Science Applications International Corp
Form 10-Q
December 06, 2018

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 November 2, 2018
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	Exact Name of Registrant as Specified in its Charter, Address of Principal Executive Offices and Telephone Number	State or other jurisdiction of incorporation or organization	I.R.S. Employer Identification No.
001-35832	Science Applications International Corporation 12010 Sunset Hills Road, Reston, VA 20190 703-676-4300	Delaware	46-1932921

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
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
Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, smaller reporting company or an emerging growth company. See the definitions of “large accelerated filer,” “accelerated filer,” “smaller reporting company” and “emerging growth company” in Rule 12b-2 of the Exchange Act.
Large accelerated filer x Accelerated filer Non-accelerated filer Smaller reporting company
Emerging growth company
If an emerging growth company, indicate by check mark if the registrant has elected not to use the extended transition period for complying with any new or revised financial accounting standards provided pursuant to Section 13(a) of the Exchange Act.
Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act).
Yes No x
The number of shares issued and outstanding of the registrant’s common stock as of November 23, 2018 was as follows:
42,544,462 shares of common stock ($.0001 par value per share)

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PART I—FINANCIAL INFORMATION

Item 1. Financial Statements
SCIENCE APPLICATIONS INTERNATIONAL CORPORATION
CONDENSED AND CONSOLIDATED STATEMENTS OF INCOME AND COMPREHENSIVE INCOME (UNAUDITED)

	Three Months Ended		Nine Months Ended	
	November 2, 2018	November 3, 2017	November 2, 2018	November 3, 2017
	(in millions, except per share amounts)			
Revenues	$1,177	$ 1,145	$3,467	$ 3,326
Cost of revenues	1,048	1,036	3,125	3,022
Selling, general and administrative expenses	42	37	115	110
Acquisition and integration costs (Note 4)	14	—	14	—
Operating income	73	72	213	194
Interest expense	16	11	38	32
Other (income) expense, net	(1)	(1)	(2)	(1)
Income before income taxes	58	62	177	163
Provision for income taxes (Note 6)	(10)	(19)	(31)	(35)
Net income	$48	$ 43	$146	$ 128
Other comprehensive income, net of tax (Note 9)	1	1	1	2
Comprehensive income	$49	$ 44	$147	$ 130
Earnings per share (Note 2):				
Basic	$1.13	$ 0.99	$3.44	$ 2.94
Diluted	$1.11	$ 0.98	$3.37	$ 2.86
Cash dividends declared and paid per share	$0.31	$ 0.31	$0.93	$ 0.93

See accompanying notes to condensed and consolidated financial statements.

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SCIENCE APPLICATIONS INTERNATIONAL CORPORATION
CONDENSED AND CONSOLIDATED BALANCE SHEETS
(UNAUDITED)

	November 2, 2018	February 2, 2018
	(in millions)	
ASSETS		
Current assets:		
Cash and cash equivalents	$193	$ 144
Receivables, net	765	674
Inventory, prepaid expenses and other current assets	114	132
Total current assets	1,072	950
Goodwill	863	863
Intangible assets (net of accumulated amortization of $70 million and $55 million at November 2, 2018 and February 2, 2018, respectively)	164	179
Property, plant, and equipment (net of accumulated depreciation of $156 million and $143 million at November 2, 2018 and February 2, 2018, respectively)	67	61
Other assets	36	20
Total assets	$2,202	$ 2,073
LIABILITIES AND EQUITY		
Current liabilities:		
Accounts payable and accrued liabilities	$452	$ 504
Accrued payroll and employee benefits	219	150
Long-term debt, current portion (Note 7)	11	41
Total current liabilities	682	695
Long-term debt, net of current portion (Note 7)	1,026	983
Deferred income taxes	30	23
Other long-term liabilities	53	45
Commitments and contingencies (Note 10)		
Equity:		
Common stock, $.0001 par value, 1 billion shares authorized, 43 million shares issued and outstanding as of November 2, 2018 and February 2, 2018	—	—
Additional paid-in capital	16	—
Retained earnings	390	323
Accumulated other comprehensive income (Note 9)	5	4
Total equity	411	327
Total liabilities and equity	$2,202	$ 2,073

See accompanying notes to condensed and consolidated financial statements.

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SCIENCE APPLICATIONS INTERNATIONAL CORPORATION
CONDENSED AND CONSOLIDATED STATEMENT OF EQUITY
(UNAUDITED)

	Shares of common stock	Additional paid-in capital	Retained earnings	Accumulated other comprehensive income	Total
	(in millions)				
Balance at February 2, 2018	43	$ —	$ 323	$ 4	$ 327
Cumulative impact from adopting ASC 606 (Note 1) on February 3, 2018	—	—	3	—	3
Net income	—	—	146	—	146
Issuances of stock	1	5	—	—	5
Other comprehensive income, net of tax	—	—	—	1	1
Cash dividends of $0.93 per share	—	—	(40)	—	(40)
Stock-based compensation	—	12	(9)	—	3
Repurchases of stock	(1)	(1)	(33)	—	(34)
Balance at November 2, 2018	43	$ 16	$ 390	$ 5	$ 411

See accompanying notes to condensed and consolidated financial statements.

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SCIENCE APPLICATIONS INTERNATIONAL CORPORATION
CONDENSED AND CONSOLIDATED STATEMENTS OF CASH FLOWS
(UNAUDITED)

	Nine Months Ended November 2, 2018		November 3, 2017	
	(in millions)			
Cash flows from operating activities:				
Net income	$ 146		$ 128	
Adjustments to reconcile net income to net cash provided by operating activities:				
Depreciation and amortization	33		33	
Stock-based compensation expense	24		21	
Loss on extinguishment of debt	4		—	
Provision for inventory	25		—	
Increase (decrease) resulting from changes in operating assets and liabilities:				
Receivables	(86	)	(178	)
Inventory, prepaid expenses and other current assets	(5	)	17	
Other assets	(9	)	1	
Accounts payable and accrued liabilities	(47	)	62	
Accrued payroll and employee benefits	69		45	
Other long-term liabilities	8		4	
Net cash provided by operating activities	162		133	
Cash flows from investing activities:				
Expenditures for property, plant, and equipment	(24	)	(15	)
Other	1		—	
Net cash used in investing activities	(23	)	(15	)
Cash flows from financing activities:				

Dividend payments to stockholders	(40)	(40)
Principal payments on borrowings	(776)	(42)
Issuances of stock	5	4
Stock repurchased and retired or withheld for taxes on equity awards	(56)	(148)
Disbursements for obligations assumed from Scitor acquisition	—	(2)
Proceeds from borrowings	791	25
Debt issuance costs	(13)	—
Net cash used in financing activities	(89)	(203)
Net increase (decrease) in cash, cash equivalents and restricted cash	50	(85)
Cash, cash equivalents and restricted cash at beginning of period	152	218
Cash, cash equivalents and restricted cash at end of period (Note 1)	$ 202	$ 133

See accompanying notes to condensed and consolidated financial statements.

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SCIENCE APPLICATIONS INTERNATIONAL CORPORATION
NOTES TO CONDENSED AND CONSOLIDATED FINANCIAL STATEMENTS
(UNAUDITED)

Note 1—Business Overview and Summary of Significant Accounting Policies:
Overview
Science Applications International Corporation (collectively, with its consolidated subsidiaries, the “Company”) is a leading provider of technical, engineering and enterprise information technology (IT) services primarily to the U.S. government. The Company provides engineering and integration services for large, complex projects and offers a broad range of services with a targeted emphasis on higher-end, differentiated technology services. The Company is organized as a matrix comprised of three customer facing operating segments supported by three market service line organizations. Each of the Company’s three customer facing operating segments is focused on providing the Company’s comprehensive technical and enterprise IT service offerings to one or more agencies of the U.S federal government. The Company's operating segments are aggregated into one reportable segment for financial reporting purposes.
Principles of Consolidation and Basis of Presentation
The accompanying financial information has been prepared by the Company pursuant to the rules and regulations of the Securities and Exchange Commission for interim reporting purposes. References to “financial statements” refer to the condensed and consolidated financial statements of the Company, which include the statements of income and comprehensive income, balance sheets, statement of equity and statements of cash flows. These financial statements were prepared in accordance with U.S. generally accepted accounting principles (GAAP). All intercompany transactions and account balances within the Company have been eliminated. The financial statements are unaudited, but in the opinion of management include all adjustments, which consist of normal recurring adjustments, necessary for a fair presentation thereof. The results reported in these financial statements are not necessarily indicative of results that may be expected for the entire year and should be read in conjunction with the information contained in the Company’s Annual Report on Form 10-K for the year ended February 2, 2018.
Use of Estimates
The preparation of the 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. Significant estimates inherent in the preparation of the financial statements may include, but are not limited to estimated profitability of long-term contracts, income taxes, fair value measurements, fair value of goodwill and other intangible assets, and contingencies. Estimates have been prepared by management on the basis of the most current and best available information at the time of estimation and actual results could differ from those estimates.
Restructuring
During fiscal 2018, the Company initiated restructuring activities (the "Restructuring") intended to improve operational efficiency, reduce costs, and better position the Company to drive future growth. The restructuring activities consisted of involuntary and voluntary terminations and the consolidation of existing leased facilities. The Company completed the Restructuring in fiscal 2018 with total restructuring costs of approximately $13 million, comprised of $6 million for employee severance and $7 million of lease exit costs. $1 million and $3 million of

restructuring costs for employee severance were included in cost of revenues in the condensed and consolidated statements of income and comprehensive income for the three and nine months ended November 3, 2017, respectively. The Company made $1 million in cash payments for severance during the nine months ended November 2, 2018 and made no cash payments for severance during the three months ended November 2, 2018 or the three and nine months ended November 3, 2017. The liability associated with lease exit costs will be substantially settled within three years of the completion of the Restructuring.

Reporting Periods

The Company utilizes a 52/53 week fiscal year ending on the Friday closest to January 31, with fiscal quarters typically consisting of 13 weeks. Fiscal 2018 began on February 4, 2017 and ended on February 2, 2018, while fiscal 2019 began on February 3, 2018 and ends on February 1, 2019.

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Operating Cycle
The Company's operating cycle may be greater than one year and is measured by the average time intervening between the inception and the completion of contracts. Contract assets and liabilities are recorded net on a contract-by-contract basis and generally are classified as current, based on our contract operating cycle.
Derivative Instruments Designated as Cash Flow Hedges
Derivative instruments are recorded on the condensed and consolidated balance sheets at fair value. Unrealized gains and losses on derivatives designated as cash flow hedges are reported in other comprehensive income (loss) and reclassified to earnings in a manner that matches the timing of the earnings impact of the hedged transactions.
The Company's fixed interest rate swaps are considered over-the-counter derivatives, and fair value is calculated using a standard pricing model for interest rate swaps with contractual terms for maturities, amortization and interest rates. Level 2, or market observable inputs (such as yield and credit curves), are used within the standard pricing models in order to determine fair value. The fair value is an estimate of the amount that the Company would pay or receive as of a measurement date if the agreements were transferred to a third party or canceled. See Note 8 for further discussion on the Company's derivative instruments designated as cash flow hedges.
Inventory
Inventory is substantially comprised of finished goods inventory purchased for resale to customers, such as tires and lubricants, and is valued at the lower of cost or net realizable value. The Company evaluates current inventory against historical and planned usage to estimate the appropriate provision for obsolete inventory.
The Company recognized a $25 million provision for inventory within cost of revenues during the three and nine months ended November 2, 2018 related to firm purchase commitments on a firm-fixed price program.
Cash, Cash Equivalents and Restricted Cash
The following table provides a reconciliation of cash, cash equivalents and restricted cash to amounts reported within the condensed and consolidated balance sheets for the periods presented:

	November 2, 2018	February 2, 2018
	(in millions)	
Cash and cash equivalents	$ 193	$ 144
Restricted cash included in other assets	9	8
Cash, cash equivalents and restricted cash	$ 202	$ 152

Accounting Standards Updates
In May 2014, the Financial Accounting Standards Board (FASB) issued Accounting Standards Update (ASU) No. 2014-09, Revenue from Contracts with Customers (Topic 606), which supersedes the revenue recognition requirements and some cost guidance included in the Accounting Standards Codification (ASC). This ASU is based on the principle that revenue is recognized to depict the transfer of goods or services to customers at an amount that reflects the consideration to which the entity expects to be entitled in exchange for those goods or services. The ASU also requires additional disclosures about the nature, amount, timing and uncertainty of revenue and cash flows arising from customer contracts, including significant judgments and changes in judgments, and assets recognized from costs

incurred to obtain or fulfill a contract.

The Company adopted the standard on February 3, 2018, using the modified retrospective method. Under this method, the Company recognized the cumulative effect of adoption as an adjustment to its opening balance of retained earnings on February 3, 2018. In determining the cumulative impact of the adoption the Company applied the provisions of ASC 606 only to contracts that had not yet been completed at the date of adoption.

Prior periods were not retrospectively adjusted, but the Company will maintain dual reporting for the year of initial application, disclosing the effect of adoption.

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Under the new standard, the Company continues to recognize revenue over time as services are rendered to fulfill its contractual obligations; however, the Company generally accounts for customer option period exercises (renewals) and service contract modifications prospectively, instead of as a cumulative adjustment to revenue under a single unit of accounting. Also, under the new standard, award and incentive-based fees generally are recognized during the discrete periods of performance to which they relate as opposed to on a cumulative basis over the contract period. The net impact to opening retained earnings from these changes as a result of the adoption was $3 million.

The Company no longer defers the recognition of revenues and costs associated with significant upfront material acquisitions on programs previously accounted for using the efforts-expended method of percentage of completion. Under the new standard, the Company recognizes revenue on an adjusted cost-to-cost basis, where the amount of revenue that is recognized is equal to the amount of costs incurred plus profit based on the adjusted cost input measure of progress. This change resulted in a $15 million reduction in inventories, prepaid expenses and other current assets and accounts payable and accrued liabilities on February 3, 2018, but had no impact on the adjustment to opening retained earnings.

The cumulative effect of adopting ASC 606 on the Company's opening balance sheet is as follows:

	Balance at February 2, 2018	Adjustments due to ASC 606	Opening Balance at February 3, 2018
	(in millions)		
Assets			
Receivables, net	$674	$ 5	$ 679
Inventories, prepaid expenses and other current assets	132	(18)	114
Liabilities and Equity			
Accounts payable and accrued liabilities	504	(16)	488
Retained earnings	$323	$ 3	$ 326

The amounts by which the Company’s financial statements were impacted by the adoption of ASC 606, as compared to the guidance in effect before the change, as of and for the three and nine months ended November 2, 2018 were as follows:

	Three Months Ended November 2, 2018			Nine Months Ended November 2, 2018		
	As reported	Balances without adoption of ASC 606	Effect of change	As reported	Balances without adoption of ASC 606	Effect of change

	(in millions)			(in millions)		
Income Statement						
Revenues	$1,177	$ 1,175	$ 2	$3,467	$ 3,477	$ (10)
Cost of revenues	1,048	1,047	1	3,125	3,136	(11)
Operating income	$73	$ 72	$ 1	$213	$ 212	$ 1

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	November 2, 2018		
	As reported	Balances without adoption of ASC 606	Effect of change
	(in millions)		
Balance Sheet			
Assets			
Receivables, net	$765	$ 755	$ 10
Inventories, prepaid expenses and other current assets	114	122	(8)
Other assets	36	34	2
Liabilities and Equity			
Accounts payable and accrued liabilities	452	452	—
Retained earnings	$390	$ 386	$ 4

These impacts were primarily attributable to the change in accounting for programs previously accounted for using the efforts-expended method of percentage of completion.

In August 2017, the FASB issued ASU No. 2017-12, Derivatives and Hedging (Topic 815): Targeted Improvements to Accounting for Hedge Activities, which simplifies the application of hedge accounting and eliminates the requirement to separately measure and report hedge ineffectiveness. The Company early adopted the provisions of the standard in the first quarter of fiscal 2019 and it did not have a material impact on the Company's financial statements.

In February 2016, the FASB issued ASU No. 2016-02, Leases (Topic 842), which supersedes the existing lease accounting standards (Topic 840). Under the new guidance, a lessee will be required to recognize lease assets and lease liabilities for all leases with lease terms in excess of twelve months. The recognition, measurement and presentation of expenses and cash flows arising from a lease by a lessee primarily will depend on its classification as either a finance lease or operating lease. The criteria for distinction between a finance lease and an operating lease are substantially similar to existing lease guidance for capital leases and operating leases. Some changes to lessor accounting have been made to conform and align that guidance with the lessee guidance and other areas within GAAP, such as Revenue from Contracts with Customers (Topic 606). In July 2018, the FASB provided an optional transition method of adoption, permitting entities to recognize a cumulative-effect adjustment to the opening balance of retained earnings in the period of adoption as opposed to the beginning of the earliest period presented in the financial statements. ASU 2016-02 becomes effective for the Company in the first quarter of fiscal 2020. The Company intends to adopt using the optional transition method. The Company is implementing new lease accounting software and is designing new processes and internal controls. The Company continues to evaluate the standard, but has not quantified the impact of adoption on its financial statements.

In August 2018, the FASB issued ASU No. 2018-15, Customer's Accounting for Implementation Costs Incurred in a Cloud Computing Arrangement That Is a Service Contract, which aligns the capitalization requirements for implementation costs incurred in a hosting arrangement that is a service contract with the existing capitalization requirements for implementation costs incurred to develop or obtain internal-use software (Subtopic 350-40). ASU 2018-15 becomes effective for the Company in the first quarter of fiscal 2021 and may be adopted either retrospectively or prospectively. Early adoption is permitted. The Company is currently evaluating the impact of the adoption of this standard on its financial statements.

Other Accounting Standards Updates effective after November 2, 2018 are not expected to have a material effect on the Company's financial statements.

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Note 2—Earnings Per Share:

Earnings Per Share

Basic earnings per share (EPS) is computed by dividing net income by the basic weighted-average number of shares outstanding. Diluted EPS is computed similarly to basic EPS, except the weighted-average number of shares outstanding is increased to include the dilutive effect of outstanding stock options and other stock-based awards.

A reconciliation of the weighted-average number of shares outstanding used to compute basic and diluted EPS was:

	Three Months Ended		Nine Months Ended	
	November 2, 2018	November 3, 2017	November 2, 2018	November 3, 2017
	(in millions)			
Basic weighted-average number of shares outstanding	42.5	43.2	42.5	43.5
Dilutive common share equivalents - stock options and other stock-based awards	0.7	1.0	0.8	1.3
Diluted weighted-average number of shares outstanding	43.2	44.2	43.3	44.8

The following stock-based awards were excluded from the weighted-average number of shares outstanding used to compute diluted EPS:

	Three Months Ended		Nine Months Ended	
	November 2, 2018	November 3, 2017	November 2, 2018	November 3, 2017
	(in millions)			
Antidilutive stock options excluded	0.3	0.2	0.2	0.2

Note 3—Revenues:

Revenue Recognition

The Company provides technical, engineering and enterprise IT services under long-term service arrangements primarily with the U.S. government including subcontracts with other contractors engaged in work for the U.S. government. The Company also serves a number of state and local governments, foreign governments and U.S. commercial customers.

The Company provides services under various contract types, including firm-fixed price (FFP), time-and-materials (T&M), cost-plus-fixed-fee, cost-plus-award-fee and cost-plus-incentive-fee contracts. Our service arrangements typically involve an annual base period of performance followed by renewal periods that are accounted for as separate contracts upon each exercise.

The Company recognizes revenue when, or as, we satisfy our performance obligations under a contract. A performance obligation is the unit of account for revenue recognition and refers to a promise in a contract to transfer a distinct service or good to the customer. The majority of the Company’s contracts contain a single performance obligation involving a significant integration of various activities that are performed together to deliver a combined service or solution. Performance obligations may be satisfied over time or at a point in time, but the majority of the

Company's performance obligations are satisfied over time. The Company selects the appropriate measure of progress for revenue recognition based on the nature of the performance obligation, contract type and other pertinent contract terms.

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Over time performance obligations may involve a series of recurring services, such as network operations and maintenance, operation and program support services, IT outsourcing services, and other IT arrangements where the Company is standing ready to provide support, when-and-if needed. Such performance obligations are satisfied over time because the customer simultaneously receives and consumes the benefits of our performance as services are provided. Alternatively, over time performance obligations may involve the completion of a contract deliverable. Examples include systems integration, network engineering, network design, and engineering and build services. Deliverable-based performance obligations are satisfied over time when the Company's performance creates or enhances an asset that is controlled by the customer, or when the Company's performance creates an asset that is customized to the customer's specifications and the Company has a right to payment, including profit, for work performed to date.

For recurring services performance obligations, the Company measures progress using either a cost input measure (cost-to-cost), a time-elapsed output measure, or the as-invoiced practical expedient. A cost input measure typically is applied to the Company's cost-reimbursable contracts. Revenue is recognized based on the ratio of costs incurred to total estimated costs at completion. Award or incentive fees are allocated to the distinct periods to which they relate. For fixed-price contracts, a time-elapsed output measure is applied to fixed consideration, such that revenue is recognized ratably over the period of performance. Where fixed-price contracts also provide for reimbursement of certain costs, such as travel or other direct costs, consideration may be attributed only to a distinct subset of time within the performance period. The Company's time-and-material and fixed price-level of effort contracts generally qualify for the as-invoiced practical expedient. Revenue is recognized in the amount to which the Company has a contractual right to invoice. Contract modifications typically create new enforceable rights and obligations, which are accounted for prospectively. Changes to our estimates of the transaction price are recognized as a cumulative adjustment to revenue.

For deliverable-based performance obligations satisfied over time, the Company recognizes revenue using a cost input measure of progress (cost-to-cost), regardless of contract type. Revenue is recognized based on the ratio of costs incurred to total estimated costs at completion, except for certain contracts for which the costs associated with significant materials or hardware procurements are excluded from the measure of progress and revenue is recognized on an adjusted cost-to-cost basis. Contract modifications typically change currently enforceable rights and obligations and are accounted for as a cumulative adjustment to revenue. Changes to our estimates of transaction price are recognized as a cumulative adjustment to revenue.

For performance obligations in which the Company does not transfer control over time, we recognize revenue at the point-in-time when the customer obtains control of the related asset, usually at the time of shipment or upon delivery. The Company accrues for shipping and handling costs occurring after the point-in-time control transfers to the customer.

Recognizing revenue on long-term contracts involves significant estimates and judgments. The transaction price is the estimated amount of consideration we expect to receive for performance under our contracts. Contract terms may include variable consideration, such as reimbursable costs, award and incentive fees, usage-based fees, service-level penalties, performance bonuses, or other provisions that can either increase or decrease the transaction price. Variable amounts generally are determined upon our achievement of certain performance metrics, program milestones or cost targets and may be based upon customer discretion. When making our estimates, the Company considers the customer, contract terms, the complexity of the work and related risks, the extent of customer discretion, historical experience and the potential of a significant reversal of revenue. The Company includes variable consideration in the transaction price only to the extent it is probable that a significant reversal of cumulative revenue recognized will not occur when the uncertainty associated with the variable consideration is resolved.

Estimating costs at completion is complex due to the nature of the services being performed and the length of certain contracts. Contract costs generally include direct costs, such as labor, subcontract costs and materials, and indirect costs identifiable with or allocable to a specific contract. Management must make assumptions regarding the complexity of the work to be performed, the schedule and associated tasks, labor productivity and availability, increases in wages and prices of materials, execution by our subcontractors, overhead cost rates, and other variables. Contract costs incurred for U.S. government contracts, including indirect costs, are subject to audit and adjustment by the Defense Contract Audit Agency ("DCAA").

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Contract fulfillment costs are expensed as incurred except for certain costs incurred for transition, set-up or other fulfillment activities under contracts, which are capitalized and amortized on a straight-line basis over the expected period of benefit, which generally includes the base contract period of performance and anticipated renewal periods. The Company provides for anticipated losses on contracts with the U.S. government by recording an expense for the total expected loss during the period in which the losses are first determined.
For contracts with multiple performance obligations, the Company allocates transaction price to each performance obligation based on the relative standalone selling price of each distinct performance obligation within the contract. Because the Company typically provides customized services and solutions that are specific to a single customer's requirements, standalone selling price is most often estimated based on expected costs plus a reasonable profit margin.
Changes in Estimates
Changes in estimates of revenues, cost of revenues or profits related to performance obligations satisfied over time are recognized in operating income 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 performance period for a variety of reasons, which include: changes in scope; changes in cost estimates due to unanticipated cost growth or reassessments of risks impacting costs; changes in the estimated transaction price, such as variable amounts for incentive or award fees; and performance being better or worse than previously estimated. In cases when total expected costs exceed total estimated revenues for a performance obligation, the Company recognizes the total estimated loss in the quarter identified. Total estimated losses are inclusive of any unexercised options that are probable of award, only if they increase the amount of the loss.
Aggregate changes in these estimates increased operating income by $19 million ($0.33 per diluted share) and $16 million ($0.28 per diluted share) for the three and nine months ended November 2, 2018, respectively, and increased operating income by $5 million ($0.07 per diluted share) and $1 million ($0.01 per diluted share) for the three and nine months ended November 3, 2017, respectively. Changes in these estimates increased net income by $14 million and $12 million for the three and nine months ended November 2, 2018. In addition, revenues were $4 million and $7 million higher for the three and nine months ended November 2, 2018, respectively, due to net revenue recognized from performance obligations satisfied in prior periods.
Disaggregation of Revenues
The Company's revenues are generated primarily from long-term contracts with the U.S. government including subcontracts with other contractors engaged in work for the U.S. government. The Company disaggregates revenues by customer, contract-type and prime vs. subcontractor to the federal government.
Disaggregated revenues by customer were as follows:

	Three Months Ended	Nine Months Ended
	November 2, 2018	
	(in millions)	

Department of Defense	$683	$ 2,107
Other federal government agencies	430	1,260
Commercial, state and local	64	100
Total	$1,177	$ 3,467

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Disaggregated revenues by contract-type were as follows:

	Three Months Ended	Nine Months Ended
	November 2, 2018	
	(in millions)	
Cost reimbursement	$598	$ 1,663
Time and materials (T&M)	253	863
Firm-fixed price (FFP)	326	941
Total	$1,177	$ 3,467

Disaggregated revenues by prime vs. subcontractor were as follows:

	Three Months Ended	Nine Months Ended
	November 2, 2018	
	(in millions)	
Prime contractor to federal government	$1,032	$ 3,123
Subcontractor to federal government	81	244
Other	64	100
Total	$1,177	$ 3,467

Contract Balances

Timing of revenue recognition may differ from the timing of billing and cash receipts from customers. Amounts are invoiced as work progresses, typically biweekly or monthly in arrears, or upon achievement of contractual milestones. We record a contract asset when revenue is recognized prior to invoicing, or a contract liability when cash is received in advance of recognizing revenue. A contract asset is a right to consideration that is conditional upon factors other than the passage of time. Contract assets include unbillable receivables and contract retentions, but exclude billed and billable receivables. Billed and billable receivables are rights to consideration which are unconditional other than to the passage of time. Contract liabilities include customer advances, cash collected in excess of revenues and deferred revenue. Contract assets and liabilities are recorded net on a contract-by-contract basis and are generally classified as current based on our contract operating cycle. Deferred revenue attributable to long-term contract material renewal options may be classified as non-current when the option renewal period will not occur within one year of the balance sheet date.

Contract balances for the periods presented were as follows:

	Balance Sheet line item	November 2, 2018	February 3,

			2018[1]
		(in millions)	
Billed and billable receivables, net[2]	Receivables, net	$ 564	$ 510
Contract assets[3]	Receivables, net	201	169
Contract liabilities - current	Accounts payable and accrued liabilities	10	12
Contract liabilities - non-current	Other long-term liabilities	$ 6	$ —

(1) Includes the cumulative effect of the changes made to the Company's opening balance sheet at February 3, 2018 from the modified retrospective adoption of ASC 606.

(2) Net of allowance for doubtful accounts of $2 million and $1 million as of November 2, 2018 and February 3, 2018, respectively.

(3) Includes contract retentions of $8 million and $11 million as of November 2, 2018 and February 3, 2018, respectively; the remaining balances of contract assets consists of unbillable receivables.

The changes in the Company's contract assets and contract liabilities during the current period primarily results from the timing differences between the Company's performance, invoicing and customer payments. During the nine months ended November 2, 2018, the Company recognized revenues of $10 million relating to amounts that were included in the opening balance of contract liabilities - current as of February 3, 2018. $1 million in revenues were recognized for the three months ended November 2, 2018, relating to amounts that were included in the opening balance of contract liabilities - current as of February 3, 2018.

Deferred Costs

Certain eligible costs, typically incurred during the initial phases of our service contracts, are capitalized when the costs relate directly to the contract, are expected to be recovered, and generate or enhance resources to be used in satisfying the performance obligation. These costs primarily consist of transition and set-up costs. Capitalized fulfillment costs are amortized on a straight-line basis over the expected period of benefit, which generally includes the contract base period and anticipated renewals.

The Company defers fulfillment costs incurred to transfer service to a customer prior to the establishment of a contract provided recovery is probable. These pre-contract costs are typically expensed upon contract award unless they are eligible for capitalization.

The Company performs periodic reviews to assess the recoverability of deferred contract transition and setup costs. The carrying amount of the asset is compared to the remaining amount of consideration the Company expects to receive for the services to which the asset relates, less the costs that relate directly to providing those services that have not yet been recognized. If the carrying amount is not recoverable, an impairment loss is recognized.

Deferred costs for the periods presented were as follows:

	Balance Sheet line item	November 2, 2018	February 3, 2018(1)
		(in millions)	
Pre-contract costs	Inventory, prepaid expenses and other current assets	$ 8	$ 1
Fulfillment costs - current	Inventory, prepaid expenses and other current assets	1	3
Fulfillment costs - non-current	Other assets	$ 12	$ —

(1) Includes the cumulative effect of the changes made to the Company's opening balance sheet at February 3, 2018 from the modified retrospective adoption of ASC 606.

Pre-contract costs of $1 million and $3 million were expensed during the three and nine months ended November 2, 2018. Fulfillment costs of $2 million were amortized during the three and nine months ended November 2, 2018.

Remaining Performance Obligations

As of November 2, 2018, the Company had $1.1 billion of remaining performance obligations. Remaining performance obligations exclude contracts with original durations of one year or less, contracts in which we recognize revenue using the as-invoiced practical expedient and any variable consideration that is allocated entirely to unsatisfied performance obligations on our supply chain contracts. The Company expects to recognize revenue on approximately 65% of the remaining performance obligations over the next 12 months and approximately 85% over the next 24 months, with the remaining recognized thereafter.

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Note 4—Pending Acquisition of Engility:
On September 9, 2018, the Company entered into the Merger Agreement by and among Science Applications International Corporation, Engility Holdings, Inc., ("Engility"), and Raptors Merger Sub, Inc., pursuant to which the Company will acquire Engility (the "Merger"). At the effective time of the Merger, each outstanding share of Engility common stock will be converted into the right to receive 0.450 shares of the Science Applications International Corporation common stock. The Company amended its credit agreement to provide for a new five-year senior secured $1.1 billion term loan facility to be funded in connection with the Merger, see Note 7. The proceeds will be used to repay Engility's existing credit facility and outstanding notes. The estimated transaction value is $2.1 billion based on the Company's per share closing price of $69.39 on November 2, 2018 including the repayment of Engility's net debt. The Merger Agreement has been unanimously approved by both companies' Board of Directors. The transaction is subject to customary closing conditions, including approval of both the Science Applications International Corporation and Engility stockholders, and is expected to close in the fourth quarter of fiscal year 2019.
For three and nine months ended November 2, 2018, the Company incurred $28 million in acquisition-related costs, including $17 million of debt issue costs, see Note 7, and $1 million in stock issue costs. For the three and nine months ended November 2, 2018, the Company recognized acquisition-related costs of $10 million and integration-related costs of $4 million, which are presented together as acquisition and integration costs on the condensed and consolidated statements of income and comprehensive income.

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Note 5—Stock-Based Compensation:

Stock Options

During the nine months ended November 2, 2018, the Company granted certain employees 0.1 million stock options with a weighted-average exercise price and weighted-average grant date fair value of $85.62 and $19.48, respectively. These options will expire on the seventh anniversary of the grant date and will vest ratably on each anniversary of the grant date over a three-year period.

Restricted Stock Units (RSUs)

During the nine months ended November 2, 2018, the Company granted certain employees 0.4 million RSUs with a weighted-average grant date fair value of $85.01, which will vest ratably on each anniversary of the grant date over a four-year period.

Performance Shares

During the nine months ended November 2, 2018, the Company granted to certain employees 0.1 million performance share awards with a grant date fair value of $85.31 per award. These awards will cliff vest at the end of the third fiscal year following the grant date, subject to meeting the minimum service requirements and the achievement of certain annual and cumulative financial metrics of the Company’s performance, with the number of shares ultimately issued, if any, ranging up to 150% of the specified target shares.

Note 6—Income Taxes:

The Company's effective income tax rate was 17.7% and 17.4% for the three and nine months ended November 2, 2018, respectively, and 30.7% and 21.5% for the three and nine months ended November 3, 2017, respectively. The Company's effective tax rate was lower for the three and nine months ended November 2, 2018 compared to the prior year period due to the lower statutory federal income tax rate, increased research tax credits and hurricane disaster zone credits, partially offset by lower excess tax benefits related to employee share-based compensation, the repeal of the manufacturer’s deduction and the changes in deductibility of executive compensation due to the Tax Cuts and Jobs Act (the "Tax Act"). Tax rates for the periods ended November 2, 2018 were lower than the combined federal and state statutory rates due to excess tax benefits related to employee share-based compensation, research and development credits, and hurricane disaster zone credits, partially offset by permanent book tax differences.

As of November 2, 2018, the balance of unrecognized tax benefits included liabilities for uncertainty in income taxes of $9 million; $8 million of which is classified as other long-term liabilities on the condensed and consolidated balance sheets and $1 million of which is classified as a reduction to the corresponding deferred tax asset and is presented in other assets on the condensed and consolidated balance sheets. $9 million of unrecognized tax benefits, if recognized, would affect the effective income tax rate for the Company. While the Company believes it has adequate accruals for uncertainty in income taxes, the tax authorities, on review of the Company’s tax filings, may determine that the Company owes taxes in excess of recorded accruals, or the recorded accruals may be in excess of the final settlement amounts agreed to by tax authorities. Although the timing of such reviews is not certain, we do not believe that it is reasonably possible that the unrecognized tax benefits will materially change in the next 12 months.

The Tax Act was enacted on December 22, 2017, which amends the Internal Revenue Code to reduce tax rates and modify policies, credits, and deductions for individuals and businesses. For businesses, the Tax Act reduces the corporate federal tax rate from a maximum of 35% to a flat 21% rate, effective January 1, 2018. The SEC staff issued Staff Accounting Bulletin No 118 (“SAB 118”), which allows registrants to record provisional amounts during a measurement period not to extend beyond one year of the enactment date. As of November 2, 2018, the Company has not completed the accounting for the tax effects of enactment of the Tax Act. Areas still under review include: (1) the expensing of qualified assets and (2) the limitation on the deductibility of certain executive compensation. The Company is collecting information on expensing of qualified assets and is evaluating guidance on the deductibility of certain executive compensation. However, the Company made reasonable estimates and has recognized provisional amounts of these effects in the provision for income taxes for the year ended February 2, 2018 and for the three and nine months ended November 2, 2018. The ultimate impact may differ from the provisional amounts recorded. The Company expects to complete the analysis within the measurement period in accordance with SAB 118.

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Note 7—Debt Obligations:

The Company's long-term debt as of the dates presented was as follows:

	November 2, 2018					February 2, 2018		
	Stated interest rate	Effective interest rate	Principal	Unamortized Debt Issuance Costs	Net	Principal	Unamortized Debt Issuance Costs	Net
			(in millions)					
Term Loan A Facility due August 2021			$—	$ —	$—	$635	$ (2)	$633
Term Loan B Facility due May 2022			—	—	—	400	(9)	391
Term Loan B Facility due October 2025	4.05 %	4.26 %	1,050	(13)	1,037	—	—	—
Total long-term debt			$1,050	$ (13)	$1,037	$1,035	$ (11)	$1,024
Less current portion			11	—	11	41	—	41
Total long-term debt, net of current portion			$1,039	$ (13)	$1,026	$994	$ (11)	$983

On February 7, 2018, the Company entered into the Second Amendment to the Second Amended and Restated Credit Agreement (Second Amendment) reducing the interest rate margins by 0.25%, 0.50%, and 0.25%, across all leverage ratios for the Term Loan A Facility due August 2021, the Term Loan B Facility due May 2022, and the Revolving Credit Facility due August 2021, respectively. Effective upon execution of the Second Amendment, the applicable margin with respect to the Term Loan A Facility due August 2021 and borrowings under the Revolving Credit Facility due August 2021 ranged from 1.25% to 2.00% for Eurocurrency Rate loans, and 0.25% to 1.00% for Base Rate loans. Under the Second Amendment, interest rate margins for the Term Loan B Facility due May 2022 were 2.00%, subject to a 0.75% floor for Eurocurrency Rate loans, or 1.00% for Base Rate loans. During the three months ended May 4, 2018, the Company incurred and paid $2 million in fees associated with the Second Amendment, including $1 million of deferred financing fees.

On October 31, 2018, the Company entered into the Third Amended and Restated Credit Agreement (Third Amended Credit Agreement) in anticipation of the Merger (see Note 4). The Third Amended Credit Agreement, among other things, provides for and permits: 1) the Merger, 2) the establishment of a senior secured Term Loan B Facility due October 2025 in the amount of $1.1 billion, 3) the establishment of a senior secured Term Loan A Facility Commitment due October 2023 in the amount of $1.1 billion, which amount shall be automatically reduced to $618 million if the Merger is terminated or abandoned, and 4) an increase to the existing $200 million Revolving Credit Facility by an additional $200 million upon the effectiveness of the Merger.

The Term Loan B Facility due October 2025 was funded in full in October 2018 and the proceeds were used to repay all indebtedness outstanding under the Second Amendment and related expenses. At the time of the Merger, the Term Loan A Facility Commitment may be drawn in full and the proceeds used to partially finance the Merger, pay fees and expenses associated with the Merger, and for general corporate purposes. If the Merger Agreement is terminated or abandoned, the reduced Term Loan A Facility Commitment will be drawn in full and the proceeds used to repay a portion of the Term Loan B Facility due October 2025.

During the three months ended November 2, 2018, the Company incurred $17 million of debt issue costs associated with the Third Amended Credit Agreement. The Company recognized $5 million in expenses associated with the Third Amended Credit Agreement, which is included in interest expense and includes a $4 million loss on extinguishment of debt. The Company deferred $12 million in financing fees that are amortized to interest expense utilizing the effective interest method.

Borrowings under the Third Amended Credit Agreement bear interest at a variable rate of interest based on LIBOR or a Base Rate, plus in each case an applicable margin. Applicable margins with respect to borrowings under the Term Loan B Facility due October 2025 are 1.75% for LIBOR loans and 0.75% for Base Rate loans. Applicable margins with respect to borrowings under the Term Loan A Facility Commitment and the Revolving Credit Facility range from 1.25% to 2.00% for LIBOR loans and 0.25% to 1.00% for Base Rate loans, in each case based on the then applicable Leverage Ratio (as defined in the Third Amended Credit Agreement). The Company also pays a commitment fee with respect to undrawn amounts under the Revolving Credit Facility ranging from 0.20% to 0.35%. Borrowings under the Term Loan A Facility Commitment will amortize quarterly beginning on January 31, 2020 at 1.25% of the original borrowed amount thereunder, with such quarterly amortization payments increasing to 1.875% on January 31, 2021 and then to 2.50% on January 31, 2022. The Term Loan B Facility due October 2025 will amortize quarterly at 0.25% of the original borrowed amount (less any amount repaid with proceeds of a borrowing under the Term Loan A Facility Commitment) beginning on January 31, 2019. Beginning with SAIC's fiscal year ending on or about January 31, 2020, annual mandatory prepayments of a portion of SAIC's Excess Cash Flow (as defined in the Third Amended Credit Agreement) will be required. The Term Loan B Facility due October 2025 matures on October 31, 2025 and future borrowings under the Term Loan A Facility Commitment and the Revolving Credit Facility mature on October 31, 2023. As of November 2, 2018, there are no balances outstanding under the Revolving Credit Facility due October 2023.

The Third Amended Credit Agreement contains certain restrictive covenants applicable to the Company and its subsidiaries including a requirement to maintain a Senior Secured Leverage Ratio (as defined in the Third Amended Credit Agreement) of not greater than 3.75 to 1.00 until the effectiveness of the Merger, not greater than 4.50 to 1.00 upon the effectiveness of the Merger and for the succeeding six fiscal quarters, and not greater than 4.00 to 1.00 thereafter, unless a Permitted Acquisition (as defined in the Third Amended Credit Agreement) occurs in which case not greater than 4.25 to 1.00 for three consecutive quarters following such a transaction. As of November 2, 2018, the Company was in compliance with the covenants under the Third Amended Credit Agreement.

As of November 2, 2018 and February 2, 2018, the carrying value of the Company's outstanding debt obligations approximated its fair value. The fair value of long-term debt is calculated using Level 2 inputs, based on interest rates available for debt with terms and maturities similar to the Company's term loan facilities.

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Note 8—Derivative Instruments Designated as Cash Flow Hedges:

The Company's derivative instruments designated as cash flow hedges consist of:

	Notional Amount at November 2, 2018 (in millions)	Pay Fixed Rate		Receive Variable Rate	Settlement and Termination	Asset Fair Value[(1)] at November 2, 2018 (in millions)	Asset Fair Value[(1)] at February 2, 2018 (in millions)
Term loan interest rate swaps #1	$ —	1.41	%	1-month LIBOR	Monthly through September 26, 2018	$ —	$ 1
Term loan interest rate swaps #2[(2)]	—	1.88	%	3-month LIBOR[(3)]	Quarterly through May 7, 2020[(2)]	—	4
Term loan interest rate swaps #3[(4)]	365	2.78	%	1-month LIBOR	Monthly through July 30, 2021	1	—
Term loan interest rate swaps #4[(5)]	500	3.07	%	1-month LIBOR	Monthly through October 31, 2025	—	—
Total	$ 865					$ 1	$ 5

(1) The fair value of the fixed interest rate swaps asset is included in other assets on the condensed and consolidated balance sheets.

(2) On October 31, 2018, the Company exited its Term loan interest rate swaps #2 and discontinued hedge accounting. The Company received cash proceeds of $6 million upon the early settlement. The $6 million of deferred gains in accumulated other comprehensive income will be reclassified into interest expense over the original contractual term of the interest rate swaps, which has a maturity date of May 7, 2020.

(3) Subject to a 0.75% floor.

(4) On June 12, 2018, the Company executed forward-starting fixed interest rate swaps that hedge the variability in interest payments on $365 million of floating rate debt. The tenor of these swaps began on September 26, 2018. The Company has designated, and will account for, these fixed interest rate swaps as cash flow hedges.

(5) On October 31, 2018, the Company executed fixed interest rate swaps that hedge the variability in interest payments on $500 million of floating rate debt. The Company has designated, and will account for, these fixed interest rate swaps as cash flow hedges.

The Company is party to fixed interest rate swap instruments that are designated and accounted for as cash flow hedges to manage risks associated with interest rate fluctuations on a portion of the Company's floating rate debt. The counterparties to all swap agreements are financial institutions. See Note 9 for the unrealized change in fair values on cash flow hedges recognized in other comprehensive income and the amounts reclassified from accumulated other comprehensive income into earnings for the current and comparative periods presented. The Company recognized no ineffectiveness during the periods presented prior to the adoption of ASU 2017-12. The Company estimates that it will reclassify $2 million of unrealized gains from accumulated other comprehensive income into earnings in the twelve months following November 2, 2018.

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Note 9—Changes in Accumulated Other Comprehensive Income by Component:
The following table presents the changes in accumulated other comprehensive income attributable to the Company's fixed interest rate swap cash flow hedges that are discussed in Note 8.

	Unrealized Gains (Losses) on Fixed Interest Rate Swap Cash Flow Hedges		
	Pre-Tax Amount	Income Tax[1][2]	Net Amount
	(in millions)		
Three months ended November 2, 2018			
Balance at August 3, 2018	$6	$ (2)	$ 4
Other comprehensive income before reclassifications	1	—	1
Amounts reclassified from accumulated other comprehensive income	—	—	—
Net other comprehensive income	1	—	1
Balance at November 2, 2018	$7	$ (2)	$ 5
Three months ended November 3, 2017			
Balance at August 4, 2017	$(2)	$ 1	$ (1)
Other comprehensive income before reclassifications	2	(1)	1
Amounts reclassified from accumulated other comprehensive income	—	—	—
Net other comprehensive income	2	(1)	1
Balance at November 3, 2017	$—	$ —	$ —
Nine months ended November 2, 2018			
Balance at February 2, 2018	$5	$ (1)	$ 4
Other comprehensive income before reclassifications	3	(1)	2
Amounts reclassified from accumulated other comprehensive income	(1)	—	(1)
Net other comprehensive income	2	(1)	1
Balance at November 2, 2018	$7	$ (2)	$ 5
Nine months ended November 3, 2017			
Balance at February 3, 2017	$(3)	$ 1	$ (2)
Other comprehensive income before reclassifications	1	(1)	—
Amounts reclassified from accumulated other comprehensive income	2	—	2
Net other comprehensive income	3	(1)	2

Balance at November 3, 2017	$—	$ —	$ —

(1) The amount reclassified from accumulated other comprehensive income was included in interest expense.

(2) The amount reclassified from accumulated other comprehensive income was included in the provision for income taxes.

Note 10—Legal Proceedings and Other Commitments and Contingencies:

Legal Proceedings

The Company is involved in various claims and lawsuits arising in the normal conduct of its business, none of which the Company's management believes, based on current information, is expected to have a material adverse effect on the Company's financial position, results of operations or cash flows.

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AAV Termination for Convenience
On August 27, 2018, the Company received a stop-work order from the United States Marine Corps on the Assault Amphibious Vehicle (AAV) contract and on October 3, 2018 the program was terminated for convenience by the customer.
Beginning in fiscal 2018, the Company entered into contracts with various vendors for long-lead time materials that would be necessary to complete the low-rate initial production (LRIP) phase of the program, including portions of the LRIP phase which had not yet been awarded. As a result of the program termination, the Company recognized an inventory provision for long-lead items, see Note 1. The Company is continuing to negotiate with the Marine Corps to recover all costs associated with the termination.
Scitor Acquisition
On May 4, 2015, the Company completed the acquisition of Scitor, a leading global provider of technical services to the U.S. intelligence community and other U.S. government customers. The acquisition was funded from cash on hand and increased borrowings. Purchase consideration paid to acquire Scitor was $764 million (net of cash acquired), including $43 million which was deposited to escrow accounts. In August 2015, $3 million was released from escrow to the sellers after finalizing the working capital adjustment and another $13 million was released in September 2016 that was held to secure a portion of the sellers' indemnification obligations. During the first quarter of fiscal 2019, the Company received a $6 million distribution from escrow to settle a claim, which was recognized as a reduction to selling, general, and administrative costs. There is no remaining amount in escrow.
Agreements with Former Parent
The Company commenced its operations on September 27, 2013 (the Distribution Date) following completion of a tax-free spin-off transaction from its former parent company, Leidos Holdings, Inc. (formerly SAIC, Inc., collectively with its consolidated subsidiaries, "former Parent"). In the spin-off transaction, former Parent's technical, engineering and enterprise IT services business was separated (the separation) into an independent, publicly traded company named Science Applications International Corporation (formerly SAIC Gemini, Inc.).
Former Parent and the Company executed various agreements to provide mechanisms for an orderly transition and to govern certain ongoing relationships between the companies following the separation. The agreements include a Distribution Agreement, Employee Matters Agreement, Tax Matters Agreement, Master Transition Services Agreement, and Master Transitional Contracting Agreement (MTCA). These agreements generally provide that each party is responsible for its respective assets, liabilities and obligations, including employee benefits, insurance and tax-related assets and liabilities. The MTCA also governs the relationship between former Parent and the Company with regard to the treatment of contracts, proposals, and teaming arrangements where both companies are or will be jointly performing work after separation. Each of former Parent and the Company indemnify the other party for work performed by it under the MTCA.
Contingent losses that were unknown at the time of separation and arise from the operation of the Company's historical business or the former Parent's historical corporate losses will be shared between the parties to the extent that losses in any such category exceed $50 million in the aggregate. If they arise and exceed the $50 million threshold, the Company will be responsible for 30% of the former Parent's incremental contingent losses on corporate claims (and

former Parent will be responsible for 70% of the Company’s incremental losses on claims relating to operations that exceed $50 million).

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Government Investigations, Audits and Reviews

The Company is routinely subject to investigations and reviews relating to compliance with various laws and regulations with respect, in particular, to its role as a contractor to federal, state and local government customers and in connection with performing services in countries outside of the United States. U.S. government agencies, including the DCAA, the Defense Contract Management Agency and others, routinely audit and review a contractor's performance on government contracts, indirect rates and pricing practices, and compliance with applicable contracting and procurement laws, regulations and standards. They also review the adequacy of the contractor's compliance with government standards for its business systems. Adverse findings in these investigations, audits, or reviews can lead to criminal, civil or administrative proceedings, and the Company could face disallowance of previously billed costs, penalties, fines, compensatory damages and suspension or debarment from doing business with governmental agencies. Due to the Company's reliance on government contracts, adverse findings could also have a material impact on the Company's business, including its financial position, results of operations and cash flows.

The indirect cost audits by the DCAA of the Company's business remain open for fiscal 2014 and subsequent years. Although the Company has recorded contract revenues subsequent to and including fiscal 2014 based on an estimate of costs that the Company believes will be approved on final audit, the Company does not know the outcome of any ongoing or future audits. If future completed audit adjustments exceed the Company's reserves for potential adjustments, the Company's profitability could be materially adversely affected.

The Company has recorded reserves for estimated net amounts to be refunded to customers for potential adjustments for indirect cost audits and compliance with Cost Accounting Standards, which include indemnification obligations owing to former Parent for periods prior to the Distribution Date. As of November 2, 2018, the Company has recorded a total liability of $43 million for estimated net amounts to be refunded to customers for potential adjustments from audits of contract costs, which is presented in accounts payable and accrued liabilities on the condensed and consolidated balance sheets. Any additional amounts which may be determined to be owed for periods prior to the separation will be allocated to former Parent and the Company in proportions determined in accordance with the Distribution Agreement.

Letters of Credit and Surety Bonds

The Company has outstanding obligations relating to letters of credit of $12 million as of November 2, 2018, principally related to guarantees on insurance policies. The Company also has outstanding obligations relating to surety bonds in the amount of $18 million, principally related to performance and payment bonds on the Company's contracts. The majority of the surety bonds outstanding were initially obtained by former Parent and the Company is required to satisfy these obligations under the terms of the Distribution Agreement.

Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations

The following discussion and analysis of our financial condition and results of operations and quantitative and qualitative disclosures about market risk should be read in conjunction with our unaudited condensed and consolidated financial statements and the related notes. It contains forward-looking statements (which may be identified by words such as those described in "Risk Factors—Forward-Looking Statement Risks" in Part I of the most recently filed Annual Report on Form 10-K), including statements regarding our intent, belief, or current expectations with respect to, among other things, trends affecting our financial condition or results of operations (including our financial targets discussed below under “Management of Operating Performance and Reporting” and “Liquidity and Capital Resources”); backlog; our industry; government budgets and spending; market opportunities; the impact of competition; and the impact of the Scitor acquisition. Such statements are not guarantees of future performance and involve risks and uncertainties, and actual results may differ materially from those in the forward-looking statements as a result of various factors. Risks, uncertainties and assumptions that could cause or contribute to these differences include those discussed below, in “Risk Factors” in Part II of this report and in Part I of the most recently filed Annual Report on Form 10-K. Due to such risks, uncertainties and assumptions you are cautioned not to place undue reliance on such forward-looking statements, which speak only as of the date hereof. We do not undertake any obligation to update these factors or to publicly announce the results of any changes to our forward-looking statements due to future results or developments.

We use the terms "SAIC," the “Company,” “we,” “us” and “our” to refer to Science Applications International Corporation and its consolidated subsidiaries.

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The Company utilizes a 52/53 week fiscal year, ending on the Friday closest to January 31, with fiscal quarters typically consisting of 13 weeks. Fiscal 2018 began on February 4, 2017 and ended on February 2, 2018, while fiscal 2019 began on February 3, 2018 and ends on February 1, 2019.

Business Overview

We are a leading technology integrator providing full life-cycle services and solutions in the technical, engineering and enterprise information technology (IT) markets. We developed our brand by addressing our customers' mission critical needs and solving their most complex problems for over 45 years. As one of the largest pure-play technical service providers to the U.S. government, we serve markets of significant scale and opportunity. Our primary customers are the departments and agencies of the U.S. government. We serve our customers through approximately 1,300 active contracts and task orders and employ more than 15,000 individuals who are led by an experienced executive team of proven industry leaders. Our long history of serving the U.S. government has afforded us the ability to develop strong and longstanding relationships with some of the largest customers in the markets we serve. Substantially all of our revenues and tangible long-lived assets are generated by or owned by entities located in the United States.

Pending Acquisition of Engility

On September 9, 2018, we entered into the Merger Agreement by and among SAIC, Engility Holdings, Inc. ("Engility"), and Raptors Merger Sub, Inc., pursuant to which we will acquire Engility (the "Merger"). At the effective time of the Merger, each outstanding share of Engility common stock will be converted into the right to receive 0.450 shares of SAIC common stock. The Company amended its credit agreement to provide for a new five-year senior secured $1.1 billion term loan facility to be funded in connection with the Merger, see Note 7 to the Condensed and Consolidated Financial Statements. The proceeds will be used to repay Engility's existing credit facility and outstanding notes. The estimated transaction value is $2.1 billion based on the Company's per share closing price of $69.39 on November 2, 2018 including the repayment of Engility's net debt. The Merger Agreement has been unanimously approved by both companies' Board of Directors. The transaction is subject to customary closing conditions, including approval of both the Science Applications International Corporation and Engility stockholders, and is expected to close in the fourth quarter of fiscal year 2019.

Economic Opportunities, Challenges, and Risks

In fiscal 2018, we generated greater than 95% of our revenues from contracts with the U.S. government, including subcontracts on which we perform. Our business performance is affected by the overall level of U.S. government spending and the alignment of our offerings and capabilities with the budget priorities of the U.S. government. An omnibus appropriations measure increased discretionary federal spending by $143 billion above previous spending caps for government fiscal year (GFY) 2018, providing additional business opportunities for the Company. A budget agreement passed in February would extend and increase those spending levels for GFY 2019. But beyond that two-year window, there remains uncertainty on whether, and by how much, discretionary spending will be increased above the budget caps put in place in August 2011. Without additional action, federal expenditures would decline sharply in GFY 2020.

Adverse changes in fiscal and economic conditions could materially impact our business. Some changes that could have an adverse impact on our business include the implementation of future spending reductions (including sequestration), government shutdowns and issues related to required increases to the nation's debt ceiling (under current law, the debt ceiling will be reached in March 2019).

The U.S. government has increasingly relied on contracts that are subject to a competitive bidding process (including indefinite delivery, indefinite quantity (IDIQ), U.S. General Services Administration (GSA) schedules and other multi-award contracts) which has resulted in greater competition and increased pricing pressure. We expect that a majority of the business that we seek in the foreseeable future will be awarded through a competitive bidding process.

Despite the budget and competitive pressures impacting the industry, we believe we are well positioned to protect and expand existing customer relationships and benefit from opportunities that we have not previously pursued. Our scale, size and prime contractor leadership position are expected to help differentiate us from our competitors, especially on large contracts. We believe our long-term, trusted customer relationships and deep technical expertise provide us with the sophistication to handle highly complex mission-critical contracts. SAIC’s value proposition is found in the proven ability to serve as a trusted adviser to our customers. In doing so, we leverage our expertise and scale to help them execute their mission.

We succeed as a business based on the solutions we deliver, our past performance and our ability to compete on price. Our solutions, inspired through innovation, are based on best practices and technology transfer. Our past performance was achieved by employee dedication and customer focus. Our current cost structure, as well as our ongoing efforts to reduce costs by strategic sourcing and developing repeatable offerings, is expected to allow us to compete effectively on price in an evolving environment. Our ability to be competitive in the future will continue to be driven by our reputation of successful program execution, competitive cost structure and efficiencies in assigning the right people, at the right time, in support of our contracts.

Restructuring

During fiscal 2018, the Company initiated restructuring activities (the "Restructuring") intended to improve operational efficiency, reduce costs, and better position the Company to drive future growth. Management's restructuring activities included involuntary and voluntary terminations and the consolidation of existing leased facilities. Management completed the Restructuring in the fourth quarter of fiscal 2018. Total restructuring costs of approximately $13 million were incurred and recognized, comprised of $6 million in severance expense and $7 million in lease exit costs, which included $1 million in accelerated depreciation expense. Refer to "Results of Operations" below, and "Restructuring" in Note 1 of the notes to the consolidated financial statements for further details.

Management of Operating Performance and Reporting

We manage our business to achieve our long-term financial targets, which we expect to accomplish on average and over time. These financial targets include:

- low single digit annual revenue growth percentage,
- adjusted EBITDA margin expansion of 10 to 20 basis points annually, and
- return of capital in excess of operating needs.

Adjusted EBITDA is a non-GAAP financial measure described in more detail in “Non-GAAP Measures” below.

Our business and program management process is directed by professional managers focused on satisfying our customers by providing high quality services in achieving program requirements. These managers carefully monitor performance by constantly evaluating risks and opportunities. Through each program life cycle, managers review performance and update estimates to reflect their understanding of the best information available. For performance obligations satisfied over time, updates to estimates are recognized on inception-to-date activity, during the period of adjustment, resulting in either a favorable or unfavorable impact to operating income.

We evaluate our results of operations by considering the drivers causing changes in revenues, operating income and operating cash flows. Given that revenues fluctuate on our contract portfolio over time due to contract awards and completions, changes in customer requirements, and increases or decreases in ordering volume of materials, we evaluate significant trends and fluctuations in these terms. Whether performed by our employees or by our subcontractors, we primarily provide services and, as a result, our cost of revenues are predominantly variable. We also analyze our cost mix (labor, subcontractor or materials) in order to understand operating margin because programs with a higher proportion of SAIC labor are generally more profitable. In addition to cost mix, changes in costs of revenues as a percentage of revenue can also be driven by fluctuations in shared or corporate costs or cumulative revenue adjustments due to changes in estimates.

Changes in operating cash flows are described with regard to changes in cash generated through the delivery of services, significant drivers of fluctuations in assets or liabilities and the impacts of changes in timing of cash receipts or disbursements.

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Results of Operations

The primary financial performance measures we use to manage our business and monitor results of operations are revenues, operating income, and cash flows from operating activities. The following table summarizes our results of operations:

	Three Months Ended			Nine Months Ended		
	November 2, 2018	Percent change	November 3, 2017	November 2, 2018	Percent change	November 3, 2017
	(in millions)					
Revenues	$1,177	3 %	$ 1,145	$3,467	4 %	$ 3,326
Cost of revenues	1,048	1 %	1,036	3,125	3 %	3,022
As a percentage of revenues	89.0 %		90.5 %	90.1 %		90.9 %
Selling, general and administrative expenses	42	14 %	37	115	5 %	110
Acquisition and integration costs	14	100 %	—	14	100 %	—
Operating income	73	1 %	72	213	10 %	194
As a percentage of revenues	6.2 %		6.3 %	6.1 %		5.8 %
Net income	$48	12 %	$ 43	$146	14 %	$ 128
Net cash provided by operating activities	$86	8 %	$ 80	$162	22 %	$ 133

Revenues. Revenues increased $32 million or 2.8% for the three months ended November 2, 2018 as compared to the same period in the prior year due to newly awarded contracts ($54 million), which includes information technology (IT) integration contracts supporting state and local customers, and increased orders in our supply chain portfolio ($24 million). These increases were partially offset by completion of contracts and other net decreases across our portfolio ($46 million).

Revenues increased $141 million or 4.2% for the nine months ended November 2, 2018 as compared to the same period in the prior year due to revenue on new contracts primarily supporting NASA, the Environmental Protection Agency (EPA) and state and local customers ($128 million), as well as increased orders in our supply chain portfolio ($120 million). These increases were partially offset by completion of contracts ($72 million) and other net decreases across our portfolio ($35 million).

Cost of Revenues. Cost of revenues increased $12 million for the three months ended November 2, 2018 as compared to the same period in the prior year primarily due to an increase in revenue volume. Cost of revenues as a percentage of revenues decreased from 90.5% in the prior year quarter to 89.0%, driven by improved performance across our portfolio ($28 million), inclusive of newly awarded contracts, and higher net favorable changes in estimates related to performance obligations satisfied over time ($14 million). These improvements were partially offset by an increase in our inventory provision ($25 million).

Cost of revenues increased $103 million for the nine months ended November 2, 2018 as compared to the same period in the prior year primarily due to an increase in revenue volume. Cost of revenues as a percentage of revenues decreased from 90.9% in the prior year period to 90.1%, driven by improved contract performance to include the effect of our restructuring efforts in fiscal 2018 ($35 million), and higher net favorable changes in estimates related to performance obligations satisfied over time ($15 million). These improvements were partially offset by an increase in our inventory provision ($25 million).

Selling, General and Administrative Expenses. SG&A increased $5 million for the three months ended November 2, 2018 as compared to the same period in the prior year primarily due to higher employee-related and consulting costs.

SG&A increased $5 million for the nine months ended November 2, 2018 as compared to the same period in the prior year primarily due to higher employee-related and consulting costs. In fiscal 2018, we realized a gain from the reversal of a vacancy reserve ($7 million), and in fiscal 2019 we settled claims against the indemnification escrow balance established when Scitor was acquired ($6 million).

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Operating Income. Operating income as a percentage of revenues of 6.2% for the three months ended November 2, 2018 was consistent with 6.3% in the comparable prior year period, due to improved performance across our portfolio, higher net favorable changes in estimates related to performance obligations satisfied over time, offset by an increase in our inventory provision and costs associated with the acquisition and integration of Engility ($14 million).
Operating income as a percentage of revenues increased to 6.1% for the nine months ended November 2, 2018 from 5.8% in the comparable prior year period primarily due to improved performance across our portfolio and the realization of cost efficiencies resulting from our restructuring activities in fiscal 2018, partially offset by an increase in our inventory provision and costs associated with the acquisition and integration of Engility ($14 million).
Net Income. Net income for the three months ended November 2, 2018 increased $5 million as compared to the same period in the prior year primarily due to a lower effective tax rate, partially offset by expenses associated with the debt refinancing activities in the current quarter.
Net income for the nine months ended November 2, 2018 increased $18 million as compared to the same period in the prior year due to higher operating income and a lower effective tax rate, partially offset by expenses associated with the debt refinancing activities in the current year.
Net Cash Provided by Operating Activities. Net cash provided by operating activities was $162 million for the nine months ended November 2, 2018, an increase of $29 million compared to the prior year, primarily due to higher customer collections and lower payments for income taxes, which was partially offset by an increase in working capital investments in platform integration programs.
Non-GAAP Measures
EBITDA and Adjusted EBITDA. Earnings before interest, taxes, depreciation and amortization (EBITDA) is a non-GAAP financial performance measure that is calculated by taking net income and excluding interest, provision for income taxes, and depreciation and amortization. Adjusted EBITDA is calculated by taking EBITDA and excluding restructuring and acquisition and integration costs that we do not consider to be indicative of our ongoing operating performance. The acquisition and integration costs relate to the Company's pending significant acquisition of Engility. The restructuring costs relate to the Company's plan in fiscal 2018 to restructure certain aspects of its operations and is the only significant restructuring since we began operating as an independent company five years ago.
While we believe that these non-GAAP financial measures may be useful in evaluating our financial information, it should be considered as supplemental in nature and not as a substitute for financial information prepared in accordance with GAAP. Other companies may define similar measures differently.
We believe that EBITDA and adjusted EBITDA provide management and investors with useful information in assessing trends in our ongoing operating performance and may provide greater visibility in understanding the long-term financial performance of the Company.

EBITDA and adjusted EBITDA for the periods presented were calculated as follows:

	Three Months Ended		Nine Months Ended	
	November 2, 2018	November 3, 2017	November 2, 2018	November 3, 2017
	(in millions)			
Net income	$48	$ 43	$146	$ 128
Interest expense	16	11	38	32
Interest income	(1)	—	(2)	—
Provision for income taxes	10	19	31	35
Depreciation and amortization	11	11	31	32
EBITDA	84	84	244	227
EBITDA as a percentage of revenues	7.1 %	7.3 %	7.0 %	6.8 %
Acquisition and integration costs	14	—	14	—
Restructuring costs	—	1	—	3
Adjusted EBITDA	$98	$ 85	$258	$ 230
Adjusted EBITDA as a percentage of revenues	8.3 %	7.4 %	7.4 %	6.9 %

Adjusted EBITDA for the three months ended November 2, 2018 increased to 8.3% of revenues from 7.4% of revenues for the prior year driven by improved performance across our portfolio and higher net favorable changes in estimates related to performance obligations satisfied over time, partially offset by an increase in our inventory provision.

Adjusted EBITDA for the nine months ended November 2, 2018 increased to 7.4% of revenues from 6.9% of revenues for the prior year, driven by improved performance across our portfolio and the realization of cost efficiencies resulting from our restructuring activities in fiscal 2018, and higher net favorable changes in estimates related to performance obligations satisfied over time, partially offset by an increase in our inventory provision.

Other Key Performance Measures

In addition to the financial measures described above, we believe that bookings and backlog are useful measures for management and investors to evaluate our potential future revenues. We also consider measures such as contract types and cost of revenues mix to be useful for management and investors to evaluate our operating income and performance.

Net Bookings and Backlog. Net bookings represent the estimated amount of revenues to be earned in the future from funded and negotiated unfunded contract awards that were received during the period, net of adjustments to estimates on previously awarded contracts. We calculate net bookings as the period’s ending backlog plus the period’s revenues less the prior period’s ending backlog and initial backlog obtained through acquisitions.

Backlog represents the estimated amount of future revenues to be recognized under negotiated contracts as work is performed. We do not include in backlog estimates of revenues to be derived from IDIQ contracts, but rather record backlog and bookings when task orders are awarded on these contracts. Given that much of our revenue is derived from IDIQ contract task orders that renew annually, bookings on these contracts tend to refresh annually as the task orders are renewed. Additionally, we do not include in backlog contract awards that are under protest until the protest is resolved in our favor.

We segregate our backlog into two categories as follows:

- Funded Backlog. Funded backlog for contracts with government agencies primarily represents estimated amounts of revenue to be earned in the future from contracts for which funding is appropriated less revenues previously recognized on these contracts. It does not include the unfunded portion of contracts in which funding is incrementally appropriated or authorized on a quarterly or annual basis by the U.S. government and other customers even though the contract may call for performance over a number of years. Funded backlog for contracts with non-government customers represents the estimated value on contracts, which may cover multiple future years, under which we are obligated to perform, less revenues previously recognized on these contracts.

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- Negotiated Unfunded Backlog. Negotiated unfunded backlog represents estimated amounts of revenue to be earned in the future from negotiated contracts for which funding has not been appropriated or otherwise authorized and from unexercised priced contract options. Negotiated unfunded backlog does not include any estimate of future potential task orders expected to be awarded under IDIQ, GSA Schedules or other master agreement contract vehicles.

We expect to recognize revenue from a substantial portion of our funded backlog within the next twelve months. However, the U.S. government can adjust the scope of services of or cancel contracts at any time. Similarly, certain contracts with commercial customers include provisions that allow the customer to cancel prior to contract completion. Most of our contracts have cancellation terms that would permit us to recover all or a portion of our incurred costs and fees (contract profit) for work performed.

The estimated value of our total backlog as of the dates presented was:

	November 2, 2018	February 2, 2018
	(in millions)	
Funded backlog	$2,394	$ 2,012
Negotiated unfunded backlog	8,051	8,215
Total backlog	$10,445	$ 10,227

We had net bookings worth an estimated $1.2 billion and $3.7 billion during the three and nine months ended November 2, 2018, respectively. Total backlog at the end of the third quarter is consistent with our total backlog at prior year end.

Contract Types. Our earnings and profitability may vary materially depending on changes in the proportionate amount of revenues derived from each type of contract. For a discussion of the types of contracts under which we generate revenues, see “Contract Types” in Part I of the most recently filed Annual Report on Form 10-K. The following table summarizes revenues by contract type as a percentage of revenues for the periods presented:

	Nine Months Ended			
	November 2, 2018		November 3, 2017	
Cost reimbursement	48	%	45	%
Time and materials (T&M)	25	%	28	%
Firm-fixed price (FFP)	27	%	27	%
Total	100	%	100	%

Our contract mix for the nine months ended November 2, 2018 reflects an increase in cost reimbursement type contracts due to newly awarded contracts supporting federal civilian agencies and a change in contract type on a significant contract supporting the Department of Defense.

Cost of Revenues Mix. We generate revenues by providing a customized mix of services to our customers. The profit generated from our service contracts is affected by the proportion of cost of revenues incurred from the efforts of our employees (which we refer to below as labor-related cost of revenues), the efforts of our subcontractors and the cost of materials used in the performance of our service obligations under our contracts. Contracts performed with a higher proportion of SAIC labor are generally more profitable. The following table presents changes in cost mix for the periods presented:

	Three Months Ended		Nine Months Ended	
	November 2, 2018	November 3, 2017	November 2, 2018	November 3, 2017
	(as a % of cost of revenues)			
Labor-related cost of revenues	48 %	47 %	47 %	47 %
Subcontractor-related cost of revenues	30 %	33 %	31 %	34 %
Supply chain materials-related cost of revenues	14 %	12 %	15 %	12 %
Other materials-related cost of revenues	8 %	8 %	7 %	7 %

Cost of revenues mix for the three and nine months ended November 2, 2018 reflects an increase in supply chain material content.

Liquidity and Capital Resources

As a services provider, our business generally requires minimal infrastructure investment. We expect to fund our ongoing working capital, commitments and any other discretionary investments with cash on hand, future operating cash flows and, if needed, borrowings under our $200 million Revolving Credit Facility.

We anticipate that our future cash needs will be for working capital, capital expenditures, and contractual and other commitments. We consider various financial measures when we develop and update our capital deployment strategy, which includes evaluating cash provided by operating activities, free cash flow and financial leverage. When our cash generation enables us to exceed our target average minimum cash balance of $150 million, we intend to deploy excess cash through dividends, share repurchases, debt prepayments or strategic acquisitions.

In connection with the Merger Agreement, we expect to assume approximately $900 million of Engility's debt. The Company amended its credit agreement to provide for a new five-year senior secured $1.1 billion term loan facility to be funded in connection with the Merger, see Note 7 to the Condensed and Consolidated Financial Statements. The proceeds will be used to repay Engility's existing credit facility and outstanding notes. In addition, the Revolving Credit Facility will increase by an additional $200 million upon effectiveness of the Merger.

Our ability to fund these needs will depend, in part, on our ability to generate cash in the future, which depends on our future financial results. Our future results are subject to general economic, financial, competitive, legislative and regulatory factors that may be outside of our direct control. Although we believe that the financing arrangements in place will permit us to finance our operations on acceptable terms and conditions for at least the next year, our future access to, and the availability of financing on acceptable terms and conditions will be impacted by many factors (including our credit rating, capital market liquidity and overall economic conditions). Therefore, we cannot ensure that such financing will be available to us on acceptable terms or that such financing will be available at all. Nevertheless, we believe that our existing cash on hand, generation of future operating cash flows, and access to bank financing and capital markets will provide adequate resources to meet our short-term liquidity and long-term capital needs.

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Historical Cash Flow Trends

The following table summarizes our cash flows:

	Nine Months Ended	
	November 2, 2018	November 3, 2017
	(in millions)	
Net cash provided by operating activities	$162	$ 133
Net cash used in investing activities	(23)	(15)
Net cash used in financing activities	(89)	(203)
Net increase (decrease) in cash, cash equivalents and restricted cash	$50	$ (85)

Net Cash Provided by Operating Activities. Refer to “Results of Operations” above for a discussion of the changes in cash provided by operating activities between the nine months ended November 2, 2018 and the comparable prior year period.

Net Cash Used in Investing Activities. Cash used in investing activities for the nine months ended November 2, 2018 increased compared to the prior year period due to higher capital expenditures for property, plant, and equipment.

Net Cash Used in Financing Activities. Cash used in financing activities for the nine months ended November 2, 2018 decreased compared to the prior year period primarily due to an increase in proceeds from borrowings and a decrease in stock repurchased and retired or withheld for taxes on equity awards, partially offset by an increase in principal payments on borrowings and debt issuance costs.

Contractual Obligations

We previously entered into contracts with various vendors for long-lead time materials necessary to complete the low-rate initial production (LRIP) phase of our Assault Amphibious Vehicle (AAV) contract with the United States Marine Corps. Beginning in fiscal 2018, the Company entered into contracts with various vendors for long-lead time materials that would be necessary to complete the low-rate initial production (LRIP) phase of the program, including portions of the LRIP phase which had not yet been awarded.

On August 27, 2018, we received a stop-work order from the Marine Corps on the AAV contract and on October 3, 2018 we received a termination for convenience.

Beginning in fiscal 2018, the Company entered into contracts with various vendors for long-lead time materials that would be necessary to complete the low-rate initial production (LRIP) phase of the program, including portions of the LRIP phase which had not yet been awarded. As a result of the program termination, the Company recognized an inventory provision for long-lead items, see Note 1 of the Notes to the condensed and consolidated financial statements.

Other than this update, there have been no material changes to our contractual obligations as reported in our most recently filed Annual Report on Form 10-K.

Critical Accounting Policies

Our discussion and analysis of our financial condition and results of operations are based on our condensed and consolidated financial statements, which are prepared in accordance with U.S. generally accepted accounting principles. The preparation of these financial statements requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and the disclosure of contingencies, as well as the reported amounts of revenues, expenses, gains and losses during the reporting periods. Management evaluates these estimates and assumptions on an ongoing basis. Our estimates and assumptions have been prepared on the basis of the most current reasonably available information and, in some cases, are our basis for making judgments about the carrying values of assets and liabilities that are not readily apparent from other sources. Estimates and assumptions may change in the future as more current information is available.

Management believes that our critical accounting policies are those that are both material to the presentation of our financial condition and results of operations and require management's most difficult, subjective and complex judgments. Typically, the circumstances that make these judgments difficult, subjective and complex have to do with making estimates about the effect of matters that are inherently uncertain.

Revenue Recognition. We generate our revenues primarily from long-term contracts in which we provide technical, engineering and enterprise IT services directly for the U.S. government and as a subcontractor with other contractors engaged in work for the U.S. government. We evaluate the nature of the contract and the services provided when determining the accounting method utilized for each contract. We recognize a significant portion of our revenues using a cost input measure of progress that requires us to rely on the skill and expertise of our engineers, program managers and business management professionals in the many areas of cost estimation. These estimates of costs can span several years and take into account many factors including the availability, productivity and cost of labor, potential delays in our performance and the level of future indirect cost allocations.

We provide for anticipated losses on long-term production type contracts and service contracts with the U.S. government by recording an expense for the total expected contract loss during the period when the loss is determined. Contract costs incurred for U.S. government contracts (including allocated indirect costs) are subject to audit and adjustment through negotiations with government representatives. Revenues on U.S. government contracts have been recorded in amounts that are expected to be realized on final settlement.

Many of our contracts include forms of variable consideration such as reimbursable costs, award and incentive fees, usage-based pricing, service-level penalties, performance bonuses, and other provisions that can either increase or decrease the transaction price. Variable amounts generally are determined upon our achievement of certain performance metrics, program milestones or cost targets and may be based upon customer discretion. At contract inception, we estimate the transaction price and may include variable consideration in the transaction price only to the extent it is probable that a significant reversal of cumulative revenue recognized will not occur when the uncertainty associated with the variable consideration is resolved. When developing these estimates, we consider the customer, contract terms, the complexity of the work and related risks, the extent of customer discretion, historical experience and the potential of a significant reversal of revenue.

Other than the item described above, there have been no changes to our existing critical accounting policies during the nine months ended November 2, 2018 from those disclosed in our most recently filed Annual Report on Form 10-K.

Recently Issued But Not Yet Adopted Accounting Pronouncements

For information on recently issued but not yet adopted accounting pronouncements, see Note 1 of the notes to the condensed and consolidated financial statements contained within this report.

Item 3. Quantitative and Qualitative Disclosures About Market Risk

There have been no material changes to our Market Risks from those discussed in our most recently filed Annual Report on Form 10-K.

Item 4. Controls and Procedures

Our management, with the participation of our Chief Executive Officer and our Chief Financial Officer, have evaluated the effectiveness of the Company's disclosure controls and procedures (as defined in Rules 13a-15(e) and 15d-15(e) of the Securities Exchange Act of 1934) and have concluded that as of November 2, 2018, these controls and procedures were operating and effective.

Changes in Internal Control Over Financial Reporting

There have been no changes in our internal control over financial reporting during the quarterly period covered by this report that materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

PART II—OTHER INFORMATION

Item 1. Legal Proceedings

We have provided information about legal proceedings in which we are involved in our fiscal 2018 Annual Report on Form 10-K, and we have provided an update to this information in Note 10 of the notes to the condensed and consolidated financial statements contained within this report.

In addition to the described legal proceedings, we are routinely subject to investigations and reviews relating to compliance with various laws and regulations. Additional information regarding such investigations and reviews is included in our fiscal 2018 Annual Report on Form 10-K, and we have also updated this information in Note 10 of the notes to the condensed and consolidated financial statements contained within this report, under the heading "Government Investigations, Audits and Reviews."

Item 1A. Risk Factors

Other than with respect to the risk factors included below related to our pending merger with Engility Holdings, Inc. (Engility), there have been no material changes from the risk factors disclosed in our most recently filed Annual Report on Form 10-K.

These risks and the other risks associated with the pending merger are more fully discussed in the joint proxy statement/prospectus included in the registration statement on Form S-4 (the "Joint Proxy Statement/Prospectus"), dated as of December 4, 2018, that was filed with the SEC in connection with the merger. We urge you to read the Joint Proxy Statement/Prospectus because it contains important information about the pending merger, including relevant risk factors.

If we are unable to complete our contemplated acquisition of Engility, our expected financial results and the market value of our common stock could be adversely affected.

On September 9, 2018, we entered into an Agreement and Plan of Merger (the "Merger Agreement") with Engility to acquire all of Engility's issued and outstanding stock through a merger of Engility with one of our subsidiaries, Raptors Merger Sub, Inc. (the "merger"). Consummation of the merger is subject to customary conditions to closing, including the approval of stockholders of both SAIC and Engility and the receipt of required regulatory approvals. If any condition to the merger is not satisfied or waived, the merger will not be completed. The parties also may terminate the Merger Agreement under certain circumstances. Any or all of the preceding could jeopardize our ability to consummate the merger on the negotiated terms. To the extent the merger is not completed for any reason, we would have devoted substantial resources and management attention to the transaction without realizing the accompanying benefits expected by our management, and our financial condition and results of operations and the market value of our stock may be adversely affected. Additional risks and uncertainties associated with the merger include:

- various conditions to the closing of the merger may not be satisfied or waived;
- the inability to obtain consents from third parties who have "change of control" or similar clauses in their agreements with Engility;
- the failure to consummate the merger may result in negative publicity and a negative impression of us in the investment community;
- litigation relating to the merger could be commenced, which may prevent the merger from becoming effective within the expected time frame, if at all;
- required regulatory approvals from governmental entities may delay the merger or result in the imposition of conditions that could cause the abandonment of the merger; and
- the attention of our employees and management may be diverted due to activities related to the merger, which may harm our relationships with our employees, customers, distributors, suppliers, and other business partners, may impair our ability to continuously innovate to meet the industry inflections, and may result in a loss of or a substantial decrease in purchases by our customers.

Even if the Engility merger is consummated, we may not be able to successfully integrate the business of Engility with our own or realize the anticipated benefits of the merger in the expected time frame, or at all.

Our ability to realize the anticipated benefits of the merger will depend, on a large extent, on our ability to integrate our and Engility's business. The merger involves the combination of two companies that currently operate as independent public companies. The combined company will be required to devote significant management attention and resources to integrating our business practices with those of Engility. The integration process may disrupt the business and, if implemented ineffectively or if impacted by unforeseen negative economic or market conditions or other factors, we may not realize the full anticipated benefits of the merger. Potential difficulties that the combined company may encounter as part of the integration process include the following:

- the inability to successfully combine our business with Engility in a manner that permits the combined company to achieve the full revenue and cost synergies and other benefits anticipated to result from the merger;
- the loss of customers and strategic partners who may not wish to continue their relationships with the combined company;
- required regulatory approvals from governmental entities may result in limitations, additional costs or placement of restrictions on the conduct of the combined company, imposition of additional material costs on or materially limiting the revenues of the combined company following the merger;
- complexities associated with managing the combined businesses, including difficulty addressing possible differences in corporate cultures and management philosophies and the challenge of integrating complex systems, technology, networks and other assets of each of the companies in a seamless manner that minimizes any adverse impact on customers, suppliers, employees and other business partners; and
- potential unknown liabilities and unforeseen increased expenses or delays associated with the merger.

Many of these factors will be outside of our control and any one of them could result in increased costs, decreases in the amount of expected revenues and diversion of management's time and energy, which could materially impact the business, financial condition and our results of operations. These benefits may not be achieved within the anticipated time frame, or at all. Furthermore, additional unanticipated costs may be incurred in the integration of the businesses. All of these factors could decrease or delay the anticipated benefits of the merger and negatively impact us. In addition, we have operated and, until the completion of the merger will continue to operate, independently. These and other factors could adversely affect our ability to maintain relationships with customers, suppliers, employees and other partners, and our ability to achieve the anticipated benefits of the merger.

The exchange ratio will not be adjusted in the event of any change in either the Company or Engility stock price.

In the merger, each outstanding share of Engility common stock (with certain exceptions), by virtue of the merger and without any action on the part of the parties to the Merger Agreement or the holders of shares of Engility common stock, will be converted into the right to receive 0.450 validly issued, fully paid and nonassessable share of SAIC common stock. This exchange ratio will not be adjusted for changes in the market price of either SAIC or Engility common stock. Changes in the price of SAIC common stock prior to completion of the merger will affect the market value of the SAIC common stock that stockholders will receive in the merger. Share price changes may result from a variety of factors (many of which are beyond SAIC's or Engility's control), including the following:

- changes in the SAIC's or Engility's respective businesses, operations and prospects, or the market assessments thereof;
- market assessments of the likelihood that the merger will be completed; and
- general market and economic conditions and other factors generally affecting the price of SAIC common stock

The price of SAIC common shares at the closing of the merger may vary from the price on the date the Merger Agreement was executed and the dates of the respective special meetings of our stockholders and Engility's stockholders. As a result, the market value of the merger consideration may also vary.

We and Engility will incur direct and indirect costs as a result of the Merger.
We and Engility will incur substantial expenses in connection with and as a result of completing the merger and, over a period of time following the completion of the merger, we further expect to incur substantial expenses in connection with coordinating our businesses, operations, policies and procedures and Engility's. While we have assumed that a certain level of transaction expenses will be incurred, factors beyond our control could affect the total amount or the timing of these expenses. Many of the expenses that will be incurred, by their nature, are difficult to estimate accurately.
In connection with the merger, we may be required to take write-downs or write-offs, restructuring and impairment or other charges that could negatively affect our business, assets, liabilities, prospects, outlook, financial condition and results of operations.
Although we have conducted extensive due diligence on Engility in connection with the merger, we cannot assure that this diligence revealed all material issues that may be present, that it would be possible to uncover all material issues through a customary amount of due diligence, or that factors outside of our control will not later arise. Even if our due diligence successfully identifies certain risks, unexpected risks may arise and previously known risks may materialize in a manner not consistent with our preliminary risk analysis. Further, as a result of the merger, purchase accounting, and the proposed operation of the company after closing, we may be required to take write-offs or write-downs, restructuring and impairment or other charges that could negatively affect business, assets, liabilities, prospects, outlook, financial condition and results of operations after closing.
Item 2. Unregistered Sales of Equity Securities and Use of Proceeds
Purchases of Equity Securities. We may repurchase shares on the open market in accordance with established repurchase plans. Whether repurchases are made and the timing and amount of repurchases depend on a variety of factors including market conditions, our capital position, internal cash generation and other factors. We also repurchase shares in connection with stock option and stock award activities to satisfy tax withholding obligations.
The following table presents repurchases of our common stock during the three months ended November 2, 2018:

Period[1]	Total Number of Shares (or Units) Purchased[2]	Average Price Paid per Share (or Unit)	Total Number of Shares (or Units) Purchased as Part of Publicly Announced Plans or Programs	Maximum Number of Shares (or Units) that May Yet Be Purchased Under the Plans or Programs[3]
August 4, 2018 - September 7, 2018	856	$ 87.55	—	2,317,844
September 8, 2018 - October 5, 2018	—		—	2,317,844
October 6, 2018 - November 2, 2018	1,337	76.12	—	2,317,844
Total	2,193		—	

(1) Date ranges represent our fiscal periods during the current quarter. Our fiscal quarters typically consist of one five-week period and two four-week periods.
(2) Includes shares purchased on surrender by stockholders of previously owned shares to satisfy minimum statutory tax withholding obligations related to stock option exercises and vesting of stock awards in addition to shares purchased under our publicly announced plans or programs.

(3) On December 15, 2016 the number of additional shares of our common stock that may be repurchased under our existing repurchase program previously announced in October 2013 was increased by approximately 3.3 million shares, bringing the total authorized shares to be repurchased under the program to approximately 11.8 million shares. As of November 2, 2018, we have repurchased approximately 9.5 million shares of common stock under the program.

Item 3. Defaults Upon Senior Securities

No information is required in response to this item.

Item 4. Mine Safety Disclosures

No information is required in response to this item.

Item 5. Other Information

No information is required in response to this item.

SCIENCE APPLICATIONS INTERNATIONAL CORPORATION

Item 6. Exhibits

Exhibit Number	Description of Exhibit
2.1	Agreement and Plan of Merger, dated September 9, 2018, by and among Science Applications International Corporation, Inc., a Delaware corporation, Engility, a Delaware corporation, and Raptors Merger Sub, Inc., a Delaware corporation. (Pursuant to Item 601(b)(2) of Regulation S-K, the registrant hereby agrees to supplementally furnish to the Securities and Exchange Commission upon request any omitted schedule or exhibit to the Agreement and Plan of Merger.) Incorporated by reference to Exhibit 2.1 to the Company's Current Report on Form 8-K as filed with the SEC on September 10, 2018.
2.2	Voting Agreement dated as of, September 9, 2018, by and among Science Applications International Corporation, Inc., and Engility Holdings, Inc., and with General Atlantic Partners 85, L.P., GAP Coinvestments III, LLC, GAP Coinvestments IV, LLC, GAP Coinvestments CDA, L.P. and GAPCO GmbH & Co. KG and KKR 2006 Fund L.P., KKR Partners III, L.P., OPERF Co-Investment LLC and 8 North America Investor L.P. Incorporated by reference to Exhibit 2.2 to the Company's Current Report on Form 8-K as filed with the SEC on September 10, 2018.
10.1	Term Loan B Incremental Facility Commitment Letter, dated as of September 9, 2018, among Citigroup Global Markets Inc. and Science Applications International Corporation. Incorporated by reference to Exhibit 10.1 to the Company's Current Report on Form 8-K filed with the SEC on September 10, 2018.
10.2	Third Amended and Restated Credit Agreement by and among SAIC, Citibank, as administrative agent and collateral agent, and certain other agents and lenders party thereto, dated October 31, 2018. Incorporated by reference to Exhibit 10.1 to the Company's Current Report on Form 8-K as filed with the SEC on November 5, 2018.
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. Section 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. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.
101	Interactive Data File.

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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.
Date: December 6, 2018

Science Applications International Corporation

/s/ Charles A. Mathis
Charles A. Mathis
Executive Vice President and Chief Financial Officer