TEXTRON INC
Form 10-Q
July 28, 2016
Table of Contents

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

Form 10-Q

(Mark One)

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

For the quarterly period ended July 2, 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	**05-0315468**
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification No.)
40 Westminster Street, Providence, RI	**02903**
(Address of principal executive offices)	(Zip code)

(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 _ü_ No____

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes _ü_ No____

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

Large accelerated filer [ü] Accelerated filer [___] Non-accelerated filer [___] Smaller reporting company [___]

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

As of July 15, 2016, there were 269,463,621 shares of common stock outstanding.

Table of Contents

TEXTRON INC.

Index to Form 10-Q

For the Quarterly Period Ended July 2, 2016

			Page
PART I.	**FINANCIAL INFORMATION**		
Item 1.	Financial Statements		
	Consolidated Statements of Operations (Unaudited)		3
	Consolidated Statements of Comprehensive Income (Unaudited)		4
	Consolidated Balance Sheets (Unaudited)		5
	Consolidated Statements of Cash Flows (Unaudited)		6
	Notes to the Consolidated Financial Statements (Unaudited)		
	Note 1.	Basis of Presentation	8
	Note 2.	Business Acquisitions	9
	Note 3.	Retirement Plans	9
	Note 4.	Earnings Per Share	10
	Note 5.	Accounts Receivable and Finance Receivables	10
	Note 6.	Inventories	12
	Note 7.	Warranty Liability	12
	Note 8.	Debt	13
	Note 9.	Derivative Instruments and Fair Value Measurements	13
	Note 10.	Accumulated Other Comprehensive Loss and Other Comprehensive Income (Loss)	14
	Note 11.	Commitments and Contingencies	15
	Note 12.	Segment Information	16
	Note 13.	Subsequent Events	16
Item 2.	Management s Discussion and Analysis of Financial Condition and Results of Operations		17
Item 3.	Quantitative and Qualitative Disclosures about Market Risk		26
Item 4.	Controls and Procedures		26
PART II.	**OTHER INFORMATION**		
Item 1.	Legal Proceedings		27
Item 6.	Exhibits		28
	Signatures		28

Table of Contents

PART I. FINANCIAL INFORMATION

Item 1. FINANCIAL STATEMENTS

TEXTRON INC.
Consolidated Statements of Operations (Unaudited)

	Three Months Ended		Six Months Ended	
(In millions, except per share amounts)	**July 2, 2016**	**July 4, 2015**	**July 2, 2016**	**July 4, 2015**
Revenues				
Manufacturing revenues	$ 3,491	$ 3,223	$ 6,672	$ 6,274
Finance revenues	20	24	40	46
Total revenues	3,511	3,247	6,712	6,320
Costs and expenses				
Cost of sales	2,889	2,635	5,524	5,144
Selling and administrative expense	318	329	626	666
Interest expense	44	42	87	85
Total costs and expenses	3,251	3,006	6,237	5,895
Income from continuing operations before income taxes	260	241	475	425
Income tax expense	82	72	146	128
Income from continuing operations	178	169	329	297
Loss from discontinued operations, net of income taxes	(1)	(2)	(2)	(2)
Net income	$ 177	$ 167	$ 327	$ 295
Basic earnings per share				
Continuing operations	$ 0.66	$ 0.61	$ 1.21	$ 1.07
Discontinued operations		(0.01)		(0.01)
Basic earnings per share	$ 0.66	$ 0.60	$ 1.21	$ 1.06
Diluted earnings per share				
Continuing operations	$ 0.66	$ 0.60	$ 1.21	$ 1.06
Discontinued operations	(0.01)		(0.01)	(0.01)
Diluted earnings per share	$ 0.65	$ 0.60	$ 1.20	$ 1.05
Dividends per share				
Common stock	$ 0.02	$ 0.02	$ 0.04	$ 0.04

See Notes to the Consolidated Financial Statements.

Table of Contents

TEXTRON INC.

Consolidated Statements of Comprehensive Income (Unaudited)

(In millions)	Three Months Ended July 2, 2016	Three Months Ended July 4, 2015	Six Months Ended July 2, 2016	Six Months Ended July 4, 2015
Net income	$ 177	$ 167	$ 327	$ 295
Other comprehensive income (loss), net of tax:				
Pension and postretirement benefits adjustments, net of reclassifications	15	87	36	111
Deferred gains (losses) on hedge contracts, net of reclassifications	4	4	25	(8)
Foreign currency translation adjustments	(20)	10	4	(46)
Other comprehensive income (loss)	(1)	101	65	57
Comprehensive income	$ 176	$ 268	$ 392	$ 352

See Notes to the Consolidated Financial Statements.

Table of Contents

TEXTRON INC.

Consolidated Balance Sheets (Unaudited)

(Dollars in millions)		July 2, 2016		January 2, 2016
Assets				
Manufacturing group				
Cash and equivalents	$	661	$	946
Accounts receivable, net		1,144		1,047
Inventories		4,595		4,144
Other current assets		370		341
Total current assets		6,770		6,478
Property, plant and equipment, less accumulated depreciation and amortization of $4,082 and $3,915		2,582		2,492
Goodwill		2,118		2,023
Other assets		2,339		2,399
Total Manufacturing group assets		13,809		13,392
Finance group				
Cash and equivalents		82		59
Finance receivables, net		985		1,087
Other assets		158		170
Total Finance group assets		1,225		1,316
Total assets	$	15,034	$	14,708
Liabilities and shareholders equity				
Liabilities				
Manufacturing group				
Short-term debt and current portion of long-term debt	$	278	$	262
Accounts payable		1,218		1,063
Accrued liabilities		2,202		2,467
Total current liabilities		3,698		3,792
Other liabilities		2,293		2,376
Long-term debt		2,785		2,435
Total Manufacturing group liabilities		8,776		8,603
Finance group				
Other liabilities		223		228
Debt		849		913
Total Finance group liabilities		1,072		1,141
Total liabilities		9,848		9,744
Shareholders equity				
Common stock		36		36
Capital surplus		1,643		1,587
Treasury stock		(774)		(559)
Retained earnings		5,614		5,298
Accumulated other comprehensive loss		(1,333)		(1,398)
Total shareholders equity		5,186		4,964
Total liabilities and shareholders equity	$	15,034	$	14,708
Common shares outstanding *(in thousands)*		269,344		274,228

See Notes to the Consolidated Financial Statements.

Table of Contents

TEXTRON INC.

Consolidated Statements of Cash Flows (Unaudited)

For the Six Months Ended July 2, 2016 and July 4, 2015, respectively

(In millions)	Consolidated 2016	2015
Cash flows from operating activities		
Net income	$ 327	$ 295
Less: Loss from discontinued operations	(2)	(2)
Income from continuing operations	329	297
Adjustments to reconcile income from continuing operations to net cash provided by (used in) operating activities:		
Non-cash items:		
Depreciation and amortization	223	220
Deferred income taxes	32	(15)
Other, net	51	53
Changes in assets and liabilities:		
Accounts receivable, net	(80)	(144)
Inventories	(454)	(516)
Other assets	28	(24)
Accounts payable	147	123
Accrued and other liabilities	(377)	27
Income taxes, net	12	93
Pension, net	14	40
Captive finance receivables, net	48	53
Other operating activities, net	(3)	(2)
Net cash provided by (used in) operating activities of continuing operations	(30)	205
Net cash used in operating activities of discontinued operations	(1)	(3)
Net cash provided by (used in) operating activities	(31)	202
Cash flows from investing activities		
Capital expenditures	(207)	(173)
Net cash used in acquisitions	(179)	(34)
Finance receivables repaid	36	46
Other investing activities, net	52	26
Net cash used in investing activities	(298)	(135)
Cash flows from financing activities		
Proceeds from long-term debt	362	9
Increase in short-term debt	12	105
Principal payments on long-term debt and nonrecourse debt	(90)	(130)
Purchases of Textron common stock	(215)	(87)
Dividends paid	(11)	(11)
Other financing activities, net	10	21
Net cash provided by (used in) financing activities	68	(93)
Effect of exchange rate changes on cash and equivalents	(1)	(4)
Net decrease in cash and equivalents	(262)	(30)
Cash and equivalents at beginning of period	1,005	822
Cash and equivalents at end of period	$ 743	$ 792

See Notes to the Consolidated Financial Statements.

Table of Contents

TEXTRON INC.

Consolidated Statements of Cash Flows (Unaudited) (Continued)

For the Six Months Ended July 2, 2016 and July 4, 2015, respectively

	Manufacturing Group		Finance Group	
(In millions)	**2016**	**2015**	**2016**	**2015**
Cash flows from operating activities				
Net income	$ 320	$ 285	$ 7	$ 10
Less: Loss from discontinued operations	(2)	(2)		
Income from continuing operations	322	287	7	10
Adjustments to reconcile income from continuing operations to net cash provided by (used in) operating activities:				
Non-cash items:				
Depreciation and amortization	217	215	6	5
Deferred income taxes	37	(6)	(5)	(9)
Other, net	51	51		2
Changes in assets and liabilities:				
Accounts receivable, net	(80)	(144)		
Inventories	(441)	(525)		
Other assets	29	(34)	(1)	10
Accounts payable	147	123		
Accrued and other liabilities	(373)	33	(4)	(6)
Income taxes, net	10	78	2	15
Pension, net	14	40		
Dividends received from Finance group	29			
Other operating activities, net	(3)	(2)		
Net cash provided by (used in) operating activities of continuing operations	(41)	116	5	27
Net cash used in operating activities of discontinued operations	(1)	(3)		
Net cash provided by (used in) operating activities	(42)	113	5	27
Cash flows from investing activities				
Capital expenditures	(207)	(173)		
Net cash used in acquisitions	(179)	(34)		
Finance receivables repaid			170	181
Finance receivables originated			(86)	(82)
Other investing activities, net	3		36	35
Net cash provided by (used in) investing activities	(383)	(207)	120	134
Cash flows from financing activities				
Proceeds from long-term debt	345		17	9
Increase in short-term debt	12	105		
Principal payments on long-term debt and nonrecourse debt			(90)	(130)
Purchases of Textron common stock	(215)	(87)		
Dividends paid	(11)	(11)	(29)	
Other financing activities, net	10	21		
Net cash provided by (used in) financing activities	141	28	(102)	(121)
Effect of exchange rate changes on cash and equivalents	(1)	(4)		
Net increase (decrease) in cash and equivalents	(285)	(70)	23	40
Cash and equivalents at beginning of period	946	731	59	91
Cash and equivalents at end of period	$ 661	$ 661	$ 82	$ 131

See Notes to the Consolidated Financial Statements.

Table of Contents

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 second quarter of 2016 and 2015 by $10 million and $36 million, respectively, ($6 million and $23 million after tax, or $0.02 and $0.08 per diluted share, respectively). For the second quarter of 2016 and 2015, the gross favorable program profit adjustments totaled $19 million and $40 million, respectively, and the gross unfavorable program profit adjustments totaled $9 million and $4 million, respectively.

The changes in estimates increased income from continuing operations before income taxes in the first half of 2016 and 2015 by $39 million and $54 million, respectively, ($25 million and $34 million after tax, or $0.09 and $0.12 per diluted share, respectively). For the first half of 2016 and 2015, the gross favorable program profit adjustments totaled $53 million and $73 million, respectively, and the gross unfavorable program profit adjustments totaled $14 million and $19 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 adoption is permitted. Entities must adopt the standard on a modified retrospective basis whereby it would be applied at the

Table of Contents

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 half 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, $95 million has been allocated to goodwill, related to expected synergies and the value of the existing workforce, and $63 million to intangible assets. Of the recorded goodwill, approximately $37 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. 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:

	Three Months Ended		Six Months Ended	
(In millions)	**July 2, 2016**	**July 4, 2015**	**July 2, 2016**	**July 4, 2015**
Pension Benefits				
Service cost	$ 25	$ 29	$ 49	$ 59
Interest cost	85	82	170	163
Expected return on plan assets	(122)	(121)	(245)	(242)
Amortization of net actuarial loss	26	39	52	78
Amortization of prior service cost	3	4	7	8
Curtailment and other charges		6		6
Net periodic benefit cost	$ 17	$ 39	$ 33	$ 72
Postretirement Benefits Other Than Pensions				
Service cost	$	$ 1	$ 1	$ 2
Interest cost	4	4	8	8
Amortization of prior service credit	(5)	(6)	(11)	(12)

Net periodic benefit credit	$ (1)	$ (1)	$ (2)	$ (2)

In April 2015, our Bell segment announced cost reduction actions that resulted in a headcount reduction of approximately 12% of the Bell workforce. We determined that a curtailment had occurred in Bell s pension plan as a result of this reduction, which triggered a remeasurement of the projected benefit obligation. We remeasured Bell s pension plan incorporating a 50 basis-point increase in the discount rate to 4.75%, while other assumptions remained consistent with year-end. The remeasurement reduced our unrealized losses by approximately $98 million which was recorded in other comprehensive income in the second quarter of 2015.

Table of Contents

Note 4. 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.

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

	Three Months Ended		Six Months Ended	
(In thousands)	**July 2, 2016**	**July 4, 2015**	**July 2, 2016**	**July 4, 2015**
Basic weighted-average shares outstanding	269,888	277,715	270,774	277,808
Dilutive effect of stock options	1,428	2,220	1,398	2,216
Diluted weighted-average shares outstanding	271,316	279,935	272,172	280,024

Stock options to purchase 5 million shares of common stock are excluded from the calculation of diluted weighted average shares outstanding for both the three and six months ended July 2, 2016, as their effect would have been anti-dilutive. Stock options to purchase 2 million and 1 million shares of common stock are excluded from the calculation of diluted weighted average shares outstanding for the three and six months ended July 4, 2015, respectively, as their effect would have been anti-dilutive.

Note 5. Accounts Receivable and Finance Receivables

Accounts Receivable

Accounts receivable is composed of the following:

(In millions)		**July 2, 2016**		**January 2, 2016**
Commercial	$	902	$	841
U.S. Government contracts		274		239
		1,176		1,080
Allowance for doubtful accounts		(32)		(33)
Total	$	1,144	$	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 $188 million at July 2, 2016 and $135 million at January 2, 2016.

Finance Receivables

Finance receivables are presented in the following table:

(In millions)		July 2, 2016		January 2, 2016
Finance receivables*	$	1,027	$	1,135
Allowance for losses		(42)		(48)
Total finance receivables, net	$	985	$	1,087

** Includes finance receivables held for sale of $30 million at both July 2, 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

Table of Contents

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.

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

(In millions)		**July 2, 2016**		**January 2, 2016**
Performing	$	792	$	891
Watchlist		106		130
Nonaccrual		99		84
Nonaccrual as a percentage of finance receivables		9.93%		7.60%
Less than 31 days past due	$	889	$	950
31-60 days past due		51		86
61-90 days past due		23		42
Over 90 days past due		34		27
60 + days contractual delinquency as a percentage of finance receivables		5.72%		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 half of 2016 or 2015.

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

(In millions)		**July 2, 2016**		**January 2, 2016**
Recorded investment:				
Impaired loans with related allowance for losses	$	62	$	62
Impaired loans with no related allowance for losses		40		42
Total	$	102	$	104

Unpaid principal balance	$ 106	$ 113
Allowance for losses on impaired loans	11	17
Average recorded investment	95	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.

(In millions)	**July 2, 2016**	**January 2, 2016**
Allowance based on collective evaluation	$ 31	$ 31
Allowance based on individual evaluation	11	17
Finance receivables evaluated collectively	$ 797	$ 883
Finance receivables evaluated individually	102	104

Table of Contents

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 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:

	Six Months Ended	
(In millions)	**July 2, 2016**	**July 4, 2015**
Beginning of period	$ 48	$ 51
Provision for losses	(1)	(1)
Charge-offs	(10)	(2)
Recoveries	5	6
End of period	$ 42	$ 54

Note 6. Inventories

Inventories are composed of the following:

(In millions)	**July 2, 2016**	**January 2, 2016**
Finished goods	$ 1,967	$ 1,735
Work in process	2,932	2,921
Raw materials and components	659	605
	5,558	5,261
Progress/milestone payments	(963)	(1,117)
Total	$ 4,595	$ 4,144

Note 7. Warranty Liability

Changes in our warranty liability are as follows:

	Six Months Ended	
(In millions)	**July 2, 2016**	**July 4, 2015**
Beginning of period	$ 143	$ 148
Provision	37	33
Settlements	(37)	(37)
Acquisitions	2	4
Adjustments*	(6)	(6)
End of period	$ 139	$ 142

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

Table of Contents

Note 8. Debt

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.

Note 9. 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 July 2, 2016 and January 2, 2016, we had foreign currency exchange contracts with notional amounts upon which the contracts were based of $734 million and $706 million, respectively. At July 2, 2016, the fair value amounts of our foreign currency exchange contracts were a $7 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 July 2, 2016 and January 2, 2016, the Finance group s impaired nonaccrual finance receivables of $51 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 six months ended July 2, 2016 and July 4, 2015.

Table of Contents

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:

	July 2, 2016		January 2, 2016	
(In millions)	Carrying Value	Estimated Fair Value	Carrying Value	Estimated Fair Value
Manufacturing group				
Long-term debt, excluding leases	$ (2,958)	$ (3,169)	$ (2,628)	$ (2,744)
Finance group				
Finance receivables, excluding leases	777	770	863	820
Debt	(849)	(750)	(913)	(840)

Fair value for the Manufacturing group debt is determined using market observable data for similar transactions (Level 2). At both July 2, 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 10. Accumulated Other Comprehensive Loss and Other Comprehensive Income (Loss)

The components of Accumulated Other Comprehensive Loss are presented below:

(In millions)	Pension and Postretirement Benefits Adjustments	Deferred Gains (Losses) on Hedge Contracts	Foreign Currency Translation Adjustments	Accumulated Other Comprehensive Loss
For the six months ended July 2, 2016				
Beginning of the period	$ (1,327)	$ (24)	$ (47)	$ (1,398)
Other comprehensive income before reclassifications	5	14	4	23
Reclassified from Accumulated other comprehensive loss	31	11		42
Other comprehensive income	36	25	4	65
End of the period	$ (1,291)	$ 1	$ (43)	$ (1,333)
For the six months ended July 4, 2015				
Beginning of the period	$ (1,511)	$ (13)	$ 18	$ (1,506)

Other comprehensive income (loss) before reclassifications	62	(14)	(46)	2
Reclassified from Accumulated other comprehensive loss	49	6		55
Other comprehensive income (loss)	111	(8)	(46)	57
End of the period	$ (1,400)	$ (21)	$ (28)	$ (1,449)

Table of Contents

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

	July 2, 2016			July 4, 2015		
(In millions)	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	$ (10)	$ 16	$ 39	$ (14)	$ 25
Amortization of prior service credit*	(2)	1	(1)			
Unrealized gains				98	(36)	62
Pension and postretirement benefits adjustments, net	24	(9)	15	137	(50)	87
Deferred gains on hedge contracts:						
Current deferrals	(2)		(2)	3	(1)	2
Reclassification adjustments	8	(2)	6	3	(1)	2
Deferred gains on hedge contracts, net	6	(2)	4	6	(2)	4
Foreign currency translation adjustments	(14)	(6)	(20)	9	1	10
Total	$ 16	$ (17)	$ (1)	$ 152	$ (51)	$ 101
Six Months Ended						
Pension and postretirement benefits adjustments:						
Amortization of net actuarial loss*	$ 52	$ (19)	$ 33	$ 78	$ (28)	$ 50
Amortization of prior service credit*	(4)	2	(2)	(2)	1	(1)
Unrealized gains	7	(2)	5	98	(36)	62
Pension and postretirement benefits adjustments, net	55	(19)	36	174	(63)	111
Deferred gains (losses) on hedge contracts:						
Current deferrals	20	(6)	14	(18)	4	(14)
Reclassification adjustments	15	(4)	11	9	(3)	6
Deferred gains (losses) on hedge contracts, net	35	(10)	25	(9)	1	(8)
Foreign currency translation adjustments	11	(7)	4	(43)	(3)	(46)
Total	$ 101	$ (36)	$ 65	$ 122	$ (65)	$ 57

**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.*

Note 11. 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.

15

Table of Contents

Note 12. 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 and certain corporate expenses. 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		Six Months Ended	
(In millions)		July 2, 2016	July 4, 2015	July 2, 2016	July 4, 2015
Revenues					
Textron Aviation	$	1,196	$ 1,124	$ 2,287	$ 2,175
Bell		804	850	1,618	1,663
Textron Systems		487	322	811	637
Industrial		1,004	927	1,956	1,799
Finance		20	24	40	46
Total revenues	$	3,511	$ 3,247	$ 6,712	$ 6,320
Segment Profit					
Textron Aviation	$	81	$ 88	$ 154	$ 155
Bell		81	101	163	177
Textron Systems		60	21	89	49
Industrial		99	86	190	168
Finance		7	10	12	16
Segment profit		328	306	608	565
Corporate expenses and other, net		(31)	(33)	(63)	(75)
Interest expense, net for Manufacturing group		(37)	(32)	(70)	(65)
Income from continuing operations before income taxes	$	260	$ 241	$ 475	$ 425

Note 13. Subsequent Events

On July 11, 2016, the Internal Revenue Service Office of Appeals approved a final settlement for our 1998 to 2008 tax years. As a result, in the third quarter of 2016 we expect to record an income tax benefit of approximately $175 million, exclusive of interest, of which $110 million is attributable to continuing operations and $65 million is attributable to discontinued operations. In addition, we expect to record a favorable income tax benefit in the third quarter of 2016 upon the reversal of accrued interest of approximately $140 million, of which approximately $90 million is attributable to continuing operations.

Table of Contents

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

Consolidated Results of Operations

	Three Months Ended			Six Months Ended		
(Dollars in millions)	July 2, 2016	July 4, 2015	% Change	July 2, 2016	July 4, 2015	% Change
Revenues	$ 3,511	$ 3,247	8%	$ 6,712	$ 6,320	6%
Operating expenses	3,207	2,964	8%	6,150	5,810	6%
Cost of sales	2,889	2,635	10%	5,524	5,144	7%
Selling and administrative expense	318	329	(3)%	626	666	(6)%
Gross margin percentage of Manufacturing revenues	17.2%	18.2%		17.2%	18.0%	

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 18 to 22.

Revenues

Revenues increased $264 million, 8%, in the second quarter of 2016, compared with the second quarter of 2015, largely driven by increases in the Textron Systems, Industrial and Textron Aviation segments, partially offset by lower revenues at the Bell segment. The net revenue increase included the following factors:

- Higher Textron Systems revenues of $165 million, primarily due to higher volume of $103 million in the Weapons and Sensors product line and higher volume of $37 million in the Unmanned Systems product line.

- Higher Industrial revenues of $77 million, primarily due to higher volume of $49 million, largely in the Fuel Systems and Functional Components product line, and the impact from acquired businesses of $35 million.

- Higher Textron Aviation revenues of $72 million, primarily due to higher volume and mix of $52 million, largely the result of higher Citation jet volume of $90 million, partially offset by lower turboprop volume.

- Lower Bell revenues of $46 million, primarily due to a decrease in commercial revenues, largely reflecting lower commercial aircraft deliveries.

Revenues increased $392 million, 6%, in the first half of 2016, compared with the first half of 2015, largely driven by increases in the Textron Systems, Industrial and Textron Aviation segments, partially offset by lower revenues at the Bell segment. The net revenue increase included the following factors:

- Higher Textron Systems revenues of $174 million, primarily due to higher volume of $83 million in the Unmanned Systems product line and higher volume of $61 million in the Weapons and Sensors product line.

- Higher Industrial revenues of $157 million, primarily due to higher volume of $111 million, largely in the Fuel Systems and Functional Components product line, and the impact from acquired businesses of $72 million.

- Higher Textron Aviation revenues of $112 million, primarily due to higher volume and mix of $84 million, largely the result of higher Citation jet volume of $152 million, partially offset by lower turboprop volume.

- Lower Bell revenues of $45 million, primarily due to an $88 million decrease in commercial revenues, largely reflecting lower commercial aircraft deliveries and $34 million of lower aftermarket volume, partially offset by a $45 million increase in other military revenues, primarily due to higher H-1 program revenues.

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 $254 million, 10%, and $380 million, 7%, in the second quarter and first half of 2016, respectively, compared with the corresponding periods of 2015, largely due to higher volume at the Textron Systems, Textron Aviation, and Industrial segments, and an increase from acquired businesses. In the second quarter and first half of 2016, the decrease in gross margin percentage was largely driven by an unfavorable impact from the mix of products sold during the period at Textron Aviation.

Selling and administrative expense decreased $11 million, 3%, and $40 million, 6%, in the second quarter and first half of 2016, respectively, compared with the corresponding periods of 2015. The decrease in selling and administrative expense in the first half of 2016 was largely due to lower share-based compensation expense.

Table of Contents

Backlog

(In millions)		July 2, 2016		January 2, 2016
Bell	$	4,908	$	5,224
Textron Systems		2,282		2,328
Textron Aviation		1,149		1,074
Total backlog	$	8,339	$	8,626

Bell s backlog decreased $316 million during 2016, as total deliveries, largely under the V-22 program, exceeded new orders.

Segment Analysis

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 and certain corporate expenses. 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

(Dollars in millions)	Three Months Ended July 2, 2016	Three Months Ended July 4, 2015	Six Months Ended July 2, 2016	Six Months Ended July 4, 2015
Revenues	$ 1,196	$ 1,124	$ 2,287	$ 2,175
Operating expenses	1,115	1,036	2,133	2,020
Segment profit	81	88	154	155
Profit margin	6.8%	7.8%	6.7%	7.1%

Textron Aviation Revenues and Operating Expenses

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

(In millions)	Q2 2016 versus Q2 2015	YTD 2016 versus YTD 2015
Volume and mix	$ 52	$ 84
Acquisitions	19	33
Other	1	(5)
Total change	$ 72	$ 112

In the second quarter of 2016, Textron Aviation s revenues increased $72 million, 6%, compared with the second quarter of 2015, primarily due to higher volume and mix of $52 million and the impact from the acquisition of a repair and overhaul business in the first quarter of 2016. The increase in volume and mix is primarily due to higher Citation jet volume of $90 million, partially offset

Table of Contents

by lower turboprop volume. We delivered 45 Citation jets and 23 King Air turboprops in the second quarter of 2016, compared with 36 Citation jets and 30 King Air turboprops in the second quarter of 2015. The portion of the segment s revenues derived from aftermarket sales and services increased to 34% of its total revenues in the second quarter of 2016, from 31% in the second quarter of 2015, in part, due to the impact from the acquisition.

In the first half of 2016, Textron Aviation s revenues increased $112 million, 5%, compared with the first half of 2015, primarily due to higher volume and mix of $84 million and the impact from the acquisition. The increase in volume and mix is primarily due to higher Citation jet volume of $152 million, partially offset by lower turboprop volume. We delivered 79 Citation jets and 49 King Air turboprops in the first half of 2016, compared with 69 Citation jets and 55 King Air turboprops in the first half of 2015. The portion of the segment s revenues derived from aftermarket sales and services represented 34% of its total revenues in the first half of 2016, compared with 33% in the first half of 2015.

Textron Aviation s operating expenses increased by $79 million, 8%, and $113 million, 6%, in the second quarter and first half 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:

(In millions)	Q2 2016 versus Q2 2015	YTD 2016 versus YTD 2015
Performance	$ (4)	$ 3
Volume and mix	1	3
Other	(4)	(7)
Total change	$ (7)	$ (1)

Segment profit at Textron Aviation decreased $7 million, 8%, in the second quarter of 2016, and was largely unchanged in the first half of 2016, compared with the corresponding periods of 2015. Volume and mix was essentially unchanged as the higher volume described above was largely offset by an unfavorable impact from the mix of products sold in 2016.

Bell

	Three Months Ended		Six Months Ended	
(Dollars in millions)	July 2, 2016	July 4, 2015	July 2, 2016	July 4, 2015
Revenues:				
V-22 program	$ 313	$ 297	$ 591	$ 593
Other military	217	207	470	425
Commercial	274	346	557	645
Total revenues	804	850	1,618	1,663

Operating expenses	723	749	1,455	1,486
Segment profit	81	101	163	177
Profit margin	10.1%	11.9%	10.1%	10.6%

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:

(In millions)		**Q2 2016 versus Q2 2015**		**YTD 2016 versus YTD 2015**
Volume and mix	$	(48)	$	(47)
Other		2		2
Total change	$	(46)	$	(45)

Table of Contents

Bell s revenues decreased $46 million, 5%, in the second quarter of 2016, compared with the second quarter of 2015, primarily due to the following factors:

- $72 million decrease in commercial revenues, primarily due to lower commercial aircraft deliveries. Bell delivered 24 commercial aircraft in the second quarter of 2016, compared with 39 commercial aircraft in the second quarter of 2015.

- $16 million increase in V-22 program revenues, primarily reflecting higher product support. Bell delivered 6 V-22 aircraft in the second quarter of both 2016 and 2015.

- $10 million increase in other military revenues, primarily reflecting higher H-1 program revenues. Bell delivered 9 H-1 aircraft in the second quarter of 2016, compared with 6 H-1 aircraft in the second quarter of 2015.

Bell s revenues decreased $45 million, 3%, in the first half of 2016, compared with the first half of 2015, primarily due to the following factors:

- $88 million decrease in commercial revenues, primarily due to lower commercial aircraft deliveries and $34 million of lower aftermarket volume. Bell delivered 54 commercial aircraft in the first half of 2016, compared with 74 commercial aircraft in the first half of 2015.

- $45 million increase in other military revenues, primarily reflecting higher H-1 program revenues. Bell delivered 19 H-1 aircraft in the first half of 2016, compared with 10 H-1 aircraft in the first half of 2015.

- V-22 program revenues were largely unchanged. Bell delivered 12 V-22 aircraft in the first half of both 2016 and 2015.

Bell s operating expenses decreased $26 million, 3%, and $31 million, 2%, in the second quarter and first half of 2016, respectively, compared with the corresponding periods of 2015, primarily due to lower net sales volume as described above.

In the second quarter of 2015, as a result of cost reduction actions announced in April 2015, Bell incurred approximately $40 million in severance and benefit costs. The impact of the restructuring on Bell s segment profit in the second quarter of 2015 was not significant due to cost savings from headcount reductions and the impact of including a portion of these costs in our indirect cost rates. These actions reduced Bell s headcount by approximately 1,100 employees representing approximately 12% of the Bell workforce at that time.

Bell Segment Profit

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

(In millions)	Q2 2016 versus Q2 2015	YTD 2016 versus YTD 2015
Volume and mix	$ (14)	$ (21)
Performance and other	(6)	7
Total change	$ (20)	$ (14)

Bell s segment profit decreased $20 million, 20%, in the second quarter of 2016, compared with the second quarter of 2015. The unfavorable impact from volume and mix was largely the result of lower commercial aircraft deliveries, while the unfavorable performance was primarily driven by lower favorable program adjustments.

Bell s segment profit decreased $14 million, 8%, in the first half of 2016, compared with the first half of 2015, primarily due to lower volume as described above.

Textron Systems

	Three Months Ended		Six Months Ended	
(Dollars in millions)	July 2, 2016	July 4, 2015	July 2, 2016	July 4, 2015
Revenues	$ 487	$ 322	$ 811	$ 637
Operating expenses	427	301	722	588
Segment profit	60	21	89	49
Profit margin	12.3%	6.5%	11.0%	7.7%

Table of Contents

Textron Systems Revenues and Operating Expenses

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

(In millions)	Q2 2016 versus Q2 2015	YTD 2016 versus YTD 2015
Volume	$ 153	$ 161
Acquisitions	12	12
Other		1
Total change	$ 165	$ 174

Revenues at Textron Systems increased $165 million, 51%, in the second quarter of 2016 compared with the second quarter of 2015, primarily due to higher volume of $103 million in the Weapons and Sensors product line and higher volume of $37 million in the Unmanned Systems product line.

Revenues at Textron Systems increased $174 million, 27%, compared with the first half of 2015, primarily due to higher volume of $83 million in the Unmanned Systems product line and higher volume of $61 million in the Weapons and Sensors product line.

Textron Systems operating expenses increased $126 million, 42%, and $134 million, 23%, in the second quarter and first half of 2016, respectively, compared with the corresponding periods of 2015, primarily due to higher volume as described above.

Textron Systems Segment Profit

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

(In millions)	Q2 2016 versus Q2 2015	YTD 2016 versus YTD 2015
Volume and mix	$ 34	$ 31
Performance	5	9
Total change	$ 39	$ 40

Textron Systems segment profit increased $39 million, 186%, and $40 million, 82%, in the second quarter and first half of 2016, respectively, compared with the corresponding periods of 2015, largely reflecting higher volume as described above and a favorable product mix in 2016.

Industrial

(Dollars in millions)	Three Months Ended July 2, 2016	Three Months Ended July 4, 2015	Six Months Ended July 2, 2016	Six Months Ended July 4, 2015
Revenues:				
Fuel Systems and Functional Components	$ 592	$ 526	$ 1,172	$ 1,039
Other Industrial	412	401	784	760
Total revenues	1,004	927	1,956	1,799
Operating expenses	905	841	1,766	1,631
Segment profit	99	86	190	168
Profit margin	9.9%	9.3%	9.7%	9.3%

Industrial Revenues and Operating Expenses

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

(In millions)	Q2 2016 versus Q2 2015	YTD 2016 versus YTD 2015
Volume	$ 49	$ 111
Acquisitions	35	72
Foreign exchange	(8)	(22)
Other	1	(4)
Total change	$ 77	$ 157

Industrial segment revenues increased $77 million, 8%, in the second quarter of 2016, compared with the second quarter of 2015, primarily due to higher volume of $49 million and the impact from acquired businesses. Higher volume was primarily related to the Fuel Systems and Functional Components product line, largely reflecting automotive industry demand in Europe.

Table of Contents

Industrial segment revenues increased $157 million, 9%, in the first half of 2016, compared with the first half of 2015, primarily due to higher volume of $111 million and the impact from acquired businesses, partially offset by an unfavorable foreign exchange impact of $22 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 $64 million, 8%, and $135 million, 8%, in the second quarter and first half 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.

Industrial Segment Profit

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

(In millions)	Q2 2016 versus Q2 2015	YTD 2016 versus YTD 2015
Volume	$ 6	$ 14
Inflation, net of pricing	5	8
Foreign exchange	(4)	(9)
Performance and other	6	9
Total change	$ 13	$ 22

Segment profit for the Industrial segment increased $13 million, 15%, and $22 million, 13%, in the second quarter and first half of 2016, respectively, compared with the corresponding periods of 2015, largely due to the impact from higher volume as described above.

Finance

	Three Months Ended		Six Months Ended	
(In millions)	July 2, 2016	July 4, 2015	July 2, 2016	July 4, 2015
Revenues	$ 20	$ 24	$ 40	$ 46
Segment profit	7	10	12	16

Finance segment revenues decreased $4 million and $6 million and segment profit decreased $3 million and $4 million in the second quarter and first half of 2016, respectively, compared with the corresponding periods of 2015, primarily due to lower average finance receivables.

Finance Portfolio Quality

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

(Dollars in millions)		July 2, 2016		January 2, 2016
Finance receivables*	$	997	$	1,105
Nonaccrual finance receivables		99		84
Ratio of nonaccrual finance receivables to finance receivables		9.93%		7.60%
60+ days contractual delinquency	$	57	$	69
60+ days contractual delinquency as a percentage of finance receivables		5.72%		6.24%

** Excludes finance receivables held for sale.*

Table of Contents

Liquidity and Capital Resources

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:

(Dollars in millions)		July 2, 2016		January 2, 2016
Manufacturing group				
Cash and equivalents	$	661	$	946
Debt		3,063		2,697
Shareholders equity		5,186		4,964
Capital (debt plus shareholders equity)		8,249		7,661
Net debt (net of cash and equivalents) to capital		32%		26%
Debt to capital		37%		35%
Finance group				
Cash and equivalents	$	82	$	59
Debt		849		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.

Textron has a senior unsecured revolving credit facility that expires in October 2018 for an aggregate principal amount of $1.0 billion, of which up to $100 million is available for the issuance of letters of credit. At July 2, 2016, there were no amounts borrowed against the 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:

	Six Months Ended	
	July 2,	July 4,
(In millions)	2016	2015
Operating activities	$ (41)	$ 116
Investing activities	(383)	(207)
Financing activities	141	28

Cash flows from operating activities decreased $157 million during the first half of 2016, compared with the first half 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 half of 2016, cash flows from operating activities included $60 million of cash proceeds from the settlements of corporate-owned life insurance policies.

Cash flows used in investing activities included capital expenditures of $207 million and $173 million in the first half of 2016 and 2015, respectively. Investing cash flows also reflected aggregate cash payments of $179 million for five business acquisitions in the first half of 2016, compared with payments of $34 million for acquisitions in the first half of 2015.

In the first half of 2016, financing activities included proceeds from long-term debt of $345 million, partially offset by $215 million in cash paid to repurchase an aggregate of 6.2 million shares of our outstanding common stock under a 2013 share

Table of Contents

repurchase authorization. Financing activities in the first half of 2015 included an increase in short-term debt of $105 million, primarily from the issuance of commercial paper, partially offset by the repurchase of an aggregate of 1.9 million shares of our outstanding common stock for $87 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:

	Six Months Ended	
	July 2,	**July 4,**
(In millions)	**2016**	**2015**
Operating activities	$ 5	$ 27
Investing activities	120	134
Financing activities	(102)	(121)

The Finance group s cash flows from investing activities primarily included collections on finance receivables totaling $170 million and $181 million in the first half of 2016 and 2015, respectively, partially offset by finance receivable originations of $86 million and $82 million, respectively. Cash flows used in financing activities included payments on long-term and nonrecourse debt of $90 million in the first half of 2016, compared with $130 million of payments in the first half of 2015.

Consolidated Cash Flows

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

	Six Months Ended	
	July 2,	**July 4,**
(In millions)	**2016**	**2015**
Operating activities	$ (30)	$ 205
Investing activities	(298)	(135)
Financing activities	68	(93)

Cash flows from operating activities decreased $235 million during the first half of 2016, compared with the first half 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 half of 2016, cash flows from operating activities included $60 million of cash proceeds from the settlements of corporate-owned life insurance policies.

Investing cash flows included cash used for capital expenditures of $207 million and $173 million and acquisitions of $179 million and $34 million in the first half of 2016 and 2015, respectively.

Total cash provided by financing activities in the first half of 2016 primarily included proceeds from long-term debt of $362 million, partially offset by share repurchases of $215 million and payments on long-term and nonrecourse debt of $90 million. Cash flows from financing activities in the first half of 2015 primarily consisted of payments on long-term and nonrecourse debt of $130 million and share repurchases of $87 million, partially offset by an increase in short-term debt of $105 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.

Table of Contents

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

	Six Months Ended	
(In millions)	**July 2, 2016**	**July 4, 2015**
Reclassification adjustments from investing activities:		
Cash received from customers	$ 134	$ 135
Finance receivable originations for Manufacturing group inventory sales	(86)	(82)
Other	(13)	9
Total reclassification adjustments from investing activities	35	62
Reclassification adjustments from financing activities:		
Dividends received by Manufacturing group from Finance group	(29)	
Total reclassification adjustments to operating activities	$ 6	$ 62

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 for long-term contracts to include program profit adjustments made during the quarter.

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.

	Three Months Ended		Six Months Ended	
(In millions)	**July 2, 2016**	**July 4, 2015**	**July 2, 2016**	**July 4, 2015**
Gross favorable	$ 19	$ 40	$ 53	$ 73
Gross unfavorable	(9)	(4)	(14)	(19)
Net adjustments	$ 10	$ 36	$ 39	$ 54

Table of Contents

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, sh 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;
- 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;
- 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 July 2, 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 July 2, 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 July 2, 2016.

There were no changes in our internal control over financial reporting during the fiscal quarter ended July 2, 2016 that materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

Table of Contents

PART II. OTHER INFORMATION

Item 1. LEGAL PROCEEDINGS

As previously reported, on October 7, 2014, the Federal Aviation Administration (FAA) of the U.S. Department of Transportation (DOT) issued a Notice of Proposed Civil Penalty to McCauley Propeller Systems, a Division of Cessna Aircraft Company (Cessna), for alleged violations of DOT s hazardous materials shipment regulations in connection with the shipment of resin product by air from McCauley s Columbus, GA facility. Cessna and the FAA have reached agreement on settlement of the matter which will require Cessna to pay a $190,000 penalty.

Table of Contents

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 July 2, 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: July 28, 2016

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

Table of Contents

LIST OF EXHIBITS

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