

NORTHROP GRUMMAN CORP /DE/

Form 10-Q

October 22, 2014

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

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

For the Quarterly Period Ended September 30, 2014

or

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

Commission File Number 1-16411

NORTHROP GRUMMAN CORPORATION

(Exact name of registrant as specified in its charter)

DELAWARE

80-0640649

(State or other jurisdiction of
incorporation or organization)

(I.R.S. Employer
Identification No.)

2980 Fairview Park Drive, Falls Church, Virginia 22042

(Address of principal executive offices)

(703) 280-2900

(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 ☒

No ☐

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files).

Yes ☒

No ☐

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer 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 ☒

Accelerated filer ☐

Non-accelerated filer ☐ (Do not check if a smaller reporting company)

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 ☒

Indicate the number of shares outstanding of each of the issuer's classes of common stock, as of the latest practicable date.

As of October 17, 2014, 201,999,289 shares of common stock were outstanding.

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PART I. FINANCIAL INFORMATION

Item 1. Financial Statements

CONDENSED CONSOLIDATED STATEMENTS OF EARNINGS AND COMPREHENSIVE INCOME

(Unaudited)

	Three Months Ended September 30		Nine Months Ended September 30	
\$ in millions, except per share amounts	2014	2013	2014	2013
Sales				
Product	\$3,494	\$3,330	\$10,466	\$10,344
Service	2,490	2,776	7,405	8,160
Total sales	5,984	6,106	17,871	18,504
Operating costs and expenses				
Product	2,614	2,499	7,815	7,833
Service	2,021	2,262	5,910	6,621
General and administrative expenses	580	555	1,712	1,695
Operating income	769	790	2,434	2,355
Other (expense) income				
Interest expense	(69	) (70	) (208	) (183
Other, net	(6	) —	10	(16
Earnings before income taxes	694	720	2,236	2,156
Federal and foreign income tax expense	221	223	673	682
Net earnings	\$473	\$497	\$1,563	\$1,474
Basic earnings per share	\$2.29	\$2.18	\$7.39	\$6.33
Weighted-average common shares outstanding, in millions	206.2	228.2	211.6	232.8
Diluted earnings per share	\$2.26	\$2.14	\$7.28	\$6.22
Weighted-average diluted shares outstanding, in millions	209.2	232.6	214.8	237.0
Net earnings (from above)	\$473	\$497	\$1,563	\$1,474
Other comprehensive income				
Change in unamortized benefit plan costs, net of tax	31	78	127	237
Change in cumulative translation adjustment	(26	) 15	(24	) 8
Change in unrealized gain (loss) on marketable securities and cash flow hedges, net of tax	3	(1	) 3	(1
Other comprehensive income, net of tax	8	92	106	244
Comprehensive income	\$481	\$589	\$1,669	\$1,718

The accompanying notes are an integral part of these unaudited condensed consolidated financial statements.

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CONDENSED CONSOLIDATED STATEMENTS OF FINANCIAL POSITION

(Unaudited)

\$ in millions	September 30, 2014	December 31, 2013
Assets		
Cash and cash equivalents	\$3,402	\$5,150
Accounts receivable, net	3,233	2,685
Inventoried costs, net	671	698
Deferred tax assets	526	605
Prepaid expenses and other current assets	290	350
Total current assets	8,122	9,488
Property, plant and equipment, net of accumulated depreciation of \$4,540 in 2014 and \$4,337 in 2013	2,845	2,806
Goodwill	12,463	12,438
Non-current deferred tax assets	129	209
Other non-current assets	1,484	1,440
Total assets	\$25,043	\$26,381
Liabilities		
Trade accounts payable	\$1,193	\$1,229
Accrued employee compensation	1,225	1,446
Advance payments and amounts in excess of costs incurred	1,610	1,722
Other current liabilities	1,483	1,418
Total current liabilities	5,511	5,815
Long-term debt, net of current portion	5,926	5,928
Pension and other post-retirement benefit plan liabilities	2,775	2,954
Other non-current liabilities	938	1,064
Total liabilities	15,150	15,761
Commitments and contingencies (Note 7)		
Shareholders' equity		
Preferred stock, \$1 par value; 10,000,000 shares authorized; no shares issued and outstanding	—	—
Common stock, \$1 par value; 800,000,000 shares authorized; issued and outstanding: 2014—203,176,629 and 2013—217,599,230	203	218
Paid-in capital	—	848
Retained earnings	12,568	12,538
Accumulated other comprehensive loss	(2,878)	(2,984)
Total shareholders' equity	9,893	10,620
Total liabilities and shareholders' equity	\$25,043	\$26,381

The accompanying notes are an integral part of these unaudited condensed consolidated financial statements.

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CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS

(Unaudited)

	Nine Months Ended September 30	
\$ in millions	2014	2013
Operating activities		
Net earnings	\$1,563	\$1,474
Adjustments to reconcile to net cash provided by operating activities:		
Depreciation and amortization	322	345
Stock-based compensation	93	118
Excess tax benefits from stock-based compensation	(75)	(37)
Deferred income taxes	76	89
Changes in assets and liabilities:		
Accounts receivable, net	(531)	(147)
Inventoried costs, net	43	10
Prepaid expenses and other assets	(30)	(53)
Accounts payable and other liabilities	(514)	(296)
Income taxes payable	201	92
Retiree benefits	5	(331)
Other, net	(50)	15
Net cash provided by operating activities	\$1,103	\$1,279
Investing activities		
Capital expenditures	(285)	(178)
Other investing activities, net	(72)	9
Net cash used in investing activities	(357)	(169)
Financing activities		
Common stock repurchases	(2,058)	(1,661)
Cash dividends paid	(423)	(411)
Net proceeds from issuance of long-term debt	—	2,841
Payments of long-term debt	—	(877)
Other financing activities, net	(13)	80
Net cash used in financing activities	(2,494)	(28)
(Decrease) increase in cash and cash equivalents	(1,748)	1,082
Cash and cash equivalents, beginning of year	5,150	3,862
Cash and cash equivalents, end of period	\$3,402	\$4,944

The accompanying notes are an integral part of these unaudited condensed consolidated financial statements.

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CONDENSED CONSOLIDATED STATEMENTS OF CHANGES IN SHAREHOLDERS' EQUITY
(Unaudited)

	Nine Months Ended September 30	
\$ in millions, except per share amounts	2014	2013
Common stock		
Beginning of year	\$218	\$239
Common stock repurchased	(17)	(21)
Shares issued for employee stock awards and options	2	6
End of period	203	224
Paid-in capital		
Beginning of year	848	2,924
Common stock repurchased	(943)	(1,652)
Stock compensation	83	212
Other	12	(5)
End of period	—	1,479
Retained earnings		
Beginning of year	12,538	11,138
Common stock repurchased	(1,099)	—
Net earnings	1,563	1,474
Dividends declared	(434)	(416)
End of period	12,568	12,196
Accumulated other comprehensive loss		
Beginning of year	(2,984)	(4,787)
Other comprehensive income, net of tax	106	244
End of period	(2,878)	(4,543)
Total shareholders' equity	\$9,893	\$9,356
Cash dividends declared per share	\$2.01	\$1.77

The accompanying notes are an integral part of these unaudited condensed consolidated financial statements.

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NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Unaudited)

1. BASIS OF PRESENTATION

Principles of Consolidation and Reporting

These unaudited condensed consolidated financial statements include the accounts of Northrop Grumman Corporation and subsidiaries (herein referred to as "Northrop Grumman," the "company," "we," "us," or "our"). Material intercompany accounts, transactions and profits are eliminated in consolidation. Investments in equity securities and joint ventures where the company has significant influence, but not control, are accounted for using the equity method.

The accompanying unaudited condensed consolidated financial statements are prepared in accordance with the rules of the Securities and Exchange Commission (SEC) for interim reporting purposes. These financial statements include adjustments of a normal recurring nature considered necessary by management for a fair presentation of the company's unaudited condensed consolidated financial position, results of operations and cash flows.

The results reported in these unaudited condensed consolidated financial statements are not necessarily indicative of results that may be expected for the entire year. These unaudited condensed consolidated financial statements should be read in conjunction with the information contained in the company's 2013 Annual Report on Form 10-K.

The quarterly information is labeled using a calendar convention; that is, first quarter is consistently labeled as ending on March 31, second quarter as ending on June 30, and third quarter as ending on September 30. It is the company's long-standing practice to establish actual interim closing dates using a "fiscal" calendar, in which we close our books on a Friday near these quarter-end dates in order to normalize the potentially disruptive effects of quarterly closings on business processes. This practice is only used at interim periods within a reporting year.

Accounting Estimates

The accompanying unaudited condensed consolidated financial statements are prepared in accordance with accounting principles generally accepted in the United States of America (GAAP). The preparation thereof requires management to make estimates and judgments that affect the reported amounts of assets and liabilities and the disclosure of contingencies at the date of the financial statements, as well as the reported amounts of revenues and expenses during the reporting period. Estimates have been prepared using the most current and best available information; however, actual results could differ materially from those estimates.

The majority of our contracts are accounted for under the percentage-of-completion method. For such contracts, changes in estimates of contract sales, costs or profits are recognized using the cumulative catch-up method of accounting. This method recognizes, in the current period, the cumulative effect of the changes on current and prior periods; revenue and profit in future periods of contract performance are recognized as if the revised estimates had been used since contract inception. Changes in estimates of contract revenue and cost occur for a variety of reasons, including changes in contract scope, the resolution of risk at lower or higher cost than anticipated, unanticipated risks affecting contract costs, changes in indirect cost allocations, such as overhead and general and administrative expenses, and changes in estimated award and incentive fees. We employ an extensive contract management process involving several functional organizations and numerous personnel who are skilled at managing contract activities. Changes in estimates are frequent; the company performs on a broad portfolio of long-term contracts, including the development of complex and customized military platforms and systems, as well as advanced electronic equipment and software, that often include technology at the forefront of science.

Significant changes in estimates on a single contract could have a material effect on the company's unaudited condensed consolidated financial position or results of operations and where such changes occur, separate disclosure is made of the nature, underlying conditions and financial impact of the change. During the three and nine months ended September 30, 2014, aggregate net changes in contract estimates recognized using the cumulative catch-up method of accounting increased operating income by \$194 million and \$556 million (\$0.60 and \$1.68 per diluted share based on statutory tax rates), respectively. During the three and nine months ended September 30, 2013, aggregate net changes in contract estimates recognized using the cumulative catch-up method of accounting increased operating income by \$236 million and \$657 million (\$0.66 and \$1.80 per diluted share based on statutory tax rates),

respectively. No discrete event or adjustment to an individual contract was material to the unaudited condensed consolidated statements of earnings and comprehensive income for any of these periods.

As of September 30, 2014, the amounts related to contract claims and requests for equitable adjustment recognized in estimated contract values were not material individually or in aggregate. In addition, as of September 30, 2014, the company was not aware of any contract terminations in process that would have a material effect on our unaudited condensed consolidated financial position or our annual results of operations and cash flows.

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Litigation, Commitments and Contingencies

Amounts associated with litigation, commitments and contingencies are recorded as charges to earnings when management determines it is probable a liability will be found to have been incurred and the amount of the loss can be reasonably estimated. Due to the inherent uncertainties surrounding gain contingencies, we generally do not recognize potential gains until realized. During the third quarter of 2014, the company received payments from the United States (U.S.) Government in a total amount of \$75 million to settle certain claims relating to use of the company's intellectual property and a terminated program. This amount is reflected in product sales of the Aerospace Systems segment for the three and nine months ending September 30, 2014.

Related Party Transactions

For all periods presented, the company had no material related party transactions.

Accounting Standards Updates

On May 28, 2014, the Financial Accounting Standards Board (FASB) issued Accounting Standards Update (ASU) No. 2014-09, Revenue from Contracts with Customers. ASU 2014-09 supersedes existing revenue recognition guidance, including Accounting Standards Codification (ASC) No. 605-35, Revenue Recognition - Construction-Type and Production-Type Contracts. ASU 2014-09 outlines a single set of comprehensive principles for recognizing revenue under U.S. GAAP. Among other things, it requires companies to identify contractual performance obligations and determine whether revenue should be recognized at a point in time or over time. These concepts, as well as other aspects of ASU 2014-09, may change the method and/or timing of revenue recognition for certain of our contracts. ASU 2014-09 will be effective January 1, 2017, and may be applied either retrospectively or through the use of a modified-retrospective method. We are currently evaluating both methods of adoption as well as the effect ASU 2014-09 will have on the company's consolidated financial position, results of operations and cash flows.

Other accounting standards updates effective after September 30, 2014, are not expected to have a material effect on the company's consolidated financial position or its annual results of operations and cash flows.

Reclassifications

Our unaudited condensed consolidated statements of cash flows for the nine months ended September 30, 2014 and 2013 reflect cash flows from operating activities presented solely on the indirect method. The company previously presented both the direct method and indirect method for our cash flows from operating activities. This change in reporting method had no effect on the amount of our net cash flows from operating activities.

In the first quarter of 2014, we reclassified our cash awards incentive compensation accrual from other current liabilities to accrued employee compensation, which are both reported within current liabilities on the unaudited condensed consolidated statement of financial position. The reclassification reduced other current liabilities and increased accrued employee compensation by \$196 million and \$277 million, as of September 30, 2014 and December 31, 2013, respectively.

Shareholders' Equity

The company records the difference between the cost of shares repurchased and their par value as a reduction of paid-in capital to the extent of its balance and then as a reduction of retained earnings.

Accumulated Other Comprehensive Loss

The components of accumulated other comprehensive loss are as follows:

\$ in millions	September 30, 2014	December 31, 2013
Unamortized benefit plan costs, net of tax benefit of \$1,888 as of September 30, 2014 and \$1,972 as of December 31, 2013	\$(2,873)	\$(3,000)
Cumulative translation adjustment	(6)	18
Net unrealized gain (loss) on marketable securities and cash flow hedges, net of tax	1	(2)
Total accumulated other comprehensive loss	\$(2,878)	\$(2,984)

Unamortized benefit plan costs consist primarily of net after-tax actuarial losses totaling \$3.2 billion and \$3.3 billion as of September 30, 2014 and December 31, 2013, respectively. Net actuarial gains or losses are re-determined annually or upon remeasurement events and principally arise from changes in the rate used to discount our benefit obligations and differences between expected and actual returns on plan assets.

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Reclassifications from other comprehensive income to net earnings related to the amortization of benefit plan costs were \$35 million and \$108 million, net of taxes, for the three and nine months ended September 30, 2014, respectively, and were \$78 million and \$237 million, net of taxes, for the three and nine months ended September 30, 2013, respectively. The reclassifications represent the amortization of net actuarial losses and prior service credits for the company's retirement benefit plans, and are included in the computation of net periodic pension cost. See Note 8 for further information.

Reclassifications from other comprehensive income to net earnings, relating to cumulative translation adjustments, marketable securities and effective cash flow hedges for the three and nine months ended September 30, 2014 and 2013, respectively, were not material. Reclassifications for cumulative translation adjustments and marketable securities are recorded in other income, and reclassifications for effective cash flow hedges are recorded in operating income.

2. EARNINGS PER SHARE, SHARE REPURCHASES AND DIVIDENDS ON COMMON STOCK**Basic Earnings Per Share**

We calculate basic earnings per share by dividing net earnings by the weighted-average number of shares of common stock outstanding during each period.

Diluted Earnings Per Share

Diluted earnings per share includes the dilutive effect of awards and options granted to employees under stock-based compensation plans. The dilutive effect of these securities totaled 3.0 million shares and 3.2 million shares for the three and nine months ended September 30, 2014, respectively. The dilutive effect of these securities totaled 4.4 million shares and 4.2 million shares for the three and nine months ended September 30, 2013, respectively. The weighted-average diluted shares outstanding would exclude stock options with exercise prices in excess of the average market price of the company's common stock during the period; however, we had no such stock options outstanding for the three and nine months ended September 30, 2014 and 2013.

Share Repurchases

The table below summarizes the company's share repurchases:

Repurchase Program Authorization Date	Amount Authorized (in millions)	Total Shares Retired (in millions)	Average Price Per Share ⁽²⁾	Date Completed	Shares Repurchased (in millions) Nine Months Ended September 30	
					2014	2013
June 16, 2010	\$5,350	83.7	\$63.86	September 2013	—	18.6
May 15, 2013 ⁽¹⁾	\$4,000	25.6	\$115.50		16.9	2.0

On May 15, 2013, the company's board of directors authorized a share repurchase program of up to \$4.0 billion of the company's common stock. Repurchases under this program commenced in September 2013 upon the (1) completion of the company's 2010 repurchase program. As of September 30, 2014, our repurchases under the program totaled \$3.0 billion; \$1.0 billion remained under this share repurchase authorization. The repurchase program is expected to expire when we have used all authorized funds for repurchase.

(2) Includes commissions paid.

Share repurchases take place from time to time, subject to market conditions and management's discretion, in the open market or in privately negotiated transactions. The company retires its common stock upon repurchase and has not made any purchases of common stock other than in connection with these publicly announced repurchase program authorizations.

Dividends on Common Stock

In May 2014, the company increased the quarterly common stock dividend 15 percent to \$0.70 per share from the previous amount of \$0.61 per share.

In May 2013, the company increased the quarterly common stock dividend 11 percent to \$0.61 per share from the previous amount of \$0.55 per share.

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3. SEGMENT INFORMATION

The company is aligned into four segments: Aerospace Systems, Electronic Systems, Information Systems and Technical Services. The U.S. Government is the primary customer of our four segments. The company, from time to time, acquires or disposes of businesses and realigns contracts, programs or business areas among and within our segments. Portfolio shaping and internal realignments are designed to more fully leverage existing capabilities and enhance development and delivery of products and services.

The following table presents sales and operating income by segment:

\$ in millions	Three Months Ended September 30		Nine Months Ended September 30	
	2014	2013	2014	2013
Sales				
Aerospace Systems	\$2,543	\$2,484	\$7,465	\$7,582
Electronic Systems	1,733	1,774	5,121	5,266
Information Systems	1,511	1,619	4,650	4,982
Technical Services	691	713	2,120	2,152
Intersegment eliminations	(494)	) (484	) (1,485	) (1,478)
Total sales	5,984	6,106	17,871	18,504
Operating income				
Aerospace Systems	402	330	1,016	936
Electronic Systems	274	273	833	891
Information Systems	150	162	465	474
Technical Services	66	67	202	201
Intersegment eliminations	(52)	) (69	) (177	) (194)
Total segment operating income	840	763	2,339	2,308
Reconciliation to total operating income:				
Net FAS/CAS pension adjustment	(20)	) 61	200	125
Unallocated corporate expenses	(50)	) (33	) (103	) (73)
Other	(1)	) (1	) (2	) (5)
Total operating income	\$769	\$790	\$2,434	\$2,355

Net FAS/CAS Pension Adjustment

The net FAS (GAAP Financial Accounting Standards)/CAS (U.S. Government Cost Accounting Standards) pension adjustment reflects the difference of pension expense charged to contracts and included as cost in segment operating income less pension expense determined in accordance with GAAP. In the third quarter of 2014, Congress passed the Highway and Transportation Funding Act of 2014 (HATFA), which includes provisions that reduce the amount of CAS pension expense charged to our contracts. The legislation was retroactive to January 1, 2014; in the third quarter of 2014 we recognized a \$132 million cumulative reduction in 2014 CAS pension expense principally reflecting the year-to-date HATFA impact. As a result, CAS expense charged to our contracts for the three and nine months ended September 30, 2014, declined as compared to the same periods in 2013. The reduction in FAS expense for the three and nine months ended September 30, 2014, respectively, is largely due to the increase in our FAS discount rate assumption as of December 31, 2013.

Unallocated Corporate Expenses

Unallocated corporate expenses include the portion of corporate expenses not considered allowable or allocable under applicable CAS regulations and the Federal Acquisition Regulation, and are therefore not allocated to the segments. Such costs consist of a portion of management and administration, legal, environmental, compensation costs, retiree benefits, and certain unallowable costs such as lobbying activities, among others.

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4. INCOME TAXES

\$ in millions	Three Months Ended September 30		Nine Months Ended September 30	
	2014	2013	2014	2013
Federal and foreign income tax expense	\$221	\$223	\$673	\$682
Effective income tax rate	31.8	% 31.0	% 30.1	% 31.6

The company's lower effective tax rate for the nine months ended September 30, 2014, reflects a \$51 million benefit for the partial resolution of the 2007-2009 Internal Revenue Service (IRS) examination, offset in part by the absence of research tax credits in 2014.

The IRS is conducting an examination of the company's tax returns for the years 2007 through 2011. In the first quarter of 2014, the U.S. Congressional Joint Committee on Taxation approved the company's partial resolution of the IRS examination of the company's 2007-2009 tax returns. As a result, the company recorded a reduction of income tax expense of \$51 million. The company also reduced its unrecognized tax benefits by \$59 million and related accrued interest by \$12 million.

The company believes it is reasonably possible that within the next 12 months we will resolve the remaining matters on our 2007-2009 tax returns and the IRS will complete its examination of our 2010 and 2011 tax returns. The combined resolution of these items, excluding interest, could result in a reduction of our unrecognized tax benefits up to \$75 million and a reduction of our income tax expense up to \$40 million. Open tax years related to state and foreign jurisdictions remain subject to examination, but are not expected to have a material effect on the company's unaudited condensed consolidated financial statements.

5. FAIR VALUE OF FINANCIAL INSTRUMENTS

The following table presents comparative carrying value and fair value information for our financial assets and liabilities:

\$ in millions	September 30, 2014		December 31, 2013	
	Carrying Value	Fair Value	Carrying Value	Fair Value
Financial Assets (Liabilities)				
Marketable securities				
Trading	\$319	\$319	\$308	\$308
Available-for-sale	6	6	2	2
Derivatives	(1	) (1	) (2	) (2
Long-term debt, including current portion	\$(5,929	) \$(6,597	) \$(5,930	) \$(6,227

There were no transfers of financial instruments between the three levels of fair value hierarchy during the nine months ended September 30, 2014.

The carrying value of cash and cash equivalents approximates fair value.

Investments in Marketable Securities

The company holds a portfolio of marketable securities to partially fund non-qualified employee benefit plans consisting of securities that are classified as either trading or available-for-sale. These assets are recorded at fair value and substantially all of these instruments are valued using Level 1 inputs, with an immaterial amount valued using Level 2 inputs. As of September 30, 2014 and December 31, 2013, marketable securities of \$325 million and \$310 million, respectively, were included in other non-current assets in the unaudited condensed consolidated statements of financial position.

Derivative Financial Instruments and Hedging Activities

The company's derivative portfolio consists primarily of foreign currency forward contracts, which are used to manage foreign currency exchange risk related to receipts from customers and payments to suppliers denominated in foreign currencies. The notional values for the company's derivative portfolio at September 30, 2014 and December 31, 2013, were \$127 million and \$161 million, respectively. The portion of notional values designated as

cash flow hedges at September 30, 2014 and December 31, 2013, were \$46 million and \$77 million, respectively.

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Derivative financial instruments are recognized as assets or liabilities in the unaudited condensed consolidated financial statements and measured at fair value. Substantially all of these instruments are valued using Level 2 inputs. Unrealized gains or losses on the effective portion of cash flow hedges are reclassified from other comprehensive income to operating income upon the settlement of the underlying transactions. The derivative fair values and related unrealized gains and losses at September 30, 2014 and December 31, 2013, were not material. Hedge contracts not designated for hedge accounting and the ineffective portion of cash flow hedges are recorded in other income.

Long-term Debt

The fair value of long-term debt is calculated using Level 2 inputs based on interest rates available for debt with terms and maturities similar to the company's existing debt arrangements.

6. INVESTIGATIONS, CLAIMS AND LITIGATION

Litigation

The company is one of several defendants in litigation brought by the Orange County Water District in Orange County Superior Court in California on December 17, 2004, for alleged contribution to volatile organic chemical contamination of the County's shallow groundwater. The lawsuit includes counts against the defendants for violation of the Orange County Water District Act, the California Super Fund Act, negligence, nuisance, trespass and declaratory relief. Among other things, the lawsuit seeks unspecified damages for the cost of remediation, payment of attorney fees and costs, and punitive damages. Trial on the statutory claims (those based on the Orange County Water District Act, the California Super Fund Act and declaratory relief) concluded on September 25, 2012. On October 29, 2013, the court issued its decision in favor of the defendants on the statutory claims. On May 9, 2014, the court granted defendants' dispositive motions on the remaining tort causes of action. Notice of entry of judgment was filed on July 1, 2014. The Orange County Water District filed a notice of appeal on August 28, 2014. The court has not yet set a briefing schedule.

On May 4, 2012, the company commenced an action, Northrop Grumman Systems Corp. v. United States, in the U.S. Court of Federal Claims. This lawsuit relates to an approximately \$875 million firm fixed price contract awarded to the company in 2007 by the U.S. Postal Service (USPS) for the construction and delivery of flats sequencing systems (FSS) as part of the postal automation program. The FSS have been delivered. The company's lawsuit is based on various theories of liability. The complaint seeks approximately \$63 million for unpaid portions of the contract price, and approximately \$115 million based on the company's assertions that, through various acts and omissions over the life of the contract, the USPS adversely affected the cost and schedule of performance and materially altered the company's obligations under the contract. The United States responded to the company's complaint with an answer, denying most of the company's claims and counterclaims, seeking approximately \$410 million, less certain amounts outstanding under the contract. The principal counterclaim alleges that the company delayed its performance and caused damages to the USPS because USPS did not realize certain costs savings as early as it had expected. On April 2, 2013, the U.S. Department of Justice informed the company of a False Claims Act complaint relating to the FSS contract that was filed under seal by a relator in June 2011 in the U.S. District Court for the Eastern District of Virginia. On June 3, 2013, the United States filed a Notice informing the Court that the United States had decided not to intervene in this case. On August 26, 2013, the relator filed a corrected First Amended Complaint. The relator alleged that the company violated the False Claims Act in a number of ways with respect to the FSS contract, alleged damage to the USPS in an amount of at least approximately \$179 million annually, and sought an unspecified partial refund of the contract purchase price, penalties, attorney's fees and other costs of suit. Damages under the False Claims Act may be trebled upon a finding of liability. The relator also alleged he was improperly discharged in retaliation. On November 22, 2013, the company filed a motion to dismiss the First Amended Complaint. By Order dated December 11, 2013, based on the relator's stipulation, the court dismissed the relator's retaliation claim. By Order dated December 13, 2013, the court dismissed the remaining allegations without prejudice and granted the relator leave to file an Amended Complaint. On January 3, 2014, the relator filed a Second Amended Complaint that, with the exception of the retaliation claim which is now the subject of an arbitration demand, includes the same allegations as the First Amended Complaint. On July 3, 2014, the relator filed a Third Amended Complaint adding an

additional theory of recovery, consolidating some earlier counts and eliminating others. On August 15, 2014, the company filed a motion for summary judgment on the Third Amended Complaint. On September 5, 2014, the court granted the company's motion and ordered the relator's False Claims Act case be dismissed with prejudice. Although the ultimate outcome of these matters ("the FSS matters," collectively),

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including any possible loss, cannot be predicted or estimated at this time, the company intends vigorously to pursue and defend the FSS matters.

On August 8, 2013, the company received a court-appointed expert's report in litigation pending in the Second Federal Court of the Federal District in Brazil brought by the Brazilian Post and Telegraph Corporation (ECT), a Brazilian state-owned entity, against Solystic SAS (Solystic), a French subsidiary of the company, and two of its consortium partners. In this suit, commenced on December 17, 2004, and relatively inactive for some period of time, ECT alleges the consortium breached its contract with ECT and seeks damages of approximately R\$111 million (the equivalent of approximately \$46 million as of September 30, 2014), plus interest, inflation adjustments and attorneys' fees, as authorized by Brazilian law, which amounts could be significant over time. The original suit sought R\$89 million (the equivalent of approximately \$37 million as of September 30, 2014) in damages. In October 2013, ECT asserted an additional damage claim of R\$22 million (the equivalent of approximately \$10 million as of September 30, 2014). In its counterclaim, Solystic alleges ECT breached the contract by wrongfully refusing to accept the equipment Solystic had designed and built and seeks damages of approximately €31 million (the equivalent of approximately \$40 million as of September 30, 2014), plus interest, inflation adjustments and attorneys' fees, as authorized by Brazilian law. The Brazilian court retained an expert to consider certain issues pending before it. On August 8, 2013 and September 10, 2014, the company received reports from the expert, which contain some recommended findings relating to liability and the damages calculations put forth by ECT. Some of the expert's recommended findings were favorable to the company and others were favorable to ECT. The parties have an opportunity to submit further comments on the expert's reports. At some point after they do so, the court is expected to hear testimony from witnesses and issue a decision on the parties' claims and counterclaims that could accept or reject, in whole or in part, the expert's recommended findings.

The company is a party to various investigations, lawsuits, claims and other legal proceedings, including government investigations and claims, that arise in the ordinary course of our business. The nature of legal proceedings is such that we cannot assure the outcome of any particular matter. However, based on information available to the company to date, and other than with respect to the FSS matters discussed separately above, the company does not believe the outcome of any matter pending against the company is likely to have a material adverse effect on the company's unaudited condensed consolidated financial position as of September 30, 2014, or its annual results of operations or cash flows.

7. COMMITMENTS AND CONTINGENCIES

Guarantees of Subsidiary Performance Obligations

From time to time in the ordinary course of business, the company guarantees obligations of its subsidiaries under certain contracts. Generally, the company is liable under such an arrangement only if its subsidiary is unable to perform under its contract. Historically, the company has not incurred any substantial liabilities resulting from these guarantees.

In addition, the company's subsidiaries may enter into joint ventures, teaming and other business arrangements (collectively, Business Arrangements) to support the company's products and services in domestic and international markets. The company generally strives to limit its exposure under these arrangements to its subsidiary's investment in the Business Arrangements or to the extent of such subsidiary's obligations under the applicable contract. In some cases, however, the company may be required to guarantee performance by the Business Arrangements and, in such cases, the company generally strives to obtain cross-indemnification from the other members of the Business Arrangements.

At September 30, 2014, the company is not aware of any existing event of default that would require it to satisfy any of these guarantees.

U.S. Government Cost Claims

From time to time, the company is advised of claims by the U.S. Government concerning certain potential disallowed costs, plus, at times, penalties and interest. When such findings are presented, the company and the U.S. Government representatives engage in discussions to enable the company to evaluate the merits of these claims, as well as to assess

the amounts being claimed. Where appropriate, provisions are made to reflect the company's estimated exposure for matters raised by the U.S. Government. Such provisions are reviewed periodically using the most recent information available. The company believes it has adequately reserved for disputed amounts that are probable and estimable, and the outcome of any such matters would not have a material adverse effect on its unaudited condensed consolidated financial position as of September 30, 2014, or its annual results of operations and/or cash flows.

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Environmental Matters

The estimated cost to complete remediation at certain current or formerly owned or leased sites has been accrued where the company believes, based on the facts and circumstances known to the company, it is probable the company will incur costs to address environmental impacts and the costs are reasonably estimable. As of September 30, 2014, management estimates the range of reasonably possible future costs for environmental remediation is between \$363 million and \$798 million, before considering the amount recoverable through overhead charges on U.S. Government contracts. At September 30, 2014, the amount within that range that is accrued for probable environmental remediation costs was \$381 million, of which \$135 million is accrued in other current liabilities and \$246 million is accrued in other non-current liabilities. A portion of the environmental remediation costs is expected to be recoverable through overhead charges on government contracts and, accordingly, such amounts are deferred in inventoried costs and other non-current assets. As of September 30, 2014, \$69 million is deferred in inventoried costs and \$124 million is deferred in other non-current assets. These amounts are evaluated for recoverability on a routine basis. Although management cannot predict whether new information gained as our environmental remediation projects progress, or as changes in facts and circumstances occur, will materially affect the estimated liability accrued, management does not anticipate future remediation expenditures associated with our currently identified projects will have a material adverse effect on the company's unaudited condensed consolidated financial position as of September 30, 2014, or its annual results of operations and/or cash flows.

Financial Arrangements

In the ordinary course of business, the company uses stand-by letters of credit and guarantees issued by commercial banks and surety bonds issued principally by insurance companies to guarantee the performance on certain obligations. At September 30, 2014, there were \$298 million of stand-by letters of credit and guarantees and \$158 million of surety bonds outstanding.

Credit Facility

The company maintains an unsecured credit facility in an aggregate principal amount of \$1.775 billion (the Credit Agreement). The Credit Agreement contains customary terms and conditions, including covenants restricting the company's ability to sell all or substantially all of its assets, merge or consolidate with another entity or undertake other fundamental changes and incur liens. The company also cannot permit the ratio of its debt to capitalization (as set forth in the Credit Agreement) to exceed 65 percent. At September 30, 2014, there was no balance outstanding under this facility. The company was in compliance with all covenants under its Credit Agreement on September 30, 2014.

Indemnifications

The company has retained certain environmental, income tax and other potential liabilities in connection with certain of its divestitures. The settlement of these liabilities is not expected to have a material adverse effect on the company's unaudited condensed consolidated financial position as of September 30, 2014, or its annual results of operations or cash flows.

Operating Leases

Rental expense for operating leases for the three and nine months ended September 30, 2014, was \$84 million and \$229 million, respectively, and was \$75 million and \$223 million for the three and nine months ended September 30, 2013, respectively. These amounts are net of immaterial amounts of sublease rental income.

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8. RETIREMENT BENEFITS

The cost to the company of its defined benefit retirement plans is shown in the following table:

	Three Months Ended September 30				Nine Months Ended September 30			
	Pension Benefits		Medical and Life Benefits		Pension Benefits		Medical and Life Benefits	
\$ in millions	2014	2013	2014	2013	2014	2013	2014	2013
Components of net periodic benefit cost								
Service cost	\$114	\$129	\$8	\$9	\$343	\$387	\$25	\$27
Interest cost	314	279	25	24	944	838	75	72
Expected return on plan assets	(467)	(452)	(21)	(19)	(1,402)	(1,357)	(63)	(57)
Amortization of:								
Prior service credit	(14)	(15)	(12)	(13)	(44)	(44)	(32)	(38)
Net loss from previous years	81	152	3	8	245	456	9	23
Other	1	—	—	—	1	—	—	—
Net periodic benefit cost	\$29	\$93	\$3	\$9	\$87	\$280	\$14	\$27

Employer Contributions

We fund our defined benefit pension plans annually in a manner consistent with the Employee Retirement Income Security Act of 1974, as amended by the Pension Protection Act of 2006. For the nine months ended September 30, 2014, we made contributions of \$59 million and \$43 million to the company's defined benefit pension plans and post-retirement benefit plans, respectively.

The company also sponsors defined contribution plans. For the three months ended September 30, 2014 and 2013, we made contributions of \$63 million and \$63 million, respectively, to these plans. For the nine months ended September 30, 2014 and 2013, we made contributions of \$210 million and \$213 million, respectively, to these plans.

9. STOCK COMPENSATION PLANS AND OTHER COMPENSATION ARRANGEMENTS

Stock Awards

In February 2014, the company granted certain employees 0.2 million restricted stock rights (RSRs) and 0.5 million restricted performance stocks rights (RPSRs) under the company's long-term incentive stock plan, with a grant date aggregate fair value of \$88 million. The RSRs will typically vest on the third anniversary of the grant date, while the RPSRs will vest and settle based on the achievement of financial metrics for the three-year period ending December 31, 2016.

Cash Awards

In February 2014, the company granted certain employees cash units (CUs) and cash performance units (CPUs) with a minimum aggregate payout amount of \$31 million and a maximum aggregate payout amount of \$176 million. The CUs will vest and settle in cash on the third anniversary of the grant date, while the CPUs will vest and settle in cash based on the achievement of financial metrics for the three-year period ending December 31, 2016.

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REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

To the Board of Directors and Shareholders of
Northrop Grumman Corporation
Falls Church, Virginia

We have reviewed the accompanying condensed consolidated statement of financial position of Northrop Grumman Corporation and subsidiaries as of September 30, 2014, and the related condensed consolidated statements of earnings and comprehensive income for the three-month and nine-month periods ended September 30, 2014 and 2013, and of cash flows and changes in shareholders' equity for the nine-month periods ended September 30, 2014 and 2013. These interim financial statements are the responsibility of the Corporation's management.

We conducted our reviews in accordance with the standards of the Public Company Accounting Oversight Board (United States). A review of interim financial information consists principally of applying analytical procedures and making inquiries of persons responsible for financial and accounting matters. It is substantially less in scope than an audit conducted in accordance with the standards of the Public Company Accounting Oversight Board (United States), the objective of which is the expression of an opinion regarding the financial statements taken as a whole.

Accordingly, we do not express such an opinion.

Based on our reviews, we are not aware of any material modifications that should be made to such condensed consolidated interim financial statements for them to be in conformity with accounting principles generally accepted in the United States of America.

We have previously audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the consolidated statement of financial position of Northrop Grumman Corporation and subsidiaries as of December 31, 2013, and the related consolidated statements of earnings and comprehensive income, cash flows, and changes in shareholders' equity for the year then ended (not presented herein); and in our report dated February 3, 2014, we expressed an unqualified opinion on those consolidated financial statements. In our opinion, the information set forth in the accompanying condensed consolidated statement of financial position as of December 31, 2013, is fairly stated, in all material respects, in relation to the consolidated statement of financial position from which it has been derived.

/s/ Deloitte & Touche LLP
McLean, Virginia
October 21, 2014

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

OVERVIEW

Northrop Grumman Corporation (herein referred to as "Northrop Grumman," the "company," "we," "us," or "our") is a leading global security company. We provide innovative systems, products and solutions in unmanned systems; cybersecurity; command, control, communications and computers (C4) intelligence, surveillance and reconnaissance (C4ISR); strike aircraft; and logistics and modernization to government and commercial customers worldwide through our four segments: Aerospace Systems, Electronic Systems, Information Systems and Technical Services. We participate in many high-priority defense and government services programs in the United States (U.S.) and abroad. We offer a broad portfolio of capabilities and technologies that enable us to deliver innovative systems and solutions for applications that range from undersea to outer space and into cyberspace. We conduct most of our business with the U.S. Government, principally the Department of Defense (DoD) and intelligence community. We also conduct business with local, state and foreign governments and domestic and international commercial customers.

The following discussion should be read along with the unaudited condensed consolidated financial statements included in this Form 10-Q, as well as our 2013 Annual Report on Form 10-K, which provides a more thorough discussion of our systems, products and solutions; political and economic environment; industry outlook; and business trends. See further discussions in the Consolidated Operating Results and Segment Operating Results sections that follow.

Political and Economic Environment

The following is an update of events affecting the company's political and economic environment since the filing of our 2013 Annual Report on Form 10-K.

On February 15, 2014, the President signed into law the Temporary Debt Limit Extension Act, suspending the statutory limit on the amount of permissible federal debt (the debt ceiling) until March 15, 2015.

On March 4, 2014, the President delivered his budget request for FY 2015 to Congress. The federal spending requested is consistent with levels mandated by the Bipartisan Budget Act of 2013. The discretionary spending request for FY 2015 totaled approximately \$1.0 trillion, including DoD base defense spending of \$489 billion. The President's budget contained placeholder funding for overseas contingency operations (OCO), and on June 26, 2014, the President submitted to Congress an updated FY 2015 OCO request of \$65.8 billion, including \$58.6 billion for DoD. In addition to his FY 2015 budget request, the President has requested an additional \$56 billion in FY 2015 spending under the Opportunity, Growth and Security (OGS) Initiative. The OGS Initiative includes further spending priorities designated by the President. The DoD's portion of the defense-related OGS Initiative totals \$26.4 billion, with proposed spending spread across military departments and other components.

The President's budget request (excluding the OGS Initiative) complies with FY 2015 sequestration levels; however, the budget's combined request for projected defense spending levels in FY 2016 through FY 2019 is approximately \$115 billion above sequestration levels. The President proposes to achieve this higher spending plan by replacing sequestration with a combination of spending cuts and tax changes. Congress is currently considering the FY 2015 budget request.

On September 22, 2014, the President signed a continuing resolution which funds the government at FY 2014 levels until December 11, 2014. It is unclear when or if annual appropriations bills will be enacted for FY 2015. The U.S. Government may operate under a continuing resolution for all of FY 2015, potentially restricting new contract or program starts for that year.

Along with the President's FY 2015 budget request, the DoD released its Quadrennial Defense Review (QDR), a congressionally-mandated report that discusses the DoD's long-term strategies and priorities. The QDR recommends spending above the sequester levels and specifies the impacts if sequester caps are imposed again in 2016. In July 2014, the National Defense Panel, a bi-partisan group of senior civilians and military officers appointed by Congress to review the QDR, recommended repealing the 2011 Budget Control Act and returning to higher defense funding levels. It is unclear whether or how the results of these strategic reviews could impact future budget plans.

Operating Performance Assessment and Reporting

We manage and assess our business based on our performance on contracts and programs (one or more closely-related contracts), with consideration given to the Critical Accounting Policies, Estimates and Judgments described in Part II, Item 7 of our 2013 Annual Report on Form 10-K. For our portfolio of long-term contracts, sales are

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primarily recognized using the cost-to-cost method of percentage of completion accounting, but in some cases the units-of-delivery method of percentage of completion accounting is utilized. As a result, sales tend to fluctuate in concert with costs incurred across our large portfolio of contracts. Due to Federal Acquisition Regulation (FAR) rules that govern our business, most types of costs are allowable, and we do not focus on individual cost groupings (such as manufacturing, engineering and design labor costs, subcontractor costs, material costs, overhead costs, and general and administrative costs), as much as we do on total contract cost, which is the key driver of our sales and operating income.

Our contract management process involves the use of contract estimates-at-completion (EACs), which are generally prepared and evaluated on a bottoms-up basis at least annually; reviews of significant contracts are performed on a quarterly basis over the contract's period of performance. These EACs include an estimated contract operating income based initially on the contract award amount, adjusted to reflect estimated risks related to contract performance. These risks typically include technical risk, schedule risk and performance risk based on our evaluation of the contract effort. Similarly, the EACs may include identified opportunities for operating margin rate improvement. Over the contract's period of performance, our business and program management organizations perform evaluations of contract performance and adjust the contract sales and cost estimates to reflect the latest reliable information available. Our business and program management organizations are comprised of skilled professional managers whose objective is to satisfy the customer's expectations, deliver high quality products and services, and manage contract cost risks and opportunities to achieve an appropriate operating margin rate on the contract. Our comprehensive business and contract management process involves personnel with expertise from various disciplines including engineering, production control, contracts, cost management, mission assurance and quality, finance and supply chain, among others. As part of this overall contract management function, personnel monitor compliance with our critical accounting policies related to contract accounting and compliance with U.S. Government regulations. Contract operating income and period-to-period contract operating margin rates are adjusted over the contract's period of performance to reflect the latest estimated sales and cost for the contract, including changes in the risks and opportunities affecting the contract. Such adjustments are accounted for under the cumulative catch-up method of accounting and may have a favorable or unfavorable effect on operating income depending upon the specific conditions affecting each contract.

In evaluating our operating performance, we look primarily at changes in sales and operating income, including the effects of meaningful changes in operating income as a result of changes in contract estimates. Where applicable, significant fluctuations in operating performance attributable to individual contracts or programs, or changes in a specific cost element across multiple contracts, are described in our analysis. Based on this approach and the nature of our operations, the discussion of results of operations first focuses on our four segments before distinguishing between products and services. Changes in sales are generally described in terms of volume, deliveries or other indicators of sales activity. For purposes of this discussion, volume generally refers to increases or decreases in sales or cost from production/service activity levels or delivery rates. Performance refers to changes in contract margin rates for the period, as well as the continuing effect of prior cumulative catch-up adjustments. Both are primarily related to the changes in estimates referred to above.

CONSOLIDATED OPERATING RESULTS

Selected financial highlights are presented in the table below:

	Three Months Ended		Nine Months Ended		
	September 30		September 30		
\$ in millions, except per share amounts	2014	2013	2014	2013	
Sales	\$5,984	\$6,106	\$17,871	\$18,504	
Operating costs and expenses	5,215	5,316	15,437	16,149	
Operating income	769	790	2,434	2,355	
Operating margin rate	12.9	% 12.9	% 13.6	% 12.7	%
Federal and foreign income tax expense	221	223	673	682	

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Effective income tax rate	31.8	%	31.0	%	30.1	%	31.6	%
Diluted earnings per share	2.26		2.14		7.28		6.22	
Net cash provided by operating activities	\$933		\$950		\$1,103		\$1,279	

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Sales

Sales for the three months ended September 30, 2014, decreased \$122 million, or 2 percent, and for the nine months ended September 30, 2014, decreased \$633 million, or 3 percent, as compared with the same periods in 2013.

Sales for the three and nine months ended September 30, 2014 include the benefit of \$75 million realized in connection with agreements reached with the U.S. Government to settle certain claims relating to use of the company's intellectual property and a terminated program, which is reflected in product sales at the Aerospace Systems segment. The table below shows the variances in segment sales from the prior year period:

\$ in millions	Three Month Variance			Nine Month Variance		
Aerospace Systems	\$59	2	%	\$(117)	) (2	%)
Electronic Systems	(41	) (2	%)	(145	) (3	%)
Information Systems	(108	) (7	%)	(332	) (7	%)
Technical Services	(22	) (3	%)	(32	) (1	%)
Intersegment sales elimination	(10	) 2	%	(7	) —	
Total sales variance	\$(122	) (2	%)	\$(633	) (3	%)

For further information by segment refer to Segment Operating Results below, and for product and service detail, refer to the Product and Service Analysis section that follows Segment Operating Results.

Operating Costs and Expenses

Operating costs and expenses are primarily comprised of labor, material, subcontractor and overhead costs, and are generally allocated to contracts as incurred. In accordance with industry practice and the regulations that govern cost accounting requirements for government contracts, most general management and corporate expenses incurred at the segment and corporate locations are considered allowable and allocable contract costs. Allowable and allocable general and administrative costs are allocated on a systematic basis to contracts in progress.

Operating costs and expenses comprise the following:

\$ in millions	Three Months Ended		Nine Months Ended	
	September 30		September 30	
	2014	2013	2014	2013
Product costs	\$2,614	\$2,499	\$7,815	\$7,833
Service costs	2,021	2,262	5,910	6,621
General and administrative expenses	580	555	1,712	1,695
Operating costs and expenses	\$5,215	\$5,316	\$15,437	\$16,149

Product costs as a percentage of product sales for the three months ended September 30, 2014 were 74.8 percent as compared to 75.0 percent during the same period in 2013; the decrease is mainly due to the settlements described in the Sales section above, offset by lower net favorable adjustments. Service costs as a percentage of service sales for the three months ended September 30, 2014 were 81.2 percent, comparable to the same period in 2013.

Product costs as a percentage of product sales for the nine months ended September 30, 2014 were 74.7 percent as compared to 75.7 percent during the same period in 2013; the decrease is mainly due to the settlements described in the Sales section above and the continuing benefit of higher margin rates resulting from previous net favorable adjustments. Service costs as a percentage of service sales for the nine months ended September 30, 2014 were 79.8 percent as compared to 81.1 percent during the same period in 2013; the decrease was mainly due to improved performance across a number of service programs at Information Systems.

For the product and service costs detail, see the Product and Service Analysis section that follows Segment Operating Results.

General and administrative expenses as a percentage of total sales for the three and nine months ended September 30, 2014 were 9.7 percent and 9.6 percent, respectively, as compared with 9.1 percent and 9.2 percent for the same periods in 2013. This change largely reflects increased investment for future business.

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Operating Income

We define operating income as sales less operating costs and expenses, which includes general and administrative expenses. Changes in estimated contract operating income at completion, resulting from changes in estimated sales, operating costs and expenses, are recorded using the cumulative catch-up method of accounting, which in aggregate can have a significant effect on our reported sales and operating income in each of our reporting periods. Cumulative catch-up adjustments are presented in the table below:

	Three Months Ended September 30		Nine Months Ended September 30	
\$ in millions	2014	2013	2014	2013
Favorable adjustments	\$254	\$290	\$736	\$837
Unfavorable adjustments	(60)	(54)	(180)	(180)
Net favorable adjustments	\$194	\$236	\$556	\$657

Net cumulative catch-up adjustments by segment are presented in the table below:

	Three Months Ended September 30		Nine Months Ended September 30	
\$ in millions	2014	2013	2014	2013
Aerospace Systems	\$114	\$129	\$309	\$334
Electronic Systems	54	80	188	272
Information Systems	20	29	54	46
Technical Services	12	17	33	41
Eliminations	(6)	(19)	(28)	(36)
Net favorable adjustments	\$194	\$236	\$556	\$657

Federal and Foreign Income Tax Expense

The effective tax rates for the three and nine months ended September 30, 2014, were 31.8 percent and 30.1 percent, respectively, compared with 31.0 percent and 31.6 percent for the three and nine months ended September 30, 2013, respectively. The company's lower effective tax rate for the nine months ended September 30, 2014, reflects a \$51 million benefit for the partial resolution of the 2007-2009 Internal Revenue Service (IRS) examination, offset in part by the absence of research tax credits in 2014.

Diluted Earnings Per Share

Diluted earnings per share for the three months ended September 30, 2014, increased \$0.12 or 6 percent, as compared with the same period in 2013, reflecting lower weighted-average shares outstanding resulting from shares repurchased in 2013 and 2014, partially offset by lower earnings primarily due to a decrease in the net FAS (GAAP Financial Accounting Standards)/CAS (U.S. Government Cost Accounting Standards) pension adjustment.

Diluted earnings per share for the nine months ended September 30, 2014, increased \$1.06, or 17 percent, as compared with the same period in 2013, reflecting lower weighted-average shares outstanding resulting from share repurchases during 2013 and 2014 and higher net earnings, principally due to increases in segment operating income and the net FAS/CAS pension adjustment, as well as a lower effective tax rate.

Cash from Operating Activities

For the three months ended September 30, 2014, net cash provided by operating activities is comparable to the same period in 2013. For the nine months ended September 30, 2014, net cash provided by operating activities decreased \$176 million, as compared with the same period in 2013, principally driven by changes in trade working capital, which were partially offset by the impact of a \$500 million voluntary pre-tax pension contribution made in April 2013.

SEGMENT OPERATING RESULTS

Basis of Presentation

We are aligned in four segments: Aerospace Systems, Electronic Systems, Information Systems and Technical Services. This section discusses segment sales, segment operating income and segment operating margin rates. The

reconciliation of segment sales to total sales is provided in Note 3 to the unaudited condensed consolidated financial

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statements in Part I, Item 1. The reconciliation of segment operating income to total operating income, as well as a discussion of the reconciling items, is provided in Note 3 to the unaudited condensed consolidated financial statements in Part I, Item 1. For purposes of the discussion in this Segment Operating Results section, references to operating income and operating margin rate reflect segment operating income and segment operating margin rate.

On February 27, 2014, the company acquired Qantas Defence Services Pty Limited (QDS), now called Northrop Grumman Integrated Defence Services Pty Limited (Northrop Grumman IDS) for \$72 million in cash. Northrop Grumman IDS provides integrated logistics, sustainment and modernization support primarily to Australian government and military customers. Preliminary estimates of the fair value of the assets acquired and liabilities assumed and the results of operations of Northrop Grumman IDS are included in the Technical Services segment. These amounts were not material to the company's unaudited condensed consolidated financial statements.

Segment Operating Income

Segment operating income, as reconciled below, is a non-GAAP measure and is used by management as an internal measure for financial performance of our operating segments. Segment operating income reflects total earnings from our four segments including allocated pension expense recognized under CAS.

	Three Months Ended		Nine Months Ended	
	September 30		September 30	
\$ in millions	2014	2013	2014	2013
Segment operating income	\$840	\$763	\$2,339	\$2,308
Segment operating margin rate	14.0	% 12.5	% 13.1	% 12.5

Segment operating income increased for the three and nine months ended September 30, 2014, principally due to the settlements described in the Consolidated Operating Results section above and the \$37 million benefit resulting from lower CAS pension cost due to the Highway and Transportation Funding Act of 2014 (HATFA) legislation described below, partially offset by lower sales volume.

The table below reconciles segment operating income to total operating income by including the impact of net FAS/CAS pension differences, as well as certain corporate-level expenses, which are not considered allowable or allocable under applicable CAS or FAR.

	Three Months Ended		Nine Months Ended	
	September 30		September 30	
\$ in millions	2014	2013	2014	2013
Segment operating income	\$840	\$763	\$2,339	\$2,308
CAS pension expense	9	154	287	405
Less: FAS pension expense	(29)	(93)	(87)	(280)
Net FAS/CAS pension adjustment	(20)	61	200	125
Unallocated corporate expenses	(50)	(33)	(103)	(73)
Other	(1)	(1)	(2)	(5)
Total operating income	\$769	\$790	\$2,434	\$2,355

For financial statement purposes, we account for our employee pension plans in accordance with GAAP under FAS. However, the cost of these plans is charged to our contracts in accordance with the FAR and the related CAS that govern such plans. The net FAS/CAS pension adjustment reflects the difference of pension expense charged to contracts and included as cost in segment operating income less pension expense determined in accordance with GAAP. In the third quarter of 2014, Congress passed HATFA, which includes provisions that reduce the amount of CAS pension expense charged to our contracts. The legislation was retroactive to January 1, 2014; in the third quarter of 2014 we recognized a \$132 million cumulative reduction in 2014 CAS pension expense principally reflecting the year-to-date HATFA impact. As a result, CAS expense charged to our contracts for the three and nine months ended September 30, 2014, declined as compared to the same periods in 2013. The reduction in FAS expense for the three and nine months ended September 30, 2014, respectively, is largely due to the increase in our FAS discount rate assumption as of December 31, 2013.

Unallocated corporate expenses generally include the portion of corporate expenses, other than FAS pension costs, not considered allowable or allocable under applicable CAS and FAR rules, and therefore not allocated to the

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segments, such as a portion of management and administration, legal, environmental, certain compensation and retiree benefits, and other expenses.

AEROSPACE SYSTEMS

\$ in millions	Three Months Ended September 30		Nine Months Ended September 30		
	2014	2013	2014	2013	
Sales	\$2,543	\$2,484	\$7,465	\$7,582	
Operating income	402	330	1,016	936	
Operating margin rate	15.8	% 13.3	% 13.6	% 12.3	%
Current Quarter					

Aerospace Systems sales for the three months ended September 30, 2014, increased \$59 million, or 2 percent, as compared with the same period in 2013, primarily due to the settlements described in the Consolidated Operating Results section above. Excluding the settlements, Aerospace Systems had lower sales in manned military aircraft programs and comparable sales in space and unmanned programs as compared to the same period in 2013. The decrease in manned military aircraft is mainly due to lower volume on the B-2, E-8 Joint Surveillance Target Attack Radar System (Joint STARS) and F/A-18 programs, which was partially offset by higher volume on the E-2D Advanced Hawkeye program.

Operating income for the three months ended September 30, 2014, increased \$72 million, or 22 percent, and operating margin rate increased to 15.8 percent, from 13.3 percent. The increases in the third quarter of 2014, as compared to the third quarter of 2013, were mainly due to the settlements noted above and additional margin resulting from lower CAS pension expense due to the HATFA legislation described above.

Year to Date

Aerospace Systems sales for the nine months ended September 30, 2014, decreased \$117 million, or 2 percent, as compared with the same period in 2013 including the impact of the settlements described in the Consolidated Operating Results section above. Excluding the settlements, Aerospace Systems had lower sales on unmanned, space and manned military aircraft programs. The decrease in unmanned programs was primarily due to lower production activity on Global Hawk and lower development activity on Fire Scout, partially offset by increased volume on the NATO Alliance Ground Surveillance (AGS) program. The decrease in space programs was mainly due to lower volume on the James Webb Space Telescope and Advanced Extremely High Frequency programs. The decrease in manned military aircraft programs was primarily the result of lower volume on the B-2 and Joint STARS programs, partially offset by ramp-up on the E-2D Advanced Hawkeye program.

Operating income for the nine months ended September 30, 2014, increased \$80 million, or 9 percent, and operating margin rate increased to 13.6 percent, from 12.3 percent. Higher operating income and margin rate in 2014 were primarily due to the settlements described above and additional margin resulting from lower CAS pension expense due to the HATFA legislation described above.

ELECTRONIC SYSTEMS

\$ in millions	Three Months Ended September 30		Nine Months Ended September 30		
	2014	2013	2014	2013	
Sales	\$1,733	\$1,774	\$5,121	\$5,266	
Operating income	274	273	833	891	
Operating margin rate	15.8	% 15.4	% 16.3	% 16.9	%
Current Quarter					

Electronic Systems sales for the three months ended September 30, 2014, decreased \$41 million, or 2 percent, as compared with the same period in 2013. Sales decreased primarily due to lower deliveries on combat avionics and infrared countermeasures programs. These declines were partially offset by higher volume on space, marine and undersea systems programs.

Operating income for the three months ended September 30, 2014, was comparable with the same period in 2013 and operating margin rate increased to 15.8 percent from 15.4 percent. The increase in third quarter 2014 operating

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margin rate is primarily driven by improved performance and additional margin resulting from lower CAS pension expense due to the HATFA legislation described above.

Year to Date

Electronic Systems sales for the nine months ended September 30, 2014, decreased \$145 million, or 3 percent, as compared with the same period in 2013. Sales declined due to fewer deliveries of infrared countermeasures, combat avionics and navigation systems programs. These decreases were partially offset by higher volume on international programs.

Operating income for the nine months ended September 30, 2014, decreased \$58 million, or 7 percent, and operating margin rate decreased to 16.3 percent from 16.9 percent. Operating income and margin rate for the nine months ended September 30, 2014 declined primarily due to lower volume and the absence in 2014 of the benefit from the reversal of a \$26 million non-programmatic risk reserve in the prior year.

INFORMATION SYSTEMS

In the third quarter of 2014, Information Systems realigned into seven business areas: Command and Control (C2); Cyber; Intelligence, Surveillance and Reconnaissance (ISR); Civil; Communications; Integrated Air and Missile Defense (IAMD) and Health. This change had no impact on the segment operating results of Information Systems as a whole.

	Three Months Ended September 30		Nine Months Ended September 30		
\$ in millions	2014	2013	2014	2013	
Sales	\$1,511	\$1,619	\$4,650	\$4,982	
Operating income	150	162	465	474	
Operating margin rate	9.9	% 10.0	% 10.0	% 9.5	%
Current Quarter					

Information Systems sales for the three months ended September 30, 2014, decreased \$108 million, or 7 percent, as compared with the same period in 2013. Sales principally declined due to lower volume for C2 programs as a result of reduced funding levels and in-theater force reductions.

Operating income for the three months ended September 30, 2014, decreased \$12 million, or 7 percent, and operating margin rate was comparable to the same period in 2013. The reduction in operating income is primarily a result of the sales decline described above.

Year to Date

Information Systems sales for the nine months ended September 30, 2014, decreased \$332 million, or 7 percent, as compared with the same period in 2013. Sales principally declined due to lower volume for C2 programs as a result of reduced funding levels and in-theater force reductions.

Operating income for the nine months ended September 30, 2014, decreased \$9 million, or 2 percent, and operating margin rate increased to 10.0 percent, from 9.5 percent. The higher operating margin rate reflects additional margin resulting from lower CAS pension expense due to the HATFA legislation described above and the continuing benefit of higher margin rates resulting from previous net favorable adjustments.

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TECHNICAL SERVICES

	Three Months Ended September 30		Nine Months Ended September 30		
\$ in millions	2014	2013	2014	2013	
Sales	\$691	\$713	\$2,120	\$2,152	
Operating income	66	67	202	201	
Operating margin rate	9.6	% 9.4	% 9.5	% 9.3	%
Current Quarter					

Technical Services sales for the three months ended September 30, 2014, decreased \$22 million, or 3 percent, as compared with the same period in 2013, due to lower volume on the InterContinental Ballistic Missile (ICBM) and the Combined Tactical Training Range (CTTR) programs, partially offset by growth in international sales, primarily related to the acquisition of QDS in the first quarter of 2014.

Operating income for the third quarter of 2014, was comparable to the third quarter of 2013. Operating margin rate for the three months ended September 30, 2014 increased to 9.6 percent from 9.4 percent in the same period in 2013.

Year to Date

Technical Services sales for the nine months ended September 30, 2014, decreased \$32 million, or 1 percent, as compared with the same period in 2013. The decrease was primarily due to lower volume on the ICBM, Hunter and C-20 programs, which were partially offset by growth in international sales, principally as a result of the acquisition of QDS in the first quarter of 2014.

Operating income for the nine months ended September 30, 2014, was comparable to the same period in 2013.

Operating margin rate for the nine months ended September 30, 2014 increased to 9.5 percent from 9.3 percent in the same period in 2013.

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PRODUCT AND SERVICE ANALYSIS

The following table presents product and service sales and operating costs and expenses by segment:

\$ in millions	Three Months Ended September 30				Nine Months Ended September 30			
	2014		2013		2014		2013	
Segment Information:	Sales	Operating Costs and Expenses	Sales	Operating Costs and Expenses	Sales	Operating Costs and Expenses	Sales	Operating Costs and Expenses
Aerospace Systems								
Product	\$2,014	\$1,671	\$1,867	\$1,620	\$5,995	\$5,147	\$6,204	\$5,450
Service	529	470	617	534	1,470	1,302	1,378	1,196
Electronic Systems								
Product	1,338	1,118	1,377	1,149	4,088	3,415	4,063	3,365
Service	395	341	397	352	1,033	873	1,203	1,010
Information Systems								
Product	346	332	260	226	1,006	953	669	598
Service	1,165	1,029	1,359	1,231	3,644	3,232	4,313	3,910
Technical Services								
Product	46	39	36	38	144	130	141	130
Service	645	586	677	608	1,976	1,788	2,011	1,821
Segment Totals								
Total Product	\$3,744	\$3,160	\$3,540	\$3,033	\$11,233	\$9,645	\$11,077	\$9,543
Total Service	2,734	2,426	3,050	2,725	8,123	7,195	8,905	7,937
Intersegment eliminations	(494)	(442)	(484)	(415)	(1,485)	(1,308)	(1,478)	(1,284)
Total segment ⁽¹⁾	\$5,984	\$5,144	\$6,106	\$5,343	\$17,871	\$15,532	\$18,504	\$16,196

(1) The reconciliation of segment operating income to total operating income, as well as a discussion of the reconciling items, is included in Note 3 to the unaudited condensed consolidated financial statements in Part I, Item 1.

Product Sales and Costs

Current Quarter

Product sales for the three months ended September 30, 2014 increased \$204 million, or 6 percent, as compared with the same period in 2013. The increase was primarily driven by higher product sales at Aerospace Systems and Information Systems. The increase at Aerospace Systems was primarily due to higher product sales from a revision in the classification of certain operations, maintenance, and sustainment contracts from product to service in the third quarter of 2013 and the settlements described in the Consolidated Operating Results section above, partially offset by lower volume. The increase at Information Systems was primarily due to higher product sales on certain restricted and C2 programs.

Product costs for the three months ended September 30, 2014, increased \$127 million, or 4 percent, as compared with the same period in 2013. The increase was primarily driven by higher product costs at Aerospace Systems and Information Systems, consistent with the changes in product sales described above, partially offset by higher product margins at Aerospace Systems.

Year to Date

Product sales for the nine months ended September 30, 2014, increased \$156 million, or 1 percent, as compared with the same period in 2013. The increase was primarily driven by higher product sales at Information Systems, partially offset by lower product sales at Aerospace Systems. The increase at Information Systems was primarily due to higher product sales on certain restricted and C2 programs. The decrease at Aerospace Systems was primarily driven by lower product volume in unmanned and space programs, partially offset by the settlements described in the Consolidating Operating Results section above.

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Product costs for the nine months ended September 30, 2014, increased \$102 million, or 1 percent, as compared with the same period in 2013, as higher product costs at Information Systems were partially offset by lower product costs at Aerospace Systems, consistent with the changes in product sales described above.

Service Sales and Costs

Current Quarter

Service sales for the three months ended September 30, 2014, decreased \$316 million, or 10 percent, as compared with the same period in 2013. The decrease was primarily driven by lower service sales at Information Systems and Aerospace Systems. The decrease at Information Systems was primarily due to reduced funding levels across a broad number of programs and the impacts of in-theater force reductions, as described in the Segment Operating Results section above. The decrease at Aerospace Systems was primarily due to the revision in the classification of certain operations, maintenance, and sustainment contracts from product to service in the third quarter of 2013, partially offset by increased volume on certain unmanned and space programs.

Service costs for the three months ended September 30, 2014, decreased \$299 million, or 11 percent, as compared with the same period in 2013. The decrease was primarily driven by the lower service sales volume described above.

Year to Date

Service sales for the nine months ended September 30, 2014, decreased \$782 million, or 9 percent, as compared with the same period in 2013. The decrease was primarily driven by lower service sales at Information Systems, primarily due to reduced volume on restricted work and the impacts of in-theater force reductions as described in the Segment Operating Results section above.

Service costs for the nine months ended September 30, 2014, decreased \$742 million, or 9 percent, as compared with the same period in 2013 consistent with the lower service sales volume described above.

BACKLOG

Total backlog includes both funded backlog (firm orders for which funding is authorized and appropriated) and unfunded backlog. Unexercised contract options and indefinite delivery indefinite quantity (IDIQ) contracts are not included in backlog until the time the option or IDIQ task order is exercised or awarded. For multi-year service contracts with non-U.S. Government customers having no stated contract values, backlog includes only the amounts committed by the customer. Backlog is converted into sales as costs are incurred or deliveries are made.

Backlog consisted of the following as of September 30, 2014, and December 31, 2013:

	September 30, 2014		December 31, 2013	
\$ in millions	Funded	Unfunded	Total Backlog	Total Backlog
Aerospace Systems	\$9,737	\$9,467	\$19,204	\$18,321
Electronic Systems	7,121	2,894	10,015	9,037
Information Systems	3,549	3,258	6,807	6,864
Technical Services	2,280	231	2,511	2,811
Total backlog	\$22,687	\$15,850	\$38,537	\$37,033

Total backlog as of September 30, 2014 increased \$1.5 billion, or 4 percent, as compared with backlog as of December 31, 2013. The increase was primarily due to the timing of awards at Aerospace Systems.

New Awards

The estimated value of contract awards recorded during the nine months ended September 30, 2014 was \$19.2 billion. New awards during this period include \$4.1 billion for the E-2D Advanced Hawkeye program, \$793 million for the F-35 program, \$552 million for the Virginia Class Submarine program, \$534 million for the Global Hawk program and \$466 million for the F/A-18 program.

LIQUIDITY AND CAPITAL RESOURCES

We endeavor to ensure the most efficient conversion of operating income into cash for deployment in our business and to maximize shareholder value. In addition to our cash position, we use various financial measures to assist in

capital deployment decision-making, including cash provided by operating activities, free cash flow, net debt-to-

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equity and net debt-to-capital. We believe these measures are useful to investors in assessing our financial performance and condition.

Cash balances and cash generated from operating activities, supplemented by borrowings under credit facilities and/or in the capital markets, if needed, is expected to be sufficient to fund our operations for at least the next 12 months.

The table below summarizes key components of cash flows provided by operating activities:

	Three Months Ended September 30		Nine Months Ended September 30	
\$ in millions	2014	2013	2014	2013
Net earnings	\$473	\$497	\$1,563	\$1,474
Non-cash items ⁽¹⁾	201	213	416	515
Changes in assets and liabilities:				
Trade working capital	287	176	(831)	(394)
Retiree benefit funding (in excess of) less than expense	(3)	66	5	(331)
Other, net	(25)	(2)	(50)	15
Net cash provided by operating activities	\$933	\$950	\$1,103	\$1,279

(1) Includes depreciation and amortization, stock-based compensation expense and deferred income taxes

Free Cash Flow from Operations

Free cash flow from operations is defined as cash provided by operating activities less capital expenditures. We believe free cash flow from operations is a useful measure for investors to consider as it represents the cash flow the company has available after capital spending to invest for future growth, strengthen the balance sheet and/or return to shareholders through dividends and share repurchases. Free cash flow is a key factor in our planning for and consideration of strategic acquisitions, the payment of dividends and stock repurchases.

Free cash flow from operations is not a measure of financial performance under GAAP, and may not be defined and calculated by other companies in the same manner. This measure should not be considered in isolation as a measure of residual cash flow available for discretionary purposes or as an alternative to operating results presented in accordance with GAAP as indicators of performance.

The table below reconciles cash provided by operating activities to free cash flow from operations:

	Three Months Ended September 30		Nine Months Ended September 30	
\$ in millions	2014	2013	2014	2013
Net cash provided by operating activities	\$933	\$950	\$1,103	\$1,279
Less: capital expenditures	(109)	(90)	(285)	(178)
Free cash flow provided by operations	\$824	\$860	\$818	\$1,101

Cash Flows

The following is a discussion of our major operating, investing and financing cash flows from operations for the nine months ended September 30, 2014 and 2013, as classified in the unaudited condensed consolidated statements of cash flows in Part I, Item 1.

Operating Activities

Net cash provided by operating activities for the nine months ended September 30, 2014, decreased \$176 million as compared to the same period in 2013. The change was principally driven by changes in trade working capital, which were partially offset by the impact of a \$500 million voluntary pre-tax pension contribution made in April 2013.

Investing Activities

Net cash used in investing activities for the nine months ended September 30, 2014, increased \$188 million, as compared to the same period in 2013, due to an increase in capital expenditures and the acquisition of QDS.

Financing Activities

Net cash used in financing activities for the nine months ended September 30, 2014, increased \$2.5 billion as compared to the same period in 2013, due to higher expenditures for stock repurchases in 2014 and the net proceeds of

\$2.0 billion from the company's debt issuance and redemption in the second quarter of 2013.

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CRITICAL ACCOUNTING POLICIES, ESTIMATES AND JUDGMENTS

There have been no material changes to our critical accounting policies, estimates or judgments from those discussed in our 2013 Annual Report on Form 10-K.

ACCOUNTING STANDARDS UPDATES

On May 28, 2014, the Financial Accounting Standards Board (FASB) issued Accounting Standards Update (ASU) No. 2014-09, Revenue from Contracts with Customers. ASU 2014-09 supersedes existing revenue recognition guidance, including Accounting Standards Codification (ASC) No. 605-35, Revenue Recognition - Construction-Type and Production-Type Contracts. ASU 2014-09 outlines a single set of comprehensive principles for recognizing revenue under U.S. GAAP. Among other things, it requires companies to identify contractual performance obligations and determine whether revenue should be recognized at a point in time or over time. These concepts, as well as other aspects of ASU 2014-09, may change the method and/or timing of revenue recognition for certain of our contracts. ASU 2014-09 will be effective January 1, 2017, and may be applied either retrospectively or through the use of a modified-retrospective method. We are currently evaluating both methods of adoption as well as the effect ASU 2014-09 will have on the company's consolidated financial position, results of operations and cash flows.

Other accounting standards updates effective after September 30, 2014, are not expected to have a material effect on the company's consolidated financial position or its annual results of operations and cash flows.

FORWARD-LOOKING STATEMENTS AND PROJECTIONS

This Form 10-Q contains statements, other than statements of historical fact, that constitute "forward-looking statements" within the meaning of the Private Securities Litigation Reform Act of 1995. Words such as "expect," "intend," "may," "could," "plan," "project," "forecast," "believe," "estimate," "outlook," "anticipate," "trends," "goals," and similar expressions generally identify these forward-looking statements. Forward-looking statements include, among other things, statements relating to our future financial condition, results of operations and cash flows. Forward-looking statements are based upon assumptions, expectations, plans and projections that we believe to be reasonable when made, but which may change over time. These statements are not guarantees of future performance and inherently involve a wide range of risks and uncertainties that are difficult to predict. Specific risks that could cause actual results to differ materially from those expressed or implied in these forward-looking statements include, but are not limited to, those identified under Risk Factors in our Form 10-K for the year ended December 31, 2013, as well as those identified in this report under Part II, Item 1A and other important factors disclosed in this report and from time to time in our other filings with the SEC.

You are urged to consider the limitations on, and risks associated with, forward-looking statements and not unduly rely on the accuracy of forward-looking statements. These forward-looking statements speak only as of the date this report is first filed. We undertake no obligation to publicly update or revise any forward-looking statements, whether as a result of new information, future events or otherwise, except as required by applicable law.

CONTRACTUAL OBLIGATIONS

There have been no material changes to our contractual obligations from those discussed in our 2013 Annual Report on Form 10-K.

Item 3. Quantitative and Qualitative Disclosures About Market Risk

There have been no material changes to our market risks from those discussed in our 2013 Annual Report on Form 10-K.

Item 4. Controls and Procedures

Disclosure Controls and Procedures

Our principal executive officer (Chairman, Chief Executive Officer and President) and principal financial officer (Corporate Vice President and Chief Financial Officer) have evaluated the company's disclosure controls and procedures (as defined in Rule 13a-15(e) and Rule 15d-15(e) under the Securities and Exchange Act of 1934, as amended) and have concluded that, as of September 30, 2014, these controls and procedures were effective.

Changes in Internal Controls over Financial Reporting

During the three months ended September 30, 2014, no change occurred in our internal controls over financial reporting that materially affected, or is reasonably likely to materially affect, our internal controls over financial reporting. On May 14, 2013, the Committee of Sponsoring Organizations of the Treadway Commission (COSO)

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published an updated Internal Control - Integrated Framework (2013) and related illustrative documents. The Company is adopting the new framework during 2014.

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PART II. OTHER INFORMATION

Item 1. Legal Proceedings

We have provided information about certain legal proceedings in which we are involved in our 2013 Annual Report on Form 10-K, and updated that information in Note 6 to the unaudited condensed consolidated financial statements in Part I, Item 1 of this report.

We are a party to various investigations, lawsuits, claims and other legal proceedings, including government investigations and claims, that arise in the ordinary course of our business. These types of matters could result in fines; penalties; compensatory, treble or other damages; or non-monetary relief. U.S. Government regulations also provide that certain allegations against a contractor may lead to suspension or debarment from future U.S. Government contracts or suspension of export privileges for the company or one or more of its components. Suspension or debarment could have a material adverse effect on the company because of the company's reliance on government contracts and authorizations. The nature of legal proceedings is such that we cannot assure the outcome of any particular matter. However, based on information available to us to date and other than as noted in our 2013 Annual Report on Form 10-K, as updated by Note 6 to the unaudited condensed consolidated financial statements in this report, we do not believe that the outcome of any matter pending against the company is likely to have a material adverse effect on the company's unaudited condensed consolidated financial position as of September 30, 2014, its annual results of operations and/or cash flows. For further information on the risks we face from existing and future investigations, claims and other legal proceedings, please see Risk Factors in Part I, Item 1A of our 2013 Annual Report on Form 10-K.

Item 1A. Risk Factors

The following is an update to one of our risk factors described in our 2013 Annual Report on Form 10-K and should be read in conjunction with the risk factors therein.

Pension and medical expenses associated with our retirement benefit plans may fluctuate significantly depending upon changes in actuarial assumptions, future investment performance of plan assets, future health care costs and legislative or other regulatory actions.

A substantial portion of our current and retired employee population is covered by pension and other post-retirement benefit plans, the costs of which are dependent upon various assumptions, including estimates of rates of return on benefit plan assets, discount rates for future payment obligations, rates of future cost growth and trends for future costs. In addition, funding requirements for benefit obligations of our pension and other post-retirement benefit plans are subject to legislative and other government regulatory actions. Variances from these estimates could have a material adverse effect on our financial position, results of operations and/or cash flows.

Recently, the Society of Actuaries released proposed mortality tables, which update life expectancy assumptions. Final updates to the mortality tables are expected to be issued by the end of 2014. We expect to revise the mortality assumptions used in determining our FAS (GAAP Financial Accounting Standards) pension and post-retirement benefit obligations as of December 31, 2014, which will have a related impact on our annual FAS benefit expense in future years. The mortality assumptions used in determining our future CAS (U.S. Government Cost Accounting Standards) benefit expense will also be revised. We expect the adoption of new mortality assumptions for purposes of funding our plans will likely trail the adoption for both FAS and CAS purposes. The new mortality assumptions for FAS will likely result in an increase in liabilities and annual FAS expense. For CAS, we expect the new mortality assumptions will result in an increase in annual CAS pension expense; however, the increase will be offset to some degree by higher discount rates due to the passage of the Highway and Transportation Funding Act of 2014 (HATFA). The new mortality assumptions may also result in additional funding requirements dependent upon the funded status of our plans. These expectations presume all other assumptions remain constant and there are no changes to applicable funding regulations.

Additionally, due to government regulations including the impact of CAS harmonization, pension plan cost recoveries under our U.S. Government contracts occur in different periods from when those pension costs are recognized for financial statement purposes or when pension funding is made. These timing differences could have a material adverse

effect on our cash flows. The cost accounting rules have been revised in order to partially harmonize the measurement and period of assignment of defined benefit pension plan costs allocable to U.S. Government contracts and the minimum required contribution under the Employee Retirement Income Security Act of 1974 (ERISA), as amended by the Pension Protection Act (PPA) of 2006. These rules better align, but do not eliminate, mismatches between ERISA funding requirements and CAS pension costs for U.S. Government CAS covered contracts.

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Item 2. Unregistered Sales of Equity Securities and Use of Proceeds

Purchases of Equity Securities – The table below summarizes our repurchases of common stock during the three months ended September 30, 2014:

Period	Number of Shares Purchased ⁽¹⁾	Average Price Paid per Share ⁽²⁾	Numbers of Shares Purchased as Part of Publicly Announced Plans or Programs	Approximate Dollar Value of Shares that May Yet Be Purchased under the Plans or Programs (\$ in millions)
July	1,886,929	\$122.27	1,886,929	\$1,568
August	2,073,400	124.73	2,073,400	1,310
September	2,038,433	129.31	2,038,433	1,046
Ending balance	5,998,762	\$125.51	5,998,762	\$1,046

On May 15, 2013, the company's board of directors authorized a share repurchase program of up to \$4.0 billion of the company's common stock. Repurchases under this program commenced in September 2013 upon the (1) completion of the company's 2010 repurchase program. As of September 30, 2014, our repurchases under the program totaled \$3.0 billion; \$1.0 billion remained under this share repurchase authorization. This repurchase program is expected to expire when we have used all authorized funds for repurchase.

(2) Includes commissions paid.

Share repurchases take place from time to time, subject to market conditions and management's discretion, in the open market or in privately negotiated transactions. The company retires its common stock upon repurchase and has not made any purchases of common stock other than in connection with these publicly announced repurchase program authorizations.

Item 3. Defaults Upon Senior Securities

No information is required in response to this item.

Item 4. Mine Safety Disclosures

No information is required in response to this item.

Item 5. Other Information

No information is required in response to this item.

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Item 6. Exhibits

- 2.1 Agreement and Plan of Merger among Titan II, Inc. (formerly Northrop Grumman Corporation), Northrop Grumman Corporation (formerly New P, Inc.) and Titan Merger Sub Inc., dated March 29, 2011 (incorporated by reference to Exhibit 10.1 to Form 8-K filed April 4, 2011)
- 2.2 Separation and Distribution Agreement dated as of March 29, 2011, among Titan II, Inc. (formerly Northrop Grumman Corporation), Northrop Grumman Corporation (formerly New P, Inc.), Huntington Ingalls Industries, Inc., Northrop Grumman Shipbuilding, Inc. and Northrop Grumman Systems Corporation (incorporated by reference to Exhibit 10.2 to Form 8-K filed April 4, 2011)
- *12(a) Computation of Ratio of Earnings to Fixed Charges
- *15 Letter from Independent Registered Public Accounting Firm
- *31.1 Rule 13a-14(a)/15d-14(a) Certification of Wesley G. Bush (Section 302 of the Sarbanes-Oxley Act of 2002)
- *31.2 Rule 13a-14(a)/15d-14(a) Certification of James F. Palmer (Section 302 of the Sarbanes-Oxley Act of 2002)
- **32.1 Certification of Wesley G. Bush pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002
- **32.2 Certification of James F. Palmer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002
- *101 Northrop Grumman Corporation Quarterly Report on Form 10-Q for the quarter ended September 30, 2014, formatted in XBRL (Extensible Business Reporting Language): (i) the Condensed Consolidated Statements of Earnings and Comprehensive Income, (ii) Condensed Consolidated Statements of Financial Position, (iii) Condensed Consolidated Statements of Cash Flows, (iv) Condensed Consolidated Statements of Changes in Shareholders' Equity, and (v) Notes to Condensed Consolidated Financial Statements
- * Filed with this report
- ** Furnished with this report

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SIGNATURES

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

NORTHROP GRUMMAN CORPORATION
(Registrant)

By: /s/ Michael A. Hardesty
Michael A. Hardesty
Corporate Vice President, Controller and
Chief Accounting Officer
(Principal Accounting Officer)

Date: October 21, 2014

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