Leidos Holdings, Inc.
Form 10-Q
November 04, 2016
Table of Contents

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549
Form 10-Q
(Mark One)
ý QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934
For the quarterly period ended September 30, 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 001-33072
Leidos Holdings, Inc.
(Exact name of registrant as specified in its charter)

Delaware	20-3562868
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification No.)
11951 Freedom Drive, Reston, Virginia	20190
(Address of principal executive office)	(Zip Code)

(571) 526-6000
(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 x No o

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes x No o

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company. See the definitions of “large accelerated filer,” “accelerated filer” and “smaller reporting company” in Rule 12b-2 of the Exchange Act.
Large accelerated filer x Accelerated filer ¨ Non-accelerated filer ¨ Smaller reporting company o

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

The number of shares issued and outstanding of each issuer’s classes of common stock as of October 25, 2016, was as follows:
150,363,756 shares of common stock ($.0001 par value per share)

LEIDOS HOLDINGS, INC.
FORM 10-Q
TABLE OF CONTENTS

Table of Contents

PART I—FINANCIAL INFORMATION

Item 1. Financial Statements.
LEIDOS HOLDINGS, INC.
CONDENSED CONSOLIDATED BALANCE SHEETS (UNAUDITED)

	September 30, 2016	January 1, 2016
	(in millions)	
ASSETS		
Current assets:		
Cash and cash equivalents	$449	$ 656
Receivables, net	1,677	921
Inventory, prepaid expenses and other current assets	430	216
Total current assets	2,556	1,793
Property, plant and equipment, net	231	142
Intangible assets, net	1,643	25
Goodwill	4,874	1,207
Deferred income taxes	15	8
Other assets	260	195
	$9,579	$ 3,370
LIABILITIES AND EQUITY		
Current liabilities:		
Accounts payable and accrued liabilities	$1,458	$ 761
Accrued payroll and employee benefits	454	268
Dividends payable	23	2
Income taxes payable	3	6
Notes payable and long-term debt, current portion	42	2
Liabilities of discontinued operations	—	1
Total current liabilities	1,980	1,040
Notes payable and long-term debt, net of current portion	3,428	1,079
Deferred tax liabilities	867	34
Other long-term liabilities	174	149
Commitments and contingencies (Notes 15 and 16)		
Stockholders' equity:		
Preferred stock, $.0001 par value, 10 million shares authorized and no shares issued and outstanding at September 30, 2016 and January 1, 2016	—	—
Common stock, $.0001 par value, 500 million shares authorized, 150 million and 72 million shares issued and outstanding at September 30, 2016 and January 1, 2016, respectively	—	—
Additional paid-in capital	3,310	1,353
Accumulated deficit	(188)	(277)
Accumulated other comprehensive loss	(6)	(8)
Total Leidos Holdings, Inc. stockholders' equity	3,116	1,068
Non-controlling interest	14	—
Total equity	3,130	1,068
	$9,579	$ 3,370

See accompanying notes to condensed consolidated financial statements.

1

Table of Contents

LEIDOS HOLDINGS, INC.
CONDENSED CONSOLIDATED STATEMENTS OF INCOME (UNAUDITED)

	Three Months Ended		Nine Months Ended	
	September 30, 2016	October 2, 2015	September 30, 2016	October 2, 2015
	(in millions, except per share amounts)			
Revenues	$1,868	$ 1,302	$4,468	$ 3,805
Cost of revenues	1,630	1,138	3,925	3,344
Selling, general and administrative expenses	87	53	203	180
Bad debt expense	1	13	1	10
Acquisition and integration costs	44	—	68	—
Asset impairment charges	—	4	—	73
Restructuring expenses	5	—	6	2
Operating income	101	94	265	196
Interest income	3	1	8	2
Interest expense	(28)	(15)	(57)	(44)
Other (expense) income, net	(1)	—	(3)	1
Income from continuing operations before income taxes	75	80	213	155
Income tax benefit (expense)	17	(31)	(27)	(46)
Income from continuing operations	92	49	186	109
Discontinued operations:				
Income tax benefit	—	—	—	18
Income from discontinued operations, net of taxes	—	—	—	18
Net income	92	49	186	127
Less: net income attributable to non-controlling interest, net of taxes	1	—	1	—
Net income attributable to Leidos Holdings, Inc.	$91	$ 49	$185	$ 127
Earnings per share:				
Basic:				
Income from continuing operations attributable to Leidos Holdings, Inc. common stockholders	$0.81	$ 0.68	$2.18	$ 1.49
Discontinued operations, net of taxes	—	—	—	0.25
Net income attributable to Leidos Holdings, Inc. common stockholders	$0.81	$ 0.68	$2.18	$ 1.74
Diluted:				
Income from continuing operations attributable to Leidos Holdings, Inc. common stockholders	$0.80	$ 0.67	$2.13	$ 1.47
Discontinued operations, net of taxes	—	—	—	0.25
Net income attributable to Leidos Holdings, Inc. common stockholders	$0.80	$ 0.67	$2.13	$ 1.72
Weighted average number of common shares outstanding:				
Basic	112	72	85	73
Diluted	114	73	87	74
Cash dividends declared per share	$13.96	$ 0.32	$14.60	$ 0.96

See accompanying notes to condensed consolidated financial statements.

2

Table of Contents

LEIDOS HOLDINGS, INC.
CONDENSED CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME (UNAUDITED)

	Three Months Ended		Nine Months Ended	
	September 30, 2016	October 2, 2015	September 30, 2016	October 2, 2015
	(in millions)			
Net income	$92	$ 49	$186	$ 127
Other comprehensive (loss) income, net of taxes:				
Foreign currency translation adjustments	2	—	9	(2)
Taxes	—	—	(3)	1
Foreign currency translation adjustments, net of taxes	2	—	6	(1)
Unrecognized loss on derivative instruments	(6)	—	(6)	—
Taxes	2	—	2	—
Unrecognized loss on derivative instruments, net of taxes	(4)	—	(4)	—
Pension liability adjustments	—	—	1	(1)
Taxes	—	—	(1)	1
Pension liability adjustments, net of taxes	—	—	—	—
Total other comprehensive (loss) income, net of taxes	(2)	—	2	(1)
Comprehensive income	90	49	188	126
Less: comprehensive income attributable to non-controlling interest, net of taxes	1	—	1	—
Comprehensive income attributable to Leidos Holdings, Inc.	$89	$ 49	$187	$ 126

See accompanying notes to condensed consolidated financial statements.

Table of Contents

LEIDOS HOLDINGS, INC.
CONDENSED CONSOLIDATED STATEMENTS OF STOCKHOLDERS' EQUITY (UNAUDITED)

	Shares of common stock	Additional paid-in capital	Accumulated deficit	Accumulated other comprehensive loss	Leidos Holdings, Inc. stockholders' equity	Non-controlling interest	Total
	(in millions, except for per share amounts)						
Balance at January 30, 2015	74	$ 1,433	$ (424)	$ (11)	$ 998	$ —	$998
Net income	—	—	116	—	116	—	116
Issuances of stock (less forfeitures)	—	4	—	—	4	—	4
Repurchases of stock and other	(2)	(114)	—	—	(114)	—	(114)
Dividends of $0.96 per share	—	—	(72)	—	(72)	—	(72)
Stock-based compensation	—	22	—	—	22	—	22
Balance at October 2, 2015	72	$ 1,345	$ (380)	$ (11)	$ 954	$ —	$954
Balance at January 1, 2016	72	$ 1,353	$ (277)	$ (8)	$ 1,068	$ —	$1,068
Net income	—	—	185	—	185	1	186
Other comprehensive income, net of taxes	—	—	—	2	2	—	2
Issuances of stock (less forfeitures)	1	36	—	—	36	—	36
Repurchases of stock and other	—	(20)	—	—	(20)	—	(20)
Dividends of $0.96 per share	—	—	(96)	—	(96)	—	(96)
Special cash dividend of $13.64 per share	—	(1,022)	—	—	(1,022)	—	(1,022)
Stock-based compensation	—	25	—	—	25	—	25
Stock issued for the IS&GS Business acquisition	77	2,938	—	—	2,938	—	2,938
Equity interest acquired	—	—	—	—	—	13	13
Balance at September 30, 2016	150	$ 3,310	$ (188)	$ (6)	$ 3,116	$ 14	$3,130

See accompanying notes to condensed consolidated financial statements.

Table of Contents

LEIDOS HOLDINGS, INC.
CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS (UNAUDITED)

	Nine Months Ended	
	September 30, 2016	October 2, 2015
	(in millions)	
Cash flows from operations:		
Net income	$ 186	$ 127
Income from discontinued operations	—	(18)
Adjustments to reconcile net income to net cash provided by operations:		
Depreciation and amortization	54	35
Stock-based compensation	25	23
Asset impairment charges	—	73
Bad debt expense and other, net	(2)	8
Change in assets and liabilities, net of effects of acquisitions and dispositions:		
Receivables	140	145
Inventory, prepaid expenses and other current assets	(124)	(22)
Accounts payable and accrued liabilities	36	71
Accrued payroll and employee benefits	(2)	(26)
Deferred income taxes and income taxes receivable/payable	(19)	(20)
Other long-term assets/liabilities	(10)	(18)
Total cash flows provided by operating activities of continuing operations	284	378
Cash flows from investing activities:		
Payments for property, plant and equipment	(20)	(15)
Acquisition of business	25	—
Payments on accrued purchase price related to prior acquisition	—	(13)
Net proceeds from sale of assets	3	9
Proceeds from disposition of business	23	27
Proceeds from collections on promissory note	4	—
Other	(1)	—
Total cash flows provided by investing activities of continuing operations	34	8
Cash flows from financing activities:		
Payments of long-term debt	(102)	(49)
Proceeds from debt issuance	690	—
Payments for debt issuance costs	(30)	—
Proceeds from issuances of stock	25	4
Repurchases of stock and other	(20)	(116)
Special cash dividend payment	(993)	—
Dividend payments	(94)	(71)
Other	—	3
Total cash flows used in financing activities of continuing operations	(524)	(229)

See accompanying notes to condensed consolidated financial statements.

Table of Contents

LEIDOS HOLDINGS, INC.
CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS [CONTINUED]
(UNAUDITED)

	Nine Months Ended	
	September 30, 2016	October 2, 2015
	(in millions)	
(Decrease) increase in cash and cash equivalents from continuing operations	(206)	157
Cash flows from discontinued operations:		
Cash provided by operating activities of discontinued operations	—	13
Cash (used in) provided by investing activities of discontinued operations	(1)	6
(Decrease) increase in cash and cash equivalents from discontinued operations	(1)	19
Total (decrease) increase in cash and cash equivalents	(207)	176
Cash and cash equivalents at beginning of period	656	459
Cash and cash equivalents at end of period	$ 449	$ 635

See accompanying notes to condensed consolidated financial statements.

LEIDOS HOLDINGS, INC.
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

Note 1–Summary of Significant Accounting Policies
Nature of Operations and Basis of Presentation
Leidos Holdings, Inc. ("Leidos"), a holding company whose direct 100%-owned subsidiaries are Leidos, Inc. and Leidos Innovations Corporation ("Leidos Innovations"), is a global science and technology solutions company that provides technology and engineering solutions in the defense, intelligence, homeland security, civil and health markets. Leidos' domestic customers include agencies of the U.S. Department of Defense ("DoD"), the intelligence community, the U.S. Department of Homeland Security ("DHS"), the Department of Health and Human Services, other U.S. Government civil agencies and state and local government agencies. Leidos' international customers include foreign governments and their agencies, primarily located in the United Kingdom, the Middle East and Australia. Unless indicated otherwise, references to the "Company," "we," "us" and "our" refer collectively to Leidos Holdings, Inc. and its consolidated subsidiaries.
The unaudited condensed consolidated financial statements of Leidos include the balances of its majority-owned and 100%-owned subsidiaries. All intercompany transactions and balances have been eliminated in consolidation.
The accompanying unaudited condensed financial information has been prepared in accordance with the rules of the U.S. Securities and Exchange Commission ("SEC") and accounting principles generally accepted in the United States of America ("GAAP"). Certain disclosures normally included in financial statements prepared in accordance with GAAP have been condensed or omitted pursuant to such rules. The preparation of financial statements in conformity with GAAP requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and the disclosure of contingencies at the date of the financial statements, as well as the reported amounts of revenues and expenses during the reporting periods. Management evaluates these estimates and assumptions on an ongoing basis, including those relating to indirect cost billings, allowances for doubtful accounts, inventories, fair value and impairment of intangible assets and goodwill, income taxes, estimated profitability of long-term contracts, pension benefits, stock-based compensation expense and contingencies. Estimates have been prepared by management on the basis of the most current and best available information; however, actual results could differ materially from those estimates.
On August 16, 2016, a wholly-owned subsidiary of Leidos Holdings, Inc. merged with the Information Systems & Global Solutions business (the "IS&GS Business") of Lockheed Martin Corporation in a Reverse Morris Trust transaction. The acquired IS&GS Business was renamed Leidos Innovations Corporation. See "Note 2–Acquisitions" for further information.
As a result of the Lockheed Martin transaction, the Company received an interest in Mission Support Alliance, LLC ("MSA"), a joint venture with Jacobs Engineering Group, Inc. and Centerra Group, LLC. The Company has consolidated the financial results for MSA into its condensed consolidated financial statements.
Certain amounts in the prior year financial statements have been reclassified to conform to the current year presentation. The Company disaggregated "Goodwill and intangible assets, net" into "Goodwill" and "Intangible assets, net"; separately disclosed "Dividends payable" and "Income taxes payable," which were previously aggregated within "Accounts payable and accrued liabilities"; and separately disclosed "Deferred tax liabilities," which was previously aggregated within "Other long-term liabilities," on the condensed consolidated balance sheets. Additionally, the Company separately disclosed "Restructuring expenses," which was previously aggregated within "Selling, general and administrative expenses" on the condensed consolidated statements of income.
During the Company's first quarter ended April 1, 2016, the company adopted ASU 2015-03, Interest - Imputation of Interest (Subtopic 835-30): Simplifying the Presentation of Debt Issuance Costs, resulting in a reclassification of deferred financing costs related to the Company's notes of $7 million from "Other assets" to "Notes payable and long-term debt, net of current portion" in the Company's condensed consolidated balance sheets as of January 1, 2016 (see "Accounting Standards Updates Adopted" below).

Table of Contents

LEIDOS HOLDINGS, INC.
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

In the opinion of management, the accompanying unaudited condensed consolidated financial statements reflect all adjustments, which consist of normal recurring adjustments, necessary for a fair presentation thereof. The results reported in these unaudited condensed consolidated financial statements are not necessarily indicative of the results that may be expected for the entire year. These unaudited condensed consolidated financial statements should be read in conjunction with the consolidated financial statements and notes thereto included in the Company’s Transition Report on Form 10-K filed on February 26, 2016.

Fair Value Measurements

The accounting standard for fair value measurements establishes a three-tier value hierarchy, which prioritizes the inputs used in measuring fair value as follows: observable inputs such as quoted prices in active markets (Level 1); inputs other than quoted prices in active markets that are observable either directly or indirectly (Level 2); and unobservable inputs in which there is little or no market data, which requires the Company to develop its own assumptions (Level 3).

The Company’s cash equivalents were primarily comprised of investments in several large institutional money market funds and bank deposits, with original maturity of three months or less. There are immaterial restrictions on the withdrawal of the Company’s cash and cash equivalents of foreign currency due to exchange control regulations. The Company's cash equivalents are recorded at historical cost, which equals fair value based on quoted market prices (Level 1 input).

The Company's financial instruments measured at fair value on a recurring basis using Level 2 inputs consisted of the Company's interest rate swaps on its $450 million fixed rate 4.45% notes maturing in December 2020 and its interest rate swaps on $1.2 billion of the aggregate principal outstanding on the Company's variable rate senior secured notes (see "Note 8–Derivative Instruments"). At September 30, 2016, the Company did not have any financial assets or liabilities measured at fair value on a recurring basis using Level 3 inputs.

The Company’s non-financial instruments measured at fair value on a non-recurring basis include goodwill, indefinite-lived intangible assets and long-lived tangible assets. The valuation methods used to determine fair value require a significant degree of management judgment to determine the key assumptions. As such, the Company generally classifies non-financial instruments as either Level 2 or Level 3 fair value measurements. On August 16, 2016, the Company had non-financial instruments measured at fair value on a non-recurring basis in connection with the acquisition of Lockheed Martin's IS&GS Business. Refer to "Note 2–Acquisitions" for the preliminary fair values of the assets acquired and liabilities assumed. At September 30, 2016, the Company did not have any non-financial instruments measured at fair value on a non-recurring basis.

The carrying amounts of the Company’s financial instruments, other than derivatives, which include cash equivalents, accounts receivable, accounts payable and accrued expenses, are reasonable estimates of their related fair values. The carrying value of the Company's notes receivable as of September 30, 2016, of $92 million approximates fair value as the stated interest rates within the agreements are consistent with the current market rates used in notes with similar terms in the market (Level 2 inputs). The fair value of long-term debt (see "Note 9–Debt") is determined based on current interest rates available for debt with terms and maturities similar to the Company’s existing debt arrangements (Level 2 inputs).

Changes in Estimates on Contracts

Changes in estimates related to certain types of contracts accounted for using the percentage of completion method of accounting are recognized in the period in which such changes are made for the inception-to-date effect of the changes. Changes in these estimates can routinely occur over the contract performance period for a variety of reasons, including changes in contract scope, contract cost estimates and estimated incentive or award fees.

Changes in estimates on contracts for the periods presented were as follows:

	Three Months Ended	Nine Months Ended

	September 30, 2016	October 2, 2015	September 30, 2016	October 2, 2015
	(in millions, except per share amounts)			
Net increase in income from continuing operations before taxes	$4	$ 10	$17	$ 20
Impact on diluted EPS from continuing operations	$0.02	$ 0.08	$0.12	$ 0.16

LEIDOS HOLDINGS, INC.
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

Supplementary Cash Flow Information
Supplementary cash flow information, including non-cash investing and financing activities, for the periods presented was as follows:

	Nine Months Ended	
	September 30, 2016	October 2, 2015
	(in millions)	
Dividends declared and other	$ 20	$ 25
Stock issued in lieu of cash dividends	$ 10	$ 2
Capital lease obligation	$ —	$ 6
Promissory note received for disposition of business	$ —	$ 73
Stock issued for acquisition of the IS&GS Business	$ 2,938	$ —
Cash paid for interest	$ 53	$ 33
Cash paid for income taxes, net of refunds (including discontinued operations)	$ 45	$ 50

Accounting Standards Updates Adopted
In April 2015, the Financial Accounting Standards Board ("FASB") issued ASU 2015-03, Interest - Imputation of Interest (Subtopic 835-30): Simplifying the Presentation of Debt Issuance Costs. This update eliminates separate presentation for debt issuance costs as an asset and requires issuance costs to be reported in the balance sheet as a direct reduction to the face amount of the associated debt. The Company adopted this ASU on a retrospective basis during the Company's first quarter ended April 1, 2016. This resulted in a reclassification of deferred financing costs related to the Company's notes of $7 million from "Other assets" to "Notes payable and long-term debt, net of current portion" in the Company's condensed consolidated balance sheets as of January 1, 2016.
In March 2016, the FASB issued ASU 2016-09 Stock Compensation (Topic 718): Improvements to Employee Share-Based Payment Accounting. This update is effective for annual periods beginning after December 15, 2016 and interim periods within those annual periods, with early adoption permitted. Among other requirements in the new standard, the ASU requires that an entity, (i) recognize excess tax benefits and deficiencies related to employee share-based payment transactions as an income tax expense or benefit in the income statement rather than in equity; (ii) present the excess tax benefits as an operating activity on the statement of cash flows versus current guidance to present them as financing activities; and, (iii) elect to either recognize stock forfeitures as they occur or estimate them. During the quarter ended July 1, 2016, the Company elected to early adopt the provisions of the ASU prospectively from January 2, 2016, including continuation of estimating forfeitures instead of recording them as they occur. Consequently, the Company recognized a $3 million and $7 million discrete tax benefit for the quarter and six months ended July 1, 2016, respectively, and operating cash flows for the six months ended July 1, 2016, increased $7 million with a corresponding decrease to financing cash flows.

Table of Contents

Accounting Standards Updates Issued But Not Yet Adopted

In May 2014, the FASB issued ASU 2014-09, Revenue from Contracts with Customers (Topic 606). This ASU affects any entity that either enters into contracts with customers to transfer goods or services or enters into contracts for the transfer of non-financial assets unless those contracts are within the scope of other standards (e.g., insurance contracts). This ASU will supersede all revenue recognition requirements in Topic 605, Revenue Recognition, and industry-specific guidance throughout the industry topics of the codification. The guidance's core principle is 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 or services. In applying the revenue principles, an entity will identify the contract(s) with a customer, identify the performance obligations, determine the transaction price, allocate the transaction price to the performance obligations and recognize revenue when the performance obligation is satisfied (either over time or at a point in time). The ASU further states that an entity should disclose sufficient information to enable users of financial statements to understand the nature, amount, timing and uncertainty of revenue and cash flows arising from contracts with customers. In August 2015, the FASB issued ASU 2015-14, Revenue from Contracts with Customers (Topic 606): Deferral of the Effective Date, which approved a one-year deferral of the effective date of the ASU from the original effective date of annual reporting periods beginning after December 15, 2016, to annual reporting periods (including interim reporting periods) beginning after December 15, 2017, with an option for early adoption of the standard on the original effective date. Additionally, in March 2016, the FASB issued ASU 2016-08, Revenue from Contracts with Customers (Topic 606): Principal versus Agent Considerations (Reporting Revenue Gross versus Net), which clarified the implementation guidance on principal versus agent considerations. In April 2016, the FASB issued ASU 2016-10, Revenue from Contracts with Customers (Topic 606): Identifying Performance Obligations and Licensing, that amended the revenue guidance on identifying performance obligations and accounting for licenses of intellectual property. In May 2016, the FASB issued ASU 2016-11 Revenue Recognition (Topic 605) and Derivatives and Hedging (Topic 805): Rescission of SEC Guidance Because of Accounting Standards Updates 2014-09 and 2014-16 Pursuant to Staff Announcements at the March 3, 2016 EITF Meeting, which rescinded from the FASB Accounting Standards Codification ("ASC") certain SEC paragraphs as a result of two SEC Staff Announcements. The FASB also issued ASU 2016-12 Revenue from Contracts with Customers (Topic 606): Narrow-Scope Improvements and Practical Expedients, which clarified guidance on assessment of collectibility, presentation of sale taxes, measurement of noncash consideration and certain transition matters. The Company is evaluating the impact that the provisions of ASU 2014-09 and related subsequent updates will have on the Company's condensed consolidated financial position, results of operations and cash flows.

In February 2016, the FASB issued ASU 2016-02, Leases (Topic 842). This ASU will supersede the current lease guidance under ASC 840 and makes several changes, such as requiring an entity to recognize a right-of-use asset and corresponding lease obligation in the balance sheet, classified as financing or operating, as appropriate. The standard requires adoption under the modified retrospective approach and is effective for annual reporting periods beginning after December 15, 2018, including interim periods within those fiscal years. Early adoption is permitted. The Company is evaluating the provisions of ASU 2016-02 and its impact on the Company's condensed consolidated financial position, results of operations and cash flows.

In June 2016, the FASB issued ASU 2016-13, Financial Instruments - Credit Losses (Topic 326), Measurement of Credit Losses on Financial Instruments. This ASU eliminates the requirement that a credit loss on a financial instrument be “probable” prior to recognition. Instead, a valuation allowance will be recorded to reflect an entity’s current estimate of all expected credit losses, based on both historical and forecasted information related to an instrument. The amendments in the update will be effective for public Companies for fiscal years beginning after December 15, 2019, including interim periods within those years and should be adopted using a modified-retrospective approach, which applies a cumulative-effect adjustment to retained earnings as of the beginning of the first reporting period in which the guidance is effective. A prospective approach is required for debt securities for which an other-than-temporary impairment had been recognized before the effective date and loans and debt securities acquired with deteriorated credit quality. The guidance may be early-adopted for fiscal years beginning after December 15, 2018, including interim periods within those fiscal years. The Company is evaluating the provisions of ASU 2016-13 and its impact on the Company's condensed consolidated financial position, results of operations and cash flows.

Table of Contents

LEIDOS HOLDINGS, INC.
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

In August 2016, the FASB issued ASU 2016-15, Statement of Cash Flows (Topic 230), Classification of Certain Cash Receipts and Cash Payments. This ASU clarifies guidance for cash flow classification to reduce current and potential future diversity in practice. The amendments should be applied using a retrospective transition method to each period presented. For items that are impractical to apply the amendments retrospectively, they shall be applied prospectively as of the earliest date practicable. The amendments in this Update are effective for public entities beginning after December 15, 2017, and interim periods within those fiscal years. Early adoption is permitted. The Company is evaluating the provisions of ASU 2016-15 and its impact on the Company's condensed consolidated cash flows.

Note 2–Acquisitions

On January 26, 2016, Leidos announced that it had entered into a definitive agreement (as amended, the "Merger Agreement") with Lockheed Martin Corporation ("Lockheed Martin"); Abacus Innovations Corporation, a Delaware corporation and a wholly owned subsidiary of Lockheed Martin ("Splitco"); and Lion Merger Co., a Delaware corporation and, at the time of announcement, a wholly owned subsidiary of Leidos ("Merger Sub"), pursuant to which Leidos would combine with Lockheed Martin's realigned Information Systems & Global Solutions business in a Reverse Morris Trust transaction. In connection with the Merger Agreement, Lockheed Martin and Splitco entered into a Separation Agreement dated January 26, 2016 (as amended, the "Separation Agreement"), pursuant to which Lockheed Martin would separate the IS&GS Business from Lockheed Martin and transfer the IS&GS Business to Splitco. The transactions contemplated by the Merger Agreement and the Separation Agreement are referred to herein as the "Transactions."

On August 16, 2016, the acquisition date, the Company completed the Transactions. In the Transactions, among other steps, (i) Lockheed Martin transferred the IS&GS Business to Splitco; (ii) Lockheed Martin offered to Lockheed Martin stockholders the right to exchange all or a portion of their shares of Lockheed Martin common stock for shares of Splitco common stock by way of an exchange offer (the "Distribution"); and (iii) Merger Sub merged with and into Splitco, with Splitco as the surviving corporation (the "Merger") and a wholly owned subsidiary of Leidos. Additionally, on the closing date of the Transactions, Splitco's name was changed to Leidos Innovations Corporation. Upon consummation of the Transactions, those Lockheed Martin stockholders who elected to participate in the exchange offer received approximately 77 million shares of Leidos common stock, which represent approximately 50.5% of the outstanding shares of Leidos common stock after consummation of the Transactions. Holders of Leidos shares prior to the transaction held the remaining 49.5% of the outstanding shares of Leidos common stock immediately after the closing.

Prior to the Distribution, Splitco incurred third-party debt financing in an aggregate principal amount of $1.8 billion and immediately thereafter, Lockheed Martin transferred the IS&GS Business to Splitco and Splitco made a special cash payment to Lockheed Martin of $1.8 billion.

In connection with the Transactions, Leidos incurred new indebtedness and assumed Splitco's indebtedness in the form of term loans in an aggregate principal amount of $690 million and $1.8 billion, respectively, and entered into a new $750 million senior secured revolving credit facility, which replaced its existing revolving credit facility. See "Note 9–Debt" for further information regarding the new debt incurred and the new senior revolving credit facility.

In conjunction with the Transactions, Leidos' Board of Directors declared a special dividend of $13.64 per share of Leidos common stock. On August 22, 2016, the Company paid $993 million to stockholders of record as of August 15, 2016. As a result of the special dividend declaration, the Company accrued $29 million of dividend equivalents with respect to outstanding equity awards. See "Note 12–Stock Based Compensation" for further information regarding the modifications made to the Company's outstanding stock awards as a result of the special dividend.

In connection with the Transactions, membership on the Leidos Board of Directors was increased to 12 directors, in which three directors designated by Lockheed Martin were appointed to the board. A majority of the senior management of Leidos immediately prior the consummation of the Transactions remained Leidos executive officers immediately after the Transactions. Leidos management determined that Leidos is the accounting acquirer in the Transactions based on the facts and circumstances noted within this section and other relevant factors.

The acquisition adds large, complex IT system implementation and operation experience and additional federal and international IT solutions and services work to the Leidos portfolio, providing more venues to sell value added services such as cybersecurity and analytics. As a result, the Company is more diversified in markets it serves and provides the Company the scale and access to markets intended to further growth.

Table of Contents

LEIDOS HOLDINGS, INC.
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

In connection with the Transactions, certain additional agreements were entered into, including, among others an employee matters agreement, a tax matters agreement, transition services agreements, an intellectual property matters agreement, agreements relating to certain government contracts matters, supply agreements and certain real estate related agreements.

The preliminary purchase consideration for the acquisition of the IS&GS Business was as follows (in millions):

Value of common stock issued to Lockheed Martin stockholders(1)	$2,929
Equity consideration for replacement awards(2)	9
Preliminary working capital adjustments	22