United States Natural Gas Fund, LP
Form 10-Q
May 10, 2018

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

x **Quarterly report pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934 for the quarterly period ended March 31, 2018.**

OR

.. **Transition report pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934 for the transition period from to .**

Commission file number: 001-33096

United States Natural Gas Fund, LP

(Exact name of registrant as specified in its charter)

Delaware	**20-5576760**
(State or other jurisdiction of incorporation or organization)	**(I.R.S. Employer Identification No.)**

1999 Harrison Street, Suite 1530

Oakland, California 94612

(Address of principal executive offices) (Zip code)

(510) 522-9600

(Registrant’s telephone number, including area code)

N/A

(Former name, former address and former fiscal year, if changed since last report)

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. x Yes ¨ No

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Website, 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). x Yes ¨ No

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

Large accelerated filer x	Accelerated filer ¨
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 to Section 7(a)(2)(B) of the Securities Act. ¨

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act). ¨ Yes x No

The registrant had 16,284,588 outstanding shares as of May 7, 2018.

UNITED STATES NATURAL GAS FUND, LP

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Part I. FINANCIAL INFORMATION

Item 1. Condensed Financial Statements.

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United States Natural Gas Fund, LP

Condensed Statements of Financial Condition

At March 31, 2018 (Unaudited) and December 31, 2017

	March 31, 2018	December 31, 2017	
Assets			
Cash and cash equivalents (at cost $303,769,409 and $550,936,887, respectively) (Notes 2 and 5)	$ 303,769,409	$ 550,936,887	
Equity in trading accounts:			
Cash and cash equivalents (at cost $64,518,650 and $101,001,407, respectively)	64,518,650	101,001,407	
Unrealized gain (loss) on open commodity futures contracts	(356,400)	55,721,680	
Dividends receivable	24,580	17,044	
Interest receivable	4,714	11,573	
Prepaid registration fees	119,003	158,272	
ETF transaction fees receivable	1,000	2,000	
Total assets	$ 368,080,956	$ 707,848,863	
Liabilities and Partners' Capital			
Payable for shares redeemed	$ 15,780,870	$ 54,457,966	
General Partner management fees payable (Note 3)	157,982	312,466	
Professional fees payable	719,996	892,759	
Brokerage commissions payable	60,300	72,800	
Directors' fees and insurance payable	10,682	8,345	
License fees payable	7,216	12,794	
Total liabilities	16,737,046	55,757,130	
Commitments and Contingencies (Notes 3, 4 and 5)			
Partners' Capital			
General Partner	—	—	
Limited Partners	351,343,910	652,091,733	
Total Partners' Capital	351,343,910	652,091,733	
Total liabilities and partners' capital	$ 368,080,956	$ 707,848,863	
Limited Partners' shares outstanding	15,584,588	27,941,619	*
Net asset value per share	$ 22.54	$ 23.34	*
Market value per share	$ 22.55	$ 23.32	*

* On January 4, 2018, there was a 1-for-4 reverse share split. Historical shares outstanding, net asset value per share and market value per share have been adjusted to reflect the 1-for-4 reverse share split on a retroactive basis.

See accompanying notes to condensed financial statements.

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United States Natural Gas Fund, LP

Condensed Schedule of Investments (Unaudited)

At March 31, 2018

	Notional Amount	**Number of Contracts**	**Value/ Unrealized Gain (Loss) on Open Commodity Contracts**	**% of Partners' Capital**
Open Futures Contracts - Long				
United States Contracts				
NYMEX Natural Gas Futures NG May 2018 contracts, expiring May 2018	$241,558,550	8,855	$ 448,600	0.13
ICE Natural Gas Futures LD1 H May 2018 contracts, expiring May 2018	110,125,000	16,000	(805,000)	(0.23)
Total Open Futures Contracts*	$351,683,550	24,855	$ (356,400)	(0.10)

	Principal Amount	**Market Value**	
Cash Equivalents			
United States Treasury Obligations			
U.S. Treasury Bills:			
1.22%, 4/12/2018	$25,000,000	$ 24,990,719	7.11
1.23%, 4/19/2018	25,000,000	24,984,781	7.11
1.25%, 4/26/2018	25,000,000	24,978,472	7.11
1.27%, 5/03/2018	15,000,000	14,983,200	4.27
1.32%, 5/10/2018	20,000,000	19,971,617	5.68
1.37%, 5/17/2018	20,000,000	19,965,308	5.68
1.43%, 5/24/2018	20,000,000	19,958,336	5.68
1.43%, 5/31/2018	20,000,000	19,952,667	5.68
1.45%, 6/07/2018	20,000,000	19,946,400	5.68
1.46%, 6/14/2018	25,000,000	24,925,743	7.10
1.49%, 6/21/2018	30,000,000	29,900,100	8.51
1.50%, 6/28/2018	30,000,000	29,890,733	8.51
1.56%, 7/05/2018	10,000,000	9,959,097	2.84
1.56%, 7/12/2018	10,000,000	9,956,083	2.83
1.77%, 8/16/2018	5,000,000	4,966,606	1.41

1.82%, 8/23/2018	5,000,000	4,964,000	1.41
1.85%, 9/06/2018	5,000,000	4,959,842	1.41
1.90%, 9/27/2018	10,000,000	9,906,647	2.82
Total Treasury Obligations		319,160,351	90.84
United States - Money Market Funds			
Goldman Sachs Financial Square Funds - Government Fund - Class FS	25,000,000	25,000,000	7.12
Total Cash Equivalents		$ 344,160,351	97.96

* Collateral amounted to $64,518,650 on open futures contracts.

See accompanying notes to condensed financial statements.

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United States Natural Gas Fund, LP

Condensed Statements of Operations (Unaudited)

For the three months ended March 31, 2018 and 2017

	Three months ended March 31, 2018	Three months ended March 31, 2017
Income		
Gain (loss) on trading of commodity futures contracts:		
Realized gain (loss) on closed futures contracts	$ 67,078,910	$ (78,689,338)
Change in unrealized gain (loss) on open futures contracts	(56,078,080)	(15,295,497)
Realized gain (loss) on short-term investments	(13,490)	(1,172)
Dividend income	56,967	19,279
Interest income*	1,394,568	640,407
ETF transaction fees	62,000	84,000
Total income (loss)	12,500,875	(93,242,321)
Expenses		
General Partner management fees (Note 3)	648,691	739,810
Professional fees	238,684	360,450
Brokerage commissions	445,015	419,698
Directors' fees and insurance	15,378	15,207
License fees	16,217	18,495
Registration fees	39,269	82,458
Total expenses	1,403,254	1,636,118
Net income (loss)	$ 11,097,621	$ (94,878,439)
Net income (loss) per limited partnership share	$ (0.80)	$ (6.90)**
Net income (loss) per weighted average limited partnership share	$ 0.59	$ (5.76)**
Weighted average limited partnership shares outstanding	18,881,532	16,466,619 **

* Interest income does not exceed paid in kind of 5%.

** On January 4, 2018, there was a 1-for-4 reverse share split. Historical shares outstanding, net asset value per share and market value per share have been adjusted to reflect the 1-for-4 reverse share split on a retroactive basis.

See accompanying notes to condensed financial statements.

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United States Natural Gas Fund, LP

Condensed Statement of Changes in Partners' Capital (Unaudited)

For the three months ended March 31, 2018

	General Partner	Limited Partners	Total
Balances, at December 31, 2017	$ —	$ 652,091,733	$ 652,091,733
Addition of 19,600,000 partnership shares	—	463,303,459	463,303,459
Redemption of 31,957,031* partnership shares	—	(775,148,903)	(775,148,903)
Net income (loss)	—	11,097,621	11,097,621
Balances, at March 31, 2018	$ —	$ 351,343,910	$ 351,343,910
Net Asset Value Per Share:			
At December 31, 2017			$ 23.34 *
At March 31, 2018			$ 22.54

* On January 4, 2018, there was a 1-for-4 reverse share split. Historical shares outstanding, net asset value per share and market value per share have been adjusted to reflect the 1-for-4 reverse share split on a retroactive basis.

See accompanying notes to condensed financial statements.

United States Natural Gas Fund, LP

Condensed Statements of Cash Flows (Unaudited)

For the three months ended March 31, 2018 and 2017

	Three months ended March 31, 2018	**Three months ended March 31, 2017**
Cash Flows from Operating Activities:		
Net income (loss)	$ 11,097,621	$ (94,878,439)
Adjustments to reconcile net income (loss) to net cash provided by (used in) operating activities:		
Unrealized (gain) loss on open futures contracts	56,078,080	15,295,497
(Increase) decrease in dividends receivable	(7,536)	11,943
(Increase) decrease in interest receivable	6,859	—
(Increase) decrease in directors' fees and insurance receivable	—	(14,015)
(Increase) decrease in prepaid registration fees	39,269	82,458
(Increase) decrease in ETF transaction fees receivable	1,000	—
Increase (decrease) in payable due to Broker	—	(24,293,941)
Increase (decrease) in General Partner management fees payable	(154,484)	(55,251)
Increase (decrease) in professional fees payable	(172,763)	(256,191)
Increase (decrease) in brokerage commissions payable	(12,500)	(12,400)
Increase (decrease) in directors' fees and insurance payable	2,337	(5,417)
Increase (decrease) in license fees payable	(5,578)	(10,859)
Net cash provided by (used in) operating activities	66,872,305	(104,136,615)
Cash Flows from Financing Activities:		
Addition of partnership shares	463,303,459	554,200,456
Redemption of partnership shares	(813,825,999)	(535,634,599)
Net cash provided by (used in) financing activities	(350,522,540)	18,565,857
Net Increase (Decrease) in Cash and Cash Equivalents	(283,650,235)	(85,570,758)
Total Cash, Cash Equivalents and Equity in Trading Accounts, beginning of period	651,938,294	567,786,082
Total Cash, Cash Equivalents and Equity in Trading Accounts, end of period	$ 368,288,059	$ 482,215,324
Components of Cash and Cash Equivalents:		
Cash and Cash Equivalents	$ 303,769,409	$ 437,239,552
Equity in Trading Accounts:		
Cash and Cash Equivalents	64,518,650	44,975,772
Total Cash, Cash Equivalents and Equity in Trading Accounts	$ 368,288,059	$ 482,215,324

See accompanying notes to condensed financial statements.

United States Natural Gas Fund, LP

Notes to Condensed Financial Statements

For the period ended March 31, 2018 (Unaudited)

NOTE 1 — ORGANIZATION AND BUSINESS

The United States Natural Gas Fund, LP ("UNG") was organized as a limited partnership under the laws of the state of Delaware on September 11, 2006. UNG is a commodity pool that issues limited partnership shares ("shares") that may be purchased and sold on the NYSE Arca, Inc. (the "NYSE Arca"). Prior to November 25, 2008, UNG's shares traded on the American Stock Exchange (the "AMEX"). UNG will continue in perpetuity, unless terminated sooner upon the occurrence of one or more events as described in its Fifth Amended and Restated Agreement of Limited Partnership dated as of December 15, 2017 (the "LP Agreement"). The investment objective of UNG is for the daily changes in percentage terms of its shares' per share net asset value ("NAV") to reflect the daily changes in percentage terms of the price of natural gas delivered at the Henry Hub, Louisiana as measured by the daily changes in the price of the futures contract on natural gas as traded on the New York Mercantile Exchange (the "NYMEX") that is the near month contract to expire, except when the near month contract is within two weeks of expiration, in which case it will be measured by the futures contract that is the next month contract to expire (the "Benchmark Futures Contract"), less UNG's expenses.

UNG's investment objective is *not* for its NAV or market price of shares to equal, in dollar terms, the spot price of natural gas or any particular futures contract based on natural gas, *nor* is UNG's investment objective for the percentage change in its NAV to reflect the percentage change of the price of any particular futures contract as measured over a time period *greater than one day*.

United States Commodity Funds LLC ("USCF"), the general partner of UNG, believes that it is not practical to manage the portfolio to achieve such an investment goal when investing in Natural Gas Futures Contracts (as defined below) and Other Natural Gas-Related Investments (as defined below). The net assets of UNG consist primarily of investments in futures contracts for natural gas that are traded on the NYMEX, ICE Futures Exchange ("ICE Futures") or other U.S. and foreign exchanges (collectively, "Natural Gas Futures Contracts") and, to a lesser extent, in order to comply with regulatory requirements or in view of market conditions, other natural gas-related investments such as cash-settled options on natural gas Futures Contracts, forward contracts for natural gas, cleared swap contracts, and non-exchange traded over-the-counter ("OTC") transactions that are based on the price of natural gas, crude oil and other petroleum-based fuels, as well as futures contracts for crude oil, diesel-heating oil, gasoline and other petroleum-based fuels and indices based on the foregoing (collectively, "Other Natural Gas-Related Investments"). Market conditions that USCF currently anticipates could cause UNG to invest in Other Natural Gas-Related Investments including those allowing UNG to obtain greater liquidity or to execute transactions with more favorable pricing. For convenience and unless otherwise specified, Natural Gas Futures Contracts and Other Natural Gas-Related Investments collectively are referred to as "Natural Gas Interests" in this quarterly report on Form 10-Q. As

of March 31, 2018, UNG held 8,855 NG Futures May 2018 Contracts traded on the NYMEX and 16,000 LD1 H Futures May 2018 Contracts traded on the ICE Futures US.

UNG commenced investment operations on April 18, 2007 and has a fiscal year ending on December 31. USCF is responsible for the management of UNG. USCF is a member of the National Futures Association (the “NFA”) and became registered as a commodity pool operator with the Commodity Futures Trading Commission (the “CFTC”) effective December 1, 2005 and a swaps firm on August 8, 2013. USCF is also the general partner of the United States Oil Fund, LP (“USO”), the United States 12 Month Oil Fund, LP (“USL”), the United States Gasoline Fund, LP (“UGA”) and the United States Diesel-Heating Oil Fund, LP (“UHN”), which listed their limited partnership shares on the AMEX under the ticker symbols “USO” on April 10, 2006, “USL” on December 6, 2007, “UGA” on February 26, 2008 and “UHN” on April 9, 2008, respectively. As a result of the acquisition of the AMEX by NYSE Euronext, each of USO’s, USL’s, UGA’s and UHN’s shares commenced trading on the NYSE Arca on November 25, 2008. USCF is also the general partner of the United States Short Oil Fund, LP (“DNO”), the United States 12 Month Natural Gas Fund, LP (“UNL”) and the United States Brent Oil Fund, LP (“BNO”), which listed their limited partnership shares on the NYSE Arca under the ticker symbols “DNO” on September 24, 2009, “UNL” on November 18, 2009 and “BNO” on June 2, 2010, respectively. USCF is also the sponsor of the United States Commodity Index Fund (“USCI”), the United States Copper Index Fund (“CPER”), the United States Agriculture Index Fund (“USAG”) and the USCF Canadian Crude Oil Index Fund (“UCCO”), each a series of the United States Commodity Index Funds Trust. USCI, CPER and USAG listed their shares on the NYSE Arca under the ticker symbols “USCI” on August 10, 2010, “CPER” on November 15, 2011 and “USAG” on April 13, 2012, respectively. UCCO is currently in registration and has not commenced operations.

In addition, USCF is the sponsor of the USCF Funds Trust, a Delaware statutory trust, and each of its series, the United States 3x Oil Fund (“USOU”) and the United States 3x Short Oil Fund (“USOD”), which commenced operations on July 20, 2017. Two separate series of the USCF Funds Trust, the REX S&P MLP Fund (“RMLP”) and the REX S&P MLP Inverse Fund (“MLPD” and together with RMLP, the “REX Funds”), which were in registration and had not commenced operations, filed to withdraw from registration on March 30, 2018.

All funds listed previously, other than UCCO and the REX Funds, are referred to collectively herein as the “Related Public Funds.”

UNG issues shares to certain authorized purchasers (“Authorized Participants”) by offering baskets consisting of 100,000 shares (“Creation Baskets”) through ALPS Distributors, Inc., as the marketing agent (the “Marketing Agent”). The purchase price for a Creation Basket is based upon the NAV of a share calculated shortly after the close of the core trading session on the NYSE Arca on the day the order to create the basket is properly received.

In addition, Authorized Participants pay UNG a $1,000 fee for each order placed to create one or more Creation Baskets or to redeem one or more baskets (“Redemption Baskets”), consisting of 100,000 shares. Shares may be purchased or sold on a nationally recognized securities exchange in smaller increments than a Creation Basket or Redemption Basket. Shares purchased or sold on a nationally recognized securities exchange are not purchased or sold at the per share NAV of UNG but rather at market prices quoted on such exchange.

In April 2007, UNG initially registered 30,000,000 shares on Form S-1 with the U.S. Securities and Exchange Commission (the “SEC”). On April 18, 2007, UNG listed its shares on the AMEX under the ticker symbol “UNG” and switched to trading on the NYSE Arca under the same ticker symbol on November 25, 2008. On that day, UNG established its initial per share NAV by setting the price at $50.00 and issued 200,000 shares in exchange for $10,001,000. UNG also commenced investment operations on April 18, 2007, by purchasing Natural Gas Futures Contracts traded on the NYMEX based on natural gas. As of March 31, 2018, UNG had registered a total of 2,080,000,000 shares.

On February 21, 2012, after the close of trading on the NYSE Arca, UNG effected a 1-for-4 reverse share split and post-split shares of UNG began trading on February 22, 2012. As a result of the reverse share split, every four pre-split shares of UNG were automatically exchanged for one post-split share. Immediately prior to the reverse share split, there were 174,297,828 shares of UNG issued and outstanding, representing a per share NAV of $5.51. Immediately after the reverse share split, the number of issued and outstanding shares of UNG decreased to 43,574,457, not accounting for fractional shares, and the per share NAV increased to $22.04. In connection with the reverse share split, the CUSIP number for UNG’s shares changed to 912318201. UNG’s ticker symbol, “UNG,” did not change.

On January 4, 2018, after the close of trading on the NYSE Arca, UNG effected a 1-for-4 reverse share split and post-split shares of UNG began trading on January 5, 2018. As a result of the reverse share split, every four pre-split shares of UNG were automatically exchanged for one post-split share. Immediately prior to the reverse split, there were 97,466,476 shares of UNG issued and outstanding, representing a per share NAV of $5.69. Immediately after the reverse share split, the number of issued and outstanding shares of UNG decreased to 24,366,619, not accounting for fractional shares, and the per share NAV increased to $22.76. In connection with the reverse share split, the CUSIP number for UNG’s shares changed to 912318300. UNG’s ticker symbol, “UNG,” did not change.

The accompanying unaudited condensed financial statements have been prepared in accordance with Rule 10-01 of Regulation S-X promulgated by the SEC and, therefore, do not include all information and footnote disclosure required under generally accepted accounting principles in the United States of America ("U.S. GAAP"). The financial information included herein is unaudited; however, such financial information reflects all adjustments, consisting only of normal recurring adjustments, which are, in the opinion of USCF, necessary for the fair presentation of the condensed financial statements for the interim period.

NOTE 2 — SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Basis of Presentation

The financial statements have been prepared in conformity with U.S. GAAP as detailed in the Financial Accounting Standards Board's ("FASB") Accounting Standards Codification. UNG is an investment company and follows the accounting and reporting guidance in FASB Topic 946.

Revenue Recognition

Commodity futures contracts, forward contracts, physical commodities and related options are recorded on the trade date. All such transactions are recorded on the identified cost basis and marked to market daily. Unrealized gains or losses on open contracts are reflected in the condensed statements of financial condition and represent the difference between the original contract amount and the market value (as determined by exchange settlement prices for futures contracts and related options and cash dealer prices at a predetermined time for forward contracts, physical commodities, and their related options) as of the last business day of the year or as of the last date of the condensed financial statements. Changes in the unrealized gains or losses between periods are reflected in the condensed statements of operations. UNG earns income on funds held at the custodian or futures commission merchant ("FCM") at prevailing market rates earned on such investments.

Brokerage Commissions

Brokerage commissions on all open commodity futures contracts are accrued on a full-turn basis.

Income Taxes

UNG is not subject to federal income taxes; each partner reports his/her allocable share of income, gain, loss deductions or credits on his/her own income tax return.

In accordance with U.S. GAAP, UNG is required to determine whether a tax position is more likely than not to be sustained upon examination by the applicable taxing authority, including resolution of any tax related appeals or litigation processes, based on the technical merits of the position. UNG files an income tax return in the U.S. federal jurisdiction, and may file income tax returns in various U.S. states. UNG is not subject to income tax return examinations by major taxing authorities for years before 2014. The tax benefit recognized is measured as the largest amount of benefit that has a greater than fifty percent likelihood of being realized upon ultimate settlement. De-recognition of a tax benefit previously recognized results in UNG recording a tax liability that reduces net assets. However, UNG's conclusions regarding this policy may be subject to review and adjustment at a later date based on factors including, but not limited to, on-going analysis of and changes to tax laws, regulations and interpretations thereof. UNG recognizes interest accrued related to unrecognized tax benefits and penalties related to unrecognized tax benefits in income tax fees payable, if assessed. No interest expense or penalties have been recognized as of and for the period ended March 31, 2018.

Creations and Redemptions

Authorized Participants may purchase Creation Baskets or redeem Redemption Baskets only in blocks of 100,000 shares at a price equal to the NAV of the shares calculated shortly after the close of the core trading session on the NYSE Arca on the day the order is placed.

UNG receives or pays the proceeds from shares sold or redeemed within two business days after the trade date of the purchase or redemption. The amounts due from Authorized Participants are reflected in UNG's condensed statements of financial condition as receivable for shares sold, and amounts payable to Authorized Participants upon redemption are reflected as payable for shares redeemed.

Authorized Participants pay UNG a transaction fee of $1,000 for each order placed to create one or more Creation Baskets or to redeem one or more Redemption Baskets.

Partnership Capital and Allocation of Partnership Income and Losses

Profit or loss shall be allocated among the partners of UNG in proportion to the number of shares each partner holds as of the close of each month. USCF may revise, alter or otherwise modify this method of allocation as described in the LP Agreement.

Calculation of Per Share NAV

UNG's per share NAV is calculated on each NYSE Arca trading day by taking the current market value of its total assets, subtracting any liabilities and dividing that amount by the total number of shares outstanding. UNG uses the closing price for the contracts on the relevant exchange on that day to determine the value of contracts held on such exchange.

Net Income (Loss) Per Share

Net income (loss) per share is the difference between the per share NAV at the beginning of each period and at the end of each period. The weighted average number of shares outstanding was computed for purposes of disclosing net income (loss) per weighted average share. The weighted average shares are equal to the number of shares outstanding at the end of the period, adjusted proportionately for shares added and redeemed based on the amount of time the shares were outstanding during such period. There were no shares held by USCF at March 31, 2018.

Offering Costs

Offering costs incurred in connection with the registration of additional shares after the initial registration of shares are borne by UNG. These costs include registration fees paid to regulatory agencies and all legal, accounting, printing and other expenses associated with such offerings. These costs are accounted for as a deferred charge and thereafter amortized to expense over twelve months on a straight-line basis or a shorter period if warranted.

Cash Equivalents

Cash equivalents include money market funds and overnight deposits or time deposits with original maturity dates of six months or less.

Reclassification

Certain amounts in the accompanying condensed financial statements were reclassified to conform to the current presentation.

Use of Estimates

The preparation of condensed financial statements in conformity with U.S. GAAP requires USCF to make estimates and assumptions that affect the reported amount of assets and liabilities and disclosure of contingent assets and liabilities at the date of the condensed financial statements, and the reported amounts of the revenue and expenses during the reporting period. Actual results may differ from those estimates and assumptions.

New Accounting Pronouncements

In November 2016, the FASB issued Accounting Standards Update No. 2016-18, "Statement of Cash Flows (Topic 230): Restricted Cash" ("ASU 2016-18"), which amends ASC 230 to provide guidance on the classification and presentation of changes in restricted cash and restricted cash equivalents on the statement of cash flows. The ASU is effective for annual periods beginning after December 15, 2017, and interim periods within those annual periods. At this time, management has evaluated the implications of these changes on the financial statements and adopted with no material impact.

Other

On January 4, 2018, after the close of the NYSA Arca, UNG effected a 1-for-4 reverse unit split and post-split units of UNG began trading on January 5, 2018. The unaudited condensed financial information in this quarterly report on Form 10-Q gives effect to the reverse split and the post-split of units as if they had been completed on January 1, 2018.

The unaudited condensed financial information and pro forma financial information, as well as the historical financial information as of and for the year ended December 31, 2017, was derived from UNG's historical financial statements

and has been audited by Spicer Jefferies LLP. The financial information as of and for the three months ended March 31, 2018 is unaudited. The condensed financial statements in this quarterly report on Form 10-Q are presented in accordance with Accounting Standards Codification 260 for purposes of presenting the 4-for-1 reverse split on historical basis for all periods reported.

NOTE 3 — FEES PAID BY THE FUND AND RELATED PARTY TRANSACTIONS

USCF Management Fee

Under the LP Agreement, USCF is responsible for investing the assets of UNG in accordance with the objectives and policies of UNG. In addition, USCF has arranged for one or more third parties to provide administrative, custody, accounting, transfer agency and other necessary services to UNG. For these services, UNG is contractually obligated to pay USCF a fee, which is paid monthly, equal to 0.60% per annum of average daily total net assets of $1,000,000,000 or less and 0.50% per annum of average daily total net assets that are greater than $1,000,000,000.

Ongoing Registration Fees and Other Offering Expenses

UNG pays all costs and expenses associated with the ongoing registration of its shares subsequent to the initial offering. These costs include registration or other fees paid to regulatory agencies in connection with the offer and sale of shares, and all legal, accounting, printing and other expenses associated with such offer and sale. For the three months ended March 31, 2018 and 2017, UNG incurred $39,269 and $82,458, respectively, in registration fees and other offering expenses.

Independent Directors' and Officers' Expenses

UNG is responsible for paying its portion of the directors' and officers' liability insurance for UNG and the Related Public Funds and the fees and expenses of the independent directors who also serve as audit committee members of UNG and the Related Public Funds. UNG shares the fees and expenses on a pro rata basis with each Related Public Fund, as described above, based on the relative assets of each Related Public Fund computed on a daily basis. These fees and expenses for the year ending December 31, 2018 are estimated to be a total of $82,000 for UNG and, in the aggregate for UNG and the Related Public Funds, $536,000.

Licensing Fees

As discussed in Note 4 below, UNG entered into a licensing agreement with the NYMEX on April 10, 2006, as amended on October 20, 2011. Pursuant to the agreement through October 19, 2011, UNG and the Related Public

Funds, other than BNO, USCI, CPER and USAG, paid a licensing fee that was equal to 0.04% for the first $1,000,000,000 of combined net assets of the funds and 0.02% for combined net assets above $1,000,000,000. On and after October 20, 2011, UNG and the Related Public Funds, other than BNO, USCI, CPER, USAG, USOU and USOD, pay a licensing fee that is equal to 0.015% on all net assets. During the three months ended March 31, 2018 and 2017, UNG incurred $16,217 and $18,495, respectively, under this arrangement.

Investor Tax Reporting Cost

The fees and expenses associated with UNG's audit expenses and tax accounting and reporting requirements are paid by UNG. These costs are estimated to be $900,000 for the year ending December 31, 2018. Tax reporting costs fluctuate between years due to the number of shareholders during any given year.

Other Expenses and Fees

In addition to the fees described above, UNG pays all brokerage fees and other expenses in connection with the operation of UNG, excluding costs and expenses paid by USCF as outlined in *Note 4 – Contracts and Agreements* below.

NOTE 4 — CONTRACTS AND AGREEMENTS

Marketing Agent Agreement

UNG is party to a marketing agent agreement, dated as of April 17, 2007, as amended from time to time, with the Marketing Agent and USCF, whereby the Marketing Agent provides certain marketing services for UNG as outlined in the agreement. The fee of the Marketing Agent, which is borne by USCF, is equal to 0.06% on UNG's assets up to $3 billion and 0.04% on UNG's assets in excess of $3 billion. In no event may the aggregate compensation paid to the Marketing Agent and any affiliate of USCF for distribution-related services exceed 10% of the gross proceeds of UNG's offering.

The above fee does not include website construction and development, which are also borne by USCF.

Brown Brothers Harriman & Co. Agreements

UNG is also party to a custodian agreement, dated March 5, 2007, as amended from time to time, with Brown Brothers Harriman & Co. (“BBH&Co.”) and USCF, whereby BBH&Co. holds investments on behalf of UNG. USCF pays the fees of the custodian, which are determined by the parties from time to time. In addition, UNG is party to an administrative agency agreement, dated March 5, 2007, as amended from time to time, with USCF and BBH&Co., whereby BBH&Co. acts as the administrative agent, transfer agent and registrar for UNG. USCF also pays the fees of BBH&Co. for its services under such agreement and such fees are determined by the parties from time to time.

Currently, USCF pays BBH&Co. for its services, in the foregoing capacities, a minimum amount of $75,000 annually for its custody, fund accounting and fund administration services rendered to UNG and each of the Related Public Funds, as well as a $20,000 annual fee for its transfer agency services. In addition, USCF pays BBH&Co. an asset-based charge of (a) 0.06% for the first $500 million of the Related Public Funds’ combined net assets, (b) 0.0465% for the Related Public Funds’ combined net assets greater than $500 million but less than $1 billion, and (c) 0.035% once the Related Public Funds’ combined net assets exceed $1 billion. The annual minimum amount will not apply if the asset-based charge for all accounts in the aggregate exceeds $75,000. USCF also pays BBH&Co. transaction fees ranging from $7 to $15 per transaction.

Brokerage and Futures Commission Merchant Agreements

On October 8, 2013, UNG entered into a brokerage agreement with RBC Capital Markets, LLC (“RBC Capital” or “RBC”) to serve as UNG's FCM effective October 10, 2013. The agreement with RBC requires it to provide services to UNG in connection with the purchase and sale of Natural Gas Futures Contracts and Other Natural Gas-Related Investments that may be purchased and sold by or through RBC Capital for UNG's account. In accordance with the agreement, RBC Capital charges UNG commissions of approximately $7 to $8 per round-turn trade, including applicable exchange, clearing and NFA fees for Natural Gas Futures Contracts and options on Natural Gas Futures Contracts. Such fees include those incurred when purchasing Natural Gas Futures Contracts and options on Natural Gas Futures Contracts when UNG issues shares as a result of a Creation Basket, as well as fees incurred when selling Natural Gas Futures Contracts and options on Natural Gas Futures Contracts when UNG redeems shares as a result of a Redemption Basket. Such fees are also incurred when Natural Gas Futures Contracts and options on Natural Gas Futures Contracts are purchased or redeemed for the purpose of rebalancing the portfolio. UNG also incurs commissions to brokers for the purchase and sale of Natural Gas Futures Contracts, Other Natural Gas-Related Investments or short-term obligations of the United States of two years or less (“Treasuries”).

	For the three months ended March 31, 2018	For the three months ended March 31, 2017
Total commissions accrued to brokers	$ 445,015	$ 419,698
Total commissions as annualized percentage of average total net assets	0.41 %	0.34 %
Commissions accrued as a result of rebalancing	$ 321,081	$ 331,242
Percentage of commissions accrued as a result of rebalancing	72.15 %	78.92 %
Commissions accrued as a result of creation and redemption activity	$ 123,934	$ 88,456
Percentage of commissions accrued as a result of creation and redemption activity	27.85 %	21.08 %

The increase in total commissions accrued to brokers for the three months ended March 31, 2018, compared to the three months ended March 31, 2017, was due primarily to a higher number of natural gas futures contracts being held and traded.

NYMEX Licensing Agreement

UNG and the NYMEX entered into a licensing agreement on April 10, 2006, as amended on October 20, 2011, whereby UNG was granted a non-exclusive license to use certain of the NYMEX's settlement prices and service marks. Under the licensing agreement, UNG and the Related Public Funds, other than BNO, USCI, CPER, USAG, USOU and USOD, pay the NYMEX an asset-based fee for the license, the terms of which are described in Note 3. UNG expressly disclaims any association with the NYMEX or endorsement of UNG by the NYMEX and acknowledges that "NYMEX" and "New York Mercantile Exchange" are registered trademarks of the NYMEX.

NOTE 5 — FINANCIAL INSTRUMENTS, OFF-BALANCE SHEET RISKS AND CONTINGENCIES

UNG may engage in the trading of futures contracts, options on futures contracts, cleared swaps and OTC swaps (collectively, "derivatives"). UNG is exposed to both market risk, which is the risk arising from changes in the market value of the contracts, and credit risk, which is the risk of failure by another party to perform according to the terms of a contract.

UNG may enter into futures contracts, options on futures contracts and cleared swaps to gain exposure to changes in the value of an underlying commodity. A futures contract obligates the seller to deliver (and the purchaser to accept) the future delivery of a specified quantity and type of a commodity at a specified time and place. Some futures contracts may call for physical delivery of the asset, while others are settled in cash. The contractual obligations of a buyer or seller may generally be satisfied by taking or making physical delivery of the underlying commodity or by making an offsetting sale or purchase of an identical futures contract on the same or linked exchange before the designated date of delivery. Cleared swaps are agreements that are eligible to be cleared by a clearinghouse, e.g., ICE Clear Europe, and provide the efficiencies and benefits that centralized clearing on an exchange offers to traders of futures contracts, including credit risk intermediation and the ability to offset positions initiated with different counterparties.

The purchase and sale of futures contracts, options on futures contracts and cleared swaps require margin deposits with an FCM. Additional deposits may be necessary for any loss on contract value. The Commodity Exchange Act requires an FCM to segregate all customer transactions and assets from the FCM's proprietary activities.

Futures contracts, options on futures contracts and cleared swaps involve, to varying degrees, elements of market risk (specifically commodity price risk) and exposure to loss in excess of the amount of variation margin. The face or contract amounts reflect the extent of the total exposure UNG has in the particular classes of instruments. Additional risks associated with the use of futures contracts are an imperfect correlation between movements in the price of the futures contracts and the market value of the underlying securities and the possibility of an illiquid market for a futures contract. Buying and selling options on futures contracts exposes investors to the risks of purchasing or selling futures contracts.

All of the futures contracts held by UNG through March 31, 2018 were exchange-traded. The risks associated with exchange-traded contracts are generally perceived to be less than those associated with OTC swaps since, in OTC swaps, a party must rely solely on the credit of its respective individual counterparties. However, in the future, if UNG were to enter into non-exchange traded contracts, it would be subject to the credit risk associated with counterparty non-performance. The credit risk from counterparty non-performance associated with such instruments is the net unrealized gain, if any, on the transaction. UNG has credit risk under its futures contracts since the sole counterparty to all domestic and foreign futures contracts is the clearinghouse for the exchange on which the relevant contracts are

traded. In addition, UNG bears the risk of financial failure by the clearing broker.

UNG's cash and other property, such as Treasuries, deposited with an FCM are considered commingled with all other customer funds, subject to the FCM's segregation requirements. In the event of an FCM's insolvency, recovery may be limited to a pro rata share of segregated funds available. It is possible that the recovered amount could be less than the total of cash and other property deposited. The insolvency of an FCM could result in the complete loss of UNG's assets posted with that FCM; however, the majority of UNG's assets are held in investments in Treasuries, cash and/or cash equivalents with UNG's custodian and would not be impacted by the insolvency of an FCM. The failure or insolvency of UNG's custodian, however, could result in a substantial loss of UNG's assets.

USCF invests a portion of UNG's cash in money market funds that seek to maintain a stable per share NAV. UNG is exposed to any risk of loss associated with an investment in such money market funds. As of March 31, 2018 and December 31, 2017, UNG held investments in money market funds in the amounts of $25,000,000 and $20,000,000, respectively. UNG also holds cash deposits with its custodian. Pursuant to a written agreement with BBH&Co., uninvested overnight cash balances are swept to offshore branches of U.S. regulated and domiciled banks located in Toronto, Canada; London, United Kingdom; Grand Cayman, Cayman Islands; and Nassau, Bahamas; which are subject to U.S. regulation and regulatory oversight. As of March 31, 2018 and December 31, 2017, UNG held cash deposits and investments in Treasuries in the amounts of $343,288,059 and $631,938,294, respectively, with the custodian and FCM. Some or all of these amounts may be subject to loss should UNG's custodian and/or FCM cease operations.

For derivatives, risks arise from changes in the market value of the contracts. Theoretically, UNG is exposed to market risk equal to the value of futures contracts purchased and unlimited liability on such contracts sold short. As both a buyer and a seller of options, UNG pays or receives a premium at the outset and then bears the risk of unfavorable changes in the price of the contract underlying the option.

UNG's policy is to continuously monitor its exposure to market and counterparty risk through the use of a variety of financial, position and credit exposure reporting controls and procedures. In addition, UNG has a policy of requiring review of the credit standing of each broker or counterparty with which it conducts business.

The financial instruments held by UNG are reported in its condensed statements of financial condition at market or fair value, or at carrying amounts that approximate fair value, because of their highly liquid nature and short-term maturity.

NOTE 6 — FINANCIAL HIGHLIGHTS

The following table presents per share performance data and other supplemental financial data for the three months ended March 31, 2018 and 2017 for the shareholders. This information has been derived from information presented in the condensed financial statements.

	For the three months ended March 31, 2018 (Unaudited)			For the three months ended March 31, 2017 (Unaudited)		
Per Share Operating Performance:						
Net asset value, beginning of period	$	23.34	*	$	37.18	*
Total income (loss)		(0.73	)		(6.80	)*
Total expenses		(0.07	)		(0.10	)*
Net increase (decrease) in net asset value		(0.80	)		(6.90	)*
Net asset value, end of period	$	22.54		$	30.28	*
Total Return		(3.43	)%		(18.51	)%
Ratios to Average Net Assets						
Total income (loss)		2.85	%		(18.65	)%
Management fees**		0.60	%		0.60	%
Expenses excluding management fees**		0.70	%		0.73	%
Net income (loss)		2.53	%		(18.97	)%

* On January 4, 2018, there was a 1-for-4 reverse share split. Historical shares outstanding, net asset value per share and market value per share have been adjusted to reflect the 1-for-4 reverse share split on a retroactive basis.

** Annualized.

Total returns are calculated based on the change in value during the period. An individual shareholder's total return and ratio may vary from the above total returns and ratios based on the timing of contributions to and withdrawals from UNG.

NOTE 7 — FAIR VALUE OF FINANCIAL INSTRUMENTS

UNG values its investments in accordance with Accounting Standards Codification 820 – Fair Value Measurements and Disclosures (“ASC 820”). ASC 820 defines fair value, establishes a framework for measuring fair value in generally accepted accounting principles, and expands disclosures about fair value measurement. The changes to past practice resulting from the application of ASC 820 relate to the definition of fair value, the methods used to measure fair value, and the expanded disclosures about fair value measurement. ASC 820 establishes a fair value hierarchy that distinguishes between: (1) market participant assumptions developed based on market data obtained from sources independent of UNG (observable inputs) and (2) UNG's own assumptions about market participant assumptions developed based on the best information available under the circumstances (unobservable inputs). The three levels defined by the ASC 820 hierarchy are as follows:

Level I – Quoted prices (unadjusted) in active markets for *identical* assets or liabilities that the reporting entity has the ability to access at the measurement date.

Level II – Inputs other than quoted prices included within Level I that are observable for the asset or liability, either directly or indirectly. Level II assets include the following: quoted prices for *similar* assets or liabilities in active markets, quoted prices for identical or similar assets or liabilities in markets that are not active, inputs other than quoted prices that are observable for the asset or liability, and inputs that are derived principally from or corroborated by observable market data by correlation or other means (market-corroborated inputs).

Level III – Unobservable pricing input at the measurement date for the asset or liability. Unobservable inputs shall be used to measure fair value to the extent that observable inputs are not available.

In some instances, the inputs used to measure fair value might fall within different levels of the fair value hierarchy. The level in the fair value hierarchy within which the fair value measurement in its entirety falls shall be determined based on the lowest input level that is significant to the fair value measurement in its entirety.

The following table summarizes the valuation of UNG's securities at March 31, 2018 using the fair value hierarchy:

At March 31, 2018	Total	Level I	Level II	Level III
Short-Term Investments	$344,160,351	$344,160,351	$ —	$ —
Exchange-Traded Futures Contracts				
United States Contracts	(356,400)	(356,400)	—	—

During the three months ended March 31, 2018, there were no transfers between Level I and Level II.

The following table summarizes the valuation of UNG's securities at December 31, 2017 using the fair value hierarchy:

At December 31, 2017	Total	Level I	Level II	Level III
Short-Term Investments	$483,194,474	$483,194,474	$ —	$ —
Exchange-Traded Futures Contracts				
United States Contracts	55,721,680	55,721,680	—	—

During the year ended December 31, 2017, there were no transfers between Level I and Level II.

Effective January 1, 2009, UNG adopted the provisions of Accounting Standards Codification 815 — Derivatives and Hedging, which require presentation of qualitative disclosures about objectives and strategies for using derivatives, quantitative disclosures about fair value amounts and gains and losses on derivatives.

Fair Value of Derivative Instruments

Derivatives not Accounted for as Hedging Instruments	**Condensed Statements of Financial Condition Location**	**Fair Value At March 31, 2018**	**Fair Value At December 31, 2017**
Futures - Commodity Contracts	Assets	$ (356,400)	$ 55,721,680

The Effect of Derivative Instruments on the Condensed Statements of Operations

		For the three months ended March 31, 2018		For the three months ended March 31, 2017	
Derivatives not Accounted for as Hedging Instruments	**Location of Gain (Loss) on Derivatives Recognized in Income**	**Realized Gain (Loss) on Derivatives Recognized in Income**	**Change in Unrealized Gain (Loss) on Derivatives Recognized in Income**	**Realized Gain (Loss) on Derivatives Recognized in Income**	**Change in Unrealized Gain (Loss) on Derivatives Recognized in Income**
Futures - Commodity Contracts	Realized gain (loss) on closed positions	$ 67,078,910		$ (78,689,338)	
	Change in unrealized gain (loss) on open positions		$ (56,078,080)		$ (15,295,497)

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NOTE 8 — SUBSEQUENT EVENTS

UNG has performed an evaluation of subsequent events through the date the condensed financial statements were issued. This evaluation did not result in any subsequent events that necessitated disclosures and/or adjustments.

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

The following discussion should be read in conjunction with the condensed financial statements and the notes thereto of the United States Natural Gas Fund, LP ("UNG") included elsewhere in this quarterly report on Form 10-Q.

Forward-Looking Information

This quarterly report on Form 10-Q, including this "Management's Discussion and Analysis of Financial Condition and Results of Operations," contains forward-looking statements regarding the plans and objectives of management for future operations. This information may involve known and unknown risks, uncertainties and other factors that may cause UNG's actual results, performance or achievements to be materially different from future results, performance or achievements expressed or implied by any forward-looking statements. Forward-looking statements, which involve assumptions and describe UNG's future plans, strategies and expectations, are generally identifiable by use of the words "may," "will," "should," "expect," "anticipate," "estimate," "believe," "intend" or "project," the negative of these words variations on these words or comparable terminology. These forward-looking statements are based on assumptions that may be incorrect, and UNG cannot assure investors that the projections included in these forward-looking statements will come to pass. UNG's actual results could differ materially from those expressed or implied by the forward-looking statements as a result of various factors.

UNG has based the forward-looking statements included in this quarterly report on Form 10-Q on information available to it on the date of this quarterly report on Form 10-Q, and UNG assumes no obligation to update any such forward-looking statements. Although UNG undertakes no obligation to revise or update any forward-looking statements, whether as a result of new information, future events or otherwise, investors are advised to consult any additional disclosures that UNG may make directly to them or through reports that UNG in the future files with the U.S. Securities and Exchange Commission (the "SEC"), including annual reports on Form 10-K, quarterly reports on Form 10-Q and current reports on Form 8-K.

Introduction

UNG, a Delaware limited partnership, is a commodity pool that issues shares that may be purchased and sold on the NYSE Arca, Inc. (the "NYSE Arca"). The investment objective of UNG is for the daily changes, in percentage terms, of its shares' per share net asset value ("NAV") to reflect the daily changes, in percentage terms, of the price of natural gas delivered at the Henry Hub, Louisiana, as measured by the daily changes, in the price of a specified short-term futures contract for natural gas traded on the New York Mercantile Exchange (the "NYMEX") that is the near month contract to expire, except when the near month contract is within two weeks of expiration, in which case it will be measured by the futures contract that is the next month contract to expire (the "Benchmark Futures Contract"), plus interest earned on the UNG's collateral holdings, less UNG's expenses. "Near month contract" means the next contract traded on the NYMEX due to expire. "Next month contract" means the first contract traded on the NYMEX due to expire after the near month contract.

UNG's investment objective is *not* for its NAV or market price of shares to equal, in dollar terms, the spot price of natural gas or any particular futures contract based on natural gas, *nor* is UNG's investment objective for the percentage change in its NAV to reflect the percentage change of the price of any particular futures contract as measured over a time period *greater than one day*. The general partner of UNG, United States Commodity Funds LLC ("USCF"), believes that it is not practical to manage the portfolio to achieve such an investment goal when investing in Natural Gas Futures Contracts (as defined below) and Other Natural Gas-Related Investments (as defined below).

UNG invests primarily in futures contracts for natural gas, crude oil, heating oil, gasoline and other petroleum-based fuels that are traded on the NYMEX, ICE Futures or other U.S. and foreign exchanges (collectively, “Natural Gas Futures Contracts”) and to a lesser extent, in order to comply with regulatory requirements or in view of market conditions, other natural gas-related investments such as cash-settled options on Natural Gas Futures Contracts, forward contracts for natural gas, cleared swap contracts and OTC swaps that are based on the price of natural gas, crude oil and other petroleum-based fuels, Natural Gas Futures Contracts and indices based on the foregoing (collectively, “Other Natural Gas-Related Investments”). For convenience and unless otherwise specified, Natural Gas Futures Contracts and Other Natural Gas-Related Investments collectively are referred to as “Natural Gas Interests” in this quarterly report on Form 10-Q.

USCF believes that market arbitrage opportunities will cause daily changes in UNG’s share price on the NYSE Arca on a percentage basis to closely track daily changes in UNG’s per share NAV on a percentage basis. USCF further believes that daily changes in prices of the Benchmark Futures Contract have historically closely tracked the daily changes in spot prices of natural gas. USCF believes that the net effect of these relationships will be that the daily changes in the price of UNG’s shares on the NYSE Arca on a percentage basis will closely track the daily changes in the spot price of natural gas on a percentage basis, plus interest earned on the Fund’s collateral holdings, less UNG’s expenses.

UNG seeks to achieve its investment objective by investing so that the average daily percentage change in UNG’s NAV for any period of 30 successive valuation days will be within plus/minus ten percent (10%) of the average daily percentage change in the price of the Benchmark Futures Contract over the same period.

Regulatory Disclosure

Accountability Levels, Position Limits and Price Fluctuation Limits. Designated contract markets (“DCMs”), such as the NYMEX and ICE Futures, have established accountability levels and position limits on the maximum net long or net short futures contracts in commodity interests that any person or group of persons under common trading control (other than as a hedge, which an investment by UNG is not) may hold, own or control. These levels and position limits apply to the futures contracts that UNG invests in to meet its investment objective. In addition to accountability levels and position limits, the NYMEX and ICE Futures also set daily price fluctuation limits on futures contracts. The daily price fluctuation limit establishes the maximum amount that the price of a futures contract may vary either up or down from the previous day’s settlement price. Once the daily price fluctuation limit has been reached in a particular futures contract, no trades may be made at a price beyond that limit.

The accountability levels for the Benchmark Futures Contract and other Natural Gas Futures Contracts traded on U.S.-based futures exchanges, such as the NYMEX, are not a fixed ceiling, but rather a threshold above which the NYMEX may exercise greater scrutiny and control over an investor’s positions. The current accountability level for

investments for any one-month in the Benchmark Futures Contract is 6,000 net contracts. In addition, the NYMEX imposes an accountability level for all months of 12,000 net futures contracts for natural gas. In addition, the ICE Futures maintains accountability levels, position limits and monitoring authority for its Henry Hub natural gas contracts. If UNG and the Related Public Funds exceed these accountability levels for investments in the futures contracts for natural gas, the NYMEX and ICE Futures will monitor such exposure and may ask for further information on their activities including the total size of all positions, investment and trading strategy, and the extent of liquidity resources of UNG and the Related Public Funds. If deemed necessary by the NYMEX and/or ICE Futures, UNG could be ordered to reduce its aggregate net futures contracts back to the accountability level. As of March 31, 2018, UNG held 8,855 NYMEX Natural Gas Futures NG contracts and 16,000 Natural Gas Futures LD1 H Contracts traded on the ICE Futures US. UNG exceeded accountability levels of the NYMEX during the three months ended March 31, 2018, when it held a maximum of 17,082 Natural Gas Futures NG Contracts. UNG exceeded accountability levels of ICE Futures during the three months ended March 31, 2018, when it held a maximum of 20,000 Natural Gas Futures LD1 H Contracts, exceeding the “any” month limit. No action was taken by the NYMEX or ICE Futures and UNG did not reduce the number of Natural Gas Futures Contracts held as a result.

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Position limits differ from accountability levels in that they represent fixed limits on the maximum number of futures contracts that any person may hold and cannot allow such limits to be exceeded without express CFTC authority to do so. In addition to accountability levels and position limits that may apply at any time, the NYMEX and the ICE Futures impose position limits on contracts held in the last few days of trading in the near month contract to expire. It is unlikely that UNG will run up against such position limits because UNG's investment strategy is to close out its positions and "roll" from the near month contract to expire to the next month contract during a four-day period beginning two weeks from expiration of the contract. For the three months ended March 31, 2018, UNG did not exceed position limits imposed by the NYMEX and ICE Futures.

The regulation of commodity interest trading in the United States and other countries is an evolving area of the law. The various statements made in this summary are subject to modification by legislative action and changes in the rules and regulations of the SEC, Financial Industry Regulatory Authority ("FINRA"), CFTC, NFA, the futures exchanges, clearing organizations and other regulatory bodies.

Futures Contracts and Position Limits

The CFTC is generally prohibited by statute from regulating trading on non-U.S. futures exchanges and markets. The CFTC, however, has adopted regulations relating to the marketing of non-U.S. futures contracts in the United States. These regulations permit certain contracts on non-U.S. exchanges to be offered and sold in the United States.

The CFTC has proposed to adopt limits on speculative positions in 25 physical commodity futures and option contracts as well as swaps that are economically equivalent to such contracts in the agriculture, energy and metals markets (the "Position Limit Rules"). The Position Limit Rules would, among other things: identify which contracts are subject to speculative position limits; set thresholds that restrict the size of speculative positions that a person may hold in the spot month, other individual months, and all months combined; create an exemption for positions that constitute bona fide hedging transactions; impose responsibilities on DCMs and swap execution facilities ("SEFs") to establish position limits or, in some cases, position accountability rules; and apply to both futures and swaps across four relevant venues: OTC, DCMs, SEFs as well as certain non-U.S. located platforms. The CFTC's first attempt at finalizing the Position Limit Rules, in 2011, was successfully challenged by market participants in 2012 and, since then, the CFTC has re-proposed them and solicited comments from market participants multiple times. At this time, it is unclear how the Position Limit Rules may affect UNG, but the effect may be substantial and adverse. By way of example, the Position Limit Rules may negatively impact the ability of UNG to meet its investment objectives through limits that may inhibit USCF's ability to sell additional Creation Baskets of UNG.

Until such time as the Position Limit Rules are adopted, the regulatory architecture in effect prior to the adoption of the Position Limit Rules will govern transactions in commodities and related derivatives. Under that system, the CFTC enforces federal limits on speculation in nine agricultural products (e.g., corn, wheat and soy), while futures

exchanges establish and enforce position limits and accountability levels for other agricultural products and certain energy products (e.g., oil and natural gas). As a result, UNG may be limited with respect to the size of its investments in any commodities subject to these limits.

Under existing and recently adopted CFTC regulations, for the purpose of position limits, a market participant is generally required, subject to certain narrow exceptions, to aggregate all positions for which that participant controls the trading decisions with all positions for which that participant has a 10 percent or greater ownership interest in an account or position, as well as the positions of two or more persons acting pursuant to an express or implied agreement or understanding with that participant (the "Aggregation Rules"). The Aggregation Rules will also apply with respect to the Position Limit Rules if and when such Position Limit Rules are adopted.

OTC Swaps

In October 2015, the Office of the Comptroller of the Currency, the Board of Governors of the Federal Reserve System, the FDIC, the Farm Credit Administration, and the Federal Housing Finance Agency (each an "Agency" and, collectively, the "Agencies") jointly adopted final rules to establish minimum margin and capital requirements for registered swap dealers, major swap participants, security-based swap dealers, and major security-based swap participants ("Swap Entities") that are subject to the jurisdiction of one of the Agencies (such entities, "Covered Swap Entities", and the joint final rules, the "Final Margin Rules").

The Final Margin Rules will subject non-cleared swaps and non-cleared security-based swaps between Covered Swap Entities and Swap Entities, and between Covered Swap Entities and financial end users that have material swaps exposure (i.e., an average daily aggregate notional of $8 billion or more in non-cleared swaps calculated in accordance with the Final Margin Rules), to a mandatory two-way minimum initial margin requirement. The minimum amount of the initial margin required to be posted or collected would be either the amount calculated by the Covered Swap Entity using a standardized schedule set forth as an appendix to the Final Margin Rules, which provides the gross initial margin (as a percentage of total notional exposure) for certain asset classes, or an internal margin model of the Covered Swap Entity conforming to the requirements of the Final Margin Rules that is approved by the Agency having jurisdiction over the particular Covered Swap Entity. The Final Margin Rules specify the types of collateral that may be posted or collected as initial margin for non-cleared swaps and non-cleared security-based swaps with financial end users (generally cash, certain government, government-sponsored enterprise securities, certain liquid debt, certain equity securities, certain eligible publicly traded debt, and gold); and sets forth haircuts for certain collateral asset classes.

The Final Margin Rules require minimum variation margin to be exchanged daily for non-cleared swaps and non-cleared security-based swaps between Covered Swap Entities and Swap Entities and between Covered Swap Entities and all financial end-users (without regard to the swaps exposure of the particular financial end-user). The minimum variation margin amount is the daily mark-to-market change in the value of the swap to the Covered Swap Entity, taking into account variation margin previously posted or collected. For non-cleared swaps and security-based swaps between Covered Swap Entities and financial end-users, variation margin may be posted or collected in cash or non-cash collateral that is considered eligible for initial margin purposes. Variation margin is not subject to segregation with an independent, third-party custodian, and may, if permitted by contract, be rehypothecated.

The initial margin requirements of the Final Margin Rules are being phased in over time, and the variation margin requirements of the Final Margin Rules are currently in effect. The Fund is not a Covered Swap Entity under the Final Margin Rules but it is a financial end-user. Accordingly, the Fund is currently subject to the variation margin requirements of the Final Margin Rules. However, the Fund does not have material swaps exposure and, accordingly, the Fund will not be subject to the initial margin requirements of the Final Margin Rules.

The Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act") required the CFTC and the SEC to adopt their own margin rules to apply to a limited number of registered swap dealers, security-based swap dealers, major swap participants, and major security-based swap participants that are not subject to the jurisdiction of one of the Agencies. On December 16, 2015 the CFTC finalized its margin rules, which are substantially the same as the Final Margin Rules and have the same implementation timeline. The SEC has yet to finalize its margin rules.

Mandatory Trading and Clearing of Swaps

CFTC regulations require that certain swap transactions be executed on organized exchanges or "swap execution facilities" and cleared through regulated clearing organizations ("derivative clearing organizations" ("DCOs")), if the CFTC mandates the central clearing of a particular class of swap and such swap is "made available to trade" on a swap execution facility. Currently, swap dealers, major swap participants, commodity pools, certain private funds and entities predominantly engaged in activities that are financial in nature are required to execute on a swap execution facility, and clear, certain interest rate swaps and index-based credit default swaps. As a result, if UNG enters into an interest rate or index-based credit default swaps that is subject to these requirements, such swap will be required to be executed on a swap execution facility and centrally cleared. Mandatory clearing and "made available to trade" determinations with respect to additional types of swaps are expected in the future, and, when finalized, could require UNG to electronically execute and centrally clear certain OTC instruments presently entered into and settled on a bi-lateral basis. If a swap is required to be cleared, initial and variation margin requirements are set by the relevant clearing organization, subject to certain regulatory requirements and guidelines. Additional margin may be required and held by UNG's FCM.

Other Requirements for Swaps

In addition to the margin requirements described above, swaps that are not required to be cleared and executed on a SEF but that are executed bilaterally are also subject to various requirements pursuant to CFTC regulations, including, among other things, reporting and recordkeeping requirements and, depending on the status of the counterparties, trading documentation requirements and dispute resolution requirements.

Derivatives Regulations in Non-U.S. Jurisdictions

In addition to U.S. laws and regulations, UNG may be subject to non-U.S. derivatives laws and regulations if it engages in futures and/or swaps transactions with non-U.S. persons. For example, UNG may be impacted by European laws and regulations to the extent that it engages in futures transactions on European exchanges or derivatives transactions with European entities. Other jurisdictions impose requirements applicable to futures and derivatives that are similar to those imposed by the U.S., including position limits, margin, clearing and trade execution requirements.

Money Market Reform

The SEC adopted amendments to Rule 2a-7 under the Investment Company Act of 1940, which became effective in 2016, to reform money market funds (“MMFs”). While the new rule applies only to MMFs, it may indirectly affect institutional investors such as UNG. A portion of UNG's assets that are not used for margin or collateral in the Futures Contracts currently are invested in government MMFs. UNG does not hold any non-government MMFs and, particularly in light of recent changes to the rule governing the operation of MMFs, does not anticipate investing in any non-government MMFs. However, if UNG invests in other types of MMFs besides government MMFs in the future, UNG could be negatively impacted by investing in an MMF that does not maintain a stable $1.00 NAV or that has the potential to impose redemption fees and gates (temporary suspension of redemptions).

Price Movements

Natural gas futures prices were volatile during the three months ended March 31, 2018. The price of the Benchmark Futures Contract started the period at $2.953 per million British thermal shares (“MMBtu”). The high of the period was on January 12, 2018 when the price reached $3.200 per MMBtu. The low of the period was on February 12, 2018 when the price dropped to $2.552 per MMBtu. The period ended with the Benchmark Futures Contract at $2.733 per MMBtu, a decrease of approximately (7.45)% over the period. UNG’s per share NAV began the period at $23.34* and ended the period at $22.54 on March 31, 2018, a decrease of approximately (3.43)% over the period. UNG’s per share NAV reached its high for the period on January 30, 2018 at $26.99 and reached its low for the period on February 12, 2018 at $21.56. The Benchmark Futures Contract prices listed above began with the February 2018 contracts and ended with the May 2018 contracts. The decrease of approximately (7.45)% on the Benchmark Futures Contract listed above is a hypothetical return only and could not actually be achieved by an investor holding Natural Gas Futures Contracts. An investment in Natural Gas Futures Contracts would need to be rolled forward during the time period described in order to simulate such a result. Furthermore, the change in the nominal price of these differing Natural Gas Futures Contracts, measured from the start of the period to the end of the period, does not represent the actual benchmark results that UNG seeks to track, which are more fully described below in the section titled “*Tracking UNG's Benchmark*.”

During the three months ended March 31, 2018, the natural gas futures market was primarily in a state of backwardation, meaning that the price of the near month natural gas futures contract was typically higher than the price of the next month natural gas futures contract or contracts further away from expiration. On days when the market is in contango, the price of the near month natural gas futures contract is typically lower than the price of the next month natural gas futures contract, or contracts further away from expiration. For a discussion of the impact of backwardation and contango on total returns, see “*Term Structure of Natural Gas Futures Prices and the Impact on Total Returns*” below.

* Adjusted to give effect to the reverse share split of 1-for-4 executed on January 4, 2018.

Valuation of Futures Contracts and the Computation of the Per Share NAV

The per share NAV of UNG’s shares is calculated once each NYSE Arca trading day. The per share NAV for a particular trading day is released after 4:00 p.m. New York time. Trading during the core trading session on the NYSE Arca typically closes at 4:00 p.m. New York time. UNG’s administrator uses the NYMEX closing price (determined at the earlier of the close of the NYMEX or 2:30 p.m. New York time) for the contracts held on the NYMEX, but calculates or determines the value of all other UNG investments, including cleared swaps or other futures contracts, as of the earlier of the close of the NYSE Arca or 4:00 p.m. New York time.

Results of Operations and the Natural Gas Market

Results of Operations. On April 18, 2007, UNG listed its shares on the American Stock Exchange (the “AMEX”) under the ticker symbol “UNG.” On that day, UNG established its initial offering price at $50.00 per share and issued 200,000 shares to the initial Authorized Purchaser in exchange for $10,000,000 in cash. As a result of the acquisition of the AMEX by NYSE Euronext, UNG’s shares ceased trading on the AMEX and commenced trading on the NYSE Arca on November 25, 2008.

Since its initial offering of 30,000,000 shares, UNG has registered seven subsequent offerings of its shares: 50,000,000 shares which were registered with the SEC on November 21, 2007, 100,000,000 shares which were registered with the SEC on August 28, 2008, 300,000,000 shares which were registered with the SEC on May 6, 2009, 1,000,000,000 shares were registered with the SEC on August 12, 2009, 200,000,000 shares were registered with the SEC on March 12, 2014, 200,000,000 shares were registered on April 28, 2015 and 200,000,000 shares were registered on April 28, 2017. Shares offered by UNG in the subsequent offerings were sold by it for cash at the shares’ per share NAV as described in the applicable prospectus. On March 8, 2011, after the close of trading on the NYSE Arca, UNG effected a 2-for-1 reverse share split and post-split shares of UNG began trading on March 9, 2011. As a result of the reverse share split, every two pre-split shares of UNG were automatically exchanged for one post-split share. Immediately prior to the reverse share split, there were 447,200,000 shares of UNG issued and outstanding, representing a per share NAV of $5.16. Immediately after the reverse share split, the number of issued and outstanding shares of UNG decreased to 223,600,000, not accounting for fractional shares, and the per share NAV increased to $10.31. On February 21, 2012, after the close of trading on the NYSE Arca, UNG effected a 1-for-4 reverse share split and post-split shares of UNG began trading on February 22, 2012. As a result of the reverse share split, every four pre-split shares of UNG were automatically exchanged for one post-split share. Immediately prior to the reverse share split, there were 174,297,828 shares of UNG issued and outstanding, representing a per share NAV of $5.51. Immediately after the reverse share split, the number of issued and outstanding shares of UNG decreased to 43,574,457, not accounting for fractional shares, and the per share NAV increased to $22.04. On January 4, 2018, after the close of trading on the NYSE Arca, UNG effected a 1-for-4 reverse share split and post-split shares of UNG began trading on January 5, 2018. As a result of the reverse share split, every four pre-split shares of UNG were automatically exchanged for one post-split share. Immediately prior to the reverse split, there were 97,466,476 shares of UNG issued and outstanding, representing a per share NAV of $5.69049. Immediately after the reverse share split,

the number of issued and outstanding shares of UNG decreased to 24,366,619, not accounting for fractional shares, and the per share NAV increased to $22.76196. As of March 31, 2018, UNG had issued 1,988,200,000 shares, 15,584,588 of which were outstanding. As of March 31, 2018, there were 91,800,000 shares registered but not yet issued.

More shares may have been issued by UNG than are outstanding due to the redemption of shares. Unlike funds that are registered under the Investment Company Act of 1940, as amended, shares that have been redeemed by UNG cannot be resold by UNG. As a result, UNG contemplates that additional offerings of its shares will be registered with the SEC in the future in anticipation of additional issuances and redemptions.

As of March 31, 2018, UNG had the folloent: 0%; font-size: 10pt; font-family: 'Times New Roman', Times; color: #000000; background: #FFFFFF"> The company has 800,000,000 shares authorized at a $1 par value per share, of which 337,834,561 and 345,921,809 shares were outstanding as of December 31, 2007 and 2006, respectively.

Preferred Stock

The company has 10,000,000 shares authorized with a liquidation value of $100 per share, of which 3,500,000 shares were designated as Series B and were issued and outstanding as of December 31, 2007 and 2006.

Subsequent Event On February 20, 2008, the company s Board of Directors approved the redemption of the Series B convertible preferred stock on April 4, 2008.

(d) *Annual Meeting of Stockholders.*

The Annual Meeting of Stockholders of Northrop Grumman Corporation will be held on May 21, 2008, at the Space Technology Presentation Center, One Space Park, Redondo Beach, California 90278.

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(e) *Stock Performance Graph.*

**COMPARISON OF FIVE-YEAR CUMULATIVE TOTAL RETURN
AMONG NORTHROP GRUMMAN CORPORATION, S & P 500 INDEX
AND S & P AEROSPACE/DEFENSE INDEX**

(1) Assumes $100 invested at the close of business on December 31, 2002, in Northrop Grumman Corporation common stock, Standard & Poor s (S&P) 500 Index, and the S&P Aerospace/Defense Index.

(2) The cumulative total return assumes reinvestment of dividends.

(3) The S&P Aerospace/Defense Index is comprised of The Boeing Company, General Dynamics Corporation, Goodrich Corporation, Honeywell International Inc., L-3 Communications, Lockheed Martin Corporation, Northrop Grumman Corporation, Precision Castparts Corp., Raytheon Company, Rockwell Collins, Inc., and United Technologies Corporation.

(4) The total return is weighted according to market capitalization of each company at the beginning of each year.

(5) The Stock Performance Graph is not incorporated by reference and shall not be deemed to be filed.

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(f) *Purchases of Equity Securities by the Issuer and Affiliated Purchasers.*

The table below summarizes the company s repurchases of common stock during the three months ended December 31, 2007.

Period	Total Number of Shares Purchased	Average Price Paid per Share	Total Numbers of Shares Purchased as of Part of Publicly Announced Plans or Programs	Approximate Dollar Value of Shares that May Yet Be Purchased Under the Plans or Programs
October 1 through October 31, 2007				$ 82 million
November 1 through November 30, 2007	1,022,600	$ 79.11	1,022,600	$
December 1 through December 31, 2007				$ 2.5 billion(1)
Total	1,022,600	$ 79.11	1,022,600	$ 2.5 billion

(1) On December 19, 2007, the company s Board of Directors authorized a share repurchase program of up to $2.5 billion of its outstanding common stock. As of December 31, 2007, the company has $2.5 billion authorized for share repurchases.

Share repurchases take place at management s discretion or under pre-established non-discretionary programs from time to time, depending on market conditions, in the open market, and 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 programs.

(g) *Securities Authorized for Issuance Under Equity Compensation Plans.*

For a description of securities authorized under the company s equity compensation plans, see Note 19 of the consolidated financial statements in Part II, Item 8.

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Item 6. Selected Financial Data

The data presented in the following table are derived from the audited financial statements and other company information adjusted to reflect the current application of discontinued operations as well as the two-for one stock split of the company s common stock in 2004. See also Business Acquisitions and Business Dispositions in Part II, Item 7.

Selected Financial Data

	Year Ended December 31				
$ in millions except per share	**2007**	2006	2005	2004	2003
Sales and Service Revenues					
United States Government	**$ 28,700**	$ 27,019	$ 27,021	$ 25,491	$ 22,063
Other customers	**3,318**	3,094	2,957	3,386	3,398
Total revenues	**$ 32,018**	$ 30,113	$ 29,978	$ 28,877	$ 25,461
Operating margin	**$ 3,006**	$ 2,464	$ 2,200	$ 1,985	$ 1,474
Income from continuing operations	**1,803**	1,573	1,396	1,079	771
Basic earnings per share, from continuing operations	**$ 5.28**	$ 4.55	$ 3.92	$ 3.00	$ 2.11
Diluted earnings per share, from continuing operations	**5.16**	4.46	3.84	2.96	2.09
Cash dividends declared per common share	**1.48**	1.16	1.01	.89	.80
Year-End Financial Position					
Total assets	**$ 33,373**	$ 32,009	$ 34,214	$ 33,303	$ 33,022
Notes payable to banks and long-term debt	**4,055**	4,162	5,145	5,158	5,891
Total long-term obligations and preferred stock	**9,254**	8,641	9,412	10,438	10,876
Financial Metrics					
Free cash flow from operations	**$ 2,068**	$ 942	$ 1,804	$ 1,264	$ 161
Net working capital (deficit)	**$ 340**	$ (28)	$ (418)	$ 692	$ (595)
Current ratio	**1.05 to 1**	1.00 to 1	.95 to 1	1.11 to 1	.91 to 1
Notes payable to banks and long-term debt as a percentage of shareholders equity	**22.9%**	25.0%	30.6%	30.9%	37.3%
Other Information					
Company-sponsored research and development expenses	**$ 537**	$ 572	$ 536	$ 502	$ 429
Maintenance and repairs	**337**	360	430	396	242

Payroll and employee benefits	**12,947**	12,510	12,191	12,445	10,936
Number of employees at year-end	**122,600**	122,200	123,600	125,400	123,400

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Item 7. Management s Discussion and Analysis of Financial Condition and Results of Operations

OVERVIEW

Business
Northrop Grumman provides technologically advanced, innovative products, services, and integrated solutions in information and services, aerospace, electronics, and shipbuilding to its global customers. As a prime contractor, principal subcontractor, partner, or preferred supplier, Northrop Grumman participates in many high-priority defense and commercial technology programs in the U.S. and abroad. Northrop Grumman conducts most of its business with the U.S. Government, principally the DoD. The company also conducts business with local, state, and foreign governments and has domestic and international commercial sales.

Notable Events
Certain notable events or activity affecting the company s 2007 consolidated financial results included the following:

- Sales increases 6 percent to record $32 billion.
- Operating margin increase of 22 percent over 2006.
- Cash from operations increases to record $2.9 billion after $200 million pension pre-funding.
- Diluted earnings per share from continuing operations of $5.16 per share.
- Total backlog of $64.1 billion.
- Share repurchases totaling $1.2 billion.
- Business acquisitions totaling approximately $690 million.
- Partial insurance settlement with all but one of the primary insurers and recognition of $62 million in business interruption recovery related to Hurricane Katrina. See Notes 15 and 17 to the consolidated financial statements in Part II, Item 8.
- Contract earnings rate charge on LHD 8 of approximately $55 million following the strike at the Pascagoula shipyard.
- Adoption of a new tax accounting standard on accounting for uncertain tax positions see Note 12 to the consolidated financial statements in Part II, Item 8.

Outlook
U.S. defense contractors have benefited from the upward trend in overall defense spending over recent years. Certain programs in which the company participates may be subject to potential reductions due to a slower rate of growth in the U.S. Defense Budget forecasts and funds being utilized to support the on-going Global War on Terrorism. Despite the trend of slower growth rates in the U.S. defense budget, the company believes that its portfolio of technologically advanced, innovative products, services, and integrated solutions will generate revenue growth in 2008 and beyond. Based on total backlog (funded and unfunded) of approximately $64 billion as of December 31, 2007, the company

expects sales in 2008 of approximately $33 billion and forecasts improvement in net income over 2007. The major industry and economic factors that may affect the company s future performance are described in the following paragraphs.

Industry Factors

Northrop Grumman is subject to the unique characteristics of the U.S. defense industry as a monopsony, and by certain elements peculiar to its own business mix. Northrop Grumman, along with Lockheed Martin Corporation, The Boeing Company, Raytheon Company, and General Dynamics Corporation are among the largest companies in the U.S. defense industry at this time. Northrop Grumman competes against these and other companies for a number of programs, both large and small. Intense competition and long operating cycles are both key characteristics of Northrop Grumman s business and the defense industry. It is common in this industry for work on major programs to be shared among a number of companies. A company competing to be a prime contractor may, upon ultimate award of the contract to another party, turn out to be a subcontractor for the ultimate prime contracting party. It is not uncommon to compete for a contract award with a peer company and simultaneously perform as a supplier to or a customer of such competitor on other contracts. The nature of

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major defense programs, conducted under binding contracts, allows companies that perform well to benefit from a level of program continuity not common in many industries.

The company s success in the competitive defense industry depends upon its ability to develop and market its products and services, as well as its ability to provide the people, technologies, facilities, equipment, and financial capacity needed to deliver those products and services with maximum efficiency. It is necessary to maintain, as the company has, sources for raw materials, fabricated parts, electronic components, and major subassemblies. In this manufacturing and systems integration environment, effective oversight of subcontractors and suppliers is as vital to success as managing internal operations.

Similarly, there is intense competition among many companies in the information and services markets which is generally more labor intensive with competitive margin rates over contract periods of shorter duration. Competitors in the information and services markets include the defense industry participants mentioned above as well as many other large and small entities with expertise in various specialized areas. The company s ability to successfully compete in the information and services markets depends on a number of factors; most important is the capability to deploy skilled professionals, many requiring security clearances, at competitive prices across the diverse spectrum of these markets. Accordingly, various workforce initiatives are in place to ensure the company is successful in attracting, developing and retaining sufficient resources to maintain or improve its competitive position within these markets.

Economic Opportunities, Challenges, and Risks

The defense of the U.S. and its allies requires the ability to respond to one or more regional conflicts, terrorist acts, or threats to homeland security and is increasingly dependent upon early threat identification. National responses to those threats may require unilateral or cooperative initiatives ranging from dissuasion, deterrence, active defense, security and stability operations, or peacekeeping. The U.S. Government continues to place a high priority on the protection of its engaged forces and citizenry and in minimizing collateral damage when force must be applied in pursuit of national objectives. As a result, the U.S. and its military coalitions increasingly rely on sophisticated systems providing long-range surveillance and intelligence, battle management, and precision strike capabilities combined with the ability to rapidly deploy effective force to any region. Accordingly, defense procurement spending is expected to be weighted toward the development and procurement of military platforms and systems demonstrating the stealth, long-range, survivability, persistence and standoff capabilities that can overcome such obstacles to access. Additionally, advanced electronics and software that enhance the capabilities of individual systems and provide for the real-time integration of individual surveillance, information management, strike, and battle management platforms will also be required.

While the upward trend in overall defense spending may slow, defense requirements are not expected to change significantly in the foreseeable future. Many allied countries are focusing their development and procurement efforts on advanced electronics and information systems capabilities to enhance their interoperability with U.S. forces. The size of future U.S. and international defense budgets is expected to remain responsive to the international security environment. The proposed 2009 budget provides $515.4 billion in discretionary authority for the DoD base budget, representing a $35.9 billion or 7.5 percent increase over the enacted level for fiscal 2008. This proposed budget includes reductions in certain programs in which the company participates or for which the company expects to compete, however the company believes that spending on recapitalization and modernization of homeland security and defense assets will continue to be a national priority, with particular emphasis on areas involving intelligence, persistent surveillance, cyber space and non-conventional warfare capabilities.

U.S. Government programs in which the company either participates, or strives to participate, must compete with other programs for consideration during the U.S. budget formulation and appropriation processes. Budget decisions made in this environment will have long-term consequences for the size and structure of the company and the entire defense industry.

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Substantial new competitive opportunities for the company include a new aerial refueling tanker, the next-generation long-range bomber, space radar, unmanned vehicles, satellite communications systems, restricted programs, technical services and information technology contracts, and several international and homeland security programs. In pursuit of these opportunities, Northrop Grumman continues to focus on operational and financial performance for continued growth in 2008 and beyond.

Northrop Grumman has historically concentrated its efforts in high technology areas such as stealth, airborne and space surveillance, battle management, systems integration, defense electronics, and information technology. The company has a significant presence in federal and civil information systems; the manufacture of combatant ships including aircraft carriers and submarines; space technology; command, control, communications, computers, intelligence, surveillance, and reconnaissance (C4ISR); and missile systems. The company believes that its programs are a high priority for national defense. Nevertheless, under budgetary pressures, there remains the possibility that one or more of them may be reduced, extended, or terminated by the company s U.S. Government customers.

The company provides certain product warranties that require repair or replacement of non-conforming items for a specified period of time. Most of the company s product warranties are provided under government contracts, the costs of which are generally incorporated into contract pricing.

Prime contracts with various agencies of the U.S. Government and subcontracts with other prime contractors are subject to numerous procurement regulations, including the False Claims Act and The International Traffic in Arms Regulations promulgated under the Arms Export Control Act, with noncompliance found by any one agency possibly resulting in fines, penalties, debarment, or suspension from receiving additional contracts with all U.S. Government agencies. Given the company s dependence on U.S. Government business, suspension or debarment could have a material adverse effect on the company.

See Risk Factors located in Part I, Item 1A for a more complete description of risks faced by the company and the defense industry.

BUSINESS ACQUISITIONS

2007 In January 2007, the company acquired Essex Corporation (Essex) for approximately $590 million in cash, including estimated transaction costs of $15 million, and the assumption of debt totaling $23 million. Essex provides signal processing services and products, and advanced optoelectronic imaging for U.S. government intelligence and defense customers. The operating results of Essex are reported in the Mission Systems segment.

In July 2007, the company and Science Applications International Corporation (SAIC) reorganized their joint venture AMSEC, LLC (AMSEC), by dividing AMSEC along customer and product lines. AMSEC is a full-service supplier that provides engineering, logistics and technical support services primarily to Navy ship and aviation programs. Under the reorganization plan, the company retained the ship engineering, logistics and technical service businesses under the AMSEC name (the AMSEC Businesses) and, in exchange, SAIC received the aviation, combat systems and strike force integration services businesses from AMSEC (the Divested Businesses). This reorganization was treated as a step acquisition for the acquisition of SAIC s interests in the AMSEC Businesses, with the company recognizing a pre-tax gain of $23 million for the effective sale of its interests in the Divested Businesses. The operating results of the AMSEC Businesses and transaction gain have been reported in the Ships segment. Prior to the reorganization, the company accounted for AMSEC, LLC under the equity method. The consolidated financial statements reflect preliminary estimates of the fair value of the assets acquired and liabilities assumed and the related allocation of the

purchase price for the entities acquired. Management does not expect adjustments to these estimates, if any, to have a material effect on the company s consolidated financial position or results of operations.

During the third quarter of 2007, the company acquired Xinetics Inc., reported in the Space Technology segment, and the remaining 61 percent of Scaled Composites, LLC, reported in the Integrated Systems segment, for an aggregate amount of approximately $100 million in cash. The consolidated financial statements reflect

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preliminary estimates of the fair value of the assets acquired and liabilities assumed and the related allocation of the purchase price for the entities acquired. Management does not expect adjustments to these estimates, if any, to have a material effect on the company s consolidated financial position or results of operations.

2006 There were no significant acquisitions during 2006.

2005 The company acquired Confluent RF Systems Corporation (Confluent), reported in the Integrated Systems segment, for $42 million in cash, which included transaction costs of $2 million, and Integic Corporation (Integic), reported in the Information Technology segment, for $319 million in cash, which included transaction costs of $6 million.

BUSINESS DISPOSITIONS

2007 During the second quarter of 2007, management announced its decision to exit the remaining Interconnect Technologies (ITD) business reported within the Electronics segment. Sales for this business for the years ended December 31, 2007, 2006, and 2005, were $14 million, $35 million, and $89 million, respectively. The shut-down was completed during the third quarter of 2007 and costs associated with the shutdown were not material. The results of this business are reported as discontinued operations in the consolidated statements of income, net of applicable income taxes, for all periods presented.

2006 The company sold the assembly business unit of ITD during the first quarter of 2006 and Winchester Electronics (Winchester) during the second quarter of 2006 for net cash proceeds of $26 million and $17 million, respectively, and recognized after-tax gains of $4 million and $2 million, respectively, in discontinued operations. The results of operations of the assembly business unit of ITD are reported as discontinued operations in the consolidated statements of income, net of applicable income taxes. The results of operations of Winchester, reported in the Electronics segment, were not material to any of the periods presented and have therefore not been reclassified as discontinued operations.

During the second quarter of 2006, the Enterprise Information Technology (EIT) business, formerly reported in the Information Technology segment, was shut down and costs associated with the exit activities were not material. The results of operations of this business are reported as discontinued operations in the consolidated statements of income, net of applicable income taxes.

2005 The company sold Teldix GmbH (Teldix) for $57 million in cash and recognized an after-tax gain of $14 million in discontinued operations. The results of operations of Teldix, reported in the Electronics segment, were not material to any of the periods presented and have therefore not been reclassified as discontinued operations.

CONTRACTS

The majority of the company s business is generated from long-term government contracts for development, production, and service activities. Government contracts typically include the following cost elements: direct material, labor and subcontracting costs, and certain indirect costs including allowable general and administrative costs. Unless otherwise specified in a contract, costs billed to contracts with the U.S. Government are determined under the requirements of the Federal Acquisition Regulation (FAR) and Cost Accounting Standards (CAS) regulations as allowable and allocable costs. Examples of costs incurred by the company and not billed to the U.S. Government in accordance with the requirements of the FAR and CAS regulations include, but are not limited to, certain legal costs,

lobbying costs, charitable donations, and advertising costs.

The company s long-term contracts typically fall into one of two broad categories:

Flexibly Priced Contracts Includes both cost-type and fixed-price incentive contracts. Cost-type contracts provide for reimbursement of the contractor s allowable costs incurred plus a fee that represents profit. Cost-type contracts generally require that the contractor use its best efforts to accomplish the scope of the work within some specified time and some stated dollar limitation. Fixed-price incentive contracts also provide for

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reimbursement of the contractor s allowable costs, but are subject to a cost-share limit which affects profitability. Fixed-price incentive contracts effectively become firm fixed-price contracts once the cost-share limit is reached.

Firm Fixed-Price Contracts A firm fixed-price contract is a contract in which the specified scope of work is agreed to for a price that is a pre-determined, negotiated amount and not generally subject to adjustment regardless of costs incurred by the contractor.

The following table summarizes 2007 revenue recognized by contract type and customer:

($ in millions)	U.S. Government	Other Customers	Total	Percent of Total
Flexibly priced	$ 21,554	$ 746	$ 22,300	70%
Firm fixed-price	7,146	2,572	9,718	30%
Total	$ 28,700	$ 3,318	$ 32,018	100%

Contract Fees Negotiated contract fee structures, for both flexibly priced and fixed-price contracts include, but are not limited to: fixed-fee amounts, cost sharing arrangements to reward or penalize for either under or over cost target performance, positive award fees, and negative penalty arrangements. Profit margins may vary materially depending on the negotiated contract fee arrangements, percentage-of-completion of the contract, the achievement of performance objectives, and the stage of performance at which the right to receive fees, particularly under incentive and award fee contracts, is finally determined.

Positive Award Fees Certain contracts contain provisions consisting of award fees based on performance criteria such as: cost, schedule, quality, and technical performance. Award fees are determined and earned based on an evaluation by the customer of the company s performance against such negotiated criteria. Award fee contracts are widely used throughout the company s operating segments. Examples of significant long-term contracts with substantial negotiated award fee amounts are the KEI, SDD, E-2D SDD, LPD, and DDG-1000 programs.

Compliance and Monitoring On a regular basis, the company monitors its policies and procedures with respect to its contracts to ensure consistent application under similar terms and conditions as well as compliance with all applicable government regulations. In addition, costs incurred and allocated to contracts with the U.S. Government are routinely audited by the Defense Contract Audit Agency.

CRITICAL ACCOUNTING POLICIES, ESTIMATES, AND JUDGMENTS

Revenue Recognition

Overview The majority of the company s business is derived from long-term contracts for the construction of facilities, production of goods, and services provided to the federal government, which are accounted for under the provisions of Accounting Research Bulletin No. 45 *Accounting for Long-Term Construction-Type Contracts*, American Institute of Certified Public Accountants (AICPA) Statement of Position (SOP) No. 81-1 *Accounting for Performance of Construction-Type and Certain Production-Type Contracts*, and the AICPA Audit and Accounting Guide, *Audits of Federal Government Contractors*. The company classifies contract revenues as product sales or service revenues depending on the predominant attributes of the relevant underlying contracts. The company also

enters into contracts that are not associated with the federal government, such as contracts to provide certain services to non-federal government customers. The company accounts for those contracts in accordance with the Securities and Exchange Commission s Staff Accounting Bulletin No. 104, *Revenue Recognition*, and other relevant revenue recognition accounting literature.

The company considers the nature of these contracts and the types of products and services provided when it determines the proper accounting method for a particular contract.

Percentage-of-Completion Accounting The company generally recognizes revenues from its long-term contracts under the cost-to-cost and the units-of-delivery measures of the percentage-of-completion method of accounting. The percentage-of-completion method recognizes income as work on a contract progresses. For

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most contracts, sales are calculated based on the percentage of total costs incurred in relation to total estimated costs at completion of the contract. For certain contracts with large up-front purchases of material, primarily in the Ships segment, sales are generally calculated based on the percentage that direct labor costs incurred bear to total estimated direct labor costs. The units-of-delivery measure is a modification of the percentage-of-completion method, which recognizes revenues as deliveries are made to the customer generally using unit sales values in accordance with the contract terms. The company estimates profit as the difference between total estimated revenue and total estimated cost of a contract and recognizes that profit over the life of the contract based on deliveries.

The use of the percentage-of-completion method depends on the ability of the company to make reasonably dependable cost estimates for the design, manufacture, and delivery of its products and services. Such costs are typically incurred over a period of several years, and estimation of these costs requires the use of judgment. Sales under cost-type contracts are recorded as costs are incurred.

Many contracts contain positive and negative profit incentives based upon performance relative to predetermined targets that may occur during or subsequent to delivery of the product. These incentives take the form of potential additional fees to be earned or penalties to be incurred. Incentives and award fees that can be reasonably assured and reasonably estimated are recorded over the performance period of the contract. Incentives and award fees that cannot be reasonably assured and reasonably estimated are recorded when awarded or at such time as a reasonable estimate can be made.

Other changes in estimates of contract sales, costs, and 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. Hence, the effect of the changes on future periods of contract performance is recognized as if the revised estimates had been the original estimates. A significant change in an estimate on one or more contracts could have a material effect on the company s consolidated financial position or results of operations.

Certain Service Contracts Revenue under contracts to provide services to non-federal government customers are generally recognized when services are performed. Service contracts include operations and maintenance contracts, and outsourcing-type arrangements, primarily in the Information and Services business. Revenue under such contracts is generally recognized on a straight-line basis over the period of contract performance, unless evidence suggests that the revenue is earned or the obligations are fulfilled in a different pattern. Costs incurred under these service contracts are expensed as incurred, except that direct and incremental set-up costs are capitalized and amortized over the life of the agreement. Operating profit related to such service contracts may fluctuate from period to period, particularly in the earlier phases of the contract.

Service contracts that include more than one type of product or service are accounted for under the provisions of Emerging Issues Task Force Issue No. 00-21 *Revenue Arrangements with Multiple Deliverables*. Accordingly, for applicable arrangements, revenue recognition includes the proper identification of separate units of accounting and the allocation of revenue across all elements based on relative fair values.

Cost Estimation The cost estimation process requires significant judgment and is based upon the professional knowledge and experience of the company s engineers, program managers, and financial professionals. Factors that are considered in estimating the work to be completed and ultimate contract recovery include the availability and productivity of labor, the nature and complexity of the work to be performed, the effect of change orders, the availability of materials, the effect of any delays in performance, availability and timing of funding from the customer, and the recoverability of any claims included in the estimates to complete. A significant change in an estimate on one

or more programs could have a material effect on the company s consolidated financial position or results of operations. Contract cost estimates are updated at least annually and more frequently as determined by events or circumstances. Cost and revenue estimates for each significant contract are generally reviewed and reassessed quarterly.

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When estimates of total costs to be incurred on a contract exceed estimates of total revenue to be earned, a provision for the entire loss on the contract is recorded to cost of sales in the period the loss is determined. Loss provisions are first offset against costs that are included in inventoried assets, with any remaining amount reflected in liabilities.

Purchase Accounting and Goodwill

Overview The purchase price of an acquired business is allocated to the underlying tangible and intangible assets acquired and liabilities assumed based upon their respective fair market values, with the excess recorded as goodwill. Such fair market value assessments require judgments and estimates that can be affected by contract performance and other factors over time, which may cause final amounts to differ materially from original estimates. Adjustments to fair value assessments are recorded to goodwill over the purchase price allocation period (typically not exceeding twelve months) with the exception of certain adjustments related to income tax uncertainties, the resolution of which may extend beyond the purchase price allocation period.

Acquisition Accruals The company has established certain accruals in connection with indemnities and other contingencies from its acquisitions and divestitures. These accruals and subsequent adjustments have been recorded during the purchase price allocation period for acquisitions and as events occur for divestitures. The accruals were determined based upon the terms of the purchase or sales agreements and, in most cases, involve a significant degree of judgment. Management has recorded these accruals in accordance with its interpretation of the terms of the purchase or sale agreements, known facts, and an estimation of probable future events based on management s experience.

Goodwill The company performs impairment tests for goodwill as of November 30th of each year, or when evidence of potential impairment exists. In order to test for potential impairment, the company uses a discounted cash flow analysis, corroborated by comparative market multiples where appropriate.

The principal factors used in the discounted cash flow analysis requiring judgment are the projected results of operations, weighted average cost of capital (WACC), and terminal value assumptions. The WACC takes into account the relative weights of each component of the company s consolidated capital structure (equity and debt) and represents the expected cost of new capital adjusted as appropriate to consider lower risk profiles associated with longer term contracts and barriers to market entry. The terminal value assumptions are applied to the final year of the discounted cash flow model.

Due to the many variables inherent in the estimation of a reporting unit s fair value and the relative size of the company s recorded goodwill, differences in assumptions may have a material effect on the results of the company s impairment analysis.

Litigation, Commitments, and Contingencies

Overview The company is subject to a range of claims, lawsuits, environmental and income tax matters, and administrative proceedings that arise in the ordinary course of business. Estimating liabilities and costs associated with these matters requires judgment and assessment based upon professional knowledge and experience of management and its internal and external legal counsel. In accordance with SFAS No. 5, *Accounting for Contingencies,* amounts are recorded as charges to earnings when management, after taking into consideration the facts and circumstances of each matter, including any settlement offers, has determined that it is probable that a liability has been incurred and the amount of the loss can be reasonably estimated. The ultimate resolution of any such exposure to the company may vary from earlier estimates as further facts and circumstances become known.

Environmental Accruals The company is subject to the environmental laws and regulations of the jurisdictions in which it conducts operations. The company records an accrual to provide for the costs of expected environmental obligations when management becomes aware that an expenditure will be incurred and the amount of the liability can be reasonably estimated. Factors which could result in changes to the company s assessment of probability, range of loss, and environmental accruals include: modification of planned remedial actions, increase or decrease in the estimated time required to remediate, discovery of more extensive

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contamination than anticipated, results of efforts to determine legally responsible parties, changes in laws and regulations or contractual obligations affecting remediation requirements, and improvements in remediation technology. Although management cannot predict whether new information gained as projects progress will materially affect the estimated liability accrued, management does not anticipate that future remediation expenditures will have a material adverse effect on the company s financial position, results of operation, or cash flows.

Litigation Accruals Litigation accruals are recorded as charges to earnings when management, after taking into consideration the facts and circumstances of each matter, including any settlement offers, has determined that it is probable that a liability has been incurred and the amount of the loss can be reasonably estimated. The ultimate resolution of any exposure to the company may vary from earlier estimates as further facts and circumstances become known. Based upon the information available, the company believes that the resolution of any of these various claims and legal proceedings would not have a material adverse effect on its consolidated financial position, results of operations, or cash flows.

Uncertain Tax Positions Effective January 1, 2007, the company measures and records uncertain tax positions in accordance with Financial Accounting Standards Board (FASB) Interpretation No. (FIN) 48 *Accounting for Uncertainty in income Taxes an Interpretation of FASB Statement No. 109.* FIN 48 prescribes a threshold for the financial statement recognition and measurement of a tax position taken or expected to be taken in a tax return. Only tax positions meeting the more-likely-than-not recognition threshold may be recognized or continue to be recognized in the financial statements. The timing and amount of accrued interest is determined by the applicable tax law associated with an underpayment of income taxes. If a tax position does not meet the minimum statutory threshold to avoid payment of penalties, the company recognizes an expense for the amount of the penalty in the period the tax position is claimed in the tax return of the company. The company recognizes interest accrued related to unrecognized tax benefits in income tax expense. Penalties, if probable and reasonably estimable, are recognized as a component of income tax expense. See Note 12 to the consolidated financial statements in Part II, Item 8. Prior to 2007, the company recorded accruals for tax contingencies and related interest when it determined that it was probable that a liability had been incurred and the amount of the contingency could be reasonably estimated based on specific events such as an audit or inquiry by a taxing authority. Under existing GAAP, changes in accruals associated with uncertainties arising from the resolution of pre-acquisition contingencies of acquired businesses are charged or credited to goodwill. Adjustments to other tax accruals are generally recorded in earnings in the period they are determined.

Retirement Benefits

Overview Assumptions used in determining projected benefit obligations and the fair values of plan assets for the company s pension plans and other postretirement benefits plans are evaluated annually by management in consultation with its outside actuaries. In the event that the company determines that plan amendments or changes in the assumptions are warranted, future pension and postretirement benefit expenses could increase or decrease.

Assumptions The principal assumptions that have a significant effect on the company s consolidated financial position and results of operations are the discount rate, the expected long-term rate of return on plan assets, and the health care cost trend rates. For certain plan assets where the fair market value is not readily determinable, such as real estate, private equity investments and hedge funds, estimates of fair value are determined using the best information available.

Discount Rate The discount rate represents the interest rate that should be used to determine the present value of future cash flows currently expected to be required to settle the pension and postretirement benefit obligations. The

discount rate is generally based on the yield on high-quality corporate fixed-income investments. At the end of each year, the discount rate is primarily determined based on the results of a hypothetical long-term bond portfolio matching the expected cash inflows with the expected benefit payments

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for each benefit plan. Taking into consideration the factors noted above, the company s weighted-average pension composite discount rate was 6.22 percent at December 31, 2007, and 5.97 percent at December 31, 2006.

Expected Long-Term Rate of Return The expected long-term rate of return on plan assets represents the average rate of earnings expected on the funds invested to provide for anticipated future benefit payment obligations. For 2007 and 2006, the company assumed an expected long-term rate of return on plan assets of 8.5 percent.

Changes in the discount rate and expected long-term rate of return on plan assets within the range indicated below would have had the following impacts on 2007 pension and other postretirement benefits results:

$ in millions	.25 Percentage Point Increase	.25 Percentage Point Decrease
(Decrease) Increase Due To Change In Assumptions Used To Determine Net Periodic Benefit Costs For The Year Ended December 31, 2007		
Discount rate	$ (38)	$ 40
Expected long-term rate of return on plan assets	(54)	54
(Decrease) Increase Due To Change In Assumptions Used To Determine Benefit Obligations For The Year Ended December 31, 2007		
Discount rate	$ (741)	$ 774

Health Care Cost Trend Rates The health care cost trend rates represent the annual rates of change in the cost of health care benefits based on estimates of health care inflation, changes in health care utilization or delivery patterns, technological advances, and changes in the health status of the plan participants. For 2007, the company assumed an expected initial health care cost trend rate of 8 percent and an ultimate health care cost trend rate of 5 percent. In 2006, the company assumed an expected initial health care cost trend rate of 8.75 percent and an ultimate health care cost trend rate of 5 percent.

Differences in the initial through the ultimate health care cost trend rates within the range indicated below would have had the following impact on 2007 postretirement benefit results:

$ in millions	1-Percentage-Point Increase	1-Percentage-Point Decrease
Increase (Decrease) From Change In Health Care Cost Trend Rates To		
Postretirement benefit expense	$ 9	$ (9)
Postretirement benefit liability	85	(91)

CONSOLIDATED OPERATING RESULTS

Selected financial highlights are presented in the table below.

Year Ended December 31

$ in millions, except per share	**2007**	2006	2005
Sales and service revenues	**$ 32,018**	$ 30,113	$ 29,978
Cost of sales and service revenues	**29,012**	27,649	27,778
Operating margin	**3,006**	2,464	2,200
Interest expense, net	**308**	303	334
Other, net	**(12)**	125	199
Federal and foreign income taxes	**883**	713	669
Diluted earnings per share from continuing operations	**5.16**	4.46	3.84
Net cash provided by operating activities	**2,890**	1,756	2,627

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Sales and Service Revenues
Sales and service revenues consist of the following:

	Year Ended December 31		
$ in millions	**2007**	2006	2005
Product sales	**$ 18,730**	$ 18,394	$ 19,471
Service revenues	**13,288**	11,719	10,507
Sales and service revenues	**$ 32,018**	$ 30,113	$ 29,978

2007 Revenues for principal product businesses in Aerospace, Electronics, and Ships during 2007 grew at a combined rate of approximately 3 percent over 2006, reflecting sales growth in Electronics and Ships, partially offset by reduced sales in Aerospace. The sales growth at Electronics and Ships was due to volume improvements across most business areas, while the sales reduction in Aerospace was anticipated as a number of contracts transitioned from development to production in 2007. Revenue for principal services businesses in Information & Services during 2007 grew approximately 11 percent over 2006 due largely to double digit growth at Information Technology and Technical Services segments, resulting from increased volume on contracts that were newly awarded in 2006 and growth across the board on other contracts.

2006 Revenues for the principal product segments of Integrated Systems, Space Technology and Electronics were relatively flat in 2006 as compared to 2005, and revenues for the Ships segment declined approximately $500 million due primarily to the effects of the damage to the Gulf Coast shipyards caused by Hurricane Katrina in August 2005. Service revenues for the principal services businesses grew principally in the Information Technology and Technical Services segments, which each had revenue increases in excess of $225 million in 2006. Revenues for Mission Systems, the company s other mainly services business, were relatively flat on a year over year basis.

Cost of Sales and General and Administrative Expenses
Cost of sales and general and administrative expenses are comprised of the following:

	Year Ended December 31		
$ in millions	**2007**	2006	2005
Cost of Sales and Service Revenues			
Cost of product sales	**$ 14,474**	$ 14,380	$ 15,543
% of product sales	***77.3%***	*78.2%*	*79.8%*
Cost of service revenues	**11,330**	10,242	9,355
% of service revenues	***85.3%***	*87.4%*	*89.0%*
General and administrative expenses	**3,208**	3,027	2,880
% of total sales and service revenues	***10.0%***	*10.1%*	*9.6%*

Cost of Sales and Service Revenues	**$ 29,012**	$ 27,649	$ 27,778

Cost of Product Sales and Service Revenues
2007 Cost of product sales during 2007 increased $94 million, or 1 percent, over 2006 while decreasing 90 basis points as a percentage of product sales over the same period. Cost of service sales during 2007 increased $1.1 billion, or 11 percent, over 2006 while decreasing 214 basis points as a percentage of service sales over the same period. Cost of product sales in 2007 increased over 2006 due largely to the sales volume increase described above, partially offset by improved program performance at Integrated Systems, Space Technology and Ships. Cost of service revenues in 2007 increased over 2006 due primarily to higher sales volume at Information & Services. The margin rate improvement was primarily driven by improved margin rate performance on service revenues by segments principally in the product businesses.

2006 Cost of product sales during 2006 decreased $1.2 billion, or 7 percent, over 2005 while decreasing 160 basis points as a percentage of product sales over the same period. Cost of service sales during 2006 increased

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$887 million, or 9 percent, over 2005 while decreasing 164 basis points as a percentage of service sales over the same period. Cost of product sales in 2006 declined over 2005 due largely to the sales volume decreases described above, improved program performance across all of the principal product segments and the absence of contract charges from Hurricane Katrina. Cost of product sales in 2005 included charges of $165 million due to the impacts of Hurricane Katrina on ship construction contracts in process when the hurricane occurred in August 2005. Cost of service revenues increased in 2006 due to higher volume at Information Technology and Technical Services, partially offset by improved cost performance at Mission Systems & Technical Services.

General and Administrative Expenses In accordance with industry practice and the regulations that govern the cost accounting requirements for government contracts, most general corporate expenses incurred at both the segment and corporate locations are considered allowable and allocable costs on government contracts and such costs, for most components of the company, are allocated to contracts in progress on a systematic basis and contract performance factors include this cost component as an element of cost. General and administrative expenses primarily relate to segment operations. General and administrative expenses remained at a constant rate of approximately 10 percent of sales in 2007 and 2006. General and administrative expenses as a percentage of sales increased from 9.6 percent in 2005 to 10.1 percent in 2006. The increase in 2006 is due primarily to higher property insurance, litigation, and bid and proposal costs, partially offset by lower IR&D.

Operating Margin

The company considers operating margin to be an important measure for evaluating its operating performance and, as is typical in the industry, defines operating margin as revenues less the related cost of producing the revenues and general and administrative expenses. Operating margin for the company is further evaluated for each of the business segments in which the company operates, and segment operating margin is one of the key metrics used by management of the company to internally manage its operations.

Operating margin represents segment operating margin (see section entitled Segment Operating Results) adjusted for a number of factors that do not affect the segments as follows:

	Year Ended December 31		
$ in millions	**2007**	2006	2005
Segment operating margin	**$ 3,103**	$ 2,807	$ 2,421
Unallocated expenses	**(224)**	(306)	(200)
Net pension adjustment	**127**	(37)	(21)
Total operating margin	**$ 3,006**	$ 2,464	$ 2,200

Segment Operating Margin

2007 Segment operating margin for the year ended December 31, 2007 increased $296 million, or 11 percent, as compared to the same period in 2006. Total segment operating margin was 9.7 percent and 9.3 percent of total sales and service revenues for the years ended December 31, 2007, and 2006, respectively. See the Segment Operating Results section below for further information.

2006 Segment operating margin for the year ended December 31, 2006 increased $386 million, or 16 percent, as compared to the same period in 2005. Total segment operating margin was 9.3 percent and 8.1 percent of total sales and service revenues for the years ended December 31, 2006, and 2005, respectively. See the Segment Operating Results section below for further information.

Unallocated Expenses Unallocated expenses for the year ended December 31, 2007 decreased $82 million, or 27 percent, as compared with the same period in 2006. The decrease was primarily due to $98 million in lower post-retirement benefit costs determined under GAAP as a result of a plan design change in 2006 and $36 million lower legal and investigative provisions, partially offset by an increase in other costs including $18 million in higher litigation expenses. During the third quarter 2006, the company recorded a $112.5 million pre-tax provision for its settlement offer to the U.S. Department of Justice and a restricted customer.

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Net Pension Adjustment The net pension adjustment reflects the excess pension expense determined in accordance with GAAP over the pension expense allocated to the operating segments under CAS. The net pension adjustment increased income by $127 million in 2007, as compared with an expense of $37 million and $21 million in 2006 and 2005, respectively. The reduction in 2007 GAAP pension cost primarily results from higher returns on plan assets and a voluntary pre-funding in the fourth quarter of 2006.

Interest Expense, net
Interest expense, net for 2007 was comparable to 2006. Interest expense, net for the year ended December 31, 2006, was $303 million, a decrease of $31 million, or 9 percent, in 2006 as compared with 2005. The decrease was primarily due to a lower average debt balance in 2006 resulting from debt maturities totaling $1.2 billion in 2006.

Other, net
2007 Other, net for the year ended December 31, 2007 was $12 million expense, a decrease of $137 million, as compared with 2006. During 2006, the company sold its remaining 9.7 million TRW Automotive (TRW Auto) shares, generating pre-tax gains of $111 million.

2006 Other, net for the year ended December 31, 2006 was $125 million income, a decrease of $74 million, or 37 percent, from 2005 income of $199 million. During 2005, the company sold 7.3 million TRW Auto shares and approximately 3.4 million Endwave shares, which generated pre-tax gains of $70 million and $95 million, respectively, as compared to the $111 million pre-tax gain in 2006 resulting from the sale of the remaining TRW Auto stock.

Federal and Foreign Income Taxes
2007 The company s effective tax rate on income from continuing operations for the year ended December 31, 2007, was 33 percent compared with 31 percent in 2006. During 2007, the company reached a partial settlement agreement with the U.S. Internal Revenue Service (IRS) regarding its audit of the company s tax years ended 2001 2003 resulting in a tax benefit of $22 million.

2006 The company s effective tax rate on income from continuing operations for 2006 and 2005 was 31 percent and 32 percent, respectively. During 2006, the company received final approval from the U.S. Congress Joint Committee on Taxation for the agreement previously reached with the IRS regarding its audits of the company s B-2 program for the years ended December 31, 1997 through December 31, 2000. As a result of the agreement the company recognized tax benefits of $48 million, due to the reversal of previously established expense provisions. The company also recognized a net tax benefit of $18 million in 2006 related to tax credits associated with qualified wages paid to employees affected by Hurricane Katrina.

Diluted Earnings Per Share from Continuing Operations
2007 Diluted earnings per share from continuing operations for 2007 was $5.16 per share, an increase of 16 percent from $4.46 per share in 2006. Earnings per share are based on weighted-average diluted shares outstanding of 354.3 million for 2007 and 358.6 million for 2006. The weighted-average diluted shares outstanding used to calculate earnings per share includes the dilutive impact of the mandatorily redeemable preferred stock.

2006 Diluted earnings per share from continuing operations for 2006 was $4.46 per share, an increase of 16 percent from $3.84 per share in 2005. Earnings per share are based on weighted-average diluted shares outstanding of 358.6 million for 2006 and 363.2 million for 2005. For 2006, weighted-average diluted shares outstanding used to calculate earnings per share includes the dilutive impact of the mandatorily redeemable preferred stock.

Net Cash Provided by Operating Activities

2007 Net cash provided by operating activities in 2007 increased $1.1 billion as compared with 2006, and reflects lower pension contributions, higher net income, and continued trade working capital reductions. Pension plan contributions totaled $342 million in 2007, of which $200 million was voluntarily pre-funded compared

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with contributions of $1.2 billion in 2006, of which $800 million was voluntarily pre-funded. Cash collected from customers increased by $2 billion, and cash paid to suppliers and employees increased by $635 million in 2007 as compared with 2006.

Net cash provided by operating activities for 2007 included the receipt of $125 million of insurance proceeds related to Hurricane Katrina, $52 million of federal and state income tax refunds, and $21 million of interest.

2006 Net cash provided by operating activities in 2006 decreased $871 million as compared with 2005, primarily due to contributions to the company s pension plans. Cash collected from customers decreased by $166 million, and cash paid to suppliers and employees increased by $361 million in 2006 as compared with 2005. Net cash provided by operating activities for 2006 included the receipt of $100 million of insurance proceeds related to Hurricane Katrina, $60 million of federal and state income tax refunds, and $45 million of interest. Net cash provided by operating activities in 2006 includes contributions to the company s pension plans totaling $1.2 billion, of which $800 million was voluntarily pre-funded as compared to contributions of $415 million in 2005, of which $203 million was voluntarily pre-funded.

SEGMENT OPERATING RESULTS

	Year Ended December 31		
$ in millions	**2007**	2006	2005
Sales and Service Revenues			
Information & Services			
Mission Systems	**$ 5,931**	$ 5,494	$ 5,494
Information Technology	**4,486**	3,962	3,736
Technical Services	**2,177**	1,858	1,617
Aerospace			
Integrated Systems	**5,067**	5,500	5,489
Space Technology	**3,133**	2,923	2,866
Electronics	**6,906**	6,543	6,513
Ships	**5,788**	5,321	5,786
Intersegment eliminations	**(1,470)**	(1,488)	(1,523)
Sales and service revenues	**$ 32,018**	$ 30,113	$ 29,978
Operating Margin			
Information & Services			
Mission Systems	**$ 566**	$ 519	$ 424
Information Technology	**329**	342	322
Technical Services	**120**	120	100
Aerospace			
Integrated Systems	**591**	551	499
Space Technology	**261**	245	219
Electronics	**813**	754	709
Ships	**538**	393	249
Intersegment eliminations	**(115)**	(117)	(101)

Segment operating margin	**$ 3,103**	$ 2,807	$ 2,421

Realignments The company, from time to time, will realign contracts, programs or business areas among or within its operating segments that possess similar customers, expertise, and capabilities. These realignments are designed to more fully leverage existing capabilities and enhance development and delivery of products and services. In January 2007, certain programs and business areas were transferred among Information Technology, Mission Systems, Space Technology, and Technical Services. The operating results for all periods presented have been revised to reflect these changes. See a description of the segment business areas and specific realignments located in Part I, Item 1.

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Subsequent Realignments In January 2008, the Newport News and Ship Systems sectors were realigned into a single segment called Northrop Grumman Shipbuilding to enable the company to more effectively utilize its shipbuilding assets and deploy its talented shipbuilders, processes, technologies, production facilities and planned capital investment to meet customer needs. This realignment had no impact on the company s consolidated financial position, results of operations, cash flows, or segment reporting.

Also in January 2008, the company announced the transfer of certain programs and assets from the Mission Systems segment to the Space Technology segment, effective July 1, 2008. This transfer will allow Mission Systems to focus on the rapidly growing command, control, communications, computers, intelligence, surveillance, and reconnaissance business, and the missiles business will be an integrated element of the company s Aerospace business growth strategy. In addition, certain Electronics businesses were transferred to Mission Systems effective January 2008. The transfer of these businesses is not expected to have a material effect on the company s consolidated financial position, results of operations, or cash flows.

These subsequent realignments have not been reflected in any of the accompanying financial information.

KEY SEGMENT FINANCIAL MEASURES

Operating Performance Assessment and Reporting

The company manages and assesses the performance of its businesses based on its performance on individual contracts and programs obtained generally from government organizations using the financial measures referred to below, with consideration given to the Critical Accounting Policies, Estimates and Judgments described on page 29. Based on this approach and the nature of the company s operations, the discussion of consolidated results of operations generally focuses around the company s seven reportable segments versus distinguishing between products and services. Product sales are predominantly generated in the Electronics, Integrated Systems, Space Technology and Ships segments, while the majority of the company s service revenues are generated by the Information Technology, Mission Systems and Technical Services segments.

Funded Contract Acquisitions

Funded contract acquisitions represent amounts funded during the period on customer contractually obligated orders. Funded contract acquisitions tend to fluctuate from period to period and are determined by the size and timing of new and follow-on orders and by obligations of funding on previously awarded unfunded orders. In the period that a business is purchased, its existing funded order backlog as of the date of purchase is reported as funded contract acquisitions. In the period that a business is sold, its existing funded order backlog as of the divestiture date is deducted from funded contract acquisitions.

Sales and Service Revenues

Period-to-period sales generally vary less than funded contract acquisitions and reflect performance under new and ongoing contracts. Changes in sales and service revenues are typically expressed in terms of volume. Unless otherwise described, volume generally refers to increases (or decreases) in revenues incurred due to varying production activity levels, delivery rates, or service levels on individual contracts. Volume changes will typically carry a corresponding margin change based on the margin rate for a particular contract.

Segment Operating Margin

Segment operating margin reflects the performance of segment contracts. Excluded from this measure are certain costs not directly associated with contract performance, including the portion of corporate expenses such as management

and administration, legal, environmental, certain compensation and other retiree benefits, and other expenses not considered allowable or allocable under applicable CAS regulations and the FAR, and therefore not allocated to the segments. Changes in segment operating margin are typically expressed in terms of volume, as discussed above, or performance. Performance refers to changes in contract margin rates. These changes typically relate to profit recognition associated with revisions to total estimated costs at completion of the contract (EAC) that reflect improved (or deteriorated) operating performance on a particular contract. Operating margin changes are accounted for on a cumulative to date basis at the time an EAC change is recorded.

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Operating margin may also be affected by, among other things, the effects of workforce stoppages, the effects of natural disasters (such as hurricanes and earthquakes), resolution of disputed items with the customer, recovery of insurance proceeds, and other discrete events. At the completion of a long-term contract, any originally estimated costs not incurred or reserves not fully utilized (such as warranty reserves) could also impact contract earnings. Where such items have occurred, and the effects are material, a separate description is provided.

Program Descriptions

For convenience, a brief description of certain programs discussed in this Form 10-K are included in the Glossary of Programs beginning on page 54.

INFORMATION & SERVICES

Mission Systems

Mission Systems is a leading global system integrator of complex, mission-enabling systems for military, government, and other clients. Products and services are grouped into the following business areas: Command, Control and Communications (C3); Intelligence, Surveillance and Reconnaissance (ISR); and Missile Systems.

	Year Ended December 31		
$ in millions	**2007**	2006	2005
Funded Contract Acquisitions	**$ 6,032**	$ 6,108	$ 4,877
Sales and Service Revenues	**5,931**	5,494	5,494
Segment Operating Margin	**566**	519	424
As a percentage of segment sales	**9.5%**	9.4%	7.7%

Funded Contract Acquisitions

2007 Mission Systems funded contract acquisitions decreased $76 million, or 1 percent, in 2007 as compared with 2006, primarily due to $626 million lower funded contract acquisitions in Missile Systems, partially offset by $401 million higher funded contract acquisitions in ISR and $164 million higher funded contract acquisitions in C3. The decrease in Missile Systems is due to timing of funding on the Intercontinental Ballistic Missile (ICBM) and Kinetic Energy Interceptors (KEI) programs and receipt of delayed funding upon approval of the federal defense budget during the first quarter of 2006. The increase in ISR is related to the acquisition of Essex. The increase in C3 is due to higher funding across various programs. Significant funded contract acquisitions in 2007 included $603 million for the ICBM program, $223 million for the Joint National Integration Center Research and Development (JRDC) program, $188 million for the F-22 program, $169 million for the KEI program, $137 million for the Ground-Based Midcourse Fire Control and Communications (GFC/C) program and $118 million for the Force XXI Battle Brigade and Below (FBCB2) Installation Kits (I-Kits) program.

2006 Mission Systems funded contract acquisitions increased $1.2 billion, or 25 percent, in 2006 as compared with 2005, primarily due to the receipt of delayed funding upon approval of the fiscal year 2006 federal defense budget, the timing of funding received in the KEI program and the timing of a production award in the ICBM program. Significant acquisitions in 2006 included $1 billion for the ICBM program, $348 million for the KEI program, $217 million for the JRDC program, $176 million for the F-22 program, $164 million for the F-35 program, $155 million for the Space Based Space Surveillance (SBSS) program, and $118 million for the Command Post Platform (CPP) program.

Sales and Service Revenues

2007 Mission Systems revenue increased $437 million, or 8 percent, as compared with 2006. The increase was due to $279 million in higher sales in ISR, $131 million in higher sales in Missile Systems and $52 million in higher sales in C3. The increase in ISR is principally due to the acquisition of Essex. The increase in Missile Systems is primarily due to increased scope and funding levels in the KEI, JRDC, ICBM and National Team Battle Management Command and Control (BMC2) programs. The increase in C3 is due to higher volume in several programs, including the FBCB2 I-Kits program, partially offset by lower volume in the F-35 development

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program as hardware development in 2006 winds down in 2007 and reduced scope and deliveries accelerated into 2006 in the F-22 program.

2006 Mission Systems revenue remained unchanged in 2006 when compared with 2005. The higher sales volume across multiple programs including SBSS, CPP, FBCB2 Systems Engineering and Integration (SE&I) and GFC/C were offset by lower sales volume in a restricted program and reduced production volume in the ICBM program.

Segment Operating Margin
2007 Mission Systems operating margin increased $47 million, or 9 percent, in 2007 as compared with 2006. The increase includes net performance improvements of $22 million driven by cost improvements achieved based on increases in customer order quantities in the FBCB2 I-Kits program, final negotiation of award fee earned on the National Team BMC2 program, lower labor costs and favorable pricing of supplier procured materials in the CPP program and elimination of risk associated with hardware obsolescence in the GFC/C program. Net performance improvements were partially offset by $12 million in higher amortization of purchased intangibles. Volume changes contributed to the 2007 operating margin increase primarily due to the acquisition of Essex.

2006 Mission Systems operating margin increased $95 million, or 22 percent, in 2006 as compared with 2005. The increase includes net performance improvements across multiple programs including a successful flight test and favorable award fee scores on the GFC/C program, successful cost and risk management in the fixed price development portion of the Global Combat Support System Army/Tactical program, continued success in fielding Communication, Navigation and Identification (CNI) systems in the F-22 production program and a decrease of $26 million in amortization of purchased intangibles. The increase in operating margin as a percentage of segment sales over 2005 is due to the net performance improvements mentioned above.

Information Technology
Information Technology is a premier provider of IT systems engineering and systems integration for the DoD, national intelligence, federal, civilian, state, and local agencies, and commercial customers. Products and services are grouped into the following business areas: Intelligence; Civilian Agencies; Commercial, State & Local (CS&L); and Defense.

	Year Ended December 31		
$ in millions	**2007**	2006	2005
Funded Contract Acquisitions	**$ 4,400**	$ 4,613	$ 3,700
Sales and Service Revenues	**4,486**	3,962	3,736
Segment Operating Margin	**329**	342	322
As a percentage of segment sales	**7.3%**	8.6%	8.6%

Funded Contract Acquisitions
2007 Information Technology funded contract acquisitions decreased $213 million, or 5 percent, in 2007 as compared to 2006, primarily reflecting decreases of $203 million in Intelligence and $98 million in CS&L, partially offset by an increase of $109 million in Defense. A significant amount of the Intelligence funded contract acquisitions decrease was related to the early funding of contracts in 2006. Significant non-restricted funded acquisitions in 2007 included $214 million for the Virginia IT outsourcing program, $146 million for the Network Centric Solutions program, $140 million for the Systems and Software Engineering Services program, and $139 million for the National Geospatial-Intelligence Agency Enterprise Engineering program.

2006 Information Technology funded contract acquisitions increased $913 million, or 25 percent, in 2006 as compared to 2005, primarily reflecting increases of $527 million in Intelligence, $322 million in CS&L, and $226 million in Defense, partially offset by a decrease of $160 million in Civilian Agencies. The increase in Intelligence was primarily related to the early funding of contracts. Significant non-restricted funded contract acquisitions in 2006 included $319 million for the New York City Wireless program, $231 million for the

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National Geospatial-Intelligence Agency Enterprise Engineering program, $130 million for the Systems and Software Engineering Services program, and $100 million for the Defense Threat Reduction Agency program.

Sales and Service Revenues
2007 Information Technology revenue increased $524 million, or 13 percent, in 2007 as compared with 2006. The increase was primarily due to $275 million in higher sales volume in CS&L, $222 million in higher sales in Intelligence, and $133 million in higher sales in Defense, partially offset by $73 million in lower sales in Civilian Agencies. The increase in CS&L is associated with the effect of a full year of sales from new programs awarded in 2006, including the New York City Wireless, Virginia IT outsourcing, and San Diego County IT outsourcing programs. The increase in Intelligence is due to new restricted program wins and higher volume on existing programs. The increase in Defense is due to increased volume on various existing programs and new business wins. The decrease in Civilian Agencies is primarily due to customer program budget reductions, and program completions.

2006 Information Technology revenue increased $226 million, or 6 percent, in 2006 as compared with 2005. The increase was primarily due to $105 million in higher sales volume in Intelligence, $101 million in higher sales volume in Defense, and $57 million in higher sales volume in CS&L, partially offset by $36 million in lower sales in Civilian Agencies. The increase in Intelligence is due to new restricted program wins and higher volume on various existing programs. The increase in Defense is due to increased volume on various existing programs. The increase in CS&L is due to higher volume associated with new programs awarded in 2006, including the Virginia IT outsourcing, San Diego County IT outsourcing, and New York City Wireless programs. The decrease in Civilian Agencies is primarily due to customer program budget reductions and program completions.

Segment Operating Margin
2007 Information Technology operating margin decreased $13 million, or 4 percent, in 2007 as compared to 2006. The decrease in operating margin was driven by $28 million in increased amortization of deferred and other outsourcing costs on large IT outsourcing programs compared to the prior period, partially offset by margin on new business wins and the effects of increased volume on several Intelligence, CS&L, and Defense programs. The operating margin decrease also reflects $22 million in discretionary spending for internal information systems infrastructure expected to yield future cost improvements. The decrease in operating margin as a percentage of segment sales is primarily due to the timing of service contract costs and amortization of deferred and other outsourcing costs on large IT outsourcing programs.

2006 Information Technology operating margin increased $20 million, or 6 percent, in 2006 as compared to 2005. The increase was driven by higher sales volume in Intelligence, Defense, and CS&L, primarily on the Virginia IT outsourcing program. The increase also reflects $5 million lower amortization expense for purchased intangibles.

Technical Services
Technical Services is a leading provider of infrastructure, base, range, logistical and sustainment support, and also provides a wide-array of technical services including training and simulation. Services are grouped into the following business areas: Systems Support (SSG); Training and Simulation (TSG); and Life Cycle Optimization and Engineering (LCOE).

	Year Ended December 31		
$ in millions	**2007**	2006	2005
Funded Contract Acquisitions	**$ 2,273**	$ 2,292	$ 1,714

Sales and Service Revenues	**2,177**	1,858	1,617
Segment Operating Margin	**120**	120	100
As a percentage of segment sales	**5.5%**	6.5%	6.2%

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Funded Contract Acquisitions
2007 Technical Services funded contract acquisitions decreased $19 million or 1 percent in 2007 as compared with 2006, primarily reflecting a decrease of $355 million at TSG, partially offset by a $327 million increase at LCOE. The decrease at TSG is primarily due to accelerated funding received in 2006 for the Saudi Arabian National Guard (SANG) program. The increase in the LCOE group is due to additional tasking across various programs, including the Hunter CLS program. Significant funded contract acquisitions in 2007 included $417 million for the Nevada Test Site (NTS) program, $310 million for the Joint Base Operations Support (JBOS) program, $174 million for the Sierra Vista Hunter program, $112 million for the Battle Command Training program, $98 million for the Ft. Irwin program, $75 million for the TSC program and $75 million for F-15 repairs at the Warner Robins Regional Repair Service Center (WRRSC).

2006 Technical Services funded contract acquisitions increased $578 million, or 34 percent, in 2006 as compared with 2005. Significant funded contract acquisitions in 2006 included $462 million for the Nevada Test Site (NTS) program, $354 million in additional funding in the JBOS program, and $297 million in additional funding in the SANG program.

Sales and Service Revenues
2007 Technical Services revenue increased $319 million or 17 percent, in 2007 as compared with 2006, primarily due to increases of $248 million and $66 million in SSG and LCOE, respectively. The increase in SSG is primarily driven by $252 million from the effects of a full year of sales for the NTS program in 2007 as compared to six months of revenue in 2006. The increase in LCOE is due to increased demand for F-15 repairs at WRRSC, increased demand on the Sierra Vista Hunter program and increased work on the B2 programs.

2006 Technical Services revenue increased $241 million, or 15 percent, in 2006 as compared with 2005. The increase was primarily due to higher sales volume for the NTS, Combined Tactical Training Range and Ft. Irwin programs, partially offset by lower volume in the JBOS program.

Segment Operating Margin
2007 Technical Services operating margin remained unchanged in 2007 when compared with 2006. The volume increases associated with the NTS, F-15 repairs, Sierra Vista Hunter and B2 programs were offset by the effects of performance improvements taken in the prior year and favorable 2006 margin adjustments to reflect risk reduction on contracts for spares production on fixed price contracts. A lower margin mix from the NTS program also contributed to offsetting the volume increase.

2006 Technical Services operating margin increased $20 million, or 20 percent, in 2006 as compared with 2005. The increase includes net performance improvements from the U.S. Citizenship and Immigration Services, SANG, and APG-66 Japan programs. Volume changes contributed to the 2006 operating margin primarily driven by higher sales volume in the NTS program.

AEROSPACE

Integrated Systems
Integrated Systems is a leader in the design, development, and production of airborne early warning, electronic warfare and surveillance, and battlefield management systems, as well as manned and unmanned tactical and strike systems. Products and services are grouped into the following business areas: Integrated Systems Western Region (ISWR) and Integrated Systems Eastern Region (ISER).

	Year Ended December 31		
$ in millions	**2007**	2006	2005
Funded Contract Acquisitions	**$ 4,986**	$ 6,108	$ 4,544
Sales and Service Revenues	**5,067**	5,500	5,489
Segment Operating Margin	**591**	551	499
As a percentage of segment sales	**11.7%**	10.0%	9.1%

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Funded Contract Acquisitions

2007 Integrated Systems funded contract acquisitions decreased $1.1 billion, or 18 percent, as compared with 2006, resulting from decreases of $641 million and $653 million at ISWR and ISER, respectively, partially offset by an increase of $160 million on International Programs. The decrease is primarily due to higher 2006 funded contract acquisitions as a result of delayed funding upon approval of the fiscal year 2006 defense budget. Significant funded contract acquisitions included $825 million for the F/A-18 program, $816 million for the E-2 program, $579 million for the B-2 program, and $560 million for the High Altitude Long Endurance (HALE) Systems (Global Hawk) program.

2006 Integrated Systems funded contract acquisitions increased $1.6 billion, or 34 percent, as compared with the same period in 2005, resulting from increases of $757 million and $826 million at ISWR and ISER, respectively. The increase is primarily due to higher 2006 funded contract acquisitions as a result of delayed funding upon approval of the fiscal year 2006 defense budget. Significant funded contract acquisitions included $1.2 billion for the E-2 program, $978 million for the F-35 program, $767 million for the F/A-18 program, and $718 million for the HALE Systems (Global Hawk) program.

Sales and Service Revenues

2007 Integrated Systems revenue decreased $433 million, or 8 percent, as compared with 2006, resulting from decreases of $105 million and $369 million at ISWR and ISER, respectively. Approximately $325 million of the decrease was a result of the transition of the E-2D Advanced Hawkeye, F-35 and EA-18G development programs to their early production phases. Also contributing to the reduction in revenue was approximately $160 million from the effects of significant customer-directed scope reductions associated with the E-10A platform and related MP-RTIP efforts. These reductions were partially offset by higher volume of $69 million for the F/A-18 Multi-Year Procurement (MYP) and $77 million for the Global Hawk programs.

2006 Integrated Systems revenue increased $11 million as compared with 2005, resulting from an increase of $239 million in ISWR, partially offset by a decrease of $209 million in ISER. The increase in ISWR is primarily due to higher sales volume for the F-35, F/A-18, and various restricted programs. The decrease in ISER is primarily due to lower volume in the E-2D Advanced Hawkeye, Joint STARS, and EA-6B programs.

Segment Operating Margin

2007 Integrated Systems operating margin increased $40 million, or 7 percent, as compared with the same period in 2006. The increase in operating margin includes net margin improvements of $86 million primarily due to risk reduction achieved on the Global Hawk and various B-2 programs and favorable settlement of a prior year s overhead costs, partially offset by the margin effects of lower sales volume described above. The increase in operating margin as a percentage of segment sales is primarily due to risk reduction on the E-2 program, improved performance on B-2 support programs, and the favorable settlement of a prior year s overhead costs described above.

2006 Integrated Systems operating margin increased $52 million, or 10 percent, as compared with 2005. The increase in operating margin primarily reflects improvements on the F-35, EA-18G, and F/A-18 programs combined with higher sales volume in the F/A-18 and F-35 programs.

Space Technology

Space Technology develops and integrates a broad range of systems at the leading edge of space, defense, and electronics technology. The segment supplies products primarily to the U.S. Government that are critical to maintaining the nation s security and leadership in science and technology. Space Technology s business areas focus on

the design, development, manufacture, and integration of spacecraft systems and subsystems, electronic and communications payloads, and high energy laser systems and subsystems. Products and services are grouped into the following business areas: Civil Systems; Military Systems; National Systems; and Technology & Emerging Systems (Technology).

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	Year Ended December 31		
$ in millions	**2007**	2006	2005
Funded Contract Acquisitions	**$ 2,770**	$ 3,916	$ 2,121
Sales and Service Revenues	**3,133**	2,923	2,866
Segment Operating Margin	**261**	245	219
As a percentage of segment sales	**8.3%**	8.4%	7.6%

Funded Contract Acquisitions
2007 Space Technology funded contract acquisitions decreased $1.1 billion, or 29 percent, in 2007 as compared with 2006, primarily representing a $693 million decrease for Military Systems, a $231 million decrease for National Systems, and a $211 million decrease for Civil Systems. The decrease is primarily due to higher 2006 funded contract acquisitions as a result of delayed funding upon approval of the fiscal year 2006 defense budget. Significant funded contract acquisitions in 2007 included $1.1 billion for restricted programs, $540 million for the NPOESS program, $239 million for the STSS program, and additional funding of $216 million for the JWST program.

2006 Space Technology funded contract acquisitions increased $1.8 billion, or 85 percent, as compared with 2005, due to increased funding in National Systems, Military Systems, and Civil Systems. The increase is primarily due to higher 2006 funded contract acquisitions as a result of delayed funding upon approval of the fiscal year 2006 defense budget. Significant funded contract acquisitions in 2006 included $1.2 billion for restricted programs, $770 million for the NPOESS program, and $611 million for the AEHF program.

Sales and Service Revenues
2007 Space Technology revenue increased $210 million, or 7 percent, in 2007 as compared with 2006. The increase was primarily due to $187 million and $49 million in higher sales on restricted contracts in National Systems and Technology & Emerging Systems, respectively.

2006 Space Technology revenues increased $57 million, or 2 percent, as compared with 2005. The increase was primarily due to higher sales in Military Systems due to higher volume in the AEHF program and higher sales in Technology & Emerging Systems due to the ABL program, partially offset by lower sales in Civil Systems due to lower volume for the NPOESS program.

Segment Operating Margin
2007 Space Technology operating margin increased $16 million, or 7 percent, in 2007 as compared with 2006. The increase in operating margin was primarily due to increased sales volume in 2007 across many programs.

2006 Space Technology operating margin increased $26 million, or 12 percent, as compared with 2005. The increase in operating margin and operating margin percentage was primarily due to performance improvements in 2006, primarily from the ABL program.

ELECTRONICS

Electronics is a leading designer, developer, manufacturer and integrator of a variety of advanced electronic and maritime systems for national security and select non-defense applications. Electronics provides systems to U.S. and international customers for such applications as airborne surveillance, aircraft fire control, precision targeting, electronic warfare, automatic test equipment, inertial navigation, integrated avionics, space sensing, intelligence

processing, air traffic control, air and missile defense, homeland defense, communications, mail processing, biochemical detection, ship bridge control, and shipboard components. Products and services are grouped into the following business areas: Aerospace Systems; Defensive Systems; Government Systems; Naval & Marine Systems; and Navigation Systems.

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	Year Ended December 31		
$ in millions	**2007**	2006	2005
Funded Contract Acquisitions	**$ 8,776**	$ 7,147	$ 6,250
Sales and Service Revenues	**6,906**	6,543	6,513
Segment Operating Margin	**813**	754	709
As a percentage of segment sales	**11.8%**	11.5%	10.9%

Funded Contract Acquisitions
2007 Electronics funded contract acquisitions increased $1.6 billion, or 23 percent, in 2007 as compared with 2006, primarily representing increases of $652 million, $560 million and $288 million for Government Systems, Defensive Systems, and Aerospace Systems, respectively. Significant funded contract acquisitions in 2007 included $875 million for the Flats Sequencing System (FSS) program, $508 million for the Large Aircraft Infrared Countermeasures (LAIRCM) Indefinite Deliver/Indefinite Quantity (IDIQ) program, $252 million for the Vehicular Intercommunications (VIS) program, $242 million for the MESA Korea program, and $76 million for the Ground/Air Task Oriented Radar (G/ATOR) program

2006 Electronics funded contract acquisitions increased $897 million, or 14 percent, in 2006 as compared with 2005, primarily representing increases of $309 million, $284 million and $180 million at Defensive Systems, Aerospace Systems, and Government Systems, respectively. Significant funded contract acquisitions in 2006 included $270 million for the VIS program, $261 million for the SBIRS program, $160 million for the F-22 program, $153 million for the Lightweight Laser Designator Rangefinder program, $150 million for the Bio-Detection program, $148 million for the Mark VII program, and $125 million for the Automated Flats Sorting Machine program.

Sales and Service Revenues
2007 Electronics revenue increased $363 million, or 6 percent, in 2007 as compared with 2006, reflecting $178 million higher sales in Defensive Systems, $116 million higher sales in the Government Systems, and $97 million in Naval & Marine Systems (NMS), partially offset by $100 million lower sales in Aerospace Systems. The increase in Defensive Systems is primarily due to higher deliveries on Land Forces and Electro-Optical & Infrared Countermeasures programs. The increase in Government Systems sales is primarily attributable to increases in Communications and ISR programs. The increase in NMS sales is primarily due to higher volume on a restricted program. The lower Aerospace Systems sales are primarily due to the effect of declining volume on fixed price development programs.

2006 Electronics revenue increased $30 million, or less than 1 percent, in 2006 as compared with 2005. The increase was primarily due to higher sales in automated flat sorting machines to the U.S. Postal Service, vehicle intercommunications systems and infrared countermeasures programs, partially offset by lower sales volume in the F-16 Block 60 and Longbow Missile programs as these programs near completion. Sales for 2006 also included adjustments resulting from charges for the MESA Wedgetail and Peace Eagle fixed-price development airborne surveillance programs.

Segment Operating Margin
2007 Electronics operating margin increased $59 million, or 8 percent, in 2007 as compared with 2006. The increase in operating margin is largely attributable to higher volume, primarily in Government Systems, Defensive Systems, and Naval & Marine Systems. Operating margin for 2007 included a $27 million pre-tax charge for the F-16 Block 60 fixed-price development combat avionics program. The 2007 charge reflected a higher estimate of software

integration costs to complete the Falcon Edge electronic warfare suite as compared to $121 million in pre-tax charges in 2006 for several programs mentioned below. The 2007 operating margin also includes $14 million in consolidation costs related to the closure of several facilities as a result of a continuing focus on effective infrastructure management and $26 million in provisions for settled and outstanding matters.

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2006 Electronics operating margin increased $45 million, or 6 percent, in 2006 as compared with 2005. The increase was primarily due to $55 million lower amortization expense and includes net performance improvements on various programs. Operating margin for 2006 included a $51 million pre-tax charge for the Wedgetail contract and a $42 million pre-tax charge for the Peace Eagle contract (both under the MESA program), and a $28 million pre-tax charge for the ASPIS II program. These charges primarily reflect the impact of development, test & evaluation schedule extension, required hardware modifications and related retrofits. Operating margin for 2005 included a $65 million pre-tax charge for the F-16 Block 60 fixed-price development combat avionics program. The charge reflected a higher estimate of costs to complete the Falcon Edge electronic warfare suite, including rework of the mission software.

SHIPS

Ships is the nation s sole industrial designer, builder, and refueler of nuclear-powered aircraft carriers and one of only two companies capable of designing and building nuclear-powered submarines for the U.S. Navy. Ships is also one of the nation s leading full service systems providers for the design, engineering, construction, and life cycle support of major surface ships for the U.S. Navy, U.S. Coast Guard, international navies, and for commercial vessels. Products and services are grouped into the following business areas: Aircraft Carriers; Expeditionary Warfare; Surface Combatants; Submarines; Coast Guard & Coastal Defense; Fleet Support; and Services, Commercial & Other.

	Year Ended December 31		
$ in millions	**2007**	2006	2005
Funded Contract Acquisitions	**$ 5,282**	$ 10,045	$ 2,749
Sales and Service Revenues	**5,788**	5,321	5,786
Segment Operating Margin	**538**	393	249
As a percentage of segment sales	**9.3%**	7.4%	4.3%

Funded Contract Acquisitions

2007 Ships funded contract acquisitions for the year ended December 31, 2007 decreased $4.8 billion, or 47 percent as compared with 2006, primarily representing decreases of $5.2 billion in Aircraft Carriers and Expeditionary Warfare. The decrease is partially due to higher 2006 funded contract acquisitions as a result of delayed funding approval for the fiscal year 2006 defense budget as well as the funding received on the *George H.W. Bush*, *USS Carl Vinson* and Ford Class programs in 2006, originally expected in 2007. Significant funded contract acquisitions during the year include $1.4 billion for the LPD program, $1.1 billion for the LHA program, $510 million for the *Virginia*-class submarine program, $624 million for the DDG 1000 program, $516 million for the Coast Guard s NSC program, $171 million from AMSEC reorganization, and an additional funding of $108 million for the DDG program.

2006 Ships funded contract acquisitions for the year ended December 31, 2006 increased $7.3 billion as compared with the 2005, primarily representing increases of $6.5 billion in Aircraft Carriers and Expeditionary Warfare. Significant acquisitions in 2006 included $3.9 billion for the LPD program, $1.8 billion for the *USS Carl Vinson* Refueling and Complex Overhaul (RCOH) program, $1.3 billion for the Ford Class program, $814 million for the *Virginia* Class Block II program, $479 million for the *George H. W. Bush* program, $261 million for the DDG 1000 program (formerly known as the DD(X) program), $176 million for the WMSL NSC program, $172 million for the Toledo Depot Modernization Period program, $168 million for the LHD program, and $116 million for the LHA program.

Sales and Service Revenues

2007 Ships revenues for the year ended December 31, 2007 increased $467 million, or 9 percent as compared with 2006. The increase was primarily due to $252 million in higher sales in Expeditionary Warfare, $92 million in higher sales in Fleet Support, $81 million in higher sales in Coast Guard and Coastal Defense, $53 million in higher sales in Submarines, $52 million in higher sales in Aircraft Carriers, partially offset by $33 million in lower sales in Surface Combatants, and $25 million in lower sales in Services, Commercial & Other. The increase in

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Expeditionary Warfare was primarily due to higher sales volume in the LPD and LHA programs due to production ramp-ups, partially offset by lower sales volume in the LHD program as a result of a labor strike at the Pascagoula, Mississippi shipyard. The increase in Fleet Support was due to the reorganization of AMSEC. The increase in Coast Guard and Coastal Defense was due to higher sales volume in the WMSL program. The decrease in Surface Combatants was due to lower sales in the DDG 1000 program and the impacts of the labor strike.

2006 Ships revenues for the year ended December 31, 2006 decreased $465 million, or 8 percent as compared with 2005. The decrease was primarily due to lower sales volume in the DDG 1000 program driven by the transition from Phase III to Phase IV and changes in the Navy acquisition strategy regarding major sub-contractors, as well as continued recovery from the impact of Hurricane Katrina in the LPD program. The decrease was partially offset by higher sales in the *USS Carl Vinson*, DDG 51, NSC, and LHA programs.

Segment Operating Margin
2007 Ships operating margin for the year ended December 31, 2007 increased $145 million, or 37 percent, as compared with 2006, primarily consisting of $62 million for recovery of lost profits due to having reached an agreement on a portion of the Katrina insurance claim, a $23 million pre-tax gain resulting from the reorganization of AMSEC, and increased volume across multiple programs, offset by $55 million resulting from a contract earnings rate adjustment on LHD 8 primarily due to a schedule extension resulting from manpower constraints in critical crafts (electrical and pipefitting) following the strike at the Pascagoula shipyard in 2007.

2006 Ships operating margin for the year ended December 31, 2006 increased $144 million, or 58 percent as compared with 2005. The increase was primarily due to a prior year charge of $150 million to account for Hurricane Katrina-related cost growth, as well as a $15 million impact from Hurricane Katrina-related work delays (see Note 17 to the consolidated financial statements in Part II, Item 8). The 2006 operating margin includes a pension benefit resulting from the Pension Protection Act of 2006. These increases were partially offset by lower sales volume in the DDG 1000 program.

BACKLOG

Total backlog at December 31, 2007, was approximately $64 billion. Total backlog includes both funded backlog (unfilled orders for which funding is contractually obligated by the customer) and unfunded backlog (firm orders for which funding is not currently contractually obligated by the customer). Unfunded backlog excludes unexercised contract options and unfunded IDIQ orders. For multi-year services contracts with non-federal government customers having no stated contract values, backlog includes only the amounts committed by the customer. Major components in unfunded backlog as of December 31, 2007, included various restricted programs and the KEI program in the Mission Systems segment; the F-35 and F/A-18 programs in the Integrated Systems segment; the NTS program in the Technical Services segment; the NPOESS and restricted programs in the Space Technology segment; Block II of the *Virginia* class submarines program and the LHA program in the Ships segment.

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The following table presents funded and unfunded backlog by segment at December 31, 2007 and 2006:

	2007			2006		
$ in millions	**Funded**	**Unfunded**	**Total Backlog**	Funded	Unfunded	Total Backlog
Information & Services						
Mission Systems	**$ 3,220**	**$ 8,985**	**$ 12,205**	$ 3,119	$ 8,488	$ 11,607
Information Technology	**2,581**	**2,268**	**4,849**	2,667	1,840	4,507
Technical Services	**1,471**	**3,193**	**4,664**	1,375	3,973	5,348
Aerospace						
Integrated Systems	**4,204**	**4,525**	**8,729**	4,285	4,934	9,219
Space Technology	**1,260**	**8,266**	**9,526**	1,623	7,138	8,761
Electronics	**8,446**	**2,062**	**10,508**	6,576	1,583	8,159
Ships	**10,348**	**3,230**	**13,578**	10,854	2,566	13,420
Total backlog	**$ 31,530**	**$ 32,529**	**$ 64,059**	$ 30,499	$ 30,522	$ 61,021

Backlog is converted into the following years sales as costs are incurred or deliveries are made. Approximately 66 percent of the 2007 year-end funded backlog is expected to be converted into sales in 2008. Total U.S. Government orders, including those made on behalf of foreign governments, comprised 89 percent, 90 percent, and 83 percent of the funded backlog at the end of 2007, 2006, and 2005, respectively. Total foreign customer orders accounted for 6 percent, 5 percent, and 10 percent of the funded backlog at the end of 2007, 2006, and 2005, respectively. Domestic commercial backlog represented 5 percent, 5 percent, and 7 percent of funded backlog at the end of 2007, 2006, and 2005, respectively.

LIQUIDITY AND CAPITAL RESOURCES

The company endeavors to ensure the most efficient conversion of operating results into cash for deployment in growing its businesses and maximizing shareholder value. The company actively manages its capital resources through working capital improvements, prudent capital expenditures, strategic business acquisitions, investment in independent research and development, debt repayments, required and voluntary pension contributions, and returning cash to its shareholders through increased dividend payments and repurchases of common stock.

Company management uses various financial measures to assist in capital deployment decision making including net cash provided by operations, free cash flow, net debt-to-equity, and net debt-to-capital. Management believes these measures are useful to investors in assessing the company s financial performance.

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

	Year Ended December 31		
$ in millions	**2007**	2006	2005
Net income	**$ 1,790**	$ 1,542	$ 1,400
Non-cash income and expense[1]	**1,034**	948	948

Retiree benefit funding in excess of expense	**(50)**	(772)	(22)
Trade working capital reduction	**142**	144	49
Other	**(12)**	(28)	216
Cash used in discontinued operations	**(14)**	(78)	36
Cash provided by operating activities	**$ 2,890**	$ 1,756	$ 2,627

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

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Free Cash Flow

Free cash flow represents cash generated from operations available for discretionary use after operational cash requirements to improve or maintain levels of production have been met. Free cash flow is a useful measure for investors as it affects the ability of the company to grow by funding strategic business acquisitions and return value to shareholders through repurchasing its shares and paying dividends.

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

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

	Year Ended December 31		
$ in millions	**2007**	2006	2005
Cash provided by operating activities	**$ 2,890**	$ 1,756	$ 2,627
Less:			
Capital expenditures	**(685)**	(737)	(823)
Outsourcing contract & related software costs	**(137)**	(77)	
Free cash flow from operations	**$ 2,068**	$ 942	$ 1,804

Cash Flows

The following is a discussion of the company s major operating, investing and financing activities for each of the three years in the period ended December 31, 2007, as classified on the consolidated statements of cash flows located in Part II, Item 8.

Operating Activities

2007 Cash provided by operating activities in 2007 increased $1.1 billion as compared with 2006, and reflects lower pension contributions, higher net income, and continued trade working capital reductions. Pension plan contributions totaled $342 million in 2007, of which $200 million was voluntarily pre-funded compared with contributions of $1.2 billion in 2006, of which $800 million was voluntarily pre-funded.

Cash collected from customers increased by $2 billion, and cash paid to suppliers and employees increased by $635 million in 2007 as compared with 2006. Net cash provided by operating activities for 2007 included the receipt of $125 million of insurance proceeds related to Hurricane Katrina, $52 million of federal and state income tax refunds, and $21 million of interest income.

At December 31, 2007, net working capital (current assets less current liabilities) was $340 million, as compared to a working capital deficit of $28 million in 2006, primarily due to a decrease in current income taxes payable as a result of the adoption in 2007 of FIN 48.

2006 Cash provided by operating activities was $1.8 billion as compared with $2.6 billion in 2005. The decrease was primarily due to contributions to the company s pension plans totaling $1.2 billion, of which $800 million was

voluntarily pre-funded in the fourth quarter, as compared to contributions of $415 million in 2005, of which $203 million was voluntarily pre-funded in the fourth quarter.

Cash collected from customers decreased by $166 million, and cash paid to suppliers and employees increased by $361 million. Net cash from operating activities for 2006 included the receipt of $100 million of insurance proceeds related to Hurricane Katrina, $60 million of federal and state income tax refunds, and $45 million of interest income.

At December 31, 2006, net working capital deficit (current assets less current liabilities) was $28 million, primarily reflecting a lower cash balance offset by a lower current portion of long-term debt.

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2005 Cash provided by operating activities was $2.6 billion. Net cash from operating activities for 2005 included the receipt of $89 million of insurance proceeds related to Hurricane Katrina, $88 million of federal and state income tax refunds, and $78 million of interest, including interest on a state tax refund for research and development credits for the years 1988 through 1990. These cash inflows were partially offset by a payment of $99 million for a litigation settlement.

Employer contributions to the company s pension plans were $415 million in 2005, including voluntary pre-funding payments of $203 million in 2005.

At December 31, 2005, net working capital deficit (current assets less current liabilities) was $418 million.

Investing Activities

2007 Cash used in investing activities was $1.4 billion in 2007. During 2007, the company acquired three businesses for $690 million (See Note 4 to the consolidated financial statements in Part II, Item 8), paid $137 million for outsourcing costs related to newly acquired outsourcing services contracts, and released $59 million of restricted cash related to the Gulf Opportunity Zone Industrial Development Revenue Bonds (see discussion in Financing Activities below) which was partially offset by restrictions related to the Xinetics purchase (see Note 4 to the consolidated financial statements in Part II, Item 8).

Capital expenditures in 2007 were $685 million, including $118 million to replace property damaged by Hurricane Katrina and $47 million of capitalized software costs. Capital expenditure commitments at December 31, 2007 were approximately $668 million, which are expected to be paid with cash on hand and restricted cash.

2006 Cash used in investing activities was $601 million in 2006. During 2006, the company received $209 million from the sale of the remaining 9.7 million of its TRW Auto common shares. Also during 2006, Ships received access to $200 million from the issuance of Gulf Opportunity Zone Industrial Development Revenue Bonds (see discussion in Financing Activities below) of which $127 million remained restricted as of December 31, 2006. In addition, the company received $117 million of insurance proceeds related to Hurricane Katrina, paid $77 million for outsourcing costs related to newly acquired outsourcing services contracts, and paid $35 million for the purchase of an investment.

During 2006, the company also received $43 million from the sales of the Interconnect Technologies assembly business unit and Winchester.

Capital expenditures in 2006 were $737 million, including $111 million to replace property damaged by Hurricane Katrina and $36 million of capitalized software costs.

2005 Cash used in investing activities was $855 million in 2005. During 2005, the company paid $361 million to acquire two businesses. This includes the acquisition of Confluent in September 2005 and Integic in March 2005. The company received $238 million from the sale of investments, including $95 million for 3.4 million common shares of Endwave and $143 million for 7.3 million common shares of TRW Auto. During 2005, the company also received $57 million from the sale of Teldix.

The company received insurance proceeds of $38 million in 2005 to replace damaged property at the Ships segment as a result of Hurricane Katrina.

Capital expenditures in 2005 were $823 million, including $80 million to replace property damaged by Hurricane Katrina and $41 million of capitalized software costs.

Financing Activities

2007 Cash used in financing activities was $1.5 billion comprised primarily of $1.2 billion in share repurchases, $504 million of dividends paid to shareholders, and $384 million in repayment of borrowings under lines of credit (See Note 13 to the consolidated financial statements in Part II, Item 8), partially offset by $315 million in borrowings under lines of credit, and $274 million in proceeds from exercises of stock options.

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2006 Cash used in financing activities was $1.7 billion comprised of $1.2 billion in repayments of long-term debt, $825 million in share repurchases, and $402 million of dividends paid to shareholders, partially offset by $393 million in proceeds from exercises of stock options and $200 million of debt incurred in relation to the Gulf Opportunity Zone Industrial Development Revenue Bonds.

2005 Cash used in financing activities was $1.4 billion comprised primarily of $1.2 billion in share repurchases and $359 million in dividends paid to shareholders, partially offset by $163 million in proceeds from exercises of stock options.

Gulf Opportunity Zone Industrial Development Revenue Bonds In December 2006, Ships entered into a loan agreement with the Mississippi Business Finance Corporation (MBFC) under which Ships received access to $200 million from the issuance of Gulf Opportunity Zone Industrial Development Revenue Bonds by the MBFC. The loan accrues interest payable semi-annually at a fixed rate of 4.55 percent per annum. The company s obligation related to these bonds is recorded in long-term debt in the consolidated statements of financial position in Part II, Item 8. The bonds are subject to redemption at the company s discretion on or after December 1, 2016, and will mature on December 1, 2028. The bond issuance proceeds must be used to finance the construction, reconstruction, and renovation of the company s interest in certain ship manufacturing and repair facilities, or portions thereof, located in the state of Mississippi. As of December 31, 2007 and 2006, approximately $140 million and $73 million, respectively, was used by Ships and the remaining $60 million and $127 million, respectively, was recorded in miscellaneous other assets as restricted cash in the consolidated statements of financial position in Part II, Item 8. Repayment of the bonds is guaranteed by the company.

Share Repurchases The table below summarizes the company s share repurchases beginning January 1, 2005:

					Shares Repurchased (in millions)		
Authorization Date	Amount Authorized (in billions)	Average Price Per Share	Total Shares Retired (in millions)	Date Completed	2007	2006	2005
October 26, 2004	$ 1.0	$ 54.83	18.2	September 2005			12.7
October 24, 2005	1.5	65.08	23.0	February 2007	2.3	11.6	9.1
December 14, 2006	1.0	75.96	13.1	November 2007	13.1		
December 20, 2007	2.5						
					15.4	11.6	21.8

As part of the share repurchase programs the company has entered into four separate accelerated share repurchase agreements since November 2005, with two different banks (the Banks) to repurchase shares of common stock. In each case, shares were immediately borrowed by the Banks that were then sold to and canceled by the company. Subsequently, shares were purchased in the open market by the Banks to settle their share borrowings. The cost of the company s share repurchases was subject to adjustment based on the actual cost of the shares subsequently purchased by the Banks. If an additional amount is owed by the company upon settlement, the price adjustment could have been

settled, at the company s option, in cash or in shares of common stock.

The table below summarizes the accelerated share repurchase transactions:

Agreement Date	Shares Repurchased (in millions)	Completion Date	Final Average Purchase Price Per Share	Dollar Amount of Shares Repurchased (in millions)
November 4, 2005	9.1	March 1, 2006	$ 59.05	$ 537
March 6, 2006	11.6	May 26, 2006	68.01	788
February 21, 2007	8.0	June 7, 2007	73.86	592
July 30, 2007	6.5	September 17, 2007	77.27	502

Share repurchases take place at management s discretion or under pre-established non-discretionary programs from time to time, depending on market conditions, in the open market, and in privately negotiated transactions.

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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 programs.

As of December 31, 2007, the company has authorized $2.5 billion for share repurchases.

Credit Ratings

The company s credit ratings at December 31, 2007, are summarized below:

	Fitch	Moody s	Standard & Poors
Long-term: Northrop Grumman	BBB+	Baa1	BBB+

In June 2007, Moody s Investors Service upgraded its ratings on debt securities issued by the company. The long term rating was changed to Baa1 from Baa2. In December 2007, Fitch revised its outlook on the company to stable from positive.

Credit Facility

In August of 2005, the company entered into a credit agreement which provides for a five-year revolving credit facility in an aggregate principal amount of $2 billion. The credit facility permits the company to request additional lending commitments from the lenders under the agreement or other eligible lenders under certain circumstances, and thereby increase the aggregate principal amount of the lending commitments under the agreement by up to an additional $500 million. The agreement provides for swingline loans and letters of credit as sub-facilities for the credit facilities provided for in the agreement. Borrowings under the credit facility bear interest at various rates, including the London Interbank Offered Rate (LIBOR), adjusted based on the company s credit rating, or an alternate base rate plus an incremental margin. The credit facility also requires a facility fee based on the daily aggregate amount of commitments (whether or not utilized) and the company s credit rating level. The company s credit agreement contains certain financial covenants relating to a maximum debt to capitalization ratio, and certain restrictions on additional asset liens, unless permitted by the agreement. As of December 31, 2007, the company was in compliance with all covenants. In August of 2007, the company entered into an amended and restated credit agreement amending the company s 2005 credit agreement.

Concurrent with the effectiveness of the 2005 credit agreement, the prior revolving credit agreement, for $2.5 billion, was terminated. No principal or interest was outstanding or accrued and unpaid under the prior agreement on its termination date.

In August of 2007, the company entered into an amended and restated credit agreement amending the company s 2005 credit agreement. The agreement extends the maturity date of the credit facility from August 5, 2010 to August 10, 2012 and provides improved pricing terms, reduced facility fees, and full availability of the facility for letters of credit. At December 31, 2007, and 2006, there was no balance outstanding under this facility. There was a maximum of $350 million borrowed under this facility during 2007 and no borrowings during 2006.

Mandatorily Redeemable Series B Convertible Preferred Stock

The company issued 3.5 million shares of mandatorily redeemable Series B convertible preferred stock in April 2001. Each share of Series B preferred stock has a liquidation value of $100 per share. The liquidation value, plus accrued but unpaid dividends, is payable on April 4, 2021, the mandatory redemption date. The company has the option to

redeem all, but not less than all, of the shares of Series B preferred stock at any time after seven years from the date of issuance for a number of shares of the company s common stock equal to the liquidation value plus accrued and unpaid dividends divided by the current market price of common stock determined in relation to the date of redemption. Under this option, had the redemption taken place at December 31, 2007, each share would have been converted into 1.261 shares of common stock. Each share of preferred stock is convertible, at any time, at the option of the holder into the right to receive shares of the company s common stock. Initially, each share was convertible into .911 shares of common stock, subject to adjustment in the event of certain dividends and distributions, a stock split, a merger, consolidation or sale of substantially all of the

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company s assets, a liquidation or distribution, and certain other events. Had the conversion taken place at December 31, 2007, each share would have been converted into 1.822 shares of common stock. Holders of preferred stock are entitled to cumulative annual cash dividends of $7 per share, payable quarterly. Upon liquidation of the company, each share of preferred stock is entitled to a liquidation preference before any distribution may be made on the company s common stock or any series of capital stock that is junior to the Series B preferred stock. In the event of a change in control of the company, holders of Series B preferred stock also have specified exchange rights into common stock of the company or into specified securities or property of another entity participating in the change in control transaction. As of December 31, 2007, 10 million shares of preferred stock are authorized, of which 3.5 million shares designated as Series B preferred are issued and outstanding. No other shares of preferred stock are issued and outstanding.

Subsequent Event On February 20, 2008, the company s Board of Directors approved the redemption of the Series B convertible preferred stock on April 4, 2008.

Other Sources and Uses of Capital

Additional Capital To provide for long-term liquidity, the company believes it can obtain additional capital, if necessary, from such sources as the public or private capital markets, the sale of assets, sale and leaseback of operating assets, and leasing rather than purchasing new assets. The company has an effective shelf registration on file with the Securities and Exchange Commission to provide for the issuance of up to $2 billion in debt and equity securities.

Cash on hand at the beginning of the year plus cash generated from operations and cash available under credit lines are expected to be sufficient in 2008 to service debt, finance capital expansion projects, pay federal, foreign, and state income taxes, and continue paying dividends to shareholders. The company will continue to provide the productive capacity to perform its existing contracts, prepare for future contracts, and conduct research and development in the pursuit of developing opportunities. While these expenditures tend to limit short-term liquidity, they are made with the intention of improving the long-term growth and profitability of the company.

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 by insurance companies principally to guarantee the performance on certain contracts and to support the company s self-insured workers compensation plans. At December 31, 2007, there were $439 million of unused stand-by letters of credit, $148 million of bank guarantees, and $538 million of surety bonds outstanding.

In December 2006, the company guaranteed a $200 million loan made to Ships in connection with the Gulf Opportunity Zone Industrial Revenue Bonds. Under the loan agreement the company guaranteed repayment by Ships of the principal and interest to the Trustee. The company also guaranteed payment of the principal and interest by the Trustee to the underlying bondholders.

Co-Operative Agreements In 2003, Ships executed agreements with the states of Mississippi and Louisiana whereby Ships leases facility improvements and equipment from Mississippi and from a non-profit economic development corporation in Louisiana in exchange for certain commitments by Ships to these states. As of December 31, 2007, Ships has fully met its obligations under the Mississippi agreement and has met all but one requirement under the Louisiana agreement. Failure by Ships to meet the remaining Louisiana commitment would result in reimbursement by Ships to Louisiana in accordance with the agreement. As of December 31, 2007, Ships expects that the remaining commitment under the Louisiana agreement will be met based on its most recent business plan.

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Contractual Obligations
The following table presents the company s contractual obligations as of December 31, 2007, and the estimated timing of future cash payments:

$ in millions	Total	2008	2009 - 2010	2011 - 2012	2013 and beyond
Long-term debt	$ 3,989	$ 111	$ 564	$ 776	$ 2,538
Interest payments on long-term debt	3,793	290	530	406	2,567
Mandatorily redeemable convertible preferred stock	675	24	49	49	553
Operating leases	2,065	445	661	394	565
Purchase obligations(1)	6,405	4,274	1,649	423	59
Other long-term liabilities(2)	1,171	180	389	148	454
Total contractual obligations	$ 18,098	$ 5,324	$ 3,842	$ 2,196	$ 6,736

(1) A purchase obligation is defined as an agreement to purchase goods or services that is enforceable and legally binding on the company and that specifies all significant terms, including: fixed or minimum quantities to be purchased; fixed, minimum, or variable price provisions; and the approximate timing of the transaction. These amounts are primarily comprised of open purchase order commitments to vendors and subcontractors pertaining to funded contracts.

(2) Other long-term liabilities primarily consist of accrued workers compensation, deferred compensation, and other miscellaneous liabilities, but excludes obligations for uncertain tax positions of $477 million and long-term deferred tax liabilities of $330 million, as the timing of the payments cannot be reasonably estimated.

The table above also excludes estimated minimum funding requirements for retiree benefit plans as set forth by ERISA in relation to the $3.4 billion pension and postretirement benefit liability, totaling approximately $2.3 billion over the next five years: $322 million in 2008, $304 million in 2009, $307 million in 2010, $499 million in 2011, and $844 million in 2012. The company also has payments due under plans that are not required to be funded in advance, but are funded on a pay-as-you-go basis. See Note 18 to the consolidated financial statements in Part II, Item 8.

Further details regarding long-term debt and operating leases can be found in Notes 13 and 16, respectively, to the consolidated financial statements in Part II, Item 8.

OTHER MATTERS

New Accounting Pronouncements
New accounting pronouncements have been issued by the FASB which are not effective until after December 31, 2007. For further discussion of new accounting standards, see Note 2 to the consolidated financial statements in Part II, Item 8.

Off-Balance Sheet Arrangements
As of December 31, 2007, the company had no significant off-balance sheet arrangements other than operating leases. For a description of the company s operating leases, see Note 16 to the consolidated financial statements in Part II,

Item 8.

GLOSSARY OF PROGRAMS

Listed below are brief descriptions of the programs mentioned in this Form 10-K.

Program Name	**Program Description**
Airborne Laser (ABL)	Design and develop the system s Chemical Oxygen Iodine Laser (COIL) and the Beacon Illuminator Laser (BILL) for Missile Defense Agency s Airborne Laser, providing a capability to destroy boost-phase missiles at very long range.

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Program Name	Program Description
Advanced Extremely High Frequency (AEHF)	Provide the communication payload for the nation s next generation military strategic and tactical relay systems that will deliver survivable, protected communications to U.S. forces and selected allies worldwide.
Automated Flats Sorting Machine (AFSM) automated induction (ai) Follow-On	Automated induction hardware deliveries to the U.S. Postal Service. Ai allows for the automated prep of flat mail into automation compatible trays and conveyed to the AFSM-100 in-feed line for sorting.
APG-66	Provide engineering services, technical support, spares and repairs for the AN/APG-66 fire control radar that is utilized for the F-16 and other military aircraft.
Advanced Self Protection Integrated Suite (ASPIS) II	Subcontract to Raytheon to design, develop, fabricate, test, qualify, deliver and support the AN/ALR-93(V) Radar Warning Receiver/Electronic Warfare Suite Controller (RWR/EWSC) Systems.
B-2 Stealth Bomber	Maintain strategic, long-range multi-role bomber with war- fighting capability that combines long range, large payload, all-aspect stealth, and near-precision weapons in one aircraft.
Battle Command Training	Operates the computer-based simulations, models and automated tools used for the collection and analysis of information used by U.S. Army Battle Command Training Program.
Biohazard Detection System (BDS)	BDS flat mail screening to rapidly analyze and detect potential biological threats at postal service mail-sorting facilities.
National Team Battle Management Command and Control (BMC2)	Provide technical talent and corporate reach back to the industry team tasked to develop, field, and sustain a global C2BM system for ballistic missile defense.
U.S. Citizenship and Immigration Services	Operate and maintain the Application Support Center facilities for the U.S. Citizenship and Immigration Services, including biometric capture, background check, application scheduling, and facility leasing and maintenance.
Coast Guard s Deepwater Program	Design, develop, construct and deploy surface assets to recapitalize the Coast Guard.
Command Post Platform (CPP)	Provide a family of vehicles that host multiple battle command and support software suites as well as communications equipment that interface with digitized vehicles.
DDG 51	

	Build Aegis guided missile destroyer, equipped for conducting anti-air, anti-submarine, anti-surface and strike operations.
DDG 1000 Zumwalt-class Destroyer	Design the first in a class of the U.S. Navy s multi-mission surface combatants tailored for land attack and littoral dominance.
E-2D Advanced Hawkeye	The E-2D builds upon the Hawkeye 2000 configuration with significant radar improvement performance. The E-2D provides over the horizon

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Program Name	Program Description
	airborne early warning (AEW), surveillance, tracking, and command and control capability to the U.S. Naval Battle Groups and Joint Forces.
E-10A	Mission Execution Program (MEP) to continue to mature the technologies of the E-10A Battle Management/Command and Control capabilities.
E/A-18G	Provide the Airborne Electronic Attack suite to Boeing which includes the ALQ-218 (V2) receiving system, the ALQ-227 communications countermeasures system and the Electronic Attack Unit that interfaces with the legacy F/A-18 air vehicle.
Electro Optical & Infrared Countermeasures	Provides protection against the ground launched man portable (MANPAD) infrared missile threat by automatically detecting missile launch and jamming the missile s guidance system with a laser beam, causing a miss. The AAQ-24 is a stand-alone electronic warfare system installed on over 380 USAF and international transport aircraft and helicopters, is fully operational with the USAF and Royal Air Force (RAF), and is the only laser DIRCM system available in the world.
F/A-18	Produce the center and aft fuselage sections, twin vertical stabilizers, and integrate all associated subsystems for the F/A-18 Hornet strike fighters.
F-15 Repairs at Warner Robins	Avionics component repair, modifications, build to print, DMS resolution, ATE builds, engineering services, and personnel augmentation for the F-15.
F-16 Block 60	Direct commercial firm fixed-price program with Lockheed Martin Aeronautics Company to develop and produce 80 Lot systems for aircraft delivery to the United Arab Emirates Air Force as well as test equipment and spares to be used to support in- country repairs of sensors.
F-35 Development (Joint Strike Fighter)	Design, integration, and/or development of the center fuselage and weapons bay, communications, navigations, identification subsystem, systems engineering, and mission systems software as well as provide ground and flight test support, modeling, simulation activities, and training courseware.
F-22	Joint venture with Raytheon to design, develop and produce the F-22 radar system. Northrop Grumman is responsible for the overall design of the AN/APG-77 and AN/APG-77(V) 1 radar systems, including the control and signal processing software and responsibility for the AESA radar systems integration and test activities. In addition, Northrop Grumman is responsible for overall design and integration of the F- 22 Communication, Navigation, and Identification (CNI) system.

Falcon Edge	Provide an integrated Electronic Warfare suite that leverages the latest radio frequency (RF) and digital technologies for air warfare.
Force XXI Battle Brigade and Below (FBCB2)	Install in Army vehicles a system of computer hardware and software that forms a wireless, tactical Internet for near-real- time situational awareness and command and control on the battlefield.
Ford Class	Design and construction for the new class of Aircraft Carriers.

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Program Name	Program Description
Flats Sequencing System/Postal Automation	Build systems for the U.S. Postal Service designed to further automate the flats mail stream, which includes large envelopes, catalogs and magazines.
Ft. Irwin Logistics Support Services (LSS)	Operate and manage a large-scale maintenance and repair program involving tracked and wheeled vehicles, basic issue items, communications equipment, and weapons needed for desert training.
Ground/Air Task Oriented Radar (G/ATOR)	A development program to provide the next generation ground based multi-mission radar for the USMC. Provides Short Range Air Defense, Air Defense Surveillance, Ground Weapon Location and Air Traffic Control. Replaces five existing USMC single-mission radars.
George H. W. Bush (CVN 77)	The 10th and final *Nimitz*-class aircraft carrier that will incorporate many new design features, with expected delivery to the Navy in late 2008.
Ground-Based Midcourse Defense Fire Control and Communications (GFC/C)	Develop software to coordinate sensor and interceptor operations during missile flight.
Hunter CLS	Operate, maintain, train and sustain the multi-mission Hunter Unmanned Aerial System in addition to deploying Hunter support teams.
Global Hawk High-Altitude, Long-Endurance Systems (HALE)	Provide the Global Hawk HALE unmanned aerial system for use in the global war on terror and has a central role in Intelligence, Reconnaissance, and Surveillance supporting operations in Afghanistan and Iraq.
Intercontinental Ballistic Missile (ICBM)	ICBM weapon systems by ensuring the system s total performance.
Joint National Integration Center Research & Development (JRDC)	Support the development and application of modeling and simulation, wargaming, test and analytic tools for air and missile defense.
Joint Base Operations Support	Provides all infrastructure support needed for launch and base operations at the NASA Spaceport.
Joint Surveillance Target Attack Radar System (Joint STARS)	Joint STARS detects, locates, classifies, tracks and targets hostile ground movements, communicating real-time information through secure data links with U.S. Air Force and Army command posts.
James Webb Space Telescope (JWST)	Design, develop, integrate and test a space-based infrared telescope satellite to observe the formation of the first stars and galaxies in the universe.

Kinetic Energy Interceptor	Develop mobile missile-defense system with the unique capability to destroy a hostile missile during its boost, ascent or midcourse phase of flight.
Large Aircraft Infrared Counter-measures Indefinite Delivery and Indefinite Quantity (LAIRCM IDIQ)	Infrared countermeasures systems for C-17 and C-130 aircraft. The IDIQ contract will further allow for the purchase of LAIRCM hardware for foreign military sales and other government agencies.

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Program Name	Program Description
LHA	Detail design and construct amphibious assault ships for use as an integral part of joint, interagency, and multinational maritime forces.
LHD	Build multipurpose amphibious assault ships.
Lightweight Laser Designator Rangefinder (LLDR)	Provide LLDRs to the U.S. Army for use in targeting enemy positions in day/night/obscurant conditions which, in turn, provides information to other members on the battlefield.
Longbow Missile	All-weather fire and forget precision strike weapon that uses a millimeter-wave radar. The Longbow Missile is launched from the Apache AH-64 helicopter. To date over 13,000 missiles have been built for the U.S. Army and several international customers.
LPD	Build amphibious transport dock ships.
Mark VIIE	The next generation electro-optical day/night hand held target location system used by Ground Forces.
MESA Korea	Consists of a 4 lot Multirole Electronically Scanned Array (MESA) radar/Identification Friend or Foe subsystem delivery with limited non-recurring engineering. The program also includes associated spares, support equipment and installation & check out activities, with direct and indirect offset projects. Northrop Grumman s customer is the Boeing Company, with ultimate product delivery to the Republic of Korea Air Force.
Multi-Platform Radar Technology Insertion Program (MP-RTIP)	Design, develop, fabricate and test modular, scalable 2-dimensional active electronically scanned array (2D- AESA) radars for integration on the E-10A and Global Hawk Airborne platforms. Also provides enhanced Wide Area Surveillance system capabilities.
New York City Wireless	Provide New York City s broadband public- safety wireless network.
Navy Unmanned Combat Air System Operational Assessment (N-UCAS)	Navy development/demonstration contract that will design, build and test two demonstration vehicles that will conduct a carrier demonstration.
National Geospatial-Intelligence Agency Enterprise Engineering (NGA EE)	Deliver engineering services necessary to direct the planning, development and implementation of all NGA s activities and systems comprising the National System for Geospatial Intelligence.
Network Centric Solution	Provide Network-Centric Information Technology, Networking, Telephony and Security, Voice, Video and Data Communications Commercial-off-the-Shelf

	products, system solutions, hardware and software.
National Polar-orbiting Operational Environmental Satellite System (NPOESS)	Design, develop, integrate, test, and operate an integrated system comprised of two satellites with mission sensors and associated ground elements for providing global and regional weather and environmental data.

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Program Name	Program Description
National Security Cutter (NSC)	Detail design and construct the U.S. Coast Guard s National Security Cutters equipped to carry out the core missions of maritime security, maritime safety, protection of natural resources, maritime mobility, and national defense.
Nevada Test Site (NTS)	Manage and operate the Nevada Test Site facility and provide infrastructure support, including management of the nuclear explosives safety team, support of hazardous chemical spill testing, emergency response training and conventional weapons testing.
Peace Eagle	Joint program with Boeing to supply MESA radar antenna for Turkey s Peace Eagle 737 airborne early warning and control aircraft.
San Diego County IT Outsourcing	Provide high-level IT consulting and services to San Diego County including data center, help desk, desktop, network, applications and cross-functional services.
Saudi Arabian National Guard (SANG)	Provides military training, logistics and support services to modernize the Saudi Arabian National Guard s capabilities to unilaterally execute and sustain military operations.
Space Based Infrared System (SBIRS)	Space-based surveillance systems for missile warning, missile defense, battlespace characterization and technical intelligence. SBIRS will meet United Stated infrared space surveillance needs through the next 2-3 decades.
Space Based Space Surveillance (SBSS)	Develop initial capability for space-based surveillance of resident space objects for missions such as deep space and near earth object detection and tracking, deep space search, space object identification, and monitoring of satellites.
Space Tracking and Surveillance System (STSS)	Develop a critical system for the nation s missile defense architecture employing low-earth orbit satellites with onboard infrared sensors to detect, track and discriminate ballistic missiles. The program includes two flight demonstration satellites with subsequent development and production blocks of satellites.
Treasury Communication System (TCS)	Provide telecommunications infrastructure for collaboration, communication and computing as required by the U.S. Department of Treasury.
USS Carl Vinson	Refueling and complex overhaul of the nuclear-powered aircraft carrier *USS Carl Vinson* (CVN 70).
USS Toledo	Depot Modernization Period (DMP) being performed at Newport News for this 688-class submarine. A DMP is a midlife availability for extensive modernization to improve war fighting capabilities and maintenance to ensure the ship remains certified for unrestricted operations to design test depth.

UK AWACS	Provide aircraft-maintenance and design-engineering support services.
Virginia IT outsourcing	Provide high-level IT consulting and services to Virginia state and local agencies including data center, help desk, desktop, network, applications and cross-functional services.

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NORTHROP GRUMMAN CORPORATION

Program Name	**Program Description**
Vehicular Intercommunications Systems (VIS)	Provide clear and noise-free communications between crew members inside combat vehicles and externally over as many as six combat net radios for the U.S. Army. The active noise- reduction features of VIS provide significant improvement in speech intelligibility, hearing protection, and vehicle crew performance.
Virginia-class Submarines	Construct the newest attack submarine in conjunction with Electric Boat.
Warner Robins Fleet Sustainment Engineering	Sustains legacy weapons systems through the application of engineering capabilities, including systems engineering, hardware design, software development and maintenance, logistics, electronic warfare, automated test equipment, and avionics engineering.
Wedgetail	Joint program with Boeing to supply MESA radar antenna for AEW&C aircraft.

Item 7A. Quantitative and Qualitative Disclosures about Market Risk

Interest Rates The company is exposed to market risk, primarily related to interest rates and foreign currency exchange rates. Financial instruments subject to interest rate risk include fixed-rate long-term debt obligations, variable-rate short-term borrowings under the credit agreement, short-term investments, and long-term notes receivable. At December 31, 2007, substantially all outstanding borrowings were fixed-rate long-term debt obligations of which a significant portion are not callable until maturity. The company has a modest exposure to interest rate risk resulting from two interest rate swap agreements described in Note 1 to the consolidated financial statements in Part II, Item 8. The company s sensitivity to a 1 percent change in interest rates is tied to its $2 billion credit agreement, which had no balance outstanding at December 31, 2007 or 2006, and the aforementioned interest rate swap agreements. See Note 13 to the consolidated financial statements in Part II, Item 8.

Derivatives The company does not hold or issue derivative financial instruments for trading purposes. The company may enter into interest rate swap agreements to manage its exposure to interest rate fluctuations. At December 31, 2007, and 2006, two interest rate swap agreements were in effect. See Note 1 to the consolidated financial statements in Part II, Item 8.

Foreign Currency The company enters into foreign currency forward contracts to manage foreign currency exchange rate risk related to receipts from customers and payments to suppliers denominated in foreign currencies. At December 31, 2007, and 2006, the amount of foreign currency forward contracts outstanding was not material. The company does not consider the market risk exposure relating to foreign currency exchange to be material to the consolidated financial statements. See Note 1 to the consolidated financial statements in Part II, Item 8.

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NORTHROP GRUMMAN CORPORATION

Item 8. Financial Statements and Supplementary Data

REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM ON THE CONSOLIDATED FINANCIAL STATEMENTS

To the Board of Directors and Shareholders of
Northrop Grumman Corporation
Los Angeles, California

We have audited the accompanying consolidated statements of financial position of Northrop Grumman Corporation and subsidiaries (the Company) as of December 31, 2007 and 2006, and the related consolidated statements of income, comprehensive income, changes in shareholders equity, and cash flows for each of the three years in the period ended December 31, 2007. Our audits also included the financial statement schedule listed in the Index at Item 15. These financial statements and the financial statement schedule are the responsibility of the Company s management. Our responsibility is to express an opinion on the financial statements and financial statement schedule based on our audits.

We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, such consolidated financial statements present fairly, in all material respects, the financial position of Northrop Grumman Corporation and subsidiaries at December 31, 2007 and 2006, and the results of their operations and their cash flows for each of the three years in the period ended December 31, 2007, in conformity with accounting principles generally accepted in the United States of America. Also, in our opinion, such financial statement schedule, when considered in relation to the basic consolidated financial statements taken as a whole, presents fairly, in all material respects, the information set forth therein.

As discussed in Note 12 to the consolidated financial statements, the Company adopted, effective January 1, 2007, a new accounting standard for income taxes. As discussed in Note 18 to the consolidated financial statements, the Company adopted, effective December 31, 2006, a new accounting standard for retirement benefits.

We have also audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the Company s internal control over financial reporting as of December 31, 2007, based on the criteria established in *Internal Control Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission and our report dated February 20, 2008 expressed an unqualified opinion on the Company s internal control over financial reporting.

/s/ Deloitte & Touche LLP
Los Angeles, California
February 20, 2008

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NORTHROP GRUMMAN CORPORATION

CONSOLIDATED STATEMENTS OF INCOME

	Year ended December 31		
$ in millions, except per share	**2007**	2006	2005
Sales and Service Revenues			
Product sales	**$ 18,730**	$ 18,394	$ 19,471
Service revenues	**13,288**	11,719	10,507
Total sales and service revenues	**32,018**	30,113	29,978
Cost of Sales and Service Revenues			
Cost of product sales	**14,474**	14,380	15,543
Cost of service revenues	**11,330**	10,242	9,355
General and administrative expenses	**3,208**	3,027	2,880
Operating margin	**3,006**	2,464	2,200
Other Income (Expense)			
Interest income	**28**	44	54
Interest expense	**(336)**	(347)	(388)
Other, net	**(12)**	125	199
Income from continuing operations before income taxes	**2,686**	2,286	2,065
Federal and foreign income taxes	**883**	713	669
Income from continuing operations	**1,803**	1,573	1,396
(Loss) gain from discontinued operations, net of tax	**(13)**	(31)	4
Net income	**$ 1,790**	$ 1,542	$ 1,400
Basic Earnings (Loss) Per Share			
Continuing operations	**$ 5.28**	$ 4.55	$ 3.92
Discontinued operations	**(.04)**	(.09)	.01
Basic earnings per share	**$ 5.24**	$ 4.46	$ 3.93
Weighted-average common shares outstanding, in millions	**341.7**	345.7	356.5
Diluted Earnings (Loss) Per Share			
Continuing operations	**$ 5.16**	$ 4.46	$ 3.84
Discontinued operations	**(.04)**	(.09)	.01
Diluted earnings per share	**$ 5.12**	$ 4.37	$ 3.85
Weighted-average diluted shares outstanding, in millions	**354.3**	358.6	363.2

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

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NORTHROP GRUMMAN CORPORATION

CONSOLIDATED STATEMENTS OF FINANCIAL POSITION

$ in millions	**December 31, 2007**	December 31, 2006
Assets:		
Current Assets		
Cash and cash equivalents	**$ 963**	$ 1,015
Accounts receivable, net	**3,813**	3,562
Inventoried costs, net	**1,045**	1,176
Deferred income taxes	**542**	706
Prepaid expenses and other current assets	**409**	266
Total current assets	**6,772**	6,725
Property, Plant, and Equipment		
Land and land improvements	**605**	588
Buildings	**2,249**	2,079
Machinery and other equipment	**4,775**	4,415
Leasehold improvements	**526**	447
	8,155	7,529
Accumulated depreciation	**(3,440)**	(3,004)
Property, plant, and equipment, net	**4,715**	4,525
Other Assets		
Goodwill	**17,672**	17,219
Other purchased intangibles, net of accumulated amortization of $1,687 in 2007 and $1,555 in 2006	**1,074**	1,139
Pension and postretirement benefits asset	**2,080**	1,349
Miscellaneous other assets	**1,060**	1,052
Total other assets	**21,886**	20,759
Total assets	**$ 33,373**	$ 32,009

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NORTHROP GRUMMAN CORPORATION

$ in millions		**December 31, 2007**		December 31, 2006
Liabilities and Shareholders Equity:				
Current Liabilities				
Notes payable to banks	**$**	**26**	$	95
Current portion of long-term debt		**111**		75
Trade accounts payable		**1,901**		1,682
Accrued employees compensation		**1,180**		1,176
Advance payments and billings in excess of costs incurred		**1,563**		1,571
Income tax payable				535
Other current liabilities		**1,651**		1,619
Total current liabilities		**6,432**		6,753
Long-term debt, net of current portion		**3,918**		3,992
Mandatorily redeemable preferred stock		**350**		350
Pension and postretirement benefits liability		**3,008**		3,302
Other long-term liabilities		**1,978**		997
Total liabilities		**15,686**		15,394
Commitments and Contingencies (Note 16)				
Shareholders Equity				
Common stock, $1 par value; 800,000,000 shares authorized; issued and outstanding: 2007 337,834,561; 2006 345,921,809		**338**		346
Paid-in capital		**10,661**		11,346
Retained earnings		**7,387**		6,183
Accumulated other comprehensive loss		**(699)**		(1,260)
Total shareholders equity		**17,687**		16,615
Total liabilities and shareholders equity	**$**	**33,373**	$	32,009

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

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NORTHROP GRUMMAN CORPORATION

CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME

	Year ended December 31		
$ in millions	**2007**	2006	2005
Net income	**$ 1,790**	$ 1,542	$ 1,400
Other Comprehensive Income (Loss)			
Change in cumulative translation adjustment	**12**	22	(14)
Change in unrealized gain (loss) on marketable securities, net of tax (expense) benefit of ($1) in 2007 and $2 in 2006	**1**	(5)	(1)
Reclassification adjustment on write-down of marketable securities, net of tax of ($5)		10	
Reclassification adjustment on sale of marketable securities, net of tax of $19			(29)
Additional minimum pension liability adjustment, net of tax of ($32)		40	
Change in unamortized benefit plan costs, net of tax of ($384)	**594**		
Other comprehensive income (loss), net of tax	**607**	67	(44)
Comprehensive income	**$ 2,397**	$ 1,609	$ 1,356

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

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NORTHROP GRUMMAN CORPORATION

CONSOLIDATED STATEMENTS OF CASH FLOWS

	Year ended December 31		
$ in millions	**2007**	2006	2005
Operating Activities			
Sources of Cash Continuing Operations			
Cash received from customers			
Progress payments	**$ 7,490**	$ 6,797	$ 6,644
Other collections	**24,570**	23,303	23,622
Insurance proceeds received	**125**	100	89
Income tax refunds received	**52**	60	88
Interest received	**21**	45	78
Other cash receipts	**34**	42	51
Total sources of cash continuing operations	**32,292**	30,347	30,572
Uses of Cash Continuing Operations			
Cash paid to suppliers and employees	**(28,024)**	(27,389)	(27,028)
Interest paid	**(355)**	(366)	(404)
Income taxes paid	**(905)**	(678)	(419)
Excess tax benefits from stock-based compensation	**(52)**	(57)	
Payments for litigation settlements	**(33)**	(11)	(99)
Other cash payments	**(19)**	(12)	(31)
Total uses of cash continuing operations	**(29,388)**	(28,513)	(27,981)
Cash provided by continuing operations	**2,904**	1,834	2,591
Cash (used in) provided by discontinued operations	**(14)**	(78)	36
Net cash provided by operating activities	**2,890**	1,756	2,627
Investing Activities			
Proceeds from sale of businesses, net of cash divested		43	57
Payments for businesses purchased, net of cash acquired	**(690)**		(361)
Proceeds from sale of property, plant, and equipment	**22**	21	11
Additions to property, plant, and equipment	**(685)**	(737)	(823)
Proceeds from insurance carrier	**4**	117	38
Proceeds from sale of investments		209	238
Payment for purchase of investment		(35)	
Restriction of cash, net of restrictions released	**59**	(127)	
Payments for outsourcing contract costs	**(137)**	(77)	
Other investing activities, net	**(3)**	(15)	(15)
Net cash used in investing activities	**(1,430)**	(601)	(855)

Financing Activities						
Borrowings under lines of credit		**315**		47		62
Repayment of borrowings under lines of credit		**(384)**		(3)		(21)
Proceeds from issuance of long-term debt				200		
Principal payments of long-term debt		**(90)**		(1,212)		(32)
Proceeds from exercises of stock options and issuances of common stock		**274**		393		163
Dividends paid		**(504)**		(402)		(359)
Excess tax benefits from stock-based compensation		**52**		57		
Common stock repurchases		**(1,175)**		(825)		(1,210)
Net cash used in financing activities		**(1,512)**		(1,745)		(1,397)
(Decrease) increase in cash and cash equivalents		**(52)**		(590)		375
Cash and cash equivalents, beginning of year		**1,015**		1,605		1,230
Cash and cash equivalents, end of year	**$**	**963**	$	1,015	$	1,605

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NORTHROP GRUMMAN CORPORATION

$ in millions	Year ended December 31 **2007**	2006	2005
Reconciliation of Net Income to Net Cash Provided by Operating Activities			
Net Income	**$ 1,790**	$ 1,542	$ 1,400
Adjustments to reconcile to net cash provided by operating activities			
Depreciation	**578**	569	556
Amortization of assets	**152**	136	216
Stock-based compensation	**196**	184	172
Excess tax benefits from stock-based compensation	**(52)**	(57)	
Loss on disposals of property, plant, and equipment	**19**	6	21
Impairment of property, plant, and equipment damaged by Hurricane Katrina		37	61
Amortization of long-term debt premium	**(11)**	(14)	(18)
Net gain on investments	**(23)**	(96)	(165)
Decrease (increase) in			
Accounts receivable	**(6,487)**	(2,222)	(5,314)
Inventoried costs	**8**	(76)	(234)
Prepaid expenses and other current assets	**9**	(10)	(85)
Increase (decrease) in			
Progress payments	**6,513**	2,261	5,249
Accounts payable and accruals	**108**	181	348
Deferred income taxes	**175**	183	105
Income taxes payable	**(59)**	(68)	295
Retiree benefits	**(50)**	(772)	(22)
Other non-cash transactions, net	**38**	50	6
Cash provided by continuing operations	**2,904**	1,834	2,591
Cash (used in) provided by discontinued operations	**(14)**	(78)	36
Net cash provided by operating activities	**$ 2,890**	$ 1,756	$ 2,627
Non-Cash Investing and Financing Activities			
Investment in unconsolidated affiliate	**$ 30**		
Sales of businesses			
Liabilities assumed by purchaser			$ 41
Purchase of businesses			
Fair value of assets acquired, including goodwill	**$ 879**		$ 399
Cash paid for businesses purchased	**(690)**		(361)
Non-cash consideration given for businesses purchased	**(53)**		
Liabilities assumed	**$ 136**		$ 38

Capital leases	**$**	**35**	$	9

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

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NORTHROP GRUMMAN CORPORATION

CONSOLIDATED STATEMENTS OF CHANGES IN SHAREHOLDERS EQUITY

	Year ended December 31		
$ in millions, except per share	**2007**	2006	2005
Common Stock			
At beginning of year	**$ 346**	$ 347	$ 364
Common stock repurchased	**(15)**	(12)	(22)
Employee stock awards and options	**7**	11	5
At end of year	**338**	346	347
Paid-in Capital			
At beginning of year	**11,346**	11,571	12,426
Common stock repurchased	**(1,160)**	(813)	(1,165)
Employee stock awards and options	**475**	588	310
At end of year	**10,661**	11,346	11,571
Retained Earnings			
At beginning of year	**6,183**	5,055	4,014
Net income	**1,790**	1,542	1,400
Adjustment to initially apply FIN 48	**(66)**		
Dividends	**(520)**	(414)	(359)
At end of year	**7,387**	6,183	5,055
Accumulated Other Comprehensive Loss			
At beginning of year	**(1,260)**	(145)	(101)
Other comprehensive income (loss), net of tax	**607**	67	(44)
Adjustment to initially apply SFAS No. 158, net of tax of $838		(1,182)	
Adjustment to deferred tax benefit recorded on adoption of SFAS No. 158	**(46)**		
At end of year	**(699)**	(1,260)	(145)
Total shareholders equity	**$ 17,687**	$ 16,615	$ 16,828
Cash dividends declared per share	**$ 1.48**	$ 1.16	$ 1.01

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

NORTHROP GRUMMAN CORPORATION

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Nature of Operations Northrop Grumman Corporation and its subsidiaries (Northrop Grumman or the company) provide technologically advanced, innovative products, services, and solutions in information and services, aerospace, electronics, and shipbuilding. As prime contractor, principal subcontractor, partner, or preferred supplier, Northrop Grumman participates in many high-priority defense and non-defense technology programs in the U.S. and abroad. Northrop Grumman conducts most of its business with the U.S. Government, principally the Department of Defense (DoD). The company is therefore affected by, among other things, the federal budget process. The company also conducts business with local, state, and foreign governments and makes domestic and international commercial sales.

Principles of Consolidation The consolidated financial statements include the accounts of Northrop Grumman and its subsidiaries. All intercompany accounts, transactions, and profits among Northrop Grumman and its subsidiaries are eliminated in consolidation.

Accounting Estimates The company s financial statements are in conformity with accounting principles generally accepted in the United States of America. 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 on the basis of the most current and best available information and actual results could differ materially from those estimates.

Revenue Recognition As a defense contractor engaging in long-term contracts, the majority of the company s business is derived from long-term contracts for the construction of facilities, production of goods, and services provided to the federal government. In accounting for these contracts, the company extensively utilizes the cost-to-cost and the units-of-delivery measures of the percentage-of-completion method of accounting. Sales under cost-reimbursement contracts and construction-type contracts that provide for delivery at a low volume per year or a small number of units after a lengthy period of time over which a significant amount of costs have been incurred are accounted for using the cost-to-cost measure of the percentage-of-completion method of accounting. Under this method, sales, including estimated earned fees or profits, are recorded as costs are incurred. For most contracts, sales are calculated based on the percentage that total costs incurred bear to total estimated costs at completion. For certain contracts with large up-front purchases of material, sales are calculated based on the percentage that direct labor costs incurred bear to total estimated direct labor costs. Sales under construction-type contracts that provide for delivery at a high volume per year are accounted for using the units-of-delivery measure of the percentage-of-completion method of accounting. Under this method, sales are recognized as deliveries are made to the customer generally using unit sales values in accordance with the contract terms. The company estimates profit as the difference between total estimated revenue and total estimated cost of a contract and recognizes that profit over the life of the contract based on deliveries. The company classifies contract revenues as product sales or service revenues depending upon the predominant attributes of the relevant underlying contracts.

Certain contracts contain provisions for price redetermination or for cost and/or performance incentives. Such redetermined amounts or incentives are included in sales when the amounts can reasonably be determined and estimated. Amounts representing contract change orders, claims, requests for equitable adjustment, or limitations in funding are included in sales only when they can be reliably estimated and realization is probable. In the period in which it is determined that a loss will result from the performance of a contract, the entire amount of the estimated

ultimate loss is charged against income. Loss provisions are first offset against costs that are included in inventories, with any remaining amount reflected in liabilities. Changes in estimates of contract sales, costs, and 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. Hence, the effect of the changes on future periods of contract performance is recognized as if the revised estimates had been the original

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estimates. A significant change in an estimate on one or more contracts could have a material adverse effect on the company s consolidated financial position or results of operations.

Revenue under contracts to provide services to non-federal government customers are generally recognized when services are performed. Service contracts include operations and maintenance contracts, and outsourcing-type arrangements, primarily in the Information Technology segment. Revenue under such contracts is generally recognized on a straight-line basis over the period of contract performance, unless evidence suggests that the revenue is earned or the obligations are fulfilled in a different pattern. Costs incurred under these service contracts are expensed as incurred, except that direct and incremental set-up costs are capitalized and amortized over the life of the agreement. Operating profit related to such service contracts may fluctuate from period to period, particularly in the earlier phases of the contract.

Service contracts that include more than one type of product or service are accounted for under the provisions of Emerging Issues Task Force (EITF) Issue No. 00-21 *Revenue Arrangements with Multiple Deliverables.* Accordingly, for applicable arrangements, revenue recognition includes the proper identification of separate units of accounting and the allocation of revenue across all elements based on relative fair values.

Research and Development Company-sponsored research and development activities primarily include independent research and development (IR&D) efforts related to government programs. IR&D expenses are included in general and administrative expenses and are generally allocated to U.S. Government contracts. Company-sponsored research and development expenses totaled $537 million, $572 million, and $536 million in 2007, 2006, and 2005, respectively. Expenses for research and development sponsored by the customer are charged directly to the related contracts.

Product Warranty Costs The company provides certain product warranties that require repair or replacement of non-conforming items for a specified period of time. Most of the company s product warranties are provided under government contracts, the costs of which are incorporated into contract pricing. Accrued product warranty costs of $80 million and $81 million were included in other current liabilities at December 31, 2007, and 2006, respectively.

Environmental Costs Environmental liabilities are accrued when the company determines it is responsible for remediation costs and such amounts are reasonably estimable. When only a range of amounts is established and no amount within the range is more probable than another, the minimum amount in the range is recorded. Environmental liabilities are recorded on an undiscounted basis. At sites involving multiple parties, the company accrues environmental liabilities based upon its expected share of liability, taking into account the financial viability of other jointly liable parties. Environmental expenditures are expensed or capitalized as appropriate. Capitalized expenditures relate to long-lived improvements in currently operating facilities. The company does not anticipate and record insurance recoveries before collection is probable. At December 31, 2007, and 2006, the company did not have any accrued receivables related to insurance reimbursements or recoveries for environmental matters.

Derivative Financial Instruments Derivative financial instruments are recognized as assets or liabilities in the financial statements and measured at fair value. Changes in the fair value of derivative financial instruments that qualify and are designated as fair value hedges are required to be recorded in income from continuing operations, while changes in the fair value of derivative financial instruments that qualify and are designated as cash flow hedges are recorded in other comprehensive income. The company may use derivative financial instruments to manage its exposure to interest rate risk and to balance its fixed and variable rate long-term debt portfolio. The company does not use derivative financial instruments for trading purposes, nor does it use leveraged financial instruments. Credit risk

related to derivative financial instruments is considered minimal and is managed by requiring high credit standards for its counterparties and periodic settlements.

The company enters into foreign currency forward contracts to manage foreign currency exchange risk related to receipts from customers and payments to suppliers denominated in foreign currencies. Gains and losses from such

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transactions are included as contract costs. At December 31, 2007 and 2006, the amount of foreign currency forward contracts outstanding was not material.

The company enters into interest rate swap agreements to benefit from floating interest rates as an offset to the fixed-rate characteristic of certain of its long-term debt instruments. At December 31, 2007, two interest rate swap agreements were in effect and accounted for as fair value hedges designed to convert fixed rates to floating rates. These interest rate swaps each hedge a $200 million notional amount of U.S. dollar fixed-rate debt, and mature on October 15, 2009, and February 15, 2011, respectively. Any changes in the fair value of the swaps are offset by an equal and opposite change in the fair value of the hedged item; therefore, there is no net impact to the company s reported consolidated results of operations. At December 31, 2007 and 2006, the aggregate net fair value of the swaps was not material. The company may also enter into interest rate swap agreements to offset the variable-rate characteristics of certain variable-rate term loans which may be outstanding from time to time under the company s credit facility (see Note 13).

Other, net For 2006, Other, net primarily consisted of a pre-tax gain of $111 million related to the sale of the company s remaining 9.7 million TRW Automotive (TRW Auto) shares. For 2005, Other, net primarily consisted of the sale of 7.3 million TRW Auto shares and approximately 3.4 million Endwave shares, which generated pre-tax gains of $70 million and $95 million, respectively.

Income Taxes Provisions for federal, foreign, state, and local income taxes are calculated on reported financial statement pre-tax income based on current tax law and include the cumulative effect of any changes in tax rates from those used previously in determining deferred tax assets and liabilities. Such provisions differ from the amounts currently payable because certain items of income and expense are recognized in different time periods for financial reporting purposes than for income tax purposes. If a tax position does not meet the minimum statutory threshold to avoid payment of penalties, the company recognizes an expense for the amount of the penalty in the period the tax position is claimed in the tax return of the company. The company recognizes interest accrued related to unrecognized tax benefits in income tax expense. Penalties, if probable and reasonably estimable, are recognized as a component of income tax expense. State and local income and franchise tax provisions are allocable to contracts in process and, accordingly, are included in general and administrative expenses.

In accordance with the recognition standards established by Financial Accounting Standards Board (FASB) Interpretation No. (FIN) 48 *Accounting for Uncertainty in Income Taxes an interpretation of FASB Statement 109*, the company makes a comprehensive review of its portfolio of uncertain tax positions regularly. In this regard, an uncertain tax position represents the company s expected treatment of a tax position taken in a filed tax return, or planned to be taken in a future tax return or claim, that has not been reflected in measuring income tax expense for financial reporting purposes. Until these positions are sustained by the taxing authorities, the company has not recognized the tax benefits resulting from such positions and reports the tax effects as a liability for uncertain tax positions in its consolidated statements of financial position.

Cash and Cash Equivalents Cash and cash equivalents include interest-earning debt instruments that mature in three months or less from the date purchased.

Marketable Securities At December 31, 2007, and 2006, substantially all of the company s investments in marketable securities were classified as available-for-sale or trading. For available-for-sale securities, any unrealized gains and losses are reported as a separate component of shareholders equity. Unrealized gains and losses on trading securities are included in Other, net in the consolidated statements of income and were not material to any period presented. The

fair values of these marketable securities are determined based on prevailing market prices.

Accounts Receivable Accounts receivable include amounts billed and currently due from customers, amounts currently due but unbilled (primarily related to contracts accounted for under the cost-to-cost measure of the percentage-of-completion method of accounting), certain estimated contract changes, claims or requests for

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equitable adjustment in negotiation that are probable of recovery, and amounts retained by the customer pending contract completion.

Inventoried Costs Inventoried costs primarily relate to work in process under fixed-price, units-of-delivery contracts. These costs represent accumulated contract costs less the portion of such costs allocated to delivered items. Accumulated contract costs include direct production costs, factory and engineering overhead, production tooling costs, and, for government contracts, allowable general and administrative expenses. The ratio of inventoried general and administrative expenses to total inventoried costs is estimated to be the same as the ratio of total general and administrative expenses incurred to total contract costs incurred. According to the provisions of U.S. Government contracts, the customer asserts title to, or a security interest in, inventories related to such contracts as a result of contract advances, performance-based payments, and progress payments. General corporate expenses and IR&D allocable to commercial contracts are expensed as incurred. In accordance with industry practice, inventoried costs are classified as a current asset and include amounts related to contracts having production cycles longer than one year. Product inventory primarily consists of raw materials and is stated at the lower of cost or market, generally using the average cost method.

Outsourcing Contract Costs Costs on outsourcing contracts, including costs incurred for bid and proposal activities, are generally expensed as incurred. However, certain costs incurred upon initiation of an outsourcing contract are deferred and expensed over the contract life. These costs represent incremental external costs or certain specific internal costs that are directly related to the contract acquisition and transition/set-up. The primary types of costs that may be capitalized include labor and related fringe benefits, subcontractor costs, and travel costs.

Depreciable Properties Property, plant, and equipment owned by the company are depreciated over the estimated useful lives of individual assets. Costs incurred for computer software developed or obtained for internal use are capitalized and classified in machinery and other equipment. Most of these assets are depreciated using declining-balance methods, with the remainder using the straight-line method, with the following lives:

	Years
Land improvements	2-45
Buildings and improvements	2-45
Machinery and other equipment	2-25
Capitalized software costs	3-5
Leasehold improvements	Length of lease

Restricted Cash Access to proceeds from the Gulf Opportunity Zone Industrial Development Revenue Bonds (see Note 13) is restricted to certain capital expenditures. As such, the amount of unexpended proceeds available is recorded in miscellaneous other assets as restricted cash in the consolidated statements of financial position.

Leases The company uses its incremental borrowing rate in the assessment of lease classification as capital or operating and defines the initial lease term to include renewal options determined to be reasonably assured. The company conducts operations primarily under operating leases.

Most lease agreements contain incentives for tenant improvements, rent holidays, or rent escalation clauses. For incentives for tenant improvements, the company records a deferred rent liability and amortizes the deferred rent over

the term of the lease as a reduction to rent expense. For rent holidays and rent escalation clauses during the lease term, the company records minimum rental expenses on a straight-line basis over the term of the lease. For purposes of recognizing lease incentives, the company uses the date of initial possession as the commencement date, which is generally when the company is given the right of access to the space and begins to make improvements in preparation of intended use.

Goodwill and Other Purchased Intangible Assets The company performs impairment tests for goodwill as of November 30th of each year, or when evidence of potential impairment exists. When it is determined that

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impairment has occurred, a charge to operations is recorded. Goodwill and other purchased intangible asset balances are included in the identifiable assets of the business segment to which they have been assigned. Any goodwill impairment, as well as the amortization of other purchased intangible assets, is charged against the respective business segments operating margin. Purchased intangible assets are amortized on a straight-line basis over their estimated useful lives.

Self-Insurance Accruals Included in other long-term liabilities is approximately $519 million and $485 million related to self-insured workers compensation as of December 31, 2007, and 2006, respectively. The company estimates the required liability of such claims on a discounted basis utilizing actuarial methods based on various assumptions, which include, but are not limited to, the company s historical loss experience and projected loss development factors.

Litigation, Commitments, and Contingencies Amounts associated with litigation, commitments, and contingencies are recorded as charges to earnings when management, after taking into consideration the facts and circumstances of each matter, including any settlement offers, has determined that it is probable that a liability has been incurred and the amount of the loss can be reasonably estimated.

Retirement Benefits The company sponsors various pension plans covering substantially all employees. The company also provides postretirement benefit plans other than pensions, consisting principally of health care and life insurance benefits, to eligible retirees and qualifying dependents. The liabilities and annual income or expense of the company s pension and other postretirement benefit plans are determined using methodologies that involve several actuarial assumptions, the most significant of which are the discount rate, the long-term rate of asset return (based on the market-related value of assets), and medical trend (rate of growth for medical costs). The fair values of plan assets are determined based on prevailing market prices or estimated fair value for investments with no available quoted prices. Not all net periodic pension income or expense is recognized in net earnings in the year incurred because it is allocated to production as product costs, and a portion remains in inventory at the end of a reporting period. The company s funding policy for pension plans is to contribute, at a minimum, the statutorily required amount to an irrevocable trust.

Foreign Currency Translation For operations outside the U.S. that prepare financial statements in currencies other than the U.S. dollar, results of operations and cash flows are translated at average exchange rates during the period, and assets and liabilities are generally translated at end-of-period exchange rates. Translation adjustments are not material and are included as a separate component of accumulated other comprehensive loss in consolidated shareholders equity.

Accumulated Other Comprehensive Loss The components of accumulated other comprehensive loss are as follows:

	December 31	
$ in millions	**2007**	2006
Cumulative translation adjustment	**$ 34**	$ 22
Unrealized gain on marketable securities, net of tax expense of ($2) in 2007, and ($1) in 2006	**3**	2
Unamortized benefit plan costs, net of tax benefit of $470 as of December 31, 2007 and $900 at December 31, 2006	**(736)**	(1,284)
Total accumulated other comprehensive loss	**$ (699)**	$ (1,260)

Financial Statement Reclassification Certain amounts in the prior year financial statements and related notes have been reclassified to conform to the 2007 presentation of the Interconnect Technologies (ITD) businesses, formerly reported in the Electronics segment, as discontinued operations (see Note 5) and the business operation realignments as of January 1, 2007 (see Note 6).

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2. NEW ACCOUNTING STANDARDS

There have been no changes in the company s critical accounting policies during 2007, except for a change in the measurement and recording of uncertain tax positions in accordance with FIN 48. The expanded disclosure requirements of FIN 48 are presented in Note 12 to the consolidated financial statements.

In January 2008, the FASB issued Statement 133 Implementation Issue No. E23 *Issues Involving the Application of the Shortcut Method under Paragraph 68*. This implementation issue amends the accounting and reporting standards of paragraph 68 of Statement of Financial Accounting Standards (SFAS) No. 133 *Accounting for Derivative Instruments and Hedging Activities* to permit use of the shortcut method for (1) swaps that have a nonzero fair value at inception, provided that the nonzero fair value at inception is attributable solely to a bid-ask spread; and (2) hedged items that have a settlement date after the swap trade date. This implementation issue is effective for hedging relationships designated on or after January 1, 2008, although adoption requires reconsideration of existing fair value hedges accounted for using the short-cut method at the date of adoption. Management is currently evaluating the effect that adoption of this implementation issue will have on the company s consolidated financial position and results of operations upon adoption in 2008.

In December 2007, the FASB issued SFAS No. 141(R) *Business Combinations*. SFAS No. 141(R) expands the definition of a business, thus increasing the number of transactions that will qualify as business combinations. SFAS No. 141(R) requires the acquirer to recognize 100 percent of an acquired business assets and liabilities, including goodwill and certain contingent assets and liabilities, at their fair values at the acquisition date. Contingent consideration will be recognized at fair value on the acquisition date, with changes in fair value recognized in earnings until settled. Likewise, changes in acquired tax contingencies, including those existing at the date of adoption, will be recognized in earnings if outside the maximum allocation period (generally one year). Transaction-related expenses and restructuring costs will be expensed as incurred, and any adjustments to finalize the purchase accounting allocations, even within the allocation period, will be shown as revised in the future financial statements to reflect the adjustments as if they had been recorded on the acquisition date. Finally, a gain could result in the event of a bargain purchase (acquisition of a business below the fair market value of the assets and liabilities), or a gain or loss in the case of a change in the control of an existing investment. SFAS No. 141(R) will be applied prospectively to business combinations with acquisition dates on or after January 1, 2009. Adoption is not expected to materially impact the company s consolidated financial position or results of operations directly when it becomes effective in 2009, as the only impact that the standard will have on recorded amounts at that time is that related to disposition of uncertain tax positions related to prior acquisitions. Following the date of adoption of the standard, the resolution of such items at values that differ from recorded amounts will be adjusted through earnings, rather than through goodwill. Adoption of this statement is, however, expected to have a significant effect on how acquisition transactions subsequent to January 1, 2009 are reflected in the financial statements.

In December 2007, the FASB issued SFAS No. 160 *Noncontrolling Interests in Consolidated Financial Statements an amendment of Accounting Research Bulletin (ARB) No. 51.* SFAS No. 160 requires (1) presentation of ownership interests in subsidiaries held by parties other than the parent within equity in the consolidated statements of financial position, but separately from the parent s equity; (2) separate presentation of the consolidated net income attributable to the parent and to the minority interest on the face of the consolidated statements of income; (3) accounting for changes in a parent s ownership interest where the parent retains its controlling financial interest in its subsidiary as equity transactions; (4) initial measurement of the noncontrolling interest retained for any deconsolidated subsidiaries at fair value with recognition of any resulting gains or losses through earnings; and (5) additional disclosures that identify and distinguish between the interests of the parent and noncontrolling owners. SFAS No. 160 is effective for

the company beginning January 1, 2009. Adoption of this statement is not expected to have a material impact on the company s consolidated financial position and results of operations when it becomes effective in 2009, but will significantly affect the accounting for noncontrolling (or minority) interests from that date forward.

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In December 2007, the EITF issued EITF Issue No. 07-1 *Accounting for Collaborative Arrangements*. Issue No. 07-1 defines collaborative arrangements and establishes reporting and disclosure requirements for transactions between participants in a collaborative arrangement and between participants in the arrangement and third parties. EITF Issue No. 07-1 is effective for the company beginning January 1, 2009. Management is currently evaluating the effect that adoption of this issue will have on the company s consolidated financial position and results of operations when it becomes effective in 2009.

In September 2006, the FASB issued SFAS No. 157 *Fair Value Measurements*, which defines fair value, establishes a framework for consistently measuring fair value under generally accepted accounting principles, and expands disclosures about fair value measurements. In February 2008, the FASB issued Staff Position (FSP) FAS 157-2, *Effective Date of FASB Statement No. 157*, which defers the implementation for the non-recurring nonfinancial assets and liabilities from fiscal years beginning after November 15 , 2007 to fiscal years beginning after November 15, 2008. The provisions of SFAS No. 157 will be applied prospectively. The statement provisions effective as of January 1, 2008, do not have a material effect on the company s consolidated financial position and results of operations. Management does not believe that the remaining provisions will have a material effect on the company s consolidated financial position and results of operations when they become effective on January 1, 2009.

3. COMMON STOCK DIVIDENDS

On February 21, 2007, the company s Board of Directors approved a 23 percent increase to the quarterly common stock dividends, from $.30 per share to $.37 per share, effective with the first quarter 2007 dividends.

On May 17, 2006, the company s Board of Directors approved a 15 percent increase to the quarterly common stock dividends, from $.26 per share to $.30 per share, effective with the second quarter 2006 dividends.

On March 23, 2005, the company s Board of Directors approved a 13 percent increase to the quarterly common stock dividends, from $.23 per share to $.26 per share, effective with the second quarter 2005 dividends.

4. BUSINESS ACQUISITIONS

2007 In January 2007, the company acquired Essex Corporation (Essex) for approximately $590 million in cash, including estimated transaction costs of $15 million, and the assumption of debt totaling $23 million. Essex provides signal processing services and products, and advanced optoelectronic imaging for U.S. government intelligence and defense customers. The operating results of Essex are reported in the Mission Systems segment. The assets, liabilities, and results of operations of Essex were not material to the company s consolidated financial position or results of operations, and thus pro-forma information is not presented.

In July 2007, the company and Science Applications International Corporation (SAIC) reorganized their joint venture AMSEC, LLC (AMSEC), by dividing AMSEC along customer and product lines. AMSEC is a full-service supplier that provides engineering, logistics and technical support services primarily to Navy ship and aviation programs. Under the reorganization plan, the company retained the ship engineering, logistics and technical service businesses under the AMSEC name (the AMSEC Businesses) and, in exchange, SAIC received the aviation, combat systems and strike force integration services businesses from AMSEC (the Divested Businesses). This reorganization was treated as a step acquisition for the acquisition of SAIC s interests in the AMSEC Businesses, with the company recognizing a pre-tax gain of $23 million for the effective sale of its interests in the Divested Businesses. The operating results of the AMSEC Businesses and transaction gain have been reported in the Ships segment. Prior to the reorganization, the

company accounted for AMSEC, LLC under the equity method. The assets, liabilities, and results of operations of the AMSEC Businesses were not material to the company s consolidated financial position or results of operations, and thus pro-forma information is not presented. The consolidated financial statements reflect preliminary estimates of the fair value of the assets acquired and liabilities assumed and the related allocation of the purchase price for the entities acquired. Management does not expect adjustments to these estimates, if any, to have a material effect on the company s consolidated financial position or results of operations.

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During the third quarter of 2007, the company acquired Xinetics Inc., reported in the Space Technology segment, and the remaining 61 percent of Scaled Composites, LLC, reported in the Integrated Systems segment, for an aggregate amount of approximately $100 million in cash. The assets, liabilities, and results of operations of these entities were not material to the company s consolidated financial position or results of operations, and thus pro-forma information is not presented. The consolidated financial statements reflect preliminary estimates of the fair value of the assets acquired and liabilities assumed and the related allocation of the purchase price for the entities acquired. Management does not expect adjustments to these estimates, if any, to have a material effect on the company s consolidated financial position or results of operations.

2006 There were no significant acquisitions during 2006.

2005 The company acquired Confluent RF Systems Corporation, reported in the Integrated Systems segment, for $42 million in cash, which included transaction costs of $2 million, and Integic Corporation, reported in the Information Technology segment, for $319 million in cash, which included transaction costs of $6 million.

5. BUSINESS DISPOSITIONS

2007 During the second quarter, management announced its decision to exit the remaining ITD business reported within the Electronics segment. Sales for this business for the years ended December 31, 2007, 2006, and 2005, were $14 million, $35 million, and $89 million, respectively. The shut-down was completed during the third quarter of 2007 and costs associated with the shutdown were not material. The results of this business are reported as discontinued operations in the consolidated statements of income, net of applicable income taxes, for all periods presented.

2006 The company sold the assembly business unit of ITD during the first quarter of 2006 and Winchester Electronics (Winchester) during the second quarter of 2006 for net cash proceeds of $26 million and $17 million, respectively, and recognized after-tax gains of $4 million and $2 million, respectively, in discontinued operations. The results of operations of the assembly business unit of ITD are reported as discontinued operations in the consolidated statements of income, net of applicable income taxes. The results of operations of Winchester, reported in the Electronics segment, were not material to any of the periods presented and have therefore not been reclassified as discontinued operations.

During the second quarter of 2006, the Enterprise Information Technology business, formerly reported in the Information Technology segment, was shut down and costs associated with the exit activities were not material. The results of operations of this business are reported as discontinued operations in the consolidated statements of income, net of applicable income taxes.

2005 The company sold Teldix GmbH (Teldix) for $57 million in cash and recognized an after-tax gain of $14 million in discontinued operations. The results of operations of Teldix, reported in the Electronics segment, were not material to any of the periods presented and have therefore not been reclassified as discontinued operations.

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Discontinued Operations Sales and operating results of the businesses classified within discontinued operations were as follows:

	Year ended December 31		
$ in millions	**2007**	2006	2005
Sales and service revenues	**$ 14**	$ 191	$ 743
Loss from discontinued operations	**(20)**	(39)	(21)
Income tax benefit	**7**	14	8
Loss from discontinued operations, net of tax	**(13)**	(25)	(13)
(Loss) gain from divestitures		11	24
Income tax expense		(17)	(7)
(Loss) gain from discontinued operations, net of tax	**$ (13)**	$ (31)	$ 4

Tax rates on discontinued operations vary from the company s effective tax rate due to the non-deductibility of goodwill for tax purposes. The amounts associated with discontinued operations on the consolidated statements of financial position are not material as of December 31, 2007 and 2006, and have been included in other assets.

6. SEGMENT INFORMATION

The company is aligned into seven reportable segments categorized into four primary businesses. The Mission Systems, Information Technology, and Technical Services segments are presented as Information & Services. The Integrated Systems and Space Technology segments are presented as Aerospace. The Electronics and Ships segments are each presented as separate businesses. Newport News and Ship Systems are aggregated and reported as the Ships business in accordance with the provisions of SFAS No. 131 *Disclosures about Segments of an Enterprise and Related Information.*

Information & Services

Mission Systems Mission Systems is a leading global systems integrator of complex, mission-enabling systems for government, military, and business clients. Products and services are focused on the fields of Command, Control, Communications, Computers and Intelligence (C4I), strategic missiles, missile and air defense, airborne reconnaissance, intelligence management and processing, and decision support systems.

Information Technology Information Technology is a premier provider of IT systems engineering and systems integration for the DoD, national intelligence, federal, civilian, state and local agencies, and commercial customers.

Technical Services Technical Services is a leading provider of logistics, infrastructure, and sustainment support, while also providing a wide array of technical services including training and simulation.

Aerospace

Integrated Systems Integrated Systems is a leader in the design, development, and production of airborne early warning, electronic warfare and surveillance systems, and battlefield management systems, as well as manned and

unmanned tactical and strike systems.

Space Technology Space Technology develops and integrates a broad range of systems at the leading edge of space, defense, and electronics technology. The segment supplies products primarily to the U.S. Government that play an important role in maintaining the nation s security and leadership in science and technology. Space Technology s business areas focus on the design, development, manufacture, and integration of satellite systems and subsystems, electronic and communications payloads, and high energy laser systems and subsystems.

Electronics

Electronics is a leading designer, developer, manufacturer and integrator of a variety of advanced electronic and maritime systems for national security and select non-defense applications. Electronics provides systems to

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U.S. and international customers for such applications as airborne surveillance, aircraft fire control, precision targeting, electronic warfare, automatic test equipment, inertial navigation, integrated avionics, space sensing, intelligence processing, air traffic control, air and missile defense, communications, mail processing, biochemical detection, ship bridge control, and shipboard components.

Ships

Ships is the nation s sole industrial designer, builder, and refueler of nuclear-powered aircraft carriers and one of only two companies capable of designing and building nuclear-powered submarines for the U.S. Navy. Ships is also one of the nation s leading full service systems providers for the design, engineering, construction, and life cycle support of major surface ships for the U.S. Navy, U.S. Coast Guard, international navies, and for commercial vessels of all types.

Summary Segment Financial Information

U.S. Government Sales In the following table of segment and major customer data, revenue from the U.S. Government includes revenue from contracts for which Northrop Grumman is the prime contractor as well as those for which the company is a subcontractor and the ultimate customer is the U.S. Government.

Foreign Sales Direct foreign sales amounted to approximately $1.8 billion, $1.6 billion, and $1.7 billion, or 5.5 percent, 5.2 percent, and 5.5 percent of total revenue for the years ended December 31, 2007, 2006, and 2005, respectively.

Discontinued Operations The company s discontinued operations are excluded from all of the data elements in the following tables, except for assets by segment.

Assets Substantially all of the company s assets are located or maintained in the United States.

Realignments The company, from time to time, acquires or disposes of businesses, and realigns contracts, programs or business areas among and within its operating segments that possess similar customers, expertise, and capabilities. These realignments are designed to more fully leverage existing capabilities and enhance development and delivery of products and services. In January 2007, certain programs and business areas were transferred between Information Technology, Mission Systems, Space Technology, and Technical Services. The sales and segment operating margin in the following tables have been revised, where applicable, to reflect these realignments for all periods presented.

Subsequent Realignments In January 2008, the Newport News and Ship Systems sectors were realigned into a single segment called Northrop Grumman Shipbuilding to enable the company to more effectively utilize its shipbuilding assets and deploy its talented shipbuilders, processes, technologies, production facilities and planned capital investment to meet customer needs. This realignment had no impact on the company s consolidated financial position, results of operations, cash flows, or segment reporting.

Also in January 2008, the company announced the transfer of certain programs and assets from the Mission Systems segment to the Space Technology segment, effective July 1, 2008. This transfer will allow Mission Systems to focus on the rapidly growing command, control, communications, computers, intelligence, surveillance, and reconnaissance business, and the missiles business will be an integrated element of the company s Aerospace business growth strategy. In addition, certain Electronics businesses were transferred to Mission Systems effective January 2008. The transfer of these businesses is not expected to have a material effect on the company s consolidated financial position, results of operations, or cash flows.

These subsequent realignments have not been reflected in any of the accompanying financial information.

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Results of Operations By Segment and Major Customer

	Year ended December 31		
$ in millions	**2007**	2006	2005
Sales and Service Revenues			
Information & Services			
Mission Systems			
United States Government	**$ 5,441**	$ 5,021	$ 5,019
Other customers	**89**	54	46
Intersegment sales	**401**	419	429
	5,931	5,494	5,494
Information Technology			
United States Government	**3,298**	3,063	2,921
Other customers	**1,042**	761	683
Intersegment sales	**146**	138	132
	4,486	3,962	3,736
Technical Services			
United States Government	**1,793**	1,483	1,282
Other customers	**92**	103	80
Intersegment sales	**292**	272	255
	2,177	1,858	1,617
Aerospace			
Integrated Systems			
United States Government	**4,789**	5,277	5,272
Other customers	**205**	169	170
Intersegment sales	**73**	54	47
	5,067	5,500	5,489
Space Technology			
United States Government	**3,022**	2,800	2,785
Other customers	**67**	87	66
Intersegment sales	**44**	36	15
	3,133	2,923	2,866
Electronics			
United States Government	**4,608**	4,112	4,015
Other customers	**1,798**	1,872	1,813

Intersegment sales	**500**	559	685
	6,906	6,543	6,513
Ships			
United States Government	**5,749**	5,263	5,727
Other customers	**25**	48	57
Intersegment sales	**14**	10	2
	5,788	5,321	5,786
Intersegment eliminations	**(1,470)**	(1,488)	(1,523)
Total sales and service revenues	**$ 32,018**	$ 30,113	$ 29,978

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Other Financial Information

$ in millions	Year ended December 31 **2007**	2006	2005
Operating Margin			
Information & Services			
Mission Systems	**$ 566**	$ 519	$ 424
Information Technology	**329**	342	322
Technical Services	**120**	120	100
Aerospace			
Integrated Systems	**591**	551	499
Space Technology	**261**	245	219
Electronics	**813**	754	709
Ships	**538**	393	249
Intersegment eliminations	**(115)**	(117)	(101)
Total Segment Operating Margin	**3,103**	2,807	2,421
Non-segment factors affecting operating margin			
Unallocated expenses	**(224)**	(306)	(200)
Net pension adjustment	**127**	(37)	(21)
Total operating margin	**$ 3,006**	$ 2,464	$ 2,200

Unallocated Expenses Unallocated expenses includes the portion of corporate expenses not considered allowable or allocable under applicable U.S. Government Cost Accounting Standards (CAS) regulations and the Federal Acquisition Regulation, and therefore not allocated to the segments, such as management and administration, legal, environmental, certain compensation and retiree benefits, and other expenses.

Net Pension Adjustment The net pension adjustment reflects the difference between pension expense determined in accordance with accounting principles generally accepted in the United States of America and pension expense allocated to the operating segments determined in accordance with CAS.

$ in millions	December 31, **2007**	2006
Assets		
Information & Services		
Mission Systems	**$ 5,856**	$ 4,789
Information Technology	**3,576**	3,289
Technical Services	**1,133**	1,108
Aerospace		
Integrated Systems	**2,217**	2,202
Space Technology	**3,993**	4,453
Electronics	**5,315**	5,454

Ships	**6,874**	6,946
Segment assets	**28,964**	28,241
Corporate	**4,409**	3,768
Total assets	**$ 33,373**	$ 32,009

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Other Financial Information (Continued)

$ in millions	Year ended December 31 **2007**	2006	2005
Capital Expenditures			
Information & Services			
Mission Systems	**$ 43**	$ 49	$ 70
Information Technology	**42**	32	35
Technical Services	**9**	4	5
Aerospace			
Integrated Systems	**100**	119	142
Space Technology	**108**	103	107
Electronics	**124**	130	165
Ships	**247**	287	266
Corporate	**12**	13	33
Total capital expenditures	**$ 685**	$ 737	$ 823
Depreciation and Amortization			
Information & Services			
Mission Systems	**$ 59**	$ 40	$ 66
Information Technology	**64**	46	49
Technical Services	**7**	7	8
Aerospace			
Integrated Systems	**108**	110	102
Space Technology	**127**	126	133
Electronics	**180**	211	247
Ships	**170**	153	155
Corporate	**15**	12	12
Total depreciation and amortization	**$ 730**	$ 705	$ 772

7. EARNINGS PER SHARE

Basic Earnings Per Share Basic earnings per share from continuing operations are calculated by dividing income from continuing operations available to common shareholders by the weighted-average number of shares of common stock outstanding during each period.

Diluted Earnings Per Share Diluted earnings per share include the dilutive effect of stock options and other stock awards granted to employees under stock-based compensation plans, and for 2007 and 2006, 6.4 million dilutive shares from the company s mandatorily redeemable convertible series B preferred stock (Note 14). The dilutive effect of these potential common stock instruments totaled 12.6 million, 12.9 million, and 6.7 million shares for the years ended December 31, 2007, 2006, and 2005, respectively. The weighted-average diluted shares outstanding for the years ended December 31, 2007, 2006, and 2005, exclude stock options to purchase approximately 59 thousand

shares, 8 thousand shares, and 4 million shares, respectively, because such options have an exercise price in excess of the average market price of the company s common stock during the year.

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Diluted earnings per share from continuing operations are calculated as follows:

in millions, except per share	December 31, **2007**	2006	2005
Diluted Earnings Per Share From Continuing Operations			
Income from continuing operations	**$ 1,803**	$ 1,573	$ 1,396
Add dividends on mandatorily redeemable convertible preferred stock	**24**	24	
Income from continuing operations available to common shareholders	**$ 1,827**	$ 1,597	$ 1,396
Weighted-average common shares outstanding	**341.7**	345.7	356.5
Dilutive effect of stock options, awards, and mandatorily redeemable convertible preferred stock	**12.6**	12.9	6.7
Weighted-average diluted common shares outstanding	**354.3**	358.6	363.2
Diluted earnings per share from continuing operations	**$ 5.16**	$ 4.46	$ 3.84

Share Repurchases The table below summarizes the company s share repurchases beginning January 1, 2005:

Authorization Date	Amount Authorized (in billions)	Average Price Per Share	Total Shares Retired (in millions)	Date Completed	Shares Repurchased (in millions) 2007	2006	2005
October 26, 2004	$ 1.0	$ 54.83	18.2	September 2005			12.7
October 24, 2005	1.5	65.08	23.0	February 2007	2.3	11.6	9.1
December 14, 2006	1.0	75.96	13.1	November 2007	13.1		
December 20, 2007	2.5						
					15.4	11.6	21.8

As part of the share repurchase programs, the company has entered into four separate accelerated share repurchase agreements since November 2005, with two different banks (the Banks) to repurchase shares of common stock. In each case, shares were immediately borrowed by the Banks that were then sold to and canceled by the company. Subsequently, shares were purchased in the open market by the Banks to settle their share borrowings. Under these arrangements, the cost of the company s share repurchases was subject to adjustment based on the actual cost of the shares subsequently purchased by the Banks. If an additional amount was owed by the company upon settlement, the price adjustment could have been settled, at the company s option, in cash or in shares of common stock.

The table below summarizes the accelerated share repurchase transactions:

Agreement Date	Shares Repurchased (in millions)	Completion Date	Final Average Purchase Price Per Share	Dollar Amount of Shares Repurchased (in millions)
November 4, 2005	9.1	March 1, 2006	$ 59.05	$ 537
March 6, 2006	11.6	May 26, 2006	68.01	788
February 21, 2007	8.0	June 7, 2007	73.86	592
July 30, 2007	6.5	September 17, 2007	77.27	502

Share repurchases take place at management s discretion or under pre-established non-discretionary programs from time to time, depending on market conditions, in the open market, and 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 programs.

As of December 31, 2007, the company has authorization to repurchase $2.5 billion shares of its common stock.

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8. ACCOUNTS RECEIVABLE, NET

Unbilled amounts represent sales for which billings have not been presented to customers at year-end. These amounts are usually billed and collected within one year. Progress payments are received on a number of fixed-price contracts.

Accounts receivable at December 31, 2007, are expected to be collected in 2008, except for approximately $262 million due in 2009 and $118 million due in 2010 and later.

Allowances for doubtful amounts mainly represent estimates of overhead costs which may not be successfully negotiated and collected.

Accounts receivable were composed of the following:

	December 31,	
$ in millions	**2007**	2006
Due From U.S. Government, Long-Term Contracts		
Billed	**$ 1,158**	$ 1,054
Unbilled	**38,867**	33,004
Progress payments received	**(37,477)**	(31,637)
	2,548	2,421
Due From Other Customers, Long-Term Contracts		
Billed	**305**	212
Unbilled	**3,228**	2,975
Progress payments received	**(2,712)**	(2,390)
	821	797
Total due, long-term contracts	**3,369**	3,218
Trade And Other Accounts Receivable		
Due from U.S. Government	**544**	477
Due from other customers	**472**	233
Progress payments received	**(286)**	(58)
Total due, trade and other	**730**	652
	4,099	3,870
Allowances for doubtful amounts	**(286)**	(308)
Total accounts receivable, net	**$ 3,813**	$ 3,562

9. INVENTORIED COSTS, NET

Inventoried costs were composed of the following:

	December 31,	
$ in millions	**2007**	2006
Production costs of contracts in process	**$ 1,910**	$ 1,951
General and administrative expenses	**172**	184
	2,082	2,135
Progress payments received	**(1,348)**	(1,226)
	734	909
Product inventory	**311**	267
Total inventoried costs, net	**$ 1,045**	$ 1,176

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10. GOODWILL AND OTHER PURCHASED INTANGIBLE ASSETS

Goodwill

Goodwill and other purchased intangible assets are included in the identifiable assets of the segment to which they have been assigned. Impairment tests are performed at least annually and more often as circumstances require. Any goodwill impairment, as well as the amortization of other purchased intangible assets, is charged against the respective segment s operating margin. The annual impairment test for all segments was performed as of November 30, 2007, with no indication of impairment. In performing the goodwill impairment tests, the company uses a discounted cash flow approach corroborated by comparative market multiples, where appropriate, to determine the fair value of reporting units.

The changes in the carrying amounts of goodwill during 2007 and 2006, are as follows:

$ in millions	**Mission Systems**	**Information Technology**	**Technical Services**	**Integrated Systems**	**Space Technology**	**Electronics**	**Ships**	**Total**
Balance as of January 1, 2006	$ 4,256	$ 2,649		$ 992	$ 3,295	$ 2,575	$ 3,616	$ 17,383
Goodwill transferred due to segment realignment	(336)	(403)	$ 792	(13)		(40)		
Fair value adjustments to net assets acquired	(37)	(27)	(5)	(3)	(41)	(19)	(32)	(164)
Balance as of December 31, 2006	3,883	2,219	787	976	3,254	2,516	3,584	17,219
Goodwill transferred due to segment realignment	346		34		(380)			
Goodwill acquired	522			47	37		57	663
Adjustment to initially apply FIN 48	(22)	(7)	(3)		(18)	(1)	(12)	(63)
Fair value adjustments to net assets acquired	(52)	(28)	(8)	(2)	(41)	(1)	(15)	(147)
Balance as of December 31, 2007	**$ 4,677**	**$ 2,184**	**$ 810**	**$ 1,021**	**$ 2,852**	**$ 2,514**	**$ 3,614**	**$ 17,672**

Segment Realignment Effective in January 2007, the Software Defined Radios business area was transferred from Space Technology to Mission Systems and Technical Services. As a result of this realignment, goodwill of approximately $380 million was reallocated among these three segments. Effective January 1, 2006, the company realigned businesses among four of its operating segments to form a new segment. As a result of this realignment, goodwill of approximately $792 million was reallocated among these five segments.

Fair Value Adjustments to Net Assets Acquired For 2007, the fair value adjustments were primarily due to the favorable settlement of Internal Revenue Service (IRS) audits and a claim for a tax refund. For 2006, the fair value adjustments were primarily due to the favorable settlement of IRS audits and the realization of additional capital loss carryforward tax assets.

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Purchased Intangible Assets
The table below summarizes the company s aggregate purchased intangible assets as follows:

	December 31, 2007			December 31, 2006		
$ in millions	Gross Carrying Amount	Accumulated Amortization	Net Carrying Amount	Gross Carrying Amount	Accumulated Amortization	Net Carrying Amount
Contract and program intangibles	$ 2,661	$ (1,616)	$ 1,045	$ 2,594	$ (1,487)	$ 1,107
Other purchased intangibles	100	(71)	29	100	(68)	32
Total	$ 2,761	$ (1,687)	$ 1,074	$ 2,694	$ (1,555)	$ 1,139

The company s purchased intangible assets are subject to amortization and are being amortized on a straight-line basis over an aggregate weighted-average period of 21 years. Aggregate amortization expense for 2007, 2006, and 2005, was $132 million, $134 million, and $216 million, respectively.

The table below shows expected amortization for purchased intangibles as of December 31, 2007, for each of the next five years:

$ in millions	
Year ending December 31	
2008	$ 122
2009	112
2010	92
2011	54
2012	52

11. FAIR VALUE OF FINANCIAL INSTRUMENTS

Carrying amounts and the related estimated fair values of the company s financial instruments at December 31 are as follows:

	2007		2006	
$ in millions	Carrying Amount	Fair Value	Carrying Amount	Fair Value
Cash and cash equivalents	$ 963	$ 963	$ 1,015	$ 1,015
Investments in marketable securities	258	258	208	208
Cash surrender value of life insurance policies	315	315	290	290
Short-term notes payable	(26)	(26)	(95)	(95)
Long-term debt	(4,029)	(4,488)	(4,067)	(4,562)

Mandatorily redeemable preferred stock	**(350)**	**(510)**	(350)	(459)
Interest rate swaps	**4**	**4**	(8)	(8)
Foreign currency forward contracts	**4**	**4**		

Short-Term Instruments For cash and cash equivalents and amounts borrowed under the company s short-term credit lines, the carrying amounts approximate fair value, due to the short-term nature of these items.

Investments in Marketable Securities The company holds a portfolio of securities, primarily consisting of equity securities that are classified as trading.

Cash Surrender Value of Life Insurance Policies The company maintains whole life insurance policies on a group of executives in connection with deferred compensation arrangements. These policies are recorded at their cash

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surrender value as determined by the insurance carrier. Additionally, the company has policies with split dollar arrangements which are recorded at the lesser of their cash surrender value or premiums paid. The amounts associated with these policies are recorded in miscellaneous other assets in the consolidated statements of financial position.

Long-Term Debt The fair value of the long-term debt was calculated based on interest rates available for debt with terms and due dates similar to the company s existing debt arrangements.

Mandatorily Redeemable Preferred Stock The fair value of the mandatorily redeemable preferred stock was calculated based on the closing market price quoted on the New York Stock Exchange at December 31, 2007, and 2006, respectively.

Interest Rate Swaps The company has from time to time entered into interest rate swap agreements to mitigate interest rate risk. As described in Note 1, two interest rate swap agreements were in effect at December 31, 2007, and 2006.

Foreign Currency Forward Contracts The company enters into foreign currency forward contracts to manage foreign currency exchange risk related to receipts from customers and payments to suppliers denominated in foreign currencies. Gains and losses from such transactions are included as contract costs.

12. INCOME TAXES

The company s effective tax rates on income from continuing operations were 33 percent, 31 percent, and 32 percent for the years ended December 31, 2007, 2006, and 2005, respectively. During 2007, the company reached a partial settlement agreement with the IRS regarding its audit of the company s tax years ended December 31, 2001 through 2003 (see below). During 2006, the company reached final approval with the IRS regarding its audit of the company s B-2 program for the years ended December 31, 1997 through December 31, 2000. As a result, during 2007 and 2006, the company recognized net tax benefits of $22 and $48 million, respectively, due to the reversal of previously established expense provisions. The company also recognized a net tax benefit of $18 million in 2006 related to tax credits associated with qualified wages paid to employees affected by Hurricane Katrina.

Income tax expense, both federal and foreign, consisted of the following:

	Year ended December 31		
$ in millions	**2007**	2006	2005
Income Taxes on Continuing Operations			
Currently Payable			
Federal income taxes	**$ 671**	$ 528	$ 503
Foreign income taxes	**42**	27	27
Total federal and foreign income taxes currently payable	**713**	555	530
Change in deferred federal and foreign income taxes	**170**	158	139
Total federal and foreign income taxes	**$ 883**	$ 713	$ 669

The geographic source of income from continuing operations before income taxes is as follows:

	Year ended December 31		
$ in millions	**2007**	2006	2005
Domestic income	**$ 2,595**	$ 2,214	$ 1,990
Foreign income	**91**	72	75
Income from continuing operations before income taxes	**$ 2,686**	$ 2,286	$ 2,065

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Income tax expense differs from the amount computed by multiplying the statutory federal income tax rate times the income from continuing operations before income taxes due to the following:

	Year ended December 31		
$ in millions	**2007**	2006	2005
Income tax expense on continuing operations at statutory rate	**$ 940**	$ 801	$ 723
Manufacturing deduction	**(19)**	(9)	(9)
Research tax credit	**(14)**	(3)	(3)
Extraterritorial income exclusion/foreign sales corporation		(6)	(6)
Wage credit		(18)	
Settlement of IRS appeals cases	**(22)**	(55)	(27)
Other, net	**(2)**	3	(9)
Total federal and foreign income taxes	**$ 883**	$ 713	$ 669

Uncertain Tax Positions The company adopted the provisions of FIN 48 in 2007. As a result of the implementation of FIN 48, the company made a comprehensive review of its portfolio of uncertain tax positions in accordance with recognition standards established by FIN 48. In this regard, an uncertain tax position represents the company s expected treatment of a tax position taken in a filed tax return, or planned to be taken in a future tax return or claim, that has not been reflected in measuring income tax expense for financial reporting purposes. Until these positions are sustained by the taxing authorities, the company has not recognized the tax benefits resulting from such positions and reports the tax effects as a liability for uncertain tax positions in its consolidated statements of financial position. The company recognizes interest accrued related to unrecognized tax benefits in income tax expense. Penalties, if probable and reasonably estimable, are recognized as a component of income tax expense.

As a result of this review, the company adjusted the estimated value of its uncertain tax positions on January 1, 2007, by recognizing additional liabilities totaling $66 million through a charge to retained earnings, and reducing the carrying value of uncertain tax positions resulting from prior acquisitions by $63 million through a reduction of goodwill. Upon the adoption of FIN 48 at January 1, 2007, the estimated value of the company s uncertain tax positions was a liability of $514 million, which includes accrued interest of $55 million. If the company s positions are sustained by the taxing authority in favor of the company, approximately $331 million would be treated as a reduction of goodwill, and the balance of $183 million would reduce the company s effective tax rate.

As of December 31, 2007, the estimated value of the company s uncertain tax positions was a liability of $554 million, which includes accrued interest of $68 million. If the company s positions are sustained by the taxing authority in favor of the company, approximately $394 million would be treated as a reduction of goodwill, and the balance of $160 million would reduce the company s effective tax rate.

The change in unrecognized tax benefits during 2007, excluding interest, is as follows:

$ in millions	Unrecognized Tax Benefit
Balance at January 1, 2007	$ 459

Additions based on tax positions related to the current year		18
Additions for tax positions of prior years		85
Reductions for tax positions of prior years		(57)
Settlements		(17)
Net change in unrecognized tax benefits		29
Balance at December 31, 2007	$	488

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In connection with the IRS examination of the company s income tax returns for the years ended 2001 through 2003, the company reached a partial settlement agreement with the IRS at the examination level during 2007. In January 2008, the company reached a tentative partial settlement agreement with IRS Appeals on substantially all of the remaining issues for the audit of the years 2001 2003. This agreement is subject to review by the Congressional Joint Committee on Taxation (Joint Committee). Although the final outcome is not determinable until the Joint Committee completes its review, during 2008, it is reasonably possible that a reduction to unrecognized tax benefits of up to $59 million may occur, which could result in a reduction to tax expense of $10 million. Also as part of the tentative partial agreement, the company anticipates that the net capital loss carryforward benefit will be reduced by $346 million.

In addition, pursuant to the company s merger with TRW in December 2002, the company is liable for tax deficiencies of TRW and its subsidiaries prior to the merger. The IRS examined the TRW income tax returns for the years ended 1999 through the date of the merger and asserted tax deficiencies for those years to which the company took exception. The 1999 through 2002 TRW audit deficiencies are currently under consideration at IRS Appeals. In January 2008 the company and the IRS reached a tentative agreement with respect to the proposed tax deficiencies. Although the final outcome is not determinable until the Joint Committee completes its review, during 2008 it is reasonably possible that a reduction to unrecognized tax benefits of up to $82 million may occur, all of which would result in a reduction to goodwill.

The company s federal tax returns for the years 2004 through 2006 are currently under examination by the IRS. In addition, open tax years related to state and foreign jurisdictions remain subject to examination but are not considered material.

Although the company believes it has adequately provided for all tax positions, amounts asserted by taxing authorities could be greater than the company s accrued position. Accordingly, additional provisions on federal, foreign and state tax related matters could be recorded in the future as revised estimates are made or the underlying matters are effectively settled or otherwise resolved.

During the year ended December 31, 2007, the company recorded approximately $14 million for tax-related interest and penalties.

Deferred Income Taxes Deferred income taxes reflect the net tax effects of temporary differences between the carrying amounts of assets and liabilities for financial reporting purposes and tax purposes. Such amounts are classified in the consolidated statements of financial position as current or noncurrent assets or liabilities based upon the classification of the related assets and liabilities.

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The tax effects of significant temporary differences and carryforwards that gave rise to year-end deferred federal, state and foreign tax balances, as presented in the consolidated statements of financial position, are as follows:

	December 31,	
$ in millions	**2007**	2006
Deferred Tax Assets		
Retirement benefit plan expense	**$ 610**	$ 1,067
Provision for accrued liabilities	**796**	693
Tax credits and carryforwards		
Capital loss	**592**	1,120
Foreign income tax credit		180
Other	**462**	415
Gross deferred tax assets	**2,460**	3,475
Less valuation allowance	**(592)**	(1,300)
Net deferred tax assets	**1,868**	2,175
Deferred Tax Liabilities		
Provision for accrued liabilities	**61**	37
Contract accounting differences	**284**	
Purchased intangibles	**327**	292
Depreciation and amortization	**418**	533
Goodwill amortization	**505**	444
Gross deferred tax liabilities	**1,595**	1,306
Total net deferred tax assets	**$ 273**	$ 869

Net deferred tax assets (liabilities) as presented in the consolidated statements of financial position are as follows:

	December 31,	
$ in millions	**2007**	2006
Net current deferred tax assets	**$ 542**	$ 706
Net non-current deferred tax assets	**65**	165
Net current deferred tax liabilities	**(4)**	(2)
Net non-current deferred tax liabilities	**(330)**	
Total net deferred tax assets	**$ 273**	$ 869

Foreign Income Deferred income taxes have not been provided on accumulated undistributed earnings of foreign subsidiaries of $358 million at December 31, 2007, as the company intends to permanently reinvest these earnings,

thereby indefinitely postponing their remittance. Should these earnings be distributed in the form of dividends or otherwise, the distributions would be subject to U.S. federal income tax at the statutory rate of 35 percent, less foreign tax credits applicable to such distributions, if any. In addition, such distributions would be subject to withholding taxes in the various tax jurisdictions.

Tax Carryforwards The company has a capital loss tax carryforward at December 31, 2007, against which a full valuation allowance has been recorded. The majority of the capital loss carryforward, which primarily arose from the sale of TRW Auto, will expire in 2008. In connection with the partial settlement agreement reached during 2007 for the tax return years ended 2001 through 2003, the capital loss carryforward and related valuation allowance decreased by $528 million during 2007. Future reductions to the valuation allowance resulting from the recognition of tax benefits, if any, will reduce goodwill. During 2007, foreign income tax credit carryforward

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items of $180 million were utilized and, as a result, the foreign tax credit carryforward and the associated valuation allowance were reversed.

13. NOTES PAYABLE TO BANKS AND LONG-TERM DEBT

Lines of Credit The company has available short-term credit lines in the form of money market facilities with several banks. The amount and conditions for borrowing under these credit lines depend on the availability and terms prevailing in the marketplace. No fees or compensating balances are required for these credit facilities.

Credit Facility In August of 2005, the company entered into a credit agreement which provides for a five-year revolving credit facility in an aggregate principal amount of $2 billion. The credit facility permits the company to request additional lending commitments from the lenders under the agreement or other eligible lenders under certain circumstances, and thereby increase the aggregate principal amount of the lending commitments under the agreement by up to an additional $500 million. The agreement provides for swingline loans and letters of credit as sub-facilities for the credit facilities provided for in the agreement. Borrowings under the credit facility bear interest at various rates, including the London Interbank Offered Rate, adjusted based on the company s credit rating, or an alternate base rate plus an incremental margin. The credit facility also requires a facility fee based on the daily aggregate amount of commitments (whether or not utilized) and the company s credit rating level. The company s credit agreement contains certain financial covenants relating to a maximum debt to capitalization ratio, and certain restrictions on additional asset liens, unless permitted by the agreement. In August of 2007, the company entered into an amended and restated credit agreement amending the company s 2005 credit agreement. The agreement extends the maturity date of the credit facility from August 5, 2010 to August 10, 2012 and provides improved pricing terms, reduced facility fees, and full availability of the facility for letters of credit. At December 31, 2007, and 2006, there was no balance outstanding under this facility. There was a maximum of $350 million borrowed under this facility during 2007 and no borrowings during 2006. As of December 31, 2007, the company was in compliance with all covenants.

Concurrent with the effectiveness of the 2005 credit agreement, the prior credit agreement, for $2.5 billion, was terminated. No principal or interest was outstanding or accrued and unpaid under the prior credit agreement on its termination date.

Gulf Opportunity Zone Industrial Development Revenue Bonds In December 2006, Ships entered into a loan agreement with the Mississippi Business Finance Corporation (MBFC) under which Ships received access to $200 million from the issuance of Gulf Opportunity Zone Industrial Development Revenue Bonds by the MBFC. The loan accrues interest payable semi-annually at a fixed rate of 4.55 percent per annum. The company s obligation related to these bonds is recorded in long-term debt in the consolidated statements of financial position. The bonds are subject to redemption at the company s discretion on or after December 1, 2016, and will mature on December 1, 2028. The bond issuance proceeds must be used to finance the construction, reconstruction, and renovation of the company s interest in certain ship manufacturing and repair facilities, or portions thereof, located in the state of Mississippi. As of December 31, 2007 and 2006, approximately $140 million and $73 million, respectively, was used by Ships and the remaining $60 million and $127 million, respectively, was recorded in miscellaneous other assets as restricted cash in the consolidated statements of financial position. Repayment of the bonds is guaranteed by the company.

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Long-term debt consisted of the following:

	December 31,	
$ in millions	**2007**	2006
Notes and debentures due 2008 to 2036, rates from 6.25% to 9.375%	**$ 3,705**	$ 3,777
Other indebtedness due 2008 to 2028, rates from 4.55% to 8.5%	**324**	290
Total long-term debt	**4,029**	4,067
Less current portion	**111**	75
Long-term debt, net of current portion	**$ 3,918**	$ 3,992

Indentures underlying long-term debt issued by the company or its subsidiaries contain various restrictions with respect to the issuer, including one or more restrictions relating to limitations on liens, sale-leaseback arrangements, and funded debt of subsidiaries.

Maturities of long-term debt as of December 31, 2007, are as follows:

$ in millions	
Year Ending December 31	
2008	$ 111
2009	473
2010	91
2011	773
2012	3
Thereafter	2,538
Total principal payments	3,989
Unamortized premium on long-term debt, net of discount	40
Total long-term debt	$ 4,029

The premium on long-term debt primarily represents non-cash fair market value adjustments resulting from acquisitions, which are amortized over the life of the related debt.

14. MANDATORILY REDEEMABLE SERIES B CONVERTIBLE PREFERRED STOCK

The company issued 3.5 million shares of mandatorily redeemable Series B convertible preferred stock in April 2001. Each share of Series B preferred stock has a liquidation value of $100 per share. The liquidation value, plus accrued but unpaid dividends, is payable on April 4, 2021, the mandatory redemption date. The company has the option to redeem all, but not less than all, of the shares of Series B preferred stock at any time after seven years from the date of issuance for a number of shares of the company s common stock equal to the liquidation value plus accrued and unpaid

dividends divided by the current market price of common stock determined in relation to the date of redemption. Under this option, had the redemption taken place at December 31, 2007, each share would have been converted into 1.261 shares of common stock. Each share of preferred stock is convertible, at any time, at the option of the holder into the right to receive shares of the company s common stock. Initially, each share was convertible into .911 shares of common stock, subject to adjustment in the event of certain dividends and distributions, a stock split, a merger, consolidation or sale of substantially all of the company s assets, a liquidation or distribution, and certain other events. Had the conversion taken place at December 31, 2007, each share would have been converted into 1.822 shares of common stock. Holders of preferred stock are entitled to cumulative annual cash dividends of $7 per share, payable quarterly. Upon liquidation of the company, each share of preferred stock is entitled to a liquidation preference before any distribution may be made on the company s common stock or any series of capital stock that is junior to the Series B preferred stock. In the event of a change in control of the company, holders of Series B preferred stock

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also have specified exchange rights into common stock of the company or into specified securities or property of another entity participating in the change in control transaction.

As of December 31, 2007, 10 million shares of preferred stock are authorized, of which 3.5 million shares designated as Series B preferred are issued and outstanding. No other shares of preferred stock are issued and outstanding.

Subsequent Event On February 20, 2008, the company s Board of Directors approved the redemption of the Series B convertible preferred stock on April 4, 2008.

15. LITIGATION

U.S. Government Investigations and Claims Departments and agencies of the U.S. Government have the authority to investigate various transactions and operations of the company, and the results of such investigations may lead to administrative, civil or criminal proceedings, the ultimate outcome of which could be fines, penalties, repayments or compensatory or treble damages. U.S. Government regulations provide that certain findings against a contractor may lead to suspension or debarment from future U.S. Government contracts or the loss of export privileges for a company or an operating division or subdivision. Suspension or debarment could have a material adverse effect on the company because of its reliance on government contracts.

As previously disclosed, in October 2005, the U.S. Department of Justice and a restricted U.S. Government customer apprised the company of potential substantial claims relating to certain microelectronic parts produced by the Space and Electronics Sector of former TRW Inc., now a component of the company. The relationship, if any, between the potential claims and a civil False Claims Act case that remains under seal in the U.S. District Court for the Central District of California remains unclear to the company. In the third quarter of 2006, the parties commenced settlement discussions. While the company continues to believe that it did not breach the contracts in question and that it acted appropriately in this matter, the company proposed to settle the claims and any associated matters and recognized a pre-tax charge of $112.5 million in the third quarter of 2006 to cover the cost of the settlement proposal and associated investigative costs. The company extended the offer in an effort to avoid litigation and in recognition of the value of the relationship with this customer. The U.S. Government has not accepted the settlement offer and has advised the company that if settlement is not reached it will pursue its claims through litigation. Because of the highly technical nature of the issues involved and their restricted status and because of the significant disagreement between the company and the U.S. Government as to the U.S. Government s theories of liability and damages (including a material difference between the U.S. Government s damage theories and the company s offer), final resolution of this matter could take a considerable amount of time, particularly if litigation should ensue. If the U.S. Government were to pursue litigation and were to be ultimately successful on its theories of liability and damages, which could be trebled under the Federal False Claims Act, the effect upon the company s consolidated financial position, results of operations, and cash flows would materially exceed the amount provided by the company. Based upon the information available to the company to date, the company believes that it has substantive defenses but can give no assurance that its views will prevail. Accordingly, the ultimate disposition of this matter cannot presently be determined.

As previously disclosed, on May 17, 2007, the U.S. Coast Guard issued a revocation of acceptance under the Deepwater Program for eight converted 123-foot patrol boats (the vessels) based on alleged hull buckling and shaft alignment problems. By letter dated June 5, 2007, the Coast Guard stated that the revocation of acceptance also was based on alleged nonconforming topside equipment on the vessels. On August 13, 2007, the company submitted a response to the Coast Guard, maintaining that the revocation of acceptance was improper. In late December 2007, the Coast Guard responded to the company s August submittal and advised Integrated Coast Guard Systems (the

contractors joint venture for performing the Deepwater Program) that the Coast Guard is seeking $96.1 million from the Joint Venture as a result of the revocation of acceptance of the eight vessels delivered under the 123-foot conversion program. The majority of the costs associated with the 123-foot conversion effort are associated with the alleged structural deficiencies of the vessels which were converted under

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contracts with the company and with a subcontractor to the company. The letter is not a contracting officer s final decision and the company and its joint venture partner and subcontractor are preparing a response. Based upon the information available to the company to date, the company believes that it has substantive defenses but can give no assurance that its views will prevail.

Based upon the available information regarding matters that are subject to U.S. Government investigations, other than as set out above, the company believes, but can give no assurance, that the outcome of any such matters would not have a material adverse effect on its consolidated financial position, results of operations, or cash flows.

Litigation Various claims and legal proceedings arise in the ordinary course of business and are pending against the company and its properties. Based upon the information available, the company believes that the resolution of any of these various claims and legal proceedings would not have a material adverse effect on its consolidated financial position, results of operations, or cash flows.

As previously disclosed, the company was a defendant in litigation brought by Cogent Systems, Inc. (Cogent) in Los Angeles Superior Court in California on April 20, 2005, for unspecified damages for alleged unauthorized use of Cogent technology relating to fingerprint recognition. On September 10, 2007, the company and Cogent announced that they had reached an agreement to settle the litigation and settlement documents were executed in the fourth quarter of 2007. Under the terms of the agreement, the company agreed to pay Cogent $25 million to settle the litigation and $15 million for a non-exclusive license to use specified Cogent state-of-the-art automated fingerprint identification software in certain existing programs. Substantially all these amounts were charged to expense in 2007. The company and Cogent also agreed to enter into a five-year research and development, service and products agreement, under which the company must purchase from Cogent $20 million in new products and services over the term of the agreement.

As previously disclosed, the U.S. District Court for the Central District of California consolidated two separately filed Employee Retirement Income Security Act (ERISA) lawsuits, which the plaintiffs seek to have certified as class actions, into the In Re Northrop Grumman Corporation ERISA Litigation. On August 7, 2007, the Court denied plaintiffs motion for class certification, and the plaintiffs appealed the Court s decision on class certification to the U.S. Court of Appeals for the Ninth Circuit. On October 11, 2007, the Ninth Circuit granted appellate review, which delayed the commencement of trial previously scheduled to begin January 22, 2008. The company believes, but can give no assurance, that the outcome of these matters would not have a material adverse effect on its consolidated financial position, results of operations, or cash flows.

Insurance Recovery Property damage from Hurricane Katrina is covered by the company s comprehensive property insurance program. The insurance provider for coverage of property damage losses over $500 million, Factory Mutual Insurance Company (FM Global), has advised management of a disagreement regarding coverage for certain losses above $500 million. As a result, the company has taken legal action against the insurance provider as the company believes that its insurance policies are enforceable and intends to pursue all of its available rights and remedies. In August 2007, the district court in which the litigation is pending issued an order finding that the excess insurance policy provided coverage for the company s Katrina related loss. In November 2007, FM Global filed a notice of appeal of the district court s order. Based on the current status of the assessment and claim process, no assurances can be made as to the ultimate outcome of this matter.

Provisions for Legal & Investigative Matters Litigation accruals are recorded as charges to earnings when management, after taking into consideration the facts and circumstances of each matter, including any settlement

offers, has determined that it is probable that a liability has been incurred and the amount of the loss can be reasonably estimated. The ultimate resolution of any exposure to the company may vary from earlier estimates as further facts and circumstances become known.

16. COMMITMENTS AND CONTINGENCIES

Contract Performance Contingencies Contract profit margins may include estimates of revenues not contractually agreed to between the customer and the company for matters such as contract changes, negotiated settlements,

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claims and requests for equitable adjustment for previously unanticipated contract costs. These estimates are based upon management s best assessment of the underlying causal events and circumstances, and are included in determining contract profit margins to the extent of expected recovery based on contractual entitlements and the probability of successful negotiation with the customer. As of December 31, 2007, the amounts related to the aforementioned items are not material individually or in the aggregate.

In April 2007, the company was notified by the prime contractor on the Wedgetail contract under the Multirole Electronic Scanned Array (MESA) program that it anticipates the prime contractor s delivery dates will be late and this could subject the prime contractor to liquidated damages from the customer. Should liquidated damages be assessed, the company would share in a proportionate amount of those damages to a maximum of approximately $40 million. As of December 31, 2007, the company has not been notified by the prime contractor as to any claim for liquidated damages. Until such time as additional information is available from the prime contractor, it is not possible to determine the impact to the consolidated financial statements, if any, for this matter.

Environmental Matters In accordance with company policy on environmental remediation, the estimated cost to complete remediation has been accrued where it is probable that the company will incur such costs in the future to address environmental impacts at currently or formerly owned or leased operating facilities, or at sites where it has been named a Potentially Responsible Party (PRP) by the Environmental Protection Agency, or similarly designated by other environmental agencies. To assess the potential impact on the company s consolidated financial statements, management estimates the total reasonably possible remediation costs that could be incurred by the company, taking into account currently available facts on each site as well as the current state of technology and prior experience in remediating contaminated sites. These estimates are reviewed periodically and adjusted to reflect changes in facts and technical and legal circumstances. Management estimates that as of December 31, 2007, the range of reasonably possible future costs for environmental remediation sites is $186 million to $285 million, of which $223 million is accrued in other current liabilities. Factors that could result in changes to the company s estimates include: modification of planned remedial actions, increases or decreases in the estimated time required to remediate, discovery of more extensive contamination than anticipated, changes in laws and regulations affecting remediation requirements, and improvements in remediation technology. Should other PRPs not pay their allocable share of remediation costs, the company may have to incur costs in addition to those already estimated and accrued. Although management cannot predict whether new information gained as projects progress will materially affect the estimated liability accrued, management does not anticipate that future remediation expenditures will have a material adverse effect on the company s consolidated financial position, results of operations, or cash flows.

Co-Operative Agreements In 2003, Ships executed agreements with the states of Mississippi and Louisiana whereby Ships leases facility improvements and equipment from Mississippi and from a non-profit economic development corporation in Louisiana in exchange for certain commitments by Ships to these states. As of December 31, 2007, Ships has fully met its obligations under the Mississippi agreement and has met all but one requirement under the Louisiana agreement. Failure by Ships to meet the remaining Louisiana commitment would result in reimbursement by Ships to Louisiana in accordance with the agreement. As of December 31, 2007, Ships expects that the remaining commitment under the Louisiana agreement will be met based on its most recent business plan.

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 by insurance companies principally to guarantee the performance on certain contracts and to support the company s self-insured workers compensation plans. At December 31, 2007, there were $439 million of unused stand-by letters of credit, $148 million of bank guarantees, and $538 million of surety bonds outstanding.

The company has also guaranteed a $200 million loan made to Ships in connection with the Gulf Opportunity Zone Industrial Revenue Bonds issued in December 2006. Under the loan agreement the company guaranteed

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Ships repayment of the principal and interest to the Trustee. The company also guaranteed payment of the principal and interest by the Trustee to the underlying bondholders. See Note 13.

Indemnifications The company has retained certain warranty, environmental, income tax, and other potential liabilities in connection with certain divestitures. The settlement of these liabilities is not expected to have a material effect on the company s consolidated financial position, results of operations, or cash flows.

In May 2006, Goodrich Corporation (Goodrich) notified the company of its claims under indemnities assumed by the company in its December 2002 acquisition of TRW that related to the sale by TRW of its Aeronautical Systems business in October 2002. During the fourth quarter of 2007, the company reached a negotiated resolution with Goodrich and paid $18.5 million in complete release of these claims.

U.S. Government Claims During the second quarter of 2006, the U.S. Government advised the company of claims and penalties concerning certain potential disallowed costs. The parties are engaged in discussions to enable the company to evaluate the merits of these claims as well as to assess the amounts being claimed. The company does not believe, but can give no assurance, that the outcome of any such matters would have a material adverse effect on its consolidated financial position, results of operations, or cash flows.

Operating Leases Rental expense for operating leases, excluding discontinued operations, was $585 million in 2007, $548 million in 2006, and $512 million in 2005. These amounts are net of immaterial amounts of sublease rental income. Minimum rental commitments under long-term noncancellable operating leases as of December 31, 2007, total approximately $2.1 billion, which are payable as follows: 2008 $445 million; 2009 $368 million; 2010 $293 million; 2011 $211 million; 2012 $183 million; and thereafter $565 million.

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

17. IMPACT FROM HURRICANE KATRINA

Background In August 2005, the company s operations in the Gulf Coast area of the U.S. were significantly impacted by Hurricane Katrina and the company s shipyards in Louisiana and Mississippi sustained significant windstorm damage from the hurricane. As a result of the storm, the company has incurred costs to replace or repair destroyed or damaged assets, suffered losses under its contracts, and incurred substantial costs to clean up and recover its operations. As of the date of the storm, the company had a comprehensive insurance program that provided coverage for, among other things, property damage, business interruption impact on net profitability (referred to in this discussion generally as lost profits), and costs associated with clean-up and recovery.

Insurance Coverage Summary The company s property insurance program at the time of loss was established in two layers of coverage. The primary layer of coverage was provided by a syndicate of leading insurers (the Primary Insurers) and covered losses up to $500 million. The excess (second) layer of coverage was provided by FM Global (the Secondary Insurer). This excess layer reimburses the company for losses above $500 million up to the policy limit of approximately $20 billion. The company has had prior experience with damage from storms and similar events and has had success in obtaining recovery from its insurers for covered damages. Based on its prior experience with processing insurance claims, the company has a well-defined process for developing, analyzing and preparing its claims for insurance recovery.

Accounting for Insurance Recoveries The company makes various assessments and estimates in determining amounts to record as insurance recoveries, including ascertaining whether damages are covered by insurance and assessing the viability and financial well-being of its insurers. The company and its Primary Insurers reached an arrangement whereby the company submitted detailed requests for reimbursement of its clean-up, restoration and capital asset repair or replacement costs while its overall claim was in the process of being evaluated by the insurers. After such requests were reviewed, progress payments against the overall coverage limits were approved by the insurers. Based on prior experience with insurance recoveries, and in reliance on the acceptance by the

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insurers of the company s claim reimbursement process, the company recognized a receivable from the Primary Insurers as costs were incurred, and offset this receivable with progress payments as received.

In accordance with U.S. government cost accounting regulations affecting the majority of the company s contracts, the cost of insurance premiums for property damage and business interruption coverage, other than coverage of profit, is an allowable cost that may be charged to long-term contracts. Because the majority of long-term contracts at the shipyards are flexibly-priced, the government customer would benefit from the majority of insurance recoveries in excess of the net book value of damaged assets and the costs for clean-up and recovery. In a similar manner, losses on property damage that are not recovered through insurance are required to be included in the company s overhead pools for allocation to long-term contracts under a systematic process. The company is currently in discussions with its government customers to determine an appropriate methodology to be used to account for these amounts for government contract purposes. The company anticipates that the ultimate outcome of such discussions will not have a material adverse effect on the consolidated financial statements.

The company has full entitlement to insurance recoveries related to lost profits; however, because of uncertainties concerning the ultimate determination of recoveries related to lost profits, in accordance with company policy no such amounts are recognized by the company until they are settled with the insurers. Furthermore, due to the uncertainties with respect to the company s disagreement with the Secondary Insurer, no receivables have been recognized by the company in the accompanying consolidated financial statements for insurance recoveries from the Secondary Insurer.

Insurance Claim The company s Hurricane Katrina insurance claim is continually being evaluated based on actions to date and an assessment of remaining recovery scope. The company updated its assessment during the fourth quarter of 2007 and, as a result, the company s aggregate claim for insurance recovery as a result of Hurricane Katrina is estimated to be $1.1 billion, consisting of clean-up and restoration costs of $278 million, property damages (including the value of destroyed assets not replaced) and other capital expenditures of $492 million and lost profits of $318 million. Certain amounts within the overall claim are still in the process of being finalized and the overall value of the claim may change from these amounts.

In June 2007, the company reached a final agreement with all but one of its Primary Insurers under which the insurers agreed to pay their policy limits (less the policy deductible and certain other minor costs). As a result of the agreement regarding the claims from the first layer of coverage, the company received a total insurance recovery for damages to the shipyards of $466 million reflecting policy limits less certain minor costs. The company is continuing to seek recovery of its claim from the remaining insurer in the first layer that did not participate in the agreement. As a result of the agreement, the company received final cash payments totaling $113 million in the second quarter of 2007, of which $62 million has been attributed to the recovery of lost profits and has been included as an adjustment to cost of sales in the Ships segment in the consolidated statement of income. Cumulative proceeds from the agreement have also been used to fund $126 million in capital expenditures for assets fully or partially damaged by the storm and $278 million in clean-up and restoration costs. Insurance recoveries received to date have enabled the company to recover the entire net book value of $98 million of assets totally or partially destroyed by the storm. To the extent that the company is unsuccessful in receiving the full value of its remaining claim relating to capital assets, the company will be responsible for funding the capital expenditures necessary to operate its shipyards. Through December 31, 2007, the company has incurred capital expenditures totaling $310 million related to assets damaged by Hurricane Katrina.

The company expects that its residual claim will be resolved separately with the remaining insurers in each of its two layers of coverage, and the company has pursued the resolution of its claim with that understanding. The Secondary

Insurer has denied coverage for substantial portions of the company s claim and the parties are presently in litigation to resolve this matter. In August 2007, the district court in which the litigation is pending issued an order finding that the excess insurance policy provided coverage for the company s Katrina related loss. The Secondary Insurer has appealed that decision and that appeal is still pending (see Note 15).

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Aside from contract cost adjustments recognized immediately following the hurricane and the subsequent effects of lower contract margins thereafter resulting from hurricane related cost growth, delay and disruption to contracts-in-progress, no other Hurricane Katrina related losses have been, or are expected to be, experienced by the company.

18. RETIREMENT BENEFITS

Plan Descriptions

Pension Benefits The company sponsors several defined benefit pension plans in the U.S. covering approximately 95 percent of its employees. Pension benefits for most employees are based on the employee s years of service and compensation. It is the policy of the company to fund at least the minimum amount required for all qualified plans, using actuarial cost methods and assumptions acceptable under U.S. Government regulations, by making payments into benefit trusts separate from the company. The pension benefit for most employees is based upon criteria whereby employees earn age and service points over their employment period. Ten of the company s 21 domestic qualified plans, which cover approximately 60 percent of all employees, were in a legally defined full-funding limitation status at December 31, 2007.

Defined Contribution Plans The company also sponsors 401(k) defined contribution plans in which most employees are eligible to participate. Company contributions for most plans are based on a cash matching of employee contributions up to 4 percent of compensation. Certain hourly employees are covered under a target benefit plan. The company also participates in a multiemployer plan for certain of the company s union employees. The company s contributions to these plans for the years ended December 31, 2007, 2006, and 2005, were $294 million, $266 million and $248 million, respectively.

Non-U.S. Benefit Plans The company sponsors several benefit plans for non-U.S. employees. These plans are designed to provide benefits appropriate to local practice and in accordance with local regulations. Some of these plans are funded using benefit trusts separate from the company.

Medical and Life Benefits The company provides a portion of the costs for certain health care and life insurance benefits for a substantial number of its active and retired employees. Covered employees achieve eligibility to participate in these contributory plans upon retirement from active service if they meet specified age and years of service requirements. Qualifying dependents are also eligible for medical coverage. Approximately 65 percent of the company s current retirees participate in the medical plans. The company reserves the right to amend or terminate the plans at any time. In November 2006, the company adopted plan amendments and communicated to plan participants that it would cap the amount of its contributions to substantially all of its remaining post retirement medical and life benefit plans that were previously not subject to limits on the company s contributions.

In addition to a medical inflation cost-sharing feature, the plans also have provisions for deductibles, co-payments, coinsurance percentages, out-of-pocket limits, conformance to a schedule of reasonable fees, the use of managed care providers, and maintenance of benefits with other plans. The plans also provide for a Medicare carve-out, and a maximum lifetime benefit of $2 million per covered individual. Subsequent to January 1, 2005 (or earlier at some segments), newly hired employees are not eligible for post employment medical and life benefits.

The effect of the Medicare prescription drug subsidy from the Medicare Prescription Drug, Improvement and Modernization Act of 2003 on the company s net periodic postretirement benefit cost for the years ended December 31, 2007, 2006 and 2005, was an increase of $3 million and a reduction of $26 million and $36 million,

respectively. The reduction in the accumulated postretirement benefit obligation as a result of the subsidy is $38 million and $76 million as of December 31, 2007 and 2006, respectively, based on the impact of the subsidy on the eligible plans.

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Summary Plan Results

The cost to the company of its retirement benefit plans in each of the three years ended December 31 is shown in the following table:

	Pension Benefits			Medical and Life Benefits		
$ in millions	**2007**	2006	2005	**2007**	2006	2005
Components of Net Periodic Benefit Cost						
Service cost	**$ 786**	$ 755	$ 675	**$ 52**	$ 69	$ 66
Interest cost	**1,250**	1,159	1,091	**164**	183	183
Expected return on plan assets	**(1,774)**	(1,572)	(1,468)	**(58)**	(52)	(49)
Amortization of						
Prior service cost (credit)	**40**	35	53	**(65)**	(16)	(1)
Net loss from previous years	**48**	91	59	**25**	31	27
Other	**2**					(13)
Net periodic benefit cost	**$ 352**	$ 468	$ 410	**$ 118**	$ 215	$ 213

The table below summarizes the 2007 changes of the components of unrecognized benefit plan costs:

$ in millions	Pension Benefits	Medical and Life Benefits	Total
Changes in Unrecognized Benefit Plan Costs			
Net actuarial gain	$ (854)	$ (90)	$ (944)
Prior service cost (credit)	17	(3)	14
Amortization of			
Prior service (cost) credit	(40)	65	25
Net loss from previous years	(48)	(25)	(73)
Tax benefits related to above items	365	19	384
Changes in unrecognized benefit plan costs	$ (560)	$ (34)	$ (594)

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The following tables set forth the funded status and amounts recognized in the consolidated statements of financial position for the company s defined benefit pension and retiree health care and life insurance benefit plans. Pension benefits data include the qualified plans as well as 21 domestic unfunded non-qualified plans for benefits provided to directors, officers, and certain employees. The company uses a December 31 measurement date for all of its plans. Effective December 31, 2006, the company adopted SFAS No. 158, which requires the recognition of the funded status of a defined benefit pension or postretirement plan in the consolidated statements of financial position.

	Pension Benefits		Medical and Life Benefits	
$ in millions	**2007**	2006	**2007**	2006
Change in Benefit Obligation				
Benefit obligation at beginning of year	**$ 21,484**	$ 20,692	**$ 2,867**	$ 3,341
Service cost	**786**	755	**52**	69
Interest cost	**1,250**	1,159	**164**	183
Plan participants contributions	**24**	29	**84**	88
Plan amendments	**18**	40	**(2)**	(464)
Actuarial gain	**(357)**	(119)	**(103)**	(64)
Benefits paid	**(1,157)**	(1,112)	**(250)**	(281)
Acquisitions, divestitures, transfers and other	**21**	40		(5)
Benefit obligation at end of year	**22,069**	21,484	**2,812**	2,867
Change in Plan Assets				
Fair value of plan assets at beginning of year	**21,407**	18,867	**880**	780
Gain on plan assets	**2,275**	2,444	**46**	95
Employer contributions	**342**	1,157	**191**	198
Plan participants contributions	**24**	29	**84**	88
Benefits paid	**(1,157)**	(1,112)	**(250)**	(281)
Acquisitions, divestitures, transfers and other		22		
Fair value of plan assets at end of year	**22,891**	21,407	**951**	880
Funded status	**$ 822**	$ (77)	**$ (1,861)**	$ (1,987)
Amounts Recognized in the Consolidated Statements of Financial Position				
Non-current assets	**$ 2,033**	$ 1,303	**$ 47**	$ 46
Current liability	**(43)**	(41)	**(68)**	(70)
Non-current liability	**(1,168)**	(1,339)	**(1,840)**	(1,963)

The following table shows those amounts expected to be recognized in net periodic benefit cost in 2008:

Pension	Medical and

$ in millions	Benefits	Life Benefits
Amounts Expected to be Recognized in 2008 Net Periodic Benefit Cost		
Net loss	$ 25	$ 22
Prior service cost (credit)	40	(65)

The accumulated benefit obligation for all defined benefit pension plans was $20.1 billion and $19.4 billion at December 31, 2007 and 2006, respectively.

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$ in millions	Pension Benefits **2007**	2006	Medical and Life Benefits **2007**	2006
Amounts Recorded in Accumulated Other Comprehensive Loss				
Net actuarial loss	**$ (975)**	(1,877)	**$ (429)**	(545)
Prior service cost and net transition obligation	**(254)**	(277)	**452**	515
Income tax benefits related to above items	**479**	890	**(9)**	10
Unamortized benefit plan costs	**$ (750)**	(1,264)	**$ 14**	(20)

Amounts for pension plans with accumulated benefit obligations in excess of fair value of plan assets are as follows:

$ in millions	December 31, **2007**	2006
Projected benefit obligation	**$ 1,772**	$ 2,055
Accumulated benefit obligation	**1,407**	1,601
Fair value of plan assets	**722**	946

The amounts previously disclosed for projected benefit obligation, accumulated benefit obligation and fair value of plan assets as of December 31, 2006 of $768 million, $639 million, and $115 million, respectively, were revised to appropriately include 15 additional plans for which the accumulated benefit obligations exceeded the fair value of plan assets.

Plan Assumptions

On a weighted-average basis, the following assumptions were used to determine the benefit obligations and the net periodic benefit cost:

	Pension Benefits **2007**	2006	Medical and Life Benefits **2007**	2006
Assumptions Used to Determine Benefit Obligation at December 31				
Discount rate	**6.22%**	5.97%	**6.12%**	5.91%
Rate of compensation increase	**4.25%**	4.25%		
Initial health care cost trend rate assumed for the next year			**8.00%**	8.75%
Rate to which the cost trend rate is assumed to decline (the ultimate trend rate)			**5.00%**	5.00%
Year that the rate reaches the ultimate trend rate			**2012**	2010
Assumptions Used to Determine Benefit Cost for the Year Ended December 31				

Discount rate	**5.97%**	5.71%	**5.91%**	5.67%
Expected long-term return on plan assets	**8.50%**	8.50%	**6.75%**	6.75%
Rate of compensation increase	**4.25%**	4.00%		
Initial health care cost trend rate assumed for the next year			**8.75%**	10.00%
Rate to which the cost trend rate is assumed to decline (the ultimate trend rate)			**5.00%**	5.00%
Year that the rate reaches the ultimate trend rate			**2010**	2010

The discount rate is determined by calculating, for the most significant plans, the weighted-average yield available on a portfolio of appropriately-rated corporate bonds whose proceeds match the expected benefit payment stream from the plan.

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The assumptions used for pension benefits are consistent with those used for retiree medical and life insurance benefits. The long-term rate of return on plan assets used for the medical and life benefits are reduced to allow for the impact of tax on expected returns as, unlike the pension trust, the earnings of certain VEBA trusts are taxable.

Through consultation with investment advisors, expected long-term returns for each of the plans strategic asset classes were developed. Several factors were considered, including survey of investment managers expectations, current market data such as yields/price-earnings ratios, and historical market returns over long periods. Using policy target allocation percentages and the asset class expected returns, a weighted-average expected return was calculated.

In 2007, the company changed the year to reach the ultimate trend rate from 2010 to 2012. Assumed health care trend rates have a significant effect on the amounts reported for the health care plans. A one-percentage-point change in the initial through the ultimate health care cost trend rates would have the following effects:

$ in millions	1-Percentage-Point Increase	1-Percentage-Point Decrease
Increase (Decrease) From Change In Health Care Cost Trend Rates To		
Postretirement benefit expense	$ 9	$ (9)
Postretirement benefit liability	85	(91)

Plan Assets and Investment Policy
Weighted-average asset allocations at December 31 by asset category are as follows:

	Pension Plan Assets		Medical and Life Benefits Plan Assets	
	2007	2006	**2007**	2006
Equity securities	**48%**	57%	**74%**	74%
Debt securities	**34**	31	**20**	22
Real estate	**6**	4	**2**	1
Other	**12**	8	**4**	3
Total	**100%**	100%	**100%**	100%

Plan assets are invested in various asset classes that are expected to produce a sufficient level of diversification and investment return over the long term. The investment goals are (1) to exceed the assumed actuarial rate of return over the long term within reasonable and prudent levels of risk, and (2) to preserve the real purchasing power of assets to meet future obligations. Liability studies are conducted on a regular basis to provide guidance in setting investment goals with an objective to balance risk. Risk targets are established and monitored against acceptable ranges.

All investment policies and procedures are designed to ensure that the plans investments are in compliance with ERISA. Guidelines are established defining permitted investments within each asset class. Derivatives are used for transitioning assets, asset class rebalancing, managing currency risk, and for management of fixed income and alternative investments. The investment policies for most of the pension plans require that the asset allocation be

maintained within the following ranges:

	Asset Allocation Ranges	
U.S. equity	30	40%
International equity	15	25
Long bonds	25	35
Real estate and other	10	20

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At December 31, 2007, and 2006, plan assets included investments with non-readily determinable fair values, comprised primarily of real estate, private equity investments, and hedge funds, totaling $4.1 billion and $2.7 billion, respectively. For these assets, estimates of fair value are determined using the best information available. At December 31, 2007, and 2006, the pension and health and welfare trusts did not hold any Northrop Grumman common stock.

In 2008, the company expects to contribute the required minimum funding level of approximately $121 million to its pension plans and approximately $201 million to its other postretirement benefit plans. During 2007 and 2006, the company made voluntary pension contributions of $200 million and $800 million, respectively.

It is not expected that any assets will be returned to the company from the benefit plans during 2008.

Benefit Payments
The following table reflects estimated future benefit payments, based upon the same assumptions used to measure the benefit obligation, and includes expected future employee service, as of December 31, 2007:

	Pension Plans	Medical and Life Plans	
$ in millions	Benefit Payments	Benefit Payments	Subsidy receipts
Year Ending December 31			
2008	$ 1,176	$ 215	$ 11
2009	1,224	221	10
2010	1,281	227	9
2011	1,344	232	8
2012	1,410	234	9
2013 through 2017	8,189	1,233	46

19. STOCK COMPENSATION PLANS

Plan Descriptions
At December 31, 2007, Northrop Grumman had stock-based compensation awards outstanding under the following plans: the 2001 Long-Term Incentive Stock Plan (2001 LTISP), the 1993 Long-Term Incentive Stock Plan (1993 LTISP), both applicable to employees, and the 1993 Stock Plan for Non-Employee Directors (1993 SPND) and 1995 Stock Plan for Non-Employee Directors (1995 SPND) as amended. All of these plans were approved by the company s shareholders. The company has historically issued new shares to satisfy award grants.

Employee Plans The 2001 LTISP and the 1993 LTISP permit grants to key employees of three general types of stock incentive awards: Stock Options, Stock Appreciation Rights (SARs), and Stock Awards. Each Stock Option grant is made with an exercise price either at the closing price of the stock on the date of grant (market options) or at a premium over the closing price of the stock on the date of grant (premium options). Stock Options generally vest in 25 percent increments over four years from the grant date under the 2001 LTISP and in years two to five under the 1993 LTISP, and grants outstanding expire ten years after the grant date. No SARs have been granted under either of the LTISPs. Stock Awards, in the form of restricted performance stock rights and restricted stock rights, are granted to key employees without payment to the company. Under the 2001 LTISP, recipients of restricted performance stock

rights earn shares of stock, based on financial metrics determined by the Board of Directors in accordance with the plan. If the objectives have not been met at the end of the applicable performance period, up to 100 percent of the original grant for the eight highest compensated employees and up to 70 percent of the original grant for all other recipients will be forfeited. If the financial metrics are met or exceeded during the performance period, all recipients can earn up to 150 percent of the original grant. Beginning in 2007, all members of the Corporate Policy Council could forfeit up to 100 percent of the original 2007 grant, and all recipients could earn up to 200 percent of the original 2007 grant. Restricted stock rights issued under either plan generally vest after three years. Termination of employment can result in forfeiture of some or all of the benefits extended. Of the 50 million shares approved

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for issuance under the 2001 LTISP, approximately 17 million shares were available for future grants as of December 31, 2007.

Non-Employee Plans Under the 1993 SPND, half of the retainer fee earned by each director must be deferred into a stock unit account. In addition, directors may defer payment of all or part of the remaining retainer fee, which is placed in a stock unit account until the conclusion of board service. The 1995 SPND provided for annual stock option grants. Effective June 1, 2005, no new grants have been issued from this plan. The 1995 SPND was amended in May 2007 to permit payment of the stock unit portion of the retainer fee described above. Each grant of stock options under the 1995 SPND was made at the closing market price on the date of the grant, was immediately exercisable, and expires ten years after the grant date. At December 31, 2007, approximately 318,000 shares were available for future grants under the 1995 SPND and 25,442 shares were available for future use under the 1993 SPND.

Adoption of New Standard

Prior to January 1, 2006, the company applied Accounting Principles Board Opinion No. 25 *Accounting for Stock Issued to Employees* and related interpretations in accounting for awards made under the company s stock-based compensation plans. Stock Options granted under the plans had an exercise price equal to or greater than the market value of the common stock on the date of the grant, and accordingly, no compensation expense was recognized. Stock Awards were valued at their fair market value measured at the date of grant, updated periodically using the mark-to-market method, and compensation expense was recognized over the vesting period of the award.

Effective January 1, 2006, the company adopted the provisions of SFAS No. 123R *Share-Based Payment* (SFAS No. 123R), using the modified-prospective transition method. Under this transition method, compensation expense recognized during the year ended December 31, 2006, included: (a) compensation expense for all share-based awards granted prior to, but not yet vested as of January 1, 2006, based on the grant date fair value estimated in accordance with the original provisions of SFAS No. 123 *Accounting for Stock-Based Compensation* (SFAS No. 123), and (b) compensation expense for all share-based awards granted or modified on or after January 1, 2006, based on the grant date fair value estimated in accordance with the provisions of SFAS No. 123R. In accordance with the modified-prospective transition method, results for prior periods have not been restated. All of the company s stock award plans are considered equity plans under SFAS No. 123R, and compensation expense recognized as previously described is net of estimated forfeitures of share-based awards over the vesting period. The effect of adopting SFAS No. 123R was not material to the company s income from continuing operations and net income for the year ended December 31, 2006, and the cumulative effect of adoption using the modified-prospective transition method was similarly not material.

Compensation Expense

Total stock-based compensation for the years ended December 31, 2007, 2006, and 2005, was $196 million, $202 million, and $180 million, respectively, of which $12 million, $11 million, and $4 million related to Stock Options and $184 million, $191 million, and $176 million related to Stock Awards, respectively. Tax benefits recognized in the consolidated statements of income for stock-based compensation during the years ended December 31, 2007, 2006, and 2005, were $77 million, $71 million, and $63 million, respectively. In addition, the company realized tax benefits of $60 million from the exercise of Stock Options and $78 million from the issuance of Stock Awards in 2007.

Effective January 1, 2006, compensation expense for restricted performance stock rights is estimated based on the grant date fair value and recognized over the vesting period. The fixed 30 percent minimum distribution portion for all but the eight highest compensated employees, and all but the Corporate Policy Council members for 2007 forward, is

measured at the grant date fair value and the variable portion is adjusted to the expected distribution at the end of each accounting period. Compensation expense for restricted stock rights is measured at the grant date fair value and recognized over the vesting period.

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Stock Options

The fair value of each of the company s Stock Option awards is estimated on the date of grant using a Black-Scholes option-pricing model that uses the assumptions noted in the table below. The fair value of the company s Stock Option awards is expensed on a straight-line basis over the vesting period of the options, which is generally four years. Expected volatility is based on an average of (1) historical volatility of the company s stock and (2) implied volatility from traded options on the company s stock. The risk-free rate for periods within the contractual life of the Stock Option award is based on the yield curve of a zero-coupon U.S. Treasury bond on the date the award is granted with a maturity equal to the expected term of the award. The company uses historical data to estimate forfeitures. The expected term of awards granted is derived from historical experience under the company s stock-based compensation plans and represents the period of time that awards granted are expected to be outstanding.

The significant weighted-average assumptions relating to the valuation of the company s Stock Options for the years ended December 31, 2007, 2006, and 2005, was as follows:

	2007	2006	2005
Dividend yield	**2.0%**	1.6%	1.8%
Volatility rate	**20%**	25%	28%
Risk-free interest rate	**4.6%**	4.6%	4.0%
Expected option life (years)	**6**	6	6

The weighted-average grant date fair value of Stock Options granted during the years ended December 31, 2007, 2006, and 2005, was $15, $17, and $15 per share, respectively.

Stock Option activity for the year ended December 31, 2007, was as follows:

	Shares Under Option (in thousands)	Weighted-Average Exercise Price	Weighted-Average Remaining Contractual Term	Aggregate Intrinsic Value ($ in millions)
Outstanding at January 1, 2007	19,888	$ 49	5.0 years	$ 367
Granted	902	73		
Exercised	(5,879)	49		
Cancelled and forfeited	(28)	43		
Outstanding at December 31, 2007	**14,883**	**$ 51**	**4.6 years**	**$ 416**
Vested and expected to vest in the future at December 31, 2007	14,820	$ 51	4.6 years	$ 415
Exercisable at December 31, 2007	13,320	$ 49	4.1 years	$ 398
Available for grant at December 31, 2007	11,978			

The total intrinsic value of options exercised during the years ended December 31, 2007, 2006, and 2005, was $153 million, $149 million, and $50 million, respectively. Intrinsic value is measured using the fair market value at the date of exercise (for options exercised) or at December 31, 2007 (for outstanding options), less the applicable exercise price.

Stock Awards Compensation expense for Stock Awards is measured at the grant date based on fair value and recognized over the vesting period. The fair value of Stock Awards is determined based on the closing market price of the company s common stock on the grant date. For purposes of measuring compensation expense, the amount of shares ultimately expected to vest is estimated at each reporting date based on management s expectations regarding the relevant performance criteria. In the table below, the share adjustment resulting from the final performance measure is considered granted in the period that the related grant is vested. During the year ended December 31, 2007, 2.6 million shares of common stock were issued to employees in settlement of

NORTHROP GRUMMAN CORPORATION

prior year Stock Awards that were fully vested, with a total value upon issuance of $199 million and a grant date fair value of $125 million. In 2008, an additional 2.9 million shares of common stock will be issued to employees that were vested in 2007, with a grant date fair value of $155 million. During the year ended December 31, 2006, 2.4 million shares of common stock were issued to employees in settlement of prior year stock awards that were fully vested, with a total value upon issuance of $143 million and a grant date fair value of $133 million. During the year ended December 31, 2005, 1.9 million shares were issued to employees in settlement of prior year Stock Awards that were fully vested, with a total value upon issuance of $104 million and a grant date fair value of $77 million. There were 4.2 million and 2.3 million Stock Awards granted for the years ended December 31, 2006, and 2005 with a weighted-average grant date fair value of $63 and $54 per share, respectively.

Stock Award activity for the year ended December 31, 2007, was as follows:

	Stock Awards (in thousands)	Weighted-Average Grant Date Fair Value	Weighted-Average Remaining Contractual Term
Outstanding at January 1, 2007	7,364	$ 57	1.3 years
Granted (including performance adjustment on shares vested)	3,584	63	
Vested	(5,520)	50	
Forfeited	(284)	63	
Outstanding at December 31, 2007	**5,144**	**$ 67**	**1.3 years**
Available for grant at December 31, 2007	5,142		

Unrecognized Compensation Expense At December 31, 2007, there was $199 million of unrecognized compensation expense related to unvested awards granted under the company s stock-based compensation plans, of which $17 million relates to Stock Options and $182 million relates to Stock Awards. These amounts are expected to be charged to expense over a weighted-average period of 1.4 years.

Pro-forma Compensation Expense Had compensation expense for the year ended December 31, 2005, been determined based on the fair value at the grant dates for Stock Awards and Stock Options, consistent with SFAS No. 123, net income, basic earnings per share, and diluted earnings per share would have been as shown in the table below:

$ in millions, except per share	Year ended December 31, 2005
Net income as reported	$ 1,400
Stock-based compensation, net of tax, included in net income as reported	117
Stock-based compensation, net of tax, that would have been included in net income, if the fair value method had been applied to all awards	(196)
Pro-forma net income using the fair value method	$ 1,321

Basic Earnings Per Share		
As reported	$	3.93
Pro-forma	$	3.71
Diluted Earnings Per Share		
As reported	$	3.85
Pro-forma	$	3.64

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20. UNAUDITED SELECTED QUARTERLY DATA

Unaudited quarterly financial results are set forth in the following tables. The financial results for all periods presented have been revised to reflect the various business dispositions that occurred during the 2006 and 2007 fiscal years (see note 5 for further details). The company s common stock is traded on the New York Stock Exchange (trading symbol NOC). This unaudited quarterly information is labeled using a calendar convention; that is, first quarter is consistently labeled as ended on March 31, second quarter as ended on June 30, and third quarter as ended on September 30. It is the company s long-standing practice to establish actual interim closing dates using a fiscal calendar, which requires the businesses to close their books on a Friday, in order to normalize the potentially disruptive effects of quarterly closings on business processes. The effects of this practice only exist within a reporting year.

2007

$ in millions, except per share	**1st Qtr**	**2nd Qtr**	**3rd Qtr**	**4th Qtr**
Sales and service revenues	$ 7,340	$ 7,926	$ 7,928	$ 8,824
Operating margin	685	754	807	760
Income from continuing operations	390	466	490	457
Net income	387	460	489	454
Basic earnings per share from continuing operations	1.13	1.36	1.44	1.35
Basic earnings per share	1.12	1.34	1.44	1.34
Diluted earnings per share from continuing operations	1.11	1.33	1.41	1.32
Diluted earnings per share	1.10	1.31	1.41	1.31

Significant 2007 Fourth Quarter Events In the fourth quarter of 2007, the company s Board of Directors authorized the repurchase of up to $2.5 billion of its outstanding common stock and the company made a voluntary pre-funding payment to the company s pension plans of $200 million.

2006

$ in millions, except per share	**1st Qtr**	**2nd Qtr**	**3rd Qtr**	**4th Qtr**
Sales and service revenues	$ 7,075	$ 7,596	$ 7,429	$ 8,013
Operating margin	606	686	549	623
Income from continuing operations	363	445	308	457
Net income	357	430	302	453
Basic earnings per share from continuing operations	1.06	1.29	.89	1.32
Basic earnings per share	1.04	1.25	.88	1.31
Diluted earnings per share from continuing operations	1.03	1.27	.88	1.29
Diluted earnings per share	1.02	1.23	.86	1.28

Significant 2006 Fourth Quarter Events In the fourth quarter of 2006, the company s Board of Directors authorized the repurchase of up to $1.0 billion of its outstanding common stock. During the quarter, the company made a voluntary pre-funding payment to the company s pension plans of $800 million. The company recorded pre-tax

forward loss provisions of $42 million for the Wedgetail contract and $19 million for the Peace Eagle contract (both under the Multi-Role Electronically Scanned Array program) in the Electronics segment. The company also sold its remaining shares of TRW Auto for $209 million for a pre-tax gain of $111 million and entered into a definitive agreement to acquire Essex Corporation for approximately $590 million, including the assumption of debt totaling $23 million and estimated transaction costs of $14 million. In November the company repaid its senior notes, totaling $690 million. Also during the fourth quarter the company incurred debt related to the Gulf Opportunity Zone Industrial Revenue Bonds of $200 million, bearing interest at 4.55%, due December 1, 2028, with early redemption on or after December 1, 2016.

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Item 9. Changes in and Disagreements with Accountants on Accounting and Financial Disclosure

No information is required in response to this item.

Item 9A. Controls and Procedures

Disclosure Controls and Procedures

The company s 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 of December 31, 2007, and have concluded that these controls and procedures are effective to ensure that information required to be disclosed by the company in the reports that it files or submits under the Securities Exchange Act of 1934 (15 USC § 78a et seq) is recorded, processed, summarized, and reported within the time periods specified in the Securities and Exchange Commission s rules and forms. These disclosure controls and procedures include, without limitation, controls and procedures designed to ensure that information required to be disclosed by the company in the reports that it files or submits 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 fourth quarter of 2007, no change occurred in the company s internal control over financial reporting that materially affected, or is likely to materially affect, the company s internal control over financial reporting.

Item 9B. Other Information

No information is required in response to this item.

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MANAGEMENT S REPORT ON INTERNAL CONTROL OVER FINANCIAL REPORTING

The management of Northrop Grumman Corporation (the company) prepared and is responsible for the consolidated financial statements and all related financial information contained in this Annual Report. This responsibility includes establishing and maintaining effective internal control over financial reporting. The company s internal control over financial reporting was designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with accounting principles generally accepted in the United States of America.

To comply with the requirements of Section 404 of the Sarbanes Oxley Act of 2002, the company designed and implemented a structured and comprehensive assessment process to evaluate its internal control over financial reporting across the enterprise. The assessment of the effectiveness of the company s internal control over financial reporting was based on criteria established in *Internal Control Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission. Because of its inherent limitations, a system of internal control over financial reporting can provide only reasonable assurance and may not prevent or detect misstatements. Management regularly monitors its internal control over financial reporting, and actions are taken to correct any deficiencies as they are identified. Based on its assessment, management has concluded that the company s internal control over financial reporting is effective as of December 31, 2007.

Deloitte & Touche LLP issued an attestation report dated February 20, 2008, concerning the company s internal control over financial reporting, which is contained in this Annual Report. The company s consolidated financial statements as of and for the year ended December 31, 2007, have been audited by the independent registered public accounting firm of Deloitte & Touche LLP in accordance with the standards of the Public Company Accounting Oversight Board (United States).

/s/ Ronald D. Sugar
Chairman and Chief Executive Officer

/s/ James F. Palmer
Corporate Vice President and Chief Financial Officer

February 20, 2008

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REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM ON INTERNAL CONTROL OVER FINANCIAL REPORTING

To the Board of Directors and Shareholders of
Northrop Grumman Corporation
Los Angeles, California

We have audited the internal control over financial reporting of Northrop Grumman Corporation and subsidiaries (the Company) as of December 31, 2007, based on criteria established in *Internal Control Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission. The Company s management is responsible for maintaining effective internal control over financial reporting and for its assessment of the effectiveness of internal control over financial reporting, included in the accompanying Management s Report on Internal Control over Financial Reporting. Our responsibility is to express an opinion on the Company s internal control over financial reporting based on our audit.

We conducted our audit in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether effective internal control over financial reporting was maintained in all material respects. Our audit included obtaining an understanding of internal control over financial reporting, assessing the risk that a material weakness exists, testing and evaluating the design and operating effectiveness of internal control based on the assessed risk, and performing such other procedures as we considered necessary in the circumstances. We believe that our audit provides a reasonable basis for our opinion.

A company s internal control over financial reporting is a process designed by, or under the supervision of, the company s principal executive and principal financial officers, or persons performing similar functions, and effected by the company s board of directors, management, and other personnel to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles. A company s internal control over financial reporting includes those policies and procedures that (1) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company; (2) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the company are being made only in accordance with authorizations of management and directors of the company; and (3) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of the company s assets that could have a material effect on the financial statements.

Because of the inherent limitations of internal control over financial reporting, including the possibility of collusion or improper management override of controls, material misstatements due to error or fraud may not be prevented or detected on a timely basis. Also, projections of any evaluation of the effectiveness of the internal control over financial reporting to future periods are subject to the risk that the controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

In our opinion, the Company maintained, in all material respects, effective internal control over financial reporting as of December 31, 2007, based on the criteria established in *Internal Control Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission.

We have also audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the consolidated financial statements and financial statement schedule as of and for the year ended December 31, 2007 of the Company and our report dated February 20, 2008 expressed an unqualified opinion on those financial statements and the financial statement schedule and included an explanatory paragraph regarding the company s adoption of a new accounting standard.

/s/ Deloitte & Touche LLP
Los Angeles, California
February 20, 2008

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PART III

Item 10. Directors, Executive Officers, and Corporate Governance

Directors

The information as to Directors will be incorporated herein by reference to the Proxy Statement for the 2008 Annual Meeting of Stockholders to be filed within 120 days after the end of the company s fiscal year.

Executive Officers

The following individuals were the executive officers of the company as of February 20, 2008:

Name	Age	Office Held	Since	Prior Business Experience (Last Five Years)
Ronald D. Sugar	59	Chairman and Chief Executive Officer	2006	Chairman, Chief Executive Officer and President (2003-2006); Prior to April 2003, Chief Executive Officer and President; President and Chief Operating Officer (2001-2003)
Jerry B. Agee	64	Corporate Vice President and President, Mission Systems Sector	2005	Vice President and Deputy Sector President, Mission Systems Sector (2004-2005); Prior to June 2004, Vice President and General Manager, Systems-Missile Defense, Mission Systems Sector (2002-2004)
Wesley G. Bush	46	President and Chief Operating Officer	2007	President and Chief Financial Officer (2006-2007); Prior to March 2007, Corporate Vice President and Chief Financial Officer (2005-2006); Corporate Vice President and President, Space Technology Sector (2003-2005); Corporate Vice President of Northrop Grumman Corporation (2002-2003)
James L. Cameron	50	Corporate Vice President and President, Technical Services Sector	2006	Vice President and General Manager of Defensive and Navigation Systems Divisions, Electronic Systems Sector (2005); Prior to February 2005, Vice President and General Manager, Defensive Systems Division, Electronic Systems Sector (2003-2005); President, ITT Systems Defense Group (2000-2003)
Gary W. Ervin	50	Corporate Vice President and President, Integrated Systems Sector	2008	Corporate Vice President (2007); Prior to September 2007, Vice President, Western Region, Integrated Systems Sector (2005-2007); Vice President, Air Combat Systems, Integrated Systems Sector (2002-2005)
Kenneth N. Heintz	61	Corporate Vice President, Controller and	2005	Independent Financial Consultant (2004-2005); Prior to June 2004, Corporate Vice President, Hughes Electronics Corporation (now The

		Chief Accounting Officer		DIRECTV Group, Inc. (2000-2004))
Robert W. Helm	56	Corporate Vice President, Business Development and Government Relations	1994	

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Name	Age	Office Held	Since	Prior Business Experience (Last Five Years)
Alexis C. Livanos	59	Corporate Vice President and President, Space Technology Sector	2005	Vice President and General Manager of Systems Development and Technology and Space Sensors Divisions, and Vice President and General Manager of Navigation and Space Sensors Division, Electronics Sector (2003-2005); Prior to February 2003, Executive Vice President, Boeing Satellite Systems (2000-2003)
Linda A. Mills	58	Corporate Vice President and President, Information Technology Sector	2008	President of the Civilian Agencies business group, Information Technology Sector (2007-January 2008); Prior to February 2007, Vice President for Operations and Processes, Information Technology Sector (2005-2007); Vice President, Mission Assurance/Six Sigma, Mission Systems Sector (2003-2005)
Rosanne P. O Brien	64	Corporate Vice President, Communications	2000	
James R. O Neill	54	Corporate Vice President	2008	Corporate Vice President and President, Information Technology Sector (2004-January 2008); Prior to May 2004, President, TASC, Inc. (2002-2004)
James F. Palmer	58	Corporate Vice President and Chief Financial Officer	2007	Executive Vice President and Chief Financial Officer, Visteon Corporation (2004-2007); Prior to June 2004, Senior Vice President, The Boeing Company and President, Boeing Capital Corporation (2000-2004)
C. Michael Petters	48	Corporate Vice President and President, Northrop Grumman Shipbuilding Sector	2008	Corporate Vice President and President, Newport News Sector (2004-January 2008); Prior to November 2004, Vice President, Human Resources, Administration and Trades, Newport News Sector (2001-2004)
James F. Pitts	56	Corporate Vice President and President, Electronics Sector	2005	Vice President and General Manager of Aerospace Systems Division, Electronics Sector (2001-2005)
Mark Rabinowitz	46	Corporate Vice President and Treasurer	2007	Vice President and Assistant Treasurer (2006-2007); Prior to June 2006, Corporate Director and Assistant Treasurer, Banking and Capital Markets (2003-2006)
Scott J. Seymour	57	Corporate Vice President	2008	Corporate Vice President and President, Integrated Systems Sector (2002-2007)
Philip A. Teel	59	Corporate Vice President and Sector	2008	Corporate Vice President and President, Ship Systems Sector (2005- January 2008); Prior to July 2005, Vice President, Airborne Early

		President-Elect, Mission Systems Sector		Warning & Electronic Warfare Systems, Integrated Systems Sector (2000-2005)
W. Burks Terry	57	Corporate Vice President and General Counsel	2000	

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Name	Age	Office Held	Since	Prior Business Experience (Last Five Years)
Ian V. Ziskin	49	Corporate Vice President and Chief Human Resources and Administrative Officer	2006	Corporate Vice President, Human Resources and Leadership Strategy (2003-2005); Prior to June 2003, President and Founder, Executive Excellence Group (2002-2003)

Audit Committee Financial Expert

The information as to the Audit Committee and the Audit Committee Financial Expert will be incorporated herein by reference to the Proxy Statement for the 2008 Annual Meeting of Stockholders to be filed within 120 days after the end of the company s fiscal year.

Code of Ethics

The company has adopted Standards of Business Conduct for all of its employees, including the principal executive officer, principal financial officer and principal accounting officer. The Standards of Business Conduct can be found on the company s internet web site at www.northropgrumman.com under Investor Relations Corporate Governance Overview.

The web site and information contained on it or incorporated in it are not intended to be incorporated in this Annual Report on Form 10-K or other filings with the Securities Exchange Commission.

Item 11. Executive Compensation

Information concerning Executive Compensation, including information concerning Compensation Committed Interlocks and Insider Participation and Compensation Committee Report, will be incorporated herein by reference to the Proxy Statement for the 2008 Annual Meeting of Stockholders to be filed within 120 days after the end of the company s fiscal year.

Item 12. Security Ownership of Certain Beneficial Owners and Management and Related Stockholder Matters

The information as to Securities Authorized for Issuance Under Equity Compensation Plans and Security Ownership of Certain Beneficial Owners and Management and Related Stockholder Matters will be incorporated herein by reference to the Proxy Statement for the 2008 Annual Meeting of Stockholders to be filed within 120 days after the end of the company s fiscal year.

Item 13. Certain Relationships and Related Transactions, and Director Independence

The information as to Certain Relationships and Related Transactions, and Director Independence will be incorporated herein by reference to the Proxy Statement for the 2008 Annual Meeting of Stockholders to be filed within 120 days after the end of the company s fiscal year.

Item 14. Principal Accountant Fees and Services

The information as to principal accountant fees and services will be incorporated herein by reference to the Proxy Statement for the 2008 Annual Meeting of Shareholders to be filed within 120 days after the end of the company s

fiscal year.

PART IV

Item 15. Exhibits and Financial Statement Schedule

(a) 1. Report of Independent Registered Public Accounting Firm on the Consolidated Financial Statements

Financial Statements
Consolidated Statements of Income
Consolidated Statements of Financial Position

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Consolidated Statements of Comprehensive Income
Consolidated Statements of Cash Flows
Consolidated Statements of Changes in Shareholders Equity
Notes to Consolidated Financial Statements

2. Financial Statement Schedule
Schedule II Valuation and Qualifying Accounts

All other schedules are omitted either because they are not applicable or not required or because the required information is included in the financial statements or notes thereto.

Exhibits

3(a)	Restated Certificate of Incorporation of Northrop Grumman Corporation effective May 18, 2006 (incorporated by reference to Exhibit 3.1 to Form 8-K dated May 16, 2006 and filed May 19, 2006)
3(b)	Bylaws of Northrop Grumman Corporation, as amended February 9, 2007 (incorporated by reference to Exhibit 3.1 to Form 8-K dated February 9, 2007 and filed February 13, 2007)
4(a)	Registration Rights Agreement dated as of January 23, 2001, by and among Northrop Grumman Systems Corporation, Northrop Grumman Corporation and Unitrin, Inc. (incorporated by reference to Exhibit(d)(6) to Amendment No. 4 to Schedule TO filed January 31, 2001)
4(b)	Certificate of Designations, Preferences and Rights of Series B Preferred Stock of Northrop Grumman Corporation (incorporated by reference to Exhibit C to the Definitive Proxy Statement on Schedule 14A filed April 13, 2001)
4(c)	Indenture dated as of October 15, 1994, between Northrop Grumman Systems Corporation and JPMorgan Chase Bank (formerly The Chase Manhattan Bank), as trustee (incorporated by reference to Exhibit 4.1 to Form 8-K dated October 20, 1994, and filed October 25, 1994)
4(d)	Form of Officer s Certificate (without exhibits) establishing the terms of Northrop Grumman Systems Corporation s 7.75 percent Debentures due 2016 and 7.875 percent Debentures due 2026 (incorporated by reference to Exhibit 4-3 to Form S-4 Registration Statement No. 333-02653 filed April 19, 1996)
4(e)	Form of Northrop Grumman Systems Corporation s 7.75 percent Debentures due 2016 (incorporated by reference to Exhibit 4-5 to Form S-4 Registration Statement No. 333-02653 filed April 19, 1996)
4(f)	Form of Northrop Grumman Systems Corporation s 7.875 percent Debentures due 2026 (incorporated by reference to Exhibit 4-6 to Form S-4 Registration Statement No. 333-02653 filed April 19, 1996)
4(g)	Form of Officers Certificate establishing the terms of Northrop Grumman Systems Corporation s 7.125 percent Notes due 2011 and 7.75 percent Debentures due 2031 (incorporated by reference to Exhibit 10.9 to Form 8-K dated and filed April 17, 2001)
4(h)	Indenture dated as of April 13, 1998, between Litton Industries, Inc. (predecessor-in-interest to Northrop Grumman Systems Corporation) and The Bank of New York, as trustee, under which its 6.75 percent Senior Debentures due 2018 were issued (incorporated by reference to Exhibit 4.1 to the Form 10-Q of Litton Industries, Inc. for the quarter ended April 30, 1998, and filed June 15, 1998)
4(i)	Supplemental Indenture with respect to Indenture dated April 13, 1998, dated as of April 3, 2001, among Litton Industries, Inc. (predecessor-in-interest to Northrop Grumman Systems Corporation),

Northrop Grumman Corporation, Northrop Grumman Systems Corporation and The Bank of New York, as trustee (incorporated by reference to Exhibit 4.5 to Form 10-Q for the quarter ended March 31, 2001, filed May 10, 2001)

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4(j)	Supplemental Indenture with respect to Indenture dated April 13, 1998, dated as of December 20, 2002, among Litton Industries, Inc. (predecessor-in-interest to Northrop Grumman Systems Corporation), Northrop Grumman Corporation, Northrop Grumman Systems Corporation and The Bank of New York, as trustee (incorporated by reference to Exhibit 4(q) to Form 10-K for the year ended December 31, 2002, filed March 24, 2003)
4(k)	Senior Indenture dated as of December 15, 1991, between Litton Industries, Inc. (predecessor-in-interest to Northrop Grumman Systems Corporation) and The Bank of New York, as trustee, under which its 7.75 percent and 6.98 percent debentures due 2026 and 2036 were issued and specimens of such debentures (incorporated by reference to Exhibit 4.1 to the Form 10-Q of Litton Industries, Inc. for the quarter ended April 30, 1996, filed June 11, 1996)
4(l)	Supplemental Indenture with respect to Indenture dated December 15, 1991, dated as of April 3, 2001, among Litton Industries, Inc. (predecessor-in-interest to Northrop Grumman Systems Corporation), Northrop Grumman Corporation, Northrop Grumman Systems Corporation and The Bank of New York, as trustee (incorporated by reference to Exhibit 4.7 to Form 10-Q for the quarter ended March 31, 2001, filed May 10, 2001)
4(m)	Supplemental Indenture with respect to Indenture dated December 15, 1991, dated as of December 20, 2002, among Litton Industries, Inc. (predecessor-in-interest to Northrop Grumman Systems Corporation), Northrop Grumman Corporation, Northrop Grumman Systems Corporation and The Bank of New York, as trustee (incorporated by reference to Exhibit 4(t) to Form 10-K for the year ended December 31, 2002, filed March 24, 2003)
4(n)	Form of Exchange Security for the $400,000,000 8 percent senior notes due 2009 of Litton Industries, Inc. (predecessor-in-interest to Northrop Grumman Systems Corporation) (incorporated by reference to Exhibit 4.3 to the Form 10-Q of Litton Industries, Inc. for the quarter ended April 30, 2000, filed June 9, 2000)
4(o)	Indenture between TRW Inc. (now named Northrop Grumman Space & Mission Systems Corp.) and The Chase Manhattan Bank, as successor Trustee, dated as of May 1, 1986 (incorporated by reference to Exhibit 2 to the Form 8-A Registration Statement of TRW Inc. dated July 3, 1986)
4(p)	First Supplemental Indenture between TRW Inc. (now named Northrop Grumman Space & Mission Systems Corp.) and The Chase Manhattan Bank, as successor Trustee, dated as of August 24, 1989 (incorporated by reference to Exhibit 4(b) to Form S-3 Registration Statement No. 33-30350 of TRW Inc.)
4(q)	Fourth Supplemental Indenture between TRW Inc. (now named Northrop Grumman Space & Mission Systems Corp.) and The Chase Manhattan Bank, as successor Trustee, dated as of June 2, 1999 (incorporated by reference to Exhibit 4(e) to Form S-4 Registration Statement No. 333-83227 of TRW Inc. filed July 20, 1999)
4(r)	Fifth Supplemental Indenture between TRW Inc. (now named Northrop Grumman Space & Mission Systems Corp.) and The Chase Manhattan Bank, as successor Trustee, dated as of June 2, 1999 (incorporated by reference to Exhibit 4(f) to Form S-4 Registration Statement No. 333-83227 of TRW Inc. filed July 20, 1999)
10(a)	Form of Amended and Restated Credit Agreement dated as of August 10, 2007, among Northrop Grumman Corporation, as Borrower; Northrop Grumman Systems Corporation and Northrop Grumman Space & Mission Systems Corp., as Guarantors; the Lenders party thereto; JPMorgan Chase Bank, N.A., as Payment Agent, an Issuing Bank, Swingline Lender and Administrative Agent; Credit Suisse, as Administrative Agent; Citicorp USA, Inc., as Syndication Agent; Deutsche Bank Securities Inc. and The Royal Bank of Scotland PLC, as Documentation Agents; and BNP

	Paribas as Co-Documentation Agent (incorporated by reference to Exhibit 10.1 to Form 8-K dated and filed August 13, 2007)
10(b)	Form of Guarantee dated as of April 3, 2001, by Northrop Grumman Corporation of the indenture indebtedness issued by the former Litton Industries, Inc. (incorporated by reference to Exhibit 10.10 to Form 8-K dated and filed April 17, 2001)

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10(c)	Form of Guarantee dated as of April 3, 2001, by Northrop Grumman Corporation of Northrop Grumman Systems Corporation indenture indebtedness (incorporated by reference to Exhibit 10.11 to Form 8-K dated and filed April 17, 2001)
10(d)	Form of Guarantee dated as of March 27, 2003, by Northrop Grumman Corporation, as Guarantor, in favor of JP Morgan Chase Bank (formerly The Chase Manhattan Bank), as trustee, of certain debt securities of Northrop Grumman Space & Mission Systems Corp. (formerly TRW Inc.) (incorporated by reference to Exhibit 4.2 to Form 10-Q for the quarter ended March 31, 2003, filed May 14, 2003)
10(e)	Form of Guarantee dated as of January 9, 2003, by Northrop Grumman Space & Mission Systems Corp. (formerly TRW Inc.) of Northrop Grumman Systems Corporation indenture indebtedness (incorporated by reference to Exhibit 10(qq) to Form 10-K for the year ended December 31, 2002, filed March 24, 2003)
10(f)	Northrop Grumman 1993 Long-Term Incentive Stock Plan, as amended and restated (incorporated by reference to Exhibit 4.1 to Form S-8 Registration Statement No. 333-68003 filed November 25, 1998)
*10(g)	Northrop Grumman Corporation 1993 Stock Plan for Non-Employee Directors (as Amended and Restated January 1, 2008)
10(h)	Northrop Grumman Corporation 1995 Stock Plan for Non-Employee Directors, as Amended as of May 16, 2007 (incorporated by reference to Exhibit A to Schedule 14A filed April 12, 2007)
*10(i)	Northrop Grumman 2001 Long-Term Incentive Stock Plan (As amended September 17, 2003) (incorporated by reference to Exhibit 10.1 to Form 10-Q for the quarter ended September 30, 2003, filed November 6, 2003), as amended by First Amendment to the Northrop Grumman 2001 Long-Term Incentive Stock Plan dated December 19, 2007

(i)	Form of Notice of Non-Qualified Grant of Stock Options and Option Agreement (incorporated by reference to Exhibit 10.5 to Form S-4 Registration Statement No. 333-83672 filed March 4, 2002)
(ii)	Form of Restricted Performance Stock Rights Agreement (officer), as amended May 16, 2005, applicable to 2005 Restricted Performance Stock Rights (incorporated by reference to Exhibit 10.3 to Form 10-Q for the quarter ended June 30, 2005, filed July 28, 2005)
(iii)	Form of Agreement for 2005 Stock Options (officer) (incorporated by reference to Exhibit 10(d)(v) to Form 10-K for the year ended December 31, 2004, filed March 4, 2005)
(iv)	Form of letter from Northrop Grumman Corporation regarding Stock Option and RPSR Retirement Enhancement (incorporated by reference to Exhibit 10.2 to Form 8-K dated March 14, 2005 and filed March 15, 2005)
(v)	Form of Restricted Performance Stock Rights Agreement (non-officer), as amended May 16, 2005, applicable to 2005 Restricted Performance Stock Rights (incorporated by reference to Exhibit 10.4 to Form 10-Q for the quarter ended June 30, 2005, filed July 28, 2005)
*(vi)	Form of Restricted Performance Stock Rights Agreement applicable to 2006 Restricted Performance Stock Rights, as amended
(vii)	Form of Agreement for 2006 Stock Options (officer) (incorporated by reference to Exhibit 10(d)(viii) to Form 10-K for the year ended December 31, 2005, filed February 17, 2006)

*(viii)	Form of Restricted Stock Rights Agreement applicable to 2006 Restricted Stock Rights, as amended
*(ix)	2006 CPC Incentive Restricted Stock Rights Agreement of Wesley G. Bush dated May 16, 2006, as amended

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NORTHROP GRUMMAN CORPORATION

	(x)	2006 CPC Incentive Restricted Stock Rights Agreement of Scott J. Seymour dated May 16, 2006 (incorporated by reference to Exhibit 10.5 to Form 10-Q for the quarter ended June 30, 2006, filed July 27, 2006)
	*(xi)	Form of Restricted Performance Stock Rights Agreement, applicable to 2007 Restricted Performance Stock Rights, as amended
	(xii)	Form of Agreement for 2007 Stock Options (officers) (incorporated by reference to Exhibit 10(2)(ii) to Form 10-Q for the quarter ended March 31, 2007, filed April 24, 2007)
	*(xiii)	Terms and Conditions Applicable to Special 2007 Restricted Stock Rights Granted to James F. Palmer dated March 12, 2007, as amended
*10(j)	Northrop Grumman Supplemental Plan 2 (Amended and Restated Effective as of January 1, 2005)	
	*(i)	Appendix A: Northrop Supplemental Retirement Income Program for Senior Executives (Amended and Restated Effective as of January 1, 2005)
	(ii)	Appendix B: ERISA Supplemental Program 2 as amended and restated effective October 1, 2004 (incorporated by reference to Exhibit 10(j)(ii) of Form 10-K for the year ended December 31, 2004, filed March 4, 2005)
	*(iii)	Appendix F: CPC Supplemental Executive Retirement Program (Amended and Restated Effective as of January 1, 2005)
	*(iv)	Appendix G: Officers Supplemental Executive Retirement Program (Amended and Restated Effective as of January 1, 2005)
*10(k)	Northrop Grumman ERISA Supplemental Plan (Amended and Restated Effective as of January 1, 2005)	
*10(l)	Northrop Grumman Supplementary Retirement Income Plan (formerly TRW Supplementary Retirement Income Plan) (Amended and Restated Effective January 1, 2005)	
*10(m)	Northrop Grumman Electronic Systems Executive Pension Plan (Amended and Restated Effective as of January 1, 2005)	
10(n)	Northrop Grumman Corporation March 2004 Change-in-Control Severance Plan (incorporated by reference to Exhibit 10.4 to Form 10-Q for the quarter ended September 30, 2003, filed November 6, 2003)	
10(o)	Form of Northrop Grumman Corporation March 2004 Special Agreement (relating to severance program for change in control) (incorporated by reference to Exhibit 10.5 to Form 10-Q for the quarter ended September 30, 2003, filed November 6, 2003)	
*10(p)	Severance Plan for Elected and Appointed Officers of Northrop Grumman Corporation As amended and restated effective January 1, 2008	
*10(q)	Northrop Grumman Corporation Non-Employee Directors Equity Participation Plan, as Amended and Restated January 1, 2008	
10(r)	Non-Employee Director Compensation Term Sheet, effective October 24, 2007 (incorporated by reference to Exhibit 10.1 to Form 10-Q for the quarter ended September 30, 2007, filed October 24, 2007)	
10(s)	Form of Indemnification Agreement between Northrop Grumman Corporation and its directors and executive officers (incorporated by reference to Exhibit 10.39 to Form S-4 Registration Statement No. 333-83672 filed March 4, 2002)	
*10(t)	Northrop Grumman Deferred Compensation Plan (Amended and Restated Effective as of January 1, 2005)	
*10(u)		

	The 2002 Incentive Compensation Plan of Northrop Grumman Corporation, As amended and restated effective as of January 1, 2008
*10(v)	Northrop Grumman 2006 Annual Incentive Plan and Incentive Compensation Plan (for Non-Section 162(m) Officers), as amended and restated effective January 1, 2008

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NORTHROP GRUMMAN CORPORATION

*10(w)	Northrop Grumman Savings Excess Plan (Amended and Restated Effective as of January 1, 2005)
10(x)	Employment Agreement dated February 19, 2003, between Northrop Grumman Corporation and Dr. Ronald D. Sugar (incorporated by reference to Exhibit 10(nn) to Form 10-K for the year ended December 31, 2002, filed March 24, 2003)
10(y)	Employment Agreement between Dr. Ronald D. Sugar and Northrop Grumman Corporation dated September 19, 2001 (incorporated by reference to Exhibit 10.3 to Form 10-Q for the quarter ended September 30, 2001, filed November 5, 2001)
10(z)	Letter Agreement dated June 21, 2000, between Litton Industries, Inc. and Ronald D. Sugar (incorporated by reference to Exhibit 10.1 to Form 8-K of Litton Industries, Inc. (LII) dated and filed June 22, 2000), and Letter Agreement dated December 21, 2000, between Northrop Grumman Corporation and Ronald D. Sugar (incorporated by reference to Exhibit 99(e)(7) to Schedule 14D-9 of LII filed January 5, 2001), as amended by Amendment dated January 31, 2001, between Northrop Grumman Corporation and Ronald D. Sugar (incorporated by reference to Exhibit 99(e)(16) to Amendment No. 3 to Schedule 14D-9 of LII filed February 1, 2001)
*10(aa)	Litton Industries, Inc. Restoration Plan 2 (Amended and Restated Effective as of January 1, 2005)
*10(bb)	Litton Industries, Inc. Restoration Plan (Amended and Restated Effective as of January 1, 2005)
10(cc)	Litton Industries, Inc. Supplemental Executive Retirement Plan as amended and restated effective October 1, 2004 (incorporated by reference to Exhibit 10(ee) to Form 10-K for the year ended December 31, 2004, filed March 4, 2005)
10(dd)	Northrop Grumman Corporation Supplemental Retirement Replacement Plan (Effective March 12, 2007) for James F. Palmer (incorporated by reference to Exhibit 10(2) to Form 10-Q for the quarter ended June 30, 2007, filed July 24, 2007)
10(ee)	Northrop Grumman Corporation Special Officer Retiree Medical Plan (As Amended and Restated Effective April 1, 2007) (incorporated by reference to Exhibit 10(5) to Form 10-Q for the quarter ended March 31, 2007, filed April 24, 2007)
10(ff)	Executive Life Insurance Policy (incorporated by reference to Exhibit 10(gg) to Form 10-K for the year ended December 31, 2004, filed March 4, 2005)
10(gg)	Executive Accidental Death, Dismemberment and Plegia Insurance Policy (incorporated by reference to Exhibit 10(hh) to Form 10-K for the year ended December 31, 2004, filed March 4, 2005)
10(hh)	Executive Long-Term Disability Insurance Policy (incorporated by reference to Exhibit 10(ii) to Form 10-K for the year ended December 31, 2004, filed March 4, 2005)
10(ii)	Executive Dental Insurance Policy Group Numbers 5134 and 5135 (incorporated by reference to Exhibit 10(m) to Form 10-K for the year ended December 31, 1995, filed February 22, 1996)
10(jj)	Group Personal Excess Liability Policy (incorporated by reference to Exhibit 10(ll) to Form 10-K for the year ended December 31, 2004, filed March 4, 2005)
10(kk)	Northrop Grumman Executive Medical Plan Benefit Matrix effective July 1, 2006 (incorporated by reference to Exhibit 10.6 to Form 10-Q for the quarter ended June 30, 2006, filed July 27, 2006)
10(ll)	Retirement Transition Agreement dated October 2, 2007 between Northrop Grumman Corporation and Scott J. Seymour (incorporated by reference to Exhibit 10.1 to Form 8-K dated and filed October 5, 2007)
10(mm)	Consultant Contract dated October 5, 2007 between Northrop Grumman Corporation and Scott J. Seymour (incorporated by reference to Exhibit 10.2 to Form 8-K dated and filed October 5, 2007)

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NORTHROP GRUMMAN CORPORATION

10(nn)	Offering letter dated February 1, 2007 from Northrop Grumman Corporation to James F. Palmer relating to position of Corporate Vice President and Chief Financial Officer (incorporated by reference to Exhibit 10(3) to Form 10-Q for the quarter ended March 31, 2007, filed April 24, 2007)
*21	Subsidiaries
*23	Consent of Independent Registered Public Accounting Firm
*24	Power of Attorney
*31.1	Rule 13a-15(e)/15d-15(e) Certification of Ronald D. Sugar (Section 302 of the Sarbanes-Oxley Act of 2002)
*31.2	Rule 13a-15(e)/15d-15(e) Certification of James F. Palmer (Section 302 of the Sarbanes-Oxley Act of 2002)
**32.1	Certification of Ronald D. Sugar pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002
**32.2	Certification of James F. Palmer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002

*	Filed with this Report
**	Furnished with this Report

NORTHROP GRUMMAN CORPORATION

SIGNATURES

Pursuant to the requirements of Section 13 or 15(d) 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, on the 20th day of February 2008.

NORTHROP GRUMMAN CORPORATION

By: **/s/ Kenneth N. Heintz**

Kenneth N. Heintz
Corporate Vice President, Controller, and
Chief Accounting Officer
(Principal Accounting Officer)

Pursuant to the requirements of the Securities Exchange Act of 1934, this report has been signed on behalf of the registrant this the 20th day of February 2007, by the following persons and in the capacities indicated.

Signature	**Title**
Ronald D. Sugar*	Chairman and Chief Executive Officer (Principal Executive Officer), and Director
James F. Palmer*	Corporate Vice President and Chief Financial Officer (Principal Financial Officer)
Lewis W. Coleman*	Director
Vic Fazio*	Director
Donald E. Felsinger*	Director
Stephen Frank*	Director
Phillip Frost*	Director
Charles R. Larson*	Director
Richard B. Myers*	Director
Phillip A. Odeen*	Director
Aulana L. Peters*	Director

Kevin W. Sharer*	Director

*By: **/s/ Stephen D. Yslas**

Stephen D. Yslas
Corporate Vice President, Secretary,
and Deputy General Counsel
Attorney-in-Fact
pursuant to a power of attorney

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NORTHROP GRUMMAN CORPORATION

SCHEDULE II VALUATION AND QUALIFYING ACCOUNTS

($ in millions)

Description	Balance at Beginning of Period	Additions At Cost	Changes Add (Deduct)	Balance at End of Period
Year ended December 31, 2005				
Reserves and allowances deducted[1] from asset accounts:				
Allowances for doubtful amounts	$ 264	$ 56	$ (97)	$ 223
Valuation allowance on deferred tax assets	1,375		(36)	1,339
Year ended December 31, 2006				
Reserves and allowances deducted[1] from asset accounts:				
Allowances for doubtful amounts	$ 223	$ 171	$ (86)	$ 308
Valuation allowance on deferred tax assets	1,339		(39)	1,300
Year ended December 31, 2007				
Reserves and allowances deducted[1] from asset accounts:				
Allowances for doubtful amounts	$ 308	$ 124	$ (146)	$ 286
Valuation allowance on deferred tax assets	1,300	3	(711)	592

(1) Uncollectible amounts written off, net of recoveries.