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

FORM 8-K

CURRENT REPORT

Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934

Date of Report: July 29, 2008
(Date of earliest event reported)

NORTHROP GRUMMAN CORPORATION

(Exact name of registrant as specified in its charter)

Delaware
(State or other jurisdiction
of incorporation)

1-16411
(Commission File Number)

95-4840775
(IRS Employer
Identification No.)

1840 Century Park East, Los Angeles, California
(Address of principal executive offices)

90067
(Zip Code)

(310) 553-6262
(Registrant's telephone number, including area code)

Check the appropriate box below if the Form 8-K filing is intended to simultaneously satisfy the filing obligation of the registrant under any of the following provisions:

- Written communications pursuant to Rule 425 under the Securities Act (17 CFR 230.425)
 - Soliciting material pursuant to Rule 14a-12 under the Exchange Act (17 CFR 240.14a-12)
 - Pre-commencement communications pursuant to Rule 14d-2(b) under the Exchange Act (17 CFR 240.14d-2(b))
 - Pre-commencement communications pursuant to Rule 13e-4(c) under the Exchange Act (17 CFR 240.13e-4(c))
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Item 8.01 Other Events.

Northrop Grumman Corporation (the “company”) is filing this Current Report on Form 8-K to recast the presentation of its consolidated financial statements that were initially filed with the Securities and Exchange Commission (“SEC”) in the company’s Annual Report on Form 10-K for the year ended December 31, 2007 (the “Form 10-K”) to reflect the following:

Realignments

During the first quarter of 2008, the company transferred certain businesses from the Electronics segment to the Mission Systems segment. The company’s financial statements included in its Quarterly Report on Form 10-Q for the quarter ended March 31, 2008 (the “First Quarter 10-Q”) reflect this new reporting structure.

During the second quarter of 2008, the company transferred certain programs and assets comprising the missiles business in the Mission Systems segment to the Space Technology segment. This transfer allows 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. The company’s financial statements included in its Quarterly Report on Form 10-Q for the quarter ended June 30, 2008 (the “Second Quarter 10-Q”) reflect this new reporting structure.

Disposition

In April 2008, the company sold its Electro-Optical Systems business, formerly a part of the Electronics segment, for \$175 million in cash to L-3 Communications Corporation. The transaction closed in April 2008 and the company recognized a small after-tax gain. Electro-Optical Systems, formerly part of the company’s Electronics segment, produces night vision and applied optics products. Operating results of this business were reported as discontinued operations in the consolidated statements of income, for all periods presented in the First Quarter 10-Q and the Second Quarter 10-Q.

The SEC requires a registrant to include or incorporate by reference in a registration statement filed with the SEC under the Securities Act of 1933 (the “Securities Act”), recasted segment information for previously issued financial statements incorporated by reference in such registration statement, whenever there has been a change in reportable segments which is not yet reflected in such previously issued financial statements, provided the change in reportable segments is deemed to be a material change. The SEC also requires the recast of previously issued financial statements to reflect the subsequent reclassification of operations to discontinued operations whenever such previously issued financial statements are incorporated by reference in a registration statement filed with the SEC under the Securities Act. Accordingly, the company is revising and including in this Form 8-K the following portions of the Form 10-K: Selected Financial Data (Item 6), Management’s Discussion and Analysis of Financial Condition and Results of Operations (Item 7) and Financial Statements and Supplementary Data (Item 8). In addition, the Company has included in this Form 8-K Management’s Report on Internal Control Over Financial Reporting, which is unchanged from the Form 10-K, the Report of Independent Registered Public Accounting Firm on Internal Control Over Financial Reporting, which reflects the dual dating of the Report of Independent Registered Public Accounting Firm on the Consolidated Financial Statements included with the Financial Statements and Supplementary Data, and Schedule II – Valuation and Qualifying Accounts (included as part of Item 15 of the Form 10-K), which is unchanged from the Form 10-K.

In order to preserve the nature and character of the disclosures set forth in such items as originally filed in the Form 10-K, no attempt has been made in this Form 8-K, and it should not be read, to modify or update disclosures as presented in the Form 10-K to reflect events or occurrences after the date of the filing of the Form 10-K, except for matters relating specifically to the recasting of the presentation described above. Therefore, this Form 8-K should be read in conjunction with the Form 10-K and the Company’s filings made with the SEC subsequent to the filing of the Form 10-K, including the First Quarter 10-Q and Second Quarter 10-Q.

Item 9.01 Financial Statements and Exhibits.

(d) Exhibits.

Exhibit 23.1 Consent of Independent Registered Public Accounting Firm*

Exhibit 99.1 Item 6: Selected Financial Data*

Exhibit 99.2 Item 7: Management’s Discussion and Analysis of Financial Condition and Results of Operations*

Exhibit 99.3 Item 8: Financial Statements and Supplementary Data*

Exhibit 99.4 Management’s Report on Internal Control Over Financial Reporting*

Exhibit 99.5 Report of Independent Registered Public Accounting Firm on Internal Control Over Financial Reporting*

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Exhibit 99.6 Schedule II-Valuation and Qualifying Accounts*

* filed herewith

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Signature(s)

Pursuant to the requirements of the Securities Exchange Act of 1934, the registrant has duly caused this Report to be signed on its behalf by the undersigned hereunto duly authorized.

July 29, 2008
(Date)

Northrop Grumman Corporation
(Registrant)

By: /s/ Stephen D. Yslas _____
(Signature)
Stephen D. Yslas
Corporate Vice President, Secretary,
and Deputy General Counsel

EXHIBIT INDEX

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Exhibit 99.3 Financial Statements and Supplementary Data*

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Exhibit 99.5 Report of Independent Registered Public Accounting Firm on Internal Control Over Financial Reporting*

Exhibit 99.6 Schedule II-Valuation and Qualifying Accounts*

* filed herewith

CONSENT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

We consent to the incorporation by reference in Registration Statement Nos. 033-59815, 033-59853, 333-03959, 333-68003, 333-67266, 333-61936, 333-100179, 333-107734, 333-121104, 333-125120 and 333-127317 on Form S-8; Registration Statement Nos. 333-78251, 333-85633 and 333-77056 on Form S-3; and Registration Statement Nos. 333-40862, 333-54800 and 333-83672 on Form S-4 of our report dated February 20, 2008 (July 29, 2008 as to the reclassification of Electro-Optical Systems as a discontinued operation and the reclassification of segment information as described in Notes 5 and 6), relating to the financial statements and financial statement schedule (which report expresses an unqualified opinion and includes an explanatory paragraph regarding Northrop Grumman Corporation's adoption of new accounting standards) of Northrop Grumman Corporation and of our report dated February 20, 2008 relating to the effectiveness of Northrop Grumman Corporation's internal control over financial reporting, appearing in this Current Report on Form 8-K of Northrop Grumman Corporation dated July 29, 2008.

/s/ Deloitte & Touche LLP
Los Angeles, California
July 29, 2008

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 Item 7.

Selected Financial Data

<i>\$ in millions except per share</i>	Year ended December 31				
	2007	2006	2005	2004	2003
Sales and Service Revenues					
United States Government	\$ 28,562	\$ 26,920	\$ 26,937	\$ 25,419	\$ 21,979
Other customers	3,266	3,071	2,927	3,345	3,358
Total revenues	\$ 31,828	\$ 29,991	\$ 29,864	\$ 28,764	\$ 25,337
Operating margin	\$ 3,018	\$ 2,494	\$ 2,227	\$ 1,987	\$ 1,473
Income from continuing operations	1,811	1,593	1,413	1,080	770
Basic earnings per share, from continuing operations	\$ 5.30	\$ 4.61	\$ 3.96	\$ 3.00	\$ 2.11
Diluted earnings per share, from continuing operations	5.18	4.51	3.89	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	\$ 2,071	\$ 947	\$ 1,811	\$ 1,266	\$ 162
Net working capital (deficit)	365	(4)	(397)	707	(580)
Current ratio	1.06 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	\$ 534	\$ 569	\$ 533	\$ 501	\$ 425
Maintenance and repairs	335	358	428	394	241
Payroll and employee benefits	12,888	12,455	12,140	12,398	10,888
Number of employees at year-end	121,700	121,400	122,800	124,600	122,600

FORWARD-LOOKING STATEMENTS AND PROJECTIONS

Statements in this Form 10-K that are in the future tense, and all statements accompanied by terms such as “believe,” “project,” “expect,” “estimate,” “forecast,” “assume,” “intend,” “plan,” “anticipate,” “outlook,” and variations thereof and similar terms are intended to be “forward-looking statements” as defined by federal securities law. Forward-looking statements are based upon assumptions, expectations, plans and projections that are believed valid when made, but that are subject to the risks and uncertainties identified under Risk Factors in Part I, Item 1A, that may cause actual results to differ materially from those expressed or implied in the forward-looking statements.

The company intends that all forward-looking statements made will be subject to safe harbor protection of the federal securities laws pursuant to Section 27A of the Securities Act of 1933 and Section 21E of the Securities Exchange Act of 1934.

Forward-looking statements are based upon, among other things, the company’s assumptions with respect to:

- § future revenues;
- § expected program performance and cash flows;
- § returns on pension plan assets and variability of pension actuarial and related assumptions;
- § the outcome of litigation, claims, appeals and investigations;
- § hurricane-related insurance recoveries;
- § environmental remediation;
- § acquisitions and divestitures of businesses;
- § joint ventures and other business arrangements;
- § access to capital;
- § performance issues with key suppliers and subcontractors;
- § product performance and the successful execution of internal plans;
- § successful negotiation of contracts with labor unions;
- § allowability and allocability of costs under U.S. Government contracts;
- § effective tax rates and timing and amounts of tax payments;
- § the results of any audit or appeal process with the Internal Revenue Service; and
- § anticipated costs of capital investments.

You should consider the limitations on, and risks associated with, forward-looking statements and not unduly rely on the accuracy of predictions contained in such forward-looking statements. As noted above, these forward-looking statements speak only as of the date when they are made. The company does not undertake any obligation to update forward-looking statements to reflect events, circumstances, changes in expectations, or the occurrence of unanticipated events after the date of those statements. Moreover, in the future, the company, through senior management, may make forward-looking statements that involve the risk factors and other matters described in this Form 10-K as well as other risk factors subsequently identified, including, among others, those identified in the company’s filings with the SEC on Form 10-Q and Form 8-K.

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 Department of Defense (“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.

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- § Operating margin increase of 21 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 \$5.18 per share.
- § Total backlog of \$63.7 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 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 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 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

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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.

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.

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

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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 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, for all periods presented.

Electro-Optical Systems – In March 2008, the company signed a definitive agreement to sell its Electro-Optical Systems business for \$175 million in cash to L-3 Communications Corporation. The transaction closed in April 2008 and the company recognized a small after-tax gain. Electro-Optical Systems, a part of the company's Electronics segment, produces night vision and applied optics products. Sales and after tax (loss) earnings for the business for the years ended December 31, 2007, 2006, and 2005 were approximately \$190 million and (\$8) million, \$122 million and (\$20) million, and \$114 million and (\$17) million, respectively. The results of this business are reported as discontinued operations in the consolidated statements of income, 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 the assembly business unit of ITD are reported as discontinued operations in the consolidated statements of income, for all periods presented. 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.

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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 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:

<i>(\$ in millions)</i>	U.S. Government	Other Customers	Total	Percent of Total
Flexibly priced	\$ 21,416	\$ 698	\$ 22,114	69%
Firm fixed-price	7,146	2,568	9,714	31%
Total	\$ 28,562	\$ 3,266	\$ 31,828	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

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recognizes income as work on a contract progresses. For 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.

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.

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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 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 Item 8. Prior to 2007, the company recorded accruals for tax contingencies and related

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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 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:

<i>\$ in millions</i>	.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:

<i>\$ in millions</i>	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)

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CONSOLIDATED OPERATING RESULTS

Selected financial highlights are presented in the table below.

<i>\$ in millions, except per share</i>	Year ended December 31		
	2007	2006	2005
Sales and service revenues	\$31,828	\$29,991	\$29,864
Cost of sales and service revenues	28,810	27,497	27,637
Operating margin	3,018	2,494	2,227
Interest expense, net	308	303	334
Other, net	(12)	125	199
Federal and foreign income taxes	887	723	679
Diluted earnings per share from continuing operations	5.18	4.51	3.89
Net cash provided by operating activities	2,890	1,756	2,627

Sales and Service Revenues

Sales and service revenues consist of the following:

<i>\$ in millions</i>	Year Ended December 31		
	2007	2006	2005
Product sales	\$ 18,577	\$ 18,294	\$ 19,371
Service revenues	13,251	11,697	10,493
Sales and service revenues	\$ 31,828	\$ 29,991	\$ 29,864

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:

<i>\$ in millions</i>	Year Ended December 31		
	2007	2006	2005
Cost of Sales and Service Revenues			
Cost of product sales	\$14,340	\$14,275	\$15,440
<i>% of product sales</i>	77.2%	78.0%	79.7%
Cost of service revenues	11,297	10,220	9,340
<i>% of service revenues</i>	85.3%	87.4%	89.0%
General and administrative expenses	3,173	3,002	2,857
<i>% of total sales and service revenues</i>	10.0%	10.0%	9.6%
Cost of sales and service revenues	\$28,810	\$27,497	\$27,637

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Cost of Product Sales and Service Revenues

2007 – Cost of product sales during 2007 increased \$65 million, or less than 1 percent, over 2006 while decreasing 80 basis points as a percentage of product sales over the same period. Cost of service revenues during 2007 increased \$1.1 billion, or 11 percent, over 2006 while decreasing 210 basis points as a percentage of service revenues 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 8 percent, over 2005 while decreasing 170 basis points as a percentage of product sales over the same period. Cost of service revenues during 2006 increased \$880 million, or 9 percent, over 2005 while decreasing 160 basis points as a percentage of service revenues 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 percent in 2006. The increase in 2006 is due primarily to higher property insurance, litigation, and bid and proposal costs, partially offset by lower independent research and development costs (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:

<i>\$ in millions</i>	Year ended December 31		
	2007	2006	2005
Segment operating margin	\$ 3,115	\$ 2,837	\$ 2,448
Unallocated expenses	(224)	(306)	(200)
Net pension adjustment	127	(37)	(21)
Total operating margin	\$ 3,018	\$ 2,494	\$ 2,227

Segment Operating Margin

2007 – Segment operating margin for the year ended December 31, 2007 increased \$278 million, or 10 percent, as compared to the same period in 2006. Total segment operating margin was 9.8 percent and 9.5 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 \$389 million, or 16 percent, as compared to the same period in 2005. Total segment operating margin was 9.5 percent and 8.2 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 \$5.18 per share, an increase of 15 percent from \$4.51 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 \$4.51 per share, an increase of 16 percent from \$3.89 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 with contributions of \$1.2 billion in 2006, of which \$800 million was voluntarily pre-funded. Cash collected from customers increased by \$1.9 billion, and cash paid to suppliers and employees increased by \$593 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 \$184 million, and cash paid to suppliers and employees increased by \$341 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

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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

\$ in millions	Year ended December 31		
	2007	2006	2005
Sales and Service Revenues			
Information & Services			
Mission Systems	\$ 5,077	\$ 4,704	\$ 4,595
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	4,176	3,869	3,909
Electronics			
Ships	5,788	5,321	5,786
Intersegment eliminations	(1,471)	(1,490)	(1,525)
Sales and service revenues	\$ 31,828	\$ 29,991	\$ 29,864
Operating Margin			
Information & Services			
Mission Systems	\$ 508	\$ 451	\$ 370
Information Technology	329	342	322
Technical Services	120	120	100
Aerospace			
Integrated Systems	591	551	499
Space Technology	329	311	284
Electronics			
Ships	538	393	249
Intersegment eliminations	(113)	(117)	(101)
Segment operating margin	\$ 3,115	\$ 2,837	\$ 2,448

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 recast to reflect these changes.

Subsequent Realignments – In January 2008, the Newport News and Ship Systems businesses 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.

During the second quarter of 2008, the company transferred certain programs and assets comprising the missiles business in the Mission Systems segment to the Space Technology segment. This transfer allows 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 segment businesses were transferred to Mission Systems during the first quarter of 2008.

These subsequent realignments have been reflected in 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

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Critical Accounting Policies, Estimates and Judgments described on page 7. 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.

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 28.

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); and Intelligence, Surveillance and Reconnaissance (ISR).

<i>\$ in millions</i>	Year ended December 31		
	2007	2006	2005
Funded Contract Acquisitions	\$ 5,402	\$ 5,005	\$ 4,381
Sales and Service Revenues	5,077	4,704	4,595
Segment Operating Margin	508	451	370
<i>As a percentage of segment sales</i>	10.0%	9.6%	8.1%

Funded Contract Acquisitions

2007 – Mission Systems funded contract acquisitions increased \$397 million, or 8 percent, in 2007 as compared with 2006 due to \$401 million higher funded contract acquisitions in ISR related to the acquisition of Essex. An increase of \$13 million in funded contract acquisitions in C3. Significant funded contract acquisitions in 2007 included \$223 million for the Joint National Integration Center Research and Development program, \$188 million for the F-22 program, \$137 million for the Ground-Based Midcourse Fire

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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 \$624 million, or 14 percent, in 2006 as compared with 2005, primarily due to timing of fiscal year funding, including the receipt of delayed funding upon approval of the fiscal year 2006 federal defense budget and new awards in international commercial businesses. Significant acquisitions in 2006 included \$217 million for the Joint National Integration Center Research and Development (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, \$118 million for the Command Post Platform (CPP) program and \$108 million for the Cutlass program.

Sales and Service Revenues

2007 – Mission Systems revenue increased \$373 million, or 8 percent, as compared with 2006. The increase was due to \$279 million in higher sales in ISR, and \$118 million in higher sales in C3. The increase in ISR is principally due to the acquisition of Essex. The increase in C3 is due to higher volume in several programs, including the FBCB2 I-Kits program and international commercial businesses and increased scope and funding levels in the JRDC and National Team Battle Management Command and Control (BMC2) programs. These increases were partially offset by lower volume in the F-35 development 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 increased \$109 million, or 2 percent as compared with 2005. The higher sales volume across multiple programs including SBSS, CPP, FBCB2 Systems Engineering & Integration (SE&I) and GFC/C were offset by lower sales volume in a restricted program.

Segment Operating Margin

2007 – Mission Systems operating margin increased \$57 million, or 13 percent, in 2007 as compared with 2006. The increase includes net performance improvements of \$40 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 \$81 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.

<i>\$ in millions</i>	Year ended December 31		
	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
<i>As a percentage of segment sales</i>	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.

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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 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).

<i>\$ in millions</i>	Year ended December 31		
	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
<i>As a percentage of segment sales</i>	5.5%	6.5%	6.2%

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

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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).

<i>\$ in millions</i>	Year ended December 31		
	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
<i>As a percentage of segment sales</i>	11.7%	10.0%	9.1%

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.

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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, intercontinental ballistic missile systems, and high energy laser systems and subsystems. Products and services are grouped into the following business areas: Civil Systems; Military Systems; Missile Systems; National Systems; and Technology & Emerging Systems (Technology).

<i>\$ in millions</i>	Year ended December 31		
	2007	2006	2005
Funded Contract Acquisitions	\$ 3,563	\$ 5,290	\$ 2,782
Sales and Service Revenues	4,176	3,869	3,909
Segment Operating Margin	329	311	284
<i>As a percentage of segment sales</i>	7.9%	8.0%	7.3%

Funded Contract Acquisitions

2007 – Space Technology funded contract acquisitions decreased \$1.7 billion, or 33 percent, in 2007 as compared with 2006, primarily representing a \$693 million decrease for Military Systems, a \$581 million decrease for Missile Systems, \$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, \$601 million for the Intercontinental Ballistic Missile (ICBM) program, \$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 \$2.5 billion, or 90 percent, as compared with 2005, due to increased funding in National Systems, Missile 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, \$1 billion for the ICBM program, \$770 million for the NPOESS program, and \$611 million for the AEHF program.

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Sales and Service Revenues

2007 – Space Technology revenue increased \$307 million, or 8 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, and \$97 million in higher sales in Missile Systems.

2006 – Space Technology revenues decreased \$40 million, or 1 percent, as compared with 2005. The decrease was primarily due to lower sales in Missile Systems due to lower production volume on the ICBM program, lower sales in National Systems due to restricted programs and in Civil Systems due to lower volume for the NPOESS program. The lower sales were partially offset by 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.

Segment Operating Margin

2007 – Space Technology operating margin increased \$18 million, or 6 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 \$27 million, or 10 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, AEHF and STSS programs.

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.

<i>\$ in millions</i>	Year ended December 31		
	2007	2006	2005
Funded Contract Acquisitions	\$ 8,327	\$ 6,713	\$ 5,937
Sales and Service Revenues	6,528	6,267	6,257
Segment Operating Margin	813	786	725
<i>As a percentage of segment sales</i>	12.5%	12.5%	11.6%

Funded Contract Acquisitions

2007 – Electronics funded contract acquisitions increased \$1.6 billion, or 24 percent, in 2007 as compared with 2006, primarily representing increases of \$756 million, \$441 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 \$776 million, or 13 percent, in 2006 as compared with 2005, primarily representing increases of \$293 million, \$284 million and \$74 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 \$261 million, or 4 percent, in 2007 as compared with 2006, reflecting \$109 million higher sales in Defensive Systems, \$83 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

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development programs.

2006 – Electronics revenue increased \$10 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 \$27 million, or 3 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.

2006 – Electronics operating margin increased \$61 million, or 8 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.

\$ in millions	Year ended December 31		
	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.

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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 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 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 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, KEI 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:

<i>\$ in millions</i>	2007			2006		
	Funded	Unfunded	Total Backlog	Funded	Unfunded	Total Backlog
Information & Services						
Mission Systems	\$ 2,365	\$ 3,288	\$ 5,653	\$ 2,040	\$ 2,659	\$ 4,699
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	2,295	13,963	16,258	2,908	12,967	15,875
Electronics	7,887	2,047	9,934	6,086	1,583	7,669
Ships	10,348	3,230	13,578	10,854	2,566	13,420
Total backlog	\$ 31,151	\$ 32,514	\$ 63,665	\$ 30,215	\$ 30,522	\$ 60,737

Backlog is converted into the following years' sales as costs are incurred or deliveries are made. Approximately 65 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.

<i>\$ in millions</i>	Year ended December 31		
	2007	2006	2005
Net Income	\$ 1,790	\$ 1,542	\$ 1,400
Non-cash income and expense ¹	1,031	946	946
Retiree benefit funding in excess of expense	(50)	(772)	(22)
Trade working capital reduction	156	166	69
Other	(12)	(28)	216
Cash used in discontinued operations	(25)	(98)	18
Cash provided by operating activities	\$ 2,890	\$ 1,756	\$ 2,627

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

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

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with GAAP as indicators of performance.

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

<i>\$ in millions</i>	Year ended December 31		
	2007	2006	2005
Cash provided by operating activities	\$ 2,890	\$ 1,756	\$ 2,627
Less:			
Capital expenditures	(682)	(732)	(816)
Outsourcing contract & related software costs	(137)	(77)	
Free cash flow from operations	\$ 2,071	\$ 947	\$ 1,811

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 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 \$1.9 billion, and cash paid to suppliers and employees increased by \$593 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 \$365 million, as compared to a working capital deficit of \$4 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 \$184 million, and cash paid to suppliers and employees increased by \$341 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 \$4 million, primarily reflecting a lower cash balance offset by a lower current portion of long-term debt.

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 \$397 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, 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 Item 8).

NORTHROP GRUMMAN CORPORATION

Capital expenditures in 2007 were \$682 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 \$732 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 \$816 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 Item 8), partially offset by \$315 million in borrowings under lines of credit, and \$274 million in proceeds from exercises of stock options.

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 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 Item 8. Repayment of the bonds is guaranteed by the company.

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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. 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. 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.

NORTHROP GRUMMAN CORPORATION

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 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

NORTHROP GRUMMAN CORPORATION

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.

Contractual Obligations

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

<i>\$ in millions</i>	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	2,064	444	661	394	565
Purchase obligations ⁽¹⁾	6,349	4,223	1,644	423	59
Other long-term liabilities ⁽²⁾	1,171	180	389	148	454
Total contractual obligations	\$ 18,041	\$ 5,272	\$ 3,837	\$ 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 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 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 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 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.
Cutlass	Design, develop, test and manufacture Explosive Ordinance Disposal (EOD) Remote Control Vehicle Systems.
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 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.

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Program Name	Program Description
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.
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.
<i>George H. W. Bush</i> (CVN 77)	The 10 th and final <i>Nimitz</i> -class aircraft carrier that will incorporate many new design features, with expected delivery to the Navy in late 2008.

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Program Name	Program Description
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)	Maintain readiness of the nation's ICBM weapon system.
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.
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/obscure 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.

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Program Name	Program Description
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.
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 States 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.

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Program Name	Program Description
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.
<i>USS Carl Vinson</i>	Refueling and complex overhaul of the nuclear-powered aircraft carrier <i>USS Carl Vinson</i> (CVN 70).
<i>USS Toledo</i>	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 program	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.
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.
<i>Virginia-class Submarines</i>	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 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 at Exhibit 99.6. 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

(July 29, 2008 as to the reclassification of Electro-Optical Systems as a discontinued operation and the reclassification of segment information as described in Notes 5 and 6)

NORTHROP GRUMMAN CORPORATION
CONSOLIDATED STATEMENTS OF INCOME

<i>\$ in millions, except per share</i>	Year ended December 31		
	2007	2006	2005
Sales and Service Revenues			
Product sales	\$ 18,577	\$ 18,294	\$ 19,371
Service revenues	13,251	11,697	10,493
Total sales and service revenues	31,828	29,991	29,864
Cost of Sales and Service Revenues			
Cost of product sales	14,340	14,275	15,440
Cost of service revenues	11,297	10,220	9,340
General and administrative expenses	3,173	3,002	2,857
Operating margin	3,018	2,494	2,227
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	2,698	2,316	2,092
Federal and foreign income taxes	887	723	679
Income from continuing operations	1,811	1,593	1,413
Loss from discontinued operations, net of tax	(21)	(51)	(13)
Net income	\$ 1,790	\$ 1,542	\$ 1,400
Basic Earnings (Loss) Per Share			
Continuing operations	\$ 5.30	\$ 4.61	\$ 3.96
Discontinued operations	(.06)	(.15)	(.04)
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	\$ 5.18	\$ 4.51	\$ 3.89
Discontinued operations	(.06)	(.14)	(.04)
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.

NORTHROP GRUMMAN CORPORATION

CONSOLIDATED STATEMENTS OF FINANCIAL POSITION

<i>\$ in millions</i>	December 31, 2007	December 31, 2006
Assets:		
Current Assets		
Cash and cash equivalents	\$ 963	\$ 1,015
Accounts receivable, net	3,790	3,551
Inventoried costs, net	1,000	1,127
Deferred income taxes	542	706
Prepaid expenses and other current assets	502	350
Total current assets	6,797	6,749
Property, Plant, and Equipment		
Land and land improvements	602	585
Buildings	2,237	2,067
Machinery and other equipment	4,749	4,392
Leasehold improvements	526	447
	8,114	7,491
Accumulated depreciation	(3,424)	(2,990)
Property, plant, and equipment, net	4,690	4,501
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

NORTHROP GRUMMAN CORPORATION

<i>\$ in millions</i>	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	1,890	1,672
Accrued employees' compensation	1,175	1,172
Advance payments and billings in excess of costs incurred	1,563	1,571
Income tax payable		535
Other current liabilities	1,667	1,633
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.

NORTHROP GRUMMAN CORPORATION

CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME

<i>\$ in millions</i>	Year ended December 31		
	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.

NORTHROP GRUMMAN CORPORATION

CONSOLIDATED STATEMENTS OF CASH FLOWS

<i>\$ in millions</i>	Year ended December 31		
	2007	2006	2005
Operating Activities			
Sources of Cash — Continuing Operations			
Cash received from customers			
Progress payments	\$ 7,312	\$ 6,670	\$ 6,535
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	32,114	30,220	30,463
Uses of Cash — Continuing Operations			
Cash paid to suppliers and employees	(27,835)	(27,242)	(26,901)
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	(29,199)	(28,366)	(27,854)
Cash provided by continuing operations	2,915	1,854	2,609
Cash (used in) provided by discontinued operations	(25)	(98)	18
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	(682)	(732)	(816)
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	(6)	(20)	(22)
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

NORTHROP GRUMMAN CORPORATION

CONSOLIDATED STATEMENTS OF CASH FLOWS

<i>\$ in millions</i>	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	575	567	554
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	(6,475)	(2,228)	(5,308)
Inventoried costs	4	(70)	(236)
Prepaid expenses and other current assets	9	(10)	(85)
Increase (decrease) in			
Progress payments	6,513	2,261	5,249
Accounts payable and accruals	114	203	364
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	2,915	1,854	2,609
Cash (used in) provided by discontinued operations	(25)	(98)	18
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.

NORTHROP GRUMMAN CORPORATION

CONSOLIDATED STATEMENTS OF CHANGES IN SHAREHOLDERS' EQUITY

<i>\$ in millions, except per share</i>	Year ended December 31		
	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 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,

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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 \$534 million, \$569 million, and \$533 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 \$78 million and \$80 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 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.

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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 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

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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 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:

\$ in millions	December 31	
	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 current presentation of the Interconnect Technologies (ITD) and Electro-optical Systems businesses, formerly reported in the Electronics segment, as discontinued operations (see Note 5) and the business operation realignments effective in 2007 as well as the subsequent realignments effective in 2008 (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.

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

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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.

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

In March 2008, the company signed a definitive agreement to sell its Electro-Optical Systems business for \$175 million in cash to L-3 Communications Corporation. The transaction closed in April 2008 and the company recognized a small after-tax gain. Electro-Optical Systems, formerly part of the company's Electronics segment, produces night vision and applied optics products. Sales and after tax (loss) earnings for the business for the years ended December 31, 2007, 2006, and 2005 were approximately \$190 million and (\$8) million, \$122 million and (\$20) million, and \$114 million and (\$17) million, respectively. Operating results of this business are reported as discontinued operations in the consolidated statements of income, for all periods presented. The accompanying financial information previously reported in the Annual Report on Form 10-K filed on February 20, 2008 has been recast to reflect the

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disposition.

2007 – During the second quarter of 2007, 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, 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, for all periods presented. 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, for all periods presented.

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.

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

<i>\$ in millions</i>	Year ended December 31		
	2007	2006	2005
Sales and service revenues	\$ 204	\$ 313	\$ 857
Loss from discontinued operations	(32)	(69)	(48)
Income tax benefit	11	24	18
Loss from discontinued operations, net of tax	(21)	(45)	(30)
(Loss) gain from divestitures		11	24
Income tax expense		(17)	(7)
(Loss) gain from discontinued operations, net of tax	\$ (21)	\$ (51)	\$ (13)

Tax rates on discontinued operations vary from the company's effective tax rate due to the non-deductibility of goodwill for tax purposes.

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) 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.

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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, missile systems, 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 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 \$1.7 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 businesses 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. Previously, these businesses were separate operating segments which were aggregated into a single segment for financial reporting purposes.

During the second quarter of 2008, the company transferred certain programs and assets comprising the missiles business in the Mission Systems segment to the Space Technology segment. This transfer allows Mission Systems to focus on the rapidly growing

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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 during the first quarter of 2008.

The accompanying financial information previously reported in the Annual Report on Form 10-K filed on February 20, 2008 has been recast to reflect these subsequent realignments.

Results of Operations By Segment and Major Customer

<i>\$ in millions</i>	Year ended December 31		
	2007	2006	2005
Sales and Service Revenues			
Information & Services			
Mission Systems			
United States Government	\$ 4,428	\$ 4,100	\$ 3,990
Other customers	251	183	172
Intersegment sales	398	421	433
	5,077	4,704	4,595
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	4,061	3,746	3,828
Other customers	67	87	66
Intersegment sales	48	36	15
	4,176	3,869	3,909
Electronics			
United States Government	4,443	3,989	3,917
Other customers	1,585	1,720	1,657
Intersegment sales	500	558	683
	6,528	6,267	6,257
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	(1,471)	(1,490)	(1,525)
Total sales and service revenues	\$ 31,828	\$ 29,991	\$ 29,864

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Other Financial Information

<i>\$ in millions</i>	Year ended December 31		
	2007	2006	2005
Operating Margin			
Information & Services			
Mission Systems	\$ 508	\$ 451	\$ 370
Information Technology	329	342	322
Technical Services	120	120	100
Aerospace			
Integrated Systems	591	551	499
Space Technology	329	311	284
Electronics			
	813	786	725
Ships			
	538	393	249
Other			
Intersegment eliminations	(113)	(117)	(101)
Total segment operating margin	3,115	2,837	2,448
Non-segment factors affecting operating margin			
Unallocated expenses	(224)	(306)	(200)
Net pension expense	127	(37)	(21)
Total operating margin	\$ 3,018	\$ 2,494	\$ 2,227

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.

<i>\$ in millions</i>	December 31,	
	2007	2006
Assets		
Information & Services		
Mission Systems	\$ 5,965	\$ 4,872
Information Technology	3,576	3,289
Technical Services	1,133	1,108
Aerospace		
Integrated Systems	2,217	2,202
Space Technology	4,016	4,484
Electronics		
	5,183	5,340
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)

<i>\$ in millions</i>	Year ended December 31		
	2007	2006	2005
Capital Expenditures			
Information & Services			
Mission Systems	\$ 43	\$ 50	\$ 68
Information Technology	42	32	35
Technical Services	9	4	5
Aerospace			
Integrated Systems	100	119	142
Space Technology	109	106	110
Electronics	120	121	157
Ships	247	287	266
Corporate	12	13	33
Total capital expenditures	\$ 682	\$ 732	\$ 816
Depreciation and Amortization			
Information & Services			
Mission Systems	\$ 56	\$ 39	\$ 60
Information Technology	64	46	49
Technical Services	7	7	8
Aerospace			
Integrated Systems	108	110	102
Space Technology	131	130	141
Electronics	176	206	243
Ships	170	153	155
Corporate	15	12	12
Total depreciation and amortization	\$ 727	\$ 703	\$ 770

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:

<i>in millions, except per share</i>	December 31,		
	2007	2006	2005
Diluted Earnings Per Share From Continuing Operations			
Income from continuing operations	\$ 1,811	\$ 1,593	\$ 1,414
Add dividends on mandatorily redeemable convertible preferred stock	24	24	
Income from continuing operations available to common shareholders	\$ 1,835	\$ 1,617	\$ 1,414
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	\$ 5.18	\$ 4.51	\$ 3.89

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)	Purchase Price Per Share	Completion Date	Final Price Adjustment (in millions)	Final Average Purchase Price Per Share	Dollar Amount of Shares Repurchased (in millions)
November 4, 2005	9.1	\$55.15	March 1, 2006	\$37	\$59.05	\$537
March 6, 2006	11.6	64.78	May 26, 2006	37	68.01	788
February 21, 2007	8.0	75.29	June 7, 2007	(8)	73.86	592
July 30, 2007	6.5	77.12	September 17, 2007	2	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:

<i>\$ in millions</i>	December 31,	
	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	530	473
Due from other customers	462	226
Progress payments received	(285)	(58)
Total due, trade and other	707	641
	4,076	3,859
Allowances for doubtful amounts	(286)	(308)
Total accounts receivable, net	\$ 3,790	\$ 3,551

9. INVENTORIED COSTS, NET

Inventoried costs were composed of the following:

<i>\$ in millions</i>	December 31,	
	2007	2006
Production costs of contracts in process	\$ 1,909	\$ 1,949
General and administrative expenses	172	184
	2,081	2,133
Progress payments received	(1,345)	(1,223)
	736	910
Product inventory	264	217
Total inventoried costs, net	\$ 1,000	\$ 1,127

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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:

<i>\$ in millions</i>	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.

Purchased Intangible Assets

The table below summarizes the company's aggregate purchased intangible assets as follows:

<i>\$ in millions</i>	December 31, 2007			December 31, 2006		
	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.

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

<i>\$ in millions</i>	
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:

<i>\$ in millions</i>	2007		2006	
	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 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.

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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:

<i>\$ in millions</i>	Year ended December 31		
	2007	2006	2005
Income Taxes on Continuing Operations			
Currently Payable			
Federal income taxes	\$ 675	\$ 538	\$ 513
Foreign income taxes	42	27	27
Total federal and foreign income taxes currently payable	717	565	540
Change in deferred federal and foreign income taxes	170	158	139
Total federal and foreign income taxes	\$ 887	\$ 723	\$ 679

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

<i>\$ in millions</i>	Year ended December 31		
	2007	2006	2005
Domestic income	\$ 2,607	\$ 2,244	\$ 2,017
Foreign income	91	72	75
Income from continuing operations before income taxes	\$ 2,698	\$ 2,316	\$ 2,092

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:

<i>\$ in millions</i>	Year ended December 31		
	2007	2006	2005
Income tax expense on continuing operations at statutory rate	\$ 944	\$ 811	\$ 732
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	(8)
Total federal and foreign income taxes	\$ 887	\$ 723	\$ 679

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

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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:

<i>\$ in millions</i>	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

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:

<i>\$ in millions</i>	December 31,	
	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:

<i>\$ in millions</i>	December 31,	
	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 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

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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.

Long-term debt consisted of the following:

<i>\$ in millions</i>	December 31,	
	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:

<i>\$ in millions</i>	
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

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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 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

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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 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, 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.

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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 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 \$584 million in 2007, \$548 million in 2006, and \$511 million in 2005. These amounts are net of immaterial amounts of sublease rental income. Minimum rental

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commitments under long-term noncancellable operating leases as of December 31, 2007, total approximately \$2.1 billion, which are payable as follows: 2008 - \$444 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 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

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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).

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.

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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.

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:

<i>\$ in millions</i>	Pension Benefits			Medical and Life Benefits		
	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:

<i>\$ in millions</i>	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.

<i>\$ in millions</i>	Pension Benefits		Medical and Life Benefits	
	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:

<i>\$ in millions</i>	Pension Benefits	Medical and 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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<i>\$ in millions</i>	Pension Benefits		Medical and Life Benefits	
	2007	2006	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:

<i>\$ in millions</i>	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		Medical and Life Benefits	
	2007	2006	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.

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.

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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:

<i>\$ in millions</i>	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

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.

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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:

\$ in millions	Pension Plans	Medical and Life Plans	
	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 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

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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.

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.

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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 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.

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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:

<i>\$ in millions, except per share</i>	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

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, 2007 and 2008 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

<i>\$ in millions, except per share</i>	1st Qtr	2nd Qtr	3rd Qtr	4th Qtr
Sales and service revenues	\$7,314	\$7,878	\$7,871	\$8,765
Operating margin	690	763	806	759
Income from continuing operations	393	472	488	457
Net income	387	460	489	454
Basic earnings per share from continuing operations	1.14	1.37	1.43	1.35
Basic earnings per share	1.12	1.34	1.44	1.34
Diluted earnings per share from continuing operations	1.11	1.35	1.40	1.32
Diluted earnings per share	1.10	1.31	1.40	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.

NORTHROP GRUMMAN CORPORATION

2006

<i>\$ in millions, except per share</i>	1st Qtr	2nd Qtr	3rd Qtr	4th Qtr
Sales and service revenues	\$7,045	\$7,571	\$7,395	\$7,980
Operating margin	611	699	557	626
Income from continuing operations	366	454	314	459
Net income	357	430	302	453
Basic earnings per share from continuing operations	1.07	1.32	.91	1.32
Basic earnings per share	1.04	1.25	.88	1.30
Diluted earnings per share from continuing operations	1.04	1.30	.89	1.29
Diluted earnings per share	1.02	1.23	.86	1.27

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.

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

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 (July 29, 2008 as to the reclassification of Electro-Optical Systems as a discontinued operation and the reclassification of segment information as described in Notes 5 and 6) 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

SCHEDULE II – VALUATION AND QUALIFYING ACCOUNTS

<u>Description</u>	<u>Balance at Beginning of Period</u>	<u>Additions At Cost</u>	<u>Changes - Add (Deduct)</u>	<u>Balance at End of Period</u>
Year ended December 31, 2005				
Reserves and allowances deducted from asset accounts(1):				
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 from asset accounts(1):				
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 from asset accounts(1):				
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 recovering.