease) in cash and equivalents | (357) | (234) | 91 | 26 |
| Cash and equivalents at beginning of period | 946 | 731 | 59 | 91 |
| Cash and equivalents at end of period | \$ 589 | \$ 497 | \$ 150 | \$ 117 |

See Notes to the Consolidated Financial Statements.

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TEXTRON INC.

Notes to the Consolidated Financial Statements (Unaudited)

Note 1. Basis of Presentation

Our Consolidated Financial Statements include the accounts of Textron Inc. (Textron) and its majority-owned subsidiaries. We have prepared these unaudited consolidated financial statements in accordance with accounting principles generally accepted in the U.S. for interim financial information. Accordingly, these interim financial statements do not include all of the information and footnotes required by accounting principles generally accepted in the U.S. for complete financial statements. The consolidated interim financial statements included in this quarterly report should be read in conjunction with the consolidated financial statements included in our Annual Report on Form 10-K for the year ended January 2, 2016. In the opinion of management, the interim financial statements reflect all adjustments (consisting only of normal recurring adjustments) that are necessary for the fair presentation of our consolidated financial position, results of operations and cash flows for the interim periods presented. The results of operations for the interim periods are not necessarily indicative of the results to be expected for the full year.

Our financings are conducted through two separate borrowing groups. The Manufacturing group consists of Textron consolidated with its majority-owned subsidiaries that operate in the Textron Aviation, Bell, Textron Systems and Industrial segments. The Finance group, which also is the Finance segment, consists of Textron Financial Corporation and its consolidated subsidiaries. We designed this framework to enhance our borrowing power by separating the Finance group. Our Manufacturing group operations include the development, production and delivery of tangible goods and services, while our Finance group provides financial services. Due to the fundamental differences between each borrowing group's activities, investors, rating agencies and analysts use different measures to evaluate each group's performance. To support those evaluations, we present balance sheet and cash flow information for each borrowing group within the Consolidated Financial Statements. All significant intercompany transactions are eliminated from the Consolidated Financial Statements, including retail financing activities for inventory sold by our Manufacturing group and financed by our Finance group.

Use of Estimates

We prepare our financial statements in conformity with generally accepted accounting principles, which require us to make estimates and assumptions that affect the amounts reported in the financial statements. Actual results could differ from those estimates. Our estimates and assumptions are reviewed periodically, and the effects of changes, if any, are reflected in the Consolidated Statements of Operations in the period that they are determined.

During 2016 and 2015, we changed our estimates of revenues and costs on certain long-term contracts that are accounted for under the percentage-of-completion method of accounting. These changes in estimates increased income from continuing operations before income taxes in the third quarter of 2016 and 2015 by \$18 million and \$14 million, respectively, (\$11 million and \$9 million after tax, or \$0.04 and \$0.03 per diluted share, respectively). For the third quarter of 2016 and 2015, the gross favorable program profit adjustments totaled \$21 million and \$20 million, respectively, and the gross unfavorable program profit adjustments totaled \$3 million and \$6 million, respectively.

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The changes in estimates increased income from continuing operations before income taxes in the first nine months of 2016 and 2015 by \$57 million and \$68 million, respectively, (\$36 million and \$43 million after tax, or \$0.13 and \$0.15 per diluted share, respectively). For the first nine months of 2016 and 2015, the gross favorable program profit adjustments totaled \$74 million and \$93 million, respectively, and the gross unfavorable program profit adjustments totaled \$17 million and \$25 million, respectively.

New Accounting Pronouncements

In May 2014, the Financial Accounting Standards Board (FASB) issued Accounting Standards Update (ASU) No. 2014-09, *Revenue from Contracts with Customers*, that outlines a comprehensive five-step revenue recognition model based on the principle that an entity should recognize revenue to depict the transfer of promised goods or services to customers in an amount that reflects the consideration to which the entity expects to be entitled in exchange for those goods and services. In July 2015, the FASB approved a one-year deferral of the effective date of the standard to the beginning of 2018 for public companies, with an option that would permit companies to adopt the standard as early as the original effective date of 2017. The new standard may be adopted either retrospectively or on a modified retrospective basis whereby it would be applied to new contracts and existing contracts with remaining performance obligations as of the effective date, with a cumulative catch-up adjustment recorded to beginning retained earnings at the effective date for those contracts. We are currently evaluating the impacts of adoption on our consolidated financial position, results of operations and related disclosures, along with the implementation approach to be used.

In February 2016, the FASB issued ASU No. 2016-02, *Leases*, that requires all leases with a term greater than 12 months be recognized on the balance sheet, while lease expenses would continue to be recognized in the statement of operations in a manner similar to current accounting guidance. The new standard is effective for our company at the beginning of fiscal 2019 and early

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adoption is permitted. Entities must adopt the standard on a modified retrospective basis whereby it would be applied at the beginning of the earliest comparative year. We are currently evaluating the impact of adoption on our consolidated financial statements.

In June 2016, the FASB issued ASU No. 2016-13, *Financial Instruments - Credit Losses*. For most financial assets, such as trade and other receivables, loans and other instruments, this standard changes the current incurred loss model to a forward-looking expected credit loss model, which generally will result in the earlier recognition of allowances for losses. The new standard is effective for our company at the beginning of fiscal 2020 with early adoption permitted beginning in fiscal 2019. Entities are required to apply the provisions of the standard through a cumulative-effect adjustment to retained earnings as of the effective date. We are currently evaluating the impact of adoption on our consolidated financial statements.

Note 2. Business Acquisitions

In the first nine months of 2016, we paid \$179 million in cash and assumed debt of \$19 million to acquire five businesses, net of cash acquired and holdbacks. Our acquisition of Able Engineering and Component Services, Inc. and Able Aerospace, Inc. (Able) in the first quarter represented the largest of these businesses and is included in the Textron Aviation segment. Able is an industry-leading repair and overhaul business that provides component repairs, component exchanges and replacement parts, among other support and service offerings for commercial rotorcraft and fixed-wing aircraft customers around the world. We are in the process of allocating the purchase price and valuing the acquired assets and liabilities for these acquisitions. Based on the preliminary allocation of the aggregate purchase price for these acquisitions, \$97 million has been allocated to goodwill, related to expected synergies and the value of the existing workforce, and \$62 million to intangible assets. Of the recorded goodwill, approximately \$43 million is deductible for tax purposes. The intangible assets are primarily related to customer relationships and technologies, which will be amortized over 10 to 18 years. The operating results of these acquisitions have been included in the Consolidated Statements of Operations since their respective closing dates.

Note 3. Special Charges

Special charges recorded in the third quarter of 2016 are as follows:

| <i>(In millions)</i> | Severance Costs | Asset Impairments | Contract Terminations and Other | Total |
|----------------------|----------------------------|------------------------------|--|--------------|
| Textron Systems | \$ 13\$ | 33\$ | 13\$ | 59 |
| Textron Aviation | 34 | 1 | | 35 |
| Industrial | 11 | 2 | | 13 |
| Bell | 8 | | | 8 |
| | \$ 66\$ | 36\$ | 13\$ | 115 |

Our Board of Directors approved a plan in the third quarter of 2016 to restructure and realign our businesses by implementing headcount reductions, facility consolidations and other actions in order to improve overall operating efficiency across Textron. The plan provides for Textron Systems to discontinue production of its sensor-fuzed weapon product, which will generate headcount reductions, facility consolidations and asset impairments within its Weapons and Sensors operating unit. Historically, sensor-fuzed weapon sales have relied on foreign military and direct commercial international customers for which both executive branch and congressional approval is required. The current political

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environment has made it difficult to obtain these approvals. Within our Industrial segment, the plan provides for the combination of our Jacobsen business with the Textron Specialized Vehicles businesses, resulting in the consolidation of certain facilities and general and administrative functions and related headcount reductions. As a result of ongoing evaluations, we subsequently decided to take additional restructuring actions, principally headcount reductions, in our Textron Aviation segment, as well as other businesses. The total headcount reduction related to restructuring activities is expected to be approximately 1,700 positions, representing approximately 5% of our workforce.

We expect to incur additional pre-tax charges under this plan of approximately \$25 million to \$55 million, primarily related to contract termination, severance, facility consolidation and relocation costs. The remaining charges are expected to primarily be in the Industrial and Textron Systems segments. We anticipate the plan to be substantially completed by March 2017.

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An analysis of our restructuring reserve activity under this plan is summarized below:

| <i>(In millions)</i> | | Severance Costs | Contract Terminations and Other | Total |
|----------------------|----|----------------------------|--|--------------|
| Provision | \$ | 66\$ | 13\$ | 79 |
| Cash paid | | (2) | | (2) |
| End of period | \$ | 64\$ | 13\$ | 77 |

Total expected cash outlays for restructuring activities are estimated to be in the range of \$100 million to \$120 million, approximately half of which is expected to be expended in 2016 and the remainder in 2017. Severance costs generally are paid on a lump-sum basis and include outplacement costs, which are paid in accordance with normal payment terms.

Note 4. Retirement Plans

We provide defined benefit pension plans and other postretirement benefits to eligible employees. The components of net periodic benefit cost (credit) for these plans are as follows:

| <i>(In millions)</i> | | Three Months Ended | | Nine Months Ended | |
|--|----|----------------------------|----------------------------|----------------------------|----------------------------|
| | | October 1, 2016 | October 3, 2015 | October 1, 2016 | October 3, 2015 |
| Pension Benefits | | | | | |
| Service cost | \$ | 25\$ | 27\$ | 74\$ | 86 |
| Interest cost | | 84 | 82 | 254 | 245 |
| Expected return on plan assets | | (123) | (121) | (368) | (363) |
| Amortization of prior service cost | | 4 | 4 | 11 | 12 |
| Amortization of net actuarial loss | | 26 | 35 | 78 | 113 |
| Curtailement and other charges | | | | | 6 |
| Net periodic benefit cost | \$ | 16\$ | 27\$ | 49\$ | 99 |
| Postretirement Benefits Other Than Pensions | | | | | |
| Service cost | \$ | 1\$ | 1\$ | 2\$ | 3 |
| Interest cost | | 4 | 4 | 12 | 12 |
| Amortization of prior service credit | | (6) | (6) | (17) | (18) |
| Amortization of net actuarial loss | | | 1 | | 1 |
| Net periodic benefit credit | \$ | (1)\$ | \$ | (3)\$ | (2) |

Note 5. Earnings Per Share

We calculate basic and diluted earnings per share (EPS) based on net income, which approximates income available to common shareholders for each period. Basic EPS is calculated using the two-class method, which includes the weighted-average number of common shares outstanding during the period and restricted stock units to be paid in stock that are deemed participating securities as they provide nonforfeitable rights to dividends. Diluted EPS considers the dilutive effect of all potential future common stock, including stock options.

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The weighted-average shares outstanding for basic and diluted EPS are as follows:

| <i>(In thousands)</i> | Three Months Ended | | Nine Months Ended | |
|---|----------------------------|----------------------------|----------------------------|----------------------------|
| | October 1, 2016 | October 3, 2015 | October 1, 2016 | October 3, 2015 |
| Basic weighted-average shares outstanding | 270,560 | 276,334 | 270,703 | 277,317 |
| Dilutive effect of stock options | 1,539 | 1,705 | 1,348 | 2,083 |
| Diluted weighted-average shares outstanding | 272,099 | 278,039 | 272,051 | 279,400 |

Stock options to purchase 4 million shares of common stock are excluded from the calculation of diluted weighted average shares outstanding for both the three and nine months ended October 1, 2016, as their effect would have been anti-dilutive. Stock options to purchase 4 million and 2 million shares of common stock are excluded from the calculation of diluted weighted average shares outstanding for the three and nine months ended October 3, 2015, respectively, as their effect would have been anti-dilutive.

Table of Contents**Note 6. Accounts Receivable and Finance Receivables****Accounts Receivable**

Accounts receivable is composed of the following:

| <i>(In millions)</i> | October 1, 2016 | January 2, 2016 |
|---------------------------------|----------------------------|----------------------------|
| Commercial | \$ 915\$ | 841 |
| U.S. Government contracts | 255 | 239 |
| Allowance for doubtful accounts | 1,170 | 1,080 |
| Total | (31) | (33) |
| | \$ 1,139\$ | 1,047 |

We have unbillable receivables, primarily on U.S. Government contracts, that arise when the revenues we have appropriately recognized based on performance cannot be billed yet under terms of the contract. Unbillable receivables within accounts receivable totaled \$179 million at October 1, 2016 and \$135 million at January 2, 2016.

Finance Receivables

Finance receivables are presented in the following table:

| <i>(In millions)</i> | October 1, 2016 | January 2, 2016 |
|--------------------------------|----------------------------|----------------------------|
| Finance receivables* | \$ 1,013\$ | 1,135 |
| Allowance for losses | (44) | (48) |
| Total finance receivables, net | \$ 969\$ | 1,087 |

* Includes finance receivables held for sale of \$30 million at both October 1, 2016 and January 2, 2016.

Credit Quality Indicators and Nonaccrual Finance Receivables

We internally assess the quality of our finance receivables based on a number of key credit quality indicators and statistics such as delinquency, loan balance to estimated collateral value and the financial strength of individual borrowers and guarantors. Because many of these indicators are difficult to apply across an entire class of receivables, we evaluate individual loans on a quarterly basis and classify these loans into three categories based on the key credit quality indicators for the individual loan. These three categories are performing, watchlist and nonaccrual.

We classify finance receivables as nonaccrual if credit quality indicators suggest full collection of principal and interest is doubtful, we automatically classify accounts as nonaccrual once they are contractually delinquent by more than three months unless collection of principal and interest is not doubtful. Accrual of interest income is suspended for these accounts and all cash collections are generally applied to reduce the net investment balance. Once we conclude that the collection of all principal and interest is no longer doubtful, we resume the accrual of interest and recognize previously suspended interest income at the time either a) the loan becomes contractually current through payment according to the original terms of the loan, or b) if the loan has been modified, following a period of performance under the terms of the modification. Accounts are classified as watchlist when credit quality indicators have deteriorated as compared with typical underwriting criteria, and we believe collection of full principal and interest is probable but not certain. All other finance receivables that do not meet the watchlist or nonaccrual categories are classified as performing.

Delinquency

We measure delinquency based on the contractual payment terms of our finance receivables. In determining the delinquency aging category of an account, any/all principal and interest received is applied to the most past-due principal and/or interest amounts due. If a significant portion of the contractually due payment is delinquent, the entire finance receivable balance is reported in accordance with the most past-due delinquency aging category.

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Finance receivables categorized based on the credit quality indicators and by the delinquency aging category are summarized as follows:

| <i>(In millions)</i> | October 1, 2016 | January 2, 2016 |
|--|----------------------------|----------------------------|
| Performing | \$ 807\$ | 891 |
| Watchlist | 86 | 130 |
| Nonaccrual | 90 | 84 |
| Nonaccrual as a percentage of finance receivables | 9.16% | 7.60% |
| Less than 31 days past due | \$ 817\$ | 950 |
| 31-60 days past due | 81 | 86 |
| 61-90 days past due | 45 | 42 |
| Over 90 days past due | 40 | 27 |
| 60 + days contractual delinquency as a percentage of finance receivables | 8.65% | 6.24% |

Impaired Loans

On a quarterly basis, we evaluate individual finance receivables for impairment in non-homogeneous portfolios and larger balance accounts in homogeneous loan portfolios. A finance receivable is considered impaired when it is probable that we will be unable to collect all amounts due according to the contractual terms of the loan agreement based on our review of the credit quality indicators described above. Impaired finance receivables include both nonaccrual accounts and accounts for which full collection of principal and interest remains probable, but the account's original terms have been, or are expected to be, significantly modified. If the modification specifies an interest rate equal to or greater than a market rate for a finance receivable with comparable risk, the account is not considered impaired in years subsequent to the modification. Interest income recognized on impaired loans was not significant in the first nine months of 2016 or 2015.

A summary of impaired finance receivables, excluding leveraged leases, and the average recorded investment is provided below:

| <i>(In millions)</i> | October 1, 2016 | January 2, 2016 |
|---|----------------------------|----------------------------|
| Recorded investment: | | |
| Impaired loans with related allowance for losses | \$ 54\$ | 62 |
| Impaired loans with no related allowance for losses | 45 | 42 |
| Total | \$ 99\$ | 104 |
| Unpaid principal balance | \$ 104\$ | 113 |
| Allowance for losses on impaired loans | 13 | 17 |
| Average recorded investment | 96 | 102 |

A summary of the allowance for losses on finance receivables, based on how the underlying finance receivables are evaluated for impairment, is provided below. The finance receivables reported in this table specifically exclude leveraged leases in accordance with U.S. generally accepted accounting principles.

| <i>(In millions)</i> | October 1, 2016 | January 2, 2016 |
|--|----------------------------|----------------------------|
| Allowance based on collective evaluation | \$ 31\$ | 31 |
| Allowance based on individual evaluation | 13 | 17 |

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| | | | |
|--|----|-------|-----|
| Finance receivables evaluated collectively | \$ | 786\$ | 883 |
| Finance receivables evaluated individually | | 99 | 104 |

Allowance for Losses

We maintain an allowance for losses on finance receivables at a level considered adequate to cover inherent losses in the portfolio based on management's evaluation. For larger balance accounts specifically identified as impaired, a reserve is established based on comparing the expected future cash flows, discounted at the finance receivable's effective interest rate, or the fair value of the underlying collateral if the finance receivable is collateral dependent, to its carrying amount. The expected future cash flows consider collateral value; financial performance and liquidity of our borrower; existence and financial strength of guarantors; estimated recovery costs, including legal expenses; and costs associated with the repossession and eventual disposal of collateral. When there is a range of potential outcomes, we perform multiple discounted cash flow analyses and weight the potential outcomes based on their relative likelihood of occurrence. The evaluation of our portfolio is inherently subjective, as it requires estimates, including the amount and timing of future cash flows expected to be received on impaired finance receivables and the estimated fair value of the underlying collateral, which may differ from actual results. While our analysis is specific to each

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individual account, critical factors included in this analysis include industry valuation guides, age and physical condition of the collateral, payment history and existence and financial strength of guarantors.

We also establish an allowance for losses to cover probable but specifically unknown losses existing in the portfolio. This allowance is established as a percentage of non-recourse finance receivables, which have not been identified as requiring specific reserves. The percentage is based on a combination of factors, including historical loss experience, current delinquency and default trends, collateral values and both general economic and specific industry trends. Finance receivables are charged off at the earlier of the date the collateral is repossessed or when no payment has been received for six months, unless management deems the receivable collectible.

A rollforward of the allowance for losses on finance receivables is provided below:

| <i>(In millions)</i> | | Nine Months Ended | |
|----------------------|----|----------------------------|----------------------------|
| | | October 1, 2016 | October 3, 2015 |
| Beginning of period | \$ | 48\$ | 51 |
| Provision for losses | | (1) | (4) |
| Charge-offs | | (11) | (8) |
| Recoveries | | 8 | 10 |
| End of period | \$ | 44\$ | 49 |

Note 7. Inventories

Inventories are composed of the following:

| <i>(In millions)</i> | | October 1, | January 2, |
|------------------------------|----|-------------------|-------------------|
| | | 2016 | 2016 |
| Finished goods | \$ | 2,076\$ | 1,735 |
| Work in process | | 2,958 | 2,921 |
| Raw materials and components | | 701 | 605 |
| | | 5,735 | 5,261 |
| Progress/milestone payments | | (944) | (1,117) |
| Total | \$ | 4,791\$ | 4,144 |

Note 8. Warranty Liability

Changes in our warranty liability are as follows:

| <i>(In millions)</i> | | Nine Months Ended | |
|----------------------|----|--------------------|--------------------|
| | | October 1, 2016 | October 3, 2015 |
| Beginning of period | \$ | 143\$ | 148 |
| Provision | | 58 | 47 |
| Settlements | | (59) | (52) |
| Adjustments* | | (10) | (3) |
| End of period | \$ | 132\$ | 140 |

* Adjustments include changes to prior year estimates, new issues on prior year sales, acquisitions and currency translation adjustments.

Note 9. Debt

On September 30, 2016, Textron entered into a senior unsecured revolving credit facility for an aggregate principal amount of \$1.0 billion, of which up to \$100 million is available for the issuance of letters of credit. This facility expires in September 2021 and replaced the existing 5-year facility, which had no outstanding borrowings, and was scheduled to expire in October 2018. At October 1, 2016, there were no amounts borrowed against the new facility.

Under our shelf registration statement, on March 11, 2016, we issued \$350 million of fixed-rate notes due March 15, 2026 that bear an annual interest rate of 4.0%. The net proceeds of the issuance totaled \$345 million, after deducting underwriting discounts, commissions and offering expenses.

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Note 10. Derivative Instruments and Fair Value Measurements

We measure fair value at the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. We prioritize the assumptions that market participants would use in pricing the asset or liability into a three-tier fair value hierarchy. This fair value hierarchy gives the highest priority (Level 1) to quoted prices in active markets for identical assets or liabilities and the lowest priority (Level 3) to unobservable inputs in which little or no market data exist, requiring companies to develop their own assumptions. Observable inputs that do not meet the criteria of Level 1, which include quoted prices for similar assets or liabilities in active markets or quoted prices for identical assets and liabilities in markets that are not active, are categorized as Level 2. Level 3 inputs are those that reflect our estimates about the assumptions market participants would use in pricing the asset or liability based on the best information available in the circumstances. Valuation techniques for assets and liabilities measured using Level 3 inputs may include methodologies such as the market approach, the income approach or the cost approach and may use unobservable inputs such as projections, estimates and management's interpretation of current market data. These unobservable inputs are utilized only to the extent that observable inputs are not available or cost effective to obtain.

Assets and Liabilities Recorded at Fair Value on a Recurring Basis

We manufacture and sell our products in a number of countries throughout the world, and, therefore, we are exposed to movements in foreign currency exchange rates. We primarily utilize foreign currency exchange contracts with maturities of no more than three years to manage this volatility. These contracts qualify as cash flow hedges and are intended to offset the effect of exchange rate fluctuations on forecasted sales, inventory purchases and overhead expenses. Net gains and losses recognized in earnings and Accumulated other comprehensive loss on cash flow hedges, including gains and losses related to hedge ineffectiveness, were not significant in the periods presented.

Our foreign currency exchange contracts are measured at fair value using the market method valuation technique. The inputs to this technique utilize current foreign currency exchange forward market rates published by third-party leading financial news and data providers. These are observable data that represent the rates that the financial institution uses for contracts entered into at that date; however, they are not based on actual transactions so they are classified as Level 2. At October 1, 2016 and January 2, 2016, we had foreign currency exchange contracts with notional amounts upon which the contracts were based of \$687 million and \$706 million, respectively. At October 1, 2016, the fair value amounts of our foreign currency exchange contracts were a \$5 million asset and an \$11 million liability. At January 2, 2016, the fair value amounts of our foreign currency exchange contracts were a \$7 million asset and a \$28 million liability.

We hedge our net investment position in major currencies and generate foreign currency interest payments that offset other transactional exposures in these currencies. To accomplish this, we borrow directly in foreign currency and designate a portion of foreign currency debt as a hedge of a net investment. We record changes in the fair value of these contracts in other comprehensive income to the extent they are effective as cash flow hedges. Currency effects on the effective portion of these hedges, which are reflected in the foreign currency translation adjustments within Accumulated other comprehensive loss, were not significant in the periods presented.

Assets Recorded at Fair Value on a Nonrecurring Basis

During the periods ended October 1, 2016 and January 2, 2016, the Finance group's impaired nonaccrual finance receivables of \$41 million and \$45 million, respectively, were measured at fair value on a nonrecurring basis using significant unobservable inputs (Level 3). Impaired nonaccrual finance receivables represent assets recorded at fair value on a nonrecurring basis since the measurement of required reserves on our impaired finance receivables is significantly dependent on the fair value of the underlying collateral. For impaired nonaccrual finance receivables secured by aviation assets, the fair values of collateral are determined primarily based on the use of industry pricing guides. Fair value measurements recorded on impaired finance receivables were not significant for both the three and nine months ended October 1, 2016

and October 3, 2015.

Assets and Liabilities Not Recorded at Fair Value

The carrying value and estimated fair value of our financial instruments that are not reflected in the financial statements at fair value are as follows:

| <i>(In millions)</i> | | October 1, 2016 | Estimated | January 2, 2016 | Estimated |
|---------------------------------------|----|------------------------|-------------------|------------------------|-------------------|
| | | Carrying | Fair Value | Carrying | Fair Value |
| | | Value | Fair Value | Value | Fair Value |
| Manufacturing group | | | | | |
| Long-term debt, excluding leases | \$ | (2,701)\$ | (2,905)\$ | (2,628)\$ | (2,744) |
| Finance group | | | | | |
| Finance receivables, excluding leases | | 757 | 778 | 863 | 820 |
| Debt | | (919) | (851) | (913) | (840) |

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Fair value for the Manufacturing group debt is determined using market observable data for similar transactions (Level 2). At both October 1, 2016 and January 2, 2016, approximately 75% of the fair value of term debt for the Finance group was determined based on discounted cash flow analyses using observable market inputs from debt with similar duration, subordination and credit default expectations (Level 2). Fair value estimates for finance receivables were determined based on internally developed discounted cash flow models primarily utilizing significant unobservable inputs (Level 3), which include estimates of the rate of return, financing cost, capital structure and/or discount rate expectations of current market participants combined with estimated loan cash flows based on credit losses, payment rates and expectations of borrowers' ability to make payments on a timely basis.

Note 11. Accumulated Other Comprehensive Loss and Other Comprehensive Income

The components of Accumulated Other Comprehensive Loss are presented below:

| <i>(In millions)</i> | Pension and Postretirement Benefits Adjustments | Deferred Gains (Losses) on Hedge Contracts | Foreign Currency Translation Adjustments | Accumulated Other Comprehensive Loss |
|--|--|---|---|---|
| For the nine months ended October 1, 2016 | | | | |
| Beginning of the period | \$ (1,327)\$ | (24)\$ | (47)\$ | (1,398) |
| Other comprehensive income before reclassifications | 5 | 11 | 8 | 24 |
| Reclassified from Accumulated other comprehensive loss | 47 | 12 | | 59 |
| Other comprehensive income | 52 | 23 | 8 | 83 |
| End of the period | \$ (1,275)\$ | (1)\$ | (39)\$ | (1,315) |
| For the nine months ended October 3, 2015 | | | | |
| Beginning of the period | \$ (1,511)\$ | (13)\$ | 18\$ | (1,506) |
| Other comprehensive income (loss) before reclassifications | 62 | (22) | (45) | (5) |
| Reclassified from Accumulated other comprehensive loss | 71 | 13 | | 84 |
| Other comprehensive income (loss) | 133 | (9) | (45) | 79 |
| End of the period | \$ (1,378)\$ | (22)\$ | (27)\$ | (1,427) |

The before and after-tax components of other comprehensive income are presented below:

| <i>(In millions)</i> | October 1, 2016 | | | October 3, 2015 | | |
|--|---------------------------|--------------------------------------|-----------------------------|---------------------------|--------------------------------------|-----------------------------|
| | Pre-Tax Amount | Tax (Expense) Benefit | After-Tax Amount | Pre-Tax Amount | Tax (Expense) Benefit | After-Tax Amount |
| Three Months Ended | | | | | | |
| Pension and postretirement benefits adjustments: | | | | | | |
| Amortization of net actuarial loss* | \$ 26\$ | (9)\$ | 17\$ | 36\$ | (12)\$ | 24 |
| Amortization of prior service credit | (2) | 1 | (1) | (2) | | (2) |
| Pension and postretirement benefits adjustments, net | 24 | (8) | 16 | 34 | (12) | 22 |
| Deferred losses on hedge contracts: | | | | | | |

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| | | | | | | |
|--|----------|--------|------|-------|--------|------|
| Current deferrals | (3) | | (3) | (10) | 2 | (8) |
| Reclassification adjustments | 1 | | 1 | 9 | (2) | 7 |
| Deferred losses on hedge contracts, net | (2) | | (2) | (1) | | (1) |
| Foreign currency translation adjustments | 13 | (9) | 4 | 4 | (3) | 1 |
| Total | \$ 35\$ | (17)\$ | 18\$ | 37\$ | (15)\$ | 22 |
| Nine Months Ended | | | | | | |
| Pension and postretirement benefits adjustments: | | | | | | |
| Amortization of net actuarial loss* | \$ 78\$ | (28)\$ | 50\$ | 114\$ | (40)\$ | 74 |
| Amortization of prior service credit* | (6) | 3 | (3) | (4) | 1 | (3) |
| Unrealized gains | 7 | (2) | 5 | 98 | (36) | 62 |
| Pension and postretirement benefits adjustments, net | 79 | (27) | 52 | 208 | (75) | 133 |
| Deferred gains (losses) on hedge contracts: | | | | | | |
| Current deferrals | 17 | (6) | 11 | (28) | 6 | (22) |
| Reclassification adjustments | 16 | (4) | 12 | 18 | (5) | 13 |
| Deferred gains (losses) on hedge contracts, net | 33 | (10) | 23 | (10) | 1 | (9) |
| Foreign currency translation adjustments | 24 | (16) | 8 | (39) | (6) | (45) |
| Total | \$ 136\$ | (53)\$ | 83\$ | 159\$ | (80)\$ | 79 |

*These components of other comprehensive income are included in the computation of net periodic pension cost. See Note 11 of our 2015 Annual Report on Form 10-K for additional information.

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Note 12. Commitments and Contingencies

We are subject to legal proceedings and other claims arising out of the conduct of our business, including proceedings and claims relating to commercial and financial transactions; government contracts; alleged lack of compliance with applicable laws and regulations; production partners; product liability; patent and trademark infringement; employment disputes; and environmental, safety and health matters. Some of these legal proceedings and claims seek damages, fines or penalties in substantial amounts or remediation of environmental contamination. As a government contractor, we are subject to audits, reviews and investigations to determine whether our operations are being conducted in accordance with applicable regulatory requirements. Under federal government procurement regulations, certain claims brought by the U.S. Government could result in our suspension or debarment from U.S. Government contracting for a period of time. On the basis of information presently available, we do not believe that existing proceedings and claims will have a material effect on our financial position or results of operations.

Note 13. Income Taxes

We recognized an income tax benefit of \$192 million in the third quarter of 2016 and \$46 million in the first nine months of 2016, largely related to a settlement with the U.S. Internal Revenue Service Office of Appeals for our 1998 to 2008 tax years, which resulted in a \$206 million benefit recognized in continuing operations. We also recognized a \$113 million benefit in discontinued operations related to the settlement. U.S. federal income tax audits have now been settled for all years prior to 2009. Our reserve for unrecognized tax benefits and accrued interest decreased to \$183 million and \$6 million, respectively, at October 1, 2016, primarily due to the settlement.

In addition to the benefit of \$206 million noted above, the effective tax rate for the third quarter of 2016 was favorably impacted by \$9 million in higher qualified research and development expenses and \$7 million from a change in the mix of our earnings from U.S. to non-U.S., which includes jurisdictions with lower tax rates than the U.S. federal statutory rate. Our U.S. earnings declined primarily due to the impact of restructuring activities as discussed in Note 3.

Note 14. Segment Information

We operate in, and report financial information for, the following five business segments: Textron Aviation, Bell, Textron Systems, Industrial and Finance. Segment profit is an important measure used for evaluating performance and for decision-making purposes. Segment profit for the manufacturing segments excludes interest expense, certain corporate expenses and special charges. The measurement for the Finance segment includes interest income and expense.

Our revenues by segment, along with a reconciliation of segment profit to income from continuing operations before income taxes, are as follows:

| | | |
|----------------------|---------------------------|--------------------------|
| | Three Months Ended | Nine Months Ended |
| <i>(In millions)</i> | | |

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| | | October 1, 2016 | October 3, 2015 | October 1, 2016 | October 3, 2015 |
|---|----|--------------------|--------------------|--------------------|--------------------|
| Revenues | | | | | |
| Textron Aviation | \$ | 1,198\$ | 1,159\$ | 3,485\$ | 3,334 |
| Bell | | 734 | 756 | 2,352 | 2,419 |
| Textron Systems | | 413 | 420 | 1,224 | 1,057 |
| Industrial | | 886 | 828 | 2,842 | 2,627 |
| Finance | | 20 | 17 | 60 | 63 |
| Total revenues | \$ | 3,251\$ | 3,180\$ | 9,963\$ | 9,500 |
| Segment Profit | | | | | |
| Textron Aviation | \$ | 100\$ | 107\$ | 254\$ | 262 |
| Bell | | 97 | 99 | 260 | 276 |
| Textron Systems | | 44 | 39 | 133 | 88 |
| Industrial | | 66 | 61 | 256 | 229 |
| Finance | | 3 | 6 | 15 | 22 |
| Segment profit | | 310 | 312 | 918 | 877 |
| Corporate expenses and other, net | | (53) | (27) | (116) | (102) |
| Interest expense, net for Manufacturing group | | (35) | (33) | (105) | (98) |
| Special charges | | (115) | | (115) | |
| Income from continuing operations before income taxes | \$ | 107\$ | 252\$ | 582\$ | 677 |

Table of Contents**Item 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS****Consolidated Results of Operations**

| <i>(Dollars in millions)</i> | Three Months Ended | | | Nine Months Ended | | |
|---|--------------------|--------------------|-------------|--------------------|--------------------|-------------|
| | October 1, 2016 | October 3, 2015 | % Change | October 1, 2016 | October 3, 2015 | % Change |
| Revenues | \$ 3,251 | \$ 3,180 | 2% | \$ 9,963 | \$ 9,500 | 5% |
| Operating expenses | 2,984 | 2,887 | 3% | 9,134 | 8,697 | 5% |
| Cost of sales | 2,661 | 2,584 | 3% | 8,185 | 7,728 | 6% |
| Selling and administrative expense | 323 | 303 | 7% | 949 | 969 | (2)% |
| Gross margin percentage of Manufacturing revenues | 17.6% | 18.3% | | 17.3% | 18.1% | |

An analysis of our consolidated operating results is set forth below. A more detailed analysis of our segments' operating results is provided in the Segment Analysis section on pages 19 to 23.

Revenues

Revenues increased \$71 million, 2%, in the third quarter of 2016, compared with the third quarter of 2015, largely driven by increases in the Industrial and Textron Aviation segments, partially offset by lower revenues at the Bell and Textron Systems segments. The net revenue increase included the following factors:

- Higher Industrial revenues of \$58 million, primarily due to the impact from acquired businesses of \$42 million and higher volume of \$21 million, largely in the Fuel Systems and Functional Components product line.
- Higher Textron Aviation revenues of \$39 million, primarily due to the impact from an acquired business of \$18 million and higher volume and mix of \$17 million, largely due to higher pre-owned aircraft volume.
- Lower Bell revenues of \$22 million, primarily due to a decrease in commercial revenues of \$108 million, largely reflecting lower aircraft deliveries. This decrease was partially offset by an increase in V-22 program revenues of \$45 million, primarily reflecting higher aircraft deliveries, and an increase in other military revenues of \$41 million, primarily reflecting higher H-1 program revenues.
- Lower Textron Systems revenues of \$7 million, as higher volume of \$25 million in the Marine and Land Systems product line and \$19 million in the Simulation, Training and Other product line was more than offset by lower volume of \$60 million in the Weapons and Sensors product line.

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Revenues increased \$463 million, 5%, in the first nine months of 2016, compared with the first nine months of 2015, largely driven by increases in the Industrial, Textron Systems and Textron Aviation segments, partially offset by lower revenues at the Bell segment. The net revenue increase included the following factors:

- Higher Industrial revenues of \$215 million, primarily due to higher volume of \$132 million, largely in the Fuel Systems and Functional Components product line, and the impact from acquired businesses of \$114 million.
- Higher Textron Systems revenues of \$167 million, primarily due to higher volume of \$81 million in the Unmanned Systems product line, \$34 million in the Simulation, Training and Other product line and \$27 million in the Marine and Land Systems product line.
- Higher Textron Aviation revenues of \$151 million, primarily due to higher volume and mix of \$101 million, largely the result of higher Citation jet volume of \$153 million, partially offset by lower turboprop volume.
- Lower Bell revenues of \$67 million, primarily due to a decrease in commercial revenues of \$196 million, largely reflecting lower aircraft deliveries. This decrease was partially offset by an increase in other military revenues of \$86 million, primarily due to higher H-1 program revenues, and an increase in V-22 program revenues of \$43 million, primarily reflecting higher aircraft deliveries.

Cost of Sales and Selling and Administrative Expense

Manufacturing cost of sales and selling and administrative expense together comprise our operating expenses. Cost of sales increased \$77 million, 3%, in the third quarter of 2016, compared with the third quarter of 2015, largely due to an increase from acquired businesses and higher volume at the Textron Aviation and Industrial segments. In the third quarter of 2016, the decrease in gross margin percentage was largely driven by an unfavorable impact from the mix of products sold at Textron Aviation.

Cost of sales increased \$457 million, 6%, in the first nine months of 2016, compared with the first nine months of 2015, largely due to higher volume at the Textron Systems, Industrial and Textron Aviation segments, and an increase from acquired businesses. In the first nine months of 2016, the decrease in gross margin percentage was largely driven by an unfavorable impact from the mix of products sold at Textron Aviation.

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Selling and administrative expense increased \$20 million, 7%, in the third quarter of 2016 and decreased \$20 million, 2%, in the first nine months of 2016, compared with the corresponding periods of 2015. The 7% increase in the third quarter of 2016 was largely due to higher share-based compensation expense.

Special Charges

Special charges recorded in the third quarter of 2016 are as follows:

| <i>(In millions)</i> | Severance Costs | Asset Impairments | Contract Terminations and Other | Total |
|----------------------|----------------------------|------------------------------|--|--------------|
| Textron Systems | \$ 13\$ | 33\$ | 13\$ | 59 |
| Textron Aviation | 34 | 1 | | 35 |
| Industrial | 11 | 2 | | 13 |
| Bell | 8 | | | 8 |
| | \$ 66\$ | 36\$ | 13\$ | 115 |

Our Board of Directors approved a plan in the third quarter of 2016 to restructure and realign our businesses by implementing headcount reductions, facility consolidations and other actions in order to improve overall operating efficiency across Textron. The plan provides for Textron Systems to discontinue production of its sensor-fuzed weapon product, which will generate headcount reductions, facility consolidations and asset impairments within its Weapons and Sensors operating unit. Historically, sensor-fuzed weapon sales have relied on foreign military and direct commercial international customers for which both executive branch and congressional approval is required. The current political environment has made it difficult to obtain these approvals. Within our Industrial segment, the plan provides for the combination of our Jacobsen business with the Textron Specialized Vehicles businesses, resulting in the consolidation of certain facilities and general and administrative functions and related headcount reductions. As a result of ongoing evaluations, we subsequently decided to take additional restructuring actions, principally headcount reductions, in our Textron Aviation segment, as well as other businesses. The total headcount reduction related to restructuring activities is expected to be approximately 1,700 positions, representing approximately 5% of our workforce.

We expect to incur additional pre-tax charges under this plan of approximately \$25 million to \$55 million, primarily related to contract termination, severance, facility consolidation and relocation costs. The remaining charges are expected to primarily be in the Industrial and Textron Systems segments. We anticipate the plan to be substantially completed by March 2017. Expected cash outlays for these activities are estimated to be in the range of \$100 million to \$120 million, approximately half of which is expected to be expended in 2016 and the remainder in 2017.

Income Taxes

We recognized an income tax benefit of \$192 million in the third quarter of 2016 and \$46 million in the first nine months of 2016, largely related to a settlement with the U.S. Internal Revenue Service Office of Appeals for our 1998 to 2008 tax years, which resulted in a \$206 million benefit recognized in continuing operations. We also recognized a \$113 million benefit in discontinued operations related to the settlement. In addition to the benefit of \$206 million, the effective tax rate for the third quarter of 2016 was favorably impacted by \$9 million in higher qualified research and development expenses and \$7 million from a change in the mix of our earnings from U.S. to non-U.S., which includes jurisdictions with lower tax rates than the U.S. federal statutory rate. Our U.S. earnings declined primarily due to the impact of restructuring activities as discussed above.

Backlog

| <i>(In millions)</i> | | October 1, | January 2, |
|----------------------|----|-------------------|-------------------|
| | | 2016 | 2016 |
| Bell | \$ | 4,944 | \$ 5,224 |
| Textron Systems | | 2,208 | 2,328 |
| Textron Aviation | | 1,114 | 1,074 |
| Total backlog | \$ | 8,266 | \$ 8,626 |

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We operate in, and report financial information for, the following five business segments: Textron Aviation, Bell, Textron Systems, Industrial and Finance. Segment profit is an important measure used for evaluating performance and for decision-making purposes. Segment profit for the manufacturing segments excludes interest expense, certain corporate expenses and special charges. The measurement for the Finance segment includes interest income and expense.

In our discussion of comparative results for the Manufacturing group, changes in revenue and segment profit typically are expressed for our commercial business in terms of volume, pricing, foreign exchange and acquisitions. Additionally, changes in segment profit may be expressed in terms of mix, inflation and cost performance. Volume changes in revenue represent increases/decreases in the number of units delivered or services provided. Pricing represents changes in unit pricing. Foreign exchange is the change resulting from translating foreign-denominated amounts into U.S. dollars at exchange rates that are different from the prior period. Revenues generated by acquired businesses are reflected in Acquisitions for a twelve-month period. For segment profit, mix represents a change due to the composition of products and/or services sold at different profit margins. Inflation represents higher material, wages, benefits, pension or other costs. Performance reflects an increase or decrease in research and development, depreciation, selling and administrative costs, warranty, product liability, quality/scrap, labor efficiency, overhead, product line profitability, start-up, ramp up and cost-reduction initiatives or other manufacturing inputs.

Approximately 24% of our 2015 revenues were derived from contracts with the U.S. Government. For our segments that have significant contracts with the U.S. Government, we typically express changes in segment profit related to the government business in terms of volume, changes in program performance or changes in contract mix. Changes in volume that are described in net sales typically drive corresponding changes in our segment profit based on the profit rate for a particular contract. Changes in program performance typically relate to profit recognition associated with revisions to total estimated costs at completion that reflect improved or deteriorated operating performance or award fee rates. Changes in contract mix refers to changes in operating margin due to a change in the relative volume of contracts with higher or lower fee rates such that the overall average margin rate for the segment changes.

Textron Aviation

| | Three Months Ended | | Nine Months Ended | |
|------------------------------|--------------------|--------------------|--------------------|--------------------|
| | October 1, 2016 | October 3, 2015 | October 1, 2016 | October 3, 2015 |
| <i>(Dollars in millions)</i> | | | | |
| Revenues | \$ 1,198 | \$ 1,159 | \$ 3,485 | \$ 3,334 |
| Operating expenses | 1,098 | 1,052 | 3,231 | 3,072 |
| Segment profit | 100 | 107 | 254 | 262 |
| Profit margin | 8.3% | 9.2% | 7.3% | 7.9% |

Textron Aviation Revenues and Operating Expenses

The following factors contributed to the change in Textron Aviation's revenues for the periods:

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| | | Q3 2016 | YTD 2016 |
|----------------------|----|----------------|-----------------|
| | | versus | versus |
| | | Q3 2015 | YTD 2015 |
| <i>(In millions)</i> | | | |
| Volume and mix | \$ | 17\$ | 101 |
| Acquisitions | | 18 | 51 |
| Other | | 4 | (1) |
| Total change | \$ | 39\$ | 151 |

In the third quarter of 2016, Textron Aviation's revenues increased \$39 million, 3%, compared with the third quarter of 2015, primarily due to the impact from an acquisition of a repair and overhaul business in the first quarter of 2016 and higher volume and mix of \$17 million, largely due to higher pre-owned aircraft volume. We delivered 41 Citation jets and 29 King Air turboprops in the third quarter of 2016, compared with 37 Citation jets and 29 King Air turboprops in the third quarter of 2015. The portion of the segment's revenues derived from aftermarket sales and services represented 30% of its total revenues in both the third quarter of 2016 and 2015.

In the first nine months of 2016, Textron Aviation's revenues increased \$151 million, 5%, compared with the first nine months of 2015, primarily due to higher volume and mix of \$101 million and the impact from the acquisition. The increase in volume and mix is primarily due to higher Citation jet volume of \$153 million, partially offset by lower turboprop volume. We delivered 120 Citation jets and 78 King Air turboprops in the first nine months of 2016, compared with 106 Citation jets and 84 King Air turboprops in the first nine months of 2015. The portion of the segment's revenues derived from aftermarket sales and services represented 33% of its total revenues in the first nine months of 2016, compared with 32% in the first nine months of 2015.

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Textron Aviation's operating expenses increased \$46 million, 4%, and \$159 million, 5%, in the third quarter and first nine months of 2016, respectively, compared with the corresponding periods of 2015, largely due to higher volume as described above and additional operating expenses resulting from the acquisition.

Textron Aviation Segment Profit

The following factors contributed to the change in Textron Aviation's segment profit for the periods:

| | | Q3 2016 | YTD 2016 |
|---------------------------|----|----------------|-----------------|
| | | versus | versus |
| | | Q3 2015 | YTD 2015 |
| <i>(In millions)</i> | | | |
| Performance | \$ | 16\$ | 19 |
| Inflation, net of pricing | | (8) | (15) |
| Volume and mix | | (15) | (12) |
| Total change | \$ | (7)\$ | (8) |

Segment profit at Textron Aviation decreased \$7 million, 7%, in the third quarter of 2016, compared with the third quarter of 2015, primarily as a result of the mix of products sold. Segment profit was also impacted by favorable performance of \$16 million, largely attributable to lower research and development costs.

Segment profit at Textron Aviation decreased \$8 million, 3%, in the first nine months of 2016, compared with the first nine months of 2015, primarily due to the mix of products sold.

Bell

| | | Three Months Ended | | Nine Months Ended | |
|------------------------------|----|---------------------------|-------------------|--------------------------|-------------------|
| | | October 1, | October 3, | October 1, | October 3, |
| | | 2016 | 2015 | 2016 | 2015 |
| <i>(Dollars in millions)</i> | | | | | |
| Revenues: | | | | | |
| V-22 program | \$ | 280\$ | 235\$ | 871\$ | 828 |
| Other military | | 213 | 172 | 683 | 597 |
| Commercial | | 241 | 349 | 798 | 994 |
| Total revenues | | 734 | 756 | 2,352 | 2,419 |
| Operating expenses | | 637 | 657 | 2,092 | 2,143 |
| Segment profit | | 97 | 99 | 260 | 276 |
| Profit margin | | 13.2% | 13.1% | 11.1% | 11.4% |

Bell's major U.S. Government programs at this time are the V-22 tiltrotor aircraft and the H-1 helicopter platforms, which are both in the production stage and represent a significant portion of Bell's revenues from the U.S. Government.

Bell Revenues and Operating Expenses

The following factors contributed to the change in Bell's revenues for the periods:

| <i>(In millions)</i> | | Q3 2016 | YTD 2016 |
|----------------------|----|----------------|-----------------|
| | | versus | versus |
| | | Q3 2015 | YTD 2015 |
| Volume and mix | \$ | (27)\$ | (74) |
| Other | | 5 | 7 |
| Total change | \$ | (22)\$ | (67) |

Bell's revenues decreased \$22 million, 3%, in the third quarter of 2016, compared with the third quarter of 2015, primarily due to the following factors:

- \$108 million decrease in commercial revenues, primarily due to lower aircraft deliveries. Bell delivered 25 commercial aircraft in the third quarter of 2016, compared with 45 aircraft in the third quarter of 2015.
- \$45 million increase in V-22 program revenues, primarily reflecting higher aircraft deliveries. Bell delivered 6 V-22 aircraft in the third quarter of 2016, compared with 4 V-22 aircraft in the third quarter of 2015.
- \$41 million increase in other military revenues, primarily reflecting higher H-1 program revenues. Bell delivered 8 H-1 aircraft in the third quarter of 2016, compared with 5 H-1 aircraft in the third quarter of 2015.

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Bell's revenues decreased \$67 million, 3%, in the first nine months of 2016, compared with the first nine months of 2015, primarily due to the following factors:

- \$196 million decrease in commercial revenues, primarily due to lower aircraft deliveries. Bell delivered 79 commercial aircraft in the first nine months of 2016, compared with 119 aircraft in the first nine months of 2015.
- \$86 million increase in other military revenues, primarily reflecting higher H-1 program revenues. Bell delivered 27 H-1 aircraft in the first nine months of 2016, compared with 15 H-1 aircraft in the first nine months of 2015.
- \$43 million increase in V-22 program revenues, primarily reflecting higher aircraft deliveries. Bell delivered 18 V-22 aircraft in the first nine months of 2016, compared with 16 V-22 aircraft in the first nine months of 2015.

Bell's operating expenses decreased \$20 million, 3%, and \$51 million, 2%, in the third quarter and first nine months of 2016, respectively, compared with the corresponding periods of 2015, primarily due to lower net sales volume as described above.

Bell Segment Profit

The following factors contributed to the change in Bell's segment profit for the periods:

| | | Q3 2016 | YTD 2016 |
|-----------------------|----|---------|----------|
| | | versus | versus |
| | | Q3 2015 | YTD 2015 |
| <i>(In millions)</i> | | | |
| Volume and mix | \$ | (12)\$ | (33) |
| Performance and other | | 10 | 17 |
| Total change | \$ | (2)\$ | (16) |

Bell's segment profit decreased \$2 million, 2%, and \$16 million, 6%, in the third quarter and first nine months of 2016, respectively, compared with the corresponding periods of 2015. The unfavorable impact from volume and mix was primarily due to lower commercial aircraft deliveries, while the favorable performance was largely the result of lower research and development costs.

Textron Systems

(Dollars in millions)

| | Three Months Ended | Nine Months Ended |
|--|--------------------|-------------------|
|--|--------------------|-------------------|

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| | | October 1, 2016 | October 3, 2015 | October 1, 2016 | October 3, 2015 |
|--------------------|----|--------------------|--------------------|--------------------|--------------------|
| Revenues | \$ | 413\$ | 420\$ | 1,224\$ | 1,057 |
| Operating expenses | | 369 | 381 | 1,091 | 969 |
| Segment profit | | 44 | 39 | 133 | 88 |
| Profit margin | | 10.7% | 9.3% | 10.9% | 8.3% |

Textron Systems Revenues and Operating Expenses

The following factors contributed to the change in Textron Systems revenues for the periods:

| <i>(In millions)</i> | | Q3 2016 versus Q3 2015 | YTD 2016 versus YTD 2015 |
|----------------------|----|------------------------------|--------------------------------|
| Volume | \$ | (19)\$ | 142 |
| Acquisitions | | 10 | 22 |
| Other | | 2 | 3 |
| Total change | \$ | (7)\$ | 167 |

Revenues at Textron Systems decreased \$7 million, 2%, in the third quarter of 2016, compared with the third quarter of 2015, as higher volume of \$25 million in the Marine and Land Systems product line and \$19 million in the Simulation, Training and Other product line was more than offset by lower volume of \$60 million in the Weapons and Sensors product line.

Revenues at Textron Systems increased \$167 million, 16%, in the first nine months of 2016, compared with the first nine months of 2015, primarily due to higher volume of \$81 million in the Unmanned Systems product line, \$34 million in the Simulation, Training and Other product line and \$27 million in the Marine and Land Systems product line.

Textron Systems operating expenses decreased \$12 million, 3%, in the third quarter of 2016, compared with the third quarter of 2015, primarily due to improved cost performance.

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Textron Systems operating expenses increased \$122 million, 13%, in the first nine months of 2016, compared with the first nine months of 2015, primarily due to higher volume as described above.

As discussed in the Special Charges section above, in the third quarter of 2016, a restructuring plan was approved by our Board of Directors. The restructuring plan provides for Textron Systems to discontinue production of sensor-fuzed weapons product within the Weapons and Sensors product line.

Textron Systems Segment Profit

The following factors contributed to the change in Textron Systems segment profit for the periods:

| <i>(In millions)</i> | | Q3 2016 | |
|----------------------|----|---------|--------------------------------|
| | | versus | |
| | | Q3 2015 | YTD 2016 versus YTD 2015 |
| Performance | \$ | 14\$ | 23 |
| Volume and mix | | (9) | 22 |
| Total change | \$ | 5\$ | 45 |

Textron Systems segment profit increased \$5 million, 13%, in the third quarter of 2016, compared with the third quarter of 2015, primarily due to improved cost performance, partially offset by lower net volume as described above.

Textron Systems segment profit increased \$45 million, 51%, in first nine months of 2016, compared with the first nine months of 2015, primarily due to improved cost performance and higher volume as described above.

Industrial

| <i>(Dollars in millions)</i> | | Three Months Ended | | Nine Months Ended | |
|--|----|--------------------|--------------------|--------------------|--------------------|
| | | October 1, 2016 | October 3, 2015 | October 1, 2016 | October 3, 2015 |
| Revenues: | | | | | |
| Fuel Systems and Functional Components | \$ | 533\$ | 485\$ | 1,705\$ | 1,524 |
| Other Industrial | | 353 | 343 | 1,137 | 1,103 |
| Total revenues | | 886 | 828 | 2,842 | 2,627 |
| Operating expenses | | 820 | 767 | 2,586 | 2,398 |
| Segment profit | | 66 | 61 | 256 | 229 |

| | | | | |
|---------------|------|------|------|------|
| Profit margin | 7.4% | 7.4% | 9.0% | 8.7% |
|---------------|------|------|------|------|

Industrial Revenues and Operating Expenses

The following factors contributed to the change in Industrial s revenues for the periods:

| <i>(In millions)</i> | | Q3 2016 versus Q3 2015 | YTD 2016 versus YTD 2015 |
|----------------------|----|---------------------------------------|---|
| Volume | \$ | 21\$ | 132 |
| Acquisitions | | 42 | 114 |
| Foreign exchange | | (4) | (26) |
| Other | | (1) | (5) |
| Total change | \$ | 58\$ | 215 |

Industrial segment revenues increased \$58 million, 7%, in the third quarter of 2016, compared with the third quarter of 2015, primarily due to the impact from acquired businesses of \$42 million and higher volume of \$21 million. Higher volume was primarily related to the Fuel Systems and Functional Components product line, largely reflecting automotive industry demand in Asia and Europe.

Industrial segment revenues increased \$215 million, 8%, in the first nine months of 2016, compared with the first nine months of 2015, primarily due to higher volume of \$132 million and the impact from acquired businesses of \$114 million. Higher volume was primarily related to the Fuel Systems and Functional Components product line, largely reflecting automotive industry demand in Europe.

Operating expenses for the Industrial segment increased \$53 million, 7%, and \$188 million, 8%, in the third quarter and first nine months of 2016, respectively, compared with the corresponding periods of 2015, primarily due to the impact from higher volume as described above and additional operating expenses from acquired businesses.

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Industrial Segment Profit

The following factors contributed to the change in Industrial s segment profit for the periods:

| <i>(In millions)</i> | | Q3 2016 versus Q3 2015 | YTD 2016 versus YTD 2015 |
|---------------------------|----|---------------------------------------|---|
| Performance | \$ | 4\$ | 13 |
| Volume | | (2) | 12 |
| Inflation, net of pricing | | 4 | 12 |
| Foreign exchange | | (1) | (10) |
| Total change | \$ | 5\$ | 27 |

Segment profit for the Industrial segment increased \$5 million, 8%, in the third quarter of 2016, compared with the third quarter of 2015, largely due to improved performance, primarily in the Fuel Systems and Functional Components product line.

Segment profit for the Industrial segment increased \$27 million, 12%, in the first nine months of 2016, compared with the first nine months of 2015, largely due to improved performance, primarily in the Fuel Systems and Functional Components product line, and the impact from higher volume as described above.

Finance

| <i>(In millions)</i> | | Three Months Ended | | Nine Months Ended | |
|----------------------|----|----------------------------|----------------------------|----------------------------|----------------------------|
| | | October 1, 2016 | October 3, 2015 | October 1, 2016 | October 3, 2015 |
| Revenues | \$ | 20\$ | 17\$ | 60\$ | 63 |
| Segment profit | | 3 | 6 | 15 | 22 |

Finance segment revenues increased \$3 million in the third quarter of 2016 and decreased \$3 million in the first nine months of 2016, compared with the corresponding periods of 2015. Finance segment profit decreased \$3 million in the third quarter of 2016, compared with the third quarter of 2015, primarily due to higher provision for loan losses. Segment profit decreased \$7 million in the first nine months of 2016, compared with the first nine months of 2015, primarily due to higher provision for loan losses and lower average finance receivables.

Finance Portfolio Quality

The following table reflects information about the Finance segment s credit performance related to finance receivables.

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| <i>(Dollars in millions)</i> | | October 1, 2016 | January 2, 2016 |
|---|----|----------------------------|----------------------------|
| Finance receivables* | \$ | 983\$ | 1,105 |
| Nonaccrual finance receivables | | 90 | 84 |
| Ratio of nonaccrual finance receivables to finance receivables | | 9.16% | 7.60% |
| 60+ days contractual delinquency | \$ | 85\$ | 69 |
| 60+ days contractual delinquency as a percentage of finance receivables | | 8.65% | 6.24% |

* Excludes finance receivables held for sale.

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Our financings are conducted through two separate borrowing groups. The Manufacturing group consists of Textron consolidated with its majority-owned subsidiaries that operate in the Textron Aviation, Bell, Textron Systems and Industrial segments. The Finance group, which also is the Finance segment, consists of Textron Financial Corporation and its consolidated subsidiaries. We designed this framework to enhance our borrowing power by separating the Finance group. Our Manufacturing group operations include the development, production and delivery of tangible goods and services, while our Finance group provides financial services. Due to the fundamental differences between each borrowing group's activities, investors, rating agencies and analysts use different measures to evaluate each group's performance. To support those evaluations, we present balance sheet and cash flow information for each borrowing group within the Consolidated Financial Statements.

Key information that is utilized in assessing our liquidity is summarized below:

| <i>(Dollars in millions)</i> | | October 1, 2016 | January 2, 2016 |
|---|----|----------------------------|----------------------------|
| Manufacturing group | | | |
| Cash and equivalents | \$ | 589\$ | 946 |
| Debt | | 2,903 | 2,697 |
| Shareholders' equity | | 5,651 | 4,964 |
| Capital (debt plus shareholders' equity) | | 8,554 | 7,661 |
| Net debt (net of cash and equivalents) to capital | | 29% | 26% |
| Debt to capital | | 34% | 35% |
| Finance group | | | |
| Cash and equivalents | \$ | 150\$ | 59 |
| Debt | | 919 | 913 |

We believe that our calculations of debt to capital and net debt to capital are useful measures as they provide a summary indication of the level of debt financing (i.e., leverage) that is in place to support our capital structure, as well as to provide an indication of the capacity to add further leverage. We believe that we will have sufficient cash to meet our future needs, based on our existing cash balances, the cash we expect to generate from our manufacturing operations and other available funding alternatives, as appropriate.

On September 30, 2016, Textron entered into a senior unsecured revolving credit facility for an aggregate principal amount of \$1.0 billion, of which up to \$100 million is available for the issuance of letters of credit. This facility expires in September 2021 and replaced the existing 5-year facility, which had no outstanding borrowings, and was scheduled to expire in October 2018. At October 1, 2016, there were no amounts borrowed against the new facility.

We also maintain an effective shelf registration statement filed with the Securities and Exchange Commission that allows us to issue an unlimited amount of public debt and other securities. In March 2016, we issued \$350 million in 4.0% Notes due March 2026 under this registration statement.

Manufacturing Group Cash Flows

Cash flows from continuing operations for the Manufacturing group as presented in our Consolidated Statements of Cash Flows are summarized below:

| <i>(In millions)</i> | | Nine Months Ended | |
|----------------------|----|----------------------------|----------------------------|
| | | October 1, 2016 | October 3, 2015 |
| Operating activities | \$ | 137 | 347 |
| Investing activities | | (480) | (365) |
| Financing activities | | (9) | (203) |

Cash flows from operating activities decreased \$210 million during the first nine months of 2016, compared with the first nine months of 2015, primarily due to a change in working capital, largely the result of a decrease in customer deposits related to performance-based payments on certain military contracts. In the first nine months of 2016, cash flows from operating activities included \$75 million of cash proceeds from the settlements of corporate-owned life insurance policies.

Cash flows used in investing activities included capital expenditures of \$306 million and \$286 million in the first nine months of 2016 and 2015, respectively. Investing cash flows also reflected aggregate cash payments of \$179 million for five business acquisitions in the first nine months of 2016, compared with payments of \$81 million for acquisitions in the first nine months of 2015.

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In the first nine months of 2016, financing cash flows included proceeds from long-term debt of \$345 million and an increase in short-term debt of \$110 million, primarily from the issuance of commercial paper. These cash inflows were more than offset by the repayment of \$253 million of long-term debt and \$215 million in cash paid to repurchase an aggregate of 6.2 million shares of our outstanding common stock under a 2013 share repurchase authorization. Financing activities in the first nine months of 2015 included the repurchase of an aggregate of 5.0 million shares of our outstanding common stock for \$211 million.

Finance Group Cash Flows

Cash flows from continuing operations for the Finance group as presented in our Consolidated Statements of Cash Flows are summarized below:

| <i>(In millions)</i> | | Nine Months Ended | |
|----------------------|----|----------------------------|----------------------------|
| | | October 1, 2016 | October 3, 2015 |
| Operating activities | \$ | 7\$ | 27 |
| Investing activities | | 118 | 160 |
| Financing activities | | (34) | (161) |

The Finance group's cash flows from investing activities primarily included collections on finance receivables totaling \$220 million and \$269 million in the first nine months of 2016 and 2015, respectively, partially offset by finance receivable originations of \$126 million and \$145 million, respectively.

In the first nine months of 2016, cash flows used in financing activities included payments on long-term and nonrecourse debt of \$180 million, which were mostly offset by proceeds from long-term debt of \$175 million. Cash flows used in financing activities in the first nine months of 2015 primarily included the repayment of \$196 million of long-term and nonrecourse debt.

Consolidated Cash Flows

The consolidated cash flows from continuing operations, after elimination of activity between the borrowing groups, are summarized below:

| <i>(In millions)</i> | | Nine Months Ended | |
|----------------------|----|----------------------------|----------------------------|
| | | October 1, 2016 | October 3, 2015 |
| Operating activities | \$ | 145\$ | 419 |
| Investing activities | | (392) | (270) |
| Financing activities | | (14) | (344) |

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Cash flows from operating activities decreased \$274 million during the first nine months of 2016, compared with the first nine months of 2015, primarily due to a change in working capital, largely the result of a decrease in customer deposits related to performance-based payments on certain military contracts. In the first nine months of 2016, cash flows from operating activities included \$75 million of cash proceeds from the settlements of corporate-owned life insurance policies.

Investing cash flows included cash used for capital expenditures of \$306 million and \$286 million and acquisitions of \$179 million and \$81 million in the first nine months of 2016 and 2015, respectively.

Total financing cash flows in the first nine months of 2016 primarily included proceeds from long-term debt of \$520 million and an increase in short-term debt of \$110 million, which were more than offset by the repayment of \$433 million of long-term and nonrecourse debt and share repurchases of \$215 million. Cash flows from financing activities in the first nine months of 2015 primarily consisted of payments on long-term and nonrecourse debt of \$196 million and share repurchases of \$211 million.

Captive Financing and Other Intercompany Transactions

The Finance group finances retail purchases and leases for new and pre-owned aircraft and helicopters manufactured by our Manufacturing group, otherwise known as captive financing. In the Consolidated Statements of Cash Flows, cash received from customers or from the sale of receivables, is reflected as operating activities when received from third parties. However, in the cash flow information provided for the separate borrowing groups, cash flows related to captive financing activities are reflected based on the operations of each group. For example, when product is sold by our Manufacturing group to a customer and is financed by the Finance group, the origination of the finance receivable is recorded within investing activities as a cash outflow in the Finance group's statement of cash flows. Meanwhile, in the Manufacturing group's statement of cash flows, the cash received from the Finance group on the customer's behalf is recorded within operating cash flows as a cash inflow. Although cash is transferred between the two borrowing groups, there is no cash transaction reported in the consolidated cash flows at the time of the original financing. These captive financing activities, along with all significant intercompany transactions, are reclassified or eliminated from the Consolidated Statements of Cash Flows.

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Reclassification adjustments included in the Consolidated Statements of Cash Flows are summarized below:

| | Nine Months Ended | |
|---|--------------------------|-------------------|
| | October 1, | October 3, |
| <i>(In millions)</i> | 2016 | 2015 |
| Reclassification adjustments from investing activities: | | |
| Cash received from customers | \$ 180 | \$ 203 |
| Finance receivable originations for Manufacturing group inventory sales | (126) | (145) |
| Other | (24) | 7 |
| Total reclassification adjustments from investing activities | 30 | 65 |
| Reclassification adjustments from financing activities: | | |
| Dividends received by Manufacturing group from Finance group | (29) | (20) |
| Total reclassification adjustments to operating activities | \$ 1 | \$ 45 |

Critical Accounting Estimates

The accounting policies that we believe are most critical to the portrayal of our financial condition and results of operations are disclosed on pages 31 through 33 in our 2015 Annual Report on Form 10-K. The following section provides an update of the year-end disclosure.

Long-Term Contracts

We make a substantial portion of our sales to government customers pursuant to long-term contracts. These contracts require development and delivery of products over multiple years and may contain fixed-price purchase options for additional products. We account for these long-term contracts under the percentage-of-completion method of accounting. Under this method, we estimate profit as the difference between total estimated revenues and cost of a contract. The percentage-of-completion method of accounting involves the use of various estimating techniques to project costs at completion and, in some cases, includes estimates of recoveries asserted against the customer for changes in specifications. Due to the size, length of time and nature of many of our contracts, the estimation of total contract costs and revenues through completion is complicated and subject to many variables relative to the outcome of future events over a period of several years. We are required to make numerous assumptions and estimates relating to items such as expected engineering requirements, complexity of design and related development costs, product performance, performance of subcontractors, availability and cost of materials, labor productivity and cost, overhead and capital costs, manufacturing efficiencies and the achievement of contract milestones, including product deliveries, technical requirements, or schedule.

At the outset of each contract, we estimate the initial profit booking rate. The initial profit booking rate of each contract considers risks surrounding the ability to achieve the technical requirements (for example, a newly-developed product versus a mature product), schedule (for example, the number and type of milestone events), and costs by contract requirements in the initial estimated costs at completion. Profit booking rates may increase during the performance of the contract if we successfully retire risks surrounding the technical, schedule, and costs aspects of the contract. Likewise, the profit booking rate may decrease if we are not successful in retiring the risks; and, as a result, our estimated costs at completion increase. All of the estimates are subject to change during the performance of the contract and, therefore, may affect the profit booking rate. When adjustments are required, any changes from prior estimates are recognized using the cumulative catch-up method with the impact of the change from inception-to-date recorded in the current period. The aggregate gross amount of all program profit adjustments that are included within segment profit are presented below.

| <i>(In millions)</i> | Three Months Ended | | Nine Months Ended | |
|----------------------|----------------------------|----------------------------|----------------------------|----------------------------|
| | October 1, 2016 | October 3, 2015 | October 1, 2016 | October 3, 2015 |
| Gross favorable | \$ 21\$ | 20\$ | 74\$ | 93 |
| Gross unfavorable | (3) | (6) | (17) | (25) |
| Net adjustments | \$ 18\$ | 14\$ | 57\$ | 68 |

Goodwill

We evaluate the recoverability of goodwill annually in the fourth quarter or more frequently if events or changes in circumstances, such as declines in sales, earnings or cash flows, or material adverse changes in the business climate, indicate that the carrying value of a reporting unit might be impaired. The reporting unit represents the operating segment unless discrete financial information is prepared and reviewed by segment management for businesses one level below that operating segment, in which case such component is the reporting unit. In certain instances, we have aggregated components of an operating segment into a single reporting unit based on similar economic characteristics.

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During the third quarter of 2016, we determined that sufficient indication existed to require performance of an interim goodwill impairment analysis of one of the reporting units within the Textron Systems segment. That reporting unit includes certain businesses that have similar economic characteristics and includes the Weapons & Sensors operating unit. Historically, sensor-fuzed weapon sales for this operating unit have relied on foreign military and direct commercial international customers for which both executive branch and congressional approval is required. The current political environment has made it difficult to obtain these approvals and we have not been able to obtain new contracts without such approvals. As a result, in the third quarter of 2016, our Board of Directors approved a restructuring plan that included discontinuing production of the sensor-fuzed weapon product. The exit from this product line will result in lower forecasted cash flows for the reporting unit going forward, which was an indicator that required an impairment analysis of the related long-lived assets and reporting unit's goodwill.

We calculated the fair value of the reporting unit using discounted cash flows, which incorporated assumptions for short- and long-term revenue growth rates, operating margins and discount rates that represent our best estimates of current and forecasted market conditions, cost structure, anticipated net cost reductions, and the implied rate of return that we believe a market participant would require for an investment in a business having similar risks and business characteristics to the reporting unit being assessed. The revenue growth rates and operating margins used in our discounted cash flow analysis were based on our strategic plans and long-range planning forecasts, which were updated to reflect the impact of discontinuing the sensor-fuzed weapon product sales. The long-term growth rate we used to determine the terminal value of the business was based on our assessment of its minimum expected terminal growth rate, as well as its past historical growth and broader economic considerations such as gross domestic product, inflation and the maturity of the markets we serve. We utilized a discount rate that reflected a rate that is consistent with the implied rate of return that an independent investor or market participant would require for an investment in a company having similar risks and business characteristics to the reporting unit. Based on our analysis, fair value exceeded the carrying value of the reporting unit by approximately 25% and goodwill is not impaired at October 1, 2016.

Forward-Looking Information

Certain statements in this Quarterly Report on Form 10-Q and other oral and written statements made by us from time to time are forward-looking statements within the meaning of the Private Securities Litigation Reform Act of 1995. These forward-looking statements, which may describe strategies, goals, outlook or other non-historical matters, or project revenues, income, returns or other financial measures, often include words such as believe, expect, anticipate, intend, plan, estimate, guidance, project, target, potential, will, may and similar expressions intended to identify forward-looking statements. These statements are only predictions and involve known and unknown risks, uncertainties, and other factors that may cause our actual results to differ materially from those expressed or implied by such forward-looking statements. Given these uncertainties, you should not place undue reliance on these forward-looking statements. Forward-looking statements speak only as of the date on which they are made, and we undertake no obligation to update or revise any forward-looking statements. In addition to those factors described in our 2015 Annual Report on Form 10-K under RISK FACTORS, among the factors that could cause actual results to differ materially from past and projected future results are the following:

- Interruptions in the U.S. Government's ability to fund its activities and/or pay its obligations;
- Changing priorities or reductions in the U.S. Government defense budget, including those related to military operations in foreign countries;
- Our ability to perform as anticipated and to control costs under contracts with the U.S. Government;
- The U.S. Government's ability to unilaterally modify or terminate its contracts with us for the U.S. Government's convenience or for our failure to perform, to change applicable procurement and accounting policies, or, under certain circumstances, to withhold payment or suspend or debar us as a contractor eligible to receive future contract awards;
- Changes in foreign military funding priorities or budget constraints and determinations, or changes in government regulations or policies on the export and import of military and commercial products;
- Volatility in the global economy or changes in worldwide political conditions that adversely impact demand for our products;
- Volatility in interest rates or foreign exchange rates;
- Risks related to our international business, including establishing and maintaining facilities in locations around the world and relying on joint venture partners, subcontractors, suppliers, representatives, consultants and other business partners in connection with international business, including in emerging market countries;

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- Our Finance segment's ability to maintain portfolio credit quality or to realize full value of receivables;
- Performance issues with key suppliers or subcontractors;
- Legislative or regulatory actions, both domestic and foreign, impacting our operations or demand for our products;
- Our ability to control costs and successfully implement various cost-reduction activities;
- The efficacy of research and development investments to develop new products or unanticipated expenses in connection with the launching of significant new products or programs;
- The timing of our new product launches or certifications of our new aircraft products;
- Our ability to keep pace with our competitors in the introduction of new products and upgrades with features and technologies desired by our customers;

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- Pension plan assumptions and future contributions;
- Demand softness or volatility in the markets in which we do business; and
- Cybersecurity threats, including the potential misappropriation of assets or sensitive information, corruption of data or operational disruption.

Item 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

There has been no significant change in our exposure to market risk during the fiscal quarter ended October 1, 2016. For discussion of our exposure to market risk, refer to Item 7A. Quantitative and Qualitative Disclosures about Market Risk contained in Textron's 2015 Annual Report on Form 10-K.

Item 4. CONTROLS AND PROCEDURES

We performed an evaluation of the effectiveness of our disclosure controls and procedures as of October 1, 2016. The evaluation was performed with the participation of senior management of each business segment and key Corporate functions, under the supervision of our Chairman, President and Chief Executive Officer (CEO) and our Executive Vice President and Chief Financial Officer (CFO). Based on this evaluation, the CEO and CFO concluded that our disclosure controls and procedures were operating and effective as of October 1, 2016.

There were no changes in our internal control over financial reporting during the fiscal quarter ended October 1, 2016 that materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

PART II. OTHER INFORMATION

Item 1. LEGAL PROCEEDINGS

On February 7, 2012, a lawsuit was filed in the United States Bankruptcy Court, Northern District of Ohio, Eastern Division (Akron) by Brian A. Bash, Chapter 7 Trustee for Fair Finance Company against TFC, Fortress Credit Corp. and Fair Facility I, LLC. TFC provided a revolving line of credit of up to \$17.5 million to Fair Finance Company from 2002 through 2007. The complaint alleges numerous counts against TFC, as Fair Finance Company's working capital lender, including receipt of fraudulent transfers and assisting in fraud perpetrated on Fair Finance investors. The Trustee seeks avoidance and recovery of alleged fraudulent transfers in the amount of \$316 million as well as damages of \$223 million on the other claims. The Trustee also seeks trebled damages on all claims under Ohio law. On November 9, 2012, the Court dismissed all claims against TFC. The trustee appealed, and on August 23, 2016, the 6th Circuit Court of Appeals reversed the dismissal in part and remanded certain claims back to the trial court. Textron intends to vigorously defend this lawsuit.

Item 5. OTHER INFORMATION

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On October 26, 2016, our Board of Directors elected Dr. Maria T. Zuber as a member of the Board effective November 1, 2016. Dr. Zuber will serve on the Board's Nominating and Corporate Governance Committee and Organization and Compensation Committee.

Dr. Maria T. Zuber is the Vice President for Research and the E. A. Griswold Professor of Geophysics at the Massachusetts Institute of Technology where she has been a member of the faculty since 1995. In her role as Vice President for Research, to which she was appointed in 2013, she has overall responsibility for research administration and policy at MIT, overseeing MIT Lincoln Laboratory and more than a dozen interdisciplinary research laboratories and centers, and plays a central role in research relationships with the federal government. Previously, she served as the Head of the Department of Earth, Atmospheric and Planetary Sciences at MIT from 2003-2011. Since 1990, she has held leadership roles associated with scientific experiments or instrumentation on nine NASA missions, notably serving as Principal Investigator for NASA's Gravity Recovery and Interior Laboratory (GRAIL) mission, an effort to map the Moon's gravitational field. In 2013, President Obama appointed Dr. Zuber to the National Science Board, and, in May 2016, she was elected Board Chair.

Dr. Zuber will participate in our Director Compensation Program as described in Exhibit 10.15 to our Annual Report on Form 10-K for the fiscal year ended January 2, 2016, which is incorporated by reference herein. Pursuant to such program, Dr. Zuber will be issued 2,000 restricted shares of our Common Stock. Dr. Zuber also will enter into our standard Indemnity Agreement for non-employee directors, pursuant to which we will, subject to certain limitations, indemnify Dr. Zuber in connection with any claim arising in connection with her service as a Director and will advance and pay her expenses incurred in connection with such claims.

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Item 6. EXHIBITS

- 12.1 Computation of ratio of income to fixed charges of Textron Inc. Manufacturing Group
- 12.2 Computation of ratio of income to fixed charges of Textron Inc. including all majority-owned subsidiaries
- 31.1 Certification of Chief Executive Officer Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002
- 31.2 Certification of Chief Financial Officer Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002
- 32.1 Certification of Chief Executive Officer Pursuant to 18 U.S.C. 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002
- 32.2 Certification of Chief Financial Officer Pursuant to 18 U.S.C. 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002
- 101 The following materials from Textron Inc.'s Quarterly Report on Form 10-Q for the quarterly period ended October 1, 2016, formatted in XBRL (eXtensible Business Reporting Language): (i) the Consolidated Statements of Operations, (ii) the Consolidated Statements of Comprehensive Income, (iii) the Consolidated Balance Sheets, (iv) the Consolidated Statements of Cash Flows and (v) the Notes to the Consolidated Financial Statements.

SIGNATURES

Pursuant to the requirements of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned thereunto duly authorized.

TEXTRON INC.

Date: October 27, 2016

/s/ Mark S. Bamford
Mark S. Bamford
Vice President and Corporate Controller
(principal accounting officer)

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