VALLEY FORGE SCIENTIFIC CORP
Form 10-Q
August 15, 2005

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549
FORM 10-Q

(Mark One)

[X] QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

For the quarterly period ended June 30, 2005

[ ] TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

For the transition period from ____________________ to ________________
Commission File Number: 001-10382

VALLEY FORGE SCIENTIFIC CORP.
(Exact name of registrant as specified in its charter)

PENNSYLVANIA	23-2131580
(State or other jurisdiction of incorporation or organization)	(I.R.S. employer identification no.)

3600 Horizon Drive, King of Prussia, Pennsylvania 19406
(Address of principal executive offices and zip code)
Telephone: (484) 690-9000

136 Green Tree Road, Oaks, Pennsylvania 19456
(Former address of Registrant)

Indicate by check mark [X] whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days.

Yes [X] No [ ]

Indicate by check mark whether the registrant is an accelerated filer (as defined in Rule 12b-2 of the Exchange Act).

Yes [ ] No [X]

At August 11, 2005 there were 7,939,712 shares outstanding of the Registrant's no par value Common Stock.

VALLEY FORGE SCIENTIFIC CORP.

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June 30, 2005

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VALLEY FORGE SCIENTIFIC CORP. AND SUBSIDIARY
CONSOLIDATED BALANCE SHEETS

	June 30, 2005 (Unaudited)	Sep (
ASSETS		
Current Assets:		
Cash and cash equivalents	$ 2,386,742	$
Accounts receivable - net	941,778	
Inventory	792,385	
Loans receivable - stockholder/officer	14,100	
Prepaid items and other current assets	107,510	
Deferred tax assets	89,242	
Total Current Assets	4,331,757	
Property, plant and equipment - net	221,101	
Goodwill	153,616	
Intangible assets - net	187,875	
Loans receivable - stockholder/officer	22,182	
Other assets	27,477	
Total Assets	$ 4,944,008	$

LIABILITIES AND STOCKHOLDERS' EQUITY

Current Liabilities:		
Accounts payable and accrued expenses	$ 423,890	$
Income taxes payable	55,713	
Deferred revenue	-	
Total Current Liabilities	479,603	
Deferred Tax Liability	15,313	
Total Liabilities	494,916	
Commitment		
Stockholders' Equity:		
Preferred stock	-	
Common stock (no par, 20,000,000 shares authorized, shares issued and outstanding at June 30, 2005 - 7,939,712 and September 30, 2004 - 7,913,712)	3,589,130	
Retained earnings	859,962	
Total Stockholders' Equity	4,449,092	
Total Liabilities and Stockholders' Equity	$ 4,944,008	$

See accompanying notes to consolidated financial statements.

VALLEY FORGE SCIENTIFIC CORP. AND SUBSIDIARY
CONSOLIDATED STATEMENTS OF OPERATIONS
(UNAUDITED)

	For the Three Months Ended June 30,		F
	2005	2004	
Net Sales	$ 1,697,982	$ 1,274,389	$
Cost of Sales	738,347	622,068	
Gross Profit	959,635	652,321	
Other Costs:			
Selling, general and administrative	526,223	417,699	
Merger related professional fees	436,729	-	
Research and development	108,307	114,754	
Amortization	10,175	10,147	

Total Other Costs	1,081,434	542,600	
Income (Loss) from Operations	(121,799)	109,721	
Other Income (Expense)			
Settlement of lawsuit	-	-	
Gain from disposition of property	111,674	-	
Interest income	11,197	5,868	
Total Other Income (Expense)	122,871	5,868	
Income before Income Taxes	1,072	115,589	
Provision for Income Taxes	890	50,583	
Net Income	$ 182	$ 65,006	$
Income per Share:			
Basic income per common share	$ 0.00	$ 0.01	$
Diluted income per common share	$ 0.00	$ 0.01	$
Basic weighted average common shares outstanding	7,919,250	7,913,712	
Diluted weighted average common shares outstanding	8,071,672	7,994,955	

See accompanying notes to consolidated financial statements.

VALLEY FORGE SCIENTIFIC CORP. AND SUBSIDIARY
CONSOLIDATED STATEMENTS OF CASH FLOWS
(UNAUDITED)

	For the Nine Months Ended June 30,	
	2005	2004
Cash Flows from Operating Activities:		
Net income	$ 139,066	$ 145,5
Adjustments to reconcile net income to net cash (used in) operating activities:		
Depreciation and amortization	54,571	52,6
Gain from disposition of property	(111,674)	
Interest accrued on loans and advances to		

employees and related parties	(1,540)	(1,7
Provision for obsolete and slow-moving inventory	-	58,7
Deferred income taxes	(9,490)	(28,5
Changes in assets and liabilities:		
(Increase) decrease in:		
Accounts receivable	(295,554)	(393,3
Inventory	(10,781)	(127,0
Prepaid items and other current assets	(2,891)	136,4
Other assets	(770)	(1,1
Increase (decrease) in:		
Accounts payable and accrued expenses and income taxes payable	227,284	70,3
Deferred tax liabilities	(430)	(5
Deferred revenue	(5,750)	9,6
Net cash (used in) operating activities	(17,959)	(78,8
Cash Flows from Investing Activities:		
Purchases of property, plant and equipment	(171,296)	(9,8
Proceeds from disposition of property (net of closing cost)	185,788	
Proceeds from repayments of loans to stockholder	7,050	6,5
Costs related to patent application	-	(1,3
Net cash provided by (used in) investing activities	21,542	(4,7
Cash Flows from Financing Activities:		
Proceeds from exercise of options	60,600	
Net cash provided by financing activities	60,600	
Net Change in Cash and Cash Equivalents	64,183	(83,5
Cash and Cash Equivalents - Beginning of Period	2,322,559	2,305,5
Cash and Cash Equivalents - End of Period	$ 2,386,742	$ 2,221,9
Schedule of non-cash operating and investing activities:		
Use of deposit for acquisition of property, plant and equipment	$ 14,400	$
Supplemental Disclosures of Cash Flow Information:		
Cash paid during the period for:		
Income taxes	$ 70,056	$ 11,7
Interest	-	

See accompanying notes to consolidated financial statements.

VALLEY FORGE SCIENTIFIC CORP. AND SUBSIDIARY
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)
JUNE 30, 2005

NOTE 1 - DESCRIPTION OF BUSINESS:

Valley Forge Scientific Corp. ("VFSC") was incorporated on March 27, 1980 in the Commonwealth of Pennsylvania and is engaged in the business of developing, manufacturing, and selling medical devices and products. On August 18, 1994, VFSC formed a wholly-owned subsidiary, Diversified Electronics Company, Inc. ("DEC"), a Pennsylvania corporation, in order to continue the operations of Diversified Electronic Corporation, a company which was merged with and into VFSC on August 31, 1994. Collectively, VFSC and DEC are referred to herein as the "Company".

On May 2, 2005, the Company entered into a merger agreement with Synergetics, Inc. ("Synergetics"), a privately-held corporation, to combine the two companies. Under the terms of the merger agreement, the stockholders of Synergetics' will receive approximately 16 million shares of the Company's common stock. As a result of the merger, the former stockholders of Synergetics will represent approximately 66% of the Company's outstanding common stock on a fully diluted basis. The merger is subject to the satisfaction of a number of closing conditions, including stockholder and regulatory approvals.

NOTE 2 - SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES:

Principles of Consolidation and Basis of Presentation

The accompanying financial statements consolidate the accounts of VFSC and its wholly-owned subsidiary. All significant intercompany accounts and transactions have been eliminated in consolidation.

The accompanying unaudited consolidated financial statements have been prepared pursuant to rules and regulations of the Securities and Exchange Commission and, therefore, do not include all information and footnote disclosures normally included in audited financial statements. However, in the opinion of management, all adjustments that are of a normal and recurring nature, necessary to present fairly the results of operations, financial position, and cash flows have been made. It is suggested that these statements be read in conjunction with the financial statements included in the Company's Annual Report on Form 10-K for the year ended September 30, 2004.

The statements of operations for the three and nine months ended June 30, 2005 are not necessarily indicative of results for the full year.

VALLEY FORGE SCIENTIFIC CORP. AND SUBSIDIARY
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)
JUNE 30, 2005

NOTE 2 - SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (CONTINUED):

Earnings per Share

The Company computes earnings per share in accordance with Statement of Financial Accounting Standards No. 128, "Earnings Per Share" (SFAS 128). Basic earnings per share are computed by dividing income available to common stockholders by the weighted average number of common shares outstanding. Diluted earnings per share reflect the potential dilution that could occur if securities or other agreements to issue common stock were exercised or converted into common stock. Diluted earnings per share is computed based upon the weighted average number of common shares and dilutive common equivalent shares outstanding, which include convertible debentures, stock options, and warrants.

Recently Issued Accounting Standards

In December 2004, the FASB issued SFAS No. 123(R), "Share-Based Payment," which replaces SFAS 123, "Accounting for Stock-Based Compensation" ("SFAS No. 123"), and supersedes Accounting Principles Board Opinion No. 25, "Accounting for Stock Issued to Employees" ("APB No. 25"). SFAS 123(R) requires companies to recognize in their income statement the grant-date fair value of stock options and other equity-based compensation issued to employees. The Company is required to adopt SFAS 123(R) beginning January 1, 2006. Grant-date fair value will be determined using one of two acceptable valuation models. This Standard requires that compensation expense for most equity-based awards be recognized over the requisite service period, usually the vesting period; while compensation expense for liability-based awards (those usually settled in cash rather than stock) be re-measured to fair-value at each balance sheet date until the award is settled. The Standard also provides guidance as to the accounting treatment for income taxes related to such compensation costs, as well as transition issues related to adopting the new Standard. The Company has been using the intrinsic value method as set forth under APB No. 25 with no stock-based compensation cost reflected in net earnings while complying with footnote disclosure requirements of SFAS No. 123 setting forth the pro forma effect on net earnings of applying fair value recognition to stock based awards. The Company is currently evaluating the impact on its operations of the adoption SFAS 123(R).

In December 2004, the FASB issued SFAS No. 153, "Exchange of Non-monetary Assets an amendment of APB Opinion No. 29." This Statement precludes companies from using the "similar productive assets" criteria to account for non-monetary exchanges at book value with no gain or loss being recognized. Effective for fiscal periods beginning after June 15, 2005, all companies will be required to use fair value for most non-monetary exchanges, recognizing gain or loss, if the transaction meets commercial, substance criteria. The Company does not expect this Standard to have a significant impact on its current consolidated financial statements.

NOTE 2 - SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (CONTINUED):

Recently Issued Accounting Standards (Continued)

In November 2004, the FASB issued Statement No. 151, "Inventory Costs, an amendment of ARB 43, Chapter 4" ("SFAS 151"), to clarify the accounting for abnormal amounts of idle facility expense, freight, handling costs, and wasted materials (spoilage). ARB 43 allowed some of these "abnormal costs" to be

carried as inventory, whereas the new Standard requires that these costs be expensed as incurred. This Statement is effective for fiscal years beginning after June 15, 2005. The Company is currently evaluating what effect, if any, this standard will have on its current consolidated financial statements.

In December 2004, the FASB issued FSP FAS 109-1, "Application of FASB Statement No. 109, "Accounting for Income Taxes," to the "Tax Deduction on Qualified Production Activities Provided by the American Jobs Creation Act of 2004" to provide accounting guidance on the appropriate treatment of tax benefits generated by the enactment of the Act. The FSP requires that the manufacturer's deduction be treated as a special deduction in accordance with SFAS 109 and not as a tax rate reduction. The Company is awaiting final tax regulations from the IRS before completing its assessment of the impact of adopting FSP FAS 109-1 on its current consolidated financial statements.

Stock-Based Compensation

In December 2002, the FASB issued Statement of Financial Accounting Standards ("SFAS") No. 148, "Accounting for Stock-Based Compensation - Transition and Disclosure - an amendment of FASB Statement No. 123." SFAS No. 148 amended SFAS No. 123, "Accounting for Stock-Based Compensation," to provide alternative methods of transition for a voluntary change to the fair value based method of accounting for stock-based employee compensation. In addition, SFAS No. 148 amended the disclosure requirements of SFAS No. 123 to require prominent disclosures in both annual and interim financial statements about the method of accounting for stock-based employee compensation and the effect of the method used on reported results. SFAS No. 148 was effective for the Company as of January 1, 2003. The Company has not elected a voluntary change in accounting to the fair value based method. Accordingly, the adoption of SFAS No. 148 did not have a significant impact on the Company's results of operations or financial position.

NOTE 2 - SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (CONTINUED):

Stock-Based Compensation (Continued)

The Black-Scholes option valuation model was developed for use in estimating the fair value of traded options which have no vesting restrictions and are fully transferable. In addition, option valuation models require the input of highly subjective assumptions including the expected stock price volatility. Because the Company's stock options have characteristics significantly different from those of traded options, and because changes in subjective input assumptions can materially affect the fair value estimated, in management's opinion, the existing models do not necessarily provide a reliable single measure of the fair value of its stock options. In addition, option pricing models require the input of highly subjective assumptions, including expected stock price volatility.

For purposes of pro forma disclosures, the estimated fair value of the options is amortized to expense over the options' vesting period. In accordance with SFAS 123 and 148, only stock options granted after September 30, 1995, have been included for the Company's pro forma information as follows:

	Three Months Ended June 30,		Nine Months Ended June 30,	
	2005	2004	2005	2004
Net income - as reported	$ 182	$ 65,006	$ 139,066	$ 145,564
Less: total compensation expense determined under fair value based method - net of tax effect	51,545	9,839	70,131	54,981
Pro Forma Net Income (Loss)	$ (51,363)	$ 55,167	$ 68,935	$ 90,583
Pro Forma Income (Loss) Per Share:				
Basic	$ (0.01)	$ 0.01	$ 0.01	$ 0.01
Diluted	$ (0.01)	$ 0.01	$ 0.01	$ 0.01

Revenue Recognition

Product revenue is recognized when the product has been shipped, which is when title and risk of loss has been transferred to the customer.

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VALLEY FORGE SCIENTIFIC CORP. AND SUBSIDIARY
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)
JUNE 30, 2005

NOTE 3 - DISTRIBUTION AGREEMENTS:

The Company sells its products to U.S. based national and international distributors and dealers including those as described below:

Codman and Shurtleff, Inc. ("Codman")

A significant part of the Company's sales were made pursuant to a distribution agreement with Codman, an affiliate of a major medical company and the Company's largest customer. On October 15, 2004, the Company executed a new agreement with Codman for the period October 1, 2004 through December 31, 2005. The agreement, as amended, provides for exclusive worldwide distribution rights of the Company's existing neurosurgery products in the fields of neurocranial and neurospinal surgery until July 15, 2005, and non-exclusive rights in these fields from July 15, 2005 through December 31, 2005. The agreement also provides that the distribution agreement can each be extended by mutual consent of the parties.

Stryker Corporation ("Stryker")

On October 25, 2004, the Company executed a Supply and Distribution Agreement

("the Agreement") with Stryker (a Michigan corporation) which provides for the Company to supply to Stryker and for Stryker to distribute exclusively, on a world-wide basis, a generator for the percutaneous treatment of pain. The Agreement is for a term of five years after the first acceptance of the generator by Stryker, which was on November 11, 2004.

NOTE 3 - DISTRIBUTION AGREEMENTS (CONTINUED):

Stryker Corporation ("Stryker") (Continued)

There is a minimum purchase obligation that is specified by "Agreement Year." The first Agreement Year commenced on the date of the first acceptance by Stryker of a generator product delivered by the Company as ready for commercial sale, which was November 11, 2004, and ends on the last day of the calendar quarter in which the first anniversary date of such inception date occurs. In the first Agreement Year, Stryker is required to make minimum purchases of $900,000 comprised of demonstration and commercial sales units. In the second and third Agreement Years, Stryker is required to make minimum purchases in each year of $500,000 of commercial sales units. After only eight months into the first Agreement Year, Stryker has already exceeded the minimum purchases for the first Agreement Year.

On or before the beginning of the last calendar quarter of the third Agreement Year, and each Agreement Year thereafter, the Company and Stryker will conduct good faith negotiations regarding the minimum purchase obligation for the next Agreement Year. Also, during the first two months of the last calendar quarter in any Agreement Year, the Company and Stryker will conduct good faith negotiations regarding changes in prices that will take effect on the first day of the ensuing Agreement Year. The Agreement also provides Stryker certain rights for other new product concepts developed by the Company in both pain control and expanded market areas. The Agreement contains various terms related to the provision of repair services for the product by the Company and maintenance of spare parts, the distributor's obligation to market the product, to provide training to sales personnel, and other provisions.

NOTE 4 - OPTION AGREEMENT:

On October 22, 2004, the Company entered into an Option Agreement with Dr. Leonard I. Malis, a director and stockholder of the Company, giving the Company the right to purchase from Dr. Malis his Malis (R) trademark at any time over a period of five years. The Company paid Dr. Malis $35,000 for the option and is required to pay an annual fee before each anniversary of the option agreement in the amount of $20,000 for each of the first two anniversaries and increasing to $60,000 before the fourth anniversary in order to keep the option in effect from year to year. The exercise price of the option is $4,157,504, which includes interest, and will be payable in 26 quarterly installments of $159,904, which will be evidenced by a promissory note payable to Dr. Malis. This note would be secured by a security interest in the Company's rights to the Malis (R) trademark and certain of the Company's patents.

VALLEY FORGE SCIENTIFIC CORP. AND SUBSIDIARY
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)
JUNE 30, 2005

NOTE 5 - SUPPLEMENTAL BALANCE SHEET INFORMATION:

Accounts Receivable - Net

	June 30, 2005 (Unaudited)	September 30, 2004 (Audited)
Accounts receivable	$ 957,258	$ 661,704
Less: Allowances	15,480	15,480
Accounts receivable - net	$ 941,778	$ 646,224

Inventory

	June 30, 2005 (Unaudited)	September 30, 2004 (Audited)
Finished goods	$ 57,178	$ 94,405
Work-in-process	371,858	396,810
Materials and parts	516,165	424,052
	945,201	915,267
Less: Allowances for slow moving and obsolete inventory	152,816	133,663
	$ 792,385	$ 781,604

VALLEY FORGE SCIENTIFIC CORP. AND SUBSIDIARY
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)
JUNE 30, 2005

NOTE 5 - SUPPLEMENTAL BALANCE SHEET INFORMATION (CONTINUED):

Property, Plant and Equipment - Net

	Useful Life (Years)	June 30, 2005	September 30, 2004

		(Unaudited)	(Audited)
Furniture and fixtures	5 - 7	$ 17,953	$ 17,953
Laboratory equipment	5 - 10	463,652	378,159
Office equipment	5	193,312	185,530
Leasehold improvements	3 - 5	87,194	9,413
Land	-	-	11,953
Buildings and improvements	15 - 39	-	103,467
		762,111	706,475
Less: Accumulated depreciation and amortization		541,010	558,508
		$ 221,101	$ 147,967

Depreciation amounted to $8,609 and $7,318 for the three months ended June 30, 2005 and 2004, respectively, and $24,048 and $22,363 for the nine months ended June 30, 2005 and 2004, respectively.

On June 27, 2005, the Company sold all of the property and certain equipment of DEC for $185,788. The income recognized by the Company is $111,674, before moving costs and taxes.

VALLEY FORGE SCIENTIFIC CORP. AND SUBSIDIARY
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)
JUNE 30, 2005

NOTE 5 - SUPPLEMENTAL BALANCE SHEET INFORMATION (CONTINUED):

Goodwill and Intangible Assets

In accordance with SFAS 142, goodwill has been reflected on the balance sheet separate from other intangible assets which continue to be amortized. No change in the carrying amount of goodwill was made for the quarter ended June 30, 2005. The Company completed its annual impairment test during the quarter ended March 31, 2005 and no impairment was identified.

Information regarding the Company's other intangible assets is as follows:

Goodwill and Intangible Assets

	June 30, 2005 (Unaudited)			September 30, 200	
	Gross Carrying Value	Accumulated Amortization	Net	Gross Carrying Value	Accumulat Amortizat

Patents, trademarks and licensing agreements	$ 573,804	$ 511,583	$ 62,221	$ 573,804	$ 503,6
Proprietary know-how	452,354	326,700	125,654	452,354	304,0
Acquisition costs	55,969	55,969	-	55,969	55,9
	$ 1,082,127	$ 894,252	$ 187,875	$ 1,082,127	$ 863,7

Amortization expense of intangible assets amounted to $10,175 and $10,147 for the three months ended June 30, 2005 and 2004, respectively, and $30,523 and $30,296 for the nine months ended June 30, 2005 and 2004, respectively.

Annual amortization expense is estimated to be $40,800 for fiscal 2005, $40,800 for fiscal 2006, $40,700 for fiscal 2007, $40,100 for fiscal 2008, $34,900 for fiscal 2009 and $21,100 thereafter.

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VALLEY FORGE SCIENTIFIC CORP. AND SUBSIDIARY
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)
JUNE 30, 2005

NOTE 6 - LOANS RECEIVABLE - STOCKHOLDER/OFFICER:

Loans receivable - stockholder/officer represent various loans to Jerry L. Malis, a principal stockholder, director and officer of the Company. The loans bear interest at rates of 4.83% to 6.97% and are payable in either quarterly installments of $3,525 or annual installments of $14,100 until the principal and accrued interest have been repaid. At June 30, 2005, loans receivable - stockholder amounted to $36,282. At June 30, 2005, the stockholder/officer was current on the loan receivable.

Loans receivable - stockholder/officer are partially secured by 5,833 shares of the Company's common stock. At June 30, 2005, the pledged common stock has a value of $23,215.

NOTE 7 - COMMITMENT:

Operating Lease

The Company leased approximately 4,200 square feet of office and warehouse space from a general partnership whose partners are Jerry L. Malis, Leonard I. Malis (principal stockholders, directors and officers of the Company) and the Frances W. Gilloway Marital Trust. The lease expired June 30, 2005.

The Company entered into a combination sublease and lease commencing on May 1, 2005 for a term of four and one-half years, for office, assembly and manufacturing space in King of Prussia, Pennsylvania, with an initial annual rental of $74,858, increasing to $129,437, plus annual operating expenses.

Rent expense amounted to $33,383 and $64,317 for three and nine months ended June 30, 2005, respectively, and $15,017 and $45,050 for the three and nine months ended June 30, 2004, respectively. Rent expense to the related entity amounted to $15,599 and $46,533 for three and nine months ended June 30, 2005, respectively, and $15,017 and $45,050 for the three and nine months ended June 30, 2004, respectively.

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VALLEY FORGE SCIENTIFIC CORP. AND SUBSIDIARY
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)
JUNE 30, 2005

NOTE 8 - EARNINGS PER SHARE:

	Three Months Ended June 30,		Nine Months Ende June 30,	
	2005	2004	2005	200
Income available to common stockholders	$ 182	$ 65,006	$ 139,066	$ 14
Weighted average common shares outstanding - basic	7,919,250	7,913,712	7,915,558	7,91
Net effect of dilutive shares issuable in connection with stock plans	152,422	81,243	85,337	6
Weighted average common shares outstanding - diluted	8,071,672	7,994,955	8,000,895	7,97
Earnings Per Share:				
Basic	$ 0.00	$ 0.01	$ 0.02	$
Diluted	$ 0.00	$ 0.01	$ 0.02	$

Options to purchase 431,500 and 507,250 shares of common stock were outstanding on June 30, 2005 and 2004, respectively. Of these shares, 279,078 and 426,007 shares were not included in the computation of diluted earnings per share for the three months ended June 30, 2005 and 2004, and 346,163 and 441,496 of these shares were not included in the computation of diluted earnings per share for the nine months ended June 30, 2005 and 2004, respectively, in accordance with SFAS 128, as the issuance prices were in excess of the average market price for the period.

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Item 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

The following is a discussion and analysis of Valley Forge Scientific Corp.'s financial condition and results of operations for the quarterly and nine month periods ended June 30, 2005 and 2004. This section should be read in conjunction with the financial statements and related notes in Item 1 of this report and Valley Forge Scientific Corp.'s annual report on Form 10-K for the year ended September 30, 2004, which has been filed with the Securities and Exchange Commission. This discussion and analysis contains forward-looking statements that involve risks, uncertainties and assumptions. Our actual results may differ materially from those anticipated in these forward looking statements as a result of many factors including but not limited to those under the headings "Special Note Regarding Forward Looking Statements" and "Factors That

Might Affect Future Results". Unless the context requires otherwise, references to "we", "us", "our" and "Valley Forge Scientific" refer to Valley Forge Scientific Corp.

Overview

Valley Forge is a medical device company that develops, manufactures and sells medical devices for use in surgery and other healthcare applications. Our core business involves the sale of bipolar electrosurgical generators and other generators, based on our DualWave(TM) technology, and complementary instrumentation and disposable products.

Our current line of bipolar electrosurgical products are used in neurosurgery and spine surgery and in dental applications. In the first quarter of fiscal 2005, we commenced selling to Stryker Corporation a lesion generator for the percutaneous treatment of pain. We plan to expand the market for our products with the introduction of our new multifunctional bipolar electrosurgical generator and new proprietary single-use, hand-switching bipolar instruments, new products based on our proprietary lesion generator technology, and other products and product refinements. Our new multifunctional bipolar electrosurgical system is designed to replace other surgical tools, such as monopolar electrosurgical systems and lasers, in certain applications.

We believe our DualWave(TM) technology distinguishes our products from our competitors. With appropriate technique, our bipolar electrosurgical systems based on our DualWave(TM) technology allow a surgeon or dentist to cut tissue in a manner that minimizes collateral damage to surrounding healthy tissue and to coagulate blood vessels quickly, safely and efficiently. By substantially reducing damage to surrounding healthy tissue, the surgeon or dentist can work safely in close proximity with nerves, blood vessels and bone. Our bipolar electrosurgical systems can also be used in close proximity with metal implants and in irrigated fields.

Merger Agreement with Synergetics, Inc.

On May 2, 2005, we entered into a merger agreement with Synergetics, Inc., a privately-held corporation, that is involved in the development, manufacture, distribution and sale of durable and disposable instruments for use in retina surgery, neurosurgery and other microsurgery markets. Pursuant to the terms of the merger agreement, Synergetics' shareholders will receive, in the

aggregate, approximately 16 million fully paid and nonassessable shares of Valley Forge's common stock, no par value, or approximately 66% of Valley Forge's then outstanding common stock on a fully diluted basis. Completion of the merger is subject to several conditions, including approval by shareholders of each company, effectiveness of a Form S-4 registration statement, and other customary closing conditions. Additionally, the merger agreement may be terminated by Valley Forge or Synergetics upon the occurrence or failure to occur of certain events, including a failure of the merger to be consummated by September 30, 2005. In the event of such termination, under certain circumstances, Valley Forge and Synergetics may be required to pay each other a break-up fee of $1 million as set forth in the merger agreement.

The merger agreement provides that the board of directors of Valley Forge following the merger will consist of seven directors including two current directors of each of Synergetics and Valley Forge and three additional independent directors. Four of the seven directors will be independent.

Certain directors, executive officers and shareholders of Valley Forge holding approximately 35 percent of outstanding shares of Valley Forge's common stock and directors and executive officers of Synergetics holding approximately 19 percent of shares of Synergetics' common stock have agreed to vote in favor of the merger, pursuant to voting agreements dated May 2, 2005. A majority of the outstanding shares of the Valley Forge common stock, and two-thirds of the outstanding shares of Synergetics' common stock, are required to approve the merger.

Codman Agreement

For over 20 years, we have had worldwide exclusive distribution agreements with Codman & Shurtleff, Inc. ("Codman"), a subsidiary of Johnson & Johnson, Inc., to market our neurosurgery bipolar electrosurgical systems and other products in the fields of neurocranial and neurospinal surgery. On October 15, 2004, we entered into a new agreement with Codman defining our business relationship from October 1, 2004 through December 31, 2005. This Agreement was amended effective March 1, 2005. Pursuant to that amendment, on July 15, 2005, the distribution agreement with Codman became a nonexclusive agreement.

Historically, we have derived a significant portion of our sales from sales to Codman. For the three and nine months ended June 30, 2005, 85% and 74%, respectively, of our revenue was derived from sales to Codman, and for the fiscal year ended September 30, 2004, 86% of our revenue was derived from sales to Codman.

Stryker Agreement

On October 25, 2004, we entered into a supply and distribution agreement with Stryker Corporation for the distribution and sale of a lesion generator manufactured by Valley Forge for the percutaneous treatment of pain. The supply and distribution agreement is the culmination of over two years of collaborative efforts with Stryker. The term of the supply and distribution agreement is for slightly over five years, commencing on November 11, 2004 and ending on March 31, 2009, and grants Stryker exclusive worldwide marketing rights for distribution and sale of the lesion generator

for use in percutaneous treatment of pain. In the first year of the agreement, Stryker has agreed to make minimum purchases of approximately $900,000 for a combination of sales demonstration units and commercial sale units. In the second and third years, Stryker has agreed to make minimum purchases of approximately $500,000 per year for commercial sale units. Minimum purchase requirements for agreement years four and five are to be determined by the parties based on market conditions and other factors. After only eight months into the first year of the supply and distribution agreement, Stryker has already exceeded the first year minimum purchases of $900,000 as set forth in that agreement. The agreement also provides Stryker certain rights for other new product concepts developed by Valley Forge in both pain control and expanded market areas.

Results of Operations

Results of Operations for the Three and Nine Months Ended June 30, 2005 compared to the Three and Nine Months Ended June 30, 2004.

Summary

Sales of $1,697,982, for the three months, and $4,926,387 for the nine months, ended June 30, 2005 were 33% and 37% greater, respectively, than sales of $1,274,389 and $3,606,629, respectively, for the three and nine months ended June 30, 2004. Primarily as a result of one-time merger related professional fees of $436,729 for the third quarter of fiscal 2005 and $518,895 for the first nine months of fiscal 2005, we had an operating loss of $121,799 for third quarter of fiscal 2005 and operating income of $254,354, as compared to operating income of $109,721 and $245,191 for the corresponding periods in fiscal 2004 Net income for the three and nine months ended June 30, 2005 was $182 and $139,066, respectively, as compared to net income of $65,006 and $145,564, respectively, for the corresponding periods in fiscal 2004.

Sales

Total Sales and Gross Profit on Sales:

	Unaudited Three Months Ended June 30,		Unaudited Nine Months Ended June 30,	
	2005	2004	2005	2004
Total sales:	$1,697,982	$1,274,389	$4,926,387	$3,606,629
Cost of sales:	738,347	622,068	2,221,128	1,689,236
Gross profit on sales:	959,635	652,321	2,705,259	1,917,393
Gross profit as a percentage of sales:	57%	51%	55%	53%

The increase in sales in the third quarter and first nine months of the 2005 fiscal year as compared to the third quarter and first nine months of the 2004 fiscal year reflects increased sales to Stryker of a lesion generator model we developed for the percutaneous treatment of pain, and increased sales to Codman. Sales for our dental products decreased for the third quarter and the first nine months of fiscal 2005.

For the third quarter of fiscal 2005, sales to Codman accounted for 85% of our sales and sales to Stryker accounted for 10% of our sales, as compared to 82% and 9%, of our sales, respectively, for the third quarter of fiscal 2004. For the first nine months of fiscal 2005, sales to Codman accounted for 74% of our sales and sales to Stryker accounted for 20% of our sales, as compared to 84% and 4% of our sales, respectively, for the first nine months of fiscal 2004.

During the third quarter and first nine months of fiscal 2005, we had sales to Stryker of $177,730 and $965,779, respectively, pursuant to a supply and distribution agreement, which we entered into on October 25, 2004. There were sales of $120,000 and $135,000, respectively, of this product during the third quarter and first nine months of fiscal 2004. After only eight months into the first year of the supply and distribution agreement, Stryker has already exceeded the first year minimum purchases of $900,000 as set forth in that agreement.

Sales of our neurosurgical products and related services to Codman increased to $1,438,304 for the three months, and $3,628,436 for the nine months, ended June 30, 2005 as compared to sales of $1,040,347 and $3,044,868

for the three and nine months ended June 30, 2004. During this time, Codman was the exclusive distributor of our existing products in fields of neurocranial and neurospinal surgery. Subsequent to the end of the quarter, effective July 15, 2005, Codman became the nonexclusive worldwide distributor of our existing products in the fields of neurocranial and neurospinal surgery until December 31, 2005. We anticipate that sales to Codman in the fourth quarter of fiscal 2005 will be at a lower level than the sales to Codman for the third quarter of fiscal 2005.

For the three and nine months ended June 30, 2005, sales of the Bident(R) Bipolar Tissue Management System for dental applications were $79,708 and $298,879, respectively, or 5% and 6% of sales, respectively, as compared to $107,948, or 8% of sales, and $398,563, or 11% of sales, respectively, for the corresponding periods in 2004. We are considering product modifications and other strategies for our dental products.

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Sales by Medical Field:

The table below sets forth our sales by medical field of "Generators, Irrigators and Other Products" and "Disposable Products" for the three months and nine months ended June 30, 2005, and 2004. Sales of "Disposable Products" in "Other fields" represent sales to Boston Scientific Corporation and direct sales to hospitals.

	For the Three Months Ended June 30,		For the Nine Months Ended June 30,	
	2005	2004	2005	2004
Generators, Irrigators and Accessory Products				
Neurosurgery field	$ 904,770	$ 503,852	$2,122,702	$1,552,478
Dental field	64,583	85,125	251,858	341,755
Pain Control fields	150,000	120,000	937,500	135,000
Total of all fields:	$1,119,353	$ 708,977	$3,312,060	$2,029,233
Disposable Products				
Neurosurgery field	$ 480,484	$ 508,306	$1,338,857	$1,313,030
Dental field	13,960	24,572	43,492	56,809
Other fields	2,240	1,963	15,476	30,218
Total of all fields:	$ 496,684	$ 534,841	$1,397,825	$1,400,057

For the third quarter of fiscal 2005, 66% of our sales related to sales of bipolar electrosurgical generators, irrigators and accessories as compared to approximately 56% of our sales for the third quarter of fiscal 2004. Sales of disposable products accounted for approximately 29% of our sales in the third quarter of fiscal 2005 as compared to approximately 42% of our sales in the third quarter of fiscal 2004.

For the first nine months of fiscal 2005, 67% of our sales related to sales of bipolar electrosurgical generators, irrigators and accessories as compared to

approximately 56% of our sales for the first nine months of fiscal 2004. Sales of disposable products accounted for approximately 28% of our sales in the first nine months of fiscal 2005, as compared to approximately 39% of our sales in the first nine months of fiscal 2004.

Cost of Sales

Cost of sales was 43% of sales for the three months, and 45% for the nine months, ended June 30, 2005 as compared to 49% and 47% of sales for the three months and nine months ended June 30, 2004. Gross margin was 57% for the three months, and 55% for the nine months, ended June 30, 2005 as compared to 51% for the three months, and 53% for the nine months, ended June 30, 2004. The higher gross margin for the three months and nine months ended June 30, 2005 reflects higher sales volume and different product mix.

We cannot be sure that gross margins will remain at current levels or show improvement in the future due to the distribution channels used, product mix, and fluctuation in manufacturing production levels and overhead costs as new products are introduced. In addition, inefficiencies in manufacturing new products and the distribution channels utilized to sell those products may adversely impact gross margin.

Operating Expenses

Selling, general and administrative expenses increased by 26%, or $108,524, to $526,223 for the third quarter and by 12%, or $160,421, to $1,446,665 for the first nine months of fiscal 2005, as compared to $417,699 and $1,286,244, respectively, for the comparable periods in fiscal 2004. For the third quarter of fiscal 2005, rent expense increased as a result of our entering into a lease for new corporate offices and assembly, engineering and manufacturing facility in King of Prussia, Pennsylvania effective May 1, 2005. The increase in selling, general and administrative expenses also reflects one-time expenses, which we incurred in the third quarter of fiscal 2005, in connection with relocating to this facility in late June and early July of 2005. Our future rent expense under this new lease will be greater than our rent expense for the facilities that it replaced.

We incurred professional fees in connection with the merger agreement with Synergetics of approximately $437,000 for the third quarter, and $519,000 for the first nine months, of fiscal 2005. It is expected that we will incur additional professional fees and printing costs in connection with the merger in the fourth quarter of fiscal 2005.

Research and development expenses were $108,307 for the three months, and $454,752 for the nine months, ended June 30, 2005, as compared to $114,754 for the three months, and $355,662 for the nine months, ended June 30, 2004. We will continue to invest in research and development to expand our technological base for use in both existing and additional clinical fields.

Other Income (Expenses)

In the third quarter of fiscal 2005, we realized a gain of $111,674 from the sale of our assembly, engineering and manufacturing in Philadelphia, Pennsylvania by our wholly-owned subsidiary, Diversified Electronics Company, Inc.

In the second quarter of fiscal 2005, we recorded an expense of $150,000 in connection with the lawsuit entitled Jeffrey Turner and Cathryn Turner v.

Phoenix Children's Hospital, Inc. , et al., in which Valley Forge was one of the defendants. In April 2005, without admitting liability in this disputed claim, and as a precondition to Valley Forge's merger agreement with Synergetics, a settlement agreement and release was entered into in which we paid $150,000 towards plaintiff's expenses in the lawsuit.

Income Tax Provision

The provision for income taxes was $890 for the three months, and $105,083 for the nine months, ended June 30, 2005 as compared to $50,583 for the three months, and $116,533 for the nine months, ended June 30, 2004.

Net Income

Net income decreased to $182 for the three months, and $139,066 for the nine months, ended June 30, 2005, as compared to net income of $65,006 for the three months, and $145,564 for the nine months, ended June 30, 2004. Basic and diluted income per share was $0.00 for the three months, and $0.02 for the nine months, ended June 30, 2005 as compared to $0.01 for the three months, and $0.02 for the nine months, ended June 30, 2004.

Liquidity and Capital Resources

At June 30, 2005, we had $3,852,154 in working capital compared to $3,718,481 at September 30, 2004 and $3,746,333 at June 30, 2004. The primary measures of our liquidity are cash, cash equivalents, accounts receivable and inventory balances. The cash equivalents are highly liquid with original maturities of ninety days or less.

Cash used in operating activities was $17,959 for the nine months ended June 30, 2005 as compared to cash used of $78,867 for the nine months ended June 30, 2004. The cash used in operating activities for the first nine months of fiscal 2005 was mainly attributable to an increase in accounts receivable of $295,554 and an increase in inventory of $10,781, partially offset by an increase in accounts payable, accrued expenses and income taxes payable of $227,284.

In the first nine months of fiscal 2005, accounts receivable net of allowances increased by $295,554 to $941,778 at June 30, 2005 from $646,224 at September 30, 2004. The increase in accounts receivable was principally due to increased sales.

In the first nine months of fiscal 2005, inventories increased by $10,781 to $792,385 at June 30, 2005 from $781,604 at September 30, 2004.

The increase in accounts payable reflects increases in material purchases due to increased sales volume and merger related expenses.

For the nine months ended June 30, 2005, our investing activities provided $21,542, which was attributable primarily to the net proceeds of $185,788 we received from the disposition of our manufacturing facility in Philadelphia, Pennsylvania by our wholly-owned subsidiary, Diversified Electronics Company, Inc., net of $171,296 primarily for the purchase of equipment and building improvements in connection with the lease of our new facility in King of Prussia, Pennsylvania. Net property and equipment increased to $221,101 at June 30, 2005 as compared to $147,967 at September 30, 2004.

In the third quarter of fiscal 2005, we entered into a combination sublease and lease, commencing on May 1, 2005, for a term of four and one-half years, for approximately 13,500 square feet of office, assembly, engineering and manufacturing space in King of Prussia, Pennsylvania, with an initial annual rent of $74,858, increasing to $129,437, plus annual operating expenses. In late June and early July 2005, we moved both our Philadelphia, Pennsylvania manufacturing, engineering and assembly facility and our Oaks, Pennsylvania offices into this facility.

In August 2002, our Board of Directors terminated our then existing stock repurchase plan and authorized a new repurchase plan to purchase up to 200,000 shares of our common stock. We did not purchase any of our stock in the third quarter of fiscal 2005 pursuant to this plan. To date, we have repurchased 154,100 shares of our common stock under the plan, leaving a balance of 45,900 that is available for repurchase under the plan.

At June 30, 2005, we had cash and cash equivalents of $2,386,742. We plan to finance our operating and capital needs principally with cash flows from operations and existing balances of cash and cash equivalents, which we believe will be sufficient to fund our operations in the near future. However, should it be necessary, we believe we could borrow adequate funds at competitive rates and terms. Our future liquidity and capital requirements will depend on numerous factors, including the funds we expend in marketing, selling and distributing our products, the success in commercializing our existing products, development and commercialization of products in other clinical markets, the ability of our suppliers to continue to meet our demands at current prices, the status of regulatory approvals and competition.

We have a line of credit of $1,000,000 with Wachovia Bank, N.A. which calls for interest to be charged at the bank's national commercial rate. The credit accommodation is unsecured and requires us to have a tangible net worth of no less than $3,400,000. Our current tangible net worth exceeds $3,400,000 at June 30, 2005. As of June 30, 2005, there was no outstanding balance on this line.

USE OF ESTIMATES AND CRITICAL ACCOUNTING POLICIES

The preparation of financial statements and related disclosures in conformity with accounting principles generally accepted in the United States requires management to make judgments, assumptions, and estimates that affect the amounts reported in the Consolidated Financial Statements and accompanying notes. Note 1 to the Consolidated Financial Statements describes the significant accounting policies and methods used in the preparation of the Consolidated Financial Statements. Estimates are used for, but not limited to, the accounting for the allowance for doubtful accounts and sales returns, inventory allowances, warranty costs, contingencies and other special charges, and taxes. Actual results could differ materially from these estimates. The following critical accounting policies are impacted significantly by judgments, assumptions, and estimates used in the preparation of the Consolidated Financial Statements.

Allowances For Doubtful Accounts, Sales Returns and Warranty Costs

We evaluate the collectibility of accounts receivable based on a combination of factors. In circumstances where a specific customer is unable to meet its financial obligations to us, we record an allowance against amounts due

to reduce the net recognized receivable to the amount that we reasonably expect to collect. For all other customers, we record allowances for doubtful accounts based on the length of time the receivables are past due, the current business environment and our historical experience. If the financial condition of customers or the length of time that receivables are past due were to change, we may change the recorded amount of allowances for doubtful accounts in the future. We record a provision for estimated sales returns and allowances on product revenues in the same period as the related revenues are recorded. We base these estimates on historical sales returns and other known factors. Actual returns could be different from our estimates and the related provisions for sales returns and allowances, resulting in future changes to the sales returns and allowances provision. Our warranty obligation is affected primarily by product that does not meet specifications within the applicable warranty period and any related costs to repair or replace such products. Should our actual experience of warranty claims differ from our estimates of such obligations, our provision for warranty costs could change.

Inventories

Inventories, which consist of raw materials, work-in-process and finished goods, and include purchased materials, direct and indirect labor and direct and indirect manufacturing overhead, are stated at the lower of cost, determined by the moving average method, or market. At each balance sheet date, we evaluate inventories for excess quantities and identified obsolescence. Our evaluation includes an analysis of historical sales levels by product and projections of future demand, as well as estimates of quantities required to support warranty and other repairs. To the extent that we determine there are excess quantities based on our projected levels of sales and other requirements, or obsolete material in inventory, we record valuation reserves against all or a portion of the value of the related parts or products. If future demand or market conditions are different than our projections, a change in recorded inventory valuation reserves may be required and would be reflected in cost of sales in the period the revision is made.

Amortization Periods

We record amortization of intangible assets using the straight-line method over the estimated useful lives of these assets. We base the determination of these useful lives on the period over which we expect the related assets to contribute to our cash flows or in the case of patents, their legal life, whichever is shorter. If our assessment of the useful lives of intangible assets changes, we may change future amortization expense.

Deferred Tax Assets and Liabilities

Our deferred tax assets and liabilities are determined based on differences between the financial statement and tax bases of assets and liabilities using enacted tax rates in effect for the year

in which the differences are expected to reverse. Deferred tax assets are reduced by a valuation allowance when a determination is made that it is more likely than not that a portion or all of the deferred tax assets will not be realized.

Loss Contingencies

We may be subject to claims and lawsuits in the ordinary course of our business, including claims by employees or former employees, with respect to our

products and involving commercial disputes. Our financial statements do not reflect any material amounts related to possible unfavorable outcomes of claims and lawsuits, as we are not aware of any such claims or lawsuits. Our financial statements do reflect the settlement of the lawsuit entitled Jeffrey Turner and Cathryn Turner v. Phoenix Children's Hospital, Inc., et al.

Goodwill Impairment

We perform goodwill impairment tests on an annual basis and as needed if events or circumstances indicate that goodwill may have been impaired. In response to changes in industry and market conditions, we may be required to strategically realign our resources and consider restructuring, disposing, or otherwise exiting businesses, which could result in an impairment of goodwill. Impairment is measured by the difference between the recorded value of goodwill and its implied fair value when the fair value of the reporting unit is less than its net book value.

Impairment of Long-Lived Assets

Long-lived assets and certain identifiable intangible assets to be held and used are reviewed for impairment whenever events or changes in circumstances indicate that the carrying amount of such assets may not be recoverable. Determination of recoverability is based on an estimate of undiscounted future cash flows resulting from the use of the group of assets and their eventual disposition. Measurement of an impairment loss for long-lived assets and certain identifiable intangible assets that management expects to hold and use is based on the fair value of the asset. Long-lived assets and certain identifiable intangible assets to be disposed of are reported at the lower of carrying amount or fair value less costs to sell.

Stock-Based Compensation

We account for stock-based employee compensation using the intrinsic value method of accounting. Under this method, employee stock-based compensation expense is based on the difference, if any, on the date of the grant between the fair value of the Company's stock and the exercise price of the award. We account for stock options issued to non-employees using the fair value method of accounting, which requires us to assign a value to the stock options issued based on an option pricing model, and to record that value as compensation expense. We use the Black-Scholes option pricing model. If we were to account for stock options issued to employees using the fair value method of accounting rather than the intrinsic value method, our results of operations would be significantly affected.

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SPECIAL NOTE REGARDING FORWARD LOOKING STATEMENTS

The information provided in this Quarterly Report on Form 10-Q contain in addition to historic information, "forward looking" statements or statements which arguably imply or suggest certain things about our future. Statements which express that we "believe", "anticipate", "expect", or "plan to" as well as other statements which are not historical fact, are forward looking statements within the meaning of the Private Securities Litigation Reform Act of 1995. These statements are based on assumptions that we believe are reasonable, but a number of factors could cause our actual results to differ materially from those expressed or implied by these statements including:

- competitive, regulatory and market conditions;

- the performance of new products and the continued acceptance of current products in the marketplace;
- the execution of strategic initiatives and alliances;
- disruptions caused by moving our assembly, engineering and manufacturing facility;
- the market penetration by third parties who distribute and sell our products;
- our ability to maintain a sufficient supply of products;
- product liability claims;
- the uncertainties associated with intellectual property protection for our products;
- the possibility that the merger transaction with Synergetics will not close or that the closing will be delayed due to the regulatory review or other factors;
- the challenges and costs of combining the operations and personnel of Synergetics with Valley Forge after a closing of the merger agreement;
- the ability to attract and retain highly qualified employees;
- competitive factors, including pricing pressures;
- reactions of customers of Valley Forge and Synergetics and end-users of Valley Forge and Synergetics products to the merger transaction and related risks of maintaining pre-existing relationships of Valley Forge and Synergetics;
- adverse changes in general economic or market conditions;
- other one-time events;
- other important factors disclosed previously and from time to time in Valley Forge's filings with the SEC; and
- other risk factors described in the sections entitled "Factors That Might Affect Future Results" in this report.

Readers are cautioned not to rely on these forward looking statements. We do not intend to update or revise these forward looking statements.

FACTORS THAT MIGHT AFFECT FUTURE RESULTS

We currently rely on our relationship with a single customer for a significant portion of our revenues, which makes our financial position and operating results vulnerable to the loss of that customer.

Our most important relationship is with Codman, an affiliate of Johnson & Johnson, for the sale of our neurosurgery products. Sales to Codman accounted for 85% of our sales for the first nine months of fiscal 2005, 86% of our sales in fiscal year 2004, and 95% and 90% of our sales in fiscal years 2003 and 2002, respectively. Under our agreement with Codman, our exclusive distributorship relationship expired on July 15, 2005. In addition, the agreement will expire on December 31, 2005, or earlier, pursuant to the terms of the agreement.

The impact to us of the expiration of our exclusive relationship with Codman, and the corresponding termination of Codman's minimum purchase obligations under the agreement, is uncertain. If we are unable to establish alternative or additional channels of distribution for our products, we may be unable to achieve the same revenue levels as those that have historically resulted from our relationship with Codman. In addition, any continuation of the distribution agreement with Codman beyond December 31, 2005 could be on terms less favorable than the existing distribution agreement with Codman.

If any of our single source suppliers were to cease providing components, we may not be able to produce our products.

We currently subcontract for the manufacturing of our disposable cord and tubing sets with a single manufacturer. If this supplier becomes unwilling or unable to provide products or components in the required volumes and quality levels or in a timely manner, we would be required to locate and contract with substitute suppliers. Although we believe that alternative sources for many of these components and raw materials are available, we could have difficulty identifying a substitute supplier in a timely manner or on commercially reasonable terms and may have to pay higher prices to obtain the necessary materials. Any supply interruption could harm our ability to manufacture our products until a new source of supply is identified and qualified.

We have also become aware that the manufacturers of several parts used in our currently available bipolar electrosurgical generator models will no longer be manufacturing these parts in the near future. While we have arranged to purchase and maintain a significant inventory of these parts and are developing alternatives for these parts, our efforts may not be sufficient depending on our unit sales. Alternative parts, if available, would require engineering redesign and may require regulatory approval before the manufacture of additional new units. In addition, in the event that we determine to continue the manufacture and sale of the existing product line together with our new multifunctional bipolar electrosurgical generator, such redesign, part sourcing and regulatory approval may also be required.

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The medical device industry is highly competitive, and we may be unable to compete effectively with other companies.

The medical technology industry is characterized by intense competition. We compete with established medical technology and early stage companies that have alternative solutions for the markets we serve or intend to serve. Many of our competitors have access to greater financial, technical, research and development, marketing, manufacturing, sales, distribution services and other resources than we do. Further, our competitors may be more effective at implementing their technologies to develop commercial products. Certain of the medical indications that can be treated by our devices can also be treated by other medical devices or by medical practices that do not include a device. The medical community widely accepts many alternative treatments and certain of these treatments have a long history of use.

Our competitive position will depend on our ability to achieve market acceptance for our products, develop new products, implement production and marketing plans, secure regulatory approval for products under development, and protect our intellectual property. We may need to develop new applications for our products to remain competitive. Technological advances by one or more of our current or future competitors could render our present or future products obsolete or uneconomical. Our future success will depend upon our ability to compete effectively against current technology as well as to respond effectively to technological advances.

Our future results are dependent, in part, upon the successful introduction of our new multifunctional bipolar electrosurgical generator.

Our future success, in a large part, may depend upon the successful launch of our new multifunctional bipolar electrosurgical generator and new proprietary single-use, hand-switching bipolar instruments. While we believe that this new generator and related instruments represent significant advancements in technology and performance and will replace other surgical tools in certain applications, such as monopolar electrosurgical systems and lasers, their

success in the marketplace is dependent upon several factors including:

- the completion of the design and testing;
- their acceptance by surgeons;
- the recognition by hospitals and surgical centers that the new generator and instruments are sufficiently improved and beneficial to warrant the cost of acquisition and training;
- our ability to create a sales network;
- our ability to sustain our average selling price through this network; and
- the reaction of our competitors in this market.

Our products may not be accepted in the market.

We cannot be certain that our current products or any other products that we may develop or market will achieve or maintain market acceptance. We cannot be certain that our devices and procedures they perform will be able to replace those established treatments or that either physicians or the medical community in general will accept and utilize our devices or any other medical

products that we may develop. For example, we cannot be certain that the medical community will accept our new multifunctional electrosurgical generator and proprietary hand-switching bipolar electrosurgical instruments over traditional monopolar electrosurgical generators.

Market acceptance of our products depends on many factors, including our ability to convince third party distributors and customers that our technology is an attractive alternative to other technologies, to manufacture products in sufficient quantities and at acceptable costs, and to supply and service sufficient quantities of our products directly or through our distribution alliances.

If we do not introduce new commercially successful products in a timely manner, our products may become obsolete over time, thereby decreasing our revenue and profitability.

Demand for our products may change because of evolving customer needs, the introduction of new products and technologies, the discovery of cures for certain medical problems, evolving surgical practices and evolving industry standards. Without the timely introduction of new commercially successful products and enhancements, our products may become obsolete over time, causing our sales and operating results to suffer. The success of our new products will depend on several factors, including our ability to:

- properly identify and anticipate customer needs;
- commercialize new products in a cost-effective and timely manner;
- manufacture and deliver products in sufficient volumes on time;
- obtain regulatory approval for new products;
- differentiate our products from those of competitors;
- achieve positive clinical outcomes;
- satisfy the increased demands by health care payors, providers and patients for lower-cost procedures and shorter hospital stays and recovery times;
- innovate and develop new materials, product designs and surgical techniques; and
- provide adequate medical and/or customer education relating to new products and attract key surgeons to advocate these new products.

New products and enhancements usually require a substantial investment in research and development before we can determine the viability of the product, and we may not have the financial resources necessary to fund this research and development. Moreover, new products and enhancements may not produce revenues in excess of the research and development costs, and they may be quickly obsolete by changing customer preferences or the introduction by our competitors of new technologies or features.

Our operating results may fluctuate.

We have experienced operating losses at various times since our inception. Our operating results, including components of operating results, such as gross margin on product sales, may fluctuate from time-to-time which could affect our stock price. Our operating results have fluctuated in the past and can be expected to fluctuate from time-to-time in the future. Some of the factors that may cause these fluctuations include, but are not limited to:

- the introduction of new product lines;
- product modifications;
- the level of market acceptance of our products;
- the timing of research and development expenditures;
- timing of the receipt of orders from, and product shipments to, distributors and customers;
- timing of expenditures;
- changes in the distribution arrangements for our products;
- manufacturing or supply delays;
- the time needed to educate and train a distributor's sales force;
- costs associated with product introduction;
- product returns; and
- receipt of necessary regulation approvals.

Changes in the health care industry may require us to decrease the selling price for our products or could result in a reduction in the size of the market for our products, each of which could have a negative impact on our financial performance.

Trends toward managed care, health care cost containment, and other changes in government and private sector initiatives in the United States and other countries in which we do business are placing increased emphasis on the delivery of more cost-effective medical therapies that could adversely affect the sale or the prices of our products. For example:

- there has been a consolidation among health care facilities and purchasers of medical devices in the United States who prefer to limit the number of suppliers from whom they purchase medical products, and these entities may decide to stop purchasing our products or demand discounts on our prices;
- major third-party payors of hospital services, including Medicare, Medicaid and private health care insurers, have substantially revised their payment methodologies, which has resulted in stricter standards for reimbursement of hospital charges for certain medical procedures;
- Medicare, Medicaid and private health care insurer cutbacks could create downward price pressure on our products;
- numerous legislative proposals have been considered that would result in major reforms in the U.S. health care system that could have an adverse effect on our business;
- there is economic pressure to contain health care costs in international markets; and

- there have been initiatives by third-party payors to challenge the prices charged for medical products that could affect our ability to sell products on a competitive basis.

Both the pressures to reduce prices for our products in response to these trends and the decrease in the size of the market as a result of these trends could adversely affect our levels of revenues and profitability of sales.

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We will first need regulatory approval to market our products under development. We may be subject to penalties and may be precluded from marketing our products if we fail To comply with extensive governmental regulations.

Our research and development activities and the manufacturing, labeling, distribution and marketing of our existing and future products are subject to regulation by numerous governmental agencies in the United States and in other countries. The Food and Drug Administration (FDA) and comparable agencies in other countries impose mandatory procedures and standards for the conduct of clinical trials and the production and marketing of products for diagnostic and human therapeutic use.

Products we have under development are subject to FDA approval or clearance prior to marketing for commercial use. The process of obtaining necessary FDA approvals or clearances can take years and is expensive and full of uncertainties. Our inability to obtain required regulatory approval or clearance on a timely or acceptable basis could harm our business. Further, approval or clearance may place substantial restrictions on the indications for which the product may be marketed or to whom it may be marketed. Further studies may be required to gain approval or clearance for the use of a product for clinical indications other than those for which the product was initially approved or cleared or for significant changes to the product.

Furthermore, another risk of application to the FDA relates to the regulatory classification of new products or proposed new uses for existing products. In the filing of each application, we are required to make a judgment about the appropriate form and content of the application. If the FDA disagrees with our judgment in any particular case and, for example, requires us to file a premarket approval (PMA) application rather than allowing us to market for approved uses while we seek broader approvals or requires extensive additional clinical data, the time and expense required to obtain the required approval might be significantly increased or approval might not be granted. Approved and cleared products are subject to continuing FDA requirements relating to quality control and quality assurance, maintenance of records, reporting of adverse events and product recalls, documentation, and labeling and promotion of medical devices.

The FDA as well as foreign regulatory authorities require that our products be manufactured according to rigorous standards. These regulatory requirements may significantly increase our production costs and may even prevent us from making our products in amounts sufficient to meet market demand. If we change our approved manufacturing process, the FDA may need to review the process before it may be used. Failure to develop our manufacturing capability may mean that even if we develop promising new products, we may not be able to produce them profitably, as a result of delays and additional capital investment costs. In addition, failure to comply with applicable regulatory requirements could subject us to enforcement action, including product seizures, recalls, withdrawal of clearances or approvals, restrictions on or injunctions against marketing our product or products based on our technology, and civil and criminal penalties.

Our intellectual property rights may not provide meaningful commercial protection for our products and could adversely affect our ability to compete in the market.

Our ability to compete effectively depends in part, on our ability to maintain the proprietary nature of our technologies and manufacturing processes, which includes the ability to obtain, protect and enforce patents on our technology and to protect our trade secrets. We own patents that cover significant aspects of our products. Certain of our patents have expired and others will expire in the future. In addition, challenges may be made to our patents and, as a result, our patents could be narrowed, invalidated or rendered unenforceable. Competitors may develop products similar to ours that our patents do not cover. In addition, our current and future patent applications may not result in the issuance of patents in the United States or foreign countries. Further, there is a substantial backlog of patent applications at the U.S. Patent and Trademark Office, and the approval or rejection of patent applications may take several years. We may become subject to patent infringement claims or litigation or interference proceedings declared by the U.S. Patent and Trademark Office to determine the priority of inventions.

Our competitive position depends, in part, upon unpatented trade secrets, which are difficult to protect. Others may independently develop substantially equivalent proprietary information and techniques or otherwise gain access to our trade secrets. In an effort to protect our trade secrets, we generally require certain of our employees, consultants and advisors to execute proprietary information and invention assignment agreements upon commencement of employment or consulting relationships with us. These agreements typically provide that, except in specified circumstances, all confidential information developed or made known to the individual during the course of their relationship with us must be kept confidential. Some jurisdictions limit the enforceability and scope of these agreements and these agreements may not provide meaningful protection for our trade secrets or other proprietary information in the event of the unauthorized use or disclosure of confidential information.

We may have product liability claims and our insurance may not cover all claims.

Our products involve a risk of product liability claims. We may not be able to obtain insurance for the potential liability on acceptable terms with adequate coverage or at reasonable costs. Any potential product liability claims could exceed the amount of our insurance coverage or may be excluded from coverage under the terms of the policy. Further, our insurance may not be renewed at a cost and level of coverage comparable to that then in effect.

The market price of our stock may be highly volatile.

During the first nine months of fiscal 2005 and during fiscal 2004 and 2003, our common stock has traded in a range of $1.05 and $5.25 per share. The market price of our common stock could continue to fluctuate substantially due to a variety of factors, including:

- our ability to successfully commercialize our products;

- the execution of new agreements and material changes in our relationships with companies with whom we contract;
- quarterly fluctuations in results of operations;
- announcements regarding technological innovations or new commercial products by us or our competitors or the results of regulatory approval filings;
- market reaction to trends in sales, marketing and research and development and reaction to acquisitions;
- sales of common stock by existing stockholders;
- economic and political conditions; and
- fluctuations in the United States financial markets.

Historically, the trading volume for our common stock has been limited.

Our common stock is thinly traded in comparison to companies with greater market capitalization. As a result, large sell trades, negative news and general economic pressures on the stock market can have an impact on the price of our common stock that is more pronounced than securities of other issuers with larger listed stock volume or higher prices per share. Further, our common stock has a limited float. A large percentage of our outstanding common stock is held by management and insiders, so the float is limited and the stock is much less liquid.

The loss of key personnel could harm our business.

We believe our success depends on the contributions of a number of our key personnel, including Jerry L. Malis, our President and Chief Executive Officer. If we lose the services of key personnel, those losses could materially harm our business. We do not maintain any significant key person life insurance on Mr. Malis.

Item 4. CONTROLS AND PROCEDURES

Our management, including our Chief Executive Officer/Principal Financial Officer, conducted an evaluation of the effectiveness of our disclosure controls and procedures as of June 30, 2005. Based on that evaluation, our management, including our Chief Executive Officer/Principal Financial Officer, has concluded that our disclosure controls and procedures are effective. During the period covered by this report, there was no change in our internal control over financial reporting that has materially affected, or is reasonably likely to materially affect, our internal control over financial reporting.

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PART II. OTHER INFORMATION

Item 1. LEGAL PROCEEDINGS

In April 2005, without admitting liability and as a precondition to Valley Forge's merger agreement with Synergetics, Inc., Valley Forge settled the lawsuit entitled Jeffrey Turner and Cathryn Turner v. Phoenix Children's Hospital, Inc. , et al., in which Valley Forge was one of the defendants, and paid $150,000 towards plaintiff's expenses in the lawsuit.

Item 6. EXHIBITS AND REPORTS ON FORM 8-K

(a) Exhibits

Exhibit 2.1	Agreement and Plan of Merger by and among Valley Forge Scientitific Corp., Synergetics Acquisition

	Corporation and Synergetics, Inc. dated May 2, 2005. (1)
Exhibit 2.2	Amendment No. 1 to Agreement and Plan of Merger by and among Valley Forge Scientitific Corp., Synergetics Acquisition Corporation and Synergetics, Inc. dated June 2, 2005. (2)
Exhibit 2.3	Amendment No. 2 to Agreement and Plan of Merger by and among Valley Forge Scientitific Corp., Synergetics Acquisition Corporation and Synergetics, Inc. dated July 15, 2005. (3)
Exhibit 9.1	Valley Forge Voting Agreement among certain shareholders of Valley Forge Scientific Corp., Valley Forge Scientific Corp. and Synergetics, Inc. dated May 2, 2005. (1)
Exhibit 9.2	Synergetics Voting Agreement among certain shareholders of Synergetics, Inc., Valley Forge Scientific Corp. and Synergetics, Inc. dated May 2, 2005. (1)
Exhibit 10.16	Agreement and Lease between Liberty Property Limited Partnership and Valley Forge Scientific Corp. (4)
Exhibit 10.17	Agreement for Sale of Commercial Real Estate between Diversified Electronics Company, Inc. and Stan Smith dated April 21, 2005. (4)
Exhibit 31.1	Certification of the Chief Executive Officer Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.

Exhibit 32.1	Certification of the Chief Executive Officer Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.

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(1) Previously filed with Valley Forge's Current Report on Form 8-K filed on May 4, 2005 and incorporated herein by reference.
(2) Previously filed with Valley Forge's Current Report on Form 8-K filed on June 3, 2005 and incorporated herein by reference.
(3) Previously filed with Valley Forge's Current Report on Form 8-K filed on July 15, 2005 and incorporated herein by reference.
(4) Previously filed with Valley Forge's Form S- 4 Registration Statement (Registration No. 333-125521) and incorporated herein by reference.

(b) Current Reports on Form 8-K

On May 4, 2005, Valley Forge Scientific Corp. filed a report on Form 8-K regarding a merger agreement with Synergetics, Inc.

On May 11, 2005, Valley Forge Scientific Corp. filed a report on Form 8-K regarding an amendment to an agreement with Codman & Shurtleff, Inc.

On May 13, 2005, Valley Forge Scientific Corp. filed a report on Form 8-K regarding its results of operations.

On May 24, 2005, Valley Forge Scientific Corp. filed a report regarding a determination by The Nasdaq Stock Market that the merger with Synergetics, Inc. constitutes a "reverse merger."

On June 3, 2005, Valley Forge Scientific Corp. filed a report on Form 8-K regarding an amendment to the merger agreement with Synergetics, Inc.

Subsequent to the end of the quarter, on July 15, 2005, Valley Forge Scientific Corp. filed a report on Form 8-K regarding an amendment to the merger agreement with Synergetics, Inc.

Subsequent to the end of the quarter, on August 11, 2005, Valley Forge Scientific Corp. filed a report on Form 8-K regarding its results of operations.

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VALLEY FORGE SCIENTIFIC CORP.

SIGNATURES

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

VALLEY FORGE SCIENTIFIC CORP.

Date: August 15, 2005

By: /s/ JERRY L. MALIS

Jerry L. Malis, President and
Chief Executive Officer
(principal financial officer)

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VALLEY FORGE SCIENTIFIC CORP.
For Quarterly Period Ended June 30, 2005
FORM 10-Q
EXHIBIT INDEX

Exhibit 31.1	Certification of the Chief Executive Officer Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002
Exhibit 32.1	Certification of the Chief Executive Officer Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002

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Basic earnings per share

Continuing operations

$ 1.91

$ 1.84

$ 3.91

$ 3.54

Discontinued operations

—

—

—

0.12

Basic earnings per share

$ 1.91

$ 1.84

$ 3.91

$ 3.66

Weighted-average common shares outstanding, in millions
250.8

282.6

252.0

287.2

Diluted earnings per share

Continuing operations

$ 1.88

$ 1.81

$ 3.84

$ 3.48

Discontinued operations
—

—

—

0.11

Diluted earnings per share

$ 1.88

$ 1.81

$ 3.84

$ 3.59

Weighted-average diluted shares outstanding, in millions
254.7

287.2

256.5

292.2

Net earnings (from above)

$ 480

$ 520

$ 986

$ 1,050

Other comprehensive income

Change in cumulative translation adjustment
(15
)

—

(9
)

27

Change in unrealized gain on marketable securities and cash flow hedges, net of tax
—

—

—

(2
)
Change in unamortized benefit plan costs, net of tax
54

14

104

35

Other comprehensive income, net of tax
39

14

95

60

Comprehensive income

$ 519

$ 534

$ 1,081

$ 1,110

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

CONDENSED CONSOLIDATED STATEMENTS OF FINANCIAL POSITION
(Unaudited)

$ in millions	June 30, 2012	December 31, 2011
Assets		
Cash and cash equivalents	$ 3,148	$ 3,002
Accounts receivable, net of progress payments	3,119	2,964
Inventoried costs, net of progress payments	704	873
Deferred tax assets	504	496
Prepaid expenses and other current assets	225	411
Total current assets	7,700	7,746
Property, plant and equipment, net of accumulated depreciation of $4,094 in 2012 and $3,933 in 2011	2,935	3,047
Goodwill	12,344	12,374
Non-current deferred tax assets	838	900
Other non-current assets	1,409	1,344
Total assets	$25,226	$25,411
Liabilities		
Trade accounts payable	$ 1,191	$ 1,481
Accrued employees compensation	1,020	1,196
Advance payments and billings in excess of costs incurred	1,826	1,777
Other current liabilities	1,571	1,681
Total current liabilities	5,608	6,135
Long-term debt, net of current portion	3,932	3,935
Pension and post-retirement plan liabilities	4,067	4,079
Other non-current liabilities	904	926
Total liabilities	14,511	15,075
Commitments and contingencies (Note 8)		
Shareholders’ equity		
Preferred stock, $1 par value; 10,000,000 shares authorized; no shares issued and outstanding	—	—
Common stock, $1 par value; 800,000,000 shares authorized; issued and outstanding: 2012—248,039,410; 2011—253,889,622	248	254
Paid-in capital	3,443	3,873
Retained earnings	10,419	9,699
Accumulated other comprehensive loss	(3,395)	(3,490)
Total shareholders’ equity	10,715	10,336
Total liabilities and shareholders’ equity	$25,226	$25,411

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

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NORTHROP GRUMMAN CORPORATION

CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS
(Unaudited)

$ in millions	Six Months Ended June 30 2012	2011
Operating activities		
Sources of cash—continuing operations		
Cash received from customers		
Collections on billings	$ 9,911	$ 11,028
Progress payments	2,553	1,975
Other cash receipts	38	80
Total sources of cash—continuing operations	12,502	13,083
Uses of cash—continuing operations		
Cash paid to suppliers and employees	(10,969)	(11,692)
Pension contributions	(33)	(550)
Interest paid, net of interest received	(102)	(119)
Income taxes paid, net of refunds received	(584)	(613)
Excess tax benefits from stock-based compensation	(29)	(21)
Other cash payments	(14)	(10)
Total uses of cash—continuing operations	(11,731)	(13,005)
Cash provided by continuing operations	771	78
Cash used in discontinued operations	—	(232)
Net cash provided by (used in) operating activities	771	(154)
Investing activities		
Continuing operations		
Maturities of short-term investments	250	—
Capital expenditures	(132)	(217)
Contribution received from the spin-off of shipbuilding business	—	1,429
Proceeds from sale of business, net of cash divested	43	—
Other investing activities, net	1	41
Cash provided by investing activities from continuing operations	162	1,253
Cash used in investing activities from discontinued operations	—	(63)
Net cash provided by investing activities	162	1,190
Financing activities		
Common stock repurchases	(555)	(1,013)
Cash dividends paid	(265)	(277)
Proceeds from exercises of stock options	67	86
Excess tax benefits from stock-based compensation	29	21
Payments of long-term debt	—	(750)
Other financing activities, net	(63)	6
Net cash used in financing activities	(787)	(1,927)
Increase (decrease) in cash and cash equivalents	146	(891)
Cash and cash equivalents, beginning of year	3,002	3,701
Cash and cash equivalents, end of period	$ 3,148	$ 2,810

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

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NORTHROP GRUMMAN CORPORATION

$ in millions	Six Months Ended June 30 2012	2011
Reconciliation of net earnings to net cash provided by (used in) operating activities		
Net earnings	$986	$1,050
Net earnings from discontinued operations	—	(34)
Adjustments to reconcile to net cash provided by (used in) operating activities:		
Depreciation	212	218
Amortization	31	37
Stock-based compensation	76	66
Excess tax benefits from stock-based compensation	(29)	(21)
(Increase) decrease in assets:		
Accounts receivable, net	(175)	(164)
Inventoried costs, net	143	6
Prepaid expenses and other assets	(95)	5
Increase (decrease) in liabilities:		
Accounts payable and accruals	(453)	(757)
Deferred income taxes	(21)	79
Income taxes payable	(22)	9
Retiree benefits	137	(440)
Other, net	(19)	24
Cash provided by continuing operations	771	78
Cash used in discontinued operations	—	(232)
Net cash provided by (used in) operating activities	$771	($ 154)

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

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NORTHROP GRUMMAN CORPORATION

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

	Six Months Ended June 30	
$ in millions, except per share amounts	2012	2011
Common stock		
Beginning of year	$ 254	$ 291
Common stock repurchased	(9)	(16)
Stock awards and options	3	3
End of period	248	278
Paid-in capital		
Beginning of year	3,873	7,778
Common stock repurchased	(548)	(991)
Stock awards and options	118	131
Spin-off of shipbuilding business	—	(1,892)
End of period	3,443	5,026
Retained earnings		
Beginning of year	9,699	8,124
Net earnings	986	1,050
Dividends declared	(266)	(277)
End of period	10,419	8,897
Accumulated other comprehensive loss		
Beginning of year	(3,490)	(2,757)
Other comprehensive income, net of tax	95	60
Spin-off of shipbuilding business	—	524
End of period	(3,395)	(2,173)
Total shareholders' equity	$10,715	$12,028
Cash dividends declared per share	$ 1.05	$ 0.97

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

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NORTHROP GRUMMAN CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Unaudited)

1. BASIS OF PRESENTATION

Principles of Consolidation and Reporting

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

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

The results reported in these financial statements are not necessarily indicative of results that may be expected for the entire year. These financial statements should be read in conjunction with the information contained in the company’s Annual Report on Form 10-K for the year ended December 31, 2011 (2011 Annual Report on Form 10-K).

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

Accounting Estimates

The accompanying unaudited condensed consolidated financial statements have been prepared in conformity with accounting principles generally accepted in the United States of America (GAAP). The preparation thereof requires management to make estimates and judgments that affect the reported amounts of assets and liabilities and the disclosure of contingencies at the date of the financial statements, as well as the reported amounts of revenues and expenses during the reporting period. Estimates have been prepared on the basis of the most current and best available information; however, actual results could differ materially from those estimates.

The majority of our contracts are accounted for under the percentage-of-completion method. For such contracts, changes in estimates of contract sales, costs 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 in contract performance as if the revised estimate had been used since contract inception. Changes in contract estimates occur for a variety of reasons, including changes in contract scope, changes in estimated contract revenue, changes in contract cost estimates due to unanticipated cost growth or the resolution of contract risks at lower cost than anticipated, as well as changes in contract overhead costs or general and administrative expenses over the performance period. The company has an extensive contract management process involving several functional organizations and numerous personnel who are skilled at managing contract activities. As the company's business involves performing on a broad portfolio of long-term contracts, generally involving complex customized products and services, changes in estimates occur routinely over the contract performance period.

Significant changes in estimates on a single contract could have a material effect on the company's consolidated financial position or results of operations, and where such changes occur, separate disclosure is made of the nature, underlying conditions and financial impact of the change. During the three and six months ended June 30, 2012, aggregate net changes in contract estimates recognized using the cumulative catch-up method of accounting increased operating income by $222 million ($0.57 per diluted share) and $487 million ($1.24 per diluted share), respectively. During the three and six months ended June 30, 2011, such changes in contract estimates increased operating income by $201 million ($0.46 per diluted share) and $345 million ($0.77 per diluted share), respectively. No discrete event or adjustment to an individual contract was material to the condensed consolidated statements of earnings and comprehensive income for any of these periods.

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

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NORTHROP GRUMMAN CORPORATION

Accounting Standards Updates
Accounting standards updates effective after June 30, 2012, are not expected to have a material effect on the company's consolidated financial position or results of operations.
Accumulated Other Comprehensive Loss
The components of accumulated other comprehensive loss are as follows:

$ in millions	June 30, 2012	December 31, 2011
Unamortized benefit plan costs, net of tax benefit of $2,217 as of June 30, 2012, and $2,289 as of December 31, 2011	($3,383)	($3,487)
Cumulative translation adjustment	(13)	(4)
Net unrealized gain on marketable securities and cash flow hedges, net of tax expense	1	1
Total accumulated other comprehensive loss	($3,395)	($3,490)

Unamortized benefit plan costs consist primarily of net after-tax actuarial losses totaling $3.8 billion and $3.9 billion as of June 30, 2012, and December 31, 2011, respectively. Net actuarial gains or losses principally arise from gains or losses on plan assets due to variations in the fair market value of the underlying assets and changes in the benefit obligation due to changes in actuarial assumptions, primarily changes in the discount rate.
2. EARNINGS PER SHARE, SHARE REPURCHASES AND DIVIDENDS ON COMMON STOCK
Basic Earnings Per Share
Basic earnings per share from both continuing and discontinued operations are calculated by dividing the respective earnings by the weighted-average number of shares of common stock outstanding during each period.
Diluted Earnings Per Share
Diluted earnings per share includes the dilutive effect of awards granted to employees under stock-based compensation plans. The dilutive effect of these securities totaled 3.9 million shares and 4.5 million shares for the three and six months ended June 30, 2012, respectively. The dilutive effect of these securities totaled 4.6 million shares and 5.0 million shares for the three and six months ended June 30, 2011, respectively. The weighted-average diluted shares outstanding for the three and six months ended June 30, 2012, excludes anti-dilutive stock options to purchase approximately 2.8 million shares in both periods, because such options have exercise prices in excess of the average market price of the company's common stock during the period. The weighted-average diluted shares outstanding for the three and six months ended June 30, 2011, excludes anti-dilutive stock options to purchase approximately 2.0 million shares and 2.8 million shares, respectively.
Share Repurchases
The table below summarizes the company's share repurchases:

Repurchase Program Authorization Date	Amount Authorized (in millions)	Total Shares Retired (in millions)	Average Price Per Share[2]	Shares Repurchased (in millions) Six Months Ended June 30 2012	2011
June 16, 2010[1]	$4,245	53.5	$57.86	9.3	15.7

(1) On June 16, 2010, the company's board of directors authorized a share repurchase program of up to $2.0 billion of the company's common stock. On April 25, 2011, after the company had repurchased $245 million of shares, the company's board of directors authorized an increase to the remaining share repurchase authorization to $4.0 billion. As of June 30, 2012, the company had $1.1 billion remaining under this authorization for share repurchases.
(2) Calculated as the average price paid per share under the respective repurchase program, including commissions paid.

Share repurchases take place at management's discretion under pre-established, non-discretionary programs, depending on market conditions, in the open market, or in privately negotiated transactions. The company retires its common stock upon repurchase and has not made any purchases of common stock other than in connection with these

publicly announced repurchase program authorizations. In connection with the spin-off of the former

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shipbuilding business (see Note 3), the company obtained a Private Letter Ruling from the Internal Revenue Service that generally limits our share repurchases to approximately 88 million shares within two years of the spin-off. The limitation expires on March 31, 2013. Due to share repurchases subsequent to the spin-off, the remaining number of shares that we can repurchase under this share repurchase limitation as of June 30, 2012, was approximately 38 million shares. Cash available from unusual transactions, such as the disposition of significant assets, should they arise, can be used to repurchase additional shares.

Dividends on Common Stock

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

In May 2011, the company increased the quarterly common stock dividend to $0.50 per share from the previous amount of $0.47 per share.

3. BUSINESS DISPOSITIONS AND DISCONTINUED OPERATIONS

Spin-off of Shipbuilding Business

Effective March 31, 2011, the company completed the spin-off to its shareholders of Huntington Ingalls Industries, Inc. (HII). HII was formed to operate the company's former shipbuilding business. The company made a pro rata distribution to its shareholders of one share of HII common stock for every six shares of the company’s common stock held on the record date of March 30, 2011, or 48.8 million shares of HII common stock. HII paid a $1.4 billion cash contribution to the company. There was no gain or loss recognized as a result of the spin-off transaction.

Prior to the completion of the spin-off, the company and HII entered into a Separation and Distribution Agreement dated March 29, 2011, and several other agreements that govern the post-separation relationship. These agreements generally provide that each party is responsible for its respective assets, liabilities and obligations following the spin-off, including employee benefits, intellectual property, information technology, insurance, and tax-related assets and liabilities. The agreements also describe the company’s commitments to provide HII with certain transition services for up to one year. During the first quarter of 2012, the company and HII agreed to extend certain information technology transition services for a limited time beyond the initial one-year term. Costs incurred for transition services are reimbursed by HII.

In connection with the spin-off, the company incurred $27 million of non-deductible transaction costs in the six months ended June 30, 2011, which were included in discontinued operations.

Discontinued Operations

Earnings for the former shipbuilding business and an adjustment to the gain from a previous divestiture recognized in the six months ended June 30, 2011, are reported as discontinued operations, as presented in the following table:

$ in millions		
Sales	$1,646	
Earnings from discontinued operations	59	
Income tax expense	(26	)
Earnings, net of tax	33	
Gain on previous divestiture, net of income tax expense of $1	1	
Earnings from discontinued operations, net of tax	$ 34	

There were no assets or liabilities related to these discontinued operations included in the condensed consolidated statements of financial position as of June 30, 2012, or December 31, 2011.

4. SEGMENT INFORMATION

The company is aligned into four reportable segments: Aerospace Systems, Electronic Systems, Information Systems, and Technical Services. The United States (U.S.) government is the primary customer for all four of our segments.

The company, from time to time, acquires or disposes of businesses and realigns contracts, programs or business areas among and within its operating segments. Portfolio shaping and internal realignments are designed to more fully leverage existing capabilities and enhance development and delivery of products and services. The change in goodwill represents goodwill allocated to a business divested from the Information Systems segment during the three months

ended June 30, 2012.

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NORTHROP GRUMMAN CORPORATION

Segment Realignment

On January 1, 2012, the company transferred its missile business (principally the Intercontinental Ballistic Missile (ICBM) program), from Aerospace Systems to Technical Services. In connection with this realignment, $51 million of goodwill was transferred from Aerospace Systems to Technical Services. The segment sales and segment operating income for the three and six months ended June 30, 2011, have been recast to reflect the missile business transfer. Sales of $119 million and $262 million for the three and six months ended June 30, 2011, respectively, were transferred from Aerospace Systems to Technical Services. Segment operating income of $11 million and $25 million for the three and six months ended June 30, 2011, respectively, were transferred from Aerospace Systems to Technical Services.

Intersegment Eliminations

As of December 31, 2011, the company revised its reporting of intersegment operating costs and expenses, whereby intersegment costs are now reported based on the predominant attributes of the customer contract, rather than the attributes of the intersegment work performed. As a result, in the condensed consolidated statements of earnings and comprehensive income, product costs have been retrospectively increased by $198 million and $359 million for the three and six months ended June 30, 2011, respectively, and service costs have been retrospectively decreased by the same amounts, while consolidated sales, operating costs and expenses, segment operating income and operating income remain unchanged.

The following table presents sales and operating income by segment:

	Three Months Ended June 30		Six Months Ended June 30	
$ in millions	2012	2011	2012	2011
Sales				
Aerospace Systems	$2,404	$2,473	$ 4,787	$ 5,066
Electronic Systems	1,744	1,791	3,468	3,599
Information Systems	1,856	2,031	3,700	4,056
Technical Services	783	776	1,533	1,607
Intersegment eliminations	(513)	(511)	(1,016)	(1,034)
Total sales	6,274	6,560	12,472	13,294
Operating income				
Aerospace Systems	292	320	571	607
Electronic Systems	276	284	580	521
Information Systems	202	189	407	383
Technical Services	74	62	144	130
Intersegment eliminations	(62)	(71)	(131)	(136)
Total segment operating income	782	784	1,571	1,505
Reconciliation to operating income:				
Unallocated corporate expenses	(39)	(38)	(62)	(48)
Net pension adjustment	35	99	67	202
Royalty income adjustment	(4)	(4)	(6)	(7)
Total operating income	$ 774	$ 841	$ 1,570	$ 1,652

Unallocated Corporate Expenses

Unallocated corporate expenses generally include 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 costs consist of management and administration, legal, environmental, certain compensation costs, certain retiree benefits, and other expenses.

Net Pension Adjustment

The net pension adjustment reflects the difference between pension expense determined in accordance with GAAP and pension expense allocated to the operating segments determined in accordance with CAS. The decreases in net pension adjustment for the three and six months ended June 30, 2012, as compared to the same periods in 2011, are

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NORTHROP GRUMMAN CORPORATION

primarily due to increased GAAP pension expense resulting from amortization of prior year actuarial losses.
Royalty Income Adjustment
Royalty income is included in segment operating income and reclassified to other income for financial reporting purposes.

5. INCOME TAXES

The company's effective tax rate on earnings from continuing operations was 34.0 percent and 33.5 percent for the three and six months ended June 30, 2012, respectively, compared to 34.0 percent and 34.3 percent for the three and six months ended June 30, 2011, respectively. The company's lower effective tax rate for the six months ended June 30, 2012, reflects increased deductions for current year domestic manufacturing and additional deductions from filing amended tax returns for certain open tax years which generated additional domestic manufacturing benefit, partially offset by the absence of research tax credits, which expired at the end of 2011.
The company recognizes accrued interest and penalties related to uncertain tax positions in federal and foreign income tax expense. The company files income tax returns in the U.S. federal jurisdiction, and in various state and foreign jurisdictions. The Internal Revenue Service is currently conducting an examination of the company's tax returns for the years 2007 through 2010. Open tax years related to state and foreign jurisdictions remain subject to examination, but are not considered material.

6. FAIR VALUE OF FINANCIAL INSTRUMENTS

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

$ in millions	June 30, 2012		December 31, 2011	
	Carrying Value	Fair Value	Carrying Value	Fair Value
Financial Assets (Liabilities)				
Marketable securities				
Trading	$ 238	$ 238	$ 219	$ 219
Available-for-sale	4	4	4	4
Held-to-maturity time deposits	—	—	250	250
Derivatives	4	4	7	7
Long-term debt, including current portion	(3,937)	(4,794)	(3,940)	(4,675)

There were no transfers of financial instruments between the three levels of fair value hierarchy during the six months ended June 30, 2012.
The carrying amounts of all other financial instruments not shown above approximate fair value due to their short-term nature.
Investments in Marketable Securities
The company holds a portfolio of marketable securities, consisting of equity securities that are classified as either trading or available-for-sale, which can be liquidated without restriction. These assets are recorded at fair value and are valued using Level 1 inputs (quoted market prices). In addition, the company occasionally holds short-term investments classified as held-to-maturity that are recorded at cost. Marketable securities as of June 30, 2012, were included in other non-current assets in the condensed consolidated statements of financial position. As of December 31, 2011, marketable securities of $250 million were included in prepaid expenses and other current assets and $223 million were included in other non-current assets in the condensed consolidated statements of financial position.
Derivative Financial Instruments and Hedging Activities
The company's derivative portfolio consists solely of foreign currency forward contracts. The notional values at June 30, 2012, and December 31, 2011, were $161 million and $233 million, respectively.
Derivative financial instruments are recognized as assets or liabilities in the financial statements and measured at fair value, and substantially all of these instruments are valued using Level 2 inputs.

Unrealized gains or losses on the effective portion of cash flow hedges are reclassified from other comprehensive

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income to earnings from continuing operations upon the settlement of the underlying transactions. Hedge contracts not designated for hedge accounting and the ineffective portion of cash flow hedges are recorded in other income. The derivative fair values and related unrealized gains/losses at June 30, 2012, and December 31, 2011, were not material.

Long-term Debt

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

7. LITIGATION, INVESTIGATIONS AND CLAIMS

Litigation

On June 22, 2007, a putative class action, Skinner et al. v. Northrop Grumman Pension Plan, etc., et al., was filed against the Northrop Grumman Pension Plan and the Northrop Grumman Retirement Plan B and their corresponding administrative committees in the U.S. District Court for the Central District of California. The putative class representatives alleged violations of Employee Retirement Income Security Act of 1974 (ERISA) and breaches of fiduciary duty concerning a 2003 modification to the Northrop Grumman Retirement Plan B. The modification relates to the employer-funded portion of the pension benefit available during a five-year transition period that ended on June 30, 2008. The plaintiffs dismissed the Northrop Grumman Pension Plan, and in 2008, the District Court granted summary judgment in favor of all remaining defendants on all claims. The plaintiffs appealed, and in May 2009, the U.S. Court of Appeals for the Ninth Circuit reversed the decision of the District Court and remanded the matter back to the District Court for further proceedings, finding that there was ambiguity in a 1998 summary plan description related to the employer-funded component of the pension benefit. After the remand, the plaintiffs filed a motion to certify a class. The parties also filed cross-motions for summary judgment. On January 26, 2010, the District Court granted summary judgment in favor of the Plan and denied the plaintiffs' motion for summary judgment. The District Court also denied the plaintiffs' motion for class certification and struck the trial date of March 23, 2010, as unnecessary given the District Court's grant of summary judgment for the Plan. The plaintiffs appealed the District Court's order to the Ninth Circuit. On March 16, 2012, the Ninth Circuit affirmed the district court. On March 30, 2012, the plaintiffs moved for rehearing or rehearing en banc, which the Ninth Circuit denied on April 30, 2012. The plaintiffs did not seek review by the U.S. Supreme Court.

On May 4, 2012, the company commenced an action, Northrop Grumman Systems Corp. v. United States, in the U.S. Court of Federal Claims. This lawsuit relates to an approximately $875 million firm fixed price contract awarded to the company in 2007 by the U.S. Postal Service (USPS) for the construction and delivery of flats sequencing systems (FSS) as part of the postal automation program. The FSS have now been delivered. Over the past two years, the company has submitted three certified claims to the USPS related to this program seeking approximately $179 million. Some of the company's claims are for unpaid portions of the contract price (approximately $63 million) and direct costs incurred. Other claims are based on the company's assertions that through various acts and omissions over the life of the contract, the USPS adversely affected the cost and schedule of performance and materially altered the company's obligations under the contract. With limited exceptions, the USPS Contracting Officer denied the company's three certified claims. On April 13, 2012, when the Contracting Officer denied most of the company's last two claims, he also asserted claims against the company in the net amount of approximately $341 million. The USPS claims appear to the company to be primarily that, due to delays in performance, the USPS was damaged because it did not realize certain cost savings it expected from deploying the systems earlier. The company's lawsuit seeks damages up to approximately $179 million under various theories of liability; it also disputes the claims asserted by the USPS Contracting Officer. The United States has not yet responded to the company's complaint. Although the ultimate outcome of this litigation, including any possible loss, cannot be predicted or estimated at this time, the company intends vigorously to pursue this matter.

The company is a party to various investigations, lawsuits, claims and other legal proceedings, including government investigations and claims, that arise in the ordinary course of our business. The nature of legal proceedings is such that we cannot assure the outcome of any particular matter. However, based on information available to the company to date and other than with respect to the FSS matter, which is discussed separately above, the company does not believe

that the outcome of any matter pending against the company is likely to have a material adverse effect on the company's consolidated financial position as of June 30, 2012, or its annual results of operations or cash flows.

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8. 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 settlements in the process of negotiation, contract changes, claims and requests for equitable adjustment for previously unanticipated contract costs. As of June 30, 2012, the recognized amounts related to claims and requests for equitable adjustment are not material individually or in the aggregate.

Contract Terminations

The company's U.S. government contracts generally contain provisions that enable the customer to terminate a contract for default, or for the convenience of the government. If the contract is terminated for default, the contractor may not be entitled to recover any of its costs on partially completed work and may be liable to the government for any excess re-procurement costs of acquiring similar products or services from another contractor, and for certain other damages. Termination of a contract for the convenience of the government may occur when the government concludes it is in the best interests of the U.S. government that the contract be terminated. Under a termination for convenience, the contractor is typically entitled to be paid in accordance with the contract's terms for costs incurred under the contract prior to the effective date of termination, plus a reasonable profit and settlement expenses. The company does not have any contract terminations in process that would have a material effect on our consolidated financial position or results of operations at June 30, 2012.

Guarantees of Subsidiary Performance Obligations

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

In addition, the company's subsidiaries may enter into joint ventures, teaming and other business arrangements (collectively, Business Arrangements) to support the company's products and services in domestic and international markets. The company generally strives to limit its exposure under these arrangements to its subsidiary's investment in the Business Arrangements, or to the extent of such subsidiary's obligations under the applicable contract. In some cases, however, the company is required to guarantee the performance of the Business Arrangements and, in such cases, the company generally obtains cross-indemnification from the other members of the Business Arrangements. At June 30, 2012, the company is not aware of any existing event of default that would require it to satisfy any of these guarantees.

U.S. Government Cost Claims

From time to time, the company is advised of claims by the U.S. government concerning certain potential disallowed costs, plus, at times, penalties and interest. When such findings are presented, the company and the U.S. government representatives engage in discussions to enable the company to evaluate the merits of these claims, as well as to assess the amounts being claimed. Where appropriate, provisions are made to reflect the company's expected exposure to the matters raised by the U.S. government. Such provisions are reviewed on a quarterly basis for sufficiency based on the most recent information available. The company believes that it has adequately reserved for any disputed amounts and that the outcome of any such matters would not have a material adverse effect on its consolidated financial position as of June 30, 2012, or its annual results of operations or cash flows.

Environmental Matters

The estimated cost to complete remediation has been accrued where the company believes, based on the facts and circumstances known to the company, that it is probable that the company will incur costs 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 by the Environmental Protection Agency, or similarly designated by other environmental agencies. As of June 30, 2012, management estimates that the range of reasonably possible future costs for environmental remediation is between $312 million and $732 million, before considering the amount recoverable through overhead charges on U.S. government contracts. At June 30, 2012, the amount accrued for probable environmental remediation

costs was $338 million, of which $86 million is accrued in other current liabilities and $252 million is accrued in other non-current liabilities. A portion of the environmental remediation costs is expected to be recoverable through overhead charges on government contracts and, accordingly, such amounts are deferred in inventoried costs and other non-current assets. As of June 30, 2012, $56 million is deferred in inventoried costs and $142 million is deferred in other non-current assets. These amounts are evaluated for recoverability on a routine basis. Although management cannot predict whether new information gained as projects

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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 as of June 30, 2012, or its annual results of operations or cash flows.

Financial Arrangements

In the ordinary course of business, the company uses standby letters of credit and guarantees issued by commercial banks and surety bonds issued principally by insurance companies to guarantee the performance on certain obligations. At June 30, 2012, there were $205 million of stand-by letters of credit, $229 million of bank guarantees, and $99 million of surety bonds outstanding.

Indemnifications

The company has retained certain warranty, environmental, income tax, and other potential liabilities in connection with certain of its divestitures. The settlement of these liabilities is not expected to have a material adverse effect on the company’s consolidated financial position as of June 30, 2012, or its annual results of operations or cash flows.

Operating Leases

Rental expense for operating leases, excluding discontinued operations, for the three and six months ended June 30, 2012, was $97 million and $181 million, respectively, and was $110 million and $215 million for the three and six months ended June 30, 2011, respectively. These amounts are net of immaterial amounts of sublease rental income.

Guarantee of Former Subsidiary

A subsidiary of the company has guaranteed HII’s outstanding $84 million Economic Development Revenue Bonds (Ingalls Shipbuilding, Inc. Project), Taxable Series 1999A, which mature in 2024. The immaterial fair value of this guarantee was recorded in other long-term liabilities. In addition, HII has assumed the responsibility for the payment and performance of all outstanding indebtedness, obligations and liabilities of the company under this guarantee, and has agreed to indemnify the company against all liabilities that may be incurred in connection with this guarantee.

9. RETIREMENT BENEFITS

The cost of the company’s pension plans and post-retirement medical and life benefit plans are shown in the following table:

	Three Months Ended June 30				Six Months Ended June 30			
	Pension Benefits		Medical and Life Benefits		Pension Benefits		Medical and Life Benefits	
$ in millions	2012	2011	2012	2011	2012	2011	2012	2011
Components of net periodic benefit cost								
Service cost	$130	$130	$ 9	$ 8	$261	$260	$17	$16
Interest cost	296	305	27	29	592	610	54	58
Expected return on plan assets	(427)	(423)	(17)	(16)	(854)	(846)	(34)	(32)
Amortization of:								
Prior service cost (credit)	(14)	6	(13)	(13)	(29)	12	(25)	(26)
Net loss from previous years	107	41	5	3	214	82	10	6
Other	—	—	—	—	2	—	—	—
Net periodic benefit cost	$ 92	$ 59	$11	$11	$186	$118	$22	$22

Employer Contributions

The company’s required minimum funding in 2012 for its defined benefit pension plans and its post-retirement medical and life benefit plans is approximately $65 million and $120 million, respectively. For the six months ended June 30, 2012, contributions of $33 million have been made to the company’s defined benefit pension plans, and contributions of $46 million have been made to the company’s post-retirement medical and life benefit plans. The company also sponsors defined contribution plans, and for the three months ended June 30, 2012 and 2011, contributions of $76 million were made to these plans in each period. For the six months ended June 30, 2012 and 2011, contributions of $152 million and $161 million, respectively, were made to these plans.

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10. STOCK COMPENSATION PLANS AND OTHER COMPENSATION ARRANGEMENTS

Stock Awards

On February 15, 2012, the company granted certain employees 0.5 million restricted stock rights (RSRs) and 1.2 million restricted performance stocks rights (RPSRs) under the company's long-term incentive stock plan with a grant date aggregate fair value of $102 million. The RSRs will vest on the third anniversary of the grant date, while the RPSRs will vest and pay out based on the achievement of financial metrics for the three-year period ending December 31, 2014.

Cash Awards

On February 15, 2012, the company granted certain employees 0.6 million cash units (CUs) and 1.3 million cash performance units (CPUs) with a minimum aggregate payout amount of $34 million and a maximum aggregate payout amount of $190 million. The CUs will vest and settle in cash on the third anniversary of the grant date, while the CPUs will vest and pay out based on the achievement of financial metrics for the three-year period ending December 31, 2014.

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REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM
To the Board of Directors and Shareholders of
Northrop Grumman Corporation
Falls Church, Virginia
We have reviewed the accompanying condensed consolidated statement of financial position of Northrop Grumman Corporation and subsidiaries as of June 30, 2012, and the related condensed consolidated statements of earnings and comprehensive income for the three-month and six-month periods ended June 30, 2012 and 2011, and cash flows and changes in shareholders' equity for the six-month periods ended June 30, 2012 and 2011. These interim financial statements are the responsibility of the Corporation's management.
We conducted our reviews in accordance with the standards of the Public Company Accounting Oversight Board (United States). A review of interim financial information consists principally of applying analytical procedures and making inquiries of persons responsible for financial and accounting matters. It is substantially less in scope than an audit conducted in accordance with the standards of the Public Company Accounting Oversight Board (United States), the objective of which is the expression of an opinion regarding the financial statements taken as a whole. Accordingly, we do not express such an opinion.
Based on our reviews, we are not aware of any material modifications that should be made to such condensed consolidated interim financial statements for them to be in conformity with accounting principles generally accepted in the United States of America.
We have previously audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the consolidated statement of financial position of Northrop Grumman Corporation and subsidiaries as of December 31, 2011, and the related consolidated statements of operations, cash flows, and changes in shareholders' equity for the year then ended (not presented herein); and in our report dated February 7, 2012, we expressed an unqualified opinion on those consolidated financial statements. In our opinion, the information set forth in the accompanying condensed consolidated statement of financial position as of December 31, 2011, is fairly stated, in all material respects, in relation to the consolidated statement of financial position from which it has been derived.
/s/ Deloitte & Touche LLP
McLean, Virginia
July 24, 2012

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

OVERVIEW

Northrop Grumman Corporation (herein referred to as “Northrop Grumman,” the “company,” “we,” “us,” or “our”) provides technologically advanced, innovative products, services, and integrated solutions to global customers through four sectors: Aerospace Systems, Electronic Systems, Information Systems and Technical Services. We participate in many high-priority defense and government services technology programs in the United States (U.S.) and abroad as a prime contractor, principal subcontractor, partner, or preferred supplier. We conduct the majority of our business with the U.S. government, principally the Department of Defense (DoD). We also conduct business with foreign, state, and local governments, as well as domestic and international commercial customers.

The following discussion should be read along with the unaudited condensed consolidated financial statements included in this Form 10-Q, as well as our Annual Report on Form 10-K for the year ended December 31, 2011. The Form 10-K provides a more thorough discussion of our products and services, environment, industry outlook, and business trends. See further discussions in the Consolidated Operating Results and Segment Operating Results sections that follow.

Political and Economic Environment

The fiscal year 2012 defense budget increased base funding (excluding Overseas Contingency Operations funding) over fiscal year 2011 levels. The President's Budget for Fiscal Year 2013 has been submitted to Congress and includes a slight decline from fiscal year 2012 levels. During the ongoing Congressional budget process, we expect significant debate within the government regarding fiscal year 2013 defense spending, and the upcoming general election in November may also generate significant dialogue around the federal deficit and potential cuts in government spending. Budget decisions made in this environment could have long-term consequences for our company and the entire defense industry. In particular, should sequestration as currently mandated by the Budget Control Act of 2011 be implemented in January 2013, absent any other changes, it would have serious negative consequences for the security of our country, the defense industrial base, and the customers, employees, suppliers, investors, and communities that rely on the companies in the defense industrial base, including Northrop Grumman. There is currently no official planning guidance from the government regarding how sequestration would be implemented, if it were to go into effect. There are many variables in how the law could be implemented that will determine the specific impacts; however, we expect that sequestration, as currently provided for under the Budget Control Act, would result in lower revenues, profits and cash flows for our company. While members of Congress are discussing various options to prevent or defer sequestration and the automatic spending cuts scheduled to begin in January 2013, we cannot predict whether any such efforts will succeed.

In addition, we expect continued draw down of U.S. force levels and budget resources tied to current major deployments. As overall defense spending declines, the DoD is re-evaluating the role and structure of the military. Earlier this year, the DoD released a new defense strategy intended to guide its priorities and budgeting decisions. The new guidance indicates the U.S. military needs to project power globally and operate effectively in all domains, including cybersecurity, and it places particular emphasis on the Asia Pacific region as an area of strategic focus.

In January 2012, the Secretary of Defense proposed a number of program changes and cancellations that are scheduled to take place over the next several years, in part to comply with certain provisions of the Budget Control Act. Certain of these announced program changes and cancellations would have an impact on programs in which we participate (such as announcements regarding the Block 30 Global Hawk and the F-35 program).

We believe that spending on recapitalization, modernization and maintenance of defense, intelligence, and homeland security assets will continue to be a national priority. Future defense spending is expected to include the development and procurement of new manned and unmanned military platforms and systems along with advanced electronics and software to enhance the capabilities of existing individual systems and provide real-time integration of individual surveillance, information management, strike, and battle management platforms. We expect significant new competitive opportunities to include long range strike, missile defense, command and control, network communications, enhanced situational awareness, satellite systems, restricted programs, cybersecurity, technical

services and information technology contracts, as well as numerous international and homeland security programs.

Recent Developments in U.S. Government Cost Accounting Standards (CAS) Pension Recovery Rules

On December 27, 2011, the CAS Board published a final rule revising Cost Accounting Standard (CAS) 412, “Composition and Measurement of Pension Cost,” and CAS 413, “Adjustment and Allocation of Pension Cost.” These revisions partially harmonize the measurement and period of assignment of defined benefit pension plan costs allocable to U.S. government contracts, and the minimum required contribution under the Employee Retirement

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Income Security Act of 1974 (ERISA), as amended, as required by the Pension Protection Act (PPA) of 2006. The rule should better align, but not eliminate, mismatches between ERISA funding requirements and CAS pension costs for government CAS covered contracts. Under the final rule, there is a five-year transition period, during which an increasing percentage of the harmonization effect is recognized, starting from 0 percent in the first year of applicability (when relatively minor changes in amortization periods for gains and losses become applicable) to 100 percent in the fifth year and thereafter. The rule became effective on February 27, 2012, (the "effective date") with 2013 being the first year of applicability of the revised rule for any of the changes to the company's cost accounting practices required by the rule. Price proposals for CAS covered contracts awarded on or after the effective date consider the effects of the rule. For CAS covered contracts that were awarded prior to the effective date, contractors are entitled to an equitable adjustment for any additional CAS basis contract costs resulting from implementation of the final rule. We currently are assessing the amounts and timing of equitable adjustments due to the Company. Such adjustments will be subject to negotiation and cannot be determined with certainty at this time.

Operating Performance Assessment and Reporting

We manage and assess the performance of our business based on our performance on contracts and programs (two or more closely-related contracts), with consideration given to the Critical Accounting Policies, Estimates and Judgments described in Part II, Item 7 of our 2011 Annual Report on Form 10-K. Our portfolio of long-term contracts is largely flexibly-priced, which means that sales tend to fluctuate in concert with costs across our large portfolio of contracts. Due to Federal Acquisition Regulations (FAR) rules that govern our business, most types of costs are allowable, and we do not focus on individual cost groupings (such as manufacturing, engineering, and design labor costs, subcontractor costs, material costs, overhead costs, and general and administrative costs), as much as we do on total contract costs, which is the key driver of both sales and operating income.

Our contract management process involves the use of contract estimates-at-completion (EACs) that are generally prepared and evaluated on a bottoms-up basis at least annually and reviewed on a quarterly basis over the performance period of the contract. These EACs include an estimated contract operating income margin based initially on the contract award amount, adjusted to reflect estimated risks related to contract performance. These risks typically include technical risk, schedule risk and performance risk based upon our evaluation of the contract effort. Similarly, the EACs include identified opportunities for operating income margin rate improvement. Over the performance period of the contract, our program management organizations perform evaluations of contract performance and adjust the contract revenue and cost estimates to reflect the latest reliable information available. Our business and program management organizations are comprised of skilled professional managers whose objective is to satisfy the customer's expectations, deliver high quality products and services, and manage contract risks and opportunities to achieve an appropriate operating income margin rate on the contract. Our comprehensive business and contract management process involves personnel from the planning, production control, contracts, cost management, supply chain and program and business management functions. As part of this overall contract management function, these personnel monitor compliance with our critical accounting policies related to contract accounting and compliance with U. S. government regulations. As a result, contract operating income and period-to-period contract operating income margin rates are adjusted over the contract performance period to reflect changes in the risks and opportunities affecting the contract, and adjustments may have a favorable or unfavorable effect on operating income margin depending upon the specific conditions affecting each contract.

In evaluating our operating performance, we look primarily at changes in sales and operating income, including the effects of meaningful changes in operating income as a result of changes in contract estimates and the use of the cumulative catch-up method of accounting in accordance with GAAP. Where applicable, significant fluctuations in operating performance attributable to individual contracts or programs, or changes in a specific cost element across multiple contracts are described in our analysis. Based on this approach and the nature of our operations, the discussion of results of operations first focuses around our four segments before distinguishing between products and services. Changes in sales are generally described in terms of volume, deliveries or other indicators of sales activity. For purposes of this discussion, volume generally refers to increases or decreases in cost or sales from

production/service activity levels or delivery rates. Performance refers to changes in contract margin rates for the period, primarily related to the changes in estimates referred to above.
Consolidated Financial Summary
Current Quarter
Sales for the three months ended June 30, 2012, were $6.3 billion, a decrease of $286 million, or 4 percent, as compared with the same period in 2011.
Segment operating income for the three months ended June 30, 2012, was comparable with the prior period at $782

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million. Segment operating margin rate increased 50 basis points to 12.5 percent, driven by improved segment performance on lower revenue. Refer to the Operating Income section under Consolidated Operating Results for a reconciliation of segment operating income to operating income.

Operating income for the three months ended June 30, 2012, decreased $67 million, or 8 percent, as a result of lower volume and a $64 million decrease in net FAS/CAS pension adjustment. Operating margin rate decreased 50 basis points from 12.8 percent to 12.3 percent primarily due to a lower FAS/CAS pension adjustment.

Year to Date

Sales for the six months ended June 30, 2012, were $12.5 billion, a decrease of $822 million, or 6 percent, as compared with the same period in 2011.

Segment operating income increased $66 million, or 4 percent, and segment operating margin rate increased 130 basis points to 12.6 percent, driven by a number of factors including improved segment performance, mitigation of contract risks, cost reduction initiatives and portfolio shaping efforts.

Operating income for the six months ended June 30, 2012, decreased $82 million, or 5 percent, as a result of lower FAS/CAS pension adjustment, which was partially offset by higher segment operating income. Operating margin rate increased 20 basis points from 12.4 percent to 12.6 percent, due to improved performance at three of the four segments.

Backlog

Total backlog at June 30, 2012, and December 31, 2011, was $41.5 billion and $39.5 billion, respectively. The value of contract awards booked during the six months ended June 30, 2012, was $14.6 billion.

CONSOLIDATED OPERATING RESULTS

Selected financial highlights are presented in the table below:

	Three Months Ended June 30		Six Months Ended June 30	
$ in millions	2012	2011	2012	2011
Sales	$6,274	$6,560	$12,472	$13,294
Operating costs and expenses	5,500	5,719	10,902	11,642
Operating income	774	841	1,570	1,652
Operating margin rate	12.3 %	12.8 %	12.6 %	12.4 %
Interest expense	(52)	(53)	(105)	(111)
Federal and foreign income tax expense	247	268	497	530
Cash provided by (used in) continuing operations	876	(34)	771	78

Sales

Sales for the three and six months ended June 30, 2012, decreased $286 million, or 4 percent, and $822 million, or 6 percent, respectively, as compared with the same periods in 2011.

The table below shows the variances from the prior year period, by sector:

$ in millions	Three Month Variance		Six Month Variance	
Aerospace Systems	($69)	(3%)	($279)	(6%)
Electronic Systems	(47)	(3%)	(131)	(4%)
Information Systems	(175)	(9%)	(356)	(9%)
Technical Services	7	1%	(74)	(5%)

For further information by segment refer to Segment Operating Results, and for product and service detail, refer to the Product and Service Analysis section that follows.

Operating Costs and Expenses

Operating costs and expenses are primarily comprised of labor, material, subcontractor, and overhead costs, and are generally allocated to contracts as they are incurred. In accordance with industry practice and the regulations that govern cost accounting requirements for government contracts, most general corporate expenses incurred at the segment and corporate locations are considered allowable and allocable costs. For most components of the company,

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these general and administrative costs are allocated to contracts in progress on a systematic basis and contract performance factors include this cost component as an element of cost. Operating costs and expenses consist of the following:

	Three Months Ended June 30		Six Months Ended June 30	
$ in millions	2012	2011	2012	2011
Product and service cost	$4,920	$5,163	$ 9,761	$10,518
General and administrative	580	556	1,141	1,124
Operating costs and expenses	$5,500	$5,719	$10,902	$11,642

Product and service costs for the three months ended June 30, 2012, decreased $243 million, or 5 percent, as compared with the same period in 2011. The primary driver of the reduction in product and service costs was reduced volume at Aerospace Systems, Electronic Systems, and Information Systems. This decrease was partially offset by higher pension costs in 2012. General and administrative expenses as a percentage of total sales increased to 9.2 percent for the three months ended June 30, 2012, from 8.5 percent for the same period in 2011, primarily due to increased bid and proposal costs of $22 million, while sales decreased from prior year.

Product and service costs for the six months ended June 30, 2012, decreased $757 million, or 7 percent, as compared with the same period in 2011. The primary driver of the reduction in product and service costs is reduced volume at all four of our segments, with Aerospace Systems and Information Systems driving the majority of the decrease. This decrease was partially offset by higher pension costs in 2012. General and administrative expenses as a percentage of total sales increased to 9.1 percent for the six months ended June 30, 2012, from 8.5 percent for the same period in 2011, primarily due to increased bid and proposal costs of $38 million, while sales decreased from prior year.

For the product and service costs detail, see the Product and Service Analysis section that follows.

Operating Income

We define operating income as sales less operating costs and expenses, including general and administrative expenses. We also further evaluate operating income for each of the business segments in which we operate. Segment operating income reflects the aggregate performance results of contracts within a business area or segment. Excluded from this measure are certain corporate-level expenses that are not considered allowable or allocable under applicable CAS and FAR.

Changes in estimated sales, operating costs and expenses and resulting operating income related to our contracts accounted for using the percentage-of-completion method are recorded using the cumulative catch-up method of accounting. The aggregate effects of these favorable and unfavorable changes in estimates across our portfolio of contracts can have a significant effect upon our reported sales and operating income in each of our reporting periods. For the three and six months ended June 30, 2012 and 2011, we recognized operating income adjustments as follows:

	Three Months Ended June 30		Six Months Ended June 30	
$ in millions	2012	2011	2012	2011
Favorable adjustments	$299	$288	$609	$505
Unfavorable adjustments	(77)	(87)	(122)	(160)
Net operating income adjustments	$222	$201	$487	$345

Contributing to the net favorable operating income adjustments was the impact of cost reduction initiatives to increase our competitiveness, including reduced 2012 pension costs for CAS purposes from a pension plan design change.

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The table below reconciles segment operating income to total operating income:

	Three Months Ended June 30		Six Months Ended June 30	
$ in millions	2012	2011	2012	2011
Segment operating income	$782	$784	$1,571	$1,505
Segment operating margin rate	12.5 %	12.0 %	12.6 %	11.3 %
Unallocated corporate expenses	(39)	(38)	(62)	(48)
Net pension adjustment	35	99	67	202
Royalty income adjustment	(4)	(4)	(6)	(7)
Total operating income	$774	$841	$1,570	$1,652

Segment Operating Income

Segment operating income for the three months ended June 30, 2012, was comparable with the prior period at $782 million, and for the six months ended June 30, 2012, increased $66 million, or 4 percent. The segment operating margin rate increase was driven by improved segment performance on lower revenue.

The table below shows the variances from the prior year period, by sector:

$ in millions	Three Month Variance		Six Month Variance	
Aerospace Systems	($28)	(9 %)	($36)	(6 %)
Electronic Systems	(8)	(3 %)	59	11 %
Information Systems	13	7 %	24	6 %
Technical Services	12	19 %	14	11 %

The segment operating income increase for the six months ended June 30, 2012, was driven by a number of factors including improved performance, mitigation of contract risks, cost reduction initiatives and portfolio shaping efforts, partially offset by lower sales volume. The increase in segment operating margin rate reflects this improved segment performance on lower revenue.

Unallocated Corporate Expenses

Unallocated corporate expenses generally include the portion of corporate expenses not considered allowable or allocable under applicable CAS and FAR rules, 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 GAAP and pension expense allocated to the operating segments determined in accordance with CAS. For the three months ended June 30, 2012 and 2011, the net pension adjustment resulted in an increase to operating income of $35 million and $99 million, respectively. For the six months ended June 30, 2012 and 2011, the net pension adjustment resulted in an increase to operating income of $67 million and $202 million, respectively. The decrease in net pension adjustment for the three and six months ended June 30, 2012, as compared with the same periods in 2011, is primarily due to increased GAAP pension expense resulting from amortization of prior year actuarial losses and decreased pension expense allocated to the operating segments due to the design change in the company's defined benefit pension plans adopted in December 2011.

Royalty Income Adjustment

Royalty income is included in segment operating income and reclassified to other income for financial reporting purposes.

Interest Expense

Interest expense for the three months and six months ended June 30, 2012, decreased $1 million and $6 million, respectively, as compared with the same periods in 2011. The decrease for the six months is primarily due to the debt repayment of $750 million in the first quarter of 2011.

Federal and Foreign Income Tax Expense

The company's effective tax rate on earnings from continuing operations for the three and six months ended June 30, 2012, was 34.0 percent and 33.5 percent, compared with 34.0 percent and 34.3 percent for the three and six months ended June 30, 2011. The company's lower effective tax rate for the six months ended June 30, 2012 reflects

increased deductions for current year domestic manufacturing and additional deductions from filing amended tax returns for certain open tax years, which generated additional domestic manufacturing benefit, partially offset by the absence of research tax credits, which expired at the end of 2011.

Cash Provided By Continuing Operations

For the three months ended June 30, 2012, cash provided by continuing operations was $876 million, as compared with cash used in continuing operations of $34 million in the same period in 2011. For the six months ended June 30, 2012, cash provided by continuing operations was $771 million, as compared with $78 million in the same period in 2011. For both periods, the increase reflects the $500 million voluntary pension contribution in the second quarter of 2011, and lower working capital, primarily driven by increased collections on units-of-delivery contracts and timing of payments on accounts payable and accruals.

SEGMENT OPERATING RESULTS

Basis of Presentation

We are aligned into four reportable segments: Aerospace Systems, Electronic Systems, Information Systems, and Technical Services. This section discusses sales, segment operating income and margin rates by segment. The reconciliation of segment sales to total sales is provided in Note 4 to the condensed consolidated financial statements, with the difference being intersegment sales eliminations. The reconciliation of segment operating income to total operating income, as well as a discussion of the reconciling items, is included in the Operating Income section of the Consolidated Operating Results section above. On January 1, 2012, we transferred our missile business (primarily the Intercontinental Ballistic Missile (ICBM) program) from the Aerospace Systems segment to our Technical Services segment. The segment sales and segment operating income for the three and six months ended June 30, 2011, have been recast to reflect the missile business transfer. Sales of $119 million and $262 million, and segment operating income of $11 million and $25 million, were transferred from Aerospace Systems to Technical Services for the three and six months ended June 30, 2011, respectively.

AEROSPACE SYSTEMS

Business Description

Aerospace Systems, headquartered in Redondo Beach, California, is a leader in the design, development, integration and production of: manned and unmanned aircraft, spacecraft, high-energy laser systems, microelectronics and other systems and subsystems. Aerospace Systems' customers, primarily U.S. government agencies, use these systems in many different mission areas, including: intelligence, surveillance and reconnaissance (ISR); communications; battle management; strike operations; electronic warfare; earth observation; space science; and space exploration. The segment consists of four business areas: Military Aircraft Systems; Unmanned Systems; Space Systems; and Advanced Programs & Technology.

	Three Months Ended June 30		Six Months Ended June 30	
$ in millions	2012	2011	2012	2011
Sales	$2,404	$2,473	$4,787	$5,066
Operating income	292	320	571	607
Operating margin rate	12.1 %	12.9 %	11.9 %	12.0 %

Current Quarter

Aerospace Systems sales for the three months ended June 30, 2012, decreased $69 million, or 3 percent, as compared with the same period in 2011. The decrease was primarily due to lower sales at Space Systems of $84 million and Military Aircraft Systems of $53 million, partially offset by higher sales at Advanced Programs & Technology and Unmanned Systems. The decline at Space Systems was primarily due to lower volume on restricted programs and the termination of a weather satellite program. The Military Aircraft Systems decrease was primarily related to the B-2, F-35 and F/A-18 programs. F-35 transitioned to the units-of-delivery revenue recognition method beginning with low rate initial production (LRIP) lot 5 in the second half of 2011. Lower volume on these programs was partially offset by higher volume on the E-2D Advanced Hawkeye aircraft program. The increase in Unmanned Systems revenue was

primarily related to the Fire Scout and NATO AGS programs.
Operating income at Aerospace Systems for the three months ended June 30, 2012, decreased $28 million, or 9 percent, and operating margin rate totaled 12.1 percent, compared with 12.9 percent. Lower operating income and margin rate reflect lower sales volume described above, as well as the effect of the F/A-18 program's transition from the multi-year 2 contract to the lower margin multi-year 3 contract, and the favorable performance adjustment in the

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prior period related to the National Polar-orbiting Operational Environmental Satellite System program restructure.

Year to Date

Aerospace Systems sales for the six months ended June 30, 2012, decreased $279 million, or 6 percent. The decrease is primarily due to lower sales at Military Aircraft Systems of $205 million and Space Systems of $177 million, partially offset by higher sales at Unmanned Systems and Advanced Programs & Technology. The Military Aircraft Systems decrease is primarily related to the F-35 program, as discussed above, and lower volume on the B-2 and F/A-18 programs, partially offset by higher volume on the E-2D Advanced Hawkeye program. The decline at Space Systems was primarily due to lower volume on restricted programs and the termination of a weather satellite program. The increase in Unmanned Systems revenue was primarily related to the Fire Scout and NATO AGS programs.

Operating income at Aerospace Systems for the six months ended June 30, 2012, decreased $36 million, or 6 percent, due to the lower sales volume described above, and operating margin rate of 11.9 percent was comparable to the prior year period.

ELECTRONIC SYSTEMS

Business Description

Electronic Systems, headquartered in Linthicum, Maryland, is a leader in the design, development, manufacture, and support of solutions for sensing, understanding, anticipating, and controlling the operating environment for our global military, civil, and commercial customers and their operations. Electronic Systems provides a variety of defense electronics and systems, airborne fire control radars, situational awareness systems, early warning systems, airspace management systems, navigation systems, communications systems, marine systems, space systems, and logistics services. The segment consists of four business areas: Intelligence, Surveillance, Reconnaissance & Targeting Systems; Land & Self Protection Systems; Naval & Marine Systems; and Navigation Systems.

	Three Months Ended June 30		Six Months Ended June 30	
$ in millions	2012	2011	2012	2011
Sales	$1,744	$1,791	$3,468	$3,599
Operating income	276	284	580	521
Operating margin rate	15.8 %	15.9 %	16.7 %	14.5 %

Current Quarter

Electronic Systems sales for the three months ended June 30, 2012, decreased $47 million, or 3 percent, as compared with the same period in 2011. The decrease reflects the company's previously announced decision to de-emphasize its domestic postal automation business. Sales were also impacted by lower volume for international postal automation, laser systems and infrared countermeasures. Declines in these programs were partially offset by $77 million higher volume for space systems programs.

Operating income at Electronic Systems for the three months ended June 30, 2012, decreased $8 million, or 3 percent, consistent with the change in volume. Segment operating margin rate of 15.8 percent was comparable to the prior year period.

Year to Date

Electronic Systems sales for the six months ended June 30, 2012, decreased $131 million, or 4 percent. The decrease was primarily due to $106 million lower domestic postal automation sales resulting from our decision to de-emphasize that business, as well as lower volume for international postal automation, laser systems and tactical communications. This decline was partially offset by higher volume on space systems programs.

Operating income at Electronic Systems for the six months ended June 30, 2012, increased $59 million, or 11 percent and segment operating margin rate increased to 16.7 percent from 14.5 percent. The higher operating income and operating margin rate are primarily the result of $60 million of increased performance improvements on several programs at Intelligence, Surveillance, Reconnaissance & Targeting Systems and Land & Self Protection Systems in the first quarter of 2012.

INFORMATION SYSTEMS

Business Description

Information Systems, headquartered in McLean, Virginia, is a leading provider of advanced solutions for the Department of Defense, intelligence, federal civilian, state and local agencies, and international customers. Products

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and services are focused on the fields of command, control, communications, computers and intelligence; cybersecurity; air and missile defense; airborne reconnaissance; intelligence processing; decision support systems; information technology; and systems engineering and integration. The segment consists of three business areas: Defense Systems; Intelligence Systems; and Civil Systems.

	Three Months Ended June 30		Six Months Ended June 30	
$ in millions	2012	2011	2012	2011
Sales	$1,856	$2,031	$3,700	$4,056
Operating income	202	189	407	383
Operating margin rate	10.9 %	9.3 %	11.0 %	9.4 %

Current Quarter

Information Systems sales for the three months ended June 30, 2012, decreased $175 million, or 9 percent, as compared with the same period in 2011. The decrease was driven by lower sales in all three business areas. The majority of the decrease in sales was from lower sales at Defense Systems of $104 million, primarily due to lower volume for the F-22 program and termination of the Joint Tactical Radio Systems Airborne, Maritime and Fixed (JTRS AMF) program, as well as timing of customer orders. Sales at Civil Systems were down primarily due to the sale of the County of San Diego contract, which reduced sales by $21 million. Lower sales at Intelligence Systems was primarily driven by program completions.

Operating income at Information Systems for the three months ended June 30, 2012, increased $13 million, or 7 percent, and operating margin rate increased to 10.9 percent from 9.3 percent. The higher operating income and operating margin rate were primarily due to performance improvements in Civil Systems, partially offset by the lower volume discussed above.

Year to Date

Information Systems sales for the six months ended June 30, 2012, decreased $356 million, or 9 percent. The decrease was driven by lower sales in all business areas. The majority of the decrease in sales was from lower sales of $199 million at Defense Systems, primarily due to the JTRS AMF program termination, lower in-theater funding on existing programs due to troop draw downs and lower volume on programs nearing completion. Sales at Civil Systems were down primarily due to the sale of the County of San Diego contract, which reduced sales by $51 million as compared with the same period in 2011.

Operating income at Information Systems for the six months ended June 30, 2012, increased $24 million, or 6 percent, and operating margin rate increased to 11.0 percent from 9.4 percent. The higher operating income and operating margin rate are primarily due to performance improvements in Civil Systems and Intelligence Systems, partially offset by the lower volume discussed above.

TECHNICAL SERVICES

Business Description

Technical Services, headquartered in Herndon, Virginia, is a leading provider of innovative and affordable logistics, modernization, and sustainment support, and also provides a wide array of other high technology services, including space, missile defense, nuclear security, training and simulation. The segment consists of three business areas: Defense & Government Services; Training Solutions; and Integrated Logistics & Modernization.

	Three Months Ended June 30		Six Months Ended June 30	
$ in millions	2012	2011	2012	2011
Sales	$783	$776	$1,533	$1,607
Operating income	74	62	144	130
Operating margin rate	9.5 %	8.0 %	9.4 %	8.1 %

Current Quarter

Technical Services sales for the three months ended June 30, 2012, increased $7 million, or 1 percent, as compared with the same period in 2011. The increase was due to higher sales at Integrated Logistics & Modernization of $37 million, partially offset by lower sales at Defense & Government Services of $27 million due to portfolio shaping

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and lower volume on the ICBM program.
Operating income for the three months ended June 30, 2012, increased $12 million, or 19 percent, and operating margin rate increased to 9.5 percent from 8.0 percent. The higher operating income and operating margin rate were primarily due to risk reduction on a Department of Homeland Security (DHS) contract.

Year to Date

Technical Services sales for the six months ended June 30, 2012, decreased $74 million, or 5 percent. The decrease was primarily due to lower sales at Defense & Government Services of $79 million, due to portfolio shaping and lower volume on the ICBM program.
Operating income at Technical Services for the six months ended June 30, 2012, increased $14 million, or 11 percent, and operating margin rate increased to 9.4 percent from 8.1 percent. The higher operating income and operating margin rate were primarily due to improved performance on the KC-10 aircraft logistics and support contract and a risk reduction on a DHS contract, partially offset by lower sales volume as described above.

PRODUCT AND SERVICE ANALYSIS

	Three Months Ended June 30				Six Months Ended June 30			
$ in millions	2012		2011		2012		2011	
Product sales	$3,399		$3,709		$6,740		$7,572	
Product costs	2,604		2,860		5,131		5,863	
% of product sales	76.6	%	77.1	%	76.1	%	77.4	%
Service sales	2,875		2,851		5,732		5,722	
Service costs	2,316		2,303		4,630		4,655	
% of service sales	80.6	%	80.8	%	80.8	%	81.4	%

As of December 31, 2011, the company revised its reporting of intersegment operating costs and expenses. See Note 4 to the condensed consolidated financial statements.

Current Quarter

Product costs as a percentage of product sales decreased 50 basis points for the three months ended June 30, 2012, as compared with the same period in 2011. The reduction in costs as a percentage of product sales relates to performance improvements in the Aerospace Systems and Electronic Systems sectors, substantially all of which relate to product sales.
Service costs as a percentage of service sales decreased 20 basis points for the three months ended June 30, 2012, as compared with the same period in 2011. The reduction in costs as a percentage of service sales relates to performance improvements in the Information Systems and Technical Services sectors, substantially all of which relate to service sales.

Year to Date

Product costs as a percentage of product sales decreased 130 basis points for the six months ended June 30, 2012, as compared with the same period in 2011. The reduction in costs as a percentage of product sales relates to performance improvements in the Aerospace Systems and Electronic Systems sectors, substantially all of which relate to product sales.
Service costs as a percentage of service sales decreased 60 basis points for the six months ended June 30, 2012, as compared with the same period in 2011. The reduction in costs as a percentage of service sales relates to performance improvements in the Information Systems and Technical Services sectors, substantially all of which relate to service sales.

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

	Three Months Ended June 30				Six Months Ended June 30			
$ in millions	2012		2011		2012		2011	
Segment Information:	Sales	Operating Costs and Expenses	Sales	Operating Costs and Expenses	Sales	Operating Costs and Expenses	Sales	Operating Costs and Expenses
Aerospace Systems								
Product	$2,118	$1,875	$2,160	$1,903	$ 4,192	$ 3,718	$ 4,440	$ 3,944
Service	286	237	313	250	595	498	626	515
Electronic Systems								
Product	1,351	1,127	1,480	1,246	2,699	2,220	2,961	2,527
Service	393	341	311	261	769	668	638	551
Information Systems								
Product	68	57	140	132	138	118	254	236
Service	1,788	1,597	1,891	1,710	3,562	3,175	3,802	3,437
Technical Services								
Product	2	1	115	104	7	5	261	236
Service	781	708	661	610	1,526	1,384	1,346	1,241
Segment Totals								
Total Product	$3,539	$3,060	$3,895	$3,385	$ 7,036	$ 6,061	$ 7,916	$ 6,943
Total Service	3,248	2,883	3,176	2,831	6,452	5,725	6,412	5,744
Intersegment eliminations	(513)	(451)	(511)	(440)	(1,016)	(885)	(1,034)	(898)
Total segment[1]	$6,274	$5,492	$6,560	$5,776	$12,472	$10,901	$13,294	$11,789

(1) For the three months ended June 30, 2012, sales of $6.3 billion less segment operating costs and expenses of $5.5 billion equals segment operating income of $782 million. For the six months ended June 30, 2012, sales of $12.5 billion less segment operating costs and expenses of $10.9 billion equals segment operating income of $1.6 billion. The reconciliation of segment operating income to total operating income, as well as a discussion of the reconciling items, is included in the Operating Income section of the Consolidated Operating Results.

Segment Product Sales and Segment Product Costs

Current Quarter

Segment product sales for the three months ended June 30, 2012, decreased $356 million, as compared with the same period in 2011, primarily due to lower sales volume at the Electronic Systems and Information Systems segments, as well as the change in classification of the ICBM program at Technical Services as that contract has transitioned from modernization to predominantly sustainment services. The reduction in product sales at Electronic Systems and Information Systems is the result of the items described in the Segment Operating Results section above.

Segment product costs for the three months ended June 30, 2012, decreased by $325 million, as compared with the same period in 2011. The decrease in segment product costs drove the overall decline in product sales as discussed above. The majority of the decrease in product costs was at Electronic Systems, a reduction of $119 million, with the next largest decrease being at Technical Services, a reduction of $103 million. The decrease at Electronic Systems was mainly the reduced domestic and international postal automation costs and winding down of the F-22 program and lower volume on the C4ISR Network Systems (CNS) Army program. The reduction at Technical Services was due to the change in the classification of the ICBM program, as described above.

Year to Date

Segment product sales for the six months ended June 30, 2012, decreased $880 million, as compared with the same period in 2011, primarily due to lower sales volume at the Aerospace Systems and Electronic Systems segments, as well as the change in classification of the ICBM program at Technical Services as that contract has transitioned from modernization to predominantly sustainment services. The reductions in product sales at Aerospace Systems and

Electronic Systems are the result of the items described in the Segment Operating Results section above.

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Segment product costs for the six months ended June 30, 2012, decreased by $882 million, as compared to the same period in 2011. The decrease in segment product costs drove the overall decline in product sales as discussed above. The decrease in product costs is primarily due to the following sectors: Electronic Systems, a reduction of $307 million, with the next largest decrease at Technical Services, a reduction of $231 million, and Aerospace Systems with a reduction of $226 million. The decrease at Electronic Systems was mainly due to reduced domestic and international postal automation costs, winding down of the F-22 program and lower volume on the CNS Army program. The reduction at Technical Services was due to the change in the classification of the ICBM program, as described above. The reduction at Aerospace Systems was primarily due to lower volume on F-35, B-2 and F/A-18 aircraft programs and restricted space systems, as well as the termination of a weather satellite program.

Segment Service Sales and Segment Service Costs

Current Quarter

Segment service sales for the three months ended June 30, 2012, increased $72 million, as compared with the same period in 2011, and segment service costs for the three months ended June 30, 2012, increased $52 million. The increases were primarily due to the transitioning of the ICBM program from product to service at Technical Services and an increase at Electronic Systems due to an increase in classified space and targeting systems. These increases were offset partially by a decrease in service sales at Information Systems.

Year to Date

Segment service sales for the six months ended June 30, 2012, increased $40 million, as compared with the same period in 2011, and segment service costs for the six months ended June 30, 2012, decreased $19 million. The increases were primarily due to higher sales volume at Electronic Systems and the change in classification of the ICBM program at Technical Services, partially offset by lower sales volume at Information Systems.

BACKLOG

Total backlog includes both funded backlog (firm orders for which funding is contractually obligated by the customer) and unfunded backlog (firm orders for which, as of the reporting date, funding is not contractually obligated by the customer). Unfunded backlog excludes unexercised contract options and unfunded IDIQ orders (except for authorized task orders, which are included up to the authorized value). For multi-year service contracts with non-federal government customers having no stated contract values, backlog includes only the amounts committed by the customer. Backlog is converted into sales as work is performed or deliveries are made and is adjusted routinely to represent the amount expected to result in future revenues.

On January 1, 2012, the company transferred its missile business, previously reported in Aerospace Systems to Technical Services. As a result of this realignment, $599 million of backlog was transferred from Aerospace Systems to Technical Services. Total backlog as of December 31, 2011, reflects this transfer.

Backlog consisted of the following at June 30, 2012, and December 31, 2011:

	June 30, 2012			December 31, 2011
$ in millions	Funded	Unfunded	Total Backlog	Total Backlog
Aerospace Systems	$11,855	$ 9,139	$20,994	$18,638
Electronic Systems	7,770	1,509	9,279	9,123
Information Systems	3,984	4,412	8,396	8,563
Technical Services	2,336	542	2,878	3,191
Total backlog	$25,945	$15,602	$41,547	$39,515

New Awards

The estimated value of contract awards booked during the six months ended June 30, 2012, was $14.6 billion. Significant new awards during this period include $1.6 billion for NATO AGS, $1.4 billion for the James Webb Space Telescope (JWST), $1.0 billion for E-2D Advanced Hawkeye and $623 million for Global Hawk.

LIQUIDITY AND CAPITAL RESOURCES

We endeavor to ensure the most efficient conversion of operating results into cash for deployment in our business and to maximize shareholder value. We actively manage our capital resources through working capital improvements, capital expenditures, strategic business acquisitions and divestitures, debt issuance and repayment,

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required and voluntary pension contributions, and returning cash to shareholders through dividend payments and repurchases of common stock. In addition to our cash position, we use 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. We believe these measures are useful to investors in assessing our financial performance and condition.

Cash generated from continuing operations, supplemented by borrowings under credit facilities and/or in the capital markets, if needed, is expected to be sufficient to service debt and contractual obligations, finance capital expenditures, fund required and voluntary pension contributions, continue acquisition of shares under our share repurchase program, and continue paying dividends to our shareholders for at least the next 12 months.

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

	Three Months Ended June 30		Six Months Ended June 30	
$ in millions	2012	2011	2012	2011
Net earnings	$480	$520	$986	$1,050
Net earnings from discontinued operations	—	—	—	(34)
Non-cash items[1]	150	215	269	379
Retiree benefit funding less than expense	60	(474)	137	(440)
Trade working capital change	186	(295)	(621)	(877)
Cash provided by (used in) continuing operations	$876	($ 34)	$771	$ 78

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

Free Cash Flow from Continuing Operations

Free cash flow from continuing operations is defined as cash provided by operating activities from continuing operations less capital expenditures. Free cash flow is a key factor in our planning for and consideration of strategic acquisitions, stock repurchases and the payment of dividends.

Free cash flow from continuing operations 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, as a measure of residual cash flow available for discretionary purposes, or as an alternative to operating results presented in accordance with GAAP as indicators of performance.

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

	Three Months Ended June 30		Six Months Ended June 30	
$ in millions	2012	2011	2012	2011
Cash provided by (used in) continuing operations	$876	($ 34)	$771	$ 78
Less: capital expenditures	(51)	(94)	(132)	(217)
Free cash flow provided by (used in) continuing operations	$825	($128)	$639	($139)

Cash Flows

The following is a discussion of our major operating, investing and financing cash flows from continuing operations for the six months ended June 30, 2012 and 2011, as classified in the condensed consolidated statements of cash flows in Part I, Item 1.

Operating Activities

For the six months ended June 30, 2012, cash provided by continuing operations was $771 million, as compared with $78 million in the same period in 2011. The increase reflects the $500 million voluntary pension contribution in the second quarter of 2011, and lower working capital, primarily driven by increased collections on units-of-delivery contracts and timing of payments on accounts payable and accruals.

Investing Activities

Net cash provided by investing activities from continuing operations for the six months ended June 30, 2012, was $162 million, as compared with $1.3 billion in the same period of 2011. The $1.1 billion decrease in net cash provided by investing activities from continuing operations was primarily due to the $1.4 billion contribution

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received from the spin-off of the shipbuilding business in 2011, partially offset by maturities of short-term investments in the first quarter of 2012.

Financing Activities

Net cash used in financing activities for the six months ended June 30, 2012, was $787 million, as compared with $1.9 billion in the same period of 2011. The $1.1 billion decrease in net cash used in financing activities was primarily due to debt repayments of $750 million in the first quarter 2011 and higher share repurchases in 2011.

CRITICAL ACCOUNTING POLICIES, ESTIMATES, AND JUDGMENTS

There have been no material changes to our critical accounting policies, estimates, or judgments from those discussed in our 2011 Annual Report on Form 10-K.

ACCOUNTING STANDARDS UPDATES

Accounting standards updates effective after June 30, 2012, are not expected to have a material effect on the company's consolidated financial position or results of operations.

FORWARD-LOOKING STATEMENTS AND PROJECTIONS

This Form 10-Q and the information we are incorporating by reference contain statements, other than statements of historical fact, that constitute "forward-looking statements" within the meaning of the Private Securities Litigation Reform Act of 1995. Words such as "expect," "intend," "may," "could," "plan," "project," "forecast," "believe," "estimate," "c "anticipate," "trends" and similar expressions generally identify these forward-looking statements. Forward-looking statements are based upon assumptions, expectations, plans and projections that we believe to be reasonable when made. These statements are not guarantees of future performance and inherently involve a wide range of risks and uncertainties that are difficult to predict. Specific factors that could cause actual results to differ materially from those expressed or implied in the forward-looking statements include, but are not limited to, those identified under Risk Factors in our Form 10-K for the year ended December 31, 2011, as well as those identified in this report under Part II, Item 1A and other important factors disclosed in this report and from time to time in our other filings with the SEC. You are urged to consider the limitations on, and risks associated with, forward-looking statements and not unduly rely on the accuracy of predictions contained in such forward-looking statements. The forward-looking statements speak only as of the date of this report or, in the case of any document incorporated by reference, the date of that document. We undertake no obligation to publicly update or revise any forward-looking statements, whether as a result of new information, future events or otherwise, except as required by applicable law.

CONTRACTUAL OBLIGATIONS

On July 6, 2012, the President signed the Moving Ahead for Progress in the 21st Century Act. This Act includes a provision that increases the interest rates used to determine plan sponsors' pension contributions for required funding purposes. Although the IRS has not yet released the new interest rates, we expect the new rates will significantly reduce our required pre-tax pension contributions for 2013 through 2016 by approximately $1.5 billion in the aggregate, as compared to the amount disclosed in our 2011 Annual Report on Form 10-K. Although the required pension contributions are decreasing through 2016, we may elect to make voluntary contributions, depending upon plan funded status, tax planning or other factors. Our analysis indicates that required pension contributions would rise subsequent to 2016, resulting in little net impact to cumulative required contributions over a 10-year period.

There have been no additional material changes to our contractual obligations from those discussed in our 2011 Annual Report on Form 10-K.

Item 3. Quantitative and Qualitative Disclosures About Market Risk

There have been no material changes to our market risks from those discussed in our 2011 Annual Report on Form 10-K.

Item 4. Controls and Procedures

Disclosure Controls and Procedures

Our principal executive officer (Chairman, Chief Executive Officer and President) and principal financial officer (Corporate Vice President and Chief Financial Officer) have evaluated the company's disclosure controls and procedures (as defined in Rule 13a-15(e) and Rule 15d-15(e) under the Securities and Exchange Act of 1934, as

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amended) and have concluded that, as of June 30, 2012, these controls and procedures were effective.

Changes in Internal Controls over Financial Reporting

During the three months ended June 30, 2012, no change occurred in our internal controls over financial reporting that materially affected, or is reasonably likely to materially affect, our internal controls over financial reporting.

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PART II. OTHER INFORMATION
Item 1. Legal Proceedings
We have provided information about certain legal proceedings in which we are involved in Note 7 to the condensed consolidated financial statements in Part I, Item 1 and in our 2011 Annual Report on Form 10-K.
We are a party to various investigations, lawsuits, claims and other legal proceedings, including government investigations and claims, that arise in the ordinary course of our business. These types of matters could result in fines, penalties, compensatory or treble damages or non-monetary relief. United States (U.S.) government regulations also provide that certain allegations against a contractor may lead to suspension or debarment from future U.S. government contracts or involving the loss of export privileges for the company or one or more of its components. Suspension or debarment could have a material adverse effect on the company because of the company's reliance on government contracts and authorizations. The nature of legal proceedings is such that we cannot assure the outcome of any particular matter. However, based on information available to us to date and other than as noted in Note 7 to the condensed consolidated financial statements, we do not believe that the outcome of any matter pending against the Company, is likely to have a material adverse effect on the company's consolidated financial position as of June 30, 2012, or its annual results of operations or cash flows. For further information on the risks we face from existing and future investigations, lawsuits, claims and other legal proceedings, please see Risk Factors in Part I, Item 1A, of our 2011 Annual Report on Form 10-K.
Item 1A. Risk Factors
The following is an update to a risk factor described in our 2011 Annual Report on Form 10-K and should be read in conjunction with the risk factors therein.
Significant delays or reductions in appropriations for our programs and federal government funding more broadly may negatively impact our business and programs and could have a material adverse effect on our financial position, results of operations or cash flows.
The funding of U.S. government programs is subject to an annual congressional budget authorization and appropriation processes. For many programs, Congress appropriates funds on a fiscal year basis even though the program performance period may extend typically several years. Consequently, programs are often partially funded initially and additional funds are committed only as Congress makes further appropriations. If we incur costs in excess of funds committed on a contract, we may be at risk for reimbursement of those costs until additional funds are appropriated. We cannot predict the extent to which total funding and/or funding for individual programs will be included, increased or reduced as part of the annual budget process ultimately approved by Congress or in separate supplemental appropriations or continuing resolutions, as applicable. The impact, severity and duration of the current U.S. economic situation and economic plans adopted or to be adopted by the U.S. government, along with pressures on, and uncertainty surrounding, the federal budget, could adversely affect the funding for individual programs and delay purchasing or payment decisions by our customers. In the event that government funding for any of our programs becomes unavailable, or is reduced or delayed, our contract or subcontract under such program may be terminated or adjusted by the U.S. government or the prime contractor, which could have a material adverse effect on our financial position, results of operations, and/or cash flows.
In August 2011, Congress enacted the Budget Control Act of 2011 (the Budget Control Act) which, while raising the existing statutory limit on the amount of permissible federal debt, also committed the U.S. government to significantly reducing the federal deficit over ten years. The Budget Control Act established caps on discretionary spending through 2021, reducing federal spending by approximately $940 billion relative to the fiscal year 2012 Presidential Budget submission. It also established a Joint Committee of Congress (the Joint Committee) that was responsible for identifying an additional $1.2 to $1.5 trillion in deficit reductions by November 23, 2011. The Joint Committee was unable to identify the additional deficit reductions by this deadline thereby triggering a second provision of the Budget Control Act called “sequestration,” which calls for very substantial automatic spending cuts split between defense and non-defense programs scheduled to start in 2013 and continue over a nine-year period. While members of Congress are discussing various options to prevent or defer sequestration and the automatic spending cuts scheduled to begin in

January 2013, we cannot predict whether any such efforts will succeed.
We are unable to predict the impact that either identified or automatic cuts would have on funding for our individual programs. Long-term funding for certain programs in which we participate is likely to be reduced, delayed or canceled. In addition, these cuts could adversely affect the viability of the suppliers and

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subcontractors under our programs. While we believe that our business is well-positioned in areas that the Department of Defense (DoD) has indicated are areas of focus for future defense spending, the impact of the Budget Control Act remains uncertain and our business and industry could be materially adversely affected. In January 2012, the Secretary of Defense announced a number of program changes and cancellations that are scheduled to take place over the next several years, in part to comply with certain provisions of the Budget Control Act. Certain of these program changes and cancellations are expected to have an impact on programs in which we participate.

The President's Budget for Fiscal Year 2013 has been submitted to Congress and includes a slight decline from fiscal year 2012 levels. During the ongoing Congressional budget process, we expect significant debate within the government regarding fiscal year 2013 defense spending, and the upcoming general election in November may also generate significant dialogue around the federal deficit and potential cuts in government spending. Budget decisions made in this environment could have long-term consequences for our company and the entire defense industry. In particular, should sequestration as currently mandated be implemented in January 2013, absent any other changes, it would have serious negative consequences for the security of our country, the defense industrial base, and the customers, employees, suppliers, investors, and communities that rely on the companies in the defense industrial base, including Northrop Grumman. There is currently no official planning guidance from the government regarding how sequestration would be implemented, if it were to go into effect. There are many variables in how the law could be implemented that will determine the specific impacts; however, we expect that sequestration, as currently provided for under the Budget Control Act, would result in lower revenues, profits and cash flows for our company.

There are no additional material changes to the risk factors previously disclosed in our 2011 Annual Report on Form 10-K.

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

Purchases of Equity Securities – The table below summarizes our repurchases of common stock during the three months ended June 30, 2012:

Period	Number of Shares Purchased[(1)]	Average Price Paid per Share[(2)]	Numbers of Shares Purchased as Part of Publicly Announced Plans or Programs	Approximate Dollar Value of Shares that May Yet Be Purchased under the Plans or Programs ($ in millions)
April 1 through April 30, 2012	1,126,200	$61.28	1,126,200	$1,373
May 1 through May 31, 2012	936,800	58.69	936,800	1,318
June 1 through June 30, 2012	2,879,700	60.03	2,879,700	1,145
Total	4,942,700	$60.06	4,942,700	$1,145

(1) On June 16, 2010, the company's board of directors authorized a share repurchase program of up to $2.0 billion of the company's common stock. On April 25, 2011, after the company had repurchased $245 million of shares, the company's board of directors authorized an increase to the remaining share repurchase authorization to $4.0 billion. As of June 30, 2012, the company had $1.1 billion remaining under this authorization for share repurchases.

(2) Calculated as the average price paid per share under the respective repurchase program, including commissions paid.

Share repurchases take place at management's discretion 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 program authorizations. In connection with the spin-off of HII, the company obtained a Private Letter Ruling from the Internal Revenue Service that generally limits our share repurchases to approximately 88 million shares within two years of the spin-off. The limitation expires on March 31, 2013. Due to share repurchases subsequent to the spin-off, the remaining number of shares that we can repurchase

under this share repurchase limitation as of June 30, 2012, was approximately 38 million shares. Cash available from unusual transactions, such as the disposition of significant assets, should they arise, can be used to repurchase additional shares.

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Item 3. Defaults Upon Senior Securities
No information is required in response to this item.
Item 4. Mine Safety Disclosures
No information is required in response to this item.
Item 5. Other Information
No information is required in response to this item.
Item 6. Exhibits

2.1	Agreement and Plan of Merger among Titan II, Inc. (formerly Northrop Grumman Corporation), Northrop Grumman Corporation (formerly New P, Inc.) and Titan Merger Sub Inc., dated March 29, 2011 (incorporated by reference to Exhibit 10.1 to Form 8-K dated March 29, 2011 and filed April 4, 2011)
2.2	Separation and Distribution Agreement dated as of March 29, 2011, among Titan II, Inc. (formerly Northrop Grumman Corporation), Northrop Grumman Corporation (formerly New P, Inc.), Huntington Ingalls Industries, Inc., Northrop Grumman Shipbuilding, Inc. and Northrop Grumman Systems Corporation (incorporated by reference to Exhibit 10.2 to Form 8-K dated March 29, 2011 and filed April 4, 2011)
*3.1	Amended and Restated Certificate of Incorporation of Northrop Grumman Corporation dated May 29, 2012 (replaces Amended and Restated Certificate of Incorporation filed as Exhibit 3.1 to Form 8-K filed May 17, 2012)
*3.2	Amended and Restated Bylaws of Northrop Grumman Corporation dated May 29, 2012 (replaces Amended and Restated Bylaws filed as Exhibit 3.2 to Form 8-K filed May 17, 2012)
*+10.1	Northrop Grumman Savings Excess Plan (Amended and Restated Effective as of May 1, 2012)
*+10.2	Non-Employee Director Compensation Term Sheet, effective May 15, 2012
*+10.3	Northrop Grumman Corporation Equity Grant Program for Non-Employee Directors under the Northrop Grumman 2011 Long-Term Incentive Stock Plan, effective January 1, 2012
*+10.4	Retirement and Separation Agreement dated July 23, 2012 between Northrop Grumman Systems Corporation and Gary W. Ervin
*12(a)	Computation of Ratio of Earnings to Fixed Charges
*15	Letter from Independent Registered Public Accounting Firm
*31.1	Rule 13a-14(a)/15d-14(a) Certification of Wesley G. Bush (Section 302 of the Sarbanes-Oxley Act of 2002)
*31.2	Rule 13a-14(a)/15d-14(a) Certification of James F. Palmer (Section 302 of the Sarbanes-Oxley Act of 2002)

**32.1	Certification of Wesley G. Bush pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002
**32.2	Certification of James F. Palmer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002
*101	Northrop Grumman Corporation Quarterly Report on Form 10-Q for the quarter ended June 30, 2012, formatted in XBRL (Extensible Business Reporting Language); (i) the Condensed Consolidated Statements of Earnings and Comprehensive Income, (ii) Condensed Consolidated Statements of Financial Position, (iii) Condensed Consolidated Statements of Cash Flows, (iv) Condensed Consolidated Statements of Changes in Shareholders’ Equity, and (v) Notes to Condensed Consolidated Financial Statements

+ Management contract or compensatory plan or arrangement

* Filed with this report

** Furnished with this report

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NORTHROP GRUMMAN CORPORATION

SIGNATURES

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

NORTHROP GRUMMAN CORPORATION
(Registrant)

By: /s/ Kenneth L. Bedingfield

Kenneth L. Bedingfield
Corporate Vice President, Controller and
Chief Accounting Officer
(Principal Accounting Officer)

Date: July 24, 2012

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