

NORTHROP GRUMMAN CORP /DE/
Form 10-Q
April 25, 2018
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 March 31, 2018

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) (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 ☒ No ☐

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

Yes ☒ No ☐

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

Large accelerated filer ☐ Accelerated filer ☐

Non-accelerated filer ☐ (Do
not check

if a
smaller
reporting
company) Smaller reporting company ☐

Emerging growth company ☐

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

Exchange Act.

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

Yes ☐ No ☒

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.

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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.

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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. | | |

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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.

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

| \$ in millions, except per share amounts | Three Months Ended March 31 | |
|--|--------------------------------|----------|
| | 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.

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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 (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

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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

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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 | |
|--|----------------|--|-------------------|--|--------|--------|
| | | | | | | % |
| 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.

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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

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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.

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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

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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:

| \$ in millions | March 31, 2018 | | | December 31, 2017 | | |
|--------------------------------|----------------|---------|-------|-------------------|---------|-------|
| | 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

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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-

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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 | Deferred |
|-------------------|--|----------------------|----------------------|
| | | Costs ⁽²⁾ | Costs ⁽³⁾ |
| March 31, 2018 | \$410 - \$789 | \$ 416 | \$ 211 |
| December 31, 2017 | 405 - 792 | 410 | 207 |

Estimated remediation costs are not discounted to present value. The range of reasonably possible future costs does not take into consideration amounts expected to be recoverable through overhead charges on U.S. Government contracts.

⁽²⁾ As of March 31, 2018, \$151 million is recorded in other current liabilities and \$265 million is recorded in other non-current liabilities.

⁽³⁾ As of March 31, 2018, \$79 million is deferred in prepaid expenses and other current assets and \$132 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, except with respect to Bethpage, we do not anticipate that 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 March 31, 2018, or its annual results of operations and/or cash flows. With respect to Bethpage, as described in Note 6, we cannot at this time estimate the range of reasonably possible additional future costs that could result from potential changes to remediation standards or requirements to which we are subject.

Financial Arrangements

In the ordinary course of business, the company uses standby 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 March 31, 2018, there were \$192 million of stand-by letters of credit and guarantees and \$196 million of surety bonds outstanding.

Indemnifications

The company has provided indemnification for 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 March 31, 2018, or its annual results of operations and/or cash flows.

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Operating Leases

Rental expense for operating leases for the three months ended March 31, 2018 and 2017 was \$92 million and \$89 million, respectively. These amounts are net of immaterial amounts of sublease rental income.

Credit Facilities

In December 2016, a subsidiary of the company entered into a two-year credit facility, with two additional one-year option periods, in an aggregate principal amount of £120 million (the equivalent of approximately \$170 million as of March 31, 2018) (the “2016 Credit Agreement”). The company exercised the first option to extend the maturity to December 2019. The 2016 Credit Agreement is guaranteed by the company. At March 31, 2018, there was £90 million (the equivalent of approximately \$127 million) outstanding under this facility, which bears interest at a rate of LIBOR plus 1.10 percent. All of the borrowings outstanding under this facility mature less than one year from the date of issuance, but may be renewed under the terms of the facility. Based on our intent and ability to refinance the obligations on a long-term basis, substantially all of the borrowings are classified as non-current.

The company also maintains a five-year unsecured credit facility in an aggregate principal amount of \$1.6 billion that matures in July 2020. At March 31, 2018, there was no balance outstanding under this facility.

At March 31, 2018, the company was in compliance with all covenants under its credit agreements.

8. RETIREMENT BENEFITS

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

| | Three Months Ended March 31 | | | |
|---|--------------------------------|-------|------------------------------------|------|
| | Pension Benefits | | Medical and Life Benefits | |
| \$ in millions | 2018 | 2017 | 2018 | 2017 |
| Components of net periodic benefit cost | | | | |
| Service cost | \$99 | \$97 | \$5 | \$5 |
| Interest cost | 290 | 313 | 19 | 21 |
| Expected return on plan assets | (529) | (471) | (25) | (22) |
| Amortization of: | | | | |
| Prior service credit | (15) | (15) | (5) | (5) |
| Net loss from previous years | 134 | 191 | — | 3 |
| Net periodic benefit cost | \$(21) | \$115 | \$(6) | \$2 |

Changes in Presentation

As discussed in Note 1, we adopted ASU 2017-07 on January 1, 2018 using the retrospective method, which changed the financial statement presentation of service costs and the other components of net periodic benefit cost. The service cost component continues to be included in operating income; however, the other components are now presented in Net FAS (non-service) pension benefit (expense) in the unaudited condensed consolidated statements of earnings and comprehensive income. In addition, interest on service cost and plan administrative expenses which, in some cases, have historically been included in service cost are now consistently presented in the interest cost and amortization of net actuarial loss components, respectively. As a result, the company reclassified interest on service cost of \$4 million and plan administrative expenses of \$13 million from service cost to the interest cost and amortization of net actuarial loss components, respectively, for its pension plans in the three months ended March 31, 2017 to conform to the current year presentation. For the company’s medical and life benefit plans, plan administrative expenses of \$1 million were reclassified from service cost to the amortization of net actuarial loss component for the three months ended March 31, 2017 to conform to the current year presentation. This change in presentation had no impact on net periodic benefit cost.

Employer Contributions

The company sponsors defined benefit pension and post-retirement plans, as well as defined contribution plans. 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, including making voluntary contributions from time to time.

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Contributions made by the company to its retirement plans are as follows:

| | | |
|--------------------------------|----------|-------|
| | Three | |
| | Months | |
| | Ended | |
| | March 31 | |
| \$ in millions | 2018 | 2017 |
| Defined benefit pension plans | \$ 22 | \$ 23 |
| Medical and life benefit plans | 11 | 11 |
| Defined contribution plans | 104 | 99 |

9. STOCK COMPENSATION PLANS AND OTHER COMPENSATION ARRANGEMENTS

Stock Awards

The following table presents the number of restricted stock rights (RSRs) and restricted performance stock rights (RPSRs) granted to employees under the company's long-term incentive stock plan and the grant date aggregate fair value of those stock awards for the periods presented:

| | | |
|---------------------------------|--------|-------|
| | Three | |
| | Months | |
| | Ended | |
| | March | |
| | 31 | |
| in millions | 2018 | 2017 |
| RSRs granted | 0.1 | 0.1 |
| RPSRs granted | 0.2 | 0.3 |
| Grant date aggregate fair value | \$ 87 | \$ 86 |

RSRs typically vest on the third anniversary of the grant date, while RPSRs generally vest and pay out based on the achievement of financial metrics over a three-year period.

Cash Awards

The following table presents the minimum and maximum aggregate payout amounts related to cash units (CUs) and cash performance units (CPUs) granted to employees in the periods presented:

| | | |
|---------------------------------|--------|-------|
| | Three | |
| | Months | |
| | Ended | |
| | March | |
| | 31 | |
| \$ in millions | 2018 | 2017 |
| Minimum aggregate payout amount | \$ 35 | \$ 35 |
| Maximum aggregate payout amount | 196 | 198 |

CUs typically vest and settle in cash on the third anniversary of the grant date, while CPUs generally vest and pay out in cash based on the achievement of financial metrics over a three-year period.

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10. SEGMENT INFORMATION

The company is aligned in three operating sectors, which also comprise our reportable segments: Aerospace Systems, Mission Systems and Technology Services.

The following table presents sales and operating income by segment:

| \$ in millions | Three Months Ended March 31 | |
|--|--------------------------------|---------|
| | 2018 | 2017 |
| Sales | | |
| Aerospace Systems | \$3,280 | \$2,984 |
| Mission Systems | 2,883 | 2,800 |
| Technology Services | 1,144 | 1,190 |
| Intersegment eliminations | (572) | (564) |
| Total sales | 6,735 | 6,410 |
| Operating income | | |
| Aerospace Systems | 341 | 323 |
| Mission Systems | 371 | 359 |
| Technology Services | 122 | 129 |
| Intersegment eliminations | (72) | (70) |
| Total segment operating income | 762 | 741 |
| Net FAS (service)/CAS pension adjustment | 127 | 154 |
| Unallocated corporate expenses | (34) | (32) |
| Other | (1) | (1) |
| Total operating income | \$854 | \$862 |

Net FAS (Service)/CAS Pension Adjustment

For financial statement purposes, we account for our employee pension plans in accordance with FAS. However, the cost of these plans is charged to our contracts in accordance with the Federal Acquisition Regulation (FAR) and the related U.S. Government Cost Accounting Standards (CAS). The net FAS (service)/CAS pension adjustment reflects the difference between CAS pension expense included as cost in segment operating income and the service cost component of FAS expense included in total operating income. The non-service cost components of FAS expense, which include interest cost, expected return on plan assets, and amortization of prior service credit and net actuarial loss, are presented in Net FAS (non-service) pension benefit (expense) in the unaudited condensed consolidated statements of earnings and comprehensive income as a result of our adoption of ASU 2017-07 discussed in Note 1.

Unallocated Corporate Expenses

Unallocated corporate expenses include the portion of corporate expenses not considered allowable or allocable under applicable CAS or FAR, and therefore not allocated to the segments. Such costs consist of a portion of management and administration, legal, environmental, compensation, retiree benefits and other corporate unallowable costs.

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Disaggregation of Revenue

| Sales by Customer Type | Three Months Ended | | | |
|--------------------------------|--------------------|------------------|---------|------------------|
| | March 31 | | | |
| | 2018 | | 2017 | |
| \$ in millions | \$ | % ⁽³⁾ | \$ | % ⁽³⁾ |
| Aerospace Systems | | | | |
| U.S. Government ⁽¹⁾ | \$2,908 | 89 % | \$2,553 | 86 % |
| International ⁽²⁾ | 271 | 8 % | 309 | 10 % |
| Other customers | 42 | 1 % | 38 | 1 % |
| Intersegment sales | 59 | 2 % | 84 | 3 % |
| Aerospace Systems sales | 3,280 | 100 % | 2,984 | 100 % |
| Mission Systems | | | | |
| U.S. Government ⁽¹⁾ | 2,190 | 76 % | 2,186 | 78 % |
| International ⁽²⁾ | 379 | 13 % | 354 | 13 % |
| Other customers | 30 | 1 % | 21 | 1 % |
| Intersegment sales | 284 | 10 % | 239 | 8 % |
| Mission Systems sales | 2,883 | 100 % | 2,800 | 100 % |
| Technology Services | | | | |
| U.S. Government ⁽¹⁾ | 602 | 53 % | 636 | 53 % |
| International ⁽²⁾ | 220 | 19 % | 209 | 18 % |
| Other customers | 93 | 8 % | 104 | 9 % |
| Intersegment sales | 229 | 20 % | 241 | 20 % |
| Technology Services sales | 1,144 | 100 % | 1,190 | 100 % |
| Total | | | | |
| U.S. Government ⁽¹⁾ | 5,700 | 85 % | 5,375 | 84 % |
| International ⁽²⁾ | 870 | 13 % | 872 | 14 % |
| Other customers | 165 | 2 % | 163 | 2 % |
| Total sales | \$6,735 | 100 % | \$6,410 | 100 % |

Sales to the U.S. Government include sales from contracts for which we are the prime contractor, as well as those

⁽¹⁾ for which we are a subcontractor and the ultimate customer is the U.S. Government. Each of the company's segments derives substantial revenue from the U.S. Government.

⁽²⁾ International sales include sales from contracts for which we are the prime contractor, as well as those for which we are a subcontractor and the ultimate customer is an international customer. These sales include foreign military sales contracted through the U.S. Government, direct sales with governments outside the U.S. and commercial sales with customers outside the U.S.

⁽³⁾ Percentages calculated based on total segment sales.

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| Sales by Contract Type | Three Months Ended | | | |
|---------------------------|--------------------|------------------|---------|------------------|
| | March 31 | | | |
| | 2018 | | 2017 | |
| \$ in millions | \$ | % ⁽¹⁾ | \$ | % ⁽¹⁾ |
| Aerospace Systems | | | | |
| Cost-type | \$1,902 | 59 % | \$1,827 | 63 % |
| Fixed-price | 1,319 | 41 % | 1,073 | 37 % |
| Intersegment sales | 59 | | 84 | |
| Aerospace Systems sales | 3,280 | | 2,984 | |
| Mission Systems | | | | |
| Cost-type | 1,279 | 49 % | 1,316 | 51 % |
| Fixed-price | 1,320 | 51 % | 1,245 | 49 % |
| Intersegment sales | 284 | | 239 | |
| Mission Systems sales | 2,883 | | 2,800 | |
| Technology Services | | | | |
| Cost-type | 437 | 48 % | 445 | 47 % |
| Fixed-price | 478 | 52 % | 504 | 53 % |
| Intersegment sales | 229 | | 241 | |
| Technology Services sales | 1,144 | | 1,190 | |
| Total | | | | |
| Cost-type | 3,618 | 54 % | 3,588 | 56 % |
| Fixed-price | 3,117 | 46 % | 2,822 | 44 % |
| Total sales | \$6,735 | 100 % | \$6,410 | 100 % |

⁽¹⁾ Percentages calculated based on external customer sales.

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| Sales by Geographic Region | Three Months Ended | | | |
|--|--------------------|------------------|---------|------------------|
| | March 31 | | | |
| | 2018 | | 2017 | |
| \$ in millions | \$ | % ⁽¹⁾ | \$ | % ⁽¹⁾ |
| Aerospace Systems | | | | |
| United States | \$2,950 | 92 % | \$2,591 | 89 % |
| Asia/Pacific | 129 | 4 % | 188 | 7 % |
| All other (principally Europe and Middle East) | 142 | 4 % | 121 | 4 % |
| Intersegment sales | 59 | | 84 | |
| Aerospace Systems sales | 3,280 | | 2,984 | |
| Mission Systems | | | | |
| United States | 2,220 | 85 % | 2,207 | 86 % |
| Asia/Pacific | 153 | 6 % | 154 | 6 % |
| All other (principally Europe and Middle East) | 226 | 9 % | 200 | 8 % |
| Intersegment sales | 284 | | 239 | |
| Mission Systems sales | 2,883 | | 2,800 | |
| Technology Services | | | | |
| United States | 695 | 76 % | 741 | 78 % |
| Asia/Pacific | 32 | 3 % | 46 | 5 % |
| All other (principally Europe and Middle East) | 188 | 21 % | 162 | 17 % |
| Intersegment sales | 229 | | 241 | |
| Technology Services sales | 1,144 | | 1,190 | |
| Total | | | | |
| United States | 5,865 | 87 % | 5,539 | 86 % |
| Asia/Pacific | 314 | 5 % | 388 | 6 % |
| All other (principally Europe and Middle East) | 556 | 8 % | 483 | 8 % |
| Total sales | \$6,735 | 100 % | \$6,410 | 100 % |

⁽¹⁾ Percentages calculated based on external customer sales.

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11. RECAST 2017 FINANCIAL INFORMATION

Our prior period financial statements were recast for the retrospective adoption of ASC Topic 606 and ASU 2017-07 as described in Note 1. The following tables summarize the effects of adopting these accounting standards 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. The adoption of ASC Topic 606 did not have a material impact on our unaudited condensed consolidated statements of cash flows and changes in shareholders' equity for the three months ended March 31, 2017.

CONDENSED CONSOLIDATED STATEMENT OF EARNINGS AND COMPREHENSIVE INCOME

(Unaudited)

| \$ in millions, except per share amounts | Three Months Ended March 31, 2017 | | | |
|--|-----------------------------------|---|-------|-------------|
| | As Reported | Effect of the Adoption of ASC Topic 606 | | As Adjusted |
| Sales | | | | |
| Product | \$3,834 | \$163 | \$ — | \$ 3,997 |
| Service | 2,433 | (20) | — | 2,413 |
| Total sales | 6,267 | 143 | — | 6,410 |
| Operating costs and expenses | | | | |
| Product | 2,871 | 121 | (9) | 2,983 |
| Service | 1,887 | (14) | (6) | 1,867 |
| General and administrative expenses | 677 | 21 | — | 698 |
| Operating income | 832 | 15 | 15 | 862 |
| Other (expense) income | | | | |
| Interest expense | (75) | — | — | (75) |
| Net FAS (non-service) pension benefit (expense) | — | — | (18) | (18) |
| Other, net | 16 | — | 3 | 19 |
| Earnings before income taxes | 773 | 15 | — | 788 |
| Federal and foreign income tax expense | 133 | 5 | — | 138 |
| Net earnings | \$640 | \$10 | \$ — | \$ 650 |
| Basic earnings per share | \$3.66 | \$0.06 | \$ — | \$ 3.72 |
| Weighted-average common shares outstanding, in millions | 174.8 | — | — | 174.8 |
| Diluted earnings per share | \$3.63 | \$0.06 | \$ — | \$ 3.69 |
| Weighted-average diluted shares outstanding, in millions | 176.1 | — | — | 176.1 |
| Net earnings (from above) | \$640 | \$10 | \$ — | \$ 650 |
| Other comprehensive income | | | | |
| Change in unamortized benefit plan costs, net of tax | 99 | — | — | 99 |
| Change in cumulative translation adjustment | 4 | — | — | 4 |
| Other, net | 2 | — | — | 2 |
| Other comprehensive income, net of tax | 105 | — | — | 105 |
| Comprehensive income | \$745 | \$10 | \$ — | \$ 755 |

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NORTHROP GRUMMAN CORPORATION

CONDENSED CONSOLIDATED STATEMENT OF FINANCIAL POSITION
(Unaudited)

| \$ in millions | December 31, 2017 | | | |
|--|-------------------|--|----|----------------|
| | As Reported | Effect of the Adoption of ASC Topic 606 | | As Adjusted |
| Assets | | | | |
| Cash and cash equivalents | \$ 11,225 | \$— | \$ | —\$ 11,225 |
| Accounts receivable, net | 829 | 225 | — | 1,054 |
| Unbilled receivables, net | 3,147 | 318 | — | 3,465 |
| Inventoried costs, net | 780 | (382) | — | 398 |
| Prepaid expenses and other current assets | 368 | 77 | — | 445 |
| Total current assets | 16,349 | 238 | — | 16,587 |
| Property, plant and equipment, net of accumulated depreciation of \$5,066 for 2017 | 4,225 | — | — | 4,225 |
| Goodwill | 12,455 | — | — | 12,455 |
| Deferred tax assets | 475 | (28) | — | 447 |
| Other non-current assets | 1,413 | 1 | — | 1,414 |
| Total assets | \$34,917 | \$211 | \$ | —\$35,128 |
| Liabilities | | | | |
| Trade accounts payable | \$ 1,661 | \$— | \$ | —\$ 1,661 |
| Accrued employee compensation | 1,382 | — | — | 1,382 |
| Advance payments and amounts in excess of costs incurred | 1,617 | 144 | — | 1,761 |
| Other current liabilities | 2,305 | (17) | — | 2,288 |
| Total current liabilities | 6,965 | 127 | — | 7,092 |
| Long-term debt, net of current portion of \$867 for 2017 | 14,399 | — | — | 14,399 |
| Pension and other post-retirement benefit plan liabilities | 5,511 | — | — | 5,511 |
| Other non-current liabilities | 994 | — | — | 994 |
| Total liabilities | 27,869 | 127 | — | 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: 2017—174,085,619 | 174 | — | — | 174 |
| Paid-in capital | 44 | — | — | 44 |
| Retained earnings | 11,548 | 84 | — | 11,632 |
| Accumulated other comprehensive loss | (4,718) | — | — | (4,718) |
| Total shareholders' equity | 7,048 | 84 | — | 7,132 |
| Total liabilities and shareholders' equity | \$34,917 | \$211 | \$ | —\$35,128 |

REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

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

Results of Review of Interim Financial Information

We have reviewed the accompanying condensed consolidated statement of financial position of Northrop Grumman Corporation and subsidiaries (the “Company”) as of March 31, 2018, and the related condensed consolidated statements of earnings and comprehensive income, cash flows, and changes in shareholders’ equity for the three-month periods ended March 31, 2018 and 2017, and the related notes (collectively referred to as the “interim financial information”). Based on our reviews, we are not aware of any material modifications that should be made to the accompanying interim financial information for it 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) (PCAOB), the consolidated statement of financial position of Northrop Grumman Corporation and subsidiaries as of December 31, 2017, and the related consolidated statements of earnings and comprehensive income, changes in shareholders’ equity, and cash flows for the year then ended prior to retrospective adjustment for the change in the Company’s method of accounting for revenue transactions, (not presented herein); and in our report dated January 29, 2018, we expressed an unqualified opinion on those consolidated financial statements. We also audited the adjustments described in Note 1 and presented in Note 11 that were applied to retrospectively adjust the December 31, 2017 consolidated statement of financial position of the Company (not presented herein). In our opinion, such adjustments are appropriate and have been properly applied to the previously issued consolidated statement of financial position in deriving the accompanying retrospectively adjusted condensed consolidated statement of financial position as of December 31, 2017.

Basis for Review Results

This interim financial information is the responsibility of the Company’s management. We are a public accounting firm registered with the PCAOB and are required to be independent with respect to the Company in accordance with the U.S. federal securities laws and the applicable rules and regulations of the Securities and Exchange Commission and the PCAOB.

We conducted our reviews in accordance with standards of the PCAOB. 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 PCAOB, 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.

/s/ Deloitte & Touche LLP
McLean, Virginia
April 24, 2018

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NORTHROP GRUMMAN CORPORATION

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 offer a broad portfolio of capabilities and technologies that enable us to deliver innovative products, systems and solutions for applications that range from undersea to outer space and into cyberspace. We provide products, systems and solutions in autonomous systems; cyber; command, control, communications and computers, intelligence, surveillance and reconnaissance (C4ISR); strike; and logistics and modernization. We participate in many high-priority defense and government programs in the United States (U.S.) and abroad. 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 foreign, state and local governments, as well as commercial customers.

The following discussion should be read along with the financial statements included in this Form 10-Q, as well as our 2017 Annual Report on Form 10-K, which provides additional information on our business and the environment in which we operate and our operating results. Our 2017 results have been recast to reflect the impact of the adoption of 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.

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"). See Item 1.01 in our Current Report on Form 8-K filed with the SEC on September 18, 2017 for a summary and copy of the merger agreement. We believe this acquisition will enable us to broaden our capabilities and offerings, create value for shareholders, provide expanded opportunities for our combined employees and enhance our ability to provide innovative solutions to meet our customers' emerging requirements. 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.

Global Security and Economic Environment

The following is an update of events relating to the global security and economic environment since the filing of our 2017 Annual Report on Form 10-K.

The global security, geopolitical and economic environment continues to be impacted by uncertainty. During the first quarter, the environment continued to be characterized by global and regional security threats from state and non-state actors as well as terrorist organizations and diverse regional security concerns. Additionally, economic tensions and changes in international trade policies, including higher tariffs on imported goods and materials and renegotiation of free trade agreements, could impact the global market for defense products, services and solutions.

U.S. Political and Economic Environment

The following is an update of events relating to the U.S. political and economic environment since the filing of our 2017 Annual Report on Form 10-K.

On February 9, 2018, Congress passed the Bipartisan Budget Act (BBA) of 2018, which extended the continuing resolution funding the government through March 23, 2018 and raised the statutory budget caps for defense spending, including for Overseas Contingency Operations (OCO), by \$80 billion for FY 2018 and by \$85 billion for FY 2019. The BBA also raised non-defense spending by \$63 billion for FY 2018 and \$68 billion for FY 2019 and suspended the debt ceiling until March 1, 2019.

On March 23, 2018, the President signed the Omnibus Appropriations Act for FY18, which provides \$1.3 trillion in discretionary funding for federal agencies. In total for FY 2018, Congress appropriated approximately \$700 billion for national security, including approximately \$630 billion for base discretionary funding and approximately \$70 billion in OCO funding.

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The federal budget and debt ceiling are expected to continue to be the subject of considerable debate, which could have a significant impact on defense spending broadly and the company's programs in particular.

Operating Performance Assessment and Reporting

We manage and assess our business based on our performance on contracts and programs (typically larger contracts or two or more closely-related contracts). We recognize sales from our portfolio of long-term contracts as control is transferred to the customer, primarily over time on a cost-to-cost basis (cost incurred relative to cost estimated at completion). 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 U.S. Government business and related Cost Accounting Standards (CAS), most types of costs are allocable to U.S. Government contracts. As such, we do not focus on individual cost groupings (such as manufacturing, engineering and design labor, subcontractor, material, overhead and general and administrative (G&A) costs), as much as we do on total contract cost, which is the key driver of our sales and operating income.

In evaluating our operating performance, we look primarily at changes in sales and operating income. 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 below first focuses on our three segments before distinguishing between products and services. Changes in sales are generally described in terms of volume, while changes in margin rates are generally described in terms of performance and/or contract mix. For purposes of this discussion, volume generally refers to increases or decreases in sales or cost from production/service activity levels. Performance generally refers to non-volume related changes in profitability. Contract mix generally refers to changes in the ratio of contract type and/or lifecycle (e.g., cost-type, fixed-price, development, production, and/or sustainment).

CONSOLIDATED OPERATING RESULTS

Selected financial highlights are presented in the table below:

| | Three Months Ended March 31 | | % |
|--|--------------------------------|---------|--------|
| \$ in millions, except per share amounts | 2018 | 2017 | Change |
| Sales | \$6,735 | \$6,410 | 5 % |
| Operating costs and expenses | 5,881 | 5,548 | 6 % |
| Operating costs and expenses as a % of sales | 87.3 % | 86.6 % | |
| Operating income | 854 | 862 | (1)% |
| Operating margin rate | 12.7 % | 13.4 % | |
| Federal and foreign income tax expense | 132 | 138 | (4)% |
| Effective income tax rate | 15.2 % | 17.5 % | |
| Net earnings | 739 | 650 | 14 % |
| Diluted earnings per share | \$4.21 | \$3.69 | 14 % |
| Sales | | | |

Sales for the three months ended March 31, 2018 increased \$325 million, or 5 percent, as compared with the same period in 2017, due to higher sales at Aerospace Systems and Mission Systems, partially offset by lower sales at Technology Services.

See "Segment Operating Results" below for further information by segment and "Product and Service Analysis" for product and service detail. See Note 10 to the financial statements for information regarding the company's sales by customer type, contract type and geographic region for each of our segments.

Operating Income

Operating income for the three months ended March 31, 2018 decreased \$8 million, or 1 percent, as compared with the same period in 2017, primarily due to a \$27 million decrease in our net FAS (service)/CAS pension adjustment, partially offset by a \$21 million increase in segment operating income. Higher operating costs and expenses as a

percentage of sales reduced our operating margin rate to 12.7 percent from 13.4 percent in the prior year period and was principally driven by the decrease in our net FAS (service)/CAS pension adjustment and a lower segment operating margin rate as described in “Segment Operating Results.”

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G&A as a percentage of sales for the three months ended March 31, 2018 decreased to 10.6 percent from 10.9 percent in the prior year period primarily due to higher sales.

For further information regarding product and service operating costs and expenses, see “Product and Service Analysis” below.

Federal and Foreign Income Taxes

Our effective tax rate for the three months ended March 31, 2018 was lower than the same period in 2017, as discussed in Note 4 to the financial statements.

Net Earnings

Net earnings for the three months ended March 31, 2018 increased \$89 million, or 14 percent, as compared with the same period in 2017, primarily due to a \$138 million increase in our net FAS (non-service) pension benefit, \$31 million of higher interest income on short-term investments and \$21 million of higher segment operating income. These increases were partially offset by \$68 million of higher interest expense on long-term debt and a \$27 million reduction in our net FAS (service)/CAS pension adjustment.

Diluted Earnings Per Share

Diluted earnings per share for the three months ended March 31, 2018 increased \$0.52, or 14 percent, as compared with the same period in 2017, primarily due to the 14 percent increase in net earnings discussed above.

SEGMENT OPERATING RESULTS

Basis of Presentation

The company is aligned in three operating sectors, which also comprise our reportable segments: Aerospace Systems, Mission Systems and Technology Services.

We present our sectors in the following business areas, which are reported in a manner reflecting core capabilities:

| | | |
|--------------------|------------------------|------------------------------------|
| Aerospace Systems | Mission Systems | Technology Services |
| Autonomous Systems | Sensors and Processing | Global Logistics and Modernization |
| Manned Aircraft | Cyber and ISR | Advanced Defense Services |
| Space | Advanced Capabilities | System Modernization and Services |

This section discusses segment sales, operating income and operating margin rates. A reconciliation of segment operating income to total operating income is provided below.

Segment Operating Income and Margin Rate

Segment operating income, as reconciled in the Reconciliation of Segment Operating Income to Total Operating Income section below, is a non-GAAP (accounting principles generally accepted in the United States of America) measure that reflects total earnings from our three segments, including allocated pension expense recognized under CAS, and excluding unallocated corporate items and FAS pension expense. This measure may be useful to investors and other users of our financial statements as a supplemental measure in evaluating the financial performance and operational trends of our sectors. This measure may not be defined and calculated by other companies in the same manner and should not be considered in isolation or as an alternative to operating results presented in accordance with GAAP.

| | Three Months Ended March 31 | | |
|-------------------------------|--------------------------------|--------|--------|
| \$ in millions | 2018 | 2017 | Change |
| Segment operating income | \$762 | \$741 | 3 % |
| Segment operating margin rate | 11.3 % | 11.6 % | |

Segment operating income for the three months ended March 31, 2018 increased \$21 million, or 3 percent, as compared with the same period in 2017 as a result of higher sales volume, which more than offset a lower segment operating margin rate. Segment operating margin rate decreased principally due to a lower segment margin rate at Aerospace Systems as described below.

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Reconciliation of Segment Operating Income to Total Operating Income - The table below reconciles segment operating income to total operating income by including the impact of the net FAS (service)/CAS pension adjustment, as well as unallocated corporate expenses (certain corporate-level expenses, which are not considered allowable or allocable under applicable CAS or the FAR). See Note 10 to the financial statements for further information on the net FAS (service)/CAS pension adjustment and unallocated corporate expenses.

| | | |
|--|--------------------------------------|-------|
| | Three Months Ended March 31 | |
| \$ in millions | 2018 | 2017 |
| Segment operating income | \$762 | \$741 |
| CAS pension expense | 226 | 251 |
| Less: FAS (service) pension expense | (99) | (97) |
| Net FAS (service)/CAS pension adjustment | 127 | 154 |
| Unallocated corporate expenses | (34) | (32) |
| Other | (1) | (1) |
| Total operating income | \$854 | \$862 |

Net FAS (service)/CAS Pension Adjustment

The decrease in our net FAS (service)/CAS pension adjustment for the three months ended March 31, 2018, as compared with the same period in 2017, is primarily due to lower CAS expense resulting from higher asset returns in 2017 and a change in our mortality assumption as of December 31, 2017.

Unallocated Corporate Expenses

Unallocated corporate expenses for the three months ended March 31, 2018 were comparable with the prior year period.

Net EAC Adjustments - We record changes in estimated contract earnings at completion (net EAC adjustments) using the cumulative catch-up method of accounting. Net EAC adjustments can have a significant effect on reported sales and operating income and the aggregate amounts are presented in the table below:

| | | |
|--|--------------------------------------|-------|
| | Three Months Ended March 31 | |
| \$ in millions | 2018 | 2017 |
| Favorable EAC adjustments | \$207 | \$182 |
| Unfavorable EAC adjustments | (91) | (41) |
| Net EAC adjustments | \$116 | \$141 |
| Net EAC adjustments by segment are presented in the table below: | | |

| | | |
|---------------------|--------------------------------------|-------|
| | Three Months Ended March 31 | |
| \$ in millions | 2018 | 2017 |
| Aerospace Systems | \$54 | \$53 |
| Mission Systems | 45 | 62 |
| Technology Services | 22 | 31 |
| Eliminations | (5) | (5) |
| Net EAC adjustments | \$116 | \$141 |

For purposes of the discussion in the remainder of this Segment Operating Results section, references to operating income and operating margin rate reflect segment operating income and segment operating margin rate, respectively.

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| AEROSPACE SYSTEMS | Three Months | | | % |
|-----------------------|----------------|---------|--------|---|
| | Ended March 31 | | | |
| \$ in millions | 2018 | 2017 | Change | |
| Sales | \$3,280 | \$2,984 | 10 | % |
| Operating income | 341 | 323 | 6 | % |
| Operating margin rate | 10.4 | % | 10.8 | % |

Aerospace Systems sales for the three months ended March 31, 2018 increased \$296 million, or 10 percent, as compared with the same period in 2017, due to higher volume on Manned Aircraft programs, as well as Autonomous Systems and Space programs. Manned Aircraft sales were driven by higher restricted, F-35 and E-2D Advanced Hawkeye volume. Autonomous Systems sales reflect higher volume on the Fire Scout and Triton programs, partially offset by lower Global Hawk volume. Space sales reflect higher restricted and Ground Based Strategic Deterrent volume, partially offset by lower intercompany, James Webb Space Telescope and Advanced Extremely High Frequency volume.

Operating income for the three months ended March 31, 2018 increased \$18 million, or 6 percent, as compared with the same period in 2017, primarily due to higher sales. Operating margin rate decreased to 10.4 percent primarily due to a non-programmatic benefit recognized during the first quarter of 2017 and higher volume on early phase development programs in 2018.

| MISSION SYSTEMS | Three Months | | | |
|-----------------------|----------------|---------|--------|---|
| | Ended March 31 | | | |
| \$ in millions | 2018 | 2017 | Change | |
| Sales | \$2,883 | \$2,800 | 3 | % |
| Operating income | 371 | 359 | 3 | % |
| Operating margin rate | 12.9 | % 12.8 | % | |

Mission Systems sales for the three months ended March 31, 2018 increased \$83 million, or 3 percent, as compared with the same period in 2017, primarily due to higher Sensors and Processing volume, partially offset by lower Cyber and ISR volume. Sensors and Processing sales increased principally due to higher volume on electro-optical/infrared (EO/IR) self-protection and targeting programs, F-35 sensors and restricted programs. Cyber and ISR sales decreased primarily due to lower volume on restricted ISR programs. Advanced Capabilities sales were comparable with the prior year period.

Operating income for the three months ended March 31, 2018 increased \$12 million, or 3 percent, as compared with the same period in 2017, primarily due to the higher sales described above. Operating margin rate was comparable with the prior year period.

| TECHNOLOGY SERVICES | Three Months | | % |
|-----------------------|----------------|---------|--------|
| | Ended March 31 | | |
| \$ in millions | 2018 | 2017 | Change |
| Sales | \$1,144 | \$1,190 | (4)% |
| Operating income | 122 | 129 | (5)% |
| Operating margin rate | 10.7 | % 10.8 | % |

Technology Services sales for the three months ended March 31, 2018 decreased \$46 million, or 4 percent, as compared with the same period in 2017, primarily due to lower volume on System Modernization and Services and Advanced Defense Services programs, partially offset by higher volume on Global Logistics and Modernization programs. System Modernization and Services and Advanced Defense Services sales decreased primarily due to the completion of several programs in 2017, partially offset by higher volume on the Saudi Arabian Ministry of National Guard Training Support program (through our interest in a joint venture for which we consolidate the financial results). Global Logistics and Modernization sales increased primarily due to higher volume for several programs, including the Special Electronic Mission Aircraft program, partially offset by lower volume from the KC-10 program as our contract nears completion.

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Operating income for the three months ended March 31, 2018 decreased \$7 million, or 5 percent, as compared with the same period in 2017, primarily due to the lower sales described above. Operating margin rate was comparable with the prior year period.

PRODUCT AND SERVICE ANALYSIS

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

| \$ in millions | Three Months Ended March 31 | | | |
|------------------------------|-----------------------------|------------------------------|---------|------------------------------|
| | 2018 | 2017 | | |
| Segment Information: | Sales | Operating Costs and Expenses | Sales | Operating Costs and Expenses |
| Aerospace Systems | | | | |
| Product | \$2,751 | \$ 2,465 | \$2,480 | \$ 2,204 |
| Service | 529 | 474 | 504 | 457 |
| Mission Systems | | | | |
| Product | 1,719 | 1,476 | 1,722 | 1,485 |
| Service | 1,164 | 1,036 | 1,078 | 956 |
| Technology Services | | | | |
| Product | 106 | 97 | 75 | 70 |
| Service | 1,038 | 925 | 1,115 | 991 |
| Segment Totals | | | | |
| Total Product | \$4,576 | \$ 4,038 | \$4,277 | \$ 3,759 |
| Total Service | 2,731 | 2,435 | 2,697 | 2,404 |
| Intersegment eliminations | (572) | (500) | (564) | (494) |
| Total segment ⁽¹⁾ | \$6,735 | \$ 5,973 | \$6,410 | \$ 5,669 |

⁽¹⁾ A reconciliation of segment operating income to total operating income is included in “Segment Operating Results.” Product Sales and Costs

Product sales for the three months ended March 31, 2018 increased \$299 million, or 7 percent, as compared with the same period in 2017. The increase was primarily due to higher restricted, F-35 and E-2D Advanced Hawkeye volume at Aerospace Systems.

Product costs for the three months ended March 31, 2018 increased \$279 million, or 7 percent, as compared with the same period in 2017, consistent with the change in product sales described above.

Service Sales and Costs

Service sales for the three months ended March 31, 2018 increased \$34 million, or 1 percent, as compared with the same period in 2017. The increase was primarily driven by higher service volume on several Sensors and Processing programs at Mission Systems, partially offset by lower service sales at Technology Services principally due to the completion of several programs in 2017.

Service costs for the three months ended March 31, 2018 increased \$31 million, or 1 percent, as compared with the same period in 2017, consistent with the change in service sales described above.

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 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. Backlog is converted into sales primarily as costs are incurred.

Company backlog as of March 31, 2018 and December 31, 2017 was \$42.3 billion and \$42.6 billion, respectively. As discussed in Note 1 to the financial statements, we adopted ASC Topic 606 on January 1, 2018 using the full

retrospective method and applied the transition practical expedient related to backlog for reporting periods presented

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before the date of initial application. However, for comparative purposes, we have recast our backlog as of December 31, 2017 to reflect the impact of adoption of ASC Topic 606.

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 through cash deployment activities. In addition to our cash position, we use various financial measures to assist in capital deployment decision-making, including cash used in operating activities and free cash flow, a non-GAAP measure described in more detail below.

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

Operating Cash Flow

The table below summarizes key components of cash flow used in operating activities:

| | Three Months Ended March 31 | |
|---------------------------------------|-----------------------------------|---------|
| \$ in millions | 2018 | 2017 |
| Net earnings | \$739 | \$650 |
| Non-cash items ⁽¹⁾ | 86 | 112 |
| Changes in assets and liabilities: | | |
| Trade working capital | (1,008) | (1,267) |
| Retiree benefits | (56) | 86 |
| Other, net | 2 | (20) |
| Net cash used in operating activities | \$(237) | \$(439) |

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

Net cash used in operating activities for the three months ended March 31, 2018 decreased \$202 million, as compared with the same period in 2017, principally due to higher net earnings and changes in trade working capital. The net use of cash during the first quarter is consistent with the company's historical timing of operating cash flows, which are generally more heavily weighted toward the second half of the year.

Free Cash Flow

Free cash flow, as reconciled in the table below, is a non-GAAP measure defined as net cash used in operating activities less capital expenditures, and may not be defined and calculated by other companies in the same manner. We use free cash flow as a key factor in our planning for, and consideration of, acquisitions, stock repurchases, and the payment of dividends. This measure may be useful to investors and other users of our financial statements as a supplemental measure of our cash performance, but should not be considered in isolation, as a measure of residual cash flow available for discretionary purposes, or as an alternative to operating cash flows presented in accordance with GAAP.

The table below reconciles net cash used in operating activities to free cash flow:

| | Three Months Ended March 31 | |
|---------------------------------------|-----------------------------------|---------|
| \$ in millions | 2018 | 2017 |
| Net cash used in operating activities | \$(237) | \$(439) |
| Less: capital expenditures | (305) | (216) |
| Free cash flow | \$(542) | \$(655) |

Free cash flow for the three months ended March 31, 2018 increased \$113 million, as compared with the same period in 2017, principally due to the decrease in net cash used in operating activities described above, partially offset by higher capital expenditures at Aerospace Systems.

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Investing Cash Flow

Net cash used in investing activities for the three months ended March 31, 2018 increased to \$307 million from \$214 million in the prior year period principally due to the higher capital expenditures described above.

Financing Cash Flow

Net cash used in financing activities for the three months ended March 31, 2018 decreased to \$312 million from \$485 million in the prior year period. The decrease was primarily due to \$229 million of share repurchases in the first quarter of 2017 compared to no share repurchases in the first quarter of 2018.

Credit Facilities and Financial Arrangements - See Note 7 to the financial statements for further information on our credit facilities and our use of standby letters of credit and guarantees.

Share Repurchases - See Note 3 to the financial statements for further information on our share repurchase programs.

Unsecured Senior Notes - See Note 5 to the financial statements for further information.

CRITICAL ACCOUNTING POLICIES, ESTIMATES AND JUDGMENTS

Effective January 1, 2018, we adopted ASC Topic 606, Revenue from Contracts with Customers, using the full retrospective method. ASC 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 GAAP. Under ASC Topic 606, revenue is recognized as control transfers to the customer. As such, under the new standard, revenue for our contracts is generally recognized over time using the cost-to-cost method, which is consistent with the revenue recognition model used for the majority of our contracts prior to the adoption of ASC Topic 606. In most cases the accounting for those contracts where we previously recognized revenue as units were delivered has 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. See "Revenue Recognition" in Note 1 to the financial statements for additional information regarding our revenue recognition accounting policies.

ACCOUNTING STANDARDS UPDATES

See Note 1 to our financial statements for further information on accounting standards updates.

FORWARD-LOOKING STATEMENTS AND PROJECTIONS

This Form 10-Q and the information we are incorporating by reference contain 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 "will," "expect," "intend," "may," "could," "plan," "project," "forecast," "believe," "estimate," "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/or 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 and discussed more fully in the section entitled "Risk Factors" in our 2017 Annual Report on Form 10-K and other filings with the Securities and Exchange Commission (SEC). They include:

- our dependence on the U.S. Government for a substantial portion of our business
- significant delays or reductions in appropriations for our programs and U.S. Government funding more broadly
- investigations, claims, disputes, enforcement actions and/or litigation
- the use of estimates when accounting for our contracts and the effect of contract cost growth and/or changes in estimated contract revenues and costs
- our exposure to additional risks as a result of our international business, including risks related to geopolitical and economic factors, laws and regulations

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the improper conduct of employees, agents, subcontractors, suppliers, business partners or joint ventures in which we participate and the impact on our reputation, our ability to do business, and our financial position, results of operations and/or cash flows

cyber and other security threats or disruptions faced by us, our customers or our suppliers and other partners

the performance and financial viability of our subcontractors and suppliers and the availability and pricing of raw materials and components

changes in procurement and other laws, regulations and practices applicable to our industry, findings by the U.S.

Government as to our compliance with such laws and regulations, and changes in our customers' business practices globally

increased competition within our markets and bid protests

the ability to maintain a qualified workforce

our ability to meet performance obligations under our contracts, including obligations that are technologically complex, require certain manufacturing expertise or are dependent on factors not wholly within our control

environmental matters, including unforeseen environmental costs and government and third party claims

natural and/or environmental disasters

- the adequacy and availability of our insurance coverage, customer indemnifications or other liability protections

products and services we provide related to hazardous and high risk operations, which subject us to various environmental, regulatory, financial, reputational and other risks

the future investment performance of plan assets, changes in actuarial assumptions associated with our pension and other post-retirement benefit plans and legislative or other regulatory actions impacting our pension, post-retirement and health and welfare plans

the satisfaction of conditions (including regulatory approvals) to and successful consummation of the Orbital ATK Acquisition; our ability successfully to integrate the Orbital ATK business and realize fully the anticipated benefits of the acquisition, without adverse consequences

our ability to exploit or protect intellectual property rights

our ability to develop new products and technologies and maintain technologies, facilities, and equipment to win new competitions and meet the needs of our customers

changes in business conditions that could impact business investments and/or recorded goodwill or the value of other long-lived assets

unanticipated changes in our tax provisions or exposure to additional tax liabilities

Additional information regarding these risks and other important factors can be found in the section entitled "Risk Factors" in our 2017 Annual Report on Form 10-K and as 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 or, in the case of any document incorporated by reference, the date of that document. 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 2017 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 2017 Annual Report on Form 10-K.

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Item 4. Controls and Procedures

DISCLOSURE CONTROLS AND PROCEDURES

Our principal executive officer (Chairman and Chief Executive Officer) 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) of the Securities Exchange Act of 1934 (the Exchange Act)) as of March 31, 2018, and have concluded that these controls and procedures are effective to ensure that information required to be disclosed by us in the reports that we file or submit under the Exchange Act is recorded, processed, summarized and reported within the time periods specified in the SEC's rules and forms. These disclosure controls and procedures include, without limitation, controls and procedures designed to ensure that information required to be disclosed in the reports that we file or submit is accumulated and communicated to management, including the principal executive officer and the principal financial officer, as appropriate to allow timely decisions regarding required disclosure.

CHANGES IN INTERNAL CONTROL OVER FINANCIAL REPORTING

During the three months ended March 31, 2018, 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.

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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 2017 Annual Report on Form 10-K, and updated that information in Notes 6 and 7 to the financial statements.

We are a party to various investigations, lawsuits, claims, enforcement actions 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 administrative, civil or criminal fines, penalties or other sanctions (which terms include judgments or convictions and consent or other voluntary decrees or agreements); compensatory, treble or other damages; non-monetary relief or actions; or other liabilities. Government regulations provide that certain allegations against a contractor may lead to suspension or debarment from future government contracts or suspension of export privileges for the company or one or more of its components. 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 2017 Annual Report on Form 10-K, as updated by Notes 6 and 7 to the financial statements in this report, we do not believe that the outcome of any matter currently 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. For further information on the risks we face from existing and future investigations, lawsuits, claims, enforcement actions and other legal proceedings, please see "Risk Factors" in our 2017 Annual Report on Form 10-K.

Item 1A. Risk Factors

For a discussion of our risk factors please see the section entitled "Risk Factors" in our 2017 Annual Report on Form 10-K.

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

We had no repurchases of common stock during the three months ended March 31, 2018. The approximate dollar value of shares that may yet be purchased under the company's share repurchase authorization is \$2.3 billion as of March 31, 2018.

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.

See Note 3 to the financial statements for further information on our share repurchase programs.

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 30, 2011 (incorporated by reference to Exhibit 10.1 to Form 8-K filed April 4, 2011, File No. 001-16411)
- 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, File No. 001-16411)
- 2.3 Agreement and Plan of Merger, dated as of September 17, 2017, among Northrop Grumman Corporation, Neptune Merger, Inc. and Orbital ATK, Inc. (incorporated by reference to Exhibit 2.1 to Form 8-K filed September 18, 2017)
- *+10.1 Grant Certificate Specifying the Terms and Conditions Applicable to 2018 Restricted Stock Rights Granted Under the 2011 Long-Term Incentive Stock Plan
- *+10.2 Grant Certificate Specifying the Terms and Conditions Applicable to 2018 Restricted Performance Stock Rights Granted Under the 2011 Long-Term Incentive Stock Plan
- *+10.3 Severance Plan for Elected and Appointed Officers of Northrop Grumman Corporation as amended and restated effective February 11, 2018
- *12(a) Computation of Ratio of Earnings to Fixed Charges
- *15 Letter from Independent Registered Public Accounting Firm
- *31.1 Certification of Wesley G. Bush pursuant to Section 302 of the Sarbanes-Oxley Act of 2002
- *31.2 Certification of Kenneth L. Bedingfield pursuant to Section 302 of the Sarbanes-Oxley Act of 2002
- **32.1 Certification of Wesley G. Bush pursuant to Section 906 of the Sarbanes-Oxley Act of 2002
- **32.2 Certification of Kenneth L. Bedingfield 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 March 31, 2018, 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
- + Management contract or compensatory plan or arrangement
- * Filed with this report
- **Furnished with this report

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NORTHROP GRUMMAN CORPORATION

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: April 24, 2018

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