NORTHROP GRUMMAN CORP /DE/
Form 10-Q
April 27, 2016

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

FORM 10-Q

x QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934
For the Quarterly Period Ended March 31, 2016
or
o TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934
Commission File Number 1-16411
NORTHROP GRUMMAN CORPORATION
(Exact name of registrant as specified in its charter)

DELAWARE	80-0640649
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification No.)
2980 Fairview Park Drive, Falls Church, Virginia	22042
(Address of principal executive offices)	(Zip Code)

(703) 280-2900
(Registrant's telephone number, including area code)

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days.
Yes x No o
Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files).
Yes x No o
Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer or a smaller reporting company. See the definitions of "large accelerated filer," "accelerated filer" and "smaller reporting company" in Rule 12b-2 of the Exchange Act:
Large accelerated filer x Accelerated filer o

Non-accelerated filer o (Do not check if a smaller reporting Smaller reporting company o

company)
Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act).
Yes o No x
Indicate the number of shares outstanding of each of the issuer’s classes of common stock, as of the latest practicable date.
As of April 22, 2016, 180,451,623 shares of common stock were outstanding.

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

	Three Months Ended March 31	
$ in millions, except per share amounts	2016	2015
Sales		
Product	$3,478	$3,429
Service	2,478	2,528
Total sales	5,956	5,957
Operating costs and expenses		
Product	2,611	2,542
Service	1,950	2,000
General and administrative expenses	656	635
Operating income	739	780
Other (expense) income		
Interest expense	(76)	(76)
Other, net	13	—
Earnings before income taxes	676	704
Federal and foreign income tax expense	120	220
Net earnings	$556	$484
Basic earnings per share	$3.07	$2.45
Weighted-average common shares outstanding, in millions	181.3	197.7
Diluted earnings per share	$3.03	$2.41
Weighted-average diluted shares outstanding, in millions	183.4	200.5
Net earnings (from above)	$556	$484
Other comprehensive income		
Change in unamortized benefit plan costs, net of tax	101	96
Change in cumulative translation adjustment	(4)	(29)
Other, net	(1)	(1)
Other comprehensive income, net of tax	96	66
Comprehensive income	$652	$550

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, 2016	December 31, 2015
Assets		
Cash and cash equivalents	$ 1,277	$ 2,319
Accounts receivable, net	3,346	2,841
Inventoried costs, net	898	807
Prepaid expenses and other current assets	185	367
Total current assets	5,706	6,334
Property, plant and equipment, net of accumulated depreciation of $4,877 in 2016 and $4,849 in 2015	3,230	3,064
Goodwill	12,462	12,460
Deferred tax assets	1,383	1,409
Other non-current assets	1,152	1,157
Total assets	$ 23,933	$ 24,424
Liabilities		
Trade accounts payable	$ 1,204	$ 1,282
Accrued employee compensation	1,071	1,195
Advance payments and amounts in excess of costs incurred	1,409	1,537
Other current liabilities	1,271	1,443
Total current liabilities	4,955	5,457
Long-term debt, net of current portion	6,387	6,386
Pension and other post-retirement benefit plan liabilities	6,117	6,172
Other non-current liabilities	853	887
Total liabilities	18,312	18,902
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: 2016—180,828,855 and 2015—181,303,083	181	181
Paid-in capital	—	—
Retained earnings	10,664	10,661
Accumulated other comprehensive loss	(5,224)	(5,320)
Total shareholders' equity	5,621	5,522
Total liabilities and shareholders' equity	$ 23,933	$ 24,424

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CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS
(Unaudited)

	Three Months Ended March 31	
$ in millions	2016	2015
Operating activities		
Net earnings	$556	$484
Adjustments to reconcile to net cash used in operating activities:		
Depreciation and amortization	103	99
Stock-based compensation	14	24
Excess tax benefits from stock-based compensation	—	(105)
Deferred income taxes	(35)	204
Changes in assets and liabilities:		
Accounts receivable, net	(514)	(325)
Inventoried costs, net	(89)	(76)
Prepaid expenses and other assets	(4)	16
Accounts payable and other liabilities	(364)	(889)
Income taxes payable	174	366
Retiree benefits	105	(440)
Other, net	(6)	(12)
Net cash used in operating activities	$(60)	$(654)
Investing activities		
Capital expenditures	(298)	(117)
Other, net	—	2
Net cash used in investing activities	(298)	(115)
Financing activities		
Common stock repurchases	(282)	(825)
Net proceeds from issuance of long-term debt	—	600
Payments of long-term debt	(107)	—
Cash dividends paid	(159)	(156)
Payments of employee taxes withheld from share-based awards	(137)	(171)
Other, net	1	104
Net cash used in financing activities	(684)	(448)
Decrease in cash and cash equivalents	(1,042)	(1,217)
Cash and cash equivalents, beginning of year	2,319	3,863
Cash and cash equivalents, end of period	$1,277	$2,646

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)

	Three Months Ended March 31	
$ in millions, except per share amounts	2016	2015
Common stock		
Beginning of year	$181	$199
Common stock repurchased	(2)	(5)
Shares issued for employee stock awards and options	2	1
End of period	181	195
Paid-in capital		
Beginning of year	—	—
End of period	—	—
Retained earnings		
Beginning of year	10,661	12,392
Common stock repurchased	(284)	(854)
Net earnings	556	484
Dividends declared	(147)	(142)
Stock compensation	(122)	(37)
End of period	10,664	11,843
Accumulated other comprehensive loss		
Beginning of year	(5,320)	(5,356)
Other comprehensive income, net of tax	96	66
End of period	(5,224)	(5,290)
Total shareholders' equity	$5,621	$6,748
Cash dividends declared per share	$0.80	$0.70

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

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NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Unaudited)

1. BASIS OF PRESENTATION

Principles of Consolidation and Reporting

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

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

The results reported in these unaudited condensed consolidated financial statements are not necessarily indicative of results that may be expected for the entire year. These unaudited condensed consolidated financial statements should be read in conjunction with the information contained in the company’s Annual Report on Form 10-K for the year ended December 31, 2015 (2015 Annual Report on Form 10-K) and the Form 8-K that we expect to file with the SEC immediately after filing this Form 10-Q, which recasts the disclosures in certain portions of the 2015 Annual Report on Form 10-K to reflect changes in the company’s organizational structure and reportable segments.

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

Accounting Estimates

The accompanying unaudited condensed consolidated financial statements are prepared in conformity with accounting principles generally accepted in the United States of America (GAAP). The preparation thereof requires management to make estimates and judgments that affect the reported amounts of assets and liabilities and the disclosure of contingencies at the date of the financial statements, as well as the reported amounts of 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 United States (U.S.) Government for the production of goods, the provision of services, or in some cases, a combination of both. In accounting for these contracts, we utilize either the cost-to-cost method or the units-of-delivery method of percentage-of-completion accounting, with cost-to-cost being the predominant method. The company estimates profit on contracts as the difference between total estimated sales and total estimated cost at completion and recognizes that profit either as costs are incurred (cost-to-cost) or as units are delivered (units-of-delivery). The company classifies sales as product or service depending upon the predominant attributes of the contract.

Net Estimate-At-Completion (EAC) Adjustments - We recognize changes in estimated contract sales, costs or profits using the cumulative catch-up method of accounting. This method recognizes, in the current period, the cumulative effect of the changes on current and prior periods as net EAC adjustments; sales and profit in future periods of contract performance are recognized as if the revised estimates had been used since contract inception. If it is determined that a loss will result from the performance of a contract, the entire amount of the estimable future loss is charged against income in the period the loss is identified. Loss provisions are first offset against any costs that are included in unbilled accounts receivable or inventoried costs, and any remaining amount is reflected in liabilities. Significant EAC adjustments on a single contract could have a material effect on the company’s unaudited condensed consolidated financial position or results of operations. Where 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 accompanying unaudited condensed consolidated financial statements.

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

	Three Months Ended March 31	
$ in millions, except per share data	2016	2015
Operating Income	$129	$187
Net Earnings[(1)]	84	122
Diluted earnings per share[(1)]	0.46	0.61

[(1)] Based on statutory tax rates

Contract sales may include estimated amounts not contractually agreed to by the customer, including cost or performance incentives (such as award and incentive fees), un-priced change orders, contract claims and requests for equitable adjustment (REAs). Further, as contracts are performed, change orders can be a regular occurrence and may be un-priced until negotiated with the customer. Un-priced change orders, contract claims (including change orders unapproved as to both scope and price) and REAs are included in estimated contract sales when management believes it is probable the un-priced change order, claim and/or REA will result in additional contract revenue and the amount can be reliably estimated based on the facts and circumstances known to us at the time. As of March 31, 2016, the company has initiated REAs with the U.S. government and an international customer seeking recovery of approximately $300 million under contracts related to two Aerospace Systems programs. A substantial portion of the REAs was initiated during the fourth quarter of 2015. The REAs relate to what we believe is work performed by the company at the direction of our customers that is beyond the scope of the related contracts as well as costs incurred by the company as a result of customer-caused delays and disruption. The total amount of additional contract sales we have assumed as of March 31, 2016 is approximately $225 million. We are currently negotiating the REAs and the terms of the contracts with our customers. Recognized amounts related to claims and REAs as of March 31, 2015 were not material individually or in aggregate.

As of March 31, 2016, the company does not have any contract terminations in process that we anticipate would have a material effect on our unaudited condensed consolidated financial position, or our annual results of operations and/or cash flows.

Related Party Transactions

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

Accounting Standards Updates

On March 30, 2016, the Financial Accounting Standards Board (FASB) issued Accounting Standards Update (ASU) No. 2016-09, Compensation - Stock Compensation (Topic 718): Improvements to Employee Share-Based Payment Accounting. The company adopted ASU 2016-09 during the first quarter of 2016. Among other things, the ASU requires that entities recognize excess tax benefits and deficiencies related to employee share-based payment transactions as income tax expense or benefit. The ASU also eliminates the requirement to reclassify excess tax benefits and deficiencies from operating activities to financing activities in the statement of cash flows. As a result of adoption, the company recognized an $80 million tax benefit as a discrete item during the first quarter of 2016. Adoption also resulted in an $80 million increase in operating cash flows and a corresponding $80 million reduction in financing cash flows for the period ended March 31, 2016.

On February 25, 2016, the FASB issued ASU No. 2016-02, Leases (Topic 842). ASU 2016-02 supersedes existing lease guidance, including Accounting Standards Codification (ASC) 840 - Leases. Among other things, the new standard requires recognition of a right-of-use asset and liability for future lease payments for contracts that meet the definition of a lease. ASU 2016-02 will be effective January 1, 2019, although early adoption is permitted. The standard must be applied using a modified retrospective approach. We are currently evaluating the timing of adoption as well as the effect ASU 2016-02 will have on the company’s consolidated financial position, annual results of operations and cash flows.

On May 28, 2014, the FASB issued ASU No. 2014-09, Revenue from Contracts with Customers. ASU 2014-09 supersedes existing revenue recognition guidance, including ASC 605-35, Revenue Recognition - Construction-Type and Production-Type Contracts. ASU 2014-09 outlines a single set of comprehensive principles for rec