NORTHROP GRUMMAN CORP /DE/
Form 10-Q
April 25, 2018
UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

FORM 10-Q

x QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934
For the Quarterly Period Ended March 31, 2018
or
o 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)	(Zip Code)

(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 x No o
Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files).
Yes x No o
Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, smaller reporting company or an emerging growth company. See the definitions of “large accelerated filer,” “accelerated filer,” “smaller reporting company” and “emerging growth company” in Rule 12b-2 of the Exchange Act:

Large accelerated filer x	Accelerated filer o
Non-accelerated filer o (Do not check if a smaller reporting company)	Smaller reporting company o
	Emerging growth company o

If an emerging growth company, indicate by check mark if the registrant has elected not to use the extended transition period for complying with any new or revised financial accounting standards provided pursuant to Section 13(a) of the

Exchange Act.o
Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act).
Yes o No x
Indicate the number of shares outstanding of each of the issuer's classes of common stock, as of the latest practicable date.
As of April 20, 2018, 174,384,166 shares of common stock were outstanding.

Table of Contents

NORTHROP GRUMMAN CORPORATION

TABLE OF CONTENTS

Table of Contents

NORTHROP GRUMMAN CORPORATION

PART I. FINANCIAL INFORMATION
Item 1. Financial Statements
CONDENSED CONSOLIDATED STATEMENTS OF EARNINGS AND COMPREHENSIVE INCOME
(Unaudited)

	Three Months Ended March 31	
$ in millions, except per share amounts	2018	2017
Sales		
Product	$4,289	$3,997
Service	2,446	2,413
Total sales	6,735	6,410
Operating costs and expenses		
Product	3,265	2,983
Service	1,905	1,867
General and administrative expenses	711	698
Operating income	854	862
Other income (expense)		
Interest expense	(143)	(75)
Net FAS (non-service) pension benefit (expense)	120	(18)
Other, net	40	19
Earnings before income taxes	871	788
Federal and foreign income tax expense	132	138
Net earnings	$739	$650
Basic earnings per share	$4.24	$3.72
Weighted-average common shares outstanding, in millions	174.3	174.8
Diluted earnings per share	$4.21	$3.69
Weighted-average diluted shares outstanding, in millions	175.4	176.1
Net earnings (from above)	$739	$650
Other comprehensive income		
Change in unamortized benefit plan costs, net of tax	86	99
Change in cumulative translation adjustment	(2)	4
Other, net	(1)	2
Other comprehensive income, net of tax	83	105
Comprehensive income	$822	$755

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

Table of Contents

NORTHROP GRUMMAN CORPORATION

CONDENSED CONSOLIDATED STATEMENTS OF FINANCIAL POSITION
(Unaudited)

$ in millions	March 31, 2018	December 31, 2017
Assets		
Cash and cash equivalents	$ 10,369	$ 11,225
Accounts receivable, net	1,241	1,054
Unbilled receivables, net	3,869	3,465
Inventoried costs, net	435	398
Prepaid expenses and other current assets	243	445
Total current assets	16,157	16,587
Property, plant and equipment, net of accumulated depreciation of $5,119 for 2018 and $5,066 for 2017	4,285	4,225
Goodwill	12,455	12,455
Deferred tax assets	474	447
Other non-current assets	1,424	1,414
Total assets	$ 34,795	$ 35,128
Liabilities		
Trade accounts payable	$ 1,395	$ 1,661
Accrued employee compensation	1,204	1,382
Advance payments and amounts in excess of costs incurred	1,479	1,761
Other current liabilities	2,337	2,288
Total current liabilities	6,415	7,092
Long-term debt, net of current portion of $868 for 2018 and $867 for 2017	14,392	14,399
Pension and other post-retirement benefit plan liabilities	5,362	5,511
Other non-current liabilities	946	994
Total liabilities	27,115	27,996
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: 2018—174,382,256 and 2017—174,085,619	174	174
Paid-in capital	—	44
Retained earnings	13,205	11,632
Accumulated other comprehensive loss	(5,699)	(4,718)
Total shareholders' equity	7,680	7,132
Total liabilities and shareholders' equity	$ 34,795	$ 35,128

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

Table of Contents

NORTHROP GRUMMAN CORPORATION

CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS
(Unaudited)

	Three Months Ended March 31	
$ in millions	2018	2017
Operating activities		
Net earnings	$739	$650
Adjustments to reconcile to net cash used in operating activities:		
Depreciation and amortization	122	104
Stock-based compensation	19	17
Deferred income taxes	(55)	(9)
Changes in assets and liabilities:		
Accounts receivable, net	(187)	(317)
Unbilled receivables, net	(404)	(665)
Inventoried costs, net	(37)	(27)
Prepaid expenses and other assets	13	(53)
Accounts payable and other liabilities	(590)	(357)
Income taxes payable, net	197	152
Retiree benefits	(56)	86
Other, net	2	(20)
Net cash used in operating activities	(237)	(439)
Investing activities		
Capital expenditures	(305)	(216)
Other, net	(2)	2
Net cash used in investing activities	(307)	(214)
Financing activities		
Common stock repurchases	—	(229)
Cash dividends paid	(198)	(166)
Payments of employee taxes withheld from share-based awards	(79)	(90)
Net (payments to) proceeds from credit facilities	(14)	—
Other, net	(21)	—
Net cash used in financing activities	(312)	(485)
Decrease in cash and cash equivalents	(856)	(1,138)
Cash and cash equivalents, beginning of year	11,225	2,541
Cash and cash equivalents, end of period	$10,369	$1,403

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

Table of Contents

NORTHROP GRUMMAN CORPORATION

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

	Three Months Ended March 31	
$ in millions, except per share amounts	2018	2017
Common stock		
Beginning of year	$174	$175
Common stock repurchased	—	(1)
Shares issued for employee stock awards and options	—	1
End of period	174	175
Paid-in capital		
Beginning of year	44	—
Stock compensation	(44)	—
End of period	—	—
Retained earnings		
Beginning of year	11,632	10,734
Impact from adoption of ASU 2018-02 and ASU 2016-01 (See Note 1)	1,064	—
Common stock repurchased	—	(215)
Net earnings	739	650
Dividends declared	(195)	(159)
Stock compensation	(35)	(72)
End of period	13,205	10,938
Accumulated other comprehensive loss		
Beginning of year	(4,718)	(5,546)
Impact from adoption of ASU 2018-02 and ASU 2016-01 (See Note 1)	(1,064)	—
Other comprehensive income, net of tax	83	105
End of period	(5,699)	(5,441)
Total shareholders' equity	$7,680	$5,672
Cash dividends declared per share	$1.10	$0.90

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

Table of Contents

NORTHROP GRUMMAN CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Unaudited)

1. BASIS OF PRESENTATION

Principles of Consolidation and Reporting

These unaudited condensed consolidated financial statements (the "financial statements") include the accounts of Northrop Grumman Corporation and its subsidiaries and joint ventures or other investments for which we consolidate the financial results (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 financial statements are prepared in conformity with accounting principles generally accepted in the United States of America ("GAAP" or "FAS") and in accordance with the rules of the Securities and Exchange Commission (SEC) for interim reporting. The 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 financial statements are not necessarily indicative of results that may be expected for the entire year. These financial statements should be read in conjunction with the information contained in the company's Annual Report on Form 10-K for the year ended December 31, 2017 (2017 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.

As previously announced, effective January 1, 2018, we adopted Accounting Standards Codification (ASC) Topic 606, Revenue from Contracts with Customers, and Accounting Standards Update (ASU) No. 2017-07, Compensation Retirement Benefits (Topic 715): Improving the Presentation of Net Periodic Pension Cost and Net Periodic Postretirement Benefit Cost, using the full retrospective method. The adoption of these standards are reflected in the amounts and disclosures set forth in this Form 10-Q and the effect of these standards on the company's unaudited condensed consolidated statement of earnings and comprehensive income for the three months ended March 31, 2017 and unaudited condensed consolidated statement of financial position as of December 31, 2017 is reflected in Note 11.

Accounting Estimates

Preparation of the financial statements 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 sales 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.

Revenue Recognition

The majority of our sales are derived from long-term contracts with the U.S. Government for the production of goods, the provision of services, or a combination of both. The company classifies sales as product or service based on the predominant attributes of each contract.

Under ASC Topic 606, the company recognizes revenue for each separately identifiable performance obligation in a contract representing a promise to transfer a distinct good or service to a customer. In most cases, goods and services provided under the company's contracts are accounted for as single performance obligations due to the complex and integrated nature of our products and services. These contracts generally require significant integration of a group of goods and/or services to deliver a combined output. In some contracts, the company provides multiple distinct goods or services to a customer, most commonly when a contract covers multiple phases of the product lifecycle (development, production, maintenance and/or support). In those cases, the company accounts for the distinct contract deliverables as separate performance obligations and allocates the transaction price to each performance obligation based on its relative standalone selling price, which is generally estimated using the cost plus a reasonable margin approach of ASC Topic 606. Warranties are provided on certain contracts, but do not typically provide for services beyond standard assurances and are therefore not within the scope of ASC Topic 606. Likewise, our

Table of Contents

accounting for costs to obtain or fulfill a contract was not significantly impacted by the adoption of ASC Topic 606 as these costs are not material.

A contract modification exists when the parties to a contract approve a change in the scope or price of a contract. Contracts are often modified for changes in contract specifications or requirements. Most of the company's contract modifications are for goods or services that are not distinct in the context of the contract and are therefore accounted for as part of the original performance obligation through a cumulative estimate-at-completion (EAC) adjustment.

The company recognizes revenue as control is transferred to the customer, either over time or at a point in time. In general, our U.S. government contracts contain termination for convenience clauses that generally entitle the customer to goods produced and/or in-process. Similarly, our non-U.S. government contracts generally contain contractual termination clauses or entitle the company to payment for work performed to date for goods and services that do not have an alternative use. As control is effectively transferred as we perform on our contracts and we are typically entitled to cost plus a reasonable margin for work in process if the contract is terminated, we generally recognize revenue over time on a cost-to-cost basis (cost incurred relative to total cost estimated at completion) as the company believes this represents the most appropriate measurement towards satisfaction of its performance obligations. Revenue for contracts in which the control of goods produced does not transfer until delivery to the customer is recognized at a point in time (i.e. typically upon delivery).

Contract Estimates

Use of the cost-to-cost method requires us to make reasonably dependable estimates regarding the revenue and cost associated with the design, manufacture and delivery of our products and services. The company estimates profit on these contracts as the difference between total estimated sales and total estimated cost at completion and recognizes that profit as costs are incurred. Significant judgment is used to estimate total revenue and cost at completion.

Contract sales may include estimates of variable consideration, including cost or performance incentives (such as award and incentive fees), contract claims and requests for equitable adjustment (REAs). Variable consideration is included in total estimated sales to the extent it is probable that a significant reversal in the amount of cumulative revenue recognized will not occur when the uncertainty associated with the variable consideration is subsequently resolved. We estimate variable consideration at the most likely amount to which we expect to be entitled.

We recognize changes in estimated contract sales or costs and the resulting changes in contract profit on a cumulative basis. Cumulative EAC adjustments represent the cumulative effect of the changes on current and prior periods; sales and operating margins in future periods are recognized as if the revised estimates had been used since contract inception. If it is determined that a loss is expected to result on an individual performance obligation, the entire amount of the estimable future loss, including an allocation of general and administrative (G&A) costs, is charged against income in the period the loss is identified. Each loss provision is first offset against costs included in unbilled accounts receivable or inventoried costs; remaining amounts are reflected in current liabilities.

Significant EAC adjustments on a single contract could have a material effect on the company's financial statements. When such adjustments occur, we generally disclose the nature, underlying conditions and financial impact of the adjustments. No discrete event or adjustments to an individual contract were material to the financial statements during the three months ended March 31, 2018 and 2017.

The following table presents the effect of aggregate net EAC adjustments:

	Three Months Ended March 31	
$ in millions, except per share data	2018	2017
Operating Income	$116	$141
Net Earnings[(1)]	92	92
Diluted earnings per share[(1)]	0.52	0.52

(1) Based on statutory tax rates in effect for each period presented.

Revenue recognized from performance obligations satisfied in previous reporting periods was $133 million and $145 million for the three months ended March 31, 2018 and 2017, respectively.

Backlog

Backlog represents the future sales we expect to recognize on firm orders received by the company and is equivalent to the company’s remaining performance obligations at the end of each period. It comprises both funded backlog (firm orders for which funding is authorized and appropriated) and unfunded backlog. Unexercised contract options

Table of Contents

NORTHROP GRUMMAN CORPORATION

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.

Company backlog as of March 31, 2018 was $42.3 billion. We expect to recognize approximately 50 percent and 75 percent of our March 31, 2018 backlog as revenue over the next 12 and 24 months, respectively, with the remainder to be recognized thereafter.

Contract Assets and Liabilities

For each of the company's contracts, the timing of revenue recognition, customer billings, and cash collections results in a net contract asset or liability at the end of each reporting period. Fixed-price contracts are typically billed to the customer either using progress payments, whereby amounts are billed monthly as costs are incurred or work is completed, or performance based payments, which are based upon the achievement of specific, measurable events or accomplishments defined and valued at contract inception. Cost-type contracts are typically billed to the customer on a monthly or semi-monthly basis.

Contract assets consist of unbilled receivables, primarily related to long-term contracts where revenue recognized under the cost-to-cost method exceeds amounts billed to customers. Unbilled receivables are classified as current assets and, in accordance with industry practice, include amounts that may be billed and collected beyond one year due to the long-cycle nature of many of our contracts. Accumulated contract costs in unbilled receivables include direct production costs, factory and engineering overhead, production tooling costs, and, for government contracts, allowable G&A. Unbilled receivables also include certain estimates of variable consideration described above. These contract assets are not considered a significant financing component of the company's contracts as the payment terms are intended to protect the customer in the event the company does not perform on its obligations under the contract.

Contract liabilities include advance payments and billings in excess of revenue recognized. Certain customers make advance payments prior to the satisfaction of the company's obligations on the contract. These amounts are recorded as contract liabilities until such obligations are satisfied, either over time as costs are incurred or at a point in time when deliveries are made. Contract liabilities are not a significant financing component as they are generally utilized to pay for contract costs within a one-year period or are used to ensure the customer meets contractual requirements.

Net contract assets (liabilities) are as follows:

$ in millions	March 31, 2018	December 31, 2017	$ Change	% Change
Unbilled receivables, net	$ 3,869	$ 3,465	$ 404	12 %
Advance payments and amounts in excess of costs incurred	(1,479)	(1,761)	282	(16)%
Net contract assets (liabilities)	$ 2,390	$ 1,704	$ 686	40 %

The amount of revenue recognized for the three months ended March 31, 2018 and 2017 that was included in the opening contract liability balances was $706 million and $578 million, respectively.

The change in the balances of the company's contract assets and liabilities primarily results from timing differences between company performance and customer payments. The increase in net contract assets during the three months ended March 31, 2018, is principally due to higher sales on restricted programs and the timing of collections on certain Manned Aircraft programs at Aerospace Systems.

Disaggregation of Revenue

See Note 10 for information regarding the company's sales by customer type, contract type and geographic region for each of our segments. We believe those categories best depict how the nature, amount, timing and uncertainty of our revenue and cash flows are affected by economic factors.

Table of Contents

NORTHROP GRUMMAN CORPORATION

Accumulated Other Comprehensive Loss

The components of accumulated other comprehensive loss are as follows:

$ in millions	March 31, 2018	December 31, 2017
Unamortized benefit plan costs, net of tax benefit of $1,968 for 2018 and $3,056 for 2017	$ (5,560)	$ (4,586)
Cumulative translation adjustment	(138)	(136)
Other, net	(1)	4
Total accumulated other comprehensive loss	$ (5,699)	$ (4,718)

Unamortized benefit plan costs as of March 31, 2018 reflect a reclassification from accumulated other comprehensive loss to retained earnings of $1.1 billion of stranded tax effects resulting from the Tax Cuts and Jobs Act (the “2017 Tax Act”). This reclassification resulted from the company’s early adoption of ASU 2018-02 on January 1, 2018. See “Accounting Standards Updates” below for more information.

Unamortized benefit plan costs consist primarily of net after-tax actuarial losses totaling $5.7 billion and $4.7 billion as of March 31, 2018 and December 31, 2017, respectively. Net actuarial gains or losses are re-determined annually or upon remeasurement events and principally arise from changes in the interest rate used to discount our benefit obligations and differences between expected and actual returns on plan assets.

Reclassifications from accumulated other comprehensive loss to net earnings related to the amortization of benefit plan costs were $86 million and $99 million, net of taxes, for the three months ended March 31, 2018 and 2017, respectively. The reclassifications represent the amortization of net actuarial losses and prior service credits, and are included in the computation of net periodic pension cost. See Note 8 for further information.

Reclassifications from accumulated other comprehensive loss to net earnings relating to cumulative translation adjustments and effective cash flow hedges were not material for the three months ended March 31, 2018 and 2017.

Related Party Transactions

The company had no material related party transactions in any period presented.

Accounting Standards Updates

On February 14, 2018, the Financial Accounting Standards Board (FASB) issued ASU 2018-02, Income Statement - Reporting Comprehensive Income (Topic 220): Reclassification of Certain Tax Effects from Accumulated Other Comprehensive Income. ASU 2018-02 allows companies to reclassify stranded tax effects resulting from the 2017 Tax Act from accumulated other comprehensive income to retained earnings. As described above, the company elected to early adopt ASU 2018-02 on January 1, 2018, which resulted in a reclassification of $1.1 billion of stranded tax effects, principally related to our unamortized benefit plan costs, from accumulated other comprehensive loss to retained earnings. This reclassification included $73 million of other income tax effects related to a reduction in the federal benefit associated with state taxes. Adoption of ASU 2018-02 did not have a material impact on the company’s results of operations and/or cash flows.

On March 10, 2017, the FASB issued ASU No. 2017-07, Compensation Retirement Benefits (Topic 715): Improving the Presentation of Net Periodic Pension Cost and Net Periodic Postretirement Benefit Cost. ASU 2017-07 requires employers that sponsor defined benefit pension and/or other post-retirement benefit plans to report the service cost component of net benefit cost in the same line item as other compensation costs arising from services rendered by the pertinent employees during the period. Employers are required to present the other components of net benefit costs in the income statement separately from the service cost component and outside a subtotal of income from operations. Additionally, only the service cost component of net periodic pension cost is eligible for asset capitalization. We adopted ASU 2017-07 on January 1, 2018 using the retrospective method. See Note 11 for information regarding the effect of adopting ASU 2017-07 on our unaudited condensed consolidated statement of earnings and comprehensive income for the three months ended March 31, 2017. Adoption of ASU 2017-07 did not have a material impact on our consolidated statements of financial position and/or cash flows.

On February 25, 2016, the FASB issued ASU No. 2016-02, Leases (Topic 842). ASU 2016-02 supersedes existing lease guidance, including ASC 840 - Leases. Among other things, ASU 2016-02 requires recognition of a right-of-use asset and liability for future lease payments for contracts that meet the definition of a lease and requires disclosure of certain information about leasing arrangements. ASU 2016-02 will be effective January 1, 2019, although early adoption is permitted, and may be adopted using a modified retrospective transition method that applies the new lease requirements at the beginning of the earliest period presented in the financial statements. The

Table of Contents

NORTHROP GRUMMAN CORPORATION

FASB has proposed a change that would allow a company to elect an optional transition method that applies the new lease requirements through a cumulative-effect adjustment in the period of adoption. We expect to adopt the standard on January 1, 2019 using the proposed optional transition method if finalized in its current form. We are reviewing our leases to determine the effect ASU 2016-02 will have on the company's consolidated financial position, annual results of operations and/or cash flows. We currently expect the right-of-use assets and lease liabilities recognized upon adoption will each approximate our future minimum lease payments, as disclosed in our Annual Reports on Form 10-K. We do not expect ASU 2016-02 to have a material impact on our annual results of operations and/or cash flows.

On January 5, 2016, the FASB issued ASU No. 2016-01, Financial Instruments (Topic 825): Recognition and Measurement of Financial Assets and Financial Liabilities. ASU 2016-01 requires equity investments that are not accounted for under the equity method of accounting or that do not result in consolidation of the investee to be measured at fair value with changes recognized in net earnings. ASU 2016-01 also eliminates the available-for-sale classification for equity investments that recognized changes in fair value as a component of other comprehensive income. We adopted ASU 2016-01 on January 1, 2018 using the modified retrospective method, which resulted in a $4 million (net of tax) cumulative-effect adjustment from accumulated other comprehensive loss to retained earnings. Adoption of ASU 2016-01 did not have a material impact on our results of operations and/or cash flows.

On May 28, 2014, the FASB issued ASU No. 2014-09, Revenue from Contracts with Customers (Topic 606). Topic 606 supersedes previous revenue recognition guidance, including ASC 605-35, Revenue Recognition - Construction-Type and Production-Type Contracts, and 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. The primary impact of the adoption of ASC Topic 606 was that, in most cases, the accounting for those contracts where we previously recognized revenue as units were delivered changed under ASC Topic 606 such that we now recognize revenue as costs are incurred. In addition, for certain of our contracts, there is a change in the number of performance obligations under ASC Topic 606, which has altered the timing of revenue and margin recognition.

We adopted ASC Topic 606 on January 1, 2018 using the full retrospective method. We applied the transition practical expedient related to remaining performance obligations for reporting periods presented before the date of initial application. No other practical expedients were applied. The cumulative effect of adopting ASC Topic 606 was a $148 million increase to retained earnings at January 1, 2016. See Note 11 for information regarding the effect of adopting ASC Topic 606 on our unaudited condensed consolidated statement of earnings and comprehensive income for the three months ended March 31, 2017 and unaudited condensed consolidated statement of financial position as of December 31, 2017.

Other accounting standards updates issued, but not effective until after March 31, 2018, are not expected to have a material effect on the company's unaudited condensed consolidated financial position, annual results of operations and/or cash flows.

2. PENDING ACQUISITION OF ORBITAL ATK

On September 17, 2017, the company entered into a definitive merger agreement to acquire all of the outstanding shares of Orbital ATK, Inc. (Orbital ATK) for approximately $7.8 billion in cash, plus the assumption of approximately $1.4 billion in net debt (the "Orbital ATK Acquisition"). Under the terms of the merger agreement, Orbital ATK shareholders are to receive all-cash consideration of $134.50 per share. We expect to fund the Orbital ATK Acquisition with the proceeds from our debt financing completed in October 2017 and cash on hand. On November 29, 2017, Orbital ATK shareholders approved the proposed Orbital ATK Acquisition. On February 12, 2018, the European Commission approved the proposed Orbital ATK Acquisition. We currently expect the transaction to close in the first half of 2018, after receiving regulatory approvals. Upon completion of the Orbital ATK Acquisition, we plan to establish Orbital ATK as a new, fourth business sector named Northrop Grumman Innovation Systems.

3. 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.

Table of Contents

NORTHROP GRUMMAN CORPORATION

Diluted Earnings Per Share

Diluted earnings per share primarily include the dilutive effect of awards granted to employees under stock-based compensation plans. The dilutive effect of these securities totaled 1.1 million shares and 1.3 million shares for the three months ended March 31, 2018 and 2017, respectively.

Share Repurchases

On September 16, 2015, the company's board of directors authorized a share repurchase program of up to $4.0 billion of the company's common stock (the "2015 Repurchase Program"). Repurchases under the 2015 Repurchase Program commenced in March 2016. As of March 31, 2018, repurchases under the 2015 Repurchase Program totaled $1.7 billion; $2.3 billion remained under this share repurchase authorization. By its terms, the 2015 Repurchase Program is set to expire when we have used all authorized funds for repurchases.

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, in the periods presented, has not made any purchases of common stock other than in connection with these publicly announced repurchase programs.

The table below summarizes the company's share repurchases to date under the authorizations described above:

Repurchase Program Authorization Date	Amount Authorized (in millions)	Total Shares Retired (in millions)	Average Price Per Share[(1)]	Date Completed	Shares Repurchased (in millions) Three Months Ended March 31 2018	2017
September 16, 2015	$ 4,000	7.4	$ 222.93		—	0.9

(1) Includes commissions paid.

Dividends on Common Stock

In January 2018, the company increased the quarterly common stock dividend 10 percent to $1.10 per share from the previous amount of $1.00 per share.

In May 2017, the company increased the quarterly common stock dividend 11 percent to $1.00 per share from the previous amount of $0.90 per share.

4. INCOME TAXES

$ in millions	Three Months Ended March 31 2018	2017
Federal and foreign income tax expense	$ 132	$ 138
Effective income tax rate	15.2 %	17.5 %

The company's effective tax rate of 15.2 percent for the three months ended March 31, 2018 was lower as compared with the same period in 2017 principally due to the reduction of the U.S. corporate income tax rate from 35 percent to 21 percent as a result of the 2017 Tax Act. Both periods reflect comparable tax benefits associated with research credits. In addition, the company's effective tax rate for the three months ended March 31, 2018 includes $26 million of excess tax benefits related to employee share-based compensation. The company's effective tax rate for the three months ended March 31, 2017 included $47 million of excess tax benefits related to employee share-based compensation, a $42 million benefit recognized in connection with the Congressional Joint Committee on Taxation's approval of the Internal Revenue Service (IRS) examination of the company's 2012-2013 tax returns, a $22 million benefit recognized for additional research credits claimed on our prior year tax returns and $15 million of domestic manufacturing deductions.

In December 2017, the 2017 Tax Act was enacted. The 2017 Tax Act includes a number of changes to previous U.S. tax laws that impact the company, most notably a reduction of the U.S. corporate income tax rate from 35 percent to 21 percent for tax years beginning after December 31, 2017. The company recognized the income tax effects of the 2017 Tax Act in the financial statements included in its 2017 Annual Report on Form 10-K in accordance with Staff Accounting Bulletin No. 118, which provides SEC staff guidance for the application of ASC Topic 740, Income Taxes, in the reporting period in which the 2017 Tax Act was signed into law. During the three months ended March

31, 2018, the company did not recognize any changes to the provisional amounts recorded in its 2017 Annual Report on Form 10-K in connection with the 2017 Tax Act as the company is continuing to collect the information necessary to complete those calculations.

We file income tax returns in the U.S. federal jurisdiction and in various state and foreign jurisdictions. Our 2014-2015 federal tax returns and our refund claims related to our 2007-2011 federal tax returns are currently under IRS examination. The company believes it is reasonably possible that within the next twelve months we may resolve certain matters related to the examination of the 2014-2015 tax years, which may result in reductions of our unrecognized tax benefits up to $115 million and income tax expense up to $30 million.

5. FAIR VALUE OF FINANCIAL INSTRUMENTS

The company holds a portfolio of marketable securities consisting of securities to partially fund non-qualified employee benefit plans. These securities are included in other non-current assets in the unaudited condensed consolidated statements of financial position.

The company's derivative portfolio consists primarily of foreign currency forward contracts. Where model-derived valuations are appropriate, the company utilizes the income approach to determine the fair value and uses the applicable London Interbank Offered Rate (LIBOR) swap rates.

The following table presents the financial assets and liabilities we record at fair value on a recurring basis identified by the level of inputs used to determine fair value:

	March 31, 2018			December 31, 2017		
$ in millions	Level 1	Level 2	Total	Level 1	Level 2	Total
Financial Assets (Liabilities)						
Marketable securities	$347	$ 1	$348	$352	$ 1	$353
Derivatives	—	1	1	—	—	—

The notional value of the company’s derivative portfolio at March 31, 2018 and December 31, 2017, was $83 million and $89 million, respectively. The portion of notional value designated as a cash flow hedge at March 31, 2018 and December 31, 2017 was $7 million and $8 million, respectively. The derivative fair values and related unrealized gains/losses at March 31, 2018 and December 31, 2017 were not material.

There were no transfers of financial instruments between the three levels of the fair value hierarchy during the three months ended March 31, 2018.

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

Long-term Debt

The estimated fair value of long-term debt was $15.4 billion and $16.0 billion as of March 31, 2018 and December 31, 2017, respectively. We calculated the fair value of long-term debt using Level 2 inputs, based on interest rates available for debt with terms and maturities similar to the company’s existing debt arrangements. The carrying value of long-term debt was $15.3 billion as of March 31, 2018 and December 31, 2017. The current portion of long-term debt is recorded in Other current liabilities in the unaudited condensed consolidated statements of financial position.

6. INVESTIGATIONS, CLAIMS AND LITIGATION

Litigation

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. 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, alleged that he was improperly discharged in retaliation, and sought an unspecified partial refund of the contract purchase price, penalties, attorney's fees and other costs of suit. The relator later voluntarily dismissed his retaliation claim and reasserted it in a separate arbitration, which he also ultimately voluntarily dismissed. On September 5, 2014, the court granted the company's motion for summary judgment and ordered the relator's False Claims Act case be dismissed with prejudice. On December 19, 2014, the company filed a motion for partial summary judgment asking the court to dismiss the principal counterclaim referenced above. On June 29, 2015, the Court heard argument and denied that motion without prejudice to filing a later motion to dismiss. On February 16, 2018, both the company and the United States filed motions to dismiss many of the claims and counterclaims in whole or in part. The United States also filed a motion seeking to amend its answer and counterclaim, including to reduce its counterclaim to approximately $193 million. Although the ultimate outcome of these matters ("the FSS matters," collectively), including any possible loss, cannot be predicted or reasonably 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 $34 million as of March 31, 2018), 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 $27 million as of March 31, 2018) in damages. In October 2013, ECT asserted an additional damage claim of R$22 million (the equivalent of approximately $7 million as of March 31, 2018). 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 $38 million as of March 31, 2018), 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. In November 2014, the parties submitted comments on the expert's most recent report. On June 16, 2015, the court published a decision denying the parties' request to present oral testimony. At some future point, the court is expected to 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 previously identified and disclosed to the U.S. Government various issues relating primarily to time-charging practices of some employees working on a particular program with remote deployments. The Department of Justice is continuing to investigate this matter, and the company is cooperating in that investigation. Depending upon the ultimate outcome of this matter, the company could be subject to damages, civil or criminal fines, penalties or other sanctions, and suspension or debarment actions; however, we cannot at this point predict the outcome.

We are engaged in remediation activities relating to environmental conditions allegedly resulting from historic operations at the former United States Navy and Grumman facilities in Bethpage, New York. For over 20 years, we have worked closely with the United States Navy, the United States Environmental Protection Agency, the New York State Department of Environmental Conservation, the New York State Department of Health and other federal, state and local governmental authorities, to address legacy environmental conditions in Bethpage. We have incurred, and expect to continue to incur, as included in Note 7, substantial remediation costs related to these environmental conditions. The remediation standards or requirements to which we are subject may change and costs may increase materially. The State of New York has notified us that it intends to seek to impose additional remedial requirements and, among other things, is evaluating natural resource damages. In addition, we are and may become a party to various legal proceedings and disputes related to remediation and/or alleged environmental impacts in Bethpage, including with federal and state entities, local municipalities and water districts, insurance carriers and class action plaintiffs. These Bethpage matters could result in additional costs, fines, penalties, sanctions, compensatory or other damages (including natural resource damages), determinations on allocation, allowability and coverage, and non-

Table of Contents

monetary relief. We cannot at this time predict or reasonably estimate the potential cumulative outcomes or ranges of possible liability of these aggregate Bethpage matters.

The company is a party to various other investigations, lawsuits, claims, enforcement actions 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, the company does not believe that the outcome of any of these other matters pending against the company is likely to have a material adverse effect on the company's unaudited condensed consolidated financial position as of March 31, 2018, or its annual results of operations and/or cash flows.

7. COMMITMENTS AND CONTINGENCIES

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 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 such potential disallowed costs. 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 reasonably estimable, and that the outcome of any such matters would not have a material adverse effect on its unaudited condensed consolidated financial position as of March 31, 2018, or its annual results of operations and/or cash flows.

Environmental Matters

The table below summarizes management's estimate of the range of reasonably possible future costs for environmental remediation, the amount accrued within that range, and the deferred costs expected to be recoverable through overhead charges on U.S. Government contracts as of March 31, 2018 and December 31, 2017:

$ in millions	Range of Reasonably Possible Future Costs(1)	Accrued Costs(2)	Deferred Costs(3)
March 31, 2018	$410 - $789	$ 416	$ 211
December 31, 2017			