

Science Applications International Corp
 Form 10-Q
 September 10, 2018

UNITED STATES
 SECURITIES AND EXCHANGE COMMISSION
 Washington, D.C. 20549

Form 10-Q

(Mark One)

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

For the quarterly period ended August 3, 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 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 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 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

The number of shares issued and outstanding of the registrant’s common stock as of August 24, 2018 was as follows:

42,490,057 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		Six Months Ended	
	August 3, 2018	August 4, 2017	August 3, 2018	August 4, 2017
	(in millions, except per share amounts)			
Revenues	\$1,115	\$ 1,078	\$2,290	\$ 2,181
Cost of revenues	1,003	979	2,077	1,986
Selling, general and administrative expenses	38	40	73	73
Operating income	74	59	140	122
Interest expense	10	10	22	21
Other (income) expense, net	—	—	(1) —
Income before income taxes	64	49	119	101
Provision for income taxes (Note 5)	(15) (13) (21) (16
Net income	\$49	\$ 36	\$98	\$ 85
Other comprehensive (loss) income, net of tax (Note 8)	(1) —	—	1
Comprehensive income	\$48	\$ 36	\$98	\$ 86
Earnings per share (Note 2):				
Basic	\$1.15	\$ 0.83	\$2.31	\$ 1.95
Diluted	\$1.13	\$ 0.80	\$2.26	\$ 1.88
Cash dividends declared and paid per share	\$0.31	\$ 0.31	\$0.62	\$ 0.62

See accompanying notes to condensed and consolidated financial statements.

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CONDENSED AND CONSOLIDATED BALANCE SHEETS
(UNAUDITED)

	August 2018	February 2, 2018
	(in millions)	
ASSETS		
Current assets:		
Cash and cash equivalents	\$106	\$ 144
Receivables, net	713	674
Inventory, prepaid expenses and other current assets	107	132
Total current assets	926	950
Goodwill	863	863
Intangible assets (net of accumulated amortization of \$65 million and \$55 million at August 3, 2018 and February 2, 2018, respectively)	169	179
Property, plant, and equipment (net of accumulated depreciation of \$152 million and \$143 million at August 3, 2018 and February 2, 2018, respectively)	70	61
Other assets	32	20
Total assets	\$2,060	\$ 2,073
LIABILITIES AND EQUITY		
Current liabilities:		
Accounts payable and accrued liabilities	\$450	\$ 504
Accrued payroll and employee benefits	163	150
Long-term debt, current portion (Note 6)	49	41
Total current liabilities	662	695
Long-term debt, net of current portion (Note 6)	959	983
Deferred income taxes	24	23
Other long-term liabilities	48	45
Commitments and contingencies (Note 9)		
Equity:		
Common stock, \$.0001 par value, 1 billion shares authorized, 43 million shares issued and outstanding as of August 3, 2018 and February 2, 2018	—	—
Additional paid-in capital	8	—
Retained earnings	355	323
Accumulated other comprehensive income (Note 8)	4	4
Total equity	367	327
Total liabilities and equity	\$2,060	\$ 2,073

See accompanying notes to condensed and consolidated financial statements.

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	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	—	—	98	—	98
Issuances of stock	1	4	—	—	4
Other comprehensive income, net of tax	—	—	—	—	—
Cash dividends of \$0.62 per share	—	—	(27)	—	(27)
Stock-based compensation	—	4	(9)	—	(5)
Repurchases of stock	(1)	—	(33)	—	(33)
Balance at August 3, 2018	43	\$ 8	\$ 355	\$ 4	\$367

See accompanying notes to condensed and consolidated financial statements.

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 (UNAUDITED)

	Six Months Ended August 3, 2018 (in millions)	August 4, 2017
Cash flows from operating activities:		
Net income	\$ 98	\$ 85
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	22	22
Stock-based compensation expense	16	15
Increase (decrease) resulting from changes in operating assets and liabilities:		
Receivables	(34)	(100)
Inventory, prepaid expenses and other current assets	6	38
Other assets	(12)	—
Accounts payable and accrued liabilities	(36)	(8)
Accrued payroll and employee benefits	13	(2)
Other long-term liabilities	3	3
Net cash provided by operating activities	76	53
Cash flows from investing activities:		
Expenditures for property, plant, and equipment	(18)	(7)
Other	1	—
Net cash used in investing activities	(17)	(7)
Cash flows from financing activities:		
Dividend payments to stockholders	(27)	(28)

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Principal payments on borrowings	(17)	(9)
Issuances of stock	3		3	
Stock repurchased and retired or withheld for taxes on equity awards	(55)	(105)
Disbursements for obligations assumed from Scitor acquisition	—		(2)
Proceeds from borrowings	—		25	
Deferred financing costs	(1)	—	
Net cash used in financing activities	(97)	(116)
Net decrease in cash, cash equivalents and restricted cash	(38)	(70)
Cash, cash equivalents and restricted cash at beginning of period	152		218	
Cash, cash equivalents and restricted cash at end of period (Note 1)	\$ 114		\$ 148	

See accompanying notes to condensed and consolidated financial statements.

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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. \$2 million of restructuring costs

for employee severance were included in cost of revenues for the three and six months ended August 4, 2017 in the condensed and consolidated statements of income and comprehensive income. The Company made \$1 million in cash payments for severance during the six months ended August 3, 2018 and made no cash payments for severance during the three months ended August 3, 2018 or the three and six months ended August 4, 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 7 for further discussion on the Company's derivative instruments designated as cash flow hedges.

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:

	August 31, 2018	February 2, 2018
	(in millions)	
Cash and cash equivalents	\$ 106	\$ 144
Restricted cash included in other assets	8	8
Cash, cash equivalents and restricted cash	\$ 114	\$ 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.

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.

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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 (in millions)	Adjustments due to ASC 606 (in millions)	Opening Balance at February 3, 2018
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 six months ended August 3, 2018 were as follows:

	Three Months Ended August 3, 2018			Six Months Ended August 3, 2018		
	Balances without Effect		Effect of change	Balances without Effect		Effect of change
As reported	adoption of ASC 606	of ASC 606		As reported	adoption of ASC 606	
	(in millions)			(in millions)		
Income Statement						
Revenues	\$1,115	\$ 1,117	\$ (2)	\$2,290	\$ 2,302	\$ (12)
Cost of revenues	1,003	1,006	(3)	2,077	2,089	(12)
Operating income	\$74	\$ 73	\$ 1	\$140	\$ 140	\$ —
	August 3, 2018					

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	As reported	Balances without adoption of ASC 606	Effect of change
(in millions)			
Balance Sheet			
Assets			
Receivables, net	\$ 713	\$ 705	\$ 8
Inventories, prepaid expenses and other current assets	107	115	(8)
Other assets	32	30	2
Liabilities and Equity			
Accounts payable and accrued liabilities	450	451	(1)
Retained earnings	\$ 355	\$ 352	\$ 3

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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 has commenced the assessment phase of the project and is evaluating the impact on its financial statements from the future adoption of the standard.

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 August 3, 2018 are not expected to have a material effect on the Company's financial statements.

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	Six Months Ended
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	August 3, 2018	August 4, 2017	August 3, 2018	August 4, 2017
	(in millions)			
Basic weighted-average number of shares outstanding	42.5	43.6	42.4	43.7
Dilutive common share equivalents - stock options and other stock-based awards	0.7	1.1	0.9	1.4
Diluted weighted-average number of shares outstanding	43.2	44.7	43.3	45.1

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

	Three Months Ended		Six Months Ended	
	August 3, 2018	August 4, 2017	August 3, 2018	August 4, 2017
	(in millions)			
Antidilutive stock options excluded	0.1	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.

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.

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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").

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.

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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 \$2 million (\$0.03 per diluted share) for the three months ended August 3, 2018, decreased operating income by \$3 million (\$0.05 per diluted share) for the six months ended August 3, 2018, increased operating income by \$1 million (\$0.01 per diluted share) for the three months ended August 4, 2017, and decreased operating income by \$4 million (\$0.06 per diluted share) for the six months ended August 4, 2017. In addition, revenues were \$2 million and \$3 million higher for the three and six months ended August 3, 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 was as follows:

	Three Months Ended August 3, 2018	Six Months Ended August 3, 2018
	(in millions)	
Department of Defense	\$678	\$1,424
Other federal government agencies	417	830
Commercial, state and local	20	36
Total	\$1,115	\$2,290

Disaggregated revenues by contract-type was as follows:

	Three Months	Six Months
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	Ended	Ended
	August 3, 2018	
	(in millions)	
Cost reimbursement	\$532	\$ 1,065
Time and materials (T&M)	295	610
Firm-fixed price (FFP)	288	615
Total	\$1,115	\$ 2,290

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Disaggregated revenues by prime vs. subcontractor was as follows:

	Three Months Ended August 3, 2018 (in millions)	Six Months Ended August 3, 2018 (in millions)
Prime contractor to federal government	\$ 1,014	\$ 2,091
Subcontractor to federal government	81	163
Other	20	36
Total	\$ 1,115	\$ 2,290

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	August 3, 2018	February 3, 2018 ⁽¹⁾
		(in millions)	
Billed and billable receivables, net ⁽²⁾	Receivables, net	\$553	\$ 510
Contract assets ⁽³⁾	Receivables, net	160	169
Contract liabilities - current	Accounts payable and accrued liabilities	\$25	\$ 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.

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

(3) Includes contract retentions of \$9 million and \$11 million as of August 3, 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 six months ended August 3, 2018, the Company recognized revenues of \$9 million relating to amounts that were included in the opening balance of contract liabilities - current as of February 3, 2018. No revenues were recognized for the three months ended August 3, 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.

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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	August 3, 2018	February 3, 2018 ⁽¹⁾
		(in millions)	
Pre-contract costs	Inventory, prepaid expenses and other current assets	\$ 4	\$ 1
Fulfillment costs - current	Inventory, prepaid expenses and other current assets	2	3
Fulfillment costs - non-current	Other assets	\$ 8	\$ —

⁽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 \$2 million were expensed during the three and six months ended August 3, 2018. Fulfillment costs amortized during the three and six months ended August 3, 2018 were not material.

Remaining Performance Obligations

As of August 3, 2018, the Company had \$1.0 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 70% of the remaining performance obligations over the next 12 months and approximately 90% over the next 24 months, with the remaining recognized thereafter.

Note 4—Stock-Based Compensation:

Stock Options

During the six months ended August 3, 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 six months ended August 3, 2018, the Company granted certain employees 0.4 million RSUs with a weighted-average grant date fair value of \$85.17, which will vest ratably on each anniversary of the grant date over a four-year period.

Performance Shares

During the six months ended August 3, 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.

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Note 5—Income Taxes:

The Company's effective income tax rate was 23.1% and 17.2% for the three and six months ended August 3, 2018, respectively, and 26.5% and 15.8% for the three and six months ended August 4, 2017, respectively. The Company's effective tax rate was lower for the three months ended August 3, 2018 compared to the prior year period due to the lower statutory federal income tax rate, 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"). The Company's effective tax rate was higher for the six months ended August 3, 2018 compared to the prior year period due to lower excess tax benefits for share-based compensation, the repeal of the manufacturer's deduction and changes in deductibility of executive compensation due to the Tax Act, partially offset by the lower statutory federal income tax rate. Tax rates for the periods ended August 3, 2018 were lower than the combined federal and state statutory rates due to excess tax benefits related to employee share-based compensation and research and development credits.

As of August 3, 2018, the balance of unrecognized tax benefits included liabilities for uncertainty in income taxes of \$8 million; \$7 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. \$8 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 August 3, 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 six months ended August 3, 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.

Note 6—Debt Obligations:

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

August 3, 2018

February 2, 2018

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	Stated interest rate	Effective interest rate	Principal	Unamortized Debt Issuance Costs (in millions)	Net	Principal	Unamortized Debt Issuance Costs	Net
Term Loan A Facility due August 2021	3.88	% 4.01	% \$618	\$ (2)	\$616	\$635	\$ (2)	\$633
Term Loan B Facility due May 2022	4.38	%						