Ascena Retail Group, Inc.
Form 10-Q
December 06, 2012

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 October 27, 2012

or

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

Commission File Number: 0-11736

ASCENA RETAIL GROUP, INC.

(Exact name of registrant as specified in its charter)

Delaware	30-0641353
(State or other jurisdiction of incorporation or organization)	*(I.R.S. Employer Identification No.)*
30 Dunnigan Drive, Suffern, New York	10901
(Address of principal executive offices)	*(Zip Code)*

(845) 369-4500

(Registrant's telephone number, including area code)

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes x No ¨

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

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

Large accelerated filer x Accelerated filer ¨ Non-accelerated filer ¨ Smaller reporting company ¨

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act).

Yes ¨ No x

The Registrant had 157,491,731 shares of common stock outstanding as of November 29, 2012.

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ASCENA RETAIL GROUP, INC.

CONSOLIDATED BALANCE SHEETS

	October 27, 2012	July 28, 2012
	(millions, except per share data)	
	(unaudited)	
ASSETS		
Current assets:		
Cash and cash equivalents	$ 132.6	$ 164.3
Short-term investments	0.9	1.4
Inventories	604.0	533.4
Assets related to discontinued operations	181.1	133.6
Deferred tax assets	48.9	48.7
Prepaid expenses and other current assets	187.2	158.8
Total current assets	1,154.7	1,040.2
Non-current investments	3.4	3.2
Property and equipment, net	693.8	674.2
Goodwill	597.6	593.2
Other intangible assets, net	453.0	453.7
Other assets	41.8	42.6
Total assets	$ 2,944.3	$ 2,807.1
LIABILITIES AND EQUITY		
Current liabilities:		
Accounts payable	$ 284.6	$ 252.8
Accrued expenses and other current liabilities	261.5	261.2
Deferred income	41.9	42.7
Liabilities related to discontinued operations	169.3	118.6
Income taxes payable	7.4	6.1
Current portion of long-term debt	3.9	4.2
Total current liabilities	768.6	685.6
Long-term debt	300.8	322.4
Lease-related liabilities	243.4	240.5
Deferred income taxes	75.3	60.6
Other non-current liabilities	150.6	157.1
Commitments and contingencies (Note 11)		
Total liabilities	1,538.7	1,466.2
Equity:		
Common stock, par value $0.01 per share; 157.4 million and 154.8 million shares issued and outstanding	1.6	1.5
Additional paid-in capital	549.9	528.8
Retained earnings	855.0	811.9
Accumulated other comprehensive (loss)	(0.9)	(1.3)

Total equity	1,405.6	1,340.9
Total liabilities and equity	$ 2,944.3	$ 2,807.1

See accompanying notes.

ASCENA RETAIL GROUP, INC.

CONSOLIDATED STATEMENTS OF OPERATIONS

	Three Months Ended	
	October 27, 2012	October 29, 2011
	(millions, except per share data) (unaudited)	
Net sales	$ 1,137.5	$ 768.3
Cost of goods sold	(481.9)	(328.5)
Gross margin	655.6	439.8
Other costs and expenses:		
Buying, distribution and occupancy costs	(205.8)	(126.3)
Selling, general and administrative expenses	(339.3)	(212.9)
Depreciation and amortization expense	(37.6)	(24.1)
Total other costs and expenses	(582.7)	(363.3)
Operating income	72.9	76.5
Interest expense	(4.8)	(0.2)
Interest and other income, net	0.3	0.9
Income from continuing operations before provision for income taxes	68.4	77.2
Provision for income taxes from continuing operations	(22.2)	(29.7)
Income from continuing operations	46.2	47.5
Loss from discontinued operations, net of taxes (1)	(3.1)	—
Net income	$ 43.1	$ 47.5
Net income (loss) per common share - basic:		
Continuing operations	$ 0.30	$ 0.31
Discontinued operations	(0.02)	—
Total net income per basic common share	$ 0.28	$ 0.31
Net income (loss) per common share – diluted:		
Continuing operations	$ 0.29	$ 0.30
Discontinued operations	(0.02)	—
Total net income per diluted common share	$ 0.27	$ 0.30
Weighted average common shares outstanding:		
Basic	155.0	153.9
Diluted	161.3	158.5

[1] Loss from discontinued operations is presented net of a $3.1 million income tax benefit for the three months ended October 27, 2012.

See accompanying notes.

ASCENA RETAIL GROUP, INC.

CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME

	Three Months Ended	
	October 27, 2012	October 29, 2011
	(millions) (unaudited)	
Net income	$ 43.1	$ 47.5
Other comprehensive income (loss), net of tax:		
Net change in unrealized gains (losses) on available-for-sale investments [1]	0.2	(0.2)
Foreign currency translation adjustment	0.2	(0.2)
Total other comprehensive income (loss)	0.4	(0.4)
Total comprehensive income	$ 43.5	$ 47.1

[1] No tax benefits have been provided in any period primarily due to the uncertainty of realization of cumulative capital loss tax benefits.

See accompanying notes.

ASCENA RETAIL GROUP, INC.

CONSOLIDATED STATEMENTS OF CASH FLOWS

	Three Months Ended	
	October 27, 2012	October 29, 2011
	(millions) (unaudited)	
Cash flows from operating activities:		
Net income	$ 43.1	$ 47.5
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization expense	37.6	24.1
Deferred income tax expense	0.4	3.0
Deferred rent and other occupancy costs	(4.1)	(6.9)
Loss on sales of assets	1.5	—
Non-cash stock-based compensation expense	7.5	7.5
Non-cash impairments of assets	0.5	0.9
Non-cash interest expense	0.3	0.2
Other non-cash (income) expense	0.2	0.1
Excess tax benefits from stock-based compensation	(6.8)	(0.3)
Changes in operating assets and liabilities:		
Inventories	(73.2)	(36.4)
Accounts payable and accrued liabilities	46.3	7.1
Deferred income liabilities	0.3	0.3
Lease-related liabilities	7.0	7.6
Other balance sheet changes	(31.4)	2.1
Changes in net assets related to discontinued operations	2.1	—
Net cash provided by operating activities	31.3	56.8
Cash flows from investing activities:		
Purchases of investments	—	(19.4)
Proceeds from sales and maturities of investments	0.5	19.4
Capital expenditures	(60.5)	(27.6)
Net cash used in investing activities	(60.0)	(27.6)
Cash flows from financing activities:		
Repayments of debt	(21.9)	—
Payment of deferred financing costs	(1.7)	—
Repurchases of common stock	—	(28.7)
Proceeds from stock options exercised and employee stock purchases	13.8	1.7
Excess tax benefits from stock-based compensation	6.8	0.3
Net cash used in financing activities	(3.0)	(26.7)
Net increase (decrease) in cash and cash equivalents	(31.7)	2.5
Cash and cash equivalents at beginning of period	164.3	243.5

Cash and cash equivalents at end of period	$ 132.6	$ 246.0

See accompanying notes.

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ASCENA RETAIL GROUP, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

1. Description of Business

Ascena Retail Group, Inc., a Delaware corporation ("Ascena" or the "Company"), is a leading national specialty retailer of apparel for women and tween girls. On June 14, 2012, the Company acquired Charming Shoppes, Inc. ("Charming Shoppes") and its related family of retail brands. Accordingly, the Company now operates, through its wholly owned subsidiaries, the following principal retail brands: **Justice**, **Lane Bryant**, **maurices**, **dressbarn** and **Catherines**. The Company now operates (through its subsidiaries) approximately 3,900 stores throughout the United States, Puerto Rico and Canada, with annual revenues on a pro forma basis of over $4.5 billion for the fiscal year ended July 28, 2012, giving effect to the acquisition of Charming Shoppes as of the beginning of such year. Ascena and its subsidiaries are collectively referred to herein as the "Company," "we," "us," "our" and "ourselves," unless the context indicate otherwise.

The Company classifies its businesses into five segments following a brand-oriented approach: **Justice**, **Lane Bryant**, **maurices**, **dressbarn**, and **Catherines**. The **Justice** segment includes approximately 961 specialty retail and outlet stores, e-commerce operations, and certain licensed franchises in international territories. The **Justice** brand offers fashionable apparel to girls who are ages 7 to 14 in an environment designed to match the energetic lifestyle of tween girls. The **Lane Bryant** segment includes approximately 815 specialty retail and outlet stores, and e-commerce operations. The **Lane Bryant** brand offers fashionable and sophisticated plus-size apparel under multiple private labels to female customers in the 35 to 55 age range. The **maurices** segment includes approximately 840 specialty retail and outlet stores, and e-commerce operations. The **maurices** brand offers up-to-date fashion designed to appeal to the 17 to 34 year-old female, with stores concentrated in small markets (approximately 25,000 to 100,000 people). The **dressbarn** segment includes approximately 840 specialty retail and outlet stores, and e-commerce operations. The **dressbarn** brand primarily attracts female consumers in the mid-30's to mid-50's age range and offers moderate-to-better quality career, special occasion and casual fashion to the working woman. The **Catherines** segment includes approximately 417 specialty retail and outlet stores, and e-commerce operations. The **Catherines** brand offers classic apparel and accessories for wear-to-work and casual lifestyles in a full range of plus sizes, generally catering to the female customer 45 years and older.

2. Basis of Presentation

Interim Financial Statements

The interim consolidated financial statements have been prepared pursuant to the rules and regulations of the Securities and Exchange Commission (the “SEC”). The interim consolidated financial statements are unaudited. In the opinion of management, however, such consolidated financial statements contain all normal and recurring adjustments necessary to present fairly the consolidated financial condition, results of operations and changes in cash flows of the Company for the interim periods presented. In addition, certain information and footnote disclosures normally included in financial statements prepared in accordance with the accounting principles generally accepted in the U.S. (“US GAAP”) have been condensed or omitted from this report as is permitted by the SEC’s rules and regulations. However, the Company believes that the disclosures herein are adequate to make the information presented not misleading.

The consolidated balance sheet data as of July 28, 2012 is derived from the audited consolidated financial statements included in the Company’s Annual Report on Form 10-K filed with the SEC for the fiscal year ended July 28, 2012 (the “Fiscal 2012 10-K”), which should be read in conjunction with these interim financial statements. Reference is made to the Fiscal 2012 10-K for a complete set of financial statements.

Basis of Consolidation

The consolidated financial statements are prepared in accordance with US GAAP, and present the financial position, results of operations and cash flows of the Company and all entities in which the Company has a controlling voting interest. The consolidated financial statements also include the accounts of any variable interest entities in which the Company is considered to be the primary beneficiary and such entities are required to be consolidated in accordance with US GAAP. There were no variable interest entities as of October 27, 2012.

All significant intercompany balances and transactions have been eliminated in consolidation.

ASCENA RETAIL GROUP, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS – (Continued)

Use of Estimates

The preparation of financial statements in conformity with US GAAP requires management to make estimates and assumptions that affect the amounts reported in the financial statements and footnotes thereto. Actual results could differ materially from those estimates.

Significant estimates inherent in the preparation of the consolidated financial statements include: the realizability of inventory; reserves for litigation and other contingencies; useful lives and impairments of long-lived tangible and intangible assets; accounting for income taxes and related uncertain tax positions; the valuation of stock-based compensation and related expected forfeiture rates; insurance reserves; and accounting for business combinations.

Fiscal Year

The Company utilizes a 52-53 week fiscal year ending on the last Saturday in July. As such, fiscal year 2013 will end on July 27, 2013 and will be a 52-week period ("Fiscal 2013"). Fiscal 2012 ended on July 28, 2012 and reflected a 52-week period ("Fiscal 2012"). The first quarter of Fiscal 2013 ended on October 27, 2012 and was a 13-week period. The first quarter of Fiscal 2012 ended on October 29, 2011 and was also a 13-week period.

The financial position and operating results of the Company's newly acquired sourcing operations of Charming Shoppes located in Hong Kong ("Charming Sourcing") are reported on a one-month lag. Accordingly, the Company's operating results for the first quarter of Fiscal 2013 include the operating results of Charming Sourcing for the post-acquisition period from July 1, 2012 through September 29, 2012. The net effect of this reporting lag is not material to the consolidated financial statements.

Discontinued Operations

In connection with the acquisition of Charming Shoppes in June 2012, certain acquired businesses have been classified as a component of discontinued operations within the consolidated financial statements.

In particular, the Company announced, contemporaneously with the closing of the acquisition of Charming Shoppes, its intent to cease operating the acquired **Fashion Bug** business. The **Fashion Bug** business, consisting of approximately 600 retail stores, is expected to be closed down by early in calendar year 2013 through an orderly liquidation of the related net assets.

In addition, the Company also announced, contemporaneously with the closing of the acquisition of Charming Shoppes, its intent to sell the acquired **Figi's** business. The **Figi's** business, which markets food and specialty gift products, is expected to be sold by the one-year anniversary date of the closing of the acquisition of Charming Shoppes.

As those businesses are available for disposal in their present conditions and active disposition efforts have already been implemented at prices that are reasonable in relation to current fair value, such businesses have been classified as discontinued operations within the consolidated financial statements. As such, assets and liabilities relating to discontinued operations have been segregated and separately disclosed in the balance sheets as of October 27, 2012 and July 28, 2012. In turn, operating results for those businesses, including $148.5 million of revenues for the post-acquisition three months ended October 27, 2012, have also been segregated and reported separately in the consolidated financial statements for the first quarter of Fiscal 2013.

ASCENA RETAIL GROUP, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS – (Continued)

The major components of assets and liabilities related to discontinued operations are summarized below:

	October 27, 2012	July 28, 2012
	(millions)	
Accounts receivable	$7.1	$6.8
Inventories	111.7	77.2
Property and equipment, net	32.1	31.9
Other intangible assets, net	8.0	5.0
Other assets	22.2	12.7
Total assets related to discontinued operations	$181.1	$133.6
Accounts payable and other current liabilities	$148.5	$93.6
Lease-related liabilities	18.0	18.0
Other liabilities	2.8	7.0
Total liabilities related to discontinued operations	$169.3	$118.6

Seasonality of Business

The Company's business is typically affected by seasonal sales trends primarily resulting from the timing of holiday and back-to-school shopping periods. In particular, **Justice** sales and operating profits tend to be significantly higher during the fall season which occurs during the first and second quarters of the fiscal year, as this includes the back-to-school period and the holiday selling period which is focused on gift-giving merchandise. The **dressbarn** and **maurices** brands have historically experienced lower earnings in the second fiscal quarter ending in January than during the three other fiscal quarters, reflecting the intense promotional environment that generally has characterized the holiday shopping season in recent years. The newly acquired **Lane Bryant** and **Catherines** brands typically experience peak sales during the Easter, Memorial Day and December holiday seasons. In addition, the Company's operating results and cash flows may fluctuate materially in any quarterly period depending on, among other things, increases or decreases in comparable store sales, adverse weather conditions, shifts in the timing of certain holidays and changes in merchandise mix. Accordingly, the Company's operating results and cash flows for the three-month period ended October 27, 2012 are not necessarily indicative of the operating results and cash flows that may be expected for the full year of Fiscal 2013.

Reclassifications

Buying, Distribution and Occupancy Costs

Historically, the Company included buying, distribution and occupancy costs within cost of goods sold on the face of its statement of operations. However, in the fourth quarter of Fiscal 2012, in connection with conforming the financial presentation of Charming Shoppes, the Company decided to present each of the aggregate of buying, distribution and occupancy costs and gross margin separately on the face of its statement of operations. In addition, certain costs, such as store utility costs, were reclassified from selling, general and administrative expenses to buying, distribution and occupancy costs. Financial information for all prior periods has been reclassified in order to conform to the current period's presentation. There have been no changes in historical operating income or historical net income for any period as a result of these changes.

ASCENA RETAIL GROUP, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS – (Continued)

3. Summary of Significant Accounting Policies

Revenue Recognition

Revenue is recognized across all segments of the business when there is persuasive evidence of an arrangement, delivery has occurred, price has been fixed or is determinable, and collectability is reasonably assured.

Retail store revenue is recognized net of estimated returns at the time of sale to consumers. E-commerce revenue from sales of products ordered through the Company's retail internet sites and revenue from direct-mail orders through **Justice's** catazine are recognized upon delivery and receipt of the shipment by our customers. Such revenue also is reduced by an estimate of returns.

Reserves for estimated product returns are recorded based on historical return trends and are adjusted for known events, as applicable.

Gift cards, gift certificates and merchandise credits (collectively, "gift cards") issued by the Company are recorded as a deferred income liability until they are redeemed, at which point revenue is recognized. Gift cards do not have expiration dates. The Company recognizes income for unredeemed gift cards when the likelihood of a gift card being redeemed by a customer is remote and the Company determines that it does not have a legal obligation to remit the value of the unredeemed gift card to the relevant jurisdiction as unclaimed or abandoned property. Gift card breakage is included in net sales in the consolidated statements of operations, and historically has not been material.

In addition to retail-store and e-commerce sales, the **Justice** segment recognizes revenue from licensing arrangements with franchised stores, advertising and other "tween-right" marketing arrangements with partner companies, as well as merchandise shipments to other third-party retailers. Revenue associated with merchandise shipments is recognized at the time title passes and risk of loss is transferred to customers, which generally occurs at the date of shipment. Royalty payments received under license agreements for the use of the **Justice** trade name and amounts received in connection with advertising and marketing arrangements with partner companies are recognized when earned in accordance with the terms of the underlying agreements.

The Company accounts for sales and other related taxes on a net basis, thereby excluding such taxes from revenue.

Cost of Goods Sold

Cost of goods sold ("COGS") consists of all costs of merchandise (net of purchase discounts and vendor allowances), merchandise acquisition costs (primarily commissions and import fees), in-bound freight to our distribution centers, and changes in reserve levels for inventory realizability and shrinkage.

Our cost of goods sold may not be comparable to those of other entities. Some entities, like us, exclude costs related to their distribution network, buying function and store occupancy costs from cost of goods sold and include them in other costs and expenses, whereas other entities include costs related to their distribution network, buying function and all store occupancy costs in their cost of goods sold.

Buying, Distribution and Occupancy costs

Buying, distribution and occupancy costs consist of store occupancy and utility costs (excluding depreciation), out-bound freight (including costs to ship merchandise between our distribution centers and our retail stores), and all costs associated with the buying and distribution functions.

Selling, General and Administrative Expenses

Selling, general and administrative expenses ("SG&A expenses") consist of compensation and benefit-related costs for sales and store operations personnel, administrative personnel and other employees not associated with the functions described above under buying, distribution and occupancy costs. SG&A expenses also include advertising and marketing costs, information technology and communication costs, supplies for our stores and administrative facilities, insurance costs, legal costs and costs related to other administrative services.

ASCENA RETAIL GROUP, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS – (Continued)

Income Taxes

Income taxes are provided using the asset and liability method. Under this method, income taxes (i.e., deferred tax assets and liabilities, current taxes payable/refunds receivable and tax expense) are recorded based on amounts refundable or payable in the current year, and include the results of any differences between US GAAP and tax reporting. Deferred income taxes reflect the tax effect of certain net operating loss, capital loss and general business credit carry forwards and the net tax effects of temporary differences between the carrying amount of assets and liabilities for financial statement and income tax purposes, as determined under enacted tax laws and rates. The Company accounts for the financial effect of changes in tax laws or rates in the period of enactment.

In addition, valuation allowances are established when management determines that it is more-likely-than-not that some portion or all of a deferred tax asset will not be realized. Tax valuation allowances are analyzed periodically and adjusted as events occur, or circumstances change, that warrant adjustments to those balances.

In determining the income tax provision for financial reporting purposes, the Company establishes a reserve for uncertain tax positions. If the Company considers that a tax position is “more-likely-than-not” of being sustained upon audit, based solely on the technical merits of the position, it recognizes the tax benefit. The Company measures the tax benefit by determining the largest amount that is greater than 50% likely of being realized upon settlement, presuming that the tax position is examined by the appropriate taxing authority that has full knowledge of all relevant information. These assessments can be complex and the Company often obtains assistance from external advisors. To the extent that the Company’s estimates change or the final tax outcome of these matters is different than the amounts recorded, such differences will impact the income tax provision in the period in which such determinations are made. If the initial assessment fails to result in the recognition of a tax benefit, the Company regularly monitors its position and subsequently recognizes the tax benefit if (i) there are changes in tax law or analogous case law that sufficiently raise the likelihood of prevailing on the technical merits of the position to “more-likely-than-not,” (ii) the statute of limitation expires, or (iii) there is a completion of an audit resulting in a settlement of that tax year with the appropriate agency. Uncertain tax positions are classified as current only when the Company expects to pay cash within the next twelve months. Interest and penalties, if any, are recorded within the provision for income taxes in the Company’s consolidated statements of operations and are classified on the consolidated balance sheets with the related liability for unrecognized tax benefits.

The Company’s liability for unrecognized tax benefits (including accrued interest and penalties), which is included in other non-current liabilities in the accompanying consolidated balance sheets, was $50.7 million as of October 27, 2012 and $61.7 million as of July 28, 2012. The Company’s liability for uncertain tax positions decreased by $11.0

million in the first quarter of Fiscal 2013 primarily as a result of the reversal of certain liabilities associated with uncertain tax positions due largely to the expiration of applicable federal and state income tax statutes of limitations for certain years in the first quarter of Fiscal 2013 and the filing of certain accounting method changes for federal income tax purposes. The amount of this liability is subject to change based on future events including, but not limited to, the settlements of ongoing audits and/or the expiration of applicable statues of limitations. Although the outcomes and timing of such events are highly uncertain, the Company anticipates that the balance of the liability for unrecognized tax benefits will decrease by approximately $6.8 million, excluding interest and penalties, during the next twelve months. However, changes in the occurrence, expected outcomes and timing of those events could cause the Company's current estimate to change materially in the future.

Net Income Per Common Share

Basic net income per common share is computed by dividing the net income applicable to common shares after preferred dividend requirements, if any, by the weighted-average number of common shares outstanding during the period. Diluted net income per common share adjusts basic net income per common share for the effects of outstanding stock options, restricted stock, restricted stock units, convertible debt securities and any other potentially dilutive financial instruments, only in the periods in which such effect is dilutive under the treasury stock method.

ASCENA RETAIL GROUP, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS – (Continued)

The weighted-average number of common shares outstanding used to calculate basic net income per common share is reconciled to those shares used in calculating diluted net income per common share as follows:

	Three Months Ended	
	October 27, 2012	October 29, 2011
	(millions)	
Basic	155.0	153.9
Dilutive effect of stock options, restricted stock, restricted stock units and convertible debt securities	6.3	4.6
Diluted shares	161.3	158.5

Options to purchase shares of common stock at an exercise price greater than the average market price of the common stock during the reporting period are anti-dilutive, and therefore not included in the computation of diluted net income per common share. In addition, the Company has outstanding restricted stock units that are issuable only upon the achievement of certain service and/or performance or market-based goals. Such performance or market-based restricted stock units are included in the computation of diluted shares only to the extent the underlying performance or market conditions (a) are satisfied prior to the end of the reporting period or (b) would be satisfied if the end of the reporting period were the end of the related contingency period and the result would be dilutive under the treasury stock method. As of October 27, 2012 and October 29, 2011, there was an aggregate of approximately 3.1 million and 6.4 million, respectively, of additional shares issuable upon the exercise of anti-dilutive options and/or the contingent vesting of performance-based and market-based restricted stock units that were excluded from the diluted share calculations.

4. Acquisitions and Dispositions

The Charming Shoppes Acquisition

In June 2012, the Company acquired Charming Shoppes, which owns and operates multiple retail brands through over 1,800 retail stores and e-commerce operations including: **Lane Bryant**; **Catherines**; **Fashion Bug**; and **Figi's**, in an all cash transaction at $7.35 per share, for an aggregate purchase price of $882.1 million (excluding the assumption of debt and transaction costs) (collectively, the "Charming Shoppes Acquisition"). The acquisition was funded with $325 million from new borrowings including (a) a $300 million six-year, variable-rate term loan and (b) $25 million of

borrowings under the Company's existing revolving credit facility, which was amended in connection with the transaction. The remainder was funded through available cash and cash equivalents and the liquidation of substantially all of the Company's investment portfolio.

The Company accounted for the Charming Shoppes Acquisition under the purchase method of accounting for business combinations. Accordingly, the cost to acquire such assets was allocated to the underlying net assets in proportion to estimates of their respective fair values. Any excess of the purchase price over the estimated fair value of the net assets acquired was recorded as goodwill. Given the close proximity of the closing date of the acquisition to the end of the Company's fiscal year, the allocation of the purchase price to the underlying net assets is preliminary at this time. The Company does not expect to finalize its valuation of the net assets acquired until the Fall of 2012, particularly as it relates to the valuation of both of the **Fashion Bug** and **Figi's** businesses.

The acquisition cost of $882.1 million was allocated to the acquired net assets on a preliminary basis based on their respective estimated fair values, as follows: cash and cash equivalents of $203.5 million; inventories of $192.0 million; net assets related to discontinued operations of $51.7 million; other current and non-current assets of $89.6 million; net current and non-current deferred tax assets of $97.7 million; property and equipment of $170.6 million; non-tax deductible goodwill of $363.3 million; intangible assets (consisting primarily of brands and trademarks) of $270.7 million; current liabilities of $196.9 million; long-term debt of $146.2 million; and other net liabilities of $213.9 million.

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ASCENA RETAIL GROUP, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS – (Continued)

The results of operations of Charming Shoppes have been consolidated in the Company's results of operations commencing on June 14, 2012, the effective date of the Charming Shoppes Acquisition. Such post-acquisition results included in the Company's consolidated statement of operations for the first quarter of Fiscal 2013 consist of the following:

	Three Months Ended October 27, 2012 (millions)
Net sales	$ 302.6
Loss from continuing operations	(14.5)
Loss from discontinued operations, net of taxes	(3.1)
Net loss	(17.6)

The following unaudited pro forma financial information is presented to supplement the historical financial information presented herein relating to the Charming Shoppes Acquisition and the related redemption of substantially all of the Charming Shoppes convertible notes, as more fully described in Note 14 to the Company's consolidated financial statements included in the Fiscal 2012 10-K. This pro forma information has been prepared as if the Charming Shoppes Acquisition and related redemption of its convertible notes had occurred as of the beginning of Fiscal 2012. The pro forma financial information is not indicative of the operating results that would have been obtained had the transactions actually occurred as of that date, nor is it necessarily indicative of the Company's future operating results.

	Three Months Ended October 29, 2011 (millions, except per share data)
Pro forma net sales	$ 1,066.2
Pro forma income from continuing operations	$ 42.0
Pro forma net income from continuing operations per common share:	
Basic	$ 0.27
Diluted	$ 0.26

5. Inventories

Inventories substantially consist of finished goods merchandise. Inventory by brand is set forth below:

	October 27, 2012	July 28, 2012	October 29, 2011
	(millions)		
Justice	$ 182.2	$ 154.1	$ 175.3
Lane Bryant [a]	153.7	139.3	—
maurices	104.1	94.1	99.4
dressbarn	120.8	111.1	127.0
Catherines [a]	43.2	34.8	—
Total inventories	$ 604.0	$ 533.4	$ 401.7

[a] The Charming Shoppes Acquisition was consummated on June 14, 2012 and, therefore, inventory amounts for **Lane Bryant** and **Catherines** are not included as of October 29, 2011.

ASCENA RETAIL GROUP, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS – (Continued)

6. Fair Value Measurements

Fair Value Measurements of Financial Instruments

Certain financial assets and liabilities are required to be carried at fair value. Fair value is 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. In determining fair value, the Company utilizes market data or assumptions that it believes market participants would use in pricing the asset or liability, which would maximize the use of observable inputs and minimize the use of unobservable inputs to the extent possible, including assumptions about risk and the risks inherent in the inputs to the valuation technique.

Cash, cash equivalents and restricted cash are recorded at carrying value, which approximates fair value. Available-for-sale investments in debt securities, which consist primarily of one investment in auction rate securities (“ARS”), have a book value of $2.9 million and a par value of $3.9 million at October 27, 2012. Those ARS are recorded at fair value using significant unobservable inputs (level three measurements), which was lower than the related cost basis in the investments by approximately $1.0 million at October 27, 2012 and $1.2 million at July 28, 2012. As the Company’s primary debt obligations are variable rate, there are no significant differences between the fair value and carrying value of the Company’s debt obligations.

The Company’s non-financial instruments, which primarily consist of goodwill, intangible assets, and property and equipment, are not required to be measured at fair value on a recurring basis and are reported at carrying value. However, on a periodic basis whenever events or changes in circumstances indicate that their carrying value may not be recoverable (and at least annually for goodwill and other indefinite-lived intangible assets), non-financial instruments are assessed for impairment and, if applicable, written-down to (and recorded at) fair value.

7. Impairments

Long-Lived Assets Impairment

Property and equipment, along with other long-lived assets, are evaluated for impairment periodically whenever events or changes in circumstances indicate that their related carrying amounts may not be recoverable. In evaluating long-lived assets for recoverability, the Company uses its best estimate of future cash flows expected to result from the use of the asset and its eventual disposition. To the extent that estimated future undiscounted net cash flows attributable to the asset are less than the carrying amount, an impairment loss is recognized equal to the difference between the carrying value of such asset and its fair value.

Fiscal 2013 Impairment

During the first quarter of Fiscal 2013, the Company recorded an aggregate of $0.5 million in non-cash impairment charges, including $0.3 million in its **maurices** segment and $0.2 million in its **dressbarn** segment. These charges reduced the net carrying value of certain long-lived assets to their estimated fair value, which was determined based on discounted expected cash flows. These impairment charges were primarily related to the lower-than-expected operating performance of certain retail stores. There were no impairment charges recorded at **Justice**, **Lane Bryant** or **Catherines** during the first quarter of Fiscal 2013.

Fiscal 2012 Impairment

During the first quarter of Fiscal 2012, the Company recorded an aggregate $0.9 million in non-cash impairment charges, including $0.1 million in its **Justice** segment, $0.3 million in its **maurices** segment, and $0.5 million in its **dressbarn** segment. These charges reduced the net carrying value of certain long-lived assets to their estimated fair value, which was determined based on discounted expected cash flows. These impairment charges were primarily related to the lower-than-expected operating performance of certain retail stores.

Such impairment charges are included as a component of SG&A expenses in the accompanying consolidated statements of operations for all periods.

ASCENA RETAIL GROUP, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS – (Continued)

8. Debt

Debt consists of the following:	October 27, 2012	July 28, 2012
	(millions)	
Term loan [a]	$ 296.4	$ 297.2
Revolving credit agreement	—	20.0
Charming Shoppes convertible notes	0.6	1.2
Mortgage notes	7.7	8.2
	304.7	326.6
Less: current portion	(3.9)	(4.2)
Total long-term debt	$ 300.8	$ 322.4

[a] The Term Loan is presented net of a $2.8 million original issue discount as of both October 27, 2012 and July 28, 2012.

Term Loan

In connection with the funding of the Charming Shoppes Acquisition, the Company incurred a $300 million Term Loan which matures on June 14, 2018. The Term Loan has mandatory quarterly repayments of 0.25%, or approximately $0.75 million, with a remaining balloon payment required at maturity. The Term Loan has been recorded net of an original issue discount of $3 million, which is being amortized to interest expense over the contractual life of the Term Loan. The Company has the right to prepay the Term Loan in any amount and at any time. Interest rates under the Term Loan are variable and are calculated using a base rate equal to the greater of (i) prime rate, (ii) federal funds rate, or (iii) LIBO rate (subject to a 1% floor); plus an applicable margin ranging from 225 basis points to 375 basis points based on a combination of the type of borrowing (prime or LIBOR) and the Company's total leverage ratio existing at the end of the previous fiscal quarter.

Revolving Credit Agreement

The Company's revolving credit facility (the "Revolving Credit Agreement") provides a senior secured revolving credit facility for up to $250 million of availability, with an optional additional increase of up to $50 million. The Revolving Credit Agreement expires in June 2017. There are no mandatory reductions in borrowing availability throughout the term of the Revolving Credit Agreement. The Revolving Credit Agreement may be used for the issuance of letters of

credit, to finance the acquisition of working capital assets in the ordinary course of business and capital expenditures, and for general corporate purposes. The Revolving Credit Agreement includes a $175 million letter of credit sublimit, of which $40 million can be used for standby letters of credit, and a $25 million swing loan sublimit.

Borrowings under the Revolving Credit Agreement bear interest at a variable rate determined using a base rate equal to the greater of (i) prime rate, (ii) federal funds rate, or (iii) LIBO rate; plus an applicable margin ranging from 50 basis points to 200 basis points based a combination of the type of borrowing (prime or LIBOR) and the Company's average borrowing availability during the previous fiscal quarter.

In addition to paying interest on any outstanding borrowings under the Revolving Credit Agreement, the Company is required to pay a commitment fee to the lenders under the Revolving Credit Agreement in respect of the unutilized commitments in the amount of 37.5 basis points per annum.

As of October 27, 2012, after taking in account the $21.5 million in outstanding letters of credit, the Company had $228.5 million available under the Revolving Credit Agreement.

Restrictions under the Term Loan and Revolving Credit Agreement

The Term Loan and Revolving Credit Agreement are subject to similar restrictions, as summarized below.

ASCENA RETAIL GROUP, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS – (Continued)

The Term Loan has financial covenants with respect to a senior secured leverage ratio, which is defined as a ratio of senior secured indebtedness to consolidated EBITDA. For such purposes, consolidated EBITDA is defined generally as net income plus (i) income tax expense, (ii) interest expense, (iii) depreciation and amortization expense, (iv) non-recurring, acquisition-related expenses, and (v) restructuring charges not exceeding predetermined limits. Consolidated fixed charges are defined generally as the sum of (a) cash interest expense, (b) rent expense, (c) cash tax expense, (d) mandatory principal repayment, (e) capital lease payments, (f) mandatory cash contributions to any employee benefit plan and (g) any restricted payments paid in cash. The Company is required to maintain a maximum senior secured leverage ratio for any period of four consecutive quarters of no greater than 1.75 to 1.00. As of October 27, 2012, the actual senior secured leverage ratio was 0.55 to 1.00. The Company was in compliance with all financial covenants contained in the Term Loan as of October 27, 2012.

The Revolving Credit Agreement has financial covenants with respect to a fixed charge coverage ratio, which is defined as a ratio of consolidated EBITDAR, less capital expenditures to consolidated fixed charges. For such purposes, consolidated EBITDAR is defined generally as net income plus (i) income tax expense, (ii) interest expense, (iii) depreciation and amortization expense, (iv) rent expense, (v) non-recurring acquisition-related expenses, and (vi) restructuring charges not exceeding predetermined limits. Consolidated fixed charges are defined generally as the sum of (a) cash interest expense, (b) rent expense, (c) cash tax expense, (d) mandatory principal repayment, (e) capital lease payments, (f) mandatory cash contributions to any employee benefit plan and (g) any restricted payments paid in cash. The Company is required to maintain a minimum fixed charge coverage ratio for any period of four consecutive fiscal quarters of at least 1.00 to 1.00. As of October 27, 2012, the actual fixed charge coverage ratio was 1.41 to 1.00. The Company was in compliance with all financial covenants contained in the Revolving Credit Agreement as of October 27, 2012.

In addition to the above, the borrowing agreements contain customary negative covenants, subject to negotiated exceptions, on (i) liens and guarantees, (ii) investments, (iii) indebtedness, (iv) significant corporate changes including mergers and acquisitions, (v) dispositions, (vi) restricted payments, cash dividends and certain other restrictive agreements. The borrowing agreements also contain customary events of default, such as payment defaults, cross-defaults to other material indebtedness, bankruptcy and insolvency, the occurrence of a defined change in control, or the failure to observe the negative covenants and other covenants related to the operation of the Company’s business.

The Company’s obligations under the borrowing agreements are guaranteed by certain of its domestic subsidiaries (the “Subsidiary Guarantors”). As collateral security under the borrowing agreements and the guarantees thereof, the Company and the Subsidiary Guarantors have granted to the administrative agent for the benefit of the lenders, a first priority lien on substantially all of their tangible and intangible assets, including, without limitation, certain domestic inventory and certain material real estate.

Other Letters of Credit

As of October 27, 2012, the Company had also issued $41.7 million of private label letters of credit relating to the importation of merchandise.

9. Equity

Summary of Changes in Equity:	Three Months Ended	
	October 27, 2012	October 29, 2011
	(millions)	
Balance at beginning of period	$ 1,340.9	$ 1,158.0
Total comprehensive income	43.5	47.1
Other	(6.9)	—
Purchases of common stock	—	(28.7)
Shares issued and equity grants made pursuant to stock-based compensation plans	28.1	9.6
Balance at end of period	$ 1,405.6	$ 1,186.0

Common Stock Repurchase Program

In Fiscal 2010, the Company's Board of Directors authorized a $100 million share repurchase program (the "2010 Stock Repurchase Program"). The program was then expanded in Fiscal 2011 to cover an additional $100 million of authorized purchases. Under the 2010 Stock Repurchase Program, purchases of shares of common stock may be made at the Company's discretion from time to time, subject to overall business and market conditions.

ASCENA RETAIL GROUP, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS – (Continued)

There were no purchases of common stock by Company during the first quarter of Fiscal 2013. Repurchased shares normally are retired and treated as authorized but unissued shares.

The remaining availability under the Stock Repurchase Program was approximately $89.9 million at October 27, 2012.

Dividends

The Company has never declared or paid cash dividends on its common stock. However, payment of dividends is within the discretion and are payable when declared by the Company’s Board of Directors. Additionally, payments of dividends are limited by the Company’s Revolving Credit Agreement as described in the Note 8, *“Revolving Credit Agreement.”*

10. Stock-based Compensation

Long-term Stock Incentive Plan

The Company issues stock-based compensation awards under its 2010 Stock Incentive Plan (as amended, the “2010 Stock Plan”), which was approved by the Company’s shareholders on December 17, 2010. The 2010 Stock Plan provides for the granting of either incentive stock options or non-qualified options to purchase shares of common stock, as well as the award of shares of restricted stock and other stock-based awards (including restricted stock units), to eligible employees and directors of the Company. The 2010 Stock Plan is scheduled to expire on September 30, 2021.

As of October 27, 2012, there were approximately 0.6 million shares under the 2010 Stock Plan available for future grants. All of the Company’s prior stock option plans have expired as to the ability to grant new options. The Company issues new shares of common stock when stock option awards are exercised.

Impact on Results

A summary of the total compensation expense and associated income tax benefit recognized related to stock-based compensation arrangements is as follows:

	Three Months Ended	
	October 27, 2012	October 29, **2011**
	(millions)	
Compensation expense	$ 7.5	$ 7.5
Income tax benefit	$ (2.7)	$ (2.8)

Stock Options

Stock option awards outstanding under the Company’s current plans have been granted at exercise prices that are equal to or exceed the market value of its common stock on the date of grant. Such options generally vest over four or five years and expire no later than ten years after the grant date. The Company recognizes compensation expense ratably over the vesting period, net of estimated forfeitures. The Company uses the Black-Scholes option-pricing model to estimate the fair value of stock options granted, which requires the input of both subjective and objective assumptions as follows:

Expected Term — The estimate of expected term is based on the historical exercise behavior of grantees, as well as the contractual life of the option grants.

Expected Volatility — The expected volatility factor is based on the historical volatility of the Company's common stock for a period equal to the stock options expected term.

Expected Dividend Yield — The expected dividend yield is based on the Company's historical practice of not paying dividends on its common stock.

Risk-free Interest Rate — The risk-free interest rate is determined using the implied yield for a traded zero-coupon U.S. Treasury bond with a term equal to the option's expected term.

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ASCENA RETAIL GROUP, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS – (Continued)

The Company's weighted-average assumptions used to estimate the fair value of stock options granted during the three months ended October 27, 2012 and October 29, 2011 are presented as follows:

	Three Months Ended			
	October 27, 2012		October 29, 2011	
Expected term (years)	4.0		4.0	
Expected volatility	41.7	%	41.7	%
Risk-free interest rate	0.7	%	0.9	%
Expected dividend yield	0	%	0	%
Weighted-average grant date fair value	$ 7.39		$ 4.71	

A summary of the stock option activity under all plans during the three months ended October 27, 2012 is as follows:

	October 27, 2012			
	Number of Shares	Weighted-Average Exercise Price	Weighted-Average Remaining Contractual Terms	**Aggregate Intrinsic Value [a]**
	(thousands)		(years)	(millions)
Options outstanding- July 28, 2012	14,103.0	$ 9.69	6.4	$ 130.1
Granted	2,110.3	20.79		
Exercised	(1,755.5)	8.16		
Cancelled/Forfeited	(350.1)	11.67		
Options outstanding – October 27, 2012	14,107.7	$ 11.49	6.8	$ 122.2
Options vested and expected to vest at October 27, 2012 [b]	13,839.3	$ 11.41	6.8	$ 120.9
Options exercisable at October 27, 2012	7,181.5	$ 8.47	5.2	$ 83.1

[a] The intrinsic value is the amount by which the market price at the end of the period of the underlying share of stock exceeds the exercise price of the stock option.

[b] The number of options expected to vest takes into consideration estimated expected forfeitures.

As of October 27, 2012, there was $34.5 million of total unrecognized compensation cost related to non-vested options, which is expected to be recognized over a remaining weighted-average vesting period of 2.9 years. The total intrinsic value of options exercised during the three months ended October 27, 2012 was approximately $22.0 million and during the three months ended October 29, 2011 was approximately $1.7 million. The total fair value of options that vested during the three months ended October 27, 2012 was approximately $10.1 million and during the three months ended October 29, 2011 was approximately $7.2 million.

Restricted Equity Awards

The 2010 Stock Plan also allows for the issuance of shares of restricted stock and restricted stock units ("RSUs"). Any shares of restricted stock or RSUs are counted against the shares available for future grant limit as three shares for every one restricted share or RSU granted. In general, if options are cancelled for any reason or expire, the shares covered by such options again become available for grant. If a share of restricted stock or a RSU is forfeited for any reason, three shares become available for grant.

Shares of restricted stock and RSUs are issued with either service-based or performance-based conditions, and some even have market-based conditions (collectively, "Restricted Equity Awards"). Service-based Restricted Equity Awards entitle the holder to receive unrestricted shares of common stock of the Company at the end of a vesting period, subject to the grantee's continuing employment. Service-based Restricted Equity Awards generally vest over a 4 year period of time.

Performance-based or market-based Restricted Equity Awards also entitle the holder to receive shares of common stock of the Company at the end of a vesting period. However, such awards are subject to (a) the grantee's continuing employment, (b) the Company's achievement of certain performance goals over a pre-defined performance period and (c) in the case of market-based conditions, the Company's achievement of certain market-based goals over the pre-defined performance period. Both performance-based and market-based Restricted Equity Awards generally vest over a 3 year period of time.

ASCENA RETAIL GROUP, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS – (Continued)

The fair values of both service-based and performance-based Restricted Equity Awards are based on the fair value of the Company's unrestricted common stock at the date of grant. However, for market-based Restricted Equity Awards, the effect of the market conditions is reflected in the fair value of the awards on the date of grant using a Monte-Carlo simulation model. A Monte-Carlo simulation model estimates the fair value of the market-based award based on the expected term, risk-free interest rate, expected dividend yield and expected volatility measure for the Company and its peer group.

Compensation expense for both service-based and performance-based Restricted Equity Awards is recognized over the vesting period based on the grant-date fair values of the awards that are expected to vest based upon the service and performance-based conditions. However, compensation expense for market-based Restricted Equity Awards is recognized over the vesting period regardless of whether the market conditions are expected to be achieved.

A summary of Restricted Equity Awards activity during the three months ended October 27, 2012 is as follows:

	Service-based Restricted Equity Awards		Performance-based Restricted Equity Awards		Market-based Restricted Equity Awards	
	Number of Shares (thousands)	Weighted-Average Grant Date Fair Value Per Share	Number of Shares (thousands)	Weighted-Average Grant Date Fair Value Per Share	Number of Shares (thousands)	Weighted-Average Grant Date Fair Value Per Share
Nonvested at July 28, 2012	1,206.1	$ 14.27	1,475.0	$ 12.69	326.6	$ 12.90
Granted	1,116.6	20.63	—	—	—	—
Vested	(414.5)	16.83	—	—	—	—
Cancelled/Forfeited	(26.0)	12.66	(1,060.0)	12.72	(213.0)	13.70
Nonvested at October 27, 2012	1,882.2	$ 17.56	415.0	$ 12.61	113.6	$ 11.40

	Service-based Restricted Equity Awards	Performance-based Restricted Equity Awards	Market-based Restricted Equity Awards
Total unrecognized compensation at October 27, 2012 (millions)	$ 29.6	$ 3.9	$ 1.0
Weighted-average years expected to be recognized over (years)	2.2	0.8	1.0

Cash-Settled Long-Term Incentive Plan Awards

In October 2012, the Compensation Committee of the Board of Directors approved certain modifications to a portion of the Company's outstanding, performance-based stock-settled awards. In particular, an aggregate of approximately 554 thousand performance-based, stock-settled awards held by 44 employees were canceled in exchange for grants of a corresponding amount of new awards that will be settled in cash (collectively, the "Cash-Settled LTIP Awards"). Other than the terms of settlement, the Cash-Settled LTIP Awards have identical restrictions and rights as the prior awards. The Cash-Settled LTIP Awards entitle the holder to a cash payment equal to the value of the number of shares of the Company's common stock earned at the end of an original three-year performance period. Consistent with the terms of the original awards, such awards are subject to (a) the grantee's continuing employment and (b) the Company's achievement of certain performance goals over a pre-defined three year performance period for, separately, the Fiscal 2011-2013 period and the Fiscal 2012-2014 period.

Compensation expense for the Cash-Settled LTIP Awards will be recognized over the original vesting period based on changes in the Company's stock price over time. As a result of this modification to the outstanding, original awards, the Company recognized a $1.7 million, one-time charge during the first quarter of Fiscal 2013. Such amount has been included as a component of selling, general and administrative expenses in the accompanying statement of operations.

ASCENA RETAIL GROUP, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS – (Continued)

11. Commitments and Contingencies

The Company is a defendant in lawsuits and other adversary proceedings arising in the ordinary course of business. Legal costs incurred in connection with the resolution of claims and lawsuits are generally expensed as incurred, and the Company establishes reserves for the outcome of litigation where it deems appropriate to do so under applicable accounting rules. Moreover, the Company's assessment of the current exposure could change in the event of the discovery of additional facts with respect to legal matters pending against the Company or determinations by judges, juries, administrative agencies or other finders of fact that are not in accordance with the Company's evaluation of claims. The results of these lawsuits, claims and proceedings cannot be predicted with certainty. However, the Company believes that the ultimate resolution of these matters will not have a material effect on the Company’s consolidated financial statements.

The Company's identified contingencies include the matters set out below. The Company intends to defend these matters vigorously, as appropriate.

Six lawsuits were filed challenging the proposed acquisition of Charming Shoppes by Ascena. Five of these lawsuits have been consolidated in state court in Pennsylvania, and one case remains in Federal court in Pennsylvania. In general, plaintiffs sued the Charming Shoppes’ board of directors for breach of their fiduciary duties under Pennsylvania state law in connection with the sale process, negotiations and public disclosures about the transaction. Ascena was sued for allegedly aiding and abetting the Charming Shoppes’ board of directors’ breach of their fiduciary duties. The parties reached an agreement in principle to settle the state and federal litigations on the basis of supplemental disclosures only, and settlement papers are expected to be filed with the court shortly. Pursuant to the settlement, Plaintiffs will seek an award of attorneys’ fees from the court, and any award will be paid by Ascena, as Charming Shoppes’ parent company. The amount of attorneys’ fees so payable is not expected to have a material adverse effect on the Company’s consolidated financial statements.

12. Segment Information

The Company’s segment reporting structure reflects a brand-focused approach, designed to optimize the operational coordination and resource allocation of its businesses across multiple functional areas including specialty retail, e-commerce and licensing. The five reportable segments described below represent the Company’s brand-based activities for which separate financial information is available and which is utilized on a regular basis by the

Company's executive team to evaluate performance and allocate resources. In identifying reportable segments, the Company considers economic characteristics, as well as products, customers, sales growth potential and long-term profitability. As such, the Company's reports its operations in five reportable segments as follows:

- **Justice** segment – consists of the specialty retail, outlet, e-commerce and licensing operations of the **Justice** brand.
- **Lane Bryant** segment – consists of the specialty retail, outlet and e-commerce operations of the **Lane Bryant** brand.
- **maurices** segment – consists of the specialty retail, outlet and e-commerce operations of the **maurices** brand.
- **dressbarn** segment – consists of the specialty retail, outlet and e-commerce operations of the **dressbarn** brand.
- **Catherines** segment - consists of the specialty retail, outlet and e-commerce operations of the **Catherines** brand.

The accounting policies of the Company's reporting segments are consistent with those described in Notes 2 and 3 to the Company's consolidated financial statements included in the Fiscal 2012 10-K. All intercompany revenues are eliminated in consolidation. Corporate overhead expenses are allocated to the segments based upon specific usage or other reasonable allocation methods.

ASCENA RETAIL GROUP, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS – (Continued)

Net sales, operating income (loss), and depreciation and amortization expense for each segment are as follows:

	Three Months Ended	
	October 27, 2012	October 29, 2011
	(millions)	
Net sales:		
Justice	$ 358.3	$ 320.0
Lane Bryant [a]	229.8	—
maurices	224.6	202.9
dressbarn	252.0	245.4
Catherines [a]	72.8	—
Total net sales	$ 1,137.5	$ 768.3
Operating income (loss):		
Justice	$ 56.3	$ 47.8
Lane Bryant [a]	(17.0)	—
maurices	29.6	23.7
dressbarn	9.0	5.0
Catherines [a]	1.4	—
Subtotal	79.3	76.5
Less unallocated acquisition-related, integration and restructuring costs	(6.4)	—
Total operating income	$ 72.9	$ 76.5
Depreciation and amortization expense:		
Justice	$ 12.0	$ 9.9
Lane Bryant [a]	9.8	—
maurices	6.8	6.5
dressbarn	7.7	7.7
Catherines [a]	1.3	—
Total depreciation and amortization expense	$ 37.6	$ 24.1

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[a] The Charming Shoppes Acquisition was consummated on June 14, 2012; therefore the data related to the **Lane Bryant** and **Catherines** segments for the prior reporting period is not presented.

13. Additional Financial Information

Cash Interest and Taxes:	Three Months Ended October 27, 2012	October 29, 2011
	(millions)	
Cash paid for interest	$5.5	$ —
Cash paid for income taxes	$4.1	$ 5.9

Non-cash Transactions

Significant non-cash investing activities included the capitalization of fixed assets and recognition of related obligations in the net amount of $11.5 million for the three months ended October 27, 2012 and $10.9 million for the three months ended October 29, 2011.

There were no other significant non-cash investing or financing activities for the three months ended October 27, 2012 or October 29, 2011.

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

Forward-Looking Statements

Various statements in this Form 10-Q, in future filings by us with the Securities and Exchange Commission (the "SEC"), in our press releases and in oral statements made from time to time by us or on our behalf constitute "forward-looking statements" within the meaning of the Private Securities Litigation Reform Act of 1995. Forward-looking statements are based on current expectations and are indicated by words or phrases such as "anticipate," "estimate," "expect," "project," "we believe," "is or remains optimistic," "currently envisions" and similar words or phrases and involve known and unknown risks, uncertainties and other factors which may cause actual results, performance or achievements to be materially different from the future results, performance or achievements expressed in or implied by such forward-looking statements.

These forward-looking statements are based largely on our expectations and judgments and are subject to a number of risks and uncertainties, many of which are unforeseeable and beyond our control. A detailed discussion of significant risk factors that have the potential to cause our actual results to differ materially from our expectations is included in our Annual Report on Form 10-K for the fiscal year ended July 28, 2012 (the "Fiscal 2012 10-K"). There are no material changes to such risk factors, nor are there any identifiable previously undisclosed risks as set forth in Part II, Item 1A — "Risk Factors" of this Form 10-Q. We undertake no obligation to publicly update or revise any forward-looking statements, whether as a result of new information, future events or otherwise.

INTRODUCTION

Management discussion and analysis of financial condition and results of operations ("MD&A") is provided as a supplement to the accompanying unaudited interim consolidated financial statements and footnotes to help provide an understanding of our financial condition and liquidity, changes in financial condition and results of our operations. MD&A is organized as follows:

- *Overview.* This section provides a general description of our business and a summary of financial performance for the three-month period ended October 27, 2012. In addition, this section includes a discussion of recent developments and transactions affecting comparability that we believe are important in understanding our results of operations and financial condition, and in anticipating future trends.

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- *Results of operations.* This section provides an analysis of our results of operations for the three-month periods ending October 27, 2012 and October 29, 2011.

- *Financial condition and liquidity.* This section provides an analysis of our cash flows for the three-month periods ending October 27, 2012 and October 29, 2011, as well as a discussion of our financial condition and liquidity as of October 27, 2012. The discussion of our financial condition and liquidity includes (i) our available financial capacity under our credit facility, (ii) a summary of our key debt compliance measures, (iii) anticipated capital expenditures, and (iv) any material changes in financial condition and commitments since the end of Fiscal 2012.

- *Market risk management.* This section discusses any significant changes in our risk exposures related to interest rates, foreign currency exchange rates and our investments, as well as the underlying market conditions since the end of Fiscal 2012.

- *Critical accounting policies.* This section discusses any significant changes in our accounting policies since the end of Fiscal 2012. Significant changes include those considered to be important to our financial condition and results of operations, which require significant judgment and estimation on the part of management in their application. In addition, all of our significant accounting policies, including our critical accounting policies, are summarized in Notes 3 and 4 to our audited consolidated financial statements included in our Fiscal 2012 10-K.

- *Recently issued accounting pronouncements.* This section notes that we have assessed the potential impact to our reported financial condition and results of operations of accounting standards that have been recently issued.

In this Form 10-Q, references to "Ascena," "ourselves," "we," "our," "us" and the "Company" refer to Ascena Retail Group, Inc. and its subsidiaries, unless the context indicates otherwise. We utilize a 52-53 week fiscal year ending on the last Saturday in July. As such, fiscal year 2013 will end on July 27, 2013 and will be a 52-week period (“Fiscal 2013”). Fiscal 2012 ended on July 28, 2012 and reflected a 52-week period (“Fiscal 2012”). The first quarter of Fiscal 2013 ended on October 27, 2012 and was a 13-week period. The first quarter of Fiscal 2012 ended on October 29, 2011 and was also a 13-week period.

OVERVIEW

Our Business

On June 14, 2012, the Company acquired Charming Shoppes, Inc. ("Charming Shoppes") and its related family of retail brands. Accordingly, the Company now operates, through its wholly owned subsidiaries, the following principal retail brands: **Justice**; **Lane Bryant**; **maurices**; **dressbarn** and **Catherines**. The Company now operates (through its subsidiaries) approximately 3,900 stores throughout the United States, Puerto Rico and Canada, with annual revenues on a pro forma basis of over $4.5 billion for Fiscal 2012, giving effect to the acquisition of Charming Shoppes as of the beginning of such year.

We classify our businesses into five segments following a brand-oriented approach: **Justice**; **Lane Bryant**; **maurices**; **dressbarn** and **Catherines**. The **Justice** segment includes approximately 961 specialty retail and outlet stores, e-commerce operations, and certain licensed franchises in international territories. The **Justice** brand offers fashionable apparel to girls who are ages 7 to 14 in an environment designed to match the energetic lifestyle of tween girls. The **Lane Bryant** segment includes approximately 815 specialty retail and outlet stores, and e-commerce operations. The **Lane Bryant** brand offers fashionable and sophisticated plus-size apparel under multiple private labels to female customers in the 35 to 55 age range. The **maurices** segment includes approximately 840 specialty retail and outlet stores, and e-commerce operations. The **maurices** brand offers up-to-date fashion designed to appeal to the 17 to 34 year-old female, with stores concentrated in small markets (approximately 25,000 to 100,000 people). The **dressbarn** segment includes approximately 840 specialty retail and outlet stores, and e-commerce operations. The **dressbarn** brand primarily attracts female consumers in the mid-30's to mid-50's age range and offers moderate-to-better quality career, special occasion and casual fashion to the working woman. The **Catherines** segment includes approximately 417 specialty retail and outlet stores, and e-commerce operations. The **Catherines** brand offers classic apparel and accessories for wear-to-work and casual lifestyles in a full range of plus sizes, generally catering to the female customer 45 years and older.

Seasonality of Business

Our business is typically affected by seasonal sales trends primarily resulting from the timing of holiday and back-to-school shopping periods. In particular, **Justice** sales and operating profits tend to be significantly higher during the fall season which occurs during the first and second quarters of our fiscal year, as this includes the back-to-school period and the holiday selling period which is focused on gift-giving merchandise. The **dressbarn** and **maurices** brands have historically experienced lower earnings in the second fiscal quarter ending in January than during the three other fiscal quarters, reflecting the intense promotional environment that generally has characterized the holiday shopping season in recent years. The newly acquired **Lane Bryant** and **Catherines** brands typically experience peak sales during the Easter, Memorial Day and December holiday seasons. In addition, our operating results and cash flows may fluctuate materially in any quarterly period depending on, among other things, increases or

decreases in comparable store sales, adverse weather conditions, shifts in the timing of certain holidays and changes in merchandise mix.

Basis of Presentation

Discontinued Operations

In June 2012, the Company announced, contemporaneously with the closing of the Charming Shoppes Acquisition, its intent to cease operating the acquired **Fashion Bug** business. The **Fashion Bug** business, consisting of approximately 600 retail stores, is expected to be closed down by early in calendar year 2013 through an orderly liquidation of the related net assets.

In addition, the Company also announced, contemporaneously with the closing of the Charming Shoppes Acquisition, its intent to sell the acquired **Figi's** business. The **Figi's** business, which markets food and specialty gift products, is expected to be sold by the one-year anniversary date of the closing of the Charming Shoppes Acquisition.

Given the Company's intent to exit both of those businesses, their financial position and operating results have been classified as discontinued operations within the accompanying consolidated financial statements of the Company.

Reclassifications

Buying, Distribution and Occupancy Costs

Historically, the Company included buying, distribution and occupancy costs within cost of goods sold on the face of its statement of operations. However, in the fourth quarter of Fiscal 2012, in connection with conforming the financial presentation of Charming Shoppes, the Company decided to present each of the aggregate of buying, distribution and occupancy costs and gross margin separately on the face of its statement of operations. In addition, certain costs, such as store utility costs, were reclassified from selling, general and administrative expenses to buying, distribution and occupancy costs. Financial information for all prior periods has been reclassified in order to conform to the current period's presentation. There have been no changes in historical operating income or historical net income for any period as a result of these changes.

Summary of Financial Performance

General Economic Conditions

Our performance is subject to macroeconomic conditions and their impact on levels of consumer spending. Some of the factors negatively impacting discretionary consumer spending include general economic conditions, wages and high unemployment, high consumer debt, reductions in net worth based on severe market declines (such as in residential real estate markets), increased taxation, higher fuel, energy and other prices, increasing interest rates, and low consumer confidence. In addition, any significant volatility in our financial markets, as has been experienced in the past, could also negatively impact the levels of future discretionary consumer spending. While the U.S. and certain other international economies have improved since the global financial crisis commenced in Fall 2008, a prolonged economic downturn and slow recovery, including high rates of unemployment, rising commodity prices and declining real estate market values, could have a material effect on our business, financial condition and results of operations.

Operating Results

Three Months Ended October 27, 2012 compared to Three Months Ended October 29, 2011

For the three months ended October 27, 2012, we reported net sales of $1,137.5 million, income from continuing operations of $46.2 million and net income from continuing operations per diluted share of $0.29. This compares to net sales of $768.3 million, income from continuing operations of $47.5 million and net income from continuing operations per diluted share of $0.30 for the three months ended October 29, 2011. Including a $3.1 million loss on discontinued operations, net income was $43.1 million and net income per diluted share was $0.27 for the three months ended October 27, 2012. The decrease in net income and net income per diluted share during the three months ended October 27, 2012 was a direct result of the incurrence of an aggregate of $26.3 million of non-recurring purchase accounting costs and certain acquisition-related, integration and restructuring costs relating to the Charming Shoppes Acquisition, as discussed more fully hereinafter.

Our operating performance for the three months ended October 27, 2012 was positively affected by a 48.1% increase in net sales, consisting of 8.7% organic growth from our legacy family of brands and 39.4% growth from the Charming Shoppes Acquisition. The increase in net sales from our legacy family of brands was driven by both our comparable store sales and new store growth, as well as strong growth in e-commerce sales. Our gross margin rate increased 40 basis points to 57.6%, primarily due to stronger margin at **maurices**, **dressbarn**, **Lane Bryant**, and **Catherines,** which more than offset lower margins at **Justice** due to increased promotional activity. In addition, the gross margin performance in the first quarter of Fiscal 2013 was negatively affected by the incurrence of $19.9 million of one-time, non-cash inventory expense associated with the write-up of Charming Shoppes's inventory to fair market

value as of the acquisition date.

Operating income decreased $3.6 million, consisting of a $18.4 million, or 24.1% increase from our legacy family of brands and a $22.0 million decrease relating to the Charming Shoppes Acquisition. The operating loss from Charming Shoppes reflected the approximate $19.9 million of one-time, non-cash inventory expense and $6.4 million of certain acquisition-related, integration and restructuring costs. In turn, the increased operating income from our legacy family of brands primarily reflected the flow-through of margin on the higher sales volume and an increase in gross margin rate.

The provision for income taxes from continuing operations decreased by $7.5 million to $22.2 million. The effective tax rate decreased 600 basis points, to 32.5% for three months ended October 27, 2012 from 38.5% for the three months ended October 29, 2011. The decrease in the effective tax rate was primarily the result of the reversal of certain liabilities associated with uncertain tax positions due largely to the expiration of applicable federal and state income tax statutes of limitations for certain years in the first quarter of Fiscal 2013.

Income from continuing operations decreased $1.3 million to $46.2 million as the decrease in operating income and $4.6 million of higher interest expense relating to debt incurred to fund the Charming Shoppes Acquisition more than offset the lower tax provision described above. Net income from continuing operations per diluted share decreased by $0.01, or 3.3%, to $0.29 per share for three months ended October 27, 2012 from $0.30 per share for the three months ended October 29, 2011. The decrease in diluted earnings per share results was primarily due to the lower level of net income and an increase in the weighted average diluted common shares outstanding.

Financial Condition and Liquidity

We ended the first quarter of Fiscal 2013 in a net debt position of $167.8 million compared to $157.7 million as of the end of Fiscal 2012. The increase in our net debt position as of October 27, 2012 as compared to July 28, 2012 was primarily due to the use of cash to support our capital expenditures and the repayment of debt under our revolving credit agreement, offset in part by our operating cash flows.

Our equity increased to $1.406 billion as of October 27, 2012, compared to $1.341 billion as of July 28, 2012, primarily due to our net income during the first quarter of Fiscal 2013.

We generated $31.3 million of cash from operations during the three months ended October 27, 2012, compared to $56.8 million during the three months ended October 29, 2011. During the first quarter of Fiscal 2013, a significant portion of our available cash was used in the repayment of debt and to reinvest in our business through capital spending. In particular, we used $60.5 million for capital expenditures primarily associated with our retail store expansion and investments in our facilities and technological infrastructure.

Transactions Affecting Comparability of Results of Operations and Financial Condition

The comparability of the Company's operating results for three-month periods ended October 27, 2012 and October 29, 2011 presented herein has been affected by certain transactions, including:

- The Charming Shoppes Acquisition that closed on June 14, 2012, as described in Note 4 to the accompanying unaudited consolidated financial statements;
- Certain acquisition-related, integration and restructuring costs;
- Certain non-recurring purchase accounting costs;
- Pretax charges related to certain one-time, executive contractual obligation costs incurred in the first quarter of Fiscal 2012.

A summary of the effect of certain of these items on pretax income for each applicable period presented is noted below:

	Three Months Ended	
	October 27, 2012	October 29, 2011
	(millions)	
Acquisition-related, integration and restructuring costs [a]	$ (6.4)	$ (1.4)
One-time, non-cash inventory expense associated with the write-up of inventory to fair market value	(19.9)	—
Executive contractual obligation costs	—	(5.4)
Total	$ (26.3)	$ (6.8)

[a] Acquisition-related, integration and restructuring costs are classified within SG&A expenses in the accompanying consolidated statements of operations.

The following discussion of results of operations highlights, as necessary, the significant changes in operating results arising from these items and transactions. However, unusual items or transactions may occur in any period. Accordingly, investors and other financial statement users individually should consider the types of events and transactions that have affected operating trends.

RESULTS OF OPERATIONS

Our segment reporting structure reflects a brand-focused approach, designed to optimize the operational coordination and resource allocation of our businesses across multiple functional areas, including specialty retail, e-commerce and licensing. The five reportable segments described below represent our brand-based activities for which separate financial information is available, and which is utilized on a regular basis by our executive team to evaluate performance and allocate resources. In identifying our reportable segments, we consider economic characteristics, as well as products, customers, sales growth potential and long-term profitability. As such, we report our operations in five reportable segments as follows:

- **Justice** segment – consists of the specialty retail, outlet, e-commerce and licensing operations of the **Justice** brand.
- **Lane Bryant** segment – consists of the specialty retail, outlet and e-commerce operations of the **Lane Bryant** brand.
- **maurices** segment – consists of the specialty retail, outlet and e-commerce operations of the **maurices** brand.
- **dressbarn** segment – consists of the specialty retail, outlet and e-commerce operations of the **dressbarn** brand.
- **Catherines** segment - consists of the specialty retail, outlet and e-commerce operations of the **Catherines** brand.

Three Months Ended October 27, 2012 compared to Three Months Ended October 29, 2011

The following table summarizes our results of operations and expresses the percentage relationship to net sales of certain financial statement captions:

	Three Months Ended			
	October 27, 2012	October 29, 2011	$ Change	% Change
	(millions, except per share data)		(millions)	
Net sales	$ 1,137.5	$ 768.3	$369.2	48.1 %
Cost of goods sold	(481.9)	(328.5)	(153.4)	46.7 %
Cost of goods sold as % of net sales	42.4 %	42.8 %		
Gross margin	655.6	439.8	215.8	49.1 %
Gross margin as a % of net sales	57.6 %	57.2 %		
Other costs and expenses:				
Buying, distribution and occupancy costs	(205.8)	(126.3)	(79.5)	62.9 %
Buying, distribution and occupancy costs as % of net sales	18.1 %	16.4 %		
Selling, general and administrative expenses	(339.3)	(212.9)	(126.4)	59.4 %
SG&A as % of net sales	29.8 %	27.7 %		
Depreciation and amortization expense	(37.6)	(24.1)	(13.5)	56.0 %
Total other costs and expenses	(582.7)	(363.3)	(219.4)	60.4 %
Operating income	72.9	76.5	(3.6)	(4.7)%
Operating income as % of net sales	6.4 %	10.0 %		
Interest expense	(4.8)	(0.2)	(4.6)	2,300.0 %
Interest and other income, net	0.3	0.9	(0.6)	(66.7)%
Income from continuing operations before provision for income taxes	68.4	77.2	(8.8)	(11.4)%
Provision for income taxes from continuing operations	(22.2)	(29.7)	7.5	(25.3)%
Effective tax rate[(a)]	32.5 %	38.5 %		
Income from continuing operations	46.2	47.5	(1.3)	2.7 %
Loss from discontinued operations, net of taxes [(b)]	(3.1)	—	(3.1)	NM
Net income	$ 43.1	$ 47.5	$(4.4)	(9.3)%
Net income (loss) per common share - basic:				
Continuing operations	$ 0.30	$ 0.31	$(0.01)	(3.2)%
Discontinued operations	(0.02)	—	(0.02)	NM
Total net income per basic common share	$ 0.28	$ 0.31	$(0.03)	(9.7)%
Net income (loss) per common share - diluted:				
Continuing operations	$ 0.29	$ 0.30	$(0.01)	(3.3)%
Discontinued operations	(0.02)	—	(0.02)	NM

Total net income per diluted common share	$ 0.27	$ 0.30	$(0.03)	(10.0)%

[a] Effective tax rate is calculated by dividing the provision for income taxes by income from continuing operations before provision for income taxes.

[b] Loss from discontinued operations is presented net of a $3.1 million tax benefit for the three months ended October 27, 2012.

[NM] Not Meaningful

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Net Sales. Net sales increased by $369.2 million, or 48.1%, to $1,137.5 million for the three months ended October 27, 2012 from $768.3 million for the three months ended October 29, 2011. The increase in net sales consisted of 8.7% organic growth from our legacy family of brands and 39.4% from the Charming Shoppes Acquisition. The increase in net sales from our legacy family of brands was driven by both our comparable store sales growth and new store growth, as well as strong growth in e-commerce sales. On a consolidated basis, comparable store sales increased 1% during the three months ended October 27, 2012. Our brand sales increases were as follows: $38.3 million at **Justice**, $229.8 million at **Lane Bryant**, $21.7 million at **maurices**, $6.6 million at **dressbarn**, and $72.8 million at **Catherines**.

Net sales and comparable store sales data for our five business segments is presented below.

	Three Months Ended						
	October 27, 2012	October 29, 2011	$ Change	% Change		**Comparable Store Sales** [a]	
	(millions)		**(millions)**				
Net sales:							
Justice	$ 358.3	$ 320.0	$38.3	12.0	%	4	%
Lane Bryant [b]	229.8	—	229.8	NM	%	(4	)%
maurices	224.6	202.9	21.7	10.7	%	3	%
dressbarn	252.0	245.4	6.6	2.7	%	1	%
Catherines [b]	72.8	—	72.8	NM	%	4	%
Total net sales	$ 1,137.5	$ 768.3	$369.2	48.1	%	1	%

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[a] Comparable store sales generally refers to the growth of sales in only stores open in both the current period and comparative period in the prior year (including stores relocated within the same shopping center and stores with minor square footage additions). The determination of which stores are included in the comparable store sales calculation normally changes at the beginning of each fiscal year, except for stores that close during the fiscal year, which are excluded from comparable store sales beginning with the fiscal month the store actually closes. However, for acquired stores, such as in the case of **Lane Bryant** and **Catherines**, comparable store sales metrics for the initial first year of acquisition reflects sales from the acquisition date through the end of the fiscal period for all stores that were open in both that period and the comparable period in the prior year.

[b] The Charming Shoppes Acquisition was consummated on June 14, 2012; therefore the data related to the **Lane Bryant** and **Catherines** segments for the prior reporting period is not presented.

[NM] Not Meaningful

***Justice** net sales.* The net increase primarily reflects:

- an increase of $11.3 million, or 4%, in comparable store sales during the three months ended October 27, 2012;
- a $14.0 million increase in non-comparable stores sales, primarily driven by an increase related to 44 net new store openings during the last twelve months;
- an increase of $5.9 million in revenues from its e-commerce operations; and
- a $7.1 million increase in wholesale, licensing operations, and other revenues.

***Lane Bryant** net sales.* Net sales reflect the operation of 815 stores in the current year, as the acquisition was consummated on June 14, 2012, which resulted in $229.8 million of net sales during the three months ended October 27, 2012. Comparable store sales in the current period decreased 4%.

***maurices** net sales.* The net increase primarily reflects:

- an increase of $5.0 million, or 3%, in comparable store sales during the three months ended October 27, 2012;
- an $11.5 million increase in non-comparable stores sales, primarily driven by an increase related to 43 net new store openings during the last twelve months; and
- an increase of $5.2 million in revenues from e-commerce operations.

***dressbarn** net sales.* The net increase primarily reflects:

- an increase of $2.0 million, or 1%, in comparable store sales during the three months ended October 27, 2012;
- a $1.6 million increase in non-comparable stores sales, primarily driven by an increase related to 4 net new store openings during the last twelve months; and
- an increase of $3.0 million in revenues from e-commerce operations.

***Catherines** net sales.* Net sales reflect the operation of 417 stores in the current year, as the acquisition was consummated on June 14, 2012, which resulted in $72.8 million of net sales during the three months ended October 27, 2012. Comparable store sales in the current period increased 4%.

Gross Margin. Gross margin, which represents the difference between net sales and cost of goods sold, expressed as a percentage of net sales, increased by 40 basis points to 57.6% for the three months ended October 27, 2012 from 57.2% for the three months ended October 29, 2011. Our gross margin rate increased, primarily due to stronger margin at **maurices**, **dressbarn**, **Lane Bryant**, and **Catherines,** which more than offset lower margins at **Justice** due to increased promotional activity.

Gross margin as a percentage of net sales is dependent upon a variety of factors, including changes in the relative sales mix among brands, changes in the mix of products sold, the timing and level of promotional activities, and fluctuations in material costs. These factors, among others, may cause cost of goods sold as a percentage of net revenues to fluctuate from period to period.

Buying, Distribution and Occupancy costs. Buying, distribution and occupancy costs consist of store occupancy and utility costs (excluding depreciation), out-bound freight (including costs to ship merchandise between our distribution centers and our retail stores), and all costs associated with the buying and distribution functions.

Buying, distribution and occupancy costs increased by $79.5 million, or 62.9%, to $205.8 million for the three months ended October 27, 2012 from $126.3 million for the three months ended October 29, 2011. Buying, distribution and occupancy costs as a percentage of net sales increased by 170 basis points to 18.1% for the three months ended October 27, 2012 from 16.4% for the three months ended October 29, 2011. The increase in buying, distribution and occupancy costs both in dollars and as a percentage of net sales was primarily due to a change in store location mix, as Lane Bryant's higher mall-based mix of stores has higher store occupancy costs as a percentage of sales.

Selling, General and Administrative ("SG&A") Expenses. SG&A expenses consist of compensation and benefit-related costs for sales and store operations personnel, administrative personnel and other employees not associated with the functions described above under cost of goods sold. SG&A expenses also include advertising and marketing costs, information technology and communication costs, supplies for our stores and administrative facilities, insurance costs, legal costs and costs related to other administrative services.

SG&A expenses increased by $126.4 million, or 59.4%, to $339.3 million for the three months ended October 27, 2012 from $212.9 million for the three months ended October 29, 2011. SG&A expenses as a percentage of net sales increased by 210 basis points to 29.8% in the first quarter of Fiscal 2013 from 27.7% in the first quarter of Fiscal 2012. SG&A expenses, expressed both in dollars and as a percentage of sales, increased largely due to the current,

duplicative corporate overhead structure relating to the Charming Shoppes Acquisition, which is expected to be significantly scaled back over the next couple of years.

Depreciation and Amortization Expense. Depreciation and amortization expense increased by $13.5 million, or 56.0%, to $37.6 million for the three months ended October 27, 2012 from $24.1 million for the three months ended October 29, 2011. The increase was primarily due to the inclusion of Charming Shoppes, which contributed $11.1 million of incremental depreciation and amortization expense during the first quarter of Fiscal 2013. Also contributing to the increase was an increase in capital expenditures, which resulted, in part, from the net opening of 91 stores from our legacy family of brands during the last twelve months.

Operating Income. Operating income decreased $3.6 million, or 4.7%, to $72.9 million for the three months ended October 27, 2012 from $76.5 million for the three months ended October 29, 2011. The decrease consisted of a $18.4 million, or 24.1% increase from our legacy family of brands and a $22.0 million decrease relating to the Charming Shoppes Acquisition. The operating loss from Charming Shoppes reflected the approximate $19.9 million non-cash inventory expense and $6.4 million of certain acquisition-related, integration and restructuring costs. In turn, the increased operating income from our legacy family of brands primarily reflected the flow-through of margin on the higher sales volume and an increase in gross margin rate.

Operating income data for our five business segments is presented below.

	Three Months Ended			
	October 27, 2012	October 29, 2011	$ Change	% Change
	(millions)		(millions)	
Operating income (loss):				
Justice	$ 56.3	$ 47.8	$ 8.5	17.8 %
Lane Bryant [(a)]	(17.0)	—	(17.0)	NM
Maurices	29.6	23.7	5.9	24.9 %
dressbarn	9.0	5.0	4.0	80.0 %
Catherines [(a)]	1.4	—	1.4	NM
Subtotal	79.3	76.5	2.8	3.7 %
Less unallocated acquisition-related, integration and restructuring costs	(6.4)	—	(6.4)	NM
Total operating income	$ 72.9	$ 76.5	$ (3.6)	40

Dividends paid	(11)	(11)	(315)	(179)
Other financing activities, net	11	(1)	1	
Net cash provided by (used in) financing activities	106	(231)	(485)	(805)
Effect of exchange rate changes on cash and equivalents	(1)	10		1
Net increase (decrease) in cash and equivalents	27	(288)	(1)	8
Cash and equivalents at beginning of period	871	898	14	33
Cash and equivalents at end of period	$ 898	$ 610	$ 13	$ 41

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. and its majority-owned subsidiaries. We have prepared these unaudited consolidated financial statements in accordance with accounting principles generally accepted in the U.S. for interim financial information. Accordingly, these interim financial statements do not include all of the information and footnotes required by accounting principles generally accepted in the U.S. for complete financial statements. The consolidated interim financial statements included in this quarterly report should be read in conjunction with the consolidated financial statements included in our Annual Report on Form 10-K for the year ended December 31, 2011. 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 Inc. consolidated with its majority-owned subsidiaries that operate in the Cessna, Bell, Textron Systems and Industrial segments. The Finance group, which also is the Finance segment, consists of Textron Financial Corporation (TFC), its consolidated subsidiaries and three other finance subsidiaries owned by Textron Inc. 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 2012 and 2011, 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. The changes in estimates increased income from continuing operations before income taxes in the second quarter of 2012 and 2011 by $12 million and $10 million, respectively, ($8 million and $7 million after tax, or $0.03 and $0.02 per diluted share, respectively). For the second quarter of 2012 and 2011, the gross favorable program profit adjustments totaled $23 million and $21 million, respectively, and the gross unfavorable program profit adjustments totaled $11 million for each quarter.

The changes in estimates increased income from continuing operations before income taxes in the first half of 2012 and 2011 by $16 million and $24 million, ($10 million and $15 million after tax, or $0.04 and $0.05 per diluted share, respectively). For the first half of 2012 and 2011, the gross favorable program profit adjustments totaled $40 million and $42 million, respectively, and the gross unfavorable program profit adjustments totaled $24 million and $18 million, respectively.

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Note 2: 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)	June 30, 2012	July 2, 2011	June 30, 2012	July 2, 2011
Three Months Ended				
Service cost	$ 29	$ 32	$ 1	$ 2
Interest cost	76	82	7	8
Expected return on plan assets	(102)	(98)		
Amortization of prior service cost (credit)	4	4	(3)	(2)
Amortization of net loss	30	19	1	3
Net periodic benefit cost	$ 37	$ 39	$ 6	$ 11
Six Months Ended				
Service cost	$ 59	$ 64	$ 3	$ 4
Interest cost	152	164	13	16
Expected return on plan assets	(203)	(196)		
Amortization of prior service cost (credit)	8	8	(6)	(3)
Amortization of net loss	59	38	3	6
Net periodic benefit cost	$ 75	$ 78	$ 13	$ 23

Note 3: Earnings Per Share

We calculate basic and diluted earnings per share (EPS) based on net income, which approximates income available to common shareholders for each period. Basic EPS is calculated using the two-class method, which includes the weighted-average number of common shares outstanding during the period and restricted stock units to be paid in stock that are deemed participating securities as they provide nonforfeitable rights to dividends. Diluted EPS considers the dilutive effect of all potential future common stock, including stock options, restricted stock units and the shares that could be issued upon the conversion of our convertible notes and upon the exercise of the related warrants. The call options purchased in connection with the issuance of the convertible notes and the capped call transaction entered into in 2011 are excluded from the calculation of diluted EPS as their impact is always anti-dilutive.

Upon conversion of our convertible notes, as described in Note 8 of our 2011 Form 10-K, the principal amount would be settled in cash, and the excess of the conversion value, as defined, over the principal amount may be settled in cash and/or shares of our common stock. Therefore, only the shares of our common stock potentially issuable with respect to the excess of the notes conversion value over the principal amount, if any, are considered as dilutive potential common shares for purposes of calculating diluted EPS.

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

(In thousands)	**Three Months Ended** June 30, 2012	July 2, 2011	**Six Months Ended** June 30, 2012	July 2, 2011
Basic weighted-average shares outstanding	281,114	277,406	280,568	276,882
Dilutive effect of:				
Convertible notes and warrants	14,021	36,838	13,960	39,275
Stock options and restricted stock units	412	964	552	1,104
Diluted weighted-average shares outstanding	295,547	315,208	295,080	317,261

Stock options to purchase 7 million shares of common stock outstanding are excluded from our calculation of diluted weighted-average shares outstanding for the three and six months ended June 30, 2012, as the exercise prices were greater than the average market price of our common stock for the periods. Stock options to purchase 3 million shares of common stock outstanding are excluded from our calculation of diluted weighted-average shares outstanding for both the three and six months ended July 2, 2011, as the exercise prices were greater than the average market price of our common stock for the periods. These securities could potentially dilute EPS in the future.

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Note 4: Accounts Receivable and Finance Receivables

Accounts Receivable

Accounts receivable is composed of the following:

(In millions)		June 30, 2012		December 31, 2011
Commercial	$	577	$	528
U.S. Government contracts		358		346
		935		874
Allowance for doubtful accounts		(18)		(18)
Total accounts receivable, net	$	917	$	856

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 $213 million at June 30, 2012 and $192 million at December 31, 2011.

Finance Receivables

Finance receivables by product line, which includes both finance receivables held for investment and finance receivables held for sale, are presented in the following table. Beginning this quarter, we are reporting our captive business as one product line, which primarily includes aviation finance receivables, and to a limited extent, golf equipment finance receivables.

(In millions)		June 30, 2012		December 31, 2011
Captive	$	1,753	$	1,945
Golf Mortgage		244		381
Timeshare		203		318
Structured Capital		149		208
Other liquidating		23		43
Total finance receivables		2,372		2,895
Less: Allowance for losses		122		156
Less: Finance receivables held for sale		244		418
Total finance receivables held for investment, net	$	2,006	$	2,321

Credit Quality Indicators and Nonaccrual Finance Receivables

We internally assess the quality of our finance receivables held for investment portfolio based on a number of key credit quality indicators and statistics such as delinquency, loan balance to estimated collateral value, the liquidity position of individual borrowers and guarantors and default rates of our notes receivable collateral in the Timeshare product line. 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 held for investment as nonaccrual if credit quality indicators suggest full collection is doubtful. In addition, we automatically classify accounts as nonaccrual once they are contractually delinquent by more than three months unless collection is not doubtful. Cash payments on nonaccrual accounts, including finance charges, generally are applied 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 held for investment that do not meet the watchlist or nonaccrual categories are classified as performing.

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

	June 30, 2012				December 31, 2011			
(In millions)	Performing	Watchlist	Nonaccrual	Total	Performing	Watchlist	Nonaccrual	Total
Captive	$ 1,491	$ 150	$ 112	$ 1,753	$ 1,558	$ 251	$ 136	$ 1,945
Timeshare	73	4	126	203	89	25	167	281
Structured Capital	144	5		149	203	5		208
Other liquidating	9		14	23	25		18	43
Total	$ 1,717	$ 159	$ 252	$ 2,128	$ 1,875	$ 281	$ 321	$ 2,477
% of Total	80.7%	7.5%	11.8%		75.7%	11.3%	13.0%	

We measure delinquency based on the contractual payment terms of our loans and leases. In determining the delinquency aging category of an account, any/all principal and interest received is applied to the most past-due principal and/or interest amounts due. If a significant portion of the contractually due payment is delinquent, the entire finance receivable balance is reported in accordance with the most past-due delinquency aging category.

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

	June 30, 2012					December 31, 2011				
(In millions)	Less Than 31 Days Past Due	31-60 Days Past Due	61-90 Days Past Due	Over 90 Days Past Due	Total	Less Than 31 Days Past Due	31-60 Days Past Due	61-90 Days Past Due	Over 90 Days Past Due	Total
Captive	$ 1,571	$ 43	$ 71	$ 68	$ 1,753	$ 1,758	$ 69	$ 43	$ 75	$ 1,945
Timeshare	171	10		22	203	238	3		40	281
Structured Capital	149				149	208				208
Other liquidating	15			8	23	35			8	43
Total	$ 1,906	$ 53	$ 71	$ 98	$ 2,128	$ 2,239	$ 72	$ 43	$ 123	$ 2,477

We had no accrual status loans that were greater than 90 days past due at June 30, 2012 or at December 31, 2011. At June 30, 2012, the 60+ days contractual delinquency as a percentage of finance receivables held for investment was 7.94%, compared with 6.70% at December 31, 2011.

Loan Modifications

Troubled debt restructurings occur when we have either modified the contract terms of finance receivables held for investment 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, extensions of revolving borrowing periods, delays in the timing of required principal payments, deferrals of interest payments, advances to protect the value of our collateral and principal reductions contingent on full repayment prior to the maturity date. The changes effected by modifications made during the first half of 2012 to finance receivables held for investment were not material, primarily as a result of the reclassification of the Golf Mortgage finance receivables from the held for investment classification to the held for sale classification at December 31, 2011.

Impaired Loans

We evaluate individual finance receivables held for investment in non-homogeneous portfolios and larger accounts in homogeneous loan portfolios for impairment on a quarterly basis. Finance receivables classified as held for sale are reflected at the lower of cost or fair value and are excluded from these evaluations. 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. There was no significant interest income recognized on impaired loans in the first half of 2012 or 2011.

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A summary of impaired finance receivables, excluding leveraged leases, is provided below:

(In millions)	Recorded Investment Impaired Loans with No Related Allowance for Credit Losses	Impaired Loans with Related Allowance for Credit Losses	Total Impaired Loans	Unpaid Principal Balance	Allowance For Losses On Impaired Loans	Average Recorded Investment
June 30, 2012						
Captive	$ 28	$ 85	$ 113	$ 119	$ 23	$ 121
Timeshare	95	62	157	214	29	195
Other liquidating	1	12	13	23	9	14
Total	$ 124	$ 159	$ 283	$ 356	$ 61	$ 330
December 31, 2011						
Captive	$ 47	$ 94	$ 141	$ 144	$ 40	$ 149
Timeshare	170	57	227	288	38	315
Golf Mortgage						232
Other liquidating	3	12	15	59	9	30
Total	$ 220	$ 163	$ 383	$ 491	$ 87	$ 726

Allowance for Losses

We maintain the allowance for losses on finance receivables held for investment at a level considered adequate to cover inherent losses in the portfolio based on management s evaluation and analysis by product line. For larger balance accounts specifically identified as impaired, including large accounts in homogeneous portfolios, a reserve is established based on comparing the carrying value with either a) the expected future cash flows, discounted at the finance receivable s effective interest rate; or b) the fair value of the underlying collateral, if the finance receivable is collateral dependent. 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/foreclosure 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 portfolios 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 vary by product line and include the following:

- *Captive* - industry valuation guides, age and physical condition of the collateral, payment history, and existence and financial strength of guarantors.

- *Timeshare* - historical performance of consumer notes receivable collateral, real estate valuations, operating expenses of the borrower, the impact of bankruptcy court rulings on the value of the collateral, legal and other professional expenses and borrower s access to capital.

We also establish an allowance for losses by product line to cover probable but specifically unknown losses existing in the portfolio. For homogeneous portfolios, including Captive, 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. For non-homogeneous portfolios, such as Timeshare, the allowance is established as a percentage of watchlist balances, as defined on page 10, which represents a combination of assumed default likelihood and loss severity based on historical experience, industry trends and collateral values. In estimating our allowance for losses to cover accounts not specifically identified, critical factors vary by product line and include the following:

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- *Captive* - the collateral value of the portfolio, historical default experience and delinquency trends.

- *Timeshare* - individual loan credit quality indicators such as borrowing base shortfalls for revolving notes receivable facilities, default rates of our notes receivable collateral, borrower s access to capital, historical progression from watchlist to nonaccrual status and estimates of loss severity based on analysis of impaired loans in the product line.

Finance receivables held for investment are written down to the fair value (less estimated costs to sell) of the related collateral when the collateral is repossessed and are charged off when the remaining balance is deemed to be uncollectible.

A rollforward of the allowances for losses on finance receivables held for investment is provided below:

(In millions)	Captive	Golf Mortgage	Timeshare	Other liquidating	Total
For the six months ended June 30, 2012					
Beginning balance	$ 101	$	$ 40	$ 15	$ 156
Provision for losses			2	(5)	(3)
Charge-offs	(26)		(13)	(1)	(40)
Recoveries	7			2	9
Ending balance	$ 82	$	$ 29	$ 11	$ 122
For the six months ended July 2, 2011					
Beginning balance	$ 123	$ 79	$ 106	$ 34	$ 342
Provision for losses	14	(1)	10	1	24
Charge-offs	(26)	(4)	(28)	(10)	(68)
Recoveries	6			8	14
Transfers				(13)	(13)
Ending balance	$ 117	$ 74	$ 88	$ 20	$ 299

A summary of the allowance for losses on finance receivables that are evaluated on an individual and on a collective basis is provided below. The finance receivables reported in this table specifically exclude $149 million and $281 million of leveraged leases at June 30, 2012 and July 2, 2011, respectively, in accordance with authoritative accounting standards.

	June 30, 2012				July 2, 2011			
	Finance Receivables Evaluated		Allowance Based on Individual Evaluation	Allowance Based on Collective Evaluation	Finance Receivables Evaluated		Allowance Based on Individual Evaluation	Allowance Based on Collective Evaluation
(In millions)	Individually	Collectively			Individually	Collectively		
Captive	$ 113	$ 1,640	$ 23	$ 59	$ 143	$ 2,009	$ 44	$ 73
Timeshare	157	46	29		322	188	86	2
Golf Mortgage					294	325	44	30
Other liquidating	13	10	9	2	28	54	9	11
Total	$ 283	$ 1,696	$ 61	$ 61	$ 787	$ 2,576	$ 183	$ 116

Note 5: Inventories

(In millions)	**June 30, 2012**	**December 31, 2011**
Finished goods	$ 1,288	$ 1,012
Work in process	2,260	2,202
Raw materials	449	399
	3,997	3,613
Progress/milestone payments	(1,238)	(1,211)
	$ 2,759	$ 2,402

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Note 6: Debt

At June 30, 2012, the principal amount of our convertible senior notes was $215 million. Our common stock price exceeded the $17.06 per share conversion threshold price set forth for these convertible notes for at least 20 trading days during the 30 consecutive trading days ended June 30, 2012. Accordingly, these notes are convertible at the holder s option through September 30, 2012. We may deliver shares of common stock, cash or a combination of cash and shares of common stock in satisfaction of our obligations upon conversion of the convertible notes. Based on a June 30, 2012 stock price of $24.87, the if converted value exceeds the face amount of the remaining notes by $192 million; however, after giving effect to the exercise of the related outstanding call options and warrants, the incremental cash or share settlement in excess of the face amount would result in either a 6 million net share issuance or a cash payment of $149 million, or a combination of cash and stock, at our option.

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:

	Six Months Ended	
(In millions)	**June 30, 2012**	**July 2, 2011**
Accrual at the beginning of period	$ 224	$ 242
Provision	124	111
Settlements	(123)	(116)
Adjustments to prior accrual estimates	(4)	(7)
Accrual at the end of period	$ 221	$ 230

Note 8: 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; compliance with applicable laws and regulations; production partners; product liability; employment; 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 being suspended or debarred 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.

On February 7, 2012, a lawsuit was filed in the United States Bankruptcy Court, Northern District of Ohio, Eastern Division (Akron) by Brian A. Bash, Chapter 7 Trustee for Fair Finance Company against TFC, Fortress Credit Corp. and Fair Facility I, LLC. TFC provided a revolving line of credit of up to $17.5 million to Fair Finance Company from 2002 through 2007. The complaint alleges numerous counts against TFC, as Fair Finance Company s working capital lender, including receipt of fraudulent transfers and assisting in fraud perpetrated on Fair Finance investors. The Trustee seeks avoidance and recovery of alleged fraudulent transfers in the amount of $316 million as well as damages of $223 million on the other claims. The Trustee also seeks trebled damages on all claims under Ohio law. We intend to vigorously defend this lawsuit,

and on April 20, 2012, TFC moved to dismiss all claims in the complaint. That motion is still pending. An estimate of a range of possible loss cannot be made at this time due to the early stage of the litigation.

Note 9: Derivative Instruments and Fair Value Measurements

We measure fair value at the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. We prioritize the assumptions that market participants would use in pricing the asset or liability into a three-tier fair value hierarchy. This fair value hierarchy gives the highest priority (Level 1) to quoted prices in active markets for identical assets or liabilities and the lowest priority (Level 3) to unobservable inputs in which little or no market data exist, requiring companies to develop their own assumptions. Observable inputs that do not meet the criteria of Level 1, which include quoted prices for similar assets or liabilities in active markets or quoted prices for identical assets and liabilities in markets that are not active, are categorized as Level 2. Level 3 inputs are those that reflect our estimates about the assumptions market participants

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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

The assets and liabilities that are recorded at fair value on a recurring basis consist primarily of our derivative financial instruments, which are categorized as Level 2 in the fair value hierarchy. The fair value amounts of these instruments that are designated as hedging instruments are provided below:

			Asset (Liability)	
(In millions)	**Borrowing Group**	**Balance Sheet Location**	**June 30, 2012**	**December 31, 2011**
Assets				
Interest rate exchange contracts*	Finance	Other assets	$ 16	$ 22
Foreign currency exchange contracts	Manufacturing	Other current assets	5	9
Total			$ 21	$ 31
Liabilities				
Interest rate exchange contracts*	Finance	Other liabilities	$ (9)	$ (7)
Foreign currency exchange contracts	Manufacturing	Accrued liabilities	(1)	(5)
Total			$ (10)	$ (12)

**Interest rate exchange contracts represent fair value hedges.*

The Finance group s 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 and foreign exchange rate data, which is based on readily observable market data published by third-party leading financial news and data providers. Credit risk is factored into the fair value of these assets and liabilities based on the differential between both our credit default swap spread for liabilities and the counterparty s credit default swap spread for assets as compared with a standard AA-rated counterparty; however, this had no significant impact on the valuation at June 30, 2012. At June 30, 2012 and December 31, 2011, we had interest rate exchange contracts with notional amounts upon which the contracts were based of $770 million and $848 million, respectively.

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 June 30, 2012 and December 31, 2011, we had foreign currency exchange contracts with notional amounts upon which the contracts were based of $680 million and $645 million, respectively.

Fair Value Hedges

Our Finance group enters 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. By using these contracts, we are able to convert our fixed-rate cash flows to floating-rate cash flows. The amount of ineffectiveness on our fair value hedges and the gain (loss) recorded in the Consolidated Statements of Operations were both insignificant in the first half of 2012 and 2011.

Cash Flow Hedges

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. The primary purpose of our foreign currency hedging activities is to manage the volatility associated with foreign currency purchases of materials, foreign currency sales of products, and other assets and liabilities in the normal course of business. We primarily utilize forward exchange contracts and purchased options with maturities of no more than three years that 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 June 30, 2012, we had a net deferred gain of $5 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 these cash flow hedges, including gains and losses related to hedge ineffectiveness, were not material in the three and six months ended June 30, 2012 and July 2, 2011. We do not expect the amount of gains and losses in Accumulated other comprehensive loss that will be reclassified to earnings in the next twelve months to be material.

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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 net investments. We also may utilize currency forwards as hedges of our related foreign net investments. We record changes in the fair value of these contracts in other comprehensive income to the extent they are effective as cash flow hedges. If a contract does not qualify for hedge accounting or is designated as a fair value hedge, changes in the fair value of the contract are recorded in earnings. Currency effects on the effective portion of these hedges, which are reflected in the foreign currency translation adjustment account within other comprehensive income, produced a $4 million after-tax gain for the first half of 2012, resulting in an accumulated net gain balance of $22 million at June 30, 2012. The ineffective portion of these hedges was insignificant.

Assets Recorded at Fair Value on a Nonrecurring Basis

The fair value measurement adjustments recorded during the first half of 2012 and 2011 for each asset class measured on a nonrecurring basis are presented in the gain (loss) columns below, along with the balance of the asset class measured at fair value at the end of each period. These assets are in the Finance group and were measured using significant unobservable inputs (Level 3).

	Balance at		Gain (Loss) Six Months Ended	
	June 30,	**July 2,**	**June 30,**	**July 2,**
(In millions)	**2012**	**2011**	**2012**	**2011**
Finance receivables held for sale	$ 244	$ 180	$ 44	$ (14)
Impaired finance receivables	110	407	(7)	(50)
Repossessed assets and properties	138	91	(32)	(18)

Finance Receivables Held for Sale Finance receivables held for sale are recorded at fair value on a nonrecurring basis during periods in which the fair value is lower than the cost value. There are no active, quoted market prices for these finance receivables. At June 30, 2012, our finance receivables held for sale represents the Golf Mortgage portfolio. Fair value of this portfolio was determined based on the use of discounted cash flow models to estimate the price we expect to receive in the principal market for each pool of similar loans, in an orderly transaction. The discount rates utilized in these models are derived from prevailing interest rate indices and are based on the nature of the assets, discussions with market participants and our experience in the actual disposition of similar assets. The cash flow models also include the use of qualitative assumptions regarding the borrower s ability to pay and the period of time that will likely be required to restructure and/or exit the account through acquisition of the underlying collateral. We utilize revenue and earnings multiples to determine the expected value of the loan collateral. The range of multiples used is based on bids from prospective buyers, inputs from market participants and prices at which sales have been transacted for similar properties. The gains on finance receivables held for sale for the six months ended June 30, 2012 are primarily the result of the payoff and sale of loans at prices in excess of the values established in previous periods.

Based on our qualitative assumptions, we separate the loans into three categories for the cash flow models. In the first category, we include loans that we assume will be paid in accordance with the contractual terms of the loan. In the second category, we include loans where we perceive that the borrower has less of an ability to pay, and we assume that the loan will be restructured and resolved typically over a period of one to four years. For the third category, we assume that the borrower will default on the loan and that it will be resolved within an average of 24 months. The fair values of these finance receivables are sensitive to variability in both the quantitative and qualitative assumptions. Changes in the borrower s ability to pay or the period of time required to restructure and/or exit accounts may significantly increase or decrease the fair value of these finance receivables, and, to a lesser extent, fluctuations in discount rates and/or revenue and earnings multiples could also change the fair value of these finance receivables.

Impaired Finance Receivables 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 our Captive impaired nonaccrual finance receivables, fair values of collateral are determined based on the use of industry pricing guides. Our Timeshare impaired nonaccrual finance receivables largely consist of notes receivable loans to developers of resort properties which are collateralized by pools of consumer notes receivable. Fair values of collateral are estimated using cash flow models incorporating estimates of credit losses in the consumer notes pools and the developer s ability to mitigate losses through the repurchase or replacement of defaulted notes. Fair value measurements recorded on impaired finance receivables resulted in charges to provision for loan losses and primarily related to initial fair value adjustments.

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Repossessed assets and properties Repossessed assets and properties in the table above primarily include both golf and hotel properties and aviation assets at June 30, 2012. The fair value of our golf and hotel properties is determined based on the use of discounted cash flow models, bids from prospective buyers or inputs from market participants. The fair value of our aviation assets is largely determined based on the use of industry pricing guides. If the carrying amount of these assets is higher than their estimated fair value, we record a corresponding charge to income for the difference.

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:

	June 30, 2012		December 31, 2011	
(In millions)	Carrying Value	Estimated Fair Value	Carrying Value	Estimated Fair Value
Manufacturing group				
Long-term debt, excluding leases	$ (2,189)	$ (2,536)	$ (2,328)	$ (2,561)
Finance group				
Finance receivables held for investment, excluding leases	1,750	1,676	1,997	1,848
Debt	(1,810)	(1,749)	(1,974)	(1,854)

Fair value for the Manufacturing group debt is determined using market observable data for similar transactions or Level 2 inputs. At June 30, 2012 and December 31, 2011, approximately 43% and 53%, respectively, of the fair value of term debt for the Finance group was determined based on observable market transactions (Level 1). The remaining Finance group debt was determined based on discounted cash flow analyses using observable market inputs from debt with similar duration, subordination and credit default expectations (Level 2). Fair value estimates for finance receivables 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 10: Segment Information

We operate in, and report financial information for, the following five business segments: Cessna, Bell, Textron Systems, Industrial and Finance. Segment profit is an important measure used for evaluating performance and for decision-making purposes. Segment profit for the manufacturing segments excludes interest expense and certain corporate expenses. The measurement for the Finance segment includes interest income and expense along with intercompany interest expense. Provisions for losses on finance receivables involving the sale or lease of our products are recorded by the selling manufacturing division when our Finance group has recourse to the Manufacturing group.

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Our revenues by segment and a reconciliation of segment profit to income from continuing operations before income taxes are as follows:

	Three Months Ended		Six Months Ended	
(In millions)	June 30, 2012	July 2, 2011	June 30, 2012	July 2, 2011
REVENUES				
Manufacturing Group				
Cessna	$ 763	$ 652	$ 1,432	$ 1,208
Bell	1,056	872	2,050	1,621
Textron Systems	389	452	766	897
Industrial	756	719	1,511	1,422
	2,964	2,695	5,759	5,148
Finance Group	55	33	116	59
Total revenues	$ 3,019	$ 2,728	$ 5,875	$ 5,207
SEGMENT OPERATING PROFIT				
Manufacturing Group				
Cessna	$ 35	$ 5	$ 29	$ (33)
Bell	152	120	297	211
Textron Systems	40	49	75	102
Industrial	61	55	134	116
	288	229	535	396
Finance Group	22	(33)	34	(77)
Segment profit	310	196	569	319
Corporate expenses and other, net	(20)	(23)	(67)	(62)
Interest expense, net for Manufacturing group	(35)	(38)	(70)	(76)
Income from continuing operations before income taxes	$ 255	$ 135	$ 432	$ 181

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

Consolidated Results of Operations

Revenues

	Three Months Ended		Six Months Ended	
(Dollars in millions)	**June 30, 2012**	**July 2, 2011**	**June 30, 2012**	**July 2, 2011**
Revenues	$ 3,019	$ 2,728	$ 5,875	$ 5,207
% change compared with prior period	11%		13%	

Revenues increased $291 million, 11%, in the second quarter of 2012, compared with the corresponding period of 2011. This increase was due to revenue increases in the Bell, Cessna, Industrial and Finance segments that were partially offset by lower revenues in the Textron Systems segment. The net revenue increase included the following factors:

- Higher Bell revenues of $184 million, largely due to higher commercial aircraft volume.
- Higher Cessna revenues of $111 million, primarily due to higher Citation jet volume.
- Increased Industrial segment revenues of $37 million, primarily due to higher volume, mostly reflecting higher market demand in the Fuel Systems and Functional Components and Golf and Turf Care product lines, partially offset by unfavorable foreign exchange primarily related to the weakening of the euro.
- Higher Finance revenues of $22 million due to lower portfolio losses and favorable net valuation adjustments related to the non-captive business, partially offset by a decline in revenues attributable to lower average finance receivables of $1.2 billion.
- Lower Textron Systems revenues of $63 million, primarily due to lower volume in the Weapons and Sensors and Land & Marine product lines.

Revenues increased $668 million, 13%, in the first half of 2012, compared with the corresponding period of 2011, as revenue increases in the Bell, Cessna, Industrial and Finance segments were partially offset by lower revenues in the Textron Systems segments. The net revenue increase included the following factors:

- Higher Bell revenues of $429 million, largely due to higher commercial aircraft volume and higher volume in our military programs.
- Higher Cessna revenues of $224 million, primarily due to higher Citation jet volume.

- Increased Industrial segment revenues of $89 million, primarily due to higher volume, mostly reflecting higher market demand in the Fuel Systems and Functional Components and Golf and Turf Care product lines, partially offset by unfavorable foreign exchange primarily related to the weakening of the euro.

- Higher Finance revenues of $57 million as favorable net valuation adjustments related to the non-captive business and lower portfolio losses offset a decline in revenues attributable to lower average finance receivables of $1.3 billion.

- Lower Textron Systems revenues of $131 million, primarily due to lower volume across all product lines.

Cost of Sales and Selling and Administrative Expense

(Dollars in millions)	Three Months Ended June 30, 2012	Three Months Ended July 2, 2011	Six Months Ended June 30, 2012	Six Months Ended July 2, 2011
Operating expenses	$ 2,718	$ 2,520	$ 5,338	$ 4,879
% change compared with prior period	8%		9%	
Cost of sales	$ 2,435	$ 2,225	$ 4,747	$ 4,280
% change compared with prior period	9%		11%	
Gross margin percentage of Manufacturing revenues	17.8%	17.4%	17.6%	16.9%
Selling and administrative expense	$ 283	$ 295	$ 591	$ 599
% change compared with prior period	(4)%		(1)%	

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Manufacturing cost of sales and selling and administrative expenses together comprise our operating expenses. Changes in operating expenses are more fully discussed in our Segment Analysis below.

Consolidated manufacturing cost of sales as a percentage of Manufacturing revenues was 82.2% and 82.6% in the second quarter of 2012 and 2011, respectively. On a dollar basis, consolidated manufacturing cost of sales increased $210 million, 9%, in the second quarter of 2012, compared with the corresponding period of 2011, principally due to higher net sales volume in the Bell, Cessna and Industrial segments, partially offset by lower net sales volume at Textron Systems. Cost of sales was favorably impacted at the Industrial segment due to the impact of foreign exchange on direct materials and labor of $27 million, largely due to fluctuations with the euro. In the second quarter of 2012, gross margin increased as a percentage of Manufacturing revenues primarily due to favorable product mix at Bell and improved leverage on higher volume at the Bell, Cessna and Industrial segments.

Consolidated manufacturing cost of sales as a percentage of Manufacturing revenues was 82.4% and 83.1% in the first half of 2012 and 2011, respectively. On a dollar basis, consolidated cost of sales increased $467 million, 11%, in the first half of 2012, principally due to higher net sales volume in the Bell, Cessna and Industrial segments, partially offset by lower net sales volume at Textron Systems. Cost of sales was favorably impacted at the Industrial segment due to the impact of foreign exchange on direct materials and labor of $33 million, largely due to fluctuations with the euro. In the first half of 2012, gross margin increased as a percentage of Manufacturing revenues primarily due to favorable product mix at Bell and improved leverage on higher volume at the Bell, Cessna and Industrial segments.

On a consolidated basis, selling and administrative expense decreased $12 million, 4%, to $283 million in the second quarter of 2012, compared with the corresponding period of 2011. For the first half of 2012, selling and administrative expense decreased $8 million, 1%, to $591 million, compared with the corresponding period of 2011. These changes were largely driven by a $10 million and $20 million reduction in operating expense at the Finance segment in the second quarter and first half of 2012 compared with the corresponding periods of 2011, respectively, primarily associated with the exit of the non-captive business.

Backlog

(In millions)	June 30, 2012	December 31, 2011
Bell	$ 6,739	$ 7,346
Cessna	1,526	1,889
Textron Systems	2,653	1,337

Backlog increased $1.3 billion at Textron Systems in the first half of 2012 largely due to additional orders in the Unmanned Aircraft Systems (UAS) and Land & Marine product lines. Backlog at Bell and Cessna decreased $0.6 billion and $0.4 billion, respectively, in the first half of 2012, primarily reflecting deliveries in excess of orders.

Segment Analysis

We operate in, and report financial information for, the following five business segments: Cessna, Bell, Textron Systems, Industrial and Finance. Segment profit is an important measure used for evaluating performance and for decision-making purposes. Segment profit for the manufacturing segments excludes interest expense and certain corporate expenses. The measurement for the Finance segment includes interest income and expense 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 refer to the results 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. Cost 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.

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Approximately 31% of our 2011 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 refer 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.

Cessna

	Three Months Ended		Six Months Ended	
(Dollars in millions)	**June 30, 2012**	**July 2, 2011**	**June 30, 2012**	**July 2, 2011**
Revenues	$ 763	$ 652	$ 1,432	$ 1,208
Operating expenses	728	647	1,403	1,241
Segment profit (loss)	35	5	29	(33)
Profit margin	4.6%	0.8%	2.0%	(2.7)%

Cessna Revenues and Operating Expenses

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

(In millions)	**Q2 2012 versus Q2 2011**	**YTD 2012 versus YTD 2011**
Volume	$ 116	$ 227
Other	(5)	(3)
Total change	$ 111	$ 224

In the second quarter of 2012, Cessna s revenues increased $111 million, 17%, compared with the corresponding period of 2011, primarily due to higher Citation business jet volume reflecting a modest recovery in the jet market, which had a $101 million impact. We delivered 49 Citation jets in the second quarter of 2012, compared with 38 jets in the corresponding period of 2011. During the second quarter of 2012, the portion of Cessna s revenues derived from aftermarket sales and services represented 26% of Cessna s revenues, compared with 29% in the second quarter of 2011.

In the first half of 2012, Cessna s revenues increased $224 million, 19%, compared with the corresponding period of 2011, primarily due to a $176 million impact from higher Citation business jet volume reflecting a modest recovery in the jet market and an increase of $24 million resulting from higher aftermarket volume, primarily due to part sales. We delivered 87 and 69 Citation business jets in the first half of 2012 and 2011, respectively. During the first half of 2012, the portion of Cessna s revenues derived from aftermarket sales and services represented 28% of Cessna s revenues, compared with 31% in the first half of 2011.

Cessna s operating expenses increased by $81 million, 13%, in the second quarter of 2012, compared with the corresponding period of 2011, primarily due to higher direct material cost and manufacturing overhead of $61 million and $24 million, respectively, resulting from higher sales volume.

Cessna s operating expenses increased by $162 million, 13%, in the first half of 2012, compared with the corresponding period of 2011, primarily due to higher direct material cost and manufacturing overhead of $122 million and $46 million, respectively, resulting from higher sales volume.

Cessna Segment Profit

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

(In millions)	**Q2 2012 versus Q2 2011**	**YTD 2012 versus YTD 2011**
Volume	$ 33	$ 59
Other	(3)	3
Total change	$ 30	$ 62

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Cessna s segment profit increased $30 million in the second quarter of 2012, compared with the corresponding period of 2011, primarily due to higher volume of $33 million as described above.

Cessna s segment profit was $62 million higher in the first half of 2012, compared with the corresponding period of 2011, primarily due to higher volume of $59 million as described above. Profit margins improved primarily due to the leveraging of higher sales volume over fixed operating costs.

Bell

	Three Months Ended		**Six Months Ended**	
(Dollars in millions)	**June 30, 2012**	**July 2, 2011**	**June 30, 2012**	**July 2, 2011**
Revenues				
V-22 program	$ 391	$ 360	$ 787	$ 718
Other military	229	259	478	429
Commercial	436	253	785	474
Total revenues	1,056	872	2,050	1,621
Operating expenses	904	752	1,753	1,410
Segment profit	152	120	297	211
Profit margin	14.4%	13.8%	14.5%	13.0%

Bell manufactures helicopters, tiltrotor aircraft, and related spare parts and provides services for military and commercial markets. Bell s major U.S. Government programs at this time are the V-22 tiltrotor aircraft and the H-1 helicopter platforms, which are both in the production stage and represent a significant portion of Bell s revenues from the U.S. Government.

Bell Revenues and Operating Expenses

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

(In millions)	**Q2 2012 versus Q2 2011**	**YTD 2012 versus YTD 2011**
Volume	$ 180	$ 421
Other	4	8
Total change	$ 184	$ 429

Bell s revenues increased $184 million, 21%, in the second quarter of 2012, compared with the corresponding period of 2011, primarily due to higher volume which included the following factors:

• $179 million increase in commercial volume, largely related to higher deliveries reflecting improved global demand. Bell delivered 47 commercial aircraft in the second quarter of 2012, compared with 22 aircraft in the second quarter of 2011.

• $31 million increase in volume related to the V-22 program, primarily reflecting higher revenues related to the support of fielded V-22 aircraft. Bell delivered 9 V-22 aircraft in both the second quarters of 2012 and 2011, respectively.

• $30 million decrease in other military volume, primarily due to the timing of deliveries under our contracts. We delivered 6 H-1 aircraft in the second quarter of 2012, compared with 8 aircraft in the second quarter of 2011.

Bell s revenues increased $429 million, 26%, in the first half of 2012, compared with the corresponding period of 2011, primarily due to higher volume which included the following factors:

• $303 million increase in commercial volume, largely related to higher deliveries reflecting improved global demand. Bell delivered 77 commercial aircraft in the first half of 2012, compared with 37 aircraft in the first half of 2011.

• $69 million increase in volume related to the V-22 program, primarily reflecting higher revenues related to the support of fielded V-22 aircraft and higher aircraft deliveries. Bell delivered 19 V-22 aircraft in the first half of 2012, compared with 18 deliveries in the first half of 2011.

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- $49 million increase in other military volume, primarily due to the timing of deliveries under our contracts. We delivered 13 H-1 aircraft in the first half of 2012, compared with 12 aircraft in the first half of 2011.

Bell s operating expenses increased $152 million, 20%, in the second quarter of 2012, compared with the corresponding period of 2011, primarily due to higher sales volume as discussed above.

Bell s operating expenses increased $343 million, 24%, in the first half of 2012, compared with the corresponding period of 2011, primarily due to higher sales volume discussed above.

Bell Segment Profit

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

(In millions)		**Q2 2012 versus Q2 2011**		**YTD 2012 versus YTD 2011**
Volume and mix	$	44	$	101
Other		(12)		(15)
Total change	$	32	$	86

Bell s segment profit increased $32 million, 27%, in the second quarter of 2012, compared with the second quarter of 2011, primarily due to higher volume and mix in our commercial aircraft business as described above. Segment profit was also impacted by higher research and development expense of $12 million due to the ramp-up of new product development.

Bell s segment profit increased $86 million, 41%, in the first half of 2012, compared with the first half of 2011, primarily due to higher volume and mix in our commercial aircraft business as described above. Segment profit was also impacted by higher selling and administrative expenses of $15 million and higher research and development costs of $10 million due to the ramp-up of new product development.

Textron Systems

	Three Months Ended				**Six Months Ended**			
(Dollars in millions)		**June 30, 2012**		**July 2, 2011**		**June 30, 2012**		**July 2, 2011**
Revenues	$	389	$	452	$	766	$	897
Operating expenses		349		403		691		795
Segment profit		40		49		75		102

Profit margin	10.3%	10.8%	9.8%	11.4%

Textron Systems Revenues and Operating Expenses

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

(In millions)	Q2 2012 versus Q2 2011	YTD 2012 versus YTD 2011
Volume	$ (65)	$ (134)
Other	2	3
Total change	$ (63)	$ (131)

Revenues at Textron Systems decreased $63 million, 14%, in the second quarter of 2012, compared with the second quarter of 2011, primarily due to lower volume reflecting the following changes:

- Lower Weapons and Sensors revenues of $51 million, largely due to the timing of deliveries on our contracts.
- Lower Land & Marine volume of $12 million, primarily related to lower deliveries based on current contract requirements.

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Revenues at Textron Systems decreased $131 million, 15%, in the first half of 2012, compared with the first half of 2011, primarily due to lower volume reflecting the following changes:

- Lower UAS volume of $47 million, largely due to the timing of deliveries.
- Lower Weapons and Sensors revenues of $32 million, primarily due to the completion of several contracts in the first quarter of 2011.
- Lower Land & Marine volume of $29 million, primarily related to lower deliveries based on current contract requirements.
- Lower Mission Support and Other product line volume of $23 million, primarily due to the completion of certain contracts in the first half of 2011.

Textron Systems operating expenses decreased $54 million, 13%, in the second quarter of 2012, compared with the second quarter of 2011, primarily due to the lower volume.

Textron Systems operating expenses decreased $104 million, 13%, in the first half of 2012, compared with the first half of 2011, primarily due to the lower volume and the impact of headcount reductions and other cost reduction initiatives.

Textron Systems Segment Profit

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

(In millions)		**Q2 2012 versus Q2 2011**		**YTD 2012 versus YTD 2011**
Volume and mix	$	(24)	$	(48)
Performance		14		19
Other		1		2
Total change	$	(9)	$	(27)

Segment profit at Textron Systems decreased $9 million, 18%, in the second quarter of 2012, compared with the corresponding period of 2011, primarily due to the impact of lower volume described above and deliveries on lower margin contracts during the current period. The favorable performance of $14 million primarily reflects the impact of headcount reductions and other cost reduction initiatives.

Segment profit at Textron Systems decreased $27 million, 26%, in the first half of 2012, compared with the corresponding period of 2011, primarily due to the impact of lower volume described above and deliveries on lower margin contracts during the current period. The favorable

performance of $19 million primarily reflects the impact of headcount reductions and other cost reduction initiatives.

Industrial

(Dollars in millions)	Three Months Ended June 30, 2012	Three Months Ended July 2, 2011	Six Months Ended June 30, 2012	Six Months Ended July 2, 2011
Revenues:				
Fuel Systems and Functional Components	$ 468	$ 450	$ 960	$ 921
Other Industrial	288	269	551	501
Total revenues	756	719	1,511	1,422
Operating expenses	695	664	1,377	1,306
Segment profit	61	55	134	116
Profit margin	8.1%	7.6%	8.9%	8.2%

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Industrial Revenues and Operating Expenses

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

(In millions)	Q2 2012 versus Q2 2011	YTD 2012 versus YTD 2011
Volume	$ 70	$ 128
Foreign exchange	(39)	(51)
Other	6	12
Total change	$ 37	$ 89

Industrial segment revenues increased $37 million, 5%, in the second quarter of 2012, compared with the corresponding period of 2011. Volume increased largely due to a $51 million increase in the Fuel Systems and Functional Components product line, reflecting higher automotive industry demand in North America and Asia, and $19 million in the Other Industrial product lines, largely related to higher market demand in the Golf and Turf Care product line. The unfavorable foreign exchange impact was mostly related to the weakening of the euro, which primarily impacted the Fuel Systems and Functional Components product line.

Industrial segment revenues increased $89 million, 6%, in the first half of 2012, compared with the corresponding period of 2011. Volume increased largely due to an $87 million increase in the Fuel Systems and Functional Components product line, reflecting higher automotive industry demand in North America and Asia, and $41 million in the Other Industrial product lines, largely related to higher market demand in the Golf and Turf Care product line. The unfavorable foreign exchange impact was mostly related to the weakening of the euro, which primarily impacted the Fuel Systems and Functional Components product line.

Operating expenses for the Industrial segment increased $31 million, 5%, in the second quarter of 2012, compared with the corresponding period of 2011, largely due to $55 million in higher direct material costs in support of higher sales volume. Operating expenses were also impacted by cost inflation of $12 million primarily due to higher commodity and material component costs. These increases in operating expenses were partially offset by a favorable foreign exchange impact of $36 million, largely due to the weakening of the euro.

Operating expenses for the Industrial segment increased $71 million, 5%, in the first half of 2012, compared with the corresponding period of 2011, largely due to $103 million in higher direct material costs in support of higher sales volume. Operating expenses were also impacted by cost inflation of $24 million primarily due to higher commodity and material component costs. These increases in operating expenses were partially offset by a favorable foreign exchange impact of $46 million, largely due to the weakening of the euro.

Industrial Segment Profit

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

(In millions)	Q2 2012 versus Q2 2011	YTD 2012 versus YTD 2011
Volume	$ 15	$ 26
Other	(9)	(8)
Total change	$ 6	$ 18

Segment profit for the Industrial segment increased $6 million, 11%, in the second quarter of 2012, compared with the corresponding period of 2011, primarily due to a $15 million impact from higher volume as described above.

Segment profit for the Industrial segment increased $18 million, 16%, in the first half of 2012, compared with the corresponding period of 2011, primarily due to a $26 million impact from higher volume as described above.

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Finance

	Three Months Ended		Six Months Ended	
(In millions)	June 30, 2012	July 2, 2011	June 30, 2012	July 2, 2011
Revenues	$ 55	$ 33	$ 116	$ 59
Segment profit (loss)	22	(33)	34	(77)

Our plan to exit the non-captive commercial finance business of our Finance segment is being effected through a combination of orderly liquidation and selected sales. Depending on market conditions, we expect continued progress in liquidating the remaining $619 million of finance receivables in the non-captive portfolio over the next several years.

Finance segment revenues increased $22 million in the second quarter of 2012, compared with the second quarter of 2011, primarily attributable to the following factors:

- $16 million of lower portfolio losses, net of gains, primarily associated with the Structured Capital portfolio.
- $15 million due to $8 million in net favorable valuation adjustments in the second quarter of 2012 related to the Golf Mortgage finance receivables held for sale and owned assets, compared with $7 million in unfavorable valuation adjustments in the second quarter of 2011.
- These increases were partially offset by a $15 million decrease attributable to lower average finance receivables of $1.2 billion.

Finance segment revenues increased $57 million in the first half of 2012, compared with the first half of 2011, primarily attributable to the following factors:

- $41 million due to $19 million in net favorable valuation adjustments in the first half of 2012 related to the Golf Mortgage finance receivables held for sale and owned assets, compared with $22 million in unfavorable valuation adjustments in the first half of 2011.
- $30 million of lower portfolio losses, net of gains, primarily associated with the Structured Capital and Timeshare portfolios.
- $9 million increase due to the resolution of one significant Timeshare account that returned to accrual status during 2012.
- These increases were partially offset by a $30 million decrease attributable to lower average finance receivables of $1.3 billion.

Finance segment profit increased $55 million in the second quarter of 2012, compared with the corresponding period of 2011, primarily due to $19 million in lower provision for loan losses mostly related to specific reserving actions taken in the non-captive portfolio during the second quarter of 2011. In addition, portfolio losses, net of gains, decreased by $16 million and net valuation adjustments changed by $15 million as

discussed above. In addition, administrative expense declined by $10 million primarily associated with the exit of the non-captive business.

Finance segment profit increased $111 million in the first half of 2012, compared with the corresponding period of 2011, primarily due to changes in net valuation adjustments of $41 million and $30 million in lower portfolio losses, net of gains, as discussed above. Provision for loan losses also decreased by $27 million mostly due to specific reserving actions taken on several captive and non-captive accounts during 2011. In addition, administrative expense declined by $20 million primarily associated with the exit of the non-captive business.

Finance Portfolio Quality

The following table reflects information about the Finance segment s credit performance related to finance receivables held for investment:

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(Dollars in millions)		June 30, 2012		December 31, 2011
Finance receivables	$	2,128	$	2,477
Nonaccrual finance receivables		252		321
Allowance for losses		122		156
Ratio of nonaccrual finance receivables to finance receivables		11.84%		12.96%
Ratio of allowance for losses on impaired nonaccrual finance receivables to impaired nonaccrual finance receivables		25.19%		28.52%
Ratio of allowance for losses on finance receivables to nonaccrual finance receivables		48.41%		48.60%
Ratio of allowance for losses on finance receivables to finance receivables		5.73%		6.30%
60+ days contractual delinquency as a percentage of finance receivables		7.94%		6.70%
60+ days contractual delinquency		169		166
Repossessed assets and properties		167		199

Finance receivables held for sale are reflected at the lower of cost or fair value on the Consolidated Balance Sheets and are not included in the credit performance statistics above. Finance receivables held for sale in the non-captive portfolio totaled $244 million at June 30, 2012, compared with $418 million at the end of 2011.

Nonaccrual finance receivables decreased $69 million, 21%, from the year-end balance, primarily due to reductions of $41 million in the Timeshare portfolio and $24 million in the Captive portfolio. The decrease in these portfolios was mostly due to cash collections and repossession of collateral, partially offset by new accounts identified as nonaccrual in 2012. The 60+ days contractual delinquency percentage increased primarily due to higher delinquencies in the Captive portfolio related to several larger accounts, partially offset by lower delinquencies in the Timeshare portfolio.

Liquidity and Capital Resources

Our financings are conducted through two separate borrowing groups. The Manufacturing group consists of Textron Inc. consolidated with its majority-owned subsidiaries that operate in the Cessna, Bell, Textron Systems and Industrial segments. The Finance group, which also is the Finance segment, consists of TFC, its consolidated subsidiaries and three other finance subsidiaries owned by Textron Inc. We designed this framework to enhance our borrowing power by separating the Finance group. Our Manufacturing group operations include the development, production and delivery of tangible goods and services, while our Finance group provides financial services. Due to the fundamental differences between each borrowing group s activities, investors, rating agencies and analysts use different measures to evaluate each group s performance. To support those evaluations, we present balance sheet and cash flow information for each borrowing group within the Consolidated Financial Statements.

Key information that is utilized in assessing our liquidity is summarized below:

(Dollars in millions)		June 30, 2012		December 31, 2011
Manufacturing group				
Cash and equivalents	$	898	$	871
Debt		2,316		2,459
Shareholders equity		3,102		2,745

Capital (debt plus shareholders equity)		5,418		5,204
Net debt (net of cash and equivalents) to capital		31.4%		36.6%
Debt to capital		42.7%		47.3%
Finance group				
Cash and equivalents	$	13	$	14
Debt		1,810		1,974

We believe that our calculations of debt to capital and net debt to capital are useful measures as they provide a summary indication of the level of debt financing (i.e., leverage) that is in place to support our capital structure, as well as to provide an indication of the capacity to add further leverage. We believe that with our existing cash balances, along with the cash we expect to generate from our manufacturing operations, we will have sufficient cash to meet our future needs.

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Textron Inc. has a senior unsecured revolving credit facility that expires in March 2015 for an aggregate principal amount of $1.0 billion, up to $200 million of which is available for the issuance of letters of credit. At June 30, 2012, there were no amounts borrowed against the facility. We also maintain an effective shelf registration statement filed with the Securities and Exchange Commission that allows us to issue an unlimited amount of public debt and other securities.

Manufacturing Group Cash Flows

Cash flows from continuing operations for the Manufacturing group as presented in our Consolidated Statements of Cash Flows are summarized below:

	Six Months Ended	
(In millions)	**June 30, 2012**	**July 2, 2011**
Operating activities	$ 81	$ 146
Investing activities	(156)	(211)
Financing activities	106	(231)

Cash flows from operating activities decreased during the first six months of 2012 as compared with the corresponding period of 2011, largely due to more cash used for our working capital requirements in support of sales growth, partially offset by higher earnings for the Manufacturing group.

Investing cash flows in the first half of 2012 and 2011 primarily included capital expenditures of $158 million and $169 million, respectively. We generated cash from financing activities in the first half of 2012, largely due to the receipt of $245 million from the Finance group in payment of a portion of its intergroup borrowing, partially offset by the repayment of $139 million of maturing debt. In the first half of 2011, financing activities primarily consisted of $395 million in intergroup financing for our Finance group, which was partially offset by the issuance of $189 million in commercial paper.

Capital Contributions Paid To and Dividends Received From TFC

Under a Support Agreement between Textron Inc. and TFC, Textron Inc. is required to maintain a controlling interest in TFC. The agreement also requires Textron Inc. to ensure that TFC maintains fixed charge coverage of no less than 125% and consolidated shareholder s equity of no less than $200 million. Cash contributions paid to TFC to maintain compliance with the Support Agreement and dividends paid by TFC to Textron Inc. are detailed below:

	Six Months Ended	
(In millions)	**June 30, 2012**	**July 2, 2011**
Dividends paid by TFC to Textron Inc.	$ 315	$ 179

Capital contributions paid to TFC under Support Agreement	(240)	(112)

Due to the nature of these contributions, we classify these contributions within cash flows used by operating activities for the Manufacturing group in the Consolidated Statements of Cash Flows. Capital contributions to support Finance group growth in the ongoing captive finance business are classified as cash flows from financing activities. The Finance group s net income (loss) is excluded from the Manufacturing group s cash flows, while dividends from the Finance group are included within cash flows from operating activities for the Manufacturing group as they represent a return on investment.

Finance Group Cash Flows

In the first half of 2012, we liquidated $523 million of the Finance group s finance receivables, net of originations. These finance receivable reductions occurred in both the non-captive and captive finance portfolios, but were primarily driven by the non-captive portfolio in connection with our exit plan, including $137 million and $115 million in the Golf Mortgage and Timeshare product lines, respectively. Depending on market conditions, we expect continued progress in liquidating the remaining $619 million of finance receivables in the non-captive portfolio over the next several years.

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The cash flows from continuing operations for the Finance group are summarized below:

(In millions)	Six Months Ended June 30, 2012	Six Months Ended July 2, 2011
Operating activities	$ (96)	$ 28
Investing activities	580	784
Financing activities	(485)	(805)

The Finance group used more cash for operating activities largely due to $112 million in taxes paid in the first half of 2012, compared with a $40 million refund in the corresponding period of 2011. The 2012 tax payment was primarily attributable to a 2008 settlement with the Internal Revenue Service related to the challenge of tax deductions we took in prior years for certain leveraged lease transactions.

Cash receipts from the collection of finance receivables continued to exceed finance receivable originations, which resulted in net cash inflow from investing activities in both periods. Finance receivables repaid and proceeds from sales totaled $617 million and $919 million in the first half of 2012 and 2011, respectively, while cash outflows for originations declined to $114 million in the first half of 2012 from $244 million in the first half of 2011. These decreases were largely driven by the wind down of the non-captive finance receivable portfolio.

Cash used for financing activities in the first half of 2012 primarily related to $254 million in long-term debt payments and a $245 million payment to the Manufacturing group in payment of a portion of its intergroup borrowings. As of June 30, 2012 and December 31, 2011, the outstanding balance due to Textron Inc. for these borrowings was $245 million and $490 million, respectively. In the first half of 2011, the Finance group made a discretionary payment of $940 million on its bank line of credit and repaid $498 million of long-term debt. To pay its maturing debt, the Finance group borrowed $395 million from Textron Inc. with interest and also received $265 million in proceeds from the issuance of long-term debt in the first half of 2011.

Consolidated Cash Flows

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

(In millions)	Six Months Ended June 30, 2012	Six Months Ended July 2, 2011
Operating activities	$ 28	$ 219
Investing activities	306	501
Financing activities	(304)	(1,009)

Cash flows from operating activities decreased during the first six months of 2012 as compared with the corresponding period of 2011, largely due to more cash used for our working capital requirements in support of sales growth and an increase in net tax payments, partially offset by higher earnings.

Cash receipts from the collection of finance receivables continued to exceed finance receivable originations, which resulted in net cash inflow from investing activities in both years. Finance receivables repaid and proceeds from sales totaled $405 million and $679 million in the first half of 2012 and 2011, respectively, while cash outflows for originations decreased to $19 million in the first half of 2012 from $110 million in the first half of 2011. These decreases were largely driven by the wind down of the non-captive finance receivable portfolio.

Total cash used for financing activities was lower in 2012 primarily due to lower repayments of long-term debt of $393 million in the first half of 2012, compared with $511 million in the first half of 2011. In addition, TFC made a $940 million discretionary payment against the outstanding balance on its bank line of credit during the first half of 2011. This decrease in cash used was partially offset by the issuance of $189 million in commercial paper and $265 million in long-term debt.

Captive Financing and Other Intercompany Transactions

The Finance group finances retail purchases and leases for new and used aircraft and equipment manufactured by our Manufacturing group, otherwise known as captive financing. In the Consolidated Statements of Cash Flows, cash received from customers or from the sale of receivables is reflected as operating activities when received from third parties. However, in the cash flow information provided for the separate borrowing groups, cash flows related to

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captive financing activities are reflected based on the operations of each group. For example, when product is sold by our Manufacturing group to a customer and is financed by the Finance group, the origination of the finance receivable is recorded within investing activities as a cash outflow in the Finance group s statement of cash flows. Meanwhile, in the Manufacturing group s statement of cash flows, the cash received from the Finance group on the customer s behalf is recorded within operating cash flows as a cash inflow. Although cash is transferred between the two borrowing groups, there is no cash transaction reported in the consolidated cash flows at the time of the original financing. These captive financing activities, along with all significant intercompany transactions, are reclassified or eliminated from the Consolidated Statements of Cash Flows.

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

	Six Months Ended			
(In millions)		**June 30, 2012**		**July 2, 2011**
Reclassifications from investing activities:				
Finance receivable originations for Manufacturing group inventory sales	$	(95)	$	(134)
Cash received from customers and sale of receivables		212		240
Other capital contributions made to Finance group				(40)
Other		1		6
Total reclassifications from investing activities		118		72
Reclassifications from financing activities:				
Capital contribution paid by Manufacturing group to Finance group under Support Agreement		240		112
Dividends received by Manufacturing group from Finance group		(315)		(179)
Other capital contributions made to Finance group				40
Total reclassifications from financing activities		(75)		(27)
Total reclassifications and adjustments to cash flow from operating activities	$	43	$	45

Critical Accounting Estimates

The accounting policies that we believe are most critical to the portrayal of our financial condition and results of operations are disclosed on pages 36 through 40 in our 2011 Annual Report on Form 10-K. The following section provides an update of the year-end disclosure for long-term contracts to include program profit adjustments made during the first half of 2012.

Long-Term Contracts

We make a substantial portion of our sales to government customers pursuant to long-term contracts. These contracts require development and delivery of products over multiple years and may contain fixed-price purchase options for additional products. We account for these long-term contracts under the percentage-of-completion method of accounting. Under this method, we estimate profit as the difference between total estimated revenues and cost of a contract. The percentage-of-completion method of accounting involves the use of various estimating techniques to project costs at completion and, in some cases, includes estimates of recoveries asserted against the customer for changes in specifications. Due to the size, length of time and nature of many of our contracts, the estimation of total contract costs and revenues through completion is complicated and subject to many variables relative to the outcome of future events over a period of several years. We are required to make numerous assumptions and estimates relating to items such as expected engineering requirements, complexity of design and related

development costs, performance of subcontractors, availability and cost of materials, labor productivity and cost, overhead and capital costs, manufacturing efficiencies and the achievement of contract milestones, including product deliveries.

At the outset of each contract, we estimate the initial profit booking rate. The initial profit booking rate of each contract considers risks surrounding the ability to achieve the technical requirements (for example, a newly-developed product versus a mature product), schedule (for example, the number and type of milestone events), and costs by contract requirements in the initial estimated costs at completion. Profit booking rates may increase during the performance of the contract if we successfully retire risks surrounding the technical, schedule, and costs aspects of the contract. Likewise, the profit booking rate may decrease if we are not successful in retiring the risks; and, as a result, our estimated costs at completion increase. All of the estimates are subject to change during the performance of the contract and, therefore, may affect the profit booking rate. When adjustments are required, any changes from prior estimates are recognized using the cumulative catch-up method with the impact of the change from inception-to-date recorded in the

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current period. The following table sets forth the aggregate gross amount of all program profit adjustments that are included within segment profit for the first half of 2012 and 2011:

	Three Months Ended		Six Months Ended	
(In millions)	June 30, 2012	July 2, 2011	June 30, 2012	July 2, 2011
Gross favorable	$ 23	$ 21	$ 40	$ 42
Gross unfavorable	(11)	(11)	(24)	(18)
Net adjustments	$ 12	$ 10	$ 16	$ 24

Forward-Looking Information

Certain statements in this Quarterly Report on Form 10-Q and other oral and written statements made by us from time to time are forward-looking statements within the meaning of the Private Securities Litigation Reform Act of 1995. These forward-looking statements, which may describe strategies, goals, outlook or other non-historical matters, or project revenues, income, returns or other financial measures, often include words such as believe, expect, anticipate, intend , plan, estimate, guidance , project , target , potential , will , sh may and similar expressions intended to identify forward-looking statements. These statements are only predictions and involve known and unknown risks, uncertainties, and other factors that may cause our actual results to differ materially from those expressed or implied by such forward-looking statements. Given these uncertainties, you should not place undue reliance on these forward-looking statements. Forward-looking statements speak only as of the date on which they are made, and we undertake no obligation to update or revise any forward-looking statements. In addition to those factors described herein under Risk Factors in our Annual Report on Form 10-K, among the factors that could cause actual results to differ materially from past and projected future results are the following:

- Changing priorities or reductions in the U.S. Government defense budget, including those related to military operations in foreign countries;
- Changes in worldwide economic or political conditions that impact demand for our products, interest rates or foreign exchange rates;
- Our ability to perform as anticipated and to control costs under contracts with the U.S. Government;
- The U.S. Government s ability to unilaterally modify or terminate its contracts with us for the U.S. Government s convenience or for our failure to perform, to change applicable procurement and accounting policies, or, under certain circumstances, to withhold payment or suspend or debar us as a contractor eligible to receive future contract awards;
- Changes in foreign military funding priorities or budget constraints and determinations, or changes in government regulations or policies on the export and import of military and commercial products;
- Our Finance segment s ability to maintain portfolio credit quality or to realize full value of receivables and of assets acquired upon foreclosure of receivables;
- Our ability to access the capital markets at reasonable rates;
- Performance issues with key suppliers, subcontractors or business partners;

- Legislative or regulatory actions impacting our operations or demand for our products;

- Our ability to control costs and successfully implement various cost-reduction activities;

- The efficacy of research and development investments to develop new products or unanticipated expenses in connection with the launching of significant new products or programs;

- The timing of our new product launches or certifications of our new aircraft products;

- Our ability to keep pace with our competitors in the introduction of new products and upgrades with features and technologies desired by our customers;

- The extent to which we are able to pass raw material price increases through to customers or offset such price increases by reducing other costs;

- Increases in pension expenses or employee and retiree medical benefits;

- Uncertainty in estimating reserves, including reserves established to address contingent liabilities, unrecognized tax benefits, or potential losses on our Finance segment s receivables;

- Difficult conditions in the financial markets which may adversely impact our customers ability to fund or finance purchases of our products; and

- Volatility in the global economy resulting in demand softness or volatility in the markets in which we do business.

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Item 3. **QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK**

There has been no significant change in our exposure to market risk during the fiscal quarter ended June 30, 2012. For discussion of our exposure to market risk, refer to Item 7A. Quantitative and Qualitative Disclosures about Market Risk contained in Textron s 2011 Annual Report on Form 10-K.

Item 4. **CONTROLS AND PROCEDURES**

We have carried out an evaluation, under the supervision and with the participation of our management, including our Chairman, President and Chief Executive Officer (CEO) and our Executive Vice President and Chief Financial Officer (CFO), of the effectiveness of the design and operation of our disclosure controls and procedures (as defined in Rule 13a-15(e) and 15d-15(e) under the Securities Exchange Act of 1934, as amended (the Act)) as of the end of the fiscal quarter covered by this report. Based upon that evaluation, our CEO and CFO concluded that our disclosure controls and procedures are effective in providing reasonable assurance that (a) the information required to be disclosed by us in the reports that we file or submit under the Act is recorded, processed, summarized and reported within the time periods specified in the Securities and Exchange Commission s rules and forms, and (b) such information is accumulated and communicated to our management, including our CEO and CFO, as appropriate to allow timely decisions regarding required disclosure.

There were no changes in our internal control over financial reporting during the fiscal quarter ended June 30, 2012 that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

PART II. OTHER INFORMATION

Item 1. **LEGAL PROCEEDINGS**

As previously reported and as updated in Textron s Annual Report on Form 10-K for the fiscal year ended December 31, 2011, on August 13, 2009, a purported shareholder class action lawsuit was filed in the United States District Court in Rhode Island against Textron, its then Chairman and former Chief Executive Officer and its former Chief Financial Officer. The suit, filed by the City of Roseville Employees Retirement System, alleged that the defendants violated the federal securities laws by making material misrepresentations or omissions related to Cessna and TFC. The complaint sought unspecified compensatory damages. In December 2009, the Automotive Industries Pension Trust Fund was appointed lead plaintiff in the case. On February 8, 2010, an amended class action complaint was filed with the Court. The amended complaint named as additional defendants TFC and three of its present and former officers. On April 6, 2010, the court entered a stipulation agreed to by the parties in which plaintiffs voluntarily dismissed, without prejudice, certain causes of action in the amended complaint. On April 9, 2010, all defendants moved to dismiss the remaining counts of the amended complaint, and on August 24, 2011, the court granted the motion to dismiss on behalf of all defendants without leave to amend and entered judgment in favor of all defendants. On September 23, 2011, plaintiffs filed a notice of appeal of the dismissal with the First Circuit Court of Appeals, and on June 7, 2012, the First Circuit affirmed the decision of the district court dismissing the suit.

As previously reported in Textron s Annual Report on Form 10-K for the fiscal year ended December 31, 2011, on February 7, 2012, a lawsuit was filed in the United States Bankruptcy Court, Northern District of Ohio, Eastern Division (Akron) by Brian A. Bash, Chapter 7 Trustee for Fair Finance Company against TFC, Fortress Credit Corp. and Fair Facility I, LLC. TFC provided a revolving line of credit of up to $17.5 million to Fair Finance Company from 2002 through 2007. The complaint alleges numerous counts against TFC, as Fair Finance Company s working capital lender, including receipt of fraudulent transfers and assisting in fraud perpetrated on Fair Finance investors. The Trustee seeks avoidance and recovery of alleged fraudulent transfers in the amount of $316 million as well as damages of $223 million on the other claims. The Trustee also seeks trebled damages on all claims under Ohio law. We intend to vigorously defend this lawsuit, and on April 20, 2012, TFC moved to dismiss all claims in the complaint. That motion is still pending.

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Item 6. EXHIBITS

10.1	Letter agreement between Textron and John D. Butler, dated June 4, 2012
10.2	Letter agreement between Textron and Cheryl H. Johnson, dated June 12, 2012
12.1	Computation of ratio of income to fixed charges of Textron Inc. Manufacturing Group
12.2	Computation of ratio of income to fixed charges of Textron Inc. including all majority-owned subsidiaries
31.1	Certification of Chief Executive Officer Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002
31.2	Certification of Chief Financial Officer Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002
32.1	Certification of Chief Executive Officer Pursuant to 18 U.S.C. 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002
32.2	Certification of Chief Financial Officer Pursuant to 18 U.S.C. 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002
101	The following materials from Textron Inc. s Quarterly Report on Form 10-Q for the quarterly period ended June 30, 2012, formatted in XBRL (eXtensible Business Reporting Language): (i) the Consolidated Statements of Operations, (ii) the Consolidated Statements of Comprehensive Income, (iii) the Consolidated Balance Sheets, (iv) the Consolidated Statements of Cash Flows and (v) Notes to the Consolidated Financial Statements.

SIGNATURES

Pursuant to the requirements of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned thereunto duly authorized.

TEXTRON INC.

Date: July 26, 2012

/s/Richard L. Yates
Richard L. Yates
Senior Vice President and Corporate Controller
(principal accounting officer)

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