NORTHROP GRUMMAN CORP /DE/
Form 10-Q
October 23, 2013

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 September 30, 2013
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
www.northropgrumman.com
(Address of principal executive offices and internet site)
(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 *

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

Yes x	No *

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

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

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

Yes *	No 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 October 18, 2013, 221,990,583 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 September 30		Nine Months Ended September 30	
$ in millions, except per share amounts	2013	2012	2013	2012
Sales				
Product	$3,330	$3,487	$10,344	$10,227
Service	2,776	2,783	8,160	8,515
Total sales	6,106	6,270	18,504	18,742
Operating costs and expenses				
Product	2,499	2,629	7,833	7,760
Service	2,262	2,333	6,621	6,963
General and administrative expenses	555	572	1,695	1,713
Operating income	790	736	2,355	2,306
Other (expense) income				
Interest expense	(70)	(53)	(183)	(158)
Other, net	—	12	(16)	30
Earnings before income taxes	720	695	2,156	2,178
Federal and foreign income tax expense	223	236	682	733
Net earnings	$ 497	$ 459	$ 1,474	$ 1,445
Basic earnings per share	$ 2.18	$ 1.86	$ 6.33	$ 5.77
Weighted-average common shares outstanding, in millions	228.2	247.2	232.8	250.4
Diluted earnings per share	$ 2.14	$ 1.82	$ 6.22	$ 5.67
Weighted-average diluted shares outstanding, in millions	232.6	252.1	237.0	255.0
Net earnings (from above)	$ 497	$ 459	$ 1,474	$ 1,445
Other comprehensive income				
Change in unamortized benefit plan costs, net of tax	78	50	237	154
Change in cumulative translation adjustment	15	12	8	3
Change in unrealized loss on marketable securities and cash flow hedges, net of tax	(1)	(1)	(1)	(1)
Other comprehensive income, net of tax	92	61	244	156
Comprehensive income	$ 589	$ 520	$ 1,718	$ 1,601

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

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CONDENSED CONSOLIDATED STATEMENTS OF FINANCIAL POSITION
(Unaudited)

$ in millions	September 30, 2013	December 31, 2012
Assets		
Cash and cash equivalents	$ 4,944	$ 3,862
Accounts receivable, net of progress payments	3,003	2,858
Inventoried costs, net of progress payments	784	798
Deferred tax assets	596	574
Prepaid expenses and other current assets	264	300
Total current assets	9,591	8,392
Property, plant and equipment, net of accumulated depreciation of $4,305 in 2013 and $4,146 in 2012	2,763	2,887
Goodwill	12,438	12,431
Non-current deferred tax assets	1,274	1,542
Other non-current assets	1,339	1,291
Total assets	$27,405	$26,543
Liabilities		
Trade accounts payable	$ 1,221	$ 1,392
Accrued employee compensation	1,058	1,173
Advance payments and amounts in excess of costs incurred	1,698	1,759
Other current liabilities	1,785	1,732
Total current liabilities	5,762	6,056
Long-term debt, net of current portion	5,928	3,930
Pension and post-retirement benefit plan liabilities	5,374	6,085
Other non-current liabilities	985	958
Total liabilities	18,049	17,029
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: 2013— 223,775,721 and 2012—239,209,812	224	239
Paid-in capital	1,479	2,924
Retained earnings	12,196	11,138
Accumulated other comprehensive loss	(4,543)	(4,787)
Total shareholders’ equity	9,356	9,514
Total liabilities and shareholders’ equity	$27,405	$26,543

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

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CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS
(Unaudited)

	Nine Months Ended September 30	
$ in millions	2013	2012
Operating activities		
Sources of cash		
Cash received from customers		
Collections on billings	$13,871	$15,632
Progress payments	4,281	3,233
Other cash receipts	66	67
Total sources of cash	18,218	18,932
Uses of cash		
Cash paid to suppliers and employees	(15,555)	(16,015)
Pension contributions	(561)	(349)
Interest paid, net of interest received	(183)	(177)
Income taxes paid, net of refunds received	(579)	(760)
Other cash payments	(61)	(48)
Total uses of cash	(16,939)	(17,349)
Net cash provided by operating activities	1,279	1,583
Investing activities		
Capital expenditures	(178)	(196)
Maturities of short-term investments	—	250
Other investing activities, net	9	7
Net cash (used in) provided by investing activities	(169)	61
Financing activities		
Net proceeds from issuance of long-term debt	2,841	—
Common stock repurchases	(1,661)	(846)
Payments of long-term debt	(877)	—
Cash dividends paid	(411)	(401)
Proceeds from exercises of stock options	158	153
Other financing activities, net	(78)	(27)
Net cash used in financing activities	(28)	(1,121)
Increase in cash and cash equivalents	1,082	523
Cash and cash equivalents, beginning of year	3,862	3,002
Cash and cash equivalents, end of period	$ 4,944	$ 3,525

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

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$ in millions	Nine Months Ended September 30 2013	2012
Reconciliation of net earnings to net cash provided by operating activities		
Net earnings	$1,474	$1,445
Adjustments to reconcile to net cash provided by operating activities:		
Depreciation and amortization	345	371
Stock-based compensation	118	111
Excess tax benefits from stock-based compensation	(37)	(41)
Deferred income taxes	89	47
(Increase) decrease in assets:		
Accounts receivable, net	(147)	(27)
Inventoried costs, net	10	224
Prepaid expenses and other assets	(53)	(90)
Increase (decrease) in liabilities:		
Accounts payable and accruals	(296)	(370)
Income taxes payable	92	32
Retiree benefits	(331)	(99)
Other, net	15	(20)
Net cash provided by operating activities	$1,279	$1,583

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

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

	Nine Months Ended September 30	
$ in millions, except per share amounts	2013	2012
Common stock		
Beginning of year	$ 239	$ 254
Common stock repurchased	(21)	(14)
Shares issued for stock awards and options	6	6
End of period	224	246
Paid-in capital		
Beginning of year	2,924	3,873
Common stock repurchased	(1,652)	(831)
Stock compensation and options exercised	212	249
Shipbuilding spin-off adjustment	(5)	5
End of period	1,479	3,296
Retained earnings		
Beginning of year	11,138	9,699
Net earnings	1,474	1,445
Dividends declared	(416)	(405)
End of period	12,196	10,739
Accumulated other comprehensive loss		
Beginning of year	(4,787)	(3,490)
Other comprehensive income, net of tax	244	156
End of period	(4,543)	(3,334)
Total shareholders' equity	$9,356	$10,947
Cash dividends declared per share	$ 1.77	$ 1.60

The accompanying notes are an integral part of these 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 of the company have been prepared by management in accordance with the rules of the Securities and Exchange Commission (SEC) for interim reporting purposes. These statements include adjustments of a normal recurring nature considered necessary by management for a fair presentation of the company's 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, 2012 (2012 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 management’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 revenues and expenses during the reporting period. Estimates have been prepared using the most current and best available information; however, actual results could differ materially from those estimates.

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

Significant changes in estimates on a single contract could have a material effect on the company's consolidated financial position or annual results of operations, and where such changes occur, separate disclosure is made of the nature, underlying conditions and financial impact of the change. During the three and nine months ended September 30, 2013, aggregate net changes in contract estimates recognized using the cumulative catch-up method of accounting increased operating income by $236 million ($0.66 per diluted share) and $657 million ($1.80 per diluted share), respectively. During the three and nine months ended September 30, 2012, such changes in contract estimates increased operating income by $214 million ($0.55 per diluted share) and $701 million ($1.79 per diluted share), respectively. No discrete event or adjustment to an individual contract was material to the condensed consolidated statements of earnings and comprehensive income for any of these periods.

As of September 30, 2013, the amounts related to claims and requests for equitable adjustment recognized in estimated contract values were not material individually or in aggregate.

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As of September 30, 2013, the company did not have any contract terminations in process that would have a material effect on our consolidated financial position or annual results of operations.

Related Party Transactions

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

Accounting Standards Updates

Accounting standards updates effective after September 30, 2013, are not expected to have a material effect on the company's consolidated financial position or annual results of operations.

Accumulated Other Comprehensive Loss

The components of accumulated other comprehensive loss are as follows:

$ in millions	September 30, 2013	December 31, 2012
Unamortized benefit plan costs, net of tax benefit of $2,990 as of September 30, 2013, and $3,149 as of December 31, 2012	$(4,553)	$(4,790)
Cumulative translation adjustment	12	4
Net unrealized loss on marketable securities and cash flow hedges, net of tax benefit	(2)	(1)
Total accumulated other comprehensive loss	$(4,543)	$(4,787)

Unamortized benefit plan costs consist primarily of net after-tax actuarial losses totaling $4.8 billion and $5.1 billion as of September 30, 2013, and December 31, 2012, respectively. Net actuarial gains or losses are re-determined annually and principally arise from changes in the rate used to discount the benefit obligations and differences in expected and actual returns on plan assets.

Reclassifications from other comprehensive income to net earnings related to the amortization of benefit plan costs were $78 million and $237 million, net of taxes, for the three and nine months ended September 30, 2013, respectively, and were $50 million and $154 million, net of taxes, for the three and nine months ended September 30, 2012, respectively. The reclassifications represent the amortization of net actuarial losses and prior service credits for the company's retirement benefit plans, and are included in the computation of net periodic pension cost (See Note 8 for further information).

Reclassifications from other comprehensive income to net earnings, relating to cumulative translation adjustments, marketable securities and effective cash flow hedges for the three and nine months ended September 30, 2013 and 2012, respectively, were not material. Reclassifications for cumulative translation adjustments and marketable securities are recorded in other income, and reclassifications for effective cash flow hedges are recorded in operating income.

2. EARNINGS PER SHARE, SHARE REPURCHASES AND DIVIDENDS ON COMMON STOCK

Basic Earnings Per Share

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

Diluted Earnings Per Share

Diluted earnings per share includes the dilutive effect of options and awards granted to employees under stock-based compensation plans. The dilutive effect of these securities totaled 4.4 million shares and 4.2 million shares for the three and nine months ended September 30, 2013, respectively. The dilutive effect of these securities totaled 4.9 million shares and 4.6 million shares for the three and nine months ended September 30, 2012, respectively. The weighted-average diluted shares outstanding excludes anti-dilutive stock options because such options have exercise prices in excess of the average market price of the company's common stock during the period. We had no anti-dilutive shares outstanding for the three and nine months ended September 30, 2013. The weighted-average diluted shares outstanding for the three and nine months ended September 30, 2012, exclude anti-dilutive stock options to purchase approximately 1.3 million shares and 2.7 million shares, respectively.

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Share Repurchases

The table below summarizes the company's share repurchases:

Repurchase Program Authorization Date	Amount Authorized (in millions)	Total Shares Retired (in millions)	Average Price Per Share[2]	Date Completed	Shares Repurchased (in millions) Nine Months Ended September 30	
					2013	2012
June 16, 2010	$5,350	83.7	$63.86	September 2013	18.6	13.6
May 15, 2013[1]	$4,000	2.0	$96.39		2.0	—

(1) On May 15, 2013, the company's board of directors authorized a share repurchase program of up to $4.0 billion of the company's common stock. Repurchases under this program commenced upon the completion of the company's 2010 repurchase program in September 2013. As of September 30, 2013, our repurchases under the program totaled $196 million, and $3.8 billion remained under this share repurchase authorization.The repurchase program will expire when we have used all authorized funds for repurchase.

(2) Includes commissions paid.

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

Dividends on Common Stock

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

In May 2012, the company increased the quarterly common stock dividend 10 percent to $0.55 per share from the previous amount of $0.50 per share.

3. SEGMENT INFORMATION

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

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The following table presents sales and operating income by segment:

	Three Months Ended September 30		Nine Months Ended September 30	
$ in millions	2013	2012	2013	2012
Sales				
Aerospace Systems	$2,484	$2,586	$7,582	$7,373
Electronic Systems	1,774	1,707	5,266	5,175
Information Systems	1,619	1,776	4,982	5,476
Technical Services	713	748	2,152	2,281
Intersegment eliminations	(484)	(547)	(1,478)	(1,563)
Total sales	6,106	6,270	18,504	18,742
Operating income				
Aerospace Systems	330	288	936	859
Electronic Systems	273	279	891	859
Information Systems	162	170	474	577
Technical Services	67	62	201	206
Intersegment eliminations	(69)	(69)	(194)	(200)
Total segment operating income	763	730	2,308	2,301
Reconciliation to total operating income:				
Net FAS/CAS pension adjustment	61	34	125	101
Unallocated corporate expenses	(33)	(27)	(73)	(89)
Other	(1)	(1)	(5)	(7)
Total operating income	$ 790	$ 736	$2,355	$2,306

Net FAS/CAS Pension Adjustment

The net FAS (GAAP Financial Accounting Standards)/CAS (U.S. Government Cost Accounting Standards) pension adjustment is the difference between pension expense determined in accordance with GAAP and pension expense allocated to the operating segments determined in accordance with CAS. The change in net FAS/CAS pension adjustment from the prior year periods reflects an update for actual demographic experience as of January 1, 2013, which resulted in an increase to the company's 2013 CAS pension expense.

Unallocated Corporate Expenses

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

4. INCOME TAXES

	Three Months Ended September 30		Nine Months Ended September 30	
$ in millions	2013	2012	2013	2012
Federal and foreign income tax expense	$223	$236	$682	$733
Effective income tax rate	31.0 %	34.0 %	31.6 %	33.7 %

The company's lower effective tax rate for the three months ended September 30, 2013, includes an additional $16 million benefit associated with the company's 2012 U.S. federal tax return and $6 million benefit for the American Taxpayer Relief Act, which reinstated research tax credits for 2012 and 2013. During the nine months ended September 30, 2013, the company recorded $29 million of research tax credits representing estimated full year 2012 research tax credits and three quarters of the expected 2013 research tax credits and an additional $16 million benefit associated with the 2012 U.S. federal tax return noted above.

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The company recognizes accrued interest and penalties related to uncertain tax positions in federal and foreign income tax expense. The company files income tax returns in the U.S. federal jurisdiction, and in various state and foreign jurisdictions. The Internal Revenue Service (IRS) is conducting an examination of the company's tax returns for the years 2007 through 2011. With respect to the tax years 2007 through 2009, the company has reached a tentative resolution with the IRS subject to final review by the U.S. Congressional Joint Committee on Taxation. It is reasonably possible that during the next twelve months, we will record a reduction in our unrecognized tax benefits up to $80 million and a reduction of our income tax expense up to $50 million. Other open tax years related to state and foreign jurisdictions remain subject to examination, but are not considered material.

5. FAIR VALUE OF FINANCIAL INSTRUMENTS

The following table presents fair value information for those assets and liabilities measured at fair value on a recurring basis:

	September 30, 2013		December 31, 2012	
$ in millions	Carrying Value	Fair Value	Carrying Value	Fair Value
Financial Assets (Liabilities)				
Marketable securities				
Trading	$285	$285	$259	$259
Available-for-sale	2	2	3	3
Derivatives	(2)	(2)	(1)	(1)
Long-term debt, including current portion	$(5,930)	$(6,358)	$(3,935)	$(4,834)

There were no transfers of financial instruments between the three levels of fair value hierarchy during the nine months ended September 30, 2013.

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

Investments in Marketable Securities

The company holds a portfolio of marketable securities to partially fund long-term deferred compensation programs. The portfolio consists of equity securities that are classified as either trading or available-for-sale, which can be liquidated without restriction. These assets are recorded at fair value, and substantially all of these instruments are valued using Level 1 inputs, with an immaterial amount valued using Level 2 inputs. As of September 30, 2013, and December 31, 2012, marketable securities of $287 million and $261 million, respectively, were included in other non-current assets in the condensed consolidated statements of financial position.

Derivative Financial Instruments and Hedging Activities

The company's derivative portfolio consists primarily of foreign currency forward contracts. The notional values for the company's derivative portfolio at September 30, 2013, and December 31, 2012, were $183 million and $164 million, respectively. The portion of notional values designated as cash flow hedges at September 30, 2013, and December 31, 2012, were $87 million and $110 million, respectively.

Derivative financial instruments are recognized as assets or liabilities in the financial statements and measured at fair value. Substantially all of these instruments are valued using Level 2 inputs.

Unrealized gains or losses on the effective portion of cash flow hedges are reclassified from other comprehensive income to operating income upon the settlement of the underlying transactions. The derivative fair values and related unrealized gains and losses at September 30, 2013, and December 31, 2012, were not material. Hedge contracts not designated for hedge accounting and the ineffective portion of cash flow hedges are recorded in other income.

Long-term Debt

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

Debt Issuance and Redemption

In May 2013, the company issued $2.85 billion of unsecured senior notes consisting of $850 million due June 1, 2018 with a fixed interest rate of 1.75 percent; $1.05 billion due August 1, 2023 with a fixed interest rate of 3.25 percent;

and $950 million due June 1, 2043 with a fixed interest rate of 4.75 percent (collectively, the Notes). Interest on the Notes is payable semi-annually in arrears. The Notes are subject to redemption at the company's

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discretion at any time, or from time to time, prior to maturity in whole or in part at the greater of the principal amount of the Notes or a “make-whole” amount, plus accrued and unpaid interest. The company used a portion of the net proceeds to fund the redemption of $350 million of the company's 3.70 percent unsecured senior notes due August 1, 2014, and $500 million of 1.85 percent unsecured senior notes due November 15, 2015. During the quarter ended June 30, 2013, the company recorded a pre-tax charge of $30 million principally related to the premiums paid on the redemption, which was recorded in other, net in the condensed consolidated statements of earnings and comprehensive income.

6. LITIGATION, INVESTIGATIONS AND CLAIMS

Litigation

The company is one of several defendants in litigation brought by the Orange County Water District in Orange County Superior Court in California on December 17, 2004, for alleged contribution to volatile organic chemical contamination of the County's shallow groundwater. The lawsuit includes counts against the defendants for violation of the Orange County Water District Act, the California Super Fund Act, negligence, nuisance, trespass and declaratory relief. Among other things, the lawsuit seeks unspecified damages for the cost of remediation, payment of attorney fees and costs, and punitive damages. Trial on the statutory claims (those based on the Orange County Water District Act, the California Super Fund Act and declaratory relief) concluded on September 25, 2012. On December 11, 2012, the court issued a tentative decision on these claims in favor of the company and the other remaining defendants. On May 10, 2013, the court issued a supplemental tentative decision, which included additional findings supporting its earlier tentative decision in favor of the company and the other remaining defendants on the statutory causes of action tried in 2012. The court has not yet set a trial date for the remaining causes of action.

On May 4, 2012, the company commenced an action, Northrop Grumman Systems Corp. v. United States, in the U.S. Court of Federal Claims. This lawsuit relates to an approximately $875 million firm fixed price contract awarded to the company in 2007 by the U.S. Postal Service (USPS) for the construction and delivery of flats sequencing systems (FSS) as part of the postal automation program. The FSS have been delivered. The company's lawsuit is based on various theories of liability. The complaint seeks approximately $63 million for unpaid portions of the contract price, and approximately $115 million based on the company's assertions that, through various acts and omissions over the life of the contract, the USPS adversely affected the cost and schedule of performance and materially altered the company's obligations under the contract. The United States responded to the company's complaint with an answer, denying most of the company's claims, and counterclaims, seeking approximately $410 million, less certain amounts outstanding under the contract. The principal counterclaim alleges that the company delayed its performance and caused damages to the USPS because USPS did not realize certain costs savings as early as it had expected. On April 2, 2013, the U.S. Department of Justice informed the company of a False Claims Act complaint relating to the FSS contract that was filed under seal by a relator in June 2011 in the U.S. District Court for the Eastern District of Virginia. On June 3, 2013, the United States filed a Notice informing the Court that the United States had decided not to intervene in this case. On August 26, 2013, the relator filed a corrected First Amended Complaint. The relator alleges that the company violated the False Claims Act in a number of ways with respect to the FSS contract, alleges damage to the USPS in an amount of at least approximately $179 million annually, and seeks an unspecified partial refund of the contract purchase price, penalties, attorney's fees and other costs of suit. Damages under the False Claims Act may be trebled upon a finding of liability. The relator also alleges he or she was improperly discharged in retaliation. Although the ultimate outcome of these matters, including any possible loss, cannot be predicted or estimated at this time, the company intends vigorously to pursue and defend these 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 $40 million (all damage amounts are stated in U.S. dollars and are subject to currency exchange fluctuations), plus interest, inflation adjustments, and attorneys’ fees, as authorized by Brazilian law, which amounts could be significant over time. 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 $42 million, plus interest, inflation adjustments, and attorneys’ fees, as authorized by Brazilian law. The Brazilian court retained the expert to consider certain issues pending before it. On August 8, 2013, the company received a report from the expert, which contains some recommended findings relating to liability and the damages calculations put forth by ECT. Some of the expert's findings are favorable to the company and others are favorable to ECT. The parties' responses to the expert's recommendations are due to be filed in October 2013. At some point thereafter, the court is expected to issue a decision that could accept or reject the expert's recommended findings.

The company is a party to various investigations, lawsuits, claims and other legal proceedings, including government investigations and claims, that arise in the ordinary course of our business. The nature of legal proceedings is such that we cannot assure the outcome of any particular matter. However, based on information available to the company to date, and other than with respect to the FSS matters discussed separately above, the company does not believe that the outcome of any matter pending against the company is likely to have a material adverse effect on the company's consolidated financial position as of September 30, 2013, or its annual results of operations or cash flows.

7. COMMITMENTS AND CONTINGENCIES

Guarantees of Subsidiary Performance Obligations

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

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

At September 30, 2013, the company is not aware of any significant existing event of default that would require it to satisfy any of these guarantees.

U.S. Government Cost Claims

From time to time, the company is advised of claims by the U.S. Government concerning certain potential disallowed costs, plus, at times, penalties and interest. When such findings are presented, the company and the U.S. Government representatives engage in discussions to enable the company to evaluate the merits of these claims, as well as to assess the amounts being claimed. Where appropriate, provisions are made to reflect the company's estimated exposure for matters raised by the U.S. Government. Such provisions are reviewed on a quarterly basis using the most recent information available. The company believes that it has adequately reserved for any disputed amounts and that the outcome of any such matters would not have a material adverse effect on its consolidated financial position as of September 30, 2013, or its annual results of operations or cash flows.

Environmental Matters

The company has been named a Potentially Responsible Party by the Environmental Protection Agency or similarly designated state or local agencies at certain current or formerly owned or leased sites. The estimated cost to complete remediation has been accrued where the company believes, based on the facts and circumstances known to the company, it is probable the company will incur costs to address environmental impacts. As of September 30, 2013, management estimates the range of reasonably possible future costs for environmental remediation is between $321 million and $812 million, before considering the amount recoverable through overhead charges on U.S. Government contracts. At September 30, 2013, the amount accrued for probable environmental remediation costs was $341 million, of which $92 million is accrued in other current liabilities and $249 million is accrued in other non-current liabilities. A portion of the environmental remediation costs is expected to be recoverable through overhead charges on government contracts and, accordingly, such amounts are deferred in inventoried costs and other non-current assets. As of September 30, 2013, $49 million is deferred in inventoried costs and $133 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 projects progress or changes in facts and circumstances will materially affect the estimated liability accrued, management does not anticipate future remediation expenditures will have a material adverse effect on the company's consolidated financial position as of September 30, 2013, or its annual results of operations or cash flows.

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NORTHROP GRUMMAN CORPORATION

Financial Arrangements
In the ordinary course of business, the company uses stand-by letters of credit and guarantees issued by commercial banks and surety bonds issued principally by insurance companies to guarantee the performance on certain obligations. At September 30, 2013, there were $188 million of stand-by letters of credit, $224 million of bank guarantees, and $165 million of surety bonds outstanding.
Credit Facility
In August 2013, the company entered into a new five-year senior unsecured credit facility in an aggregate principal amount of $1.775 billion (the Credit Agreement). The Credit Agreement replaced the company’s prior five-year revolving credit facility in an aggregate principal amount of $1.5 billion entered into on September 8, 2011, and its 364-day revolving credit facility in an aggregate principal amount of $500 million entered into on September 4, 2012.

The Credit Agreement contains customary terms and conditions, including covenants restricting the company's ability to sell all or substantially all of its assets, merge or consolidate with another entity or undertake other fundamental changes and incur liens. The company also cannot permit the ratio of its debt to capitalization (as set forth in the Credit Agreement) to exceed 65 percent. At September 30, 2013, there was no balance outstanding under this facility. The company was in compliance with all covenants under its credit agreement on September 30, 2013.
Indemnifications
The company has retained certain environmental, income tax, and other potential liabilities in connection with certain of its divestitures. The settlement of these liabilities is not expected to have a material adverse effect on the company’s consolidated financial position as of September 30, 2013, or its annual results of operations or cash flows.
Operating Leases
Rental expense for operating leases for the three and nine months ended September 30, 2013, was $75 million and $223 million, respectively, and was $80 million and $260 million for the three and nine months ended September 30, 2012, respectively. These amounts are net of immaterial amounts of sublease rental income.
8. RETIREMENT BENEFITS
The cost to the company of its retirement benefit plans is shown in the following table:

	Three Months Ended September 30				Nine Months Ended September 30			
	Pension Benefits		Medical and Life Benefits		Pension Benefits		Medical and Life Benefits	
$ in millions	2013	2012	2013	2012	2013	2012	2013	2012
Components of net periodic benefit cost								
Service cost	$129	$131	$ 9	$ 8	$ 387	$ 392	$27	$25
Interest cost	279	296	24	28	838	888	72	82
Expected return on plan assets	(452)	(427)	(19)	(17)	(1,357)	(1,281)	(57)	(51)
Amortization of:								
Prior service credit	(15)	(15)	(13					