TEXTRON INC
Form 10-Q
October 24, 2014
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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 September 27, 2014

OR

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

For the transition period from ______ to ______.

Commission File Number 1-5480

Textron Inc.

(Exact name of registrant as specified in its charter)

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

(401) 421-2800

(Registrant s telephone number, including area code)

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes ü No__

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

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

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

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

As of October 10, 2014, there were 276,048,870 shares of common stock outstanding.

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PART I. FINANCIAL INFORMATION

Item 1. FINANCIAL STATEMENTS

TEXTRON INC.
Consolidated Statements of Operations (Unaudited)

	Three Months Ended		Nine Months Ended	
(In millions, except per share amounts)	**September 27, 2014**	**September 28, 2013**	**September 27, 2014**	**September 28, 2013**
Revenues				
Manufacturing revenues	$ 3,405	$ 2,871	$ 9,701	$ 8,492
Finance revenues	25	33	81	106
Total revenues	3,430	2,904	9,782	8,598
Costs and expenses				
Cost of sales	2,845	2,473	8,077	7,193
Selling and administrative expense	304	245	959	820
Interest expense	47	41	141	134
Acquisition and restructuring costs	3		39	
Total costs and expenses	3,199	2,759	9,216	8,147
Income from continuing operations before income taxes	231	145	566	451
Income tax expense	71	47	174	124
Income from continuing operations	160	98	392	327
Income (loss) from discontinued operations, net of income taxes	(1)	1	(4)	4
Net income	$ 159	$ 99	$ 388	$ 331
Basic earnings per share				
Continuing operations	$ 0.57	$ 0.35	$ 1.40	$ 1.18
Discontinued operations			(0.02)	0.01
Basic earnings per share	$ 0.57	$ 0.35	$ 1.38	$ 1.19
Diluted earnings per share				
Continuing operations	$ 0.57	$ 0.35	$ 1.39	$ 1.15
Discontinued operations			(0.02)	0.01
Diluted earnings per share	$ 0.57	$ 0.35	$ 1.37	$ 1.16
Dividends per share				
Common stock	$ 0.02	$ 0.02	$ 0.06	$ 0.06

See Notes to the consolidated financial statements.

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TEXTRON INC.

Consolidated Statements of Comprehensive Income (Unaudited)

	Three Months Ended		Nine Months Ended	
(In millions)	**September 27, 2014**	**September 28, 2013**	**September 27, 2014**	**September 28, 2013**
Net income	$ 159	$ 99	$ 388	$ 331
Other comprehensive income, net of tax:				
Pension and postretirement benefits adjustments, net of reclassifications	17	64	62	127
Deferred gains/losses on hedge contracts, net of reclassifications	(5)	2	2	(11)
Foreign currency translation adjustments	(43)	12	(47)	3
Other comprehensive income (loss)	(31)	78	17	119
Comprehensive income	$ 128	$ 177	$ 405	$ 450

See Notes to the consolidated financial statements.

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TEXTRON INC.

Consolidated Balance Sheets (Unaudited)

(Dollars in millions)	**September 27, 2014**	**December 28, 2013**
Assets		
Manufacturing group		
Cash and equivalents	$ 430	$ 1,163
Accounts receivable, net	1,150	979
Inventories	4,081	2,963
Other current assets	539	467
Total current assets	6,200	5,572
Property, plant and equipment, less accumulated depreciation and amortization of $3,662 and $3,463	2,442	2,215
Goodwill	2,020	1,735
Other assets	2,509	1,697
Total Manufacturing group assets	13,171	11,219
Finance group		
Cash and equivalents	81	48
Finance receivables, net	1,308	1,493
Other assets	179	184
Total Finance group assets	1,568	1,725
Total assets	$ 14,739	$ 12,944
Liabilities and shareholders equity		
Liabilities		
Manufacturing group		
Short-term and current portion of long-term debt	$ 383	$ 8
Accounts payable	1,135	1,107
Accrued liabilities	2,375	1,888
Total current liabilities	3,893	3,003
Other liabilities	2,451	2,118
Long-term debt	2,474	1,923
Total Manufacturing group liabilities	8,818	7,044
Finance group		
Other liabilities	238	260
Debt	1,111	1,256
Total Finance group liabilities	1,349	1,516
Total liabilities	10,167	8,560
Shareholders equity		
Common stock	36	35
Capital surplus	1,432	1,331
Treasury stock	(302)	
Retained earnings	4,416	4,045
Accumulated other comprehensive loss	(1,010)	(1,027)
Total shareholders equity	4,572	4,384
Total liabilities and shareholders equity	$ 14,739	$ 12,944
Common shares outstanding *(in thousands)*	276,195	282,059

See Notes to the consolidated financial statements.

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TEXTRON INC.

Consolidated Statements of Cash Flows (Unaudited)

For the Nine Months Ended September 27, 2014 and September 28, 2013, respectively

	Consolidated	
(In millions)	**2014**	**2013**
Cash flows from operating activities		
Net income	$ 388	$ 331
Less: Income (loss) from discontinued operations	(4)	4
Income from continuing operations	392	327
Adjustments to reconcile income from continuing operations to net cash provided by (used in) operating activities:		
Non-cash items:		
Depreciation and amortization	325	285
Deferred income taxes	(41)	74
Other, net	80	38
Changes in assets and liabilities:		
Accounts receivable, net	(55)	(178)
Inventories	(370)	(443)
Other assets	24	(51)
Accounts payable	(120)	(25)
Accrued and other liabilities	137	(276)
Income taxes, net	61	(96)
Pension, net	31	(17)
Captive finance receivables, net	107	257
Other operating activities, net	(2)	2
Net cash provided by (used in) operating activities of continuing operations	569	(103)
Net cash used in operating activities of discontinued operations	(3)	(5)
Net cash provided by (used in) operating activities	566	(108)
Cash flows from investing activities		
Net cash used in acquisitions	(1,580)	(53)
Capital expenditures	(255)	(300)
Finance receivables repaid	77	157
Proceeds from sales of receivables and other finance assets	37	152
Other investing activities, net	(4)	13
Net cash used in investing activities	(1,725)	(31)
Cash flows from financing activities		
Proceeds from long-term debt	1,187	412
Principal payments on long-term and nonrecourse debt	(462)	(997)
Increase in short-term debt	25	96
Purchases of Textron common stock	(302)	
Settlement of convertible notes		(215)
Proceeds from settlement of capped call		75
Dividends paid	(17)	(16)
Other financing activities, net	33	16
Net cash provided by (used in) financing activities	464	(629)
Effect of exchange rate changes on cash and equivalents	(5)	(8)
Net decrease in cash and equivalents	(700)	(776)
Cash and equivalents at beginning of period	1,211	1,413
Cash and equivalents at end of period	$ 511	$ 637

See Notes to the consolidated financial statements.

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TEXTRON INC.

Consolidated Statements of Cash Flows (Unaudited) (Continued)

For the Nine Months Ended September 27, 2014 and September 28, 2013, respectively

	Manufacturing Group		Finance Group	
(In millions)	**2014**	**2013**	**2014**	**2013**
Cash flows from operating activities				
Net income	$ 378	$ 300	$ 10	$ 31
Less: Income (loss) from discontinued operations	(4)	4		
Income from continuing operations	382	296	10	31
Adjustments to reconcile income from continuing operations to net cash provided by (used in) operating activities:				
Non-cash items:				
Depreciation and amortization	315	271	10	14
Deferred income taxes	(25)	29	(16)	45
Other, net	69	69	11	(31)
Changes in assets and liabilities:				
Accounts receivable, net	(55)	(178)		
Inventories	(344)	(459)		
Other assets	38	(40)	(14)	(11)
Accounts payable	(120)	(25)		
Accrued and other liabilities	145	(262)	(8)	(24)
Income taxes, net	57	(101)	4	5
Pension, net	31	(12)		(5)
Dividends received from Finance Group		30		
Capital contributions paid to Finance Group		(1)		
Other operating activities, net	(2)	2		
Net cash provided by (used in) operating activities of continuing operations	491	(381)	(3)	24
Net cash used in operating activities of discontinued operations	(3)	(5)		
Net cash provided by (used in) operating activities	488	(386)	(3)	24
Cash flows from investing activities				
Net cash used in acquisitions	(1,580)	(53)		
Capital expenditures	(255)	(300)		
Finance receivables repaid			307	558
Finance receivables originated or purchased			(123)	(164)
Proceeds from sales of receivables and other finance assets			37	152
Other investing activities, net	(12)	19	(18)	40
Net cash provided by (used in) investing activities	(1,847)	(334)	203	586
Cash flows from financing activities				
Proceeds from long-term debt	1,093	150	94	262
Principal payments on long-term and nonrecourse debt	(201)	(312)	(261)	(685)
Increase in short-term debt	25	96		
Purchases of Textron common stock	(302)			
Settlement of convertible notes		(215)		
Proceeds from settlement of capped call		75		
Dividends paid	(17)	(16)		(30)
Capital contributions paid to Finance group				1
Other financing activities, net	33	16		
Net cash provided by (used in) financing activities	631	(206)	(167)	(452)
Effect of exchange rate changes on cash and equivalents	(5)	(8)		
Net increase (decrease) in cash and equivalents	(733)	(934)	33	158
Cash and equivalents at beginning of period	1,163	1,378	48	35
Cash and equivalents at end of period	$ 430	$ 444	$ 81	$ 193

See Notes to the consolidated financial statements.

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TEXTRON INC.

Notes to the Consolidated Financial Statements (Unaudited)

Note 1. Basis of Presentation

Our Consolidated Financial Statements include the accounts of Textron Inc. (Textron) and its majority-owned subsidiaries. On March 14, 2014, we completed the acquisition of all of the outstanding equity interests in Beech Holdings, LLC, which included Beechcraft Corporation and other subsidiaries, (collectively Beechcraft). The results of Beechcraft have been included in our consolidated financial statements only for the period subsequent to the completion of the acquisition. As a result, the consolidated financial results for the nine months ended September 27, 2014 do not reflect a full nine months of Beechcraft operations.

We have prepared these unaudited consolidated financial statements in accordance with accounting principles generally accepted in the U.S. for interim financial information. Accordingly, these interim financial statements do not include all of the information and footnotes required by accounting principles generally accepted in the U.S. for complete financial statements. The consolidated interim financial statements included in this quarterly report should be read in conjunction with the consolidated financial statements included in our Annual Report on Form 10-K for the year ended December 28, 2013. In the opinion of management, the interim financial statements reflect all adjustments (consisting only of normal recurring adjustments) that are necessary for the fair presentation of our consolidated financial position, results of operations and cash flows for the interim periods presented. The results of operations for the interim periods are not necessarily indicative of the results to be expected for the full year.

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

Use of Estimates

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

During 2014 and 2013, we changed our estimates of revenues and costs on certain long-term contracts that are accounted for under the percentage-of-completion method of accounting. These changes in estimates increased income from continuing operations before income taxes

in the third quarter of 2014 and 2013 by $10 million and $4 million, respectively, ($6 million and $2 million after tax, or $0.02 and $0.01 per diluted share, respectively). For the third quarter of 2014 and 2013, the gross favorable program profit adjustments totaled $25 million and $12 million, respectively, and the gross unfavorable program profit adjustments totaled $15 million and $8 million, respectively.

The changes in estimates increased income from continuing operations before income taxes in the first nine months of 2014 and 2013 by $69 million and $13 million, respectively, ($43 million and $8 million after tax, or $0.15 and $0.03 per diluted share, respectively). For the first nine months of 2014 and 2013, the gross favorable program profit adjustments totaled $90 million and $30 million, respectively, and the gross unfavorable program profit adjustments totaled $21 million and $17 million, respectively. Gross favorable program profit adjustments in the second quarter of 2014 included $16 million related to the settlement of the System Development and Demonstration phase of the Armed Reconnaissance Helicopter (ARH) program which was terminated in October 2008.

New Accounting Pronouncements

In May 2014, the Financial Accounting Standards Board (FASB) issued Accounting Standards Update (ASU) No. 2014-09, Revenue from Contracts with Customers, that outlines a comprehensive five-step revenue recognition model based on the principle that an entity should recognize revenue to depict the transfer of promised goods or services to customers in an amount that reflects the consideration to which the entity expects to be entitled in exchange for those goods and services. Entities have the option of using either a full retrospective or a modified retrospective approach for the adoption. This ASU is effective for our

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company at the beginning of fiscal 2017; early adoption is not permitted. We are currently evaluating the new guidance to determine the impact it is expected to have on our consolidated financial statements, along with the transition method we expect to utilize.

Note 2. Business Acquisitions

2014 Beechcraft Acquisition

On March 14, 2014, we acquired Beechcraft for an aggregate cash payment of $1.5 billion that included a repayment of a portion of Beechcraft s working capital credit facility at closing. We financed a portion of the purchase price with the issuance of $600 million in senior notes on January 30, 2014 and by drawing $500 million under the five-year term loan agreement entered into on January 24, 2014. The balance was paid from cash on hand.

Beechcraft is a leading manufacturer of business, special mission, light attack and trainer aircraft, including the King Air turboprops, piston-engine Baron and Bonanza, and the T-6 trainer and AT-6 light attack military aircraft. Beechcraft also has a global network of both factory-owned and authorized service centers. The acquisition of Beechcraft and the formation of the Textron Aviation segment provide increased scale and complementary product offerings, allowing us to strengthen our position across the aviation industry and enhance our ability to support our customers.

The consideration paid for this business was allocated on a preliminary basis to the assets acquired and liabilities assumed based on their estimated fair values at the acquisition date, which have been subsequently adjusted as estimates are being finalized. Due to the size and breadth of this acquisition, additional time is necessary to complete the purchase accounting related to the fair values of certain assets and liabilities. We will finalize the purchase accounting as soon as reasonably possible during the one-year-measurement period allowed under generally accepted accounting principles. Any potential adjustments to the preliminary fair values could be material. Our allocation of the purchase price is presented below.

(In millions)	
Accounts receivable	$ 118
Inventories	770
Other current assets	175
Property, plant and equipment	258
Intangible assets	581
Goodwill	226
Other assets	171
Accounts payable	(143)
Accrued liabilities	(282)
Other liabilities	(396)
Total net assets acquired	$ 1,478

Goodwill of $226 million was primarily related to expected synergies from combining operations and the value of the existing workforce, and intangible assets of $581 million included unpatented technology related to original equipment manufactured parts and designs and customer relationships valued at $373 million and trade names valued at $208 million. The unpatented technology and customer relationships assets have a life of 15 years, resulting in amortization expense in the range of approximately $17 million to $31 million annually. Substantially all of the trade names intangible asset has an indefinite life and therefore is not subject to amortization.

We acquired tax-deductible goodwill of approximately $260 million in this transaction. We also recorded unrecognized tax benefits of approximately $95 million at the acquisition date.

In connection with the integration of Beechcraft, we initiated a restructuring program in our Textron Aviation segment in the first quarter of 2014 to align the Cessna and Beechcraft businesses, reduce operating redundancies and maximize efficiencies. We expect to incur costs for this program related to employee terminations, facility consolidations, contract terminations and other transition-related costs, and estimate that this program will result in charges of approximately $35 million in 2014. We expect to incur additional costs in 2015, but do not expect these costs to be material. In the third quarter and first nine months of 2014, we recorded charges of $3 million and $28 million, respectively, related to restructuring activities that were included in the Acquisition and restructuring costs line on the Consolidated Statements of Operations. In addition, we incurred transaction costs of $11 million during the first quarter of 2014 related to the acquisition that were also included in the Acquisition and restructuring costs line.

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Other 2014 Acquisitions

During the first nine months of 2014, we made aggregate cash payments of $101 million for the following acquisitions:

Industrial

- Tug Technologies Corporation, a manufacturer of ground support equipment in the aviation industry, acquired on May 2, 2014.
- The assets of Dixie Chopper, a manufacturer of zero-turn radius mowers for the commercial and residential markets, acquired on February 6, 2014.

Textron Systems

- ProFlight, LLC, a pilot training operation, acquired on July 2, 2014.

Actual and Pro-Forma Impact from 2014 Acquisitions

The operating results for the 2014 acquisitions are included in the Consolidated Statement of Operations since their respective closing dates. From the closing dates through September 27, 2014, revenues related to these acquisitions totaled $435 million and $993 million for the three- and nine-month periods, respectively. The cost structures of Beechcraft and Cessna have been significantly integrated since the acquisition of Beechcraft, therefore, it is not possible to separately report earnings for this acquisition. The earnings related to the other 2014 acquisitions were not significant.

The unaudited supplemental pro-forma data included in the table below presents consolidated information as if our 2014 acquisitions had been completed on December 30, 2012. This pro-forma information should not be considered indicative of the results that would have occurred if the acquisition and related financing had been consummated on December 30, 2012, nor are they necessarily indicative of future results as they do not reflect the potential realization of cost savings and synergies associated with the acquisition.

	Three Months Ended		Nine Months Ended	
(In millions, except per share amounts)	September 27, 2014	September 28, 2013	September 27, 2014	September 28, 2013
Revenues	$ 3,430	$ 3,308	$ 10,145	$ 9,907
Income from continuing operations, net of income taxes	169	78	462	279
Diluted earnings per share from continuing operations	$ 0.60	$ 0.28	$ 1.64	$ 0.98

Certain pro-forma adjustments were made to reflect the allocation of the preliminary purchase price to the acquired net assets including depreciation and intangible amortization expense, resulting from the valuation of tangible and intangible assets, and amortization of inventory fair value step-up adjustments, along with the related tax effects. The pro-forma results for 2013 were also adjusted to include transaction and restructuring costs of $3 million and $39 million for the three- and nine-month periods, respectively, related to the Beechcraft acquisition; these costs were excluded from the 2014 pro-forma results. In addition, the pro-forma results exclude the financial impact related to Beechcraft s emergence from bankruptcy in 2013.

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Note 3. Retirement Plans

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

	Pension Benefits		Postretirement Benefits Other Than Pensions	
(In millions)	**September 27, 2014**	**September 28, 2013**	**September 27, 2014**	**September 28, 2013**
Three Months Ended				
Service cost	$ 27	$ 33	$ 1	$ 1
Interest cost	86	72	5	5
Expected return on plan assets	(117)	(104)		
Amortization of prior service cost (credit)	3	4	(5)	(6)
Amortization of net actuarial loss	28	46		2
Net periodic benefit cost	$ 27	$ 51	$ 1	$ 2
Nine Months Ended				
Service cost	$ 81	$ 100	$ 3	$ 5
Interest cost	250	218	15	15
Expected return on plan assets	(345)	(314)		
Amortization of prior service cost (credit)	11	11	(16)	(11)
Amortization of net actuarial loss	84	138	1	5
Net periodic benefit cost	$ 81	$ 153	$ 3	$ 14

Note 4. Earnings Per Share

In February 2014, we entered into an Accelerated Share Repurchase agreement (ASR) with a counterparty and repurchased 4.3 million shares of our outstanding common stock from the counterparty for $150 million. The initial delivery of shares resulted in an immediate reduction of the outstanding shares used to calculate the weighted average common shares for basic and diluted earnings per share. The ASR is scheduled to settle in December 2014. Upon final settlement of the ASR, we may receive additional shares or pay additional cash or shares, at our option, based on the daily volume weighted average market price (VWAP) of our common stock over the course of the calculation period, less a discount. We intend to settle any amount payable by us in shares. At September 27, 2014, based on the VWAP through that date, we would be required to issue to the counterparty approximately 278,000 shares to settle the ASR. For accounting purposes, the ASR is considered a treasury stock purchase for the 4.3 million shares delivered to us by the counterparty, and a forward contract indexed to our common stock for the shares to be delivered upon settlement, if any. The forward contract is not required to be separately accounted for as a derivative.

We calculate basic and diluted earnings per share (EPS) based on net income, which approximates income available to common shareholders for each period. Basic EPS is calculated using the two-class method, which includes the weighted-average number of common shares outstanding during the period and restricted stock units to be paid in stock that are deemed participating securities as they provide nonforfeitable rights to dividends. Diluted EPS considers the dilutive effect of all potential future common stock, including stock options and shares that would have been delivered if the ASR were settled at September 27, 2014. In addition, for the first nine months of 2013, prior to the maturity of our convertible notes on May 1, 2013 as disclosed in Note 7 of our 2013 Annual Report on Form 10-K, diluted EPS included the shares that could have been issued upon the conversion of the notes and upon the exercise of the related warrants.

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

	Three Months Ended		Nine Months Ended	
(In thousands)	**September 27, 2014**	**September 28, 2013**	**September 27, 2014**	**September 28, 2013**
Basic weighted-average shares outstanding	278,860	281,525	280,096	278,296
Dilutive effect of:				
Stock options	1,892	185	2,027	221
ASR	278		301	
Convertible notes and warrants				6,226
Diluted weighted-average shares outstanding	281,030	281,710	282,424	284,743

Stock options to purchase 2 million shares of common stock outstanding are excluded from our calculation of diluted weighted-average shares outstanding for both the three and nine months ended September 27, 2014, as their effect would have been anti-dilutive. Stock options to purchase 6 million and 5 million shares of common stock outstanding are excluded from our calculation

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of diluted weighted-average shares outstanding for the three and nine months ended September 28, 2013, respectively, as their effect would have been anti-dilutive.

Note 5. Accounts Receivable and Finance Receivables

Accounts Receivable

Accounts receivable is composed of the following:

(In millions)	**September 27, 2014**	**December 28, 2013**
Commercial	$ 849	$ 654
U.S. Government contracts	329	347
	1,178	1,001
Allowance for doubtful accounts	(28)	(22)
Total	$ 1,150	$ 979

We have unbillable receivables, primarily on U.S. Government contracts, that arise when the revenues we have appropriately recognized based on performance cannot be billed yet under terms of the contract. Unbillable receivables within accounts receivable totaled $124 million at September 27, 2014 and $163 million at December 28, 2013.

Finance Receivables

Finance receivables by classification are presented in the following table:

(In millions)	**September 27, 2014**	**December 28, 2013**
Finance receivables held for investment	$ 1,329	$ 1,483
Allowance for losses	(56)	(55)
Total finance receivables held for investment, net	1,273	1,428
Finance receivables held for sale	35	65
Total finance receivables, net	$ 1,308	$ 1,493

Credit Quality Indicators and Nonaccrual Finance Receivables

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

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

A summary of finance receivables categorized based on the credit quality indicators discussed above is as follows:

(In millions)	**September 27, 2014**	**December 28, 2013**
Performing	$ 1,111	$ 1,285
Watchlist	117	93
Nonaccrual	101	105
Total	$ 1,329	$ 1,483
Nonaccrual as a percentage of total finance receivables	7.60%	7.08%

We measure delinquency based on the contractual payment terms of our loans and leases. In determining the delinquency aging

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

Finance receivables by delinquency aging category are summarized in the table below:

(In millions)	**September 27, 2014**	**December 28, 2013**
Less than 31 days past due	$ 1,165	$ 1,295
31-60 days past due	94	108
61-90 days past due	41	37
Over 90 days past due	29	43
Total	$ 1,329	$ 1,483

Accrual status loans that were greater than 90 days past due totaled $4 million at September 27, 2014 and $5 million at December 28, 2013. At September 27, 2014 and December 28, 2013, 60+ days contractual delinquency as a percentage of finance receivables was 5.27% and 5.39%, respectively.

Loan Modifications

Troubled debt restructurings occur when we have either modified the contract terms of finance receivables for borrowers experiencing financial difficulties or accepted a transfer of assets in full or partial satisfaction of the loan balance. The types of modifications we typically make include extensions of the original maturity date of the contract, delays in the timing of required principal payments and deferrals of interest payments. The changes effected by modifications made during the first nine months of 2014 and 2013 to finance receivables were not material.

Impaired Loans

On a quarterly basis, we evaluate individual finance receivables for impairment in non-homogeneous portfolios and larger balance accounts in homogeneous loan portfolios. A finance receivable is considered impaired when it is probable that we will be unable to collect all amounts due according to the contractual terms of the loan agreement based on our review of the credit quality indicators discussed above. Impaired finance receivables include both nonaccrual accounts and accounts for which full collection of principal and interest remains probable, but the account s original terms have been, or are expected to be, significantly modified. If the modification specifies an interest rate equal to or greater than a market rate for a finance receivable with comparable risk, the account is not considered impaired in years subsequent to the modification. Interest income recognized on impaired loans was not significant in the first nine months of 2014 or 2013.

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

(In millions)	**September 27, 2014**	**December 28, 2013**
Recorded investment:		

Impaired loans with related allowance for losses	$ 78	$ 59
Impaired loans with no related allowance for losses	53	78
Total	$ 131	$ 137
Unpaid principal balance	$ 135	$ 141
Allowance for losses on impaired loans	23	14
Average recorded investment	116	155

A summary of the allowance for losses on finance receivables that are evaluated on an individual basis and on a collective basis is provided below. The finance receivables included in the table below excludes leveraged leases in accordance with generally accepted accounting principles.

(In millions)	**September 27, 2014**	**December 28, 2013**
Allowance based on collective evaluation	$ 33	$ 41
Allowance based on individual evaluation	23	14
Finance receivables evaluated collectively	$ 1,077	$ 1,226
Finance receivables evaluated individually	131	137

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Allowance for Losses

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

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

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

	Nine Months Ended	
(In millions)	**September 27, 2014**	**September 28, 2013**
Balance at the beginning of period	$ 55	$ 84
Provision for losses	7	(23)
Charge-offs	(11)	(9)
Recoveries	5	11
Transfers		(1)
Balance at the end of period	$ 56	$ 62

Note 6. Inventories

Inventories are composed of the following:

(In millions)	**September 27, 2014**	**December 28, 2013**
Finished goods	$ 1,646	$ 1,276
Work in process	2,791	2,477
Raw materials and components	555	407
	4,992	4,160
Progress/milestone payments	(911)	(1,197)

Total	$ 4,081	$ 2,963

Note 7. Accrued Liabilities

We provide limited warranty and product maintenance programs, including parts and labor, for certain products for periods ranging from one to five years. Changes in our warranty and product maintenance liabilities are as follows:

	Nine Months Ended	
(In millions)	**September 27, 2014**	**September 28, 2013**
Accrual at the beginning of period	$ 223	$ 222
Provision	240	203
Settlements	(240)	(210)
Acquisitions	65	
Adjustments*	(8)	(3)
Accrual at the end of period	$ 280	$ 212

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

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Note 8. Debt

On January 24, 2014, we entered into a five-year term loan agreement with a syndicate of banks in the principal amount of $500 million. On January 30, 2014, we issued $250 million in 3.65% notes due 2021 and $350 million in 4.30% notes due 2024 under our shelf registration statement. Upon the closing of the Beechcraft acquisition on March 14, 2014, we fully drew down on the five-year term loan and used the cash, along with the net proceeds of the issuance of the notes, to finance a portion of the acquisition. During the third quarter of 2014, we repaid $200 million of the five-year term loan.

Note 9. Accumulated Other Comprehensive Loss and Other Comprehensive Income

The components of Accumulated Other Comprehensive Loss are presented below:

(In millions)	Foreign Currency Translation Adjustments	Pension and Postretirement Benefits Adjustments	Deferred Gains/Losses on Hedge Contracts	Accumulated Other Comprehensive Loss
For the nine months ended September 27, 2014				
Beginning balance	$ 93	$ (1,110)	$ (10)	$ (1,027)
Other comprehensive income (loss) before reclassifications	(47)	9	(4)	(42)
Amounts reclassified from Accumulated Other Comprehensive Loss		53	6	59
Other comprehensive income (loss)	(47)	62	2	17
Ending balance	$ 46	$ (1,048)	$ (8)	$ (1,010)
For the nine months ended September 28, 2013				
Beginning balance	$ 81	$ (1,857)	$ 6	$ (1,770)
Other comprehensive income (loss) before reclassifications	3		(9)	(6)
Amounts reclassified from Accumulated Other Comprehensive Loss		127	(2)	125
Other comprehensive income (loss)	3	127	(11)	119
Ending balance	$ 84	$ (1,730)	$ (5)	$ (1,651)

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The before and after-tax components of Other Comprehensive Income are presented below:

(In millions)		Pre-Tax Amount		Tax (Expense) Benefit		After-Tax Amount
For the three months ended September 27, 2014						
Pension and postretirement benefits adjustments:						
Amortization of net actuarial loss*	$	28	$	(10)	$	18
Amortization of prior service credit*		(2)		1		(1)
Pension and postretirement benefits adjustments, net		26		(9)		17
Deferred gains/losses on hedge contracts:						
Current deferrals		(9)		3		(6)
Reclassification adjustments		2		(1)		1
Deferred gains/losses on hedge contracts, net		(7)		2		(5)
Foreign currency translation adjustments		(39)		(4)		(43)
Total	$	(20)	$	(11)	$	(31)
For the three months ended September 28, 2013						
Pension and postretirement benefits adjustments:						
Amortization of net actuarial loss*	$	48	$	(18)	$	30
Amortization of prior service credit*		(2)		1		(1)
Amendment to postretirement benefit plan		55		(20)		35
Pension and postretirement benefits adjustments, net		101		(37)		64
Deferred gains/losses on hedge contracts:						
Current deferrals		3		(1)		2
Deferred gains/losses on hedge contracts, net		3		(1)		2
Foreign currency translation adjustments		8		4		12
Total	$	112	$	(34)	$	78
For the nine months ended September 27, 2014						
Pension and postretirement benefits adjustments:						
Amortization of net actuarial loss*	$	85	$	(30)	$	55
Amortization of prior service credit*		(5)		3		(2)
Amendment to postretirement benefit plan		15		(6)		9
Pension and postretirement benefits adjustments, net		95		(33)		62
Deferred gains/losses on hedge contracts:						
Current deferrals		(7)		3		(4)
Reclassification adjustments		9		(3)		6
Deferred gains/losses on hedge contracts, net		2				2
Foreign currency translation adjustments		(46)		(1)		(47)
Total	$	51	$	(34)	$	17
For the nine months ended September 28, 2013						
Pension and postretirement benefits adjustments:						
Amortization of net actuarial loss*	$	143	$	(51)	$	92
Amendment to postretirement benefit plan		55		(20)		35
Pension and postretirement benefits adjustments, net		198		(71)		127
Deferred gains/losses on hedge contracts:						
Current deferrals		(11)		2		(9)
Reclassification adjustments		(3)		1		(2)
Deferred gains/losses on hedge contracts, net		(14)		3		(11)
Foreign currency translation adjustments		6		(3)		3
Total	$	190	$	(71)	$	119

**These components of other comprehensive income are included in the computation of net periodic pension cost. See Note 11 of our 2013 Annual Report on Form 10-K for additional information.*

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Note 10. Commitments and Contingencies

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

Note 11. Derivative Instruments and Fair Value Measurements

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

Assets and Liabilities Recorded at Fair Value on a Recurring Basis

We manufacture and sell our products in a number of countries throughout the world, and, therefore, we are exposed to movements in foreign currency exchange rates. We utilize foreign currency exchange contracts to manage this volatility. Our foreign currency exchange contracts are measured at fair value using the market method valuation technique. The inputs to this technique utilize current foreign currency exchange forward market rates published by third-party leading financial news and data providers. These are observable data that represent the rates that the financial institution uses for contracts entered into at that date; however, they are not based on actual transactions so they are classified as Level 2. At September 27, 2014 and December 28, 2013, we had foreign currency exchange contracts with notional amounts upon which the contracts were based of $753 million and $636 million, respectively. At September 27, 2014, the fair value amounts of our foreign currency exchange contracts were a $7 million asset and a $15 million liability. At December 28, 2013, the fair value amounts of our foreign currency exchange contracts were a $2 million asset and a $15 million liability.

We primarily utilize forward exchange contracts which have maturities of no more than three years. These contracts qualify as cash flow hedges and are intended to offset the effect of exchange rate fluctuations on forecasted sales, inventory purchases and overhead expenses. At September 27, 2014, we had a net deferred loss of $8 million in Accumulated other comprehensive loss related to these cash flow hedges. Net gains and losses recognized in earnings and Accumulated other comprehensive loss on cash flow hedges, including gains and losses related to hedge ineffectiveness, were not significant in the periods presented.

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

Our Finance group has entered into interest rate exchange contracts to mitigate exposure to changes in the fair value of its fixed-rate receivables and debt due to fluctuations in interest rates. These interest rate exchange contracts are not exchange traded and are measured at fair value utilizing widely accepted, third-party developed valuation models. The actual terms of each individual contract are entered into a valuation model, along with interest rate data, which is based on readily observable market data published by third-party leading financial news and data providers. At September 27, 2014 and December 28, 2013, we had interest rate exchange contracts with notional amounts upon which the contracts were based of $162 million and $229 million, respectively. The fair value amounts of our interest rate exchange contracts were a $1 million asset and a $3 million liability at September 27, 2014. At December 28, 2013, the fair value amounts of our interest rate exchange contracts were a $2 million asset and $5 million liability.

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Our exposure to loss from nonperformance by the counterparties to our derivative agreements at September 27, 2014 was minimal. We do not anticipate nonperformance by counterparties in the periodic settlements of amounts due. We historically have minimized this potential for risk by entering into contracts exclusively with major, financially sound counterparties having no less than a long-term bond rating of A. The credit risk generally is limited to the amount by which the counterparties contractual obligations exceed our obligations to the counterparty. We continuously monitor our exposures to ensure that we limit our risks.

Assets Recorded at Fair Value on a Nonrecurring Basis

During the periods ended September 27, 2014 and December 28, 2013, the Finance group s impaired nonaccrual finance receivables of $55 million and $45 million, respectively, were measured at fair value on a nonrecurring basis using significant unobservable inputs (Level 3). Impaired nonaccrual finance receivables represent assets recorded at fair value on a nonrecurring basis since the measurement of required reserves on our impaired finance receivables is significantly dependent on the fair value of the underlying collateral. For impaired nonaccrual finance receivables secured by aviation assets, the fair values of collateral are determined primarily based on the use of industry pricing guides. Fair value measurements recorded on impaired finance receivables resulted in charges to provision for loan losses totaling $5 million and $16 million for the three and nine months ended September 27, 2014, respectively, and $3 million and $8 million for the three and nine months ended September 27, 2013, respectively.

Assets and Liabilities Not Recorded at Fair Value

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

	September 27, 2014		December 28, 2013	
(In millions)	Carrying Value	Estimated Fair Value	Carrying Value	Estimated Fair Value
Manufacturing group				
Long-term debt, excluding leases	$ (2,760)	$ (2,959)	$ (1,854)	$ (2,027)
Finance group				
Finance receivables held for investment, excluding leases	1,072	1,102	1,231	1,290
Debt	(1,111)	(1,112)	(1,256)	(1,244)

Fair value for the Manufacturing group debt is determined using market observable data for similar transactions (Level 2). At September 27, 2014 and December 28, 2013, approximately 76% and 70%, respectively, of the fair value of term debt for the Finance group was determined based on discounted cash flow analyses using observable market inputs from debt with similar duration, subordination and credit default expectations (Level 2). The remaining Finance group debt was determined based on observable market transactions (Level 1). Fair value estimates for finance receivables held for investment were determined based on internally developed discounted cash flow models primarily utilizing significant unobservable inputs (Level 3), which include estimates of the rate of return, financing cost, capital structure and/or discount rate expectations of current market participants combined with estimated loan cash flows based on credit losses, payment rates and expectations of borrowers ability to make payments on a timely basis.

Note 12. Income Tax Expense

Income tax expense equated to an effective income tax rate of 30.7% for both the three and nine months ended September 27, 2014, compared with the U.S. federal statutory income tax rate of 35.0%. The difference between the statutory and the effective income tax rate was primarily due to benefits from income attributable to international operations in countries with lower tax rates.

Income tax expense equated to an effective income tax rate of 32.4% and 27.5% for the three and nine months ended September 28, 2013, respectively, compared with the U.S. federal statutory income tax rate of 35.0%. For the nine months ended September 28, 2013, the difference between the statutory and the effective income tax rate was primarily due to benefits from income attributable to international operations in countries with lower tax rates and a favorable impact of four percentage points, resulting from the retroactive reinstatement and extension of the Federal Research and Development Tax Credit as part of the American Taxpayer Relief Act of 2012 enacted on January 2, 2013.

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Note 13. Segment Information

We operate in, and report financial information for, the following five business segments: Bell, Textron Systems, Industrial, Finance and the recently formed Textron Aviation segment as discussed in Note 1.

Segment profit is an important measure used for evaluating performance and for decision-making purposes. Segment profit for the manufacturing segments excludes interest expense, certain corporate expenses and acquisition and restructuring costs related to the Beechcraft acquisition. The measurement for the Finance segment includes interest income and expense along with intercompany interest expense. Our revenues by segment and a reconciliation of segment profit to income from continuing operations before income taxes are as follows:

	Three Months Ended		Nine Months Ended	
(In millions)	**September 27, 2014**	**September 28, 2013**	**September 27, 2014**	**September 28, 2013**
REVENUES				
Manufacturing group				
Textron Aviation	$ 1,080	$ 593	$ 3,048	$ 1,861
Bell	1,182	1,162	3,174	3,136
Textron Systems	358	405	1,003	1,256
Industrial	785	711	2,476	2,239
	3,405	2,871	9,701	8,492
Finance segment	25	33	81	106
Total revenues	$ 3,430	$ 2,904	$ 9,782	$ 8,598
SEGMENT PROFIT				
Manufacturing Group				
Textron Aviation	$ 62	$ (23)	$ 104	$ (81)
Bell	146	131	383	395
Textron Systems	27	35	100	107
Industrial	53	52	213	188
	288	195	800	609
Finance segment	5	13	16	47
Segment profit	293	208	816	656
Corporate expenses and other, net	(22)	(34)	(103)	(109)
Interest expense, net for Manufacturing group	(37)	(29)	(108)	(96)
Acquisition and restructuring costs	(3)		(39)	
Income from continuing operations before income taxes	$ 231	$ 145	$ 566	$ 451

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

Overview and Consolidated Results of Operations

On March 14, 2014, we completed the acquisition of Beech Holdings, LLC, which included Beechcraft Corporation and other subsidiaries, (collectively Beechcraft). The acquired Beechcraft business and the legacy Cessna segment were combined to form a new segment named Textron Aviation. The results of Beechcraft have been included in Textron s consolidated financial statements only for the period subsequent to the completion of the acquisition. As a result, the consolidated financial results for the nine months ended September 27, 2014 do not reflect a full nine months of Beechcraft operations.

An analysis of our consolidated operating results is set forth below. A more detailed analysis of our segments operating results is provided in the Segment Analysis section on pages 22 to 27.

Revenues

	Three Months Ended		Nine Months Ended	
(Dollars in millions)	September 27, 2014	September 28, 2013	September 27, 2014	September 28, 2013
Revenues	$ 3,430	$ 2,904	$ 9,782	$ 8,598
% change compared with prior period	18%		14%	

Revenues increased $526 million, 18%, in the third quarter of 2014, compared with the corresponding period of 2013, as revenue increases in the Textron Aviation, Industrial and Bell segments were partially offset by lower revenues in the Textron Systems and Finance segments. The net revenue increase included the following factors:

- Higher Textron Aviation revenues of $487 million, primarily due to a $398 million impact from the Beechcraft acquisition and $80 million in higher volume, largely resulting from higher Citation jet volume.
- Higher Industrial segment revenues of $74 million, primarily due to a $39 million impact from acquisitions and $36 million in higher volume, largely in the Fuel Systems and Functional Components product line.
- Higher Bell revenues of $20 million, primarily reflecting a $158 million increase in V-22 program volume due to an increase in deliveries and higher product support and other volume, partially offset by lower other military and commercial volume primarily reflecting lower aircraft deliveries.
- Lower Textron Systems revenues of $47 million, primarily due to lower volume, principally reflecting lower vehicle deliveries in the Marine and Land Systems product line.

- Lower Finance revenues of $8 million, primarily attributable to gains on the disposition of finance receivables held for sale during 2013.

Revenues increased $1,184 million, 14%, in the first nine months of 2014, compared with the corresponding period of 2013, as revenue increases in the Textron Aviation, Industrial and Bell segments were partially offset by lower revenues in the Textron Systems and Finance segments. The net revenue increase included the following factors:

- Higher Textron Aviation revenues of $1.2 billion, primarily due to a $924 million impact from the Beechcraft acquisition and $233 million in higher volume, largely resulting from higher Citation jet volume.

- Higher Industrial segment revenues of $237 million, primarily due to $113 million in higher volume, largely in the Fuel Systems and Functional Components product line, and a $97 million impact from acquisitions.

- Higher Bell revenues of $38 million, primarily due to a $208 million increase related to the V-22 program reflecting product support and other volume, partially offset by lower commercial and other military volume primarily reflecting lower aircraft deliveries. The decrease in other military volume was partially offset by $41 million related to the settlement of the System Development and Demonstration (SDD) phase of the Armed Reconnaissance Helicopter (ARH) program, which was terminated in October 2008.

- Lower Textron Systems revenues of $253 million, largely due to lower volume in the Marine and Land Systems product line of $172 million, reflecting lower vehicle deliveries, and in the UAS product line of $103 million, reflecting the timing of deliveries.

- Lower Finance revenues of $25 million, primarily attributable to gains on the disposition of finance receivables held for sale during 2013.

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Cost of Sales and Selling and Administrative Expense

	Three Months Ended		Nine Months Ended	
(Dollars in millions)	**September 27, 2014**	**September 28, 2013**	**September 27, 2014**	**September 28, 2013**
Operating expenses	$ 3,149	$ 2,718	$ 9,036	$ 8,013
Cost of sales	2,845	2,473	8,077	7,193
% change compared with prior period	*15%*		*12%*	
Gross margin percentage of Manufacturing revenues	*16.4%*	*13.9%*	*16.7%*	*15.3%*
Selling and administrative expenses	$ 304	$ 245	$ 959	$ 820
% change compared with prior period	*24%*		*17%*	

Manufacturing cost of sales and selling and administrative expenses together comprise our operating expenses. Cost of sales increased $372 million, 15%, in the third quarter of 2014, and $884 million, 12%, in the first nine months of 2014, compared with the corresponding periods of 2013, largely due to the impact of acquired businesses, primarily Beechcraft. In the third quarter and first nine months of 2014, gross margin increased as a percentage of Manufacturing revenues largely due to improved leverage resulting from higher revenues primarily in the Textron Aviation segment.

Selling and administrative expense increased $59 million, 24%, and $139 million, 17%, in the third quarter and first nine months of 2014, respectively, compared with the corresponding periods of 2013, largely related to businesses acquired in the past year and compensation expense. In addition, the increase in the first nine months of 2014 was partially offset by $28 million in severance costs incurred in 2013 in connection with a voluntary separation program in the legacy Cessna segment.

Acquisition and Restructuring Costs

In the third quarter and first nine months of 2014, we incurred $3 million and $39 million, respectively, in acquisition and restructuring costs related to the Beechcraft acquisition. These costs included severance costs of $3 million and $28 million, respectively, resulting from a restructuring program described below and transaction costs of $11 million incurred during the first quarter of 2014, primarily related to advisory services. Acquisition and restructuring costs are not included in segment profit.

In connection with the integration of Beechcraft, we initiated a restructuring program in our Textron Aviation segment in the first quarter of 2014 to align the Cessna and Beechcraft businesses, reduce operating redundancies and maximize efficiencies. We expect to incur costs for this program related to employee terminations, facility consolidations, contract terminations and other transition-related costs, and estimate that this program will result in charges of approximately $35 million in 2014. We expect to incur additional costs in 2015, but do not expect these costs to be material.

Interest Expense

	Three Months Ended		Nine Months Ended	
(Dollars in millions)	**September 27, 2014**	**September 28, 2013**	**September 27, 2014**	**September 28, 2013**
Interest expense	$ 47	$ 41	$ 141	$ 134

% change compared with prior period	15%	5%

Interest expense on the Consolidated Statement of Operations includes interest for both the Finance and Manufacturing borrowing groups with interest related to intercompany borrowings eliminated. Interest expense for the Finance segment is included within segment profit and includes intercompany interest.

Consolidated interest expense increased $6 million, 15%, and $7 million, 5%, in the third quarter and first nine months of 2014, respectively, compared with the corresponding periods of 2013, primarily due to higher average debt outstanding related to the Beechcraft acquisition financing. The increase in interest expense for the first nine months of 2014 was partially offset by the maturity of our convertible notes in the second quarter of 2013.

Income Taxes

Income tax expense equated to an effective income tax rate of 30.7% for both the third quarter and first nine months of 2014 compared with the U.S. federal statutory income tax rate of 35.0%. The difference between the statutory and the effective income tax rate was primarily due to benefits from income attributable to international operations in countries with lower tax rates.

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Income tax expense equated to an effective income tax rate of 32.4% and 27.5% in the third quarter and first nine months of 2013, respectively, compared with the U.S. federal statutory income tax rate of 35.0%. In the first nine months of 2013, the difference between the statutory and the effective income tax rate was primarily due to benefits from income attributable to international operations in countries with lower tax rates and a favorable impact of four percentage points, resulting from the retroactive reinstatement and extension of the Federal Research and Development Tax Credit as part of the American Taxpayer Relief Act of 2012 enacted on January 2, 2013.

Backlog

(In millions)	**September 27, 2014**	**December 28, 2013**
Bell	$ 5,332	$ 6,450
Textron Systems	3,126	2,803
Textron Aviation	1,358	1,018

Backlog at the Bell segment decreased $1.1 billion primarily due to V-22 helicopter deliveries. The increase in backlog of $340 million at the Textron Aviation segment was primarily the result of the Beechcraft acquisition.

Segment Analysis

We operate in, and report financial information for, the following five business segments: Textron Aviation, which consists of the legacy Cessna segment combined with the newly-acquired Beechcraft business, Bell, Textron Systems, Industrial and Finance. Segment profit is an important measure used for evaluating performance and for decision-making purposes. Segment profit for the manufacturing segments excludes interest expense, certain corporate expenses and acquisition and restructuring costs related to the Beechcraft acquisition. The measurement for the Finance segment includes interest income and expense along with intercompany interest expense.

In our discussion of comparative results for the Manufacturing group, changes in revenue and segment profit typically are expressed for our commercial business in terms of volume, pricing, foreign exchange and acquisitions. Additionally, changes in segment profit may be expressed in terms of mix, inflation and cost performance. Volume changes in revenue represent increases/decreases in the number of units delivered or services provided. Pricing represents changes in unit pricing. Foreign exchange is the change resulting from translating foreign-denominated amounts into U.S. dollars at exchange rates that are different from the prior period. Acquisitions refers to the revenues generated from businesses that were acquired within the previous 12 months. For segment profit, mix represents a change due to the composition of products and/or services sold at different profit margins. Inflation represents higher material, wages, benefits, pension or other costs. Performance reflects an increase or decrease in research and development, depreciation, selling and administrative costs, warranty, product liability, quality/scrap, labor efficiency, overhead, product line profitability, start-up, ramp up and cost-reduction initiatives or other manufacturing inputs.

Approximately 30% of our 2013 full year revenues were derived from contracts with the U.S. Government. For our segments that have significant contracts with the U.S. Government, we typically express changes in segment profit related to the government business in terms of volume, changes in program performance or changes in contract mix. Changes in volume that are discussed in net sales typically drive corresponding changes in our segment profit based on the profit rate for a particular contract. Changes in program performance typically relate to profit recognition associated with revisions to total estimated costs at completion that reflect improved or deteriorated operating performance or award fee rates. Changes in contract mix refers to changes in operating margin due to a change in the relative volume of contracts with higher

or lower fee rates such that the overall average margin rate for the segment changes.

Textron Aviation