LOCKHEED MARTIN CORP
Form 10-K
February 28, 2013
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United States

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

Form 10-K

ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d) OF

THE SECURITIES EXCHANGE ACT OF 1934

For the fiscal year ended December 31, 2012

Commission file number 1-11437

LOCKHEED MARTIN CORPORATION

(Exact name of registrant as specified in its charter)

Maryland	**52-1893632**
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification No.)

6801 Rockledge Drive, Bethesda, Maryland 20817-1877 (301/897-6000)

(Address and telephone number of principal executive offices)

Securities registered pursuant to Section 12(b) of the Act:

Title of each class	Name of each exchange on which registered
Common Stock, $1 par value	New York Stock Exchange

Securities registered pursuant to Section 12(g) of the Act: None

Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act. Yes x No ¨

Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or Section 15(d) of the Act. Yes ¨ No x

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes x No ¨

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes x No ¨

Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K (§229.405 of this chapter) is not contained herein, and will not be contained, to the best of registrant s knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K. x

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

Large accelerated filer x Accelerated filer ¨ Non-accelerated filer ¨ Smaller reporting company ¨

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12-b2 of the Exchange Act). Yes ¨ No x

The aggregate market value of voting and non-voting common stock held by non-affiliates of the registrant computed by reference to the last sales price of such stock, as of the last business day of the registrant s most recently completed second fiscal quarter, which was June 22, 2012, was approximately $27.5 billion.

Indicate the number of shares outstanding of each of the registrant s classes of common stock, as of the latest practicable date. Common Stock, $1 par value, 322,583,334 shares outstanding as of January 31, 2013.

DOCUMENTS INCORPORATED BY REFERENCE

Portions of Lockheed Martin Corporation s 2013 Definitive Proxy Statement are incorporated by reference in Part III of this

Form 10-K.

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LOCKHEED MARTIN CORPORATION

FORM 10-K

For the Fiscal Year Ended December 31, 2012

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PART I

ITEM 1. BUSINESS

General

We are a global security and aerospace company principally engaged in the research, design, development, manufacture, integration, and sustainment of advanced technology systems and products. We also provide a broad range of management, engineering, technical, scientific, logistic, and information services. We serve both domestic and international customers with products and services that have defense, civil, and commercial applications, with our principal customers being agencies of the U.S. Government. In 2012, 82% of our $47.2 billion in net sales were from the U.S. Government, either as a prime contractor or as a subcontractor (including 61% from the Department of Defense (DoD)), 17% were from international customers (including foreign military sales (FMS) contracted through the U.S. Government), and 1% were from U.S. commercial and other customers. Our main areas of focus are in defense, space, intelligence, homeland security, and information technology, including cyber security.

We are operating in an environment that is characterized by both increasing complexity in global security, as well as continuing economic pressures in the U.S. and globally. A significant component of our strategy in this environment is to focus on program execution, improving the quality and predictability of the delivery of our products and services, and placing more security capability quickly into the hands of both our domestic and international customers at affordable prices. Recognizing that our customers are resource constrained, we are endeavoring to develop and extend our portfolio in a disciplined manner with a focus on adjacent markets close to our core capabilities. Despite the challenges we face, we expect to continue to invest in technologies to fulfill new mission requirements for our customers, and invest in our people so that we have the technical skills necessary to be successful in this environment, and return cash to investors in the form of dividends and share repurchases.

We are a Maryland corporation and were formed in 1995 by combining the businesses of Lockheed Corporation and Martin Marietta Corporation. Our principal executive offices are located at 6801 Rockledge Drive, Bethesda, Maryland 20817-1877. Our telephone number is (301) 897-6000. Our website home page on the Internet is www.lockheedmartin.com. We make our website content available for information purposes only. It should not be relied upon for investment purposes, nor is it incorporated by reference into this Form 10-K.

Throughout this Form 10-K, we incorporate by reference information from parts of other documents filed with the U.S. Securities and Exchange Commission (SEC). The SEC allows us to disclose important information by referring to it in this manner, and you should review that information.

We make our annual report on Form 10-K, quarterly reports on Form 10-Q, current reports on Form 8-K, and proxy statement for our annual stockholders meeting, as well as any amendments to those reports, available free of charge through our website as soon as reasonably practical after we electronically file the material with, or furnish it to, the SEC. You can learn more about us by reviewing our SEC filings. Our SEC filings can be accessed through the investor relations page of our website, www.lockheedmartin.com/investor. The SEC also maintains a website at www.sec.gov that contains reports, proxy statements, and other information regarding SEC registrants, including Lockheed Martin Corporation.

Business Segments

We organize our business segments based on the nature of the products and services offered. Effective December 31, 2012, we operate in five business segments: Aeronautics, Information Systems & Global Solutions (IS&GS), Missiles and Fire Control (MFC), Mission Systems and Training (MST), and Space Systems. This structure reflects the reorganization of our former Electronic Systems business segment into the new MFC and MST business segments in order to streamline our operations and enhance customer alignment. In connection with this reorganization, management layers at our former Electronic Systems business segment and our former Global Training and Logistics (GTL) business were eliminated, and the former GTL business was split between the two new business segments. In addition, operating results for Sandia Corporation, which manages the Sandia National Laboratories for the U.S. Department of Energy, and our equity interest in the U.K. Atomic Weapons Establishment joint venture were transferred from our former Electronic Systems business segment to our Space Systems business segment.

The amounts, discussion, and presentation of our business segments reflect this reorganization for all years presented in this Annual Report on Form 10-K. For more information concerning our segment presentation, including comparative

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segment net sales, operating profit, and related financial information for 2012, 2011, and 2010, see Business Segment Results of Operations in Management s Discussion and Analysis of Financial Condition and Results of Operations and Note 3 Information on Business Segments of our consolidated financial statements.

Aeronautics

In 2012, our Aeronautics business segment generated net sales of $15.0 billion, which represented 31% of our total consolidated net sales. Aeronautics customers include the military services and various other government agencies of the U.S. and allied countries. In 2012, U.S. Government customers accounted for 78% and international customers accounted for 22% of Aeronautics net sales. Net sales from Aeronautics combat aircraft products and services represented 21% of our total consolidated net sales in 2012 and 20% of our total consolidated net sales in each of 2011 and 2010.

Aeronautics is engaged in the research, design, development, manufacture, integration, sustainment, support, and upgrade of advanced military aircraft, including combat and air mobility aircraft, unmanned air vehicles, and related technologies. Aeronautics major programs include:

- F-35 Lightning II Joint Strike Fighter international multi-role, fifth generation stealth fighter;
- F-22 Raptor air dominance and multi-mission fifth generation stealth fighter;
- F-16 Fighting Falcon low-cost, combat-proven, international multi-role fighter;
- C-130 Hercules international tactical airlifter; and
- C-5M Super Galaxy strategic airlifter.

The F-35 program is the largest in our corporation generating 14% of our total consolidated net sales, as well as 45% of Aeronautics net sales in 2012. The F-35 program consists of multiple contracts. The development contract is being performed concurrently with the low-rate initial production (LRIP) contracts. Concurrent performance of development and production contracts is used for complex programs to test airplanes, shorten the time to field systems, and achieve overall cost savings. We expect the development portion of the F-35 program will be substantially complete in 2017, with less significant efforts to continue into 2019. Production of the aircraft is expected to continue for many years given the U.S. Government s current inventory objective of 2,443 aircraft for the Air Force, Marine and Navy variants of the aircraft, commitments from our eight international partners and two international customers, as well as expressions of interest from other countries. For additional information on the F-35 program, see Status of F-35 Program and Industry Considerations in Management s Discussion and Analysis of Financial Condition and Results of Operations.

Although production and deliveries of F-22 aircraft were completed in 2012, Aeronautics continues to provide on-going modernization and sustainment activities for the U.S. Air Force s F-22 aircraft fleet. The modernization program comprises upgrading existing systems requirements, developing new systems requirements, and adding capabilities and enhancing the performance of the weapon systems. The sustainment program consists of sustaining the weapon systems of the F-22 fleet at all operational bases, including training systems, customer support, integrated support planning, supply chain management, aircraft modifications and heavy maintenance, sustained engineering, support products, and systems engineering.

Currently, Aeronautics produces F-16 aircraft for international customers. Aeronautics also provides service-life extension, modernization, and other upgrade programs for our customers F-16 aircraft. In 2012, we were awarded a contract to upgrade 145 of Taiwan s F-16 aircraft.

Aeronautics produces and provides support and sustainment services for the C-130J Super Hercules, as well as upgrades and support services for the legacy C-130 Hercules worldwide fleet. We delivered 34 C-130J aircraft in 2012, including eight to international customers.

Aeronautics also provides support services for the existing U.S. Air Force C-5A/B/C/M Galaxy fleet and a modernization program to convert 49 Galaxy aircraft to the C-5M Super Galaxy configuration. The modernization effort includes avionics upgrades comprised of a new cockpit with a digital, all-weather flight control system and autopilot, a new communications suite, flat-panel displays, and enhanced navigation and safety equipment; as well as installing new engines that will produce more thrust, enabling a shorter takeoff, increased climb rate, an increased cargo load, and longer range. We delivered four C-5M aircraft in 2012.

In addition to the above aircraft programs, Aeronautics is involved in advanced development programs incorporating innovative design and rapid prototype applications. Our Advanced Development Programs (ADP) organization, also known as the Skunk Works®, is focused on future systems, including unmanned aerial systems and next generation capabilities for advanced strike, intelligence, surveillance, reconnaissance, situational awareness, and air mobility. We continue to explore

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technology advancement and insertion in our existing aircraft. We also are involved in numerous network-enabled activities that allow separate systems to work together to increase effectiveness, and continue to invest in new technologies to maintain and enhance competitiveness in military aircraft design, development, and production.

Information Systems & Global Solutions

In 2012, our IS&GS business segment generated net sales of $8.8 billion, which represented 19% of our total consolidated net sales. IS&GS customers include the various government agencies of the U.S. and allied countries around the world and military services, as well as commercial and other customers. In 2012, U.S. Government customers accounted for 95%, international customers accounted for 4%, and U.S. commercial and other customers accounted for 1% of IS&GS net sales. IS&GS has been impacted by the continuing downturn in the federal information technology budgets and the impact of the continuing resolution that was effective on October 1, 2012, the start of the U.S. Government s fiscal year.

IS&GS provides management services, integrated information technology solutions, and advanced technology systems and expertise across a broad spectrum of applications for civil, defense, intelligence, and other government customers. IS&GS supports the needs of customers in cyber-security, health care, energy and environmental protection management, transportation, space exploration, human capital planning, financial services, data protection and sharing, and biometrics. IS&GS provides network-enabled situational awareness, delivers communications and command and control capability through complex mission solutions for defense applications, and integrates complex global systems to help our customers gather, analyze, and securely distribute critical intelligence data. IS&GS is also responsible for various classified systems and services in support of vital national security systems. While IS&GS has a portfolio of many smaller contracts as compared to our other business segments, this business segment s major programs include:

- The Command, Control, Battle Management and Communications (C2BMC) contract, a program to increase the integration of the Ballistic Missile Defense System for the U.S. Government.
- The En-Route Automation Modernization (ERAM) contract, which is a program to replace the Federal Aviation Administration s infrastructure with a modern automation environment that includes new functions and capabilities.
- The Hanford Mission Support contract, which provides infrastructure and site support services to the Department of Energy.
- The National Science Foundation s U.S. Antarctic Support program, which manages sites and equipment to enable universities, research institutions, and federal agencies to conduct scientific research in the Antarctic.

Missiles and Fire Control

In 2012, our MFC business segment generated net sales of $7.5 billion, which represented 16% of our total consolidated net sales. MFC s customers include the military services, principally the U.S. Army, and various government agencies of the U.S. and allied countries, as well as commercial and other customers. In 2012, U.S. Government customers accounted for 70% and international customers accounted for 30% of MFC s net sales.

MFC provides air and missile defense systems; tactical missiles and air-to-ground precision strike weapon systems; fire control systems; mission operations support, readiness, engineering support, and integration services; logistics and other technical services; and manned and unmanned ground vehicles. MFC s major programs include:

- The Patriot Advanced Capability-3 (PAC-3) and Terminal High Altitude Area Defense (THAAD) air and missile defense programs. PAC-3 is an advanced defensive missile for the U.S. Army and international customers designed to intercept and eliminate incoming airborne threats using kinetic energy. THAAD is a transportable defensive missile system for the U.S. Government and international customers designed to engage targets both within and outside of the Earth s atmosphere.
- The Multiple Launch Rocket System (MLRS), Hellfire, Javelin, and Joint Air-to-Surface Standoff Missile (JASSM) tactical missile programs. MLRS is a highly mobile, automatic system that fires surface-to-surface rockets and missiles from the M270 and High Mobility Artillery Rocket System platforms produced for the U.S. Army and international customers. Hellfire is an air-to-ground missile used on rotary and fixed-wing aircraft, which is produced for the U.S. Army, Navy, Marine Corps, and international customers. Javelin is a shoulder-fired anti-armor rocket system, which is produced for the U.S. Army, Marine Corps, and international customers. JASSM is an air-to-ground missile launched from fixed-wing aircraft, which is produced for the U.S. Air Force and international customers.

The Apache, Sniper®, and Low Altitude Navigation and Targeting Infrared for Night (LANTIRN®) fire control systems programs. The Apache fire control system provides weapons targeting capability for the Apache helicopter for the U.S. Army and international customers. Sniper® is a targeting system for fixed-wing aircraft, and LANTIRN® is a combined navigation and targeting system for fixed-wing aircraft. Both Sniper® and LANTIRN® are produced for the U.S. Air Force and international customers.

The Special Operations Forces Contractor Logistics Support Services program, which provides logistics support services to the special operations forces of the U.S. military.

Mission Systems and Training

In 2012, our MST business segment generated net sales of $7.6 billion, which represented 16% of our total consolidated net sales. MST s customers include the military services, principally the U.S. Navy, and various government agencies of the U.S. and allied countries, as well as commercial and other customers. In 2012, U.S. Government customers accounted for 75%, international customers accounted for 24%, and U.S. commercial and other customers accounted for 1% of MST s net sales.

MST provides surface ship and submarine combat systems; sea and land-based missile defense systems; radar systems; mission systems and sensors for rotary and fixed-wing aircraft; littoral combat ships; simulation and training services; unmanned technologies and platforms; ship systems integration; and military and commercial training systems. MST s major programs include:

The Aegis Combat System, which is a fleet ballistic missile defense system for the U.S. Navy and international customers and is also a sea-based element of the U.S. missile defense system.

The MK-41 Vertical Launching System (VLS) is a shipborne missile canister launching system that provides for rapid-fire launch capability, which is produced for the U.S. Navy and international customers.

The TPQ-53 Radar System is a sensor that quickly locates and neutralizes mortar and rocket threats, which is produced for the U.S. Army and international customers.

MH-60 mission systems and sensors, including the digital cockpit and weapons, which MST provides for the MH-60 maritime helicopter produced for the U.S. Navy and the Royal Australian Navy, and was selected by the Danish government in December 2012.

The Littoral Combat Ship (LCS), which is a surface combatant for the U.S. Navy designed to operate in shallow waters. We delivered our second LCS vessel, the USS Fort Worth, to the U.S. Navy in 2012. Construction is progressing on our third and fourth LCS vessels, the Milwaukee and the Detroit, which are scheduled for completion in 2014 and 2015.

The Persistent Threat Detection System (PTDS), which is a lighter-than-air continuous communications and persistent surveillance system produced for the U.S. Army. Deliveries on the PTDS program completed in 2012.

Space Systems

In 2012, our Space Systems business segment generated net sales of $8.3 billion, which represented 18% of our total consolidated net sales. Space Systems customers include various government agencies of the U.S. and commercial customers. In 2012, U.S. Government customers accounted for 95%, international customers accounted for 4%, and U.S. commercial and other customers accounted for 1% of Space Systems net sales. Net sales from Space Systems satellite products and services represented 12% of our total consolidated net sales in 2012 and 2011, and 13% in 2010.

Space Systems is engaged in the research and development, design, engineering, and production of satellites, strategic and defensive missile systems, and space transportation systems. Space Systems is also responsible for various classified systems and services in support of vital national security systems. Space Systems major programs include:

The Space-Based Infrared System (SBIRS) program, which provides the U.S. Air Force with enhanced worldwide missile launch detection and tracking capabilities.

The Advanced Extremely High Frequency (AEHF) system, which is the next generation of highly secure communications satellites for the U.S. Air Force.

The Mobile User Objective System (MUOS), which is a next-generation narrow band satellite communication system for the U.S. Navy.

Global Positioning System (GPS) III, which is a program to modernize the GPS satellite system for the U.S. Air Force.

The Geostationary Operational Environmental Satellite R-Series (GOES-R), which is the National Oceanic and Atmospheric Association s next generation of meteorological satellites.

The Trident II D5 Fleet Ballistic Missile, which is a program with the U.S. Navy for the only current submarine-launched intercontinental ballistic missile in production in the U.S.

The Orion Multi-Purpose Crew Vehicle (Orion) program, an advanced crew capsule for the National Aeronautics and Space Administration (NASA) utilizing new technology for human exploration beyond low earth orbit that replaces the Space Shuttle.

Operating results for our Space Systems business segment include our equity interests in United Launch Alliance, which provides expendable launch services for the U.S. Government, United Space Alliance, which provided processing activities for the Space Shuttle program and is winding down following the completion of the last Space Shuttle mission in 2011, and a joint venture that manages the U.K. s Atomic Weapons Establishment program. Additionally, operating results for Space Systems include Sandia Corporation, which manages and operates Sandia National Laboratories for the U.S. Department of Energy.

Competition

Our broad portfolio of products and services competes against the products and services of other large aerospace, defense, and information technology companies, as well as numerous smaller competitors, particularly in the IS&GS segment. We often form teams with other companies that are competitors in other efforts to provide customers with the best mix of capabilities to address specific requirements. In some areas of our business, customer requirements are changing to encourage expanded competition, such as information technology contracts where there may be a wide range of small to large contractors bidding on procurements. Principal factors of competition include: value of our products and services to the customer; technical and management capability; the ability to develop and implement complex, integrated system architectures; financing and total cost of ownership; release of technology; our demonstrated ability to execute and perform against contract requirements; and our ability to provide timely solutions.

The competition for foreign sales is subject to additional U.S. Government stipulations (e.g., export restrictions, market access, technology transfer, industrial cooperation, and contracting practices). We may compete against domestic and foreign companies (or teams) for contract awards by other governments. International competitions also may be subject to different laws or contracting practices of other governments that may affect how we structure our bid for the procurement. In many international procurements, the purchasing government s relationship with the U.S. and its industrial cooperation programs are also important factors in determining the outcome of a competition. It is common for international customers to require contractors to comply with their industrial cooperation regulations, sometimes referred to as offset requirements, and we have undertaken foreign offset agreements as part of securing some international business. For more information concerning offset agreements, see Contractual Commitments and Off-Balance Sheet Arrangements in Management s Discussion and Analysis of Financial Condition and Results of Operations.

Patents

We routinely apply for and own a substantial number of U.S. and international patents related to the products and services we provide. In addition to owning a large portfolio of intellectual property, we also license intellectual property to and from third parties. The U.S. Government has licenses in our patents that are developed in performance of government contracts, and it may use or authorize others to use the inventions covered by our patents for government purposes. Unpatented research, development, and engineering skills also make an important contribution to our business. Although our intellectual property rights in the aggregate are important to the operation of our business, we do not believe that any existing patent, license, or other intellectual property right is of such importance that its loss or termination would have a material adverse effect on our business taken as a whole.

Raw Materials and Seasonality

Aspects of our business require relatively scarce raw materials. Historically, we have been successful in obtaining the raw materials and other supplies needed in our manufacturing processes. We seek to manage raw materials supply risk through long-term contracts and by maintaining a stock of key materials in inventory.

Aluminum and titanium are important raw materials used in certain of our Aeronautics and Space Systems programs. Long-term agreements have helped enable a continued supply of aluminum and titanium. Carbon fiber is an important ingredient in the composite material that is used in our Aeronautics programs, such as the F-35 aircraft. Aluminum lithium, which we use for F-16 aircraft structural components, is currently only available from limited sources. We have been advised by some suppliers that pricing and the timing of availability of materials in some commodities markets can fluctuate widely. These fluctuations may negatively affect price and the availability of certain materials. While we do not anticipate material problems regarding the supply of our raw materials and believe that we have taken appropriate measures to mitigate these variations, if key materials become unavailable or if pricing fluctuates widely in the future, it could result in delay of one or more of our programs, increased costs, or reduced profits.

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No material portion of our business is considered to be seasonal. Various factors can affect the distribution of our sales between accounting periods, including the timing of government awards, the availability of government funding, product deliveries, and customer acceptance.

Government Contracts and Regulation

Our business is heavily regulated. We contract with numerous U.S. Government agencies and entities, including all branches of the U.S. military, the Departments of Defense, Homeland Security, Justice, Commerce, Health and Human Services, Transportation, and Energy, the U.S. Postal Service, the Social Security Administration, the Federal Aviation Administration, NASA, and the Environmental Protection Agency. Similar government authorities exist in other countries and regulate our international efforts.

We must comply with and are affected by laws and regulations relating to the formation, administration, and performance of U.S. Government and other contracts. These laws and regulations, among other things:

- require certification and disclosure of all cost or pricing data in connection with certain types of contract negotiations;
- impose specific and unique cost accounting practices that may differ from U.S. generally accepted accounting principles;
- impose acquisition regulations, which may change or be replaced over time, that define allowable and unallowable costs and otherwise govern our right to reimbursement under certain cost-based U.S. Government contracts;
- restrict the use and dissemination of information classified for national security purposes and the export of certain products, services, and technical data; and
- require the review and approval of contractor business systems, defined in the regulations as: (i) Accounting; (ii) Estimating; (iii) Earned Value Management Systems (EVMS, for managing cost and schedule performance on certain complex programs); (iv) Purchasing; (v) Material Management and Accounting System (MMAS, for planning, controlling, and accounting for the acquisition, use, issuing, and disposition of material); and (vi) Property Management systems.

For more information regarding government contracting laws and regulations, see Item 1A - Risk Factors as well as Industry Considerations and Critical Accounting Policies Contract Accounting / Sales Recognition in Management s Discussion and Analysis of Financial Condition and Results of Operations.

A portion of our business is classified by the U.S. Government and cannot be specifically described. The operating results of these classified programs are included in our consolidated financial statements. The business risks associated with classified programs historically have not differed materially from those of our other U.S. Government programs. The internal controls addressing the financial reporting of classified programs are consistent with the internal control practices for non-classified contracts.

Backlog

At December 31, 2012, our backlog was $82.3 billion compared with $80.7 billion at December 31, 2011. Backlog is converted into sales in future periods as work is performed or deliveries are made. Approximately $35.0 billion, or 43%, of our total 2012 year-end backlog is expected to be converted into sales in 2013.

Our backlog includes both funded (unfilled firm orders for our products and services for which funding has been both authorized and appropriated by the customer Congress, in the case of U.S. Government agencies) and unfunded (firm orders for which funding has not been appropriated) amounts. We do not include unexercised options or potential indefinite-delivery, indefinite-quantity orders in our backlog. If any of our contracts were to be terminated, our backlog would be reduced by the expected value of the remaining terms of such contracts. Funded backlog was $54.8 billion at December 31, 2012, as compared to $55.1 billion at December 31, 2011. For backlog related to each of our business segments, see Business Segment Results of Operations in Management s Discussion and Analysis of Financial Condition and Results of Operations.

Research and Development

We conduct research and development activities under customer-funded contracts and with our own independent research and development funds. Our independent research and development costs include basic research, applied research,

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development, systems, and other concept formulation studies. Generally, these costs are allocated among all contracts and programs in progress under U.S. Government contractual arrangements. Costs we incur under customer-sponsored research and development programs pursuant to contracts are included in net sales and cost of sales. Under certain arrangements in which a customer shares in product development costs, our portion of the unreimbursed costs is expensed as incurred in cost of sales. Independent research and development costs charged to costs of sales were $616 million in 2012, $585 million in 2011, and $639 million in 2010. See Research and development and similar costs in Note 1 Significant Accounting Policies of our consolidated financial statements.

Employees

At December 31, 2012, we had about 120,000 employees, approximately 95% of whom were located in the U.S. We have a continuing need for numerous skilled and professional personnel to meet contract schedules and obtain new and ongoing orders for our products. The majority of our employees possess a security clearance. The demand for workers with security clearances who have specialized engineering, information technology, and technical skills within the aerospace, defense, and information technology industries is likely to remain high for the foreseeable future, while growth of the pool of trained individuals with those skills has not matched demand. As a result, we are competing with other companies with similar needs in hiring skilled employees.

Approximately 15% of our employees are covered by any one of approximately 65 separate collective bargaining agreements with various unions. A number of our existing collective bargaining agreements expire in any given year. Historically, we have been successful in renegotiating expiring agreements without any material disruption of operating activities. Management considers employee relations to be good.

Forward-Looking Statements

This Form 10-K contains statements which, to the extent that they are not recitations of historical fact, constitute forward-looking statements within the meaning of the federal securities laws, and are based on our current expectations and assumptions. The words believe, estimate, anticipate, project, intend, expect, plan, outlook, scheduled, forecast, and similar expressions are intended to identify forward-looki statements.

Statements and assumptions with respect to future sales, income and cash flows, program performance, the outcome of litigation, environmental remediation cost estimates, and planned acquisitions or dispositions of assets are examples of forward-looking statements. Numerous factors, including potentially the risk factors described in the following section, could affect our forward-looking statements and actual performance.

Our future financial results likely will be different from those projected due to the inherent nature of projections, and may be better or worse than expected. Given these uncertainties, you should not rely on forward-looking statements. The forward-looking statements contained in this Form 10-K speak only as of the date of this Form 10-K. We expressly disclaim a duty to provide updates to forward-looking statements after the date of this Form 10-K to reflect the occurrence of subsequent events, changed circumstances, changes in our expectations, or the estimates and assumptions associated with them. The forward-looking statements in this Form 10-K are intended to be subject to the safe harbor protection provided by the federal securities laws.

ITEM 1A. RISK FACTORS

An investment in our common stock or debt securities involves risks and uncertainties. We seek to identify, manage, and mitigate risks to our business, but risk and uncertainty cannot be eliminated or necessarily predicted. You should consider the following factors carefully, in addition to the other information contained in this Form 10-K, before deciding to purchase our securities.

We depend heavily on U.S. Government contracts. Our programs could be materially reduced, extended, or terminated as a result of the government s continuing assessment of priorities, changes in government priorities, the implementation of sequestration, or other budget cuts intended to avoid sequestration. These matters and/or delays in the budget process, including a continuing resolution, could adversely affect our ability to grow or maintain our sales, earnings, and cash flow.

We derived 82% of our consolidated net sales from U.S. Government customers in 2012, including 61% from the Department of Defense (DoD). We expect to continue to derive most of our sales from work performed under U.S. Government contracts. Those contracts are conditioned upon the continuing availability of Congressional appropriations. Congress usually appropriates funds on a fiscal-year basis even though contract performance may extend over many years.

The programs in which we participate must compete with other programs and policy imperatives for consideration during the budget and appropriation process. Concerns about increased deficit spending, along with continued economic challenges, continue to place pressure on U.S. and international customer budgets. While we believe that our programs are well aligned with national defense and other priorities, shifts in domestic and international spending and tax policy, changes in security, defense, and intelligence priorities, the affordability of our products and services, general economic conditions and developments, and other factors may affect a decision to fund or the level of funding for existing or proposed programs.

Should Congress and the Administration fail to change or further delay the pending sequestration of appropriations in government fiscal year (GFY) 2013 imposed by the Budget Control Act of 2011 (Budget Act) now scheduled to take effect on March 1, 2013, our customers budgets would be reduced significantly and there would be a direct and significant reduction in our customers contract awards. While we understand customers have started to plan for sequestration, the specific effects of sequestration are not yet available and cannot be determined by us. The automatic across-the-board cuts from sequestration would approximately double the amount of the ten-year $487 billion reduction in defense spending that began in GFY 2012 already required by the Budget Act, including the budget for Overseas Contingencies Operations and any unobligated balances from prior years, and would have significant consequences to our business and industry. Non-DoD agencies would also have significantly reduced budgets. There would be disruption of ongoing programs, impacts to our supply chain, contractual actions (including partial or complete terminations), potential facilities closures, and thousands of personnel reductions across the industry that would severely impact advanced manufacturing operations and engineering expertise, and accelerate the loss of skills and knowledge. Consequently, we expect that sequestration, or other budgetary cuts in lieu of sequestration, would have a material effect on our corporation. For more information regarding sequestration, see Industry Considerations in Management s Discussion and Analysis of Financial Condition and Results of Operations.

Under such conditions, large or complex programs, which consist of multiple contracts and phases, are potentially subject to increased scrutiny. Our largest program, the F-35, represented 14% of our total consolidated net sales in 2012, and is expected to represent a higher percentage of our sales in future years. For more information regarding the F-35 program, see Status of F-35 Program in Management s Discussion and Analysis of Financial Condition and Results of Operations.

Based upon our diverse range of defense, homeland security, and information technology products and services, we believe that this makes it less likely that cuts in any specific contract or program will have a long-term effect on our business. However, termination of multiple or large programs or contracts could adversely affect our business and future financial performance. We could incur expenses beyond those that would be reimbursed if one or more of our existing contracts were terminated for convenience due to lack of funding or other reasons. Potential changes in funding priorities may afford new or additional opportunities for our businesses in terms of existing, follow-on, or replacement programs. While we would expect to compete, and be well positioned as the incumbent on existing programs, we may not be successful, or the replacement programs may be funded at lower levels.

In years when the U.S. Government does not complete its budget process before the end of its fiscal year (September 30), government operations typically are funded through a continuing resolution that authorizes agencies of the U.S. Government to continue to operate, but does not authorize new spending initiatives. When the U.S. Government operates under a continuing resolution, delays can occur in contract awards due to lack of funding. The U.S. Government is currently operating under a continuing resolution that is effective through March 27, 2013, and its budget for GFY 2013 has not been finalized. Historically, this has not had a material effect on our business, although we did experience a decrease in contract awards and sales at our IS&GS business segment during the fourth quarter of 2012 due to the continued downturn in federal information technology budgets impacted by the continuing resolution. Should the continuing resolution be prolonged further or extended through the entire government fiscal year or decisions regarding sequestration remain pending, it may cause additional government contract awards to shift and cause our results of operations to vary between periods. In limited circumstances, we may continue to work without funding, and use our funds, in order to meet our customer s desired delivery dates for products or services. Such funds could be at risk if the U.S. Government does not provide authorization and additional funding to our programs.

We are subject to a number of procurement laws and regulations. Our business and our reputation could be adversely affected if we fail to comply with these laws.

We must comply with and are affected by laws and regulations relating to the award, administration, and performance of U.S. Government contracts. Government contract laws and regulations affect how we do business with our customers and impose certain risks and costs on our business. A violation of specific laws and regulations could harm our reputation and result in the imposition of fines and penalties, the termination of our contracts, debarment from bidding on contracts, loss of our ability to export products or services, and civil or criminal investigations or proceedings.

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In some instances, these laws and regulations impose terms or rights that are different than those typically found in commercial transactions. For example, the U.S. Government may terminate any of our government contracts and subcontracts either at its convenience or for default based on performance. Upon termination for convenience of a fixed-price type contract, we normally are entitled to receive the purchase price for delivered items, reimbursement for allowable costs for work-in-process, and an allowance for profit on the contract or adjustment for loss if completion of performance would have resulted in a loss.

Upon termination for convenience of a cost-reimbursable contract, we normally are entitled to reimbursement of allowable costs plus a portion of the fee. Allowable costs would include our cost to terminate agreements with our suppliers and subcontractors. The amount of the fee recovered, if any, is related to the portion of the work accomplished prior to termination and is determined by negotiation. We attempt to ensure that adequate funds are available by notifying the customer when its estimated costs, including those associated with a possible termination for convenience, approach levels specified as being allotted to its programs. As funds are typically appropriated on a fiscal-year basis and as the costs of a termination for convenience may exceed the costs of continuing a program in a given fiscal year, occasionally programs do not have sufficient funds appropriated to cover the termination costs were the government to terminate them for convenience. Under such circumstances, the U.S. Government could assert that it is not required to appropriate additional funding.

A termination arising out of our default may expose us to liability and have a material adverse effect on our ability to compete for future contracts and orders. In addition, on those contracts for which we are teamed with others and are not the prime contractor, the U.S. Government could terminate a prime contract under which we are a subcontractor, notwithstanding the quality of our services as a subcontractor. In the case of termination for default, the U.S. Government could make claims to reduce the contract value or recover its procurement costs and could assess other special penalties. However, under such circumstances we have rights and remedial actions under laws and Federal Acquisition Regulations (FAR).

In addition, certain of our U.S. Government contracts span one or more base years and multiple option years. The U.S. Government generally has the right not to exercise option periods and may not exercise an option period for various reasons. However, the U.S. Government may exercise option periods, even for contracts for which it is expected that our costs may exceed the contract price or ceiling.

U.S. Government agencies, including the Defense Contract Audit Agency, the Defense Contract Management Agency (DCMA), and various agency Inspectors General, routinely audit and investigate government contractors. These agencies review a contractor s performance under its contracts, its cost structure, its business systems, and compliance with applicable laws, regulations, and standards. Any costs found to be misclassified may be subject to repayment. We have unaudited and/or unsettled incurred cost claims related to past years, which places risk on our ability to issue final billings on contracts for which authorized and appropriated funds may be expiring.

Certain deficiencies identified during government audits of contractor business systems may result in the government withholding payments on receivables for certain contract types such as cost-reimbursable contracts and fixed-price incentive-fee contracts. Withholds are capped at 5% of billings when deficiencies impact a single business system and 10% when deficiencies impact multiple systems, and are typically reduced to 2% after the contractor s corrective action plan has been accepted and progress to implement the corrective actions has been demonstrated. Such deficiencies have not impacted our internal control over financial reporting. For example, the U.S. Government is currently withholding certain funds on receivables for the F-35 program due to the DCMA s prior withdrawal of its validation and determination of compliance of the Earned Value Management Systems at our Fort Worth, Texas location. In 2012, the DCMA conducted a compliance review and concluded that although we have made notable progress toward compliance, additional corrective actions are necessary to achieve full compliance.

If an audit or investigation uncovers improper or illegal activities, we may be subject to civil or criminal penalties and administrative sanctions, including termination of contracts, forfeiture of profits, suspension of payments, fines, and suspension or prohibition from doing business with the U.S. Government. In addition, we could suffer serious reputational harm if allegations of impropriety were made against us. Similar government oversight exists in most other countries where we conduct business.

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Increased competition and bid protests in a budget-constrained environment may make it more difficult to maintain our financial performance.

As a leader in defense and global security, we have a large number of programs for which we are the incumbent contractor. A substantial portion of our business is awarded through competitive bidding. The U.S. Government increasingly has relied upon competitive contract award types, including indefinite-delivery, indefinite-quantity, GSA Schedule, and other multi-award contracts, which has the potential to create pricing pressure and increase our cost by requiring that we submit multiple bids and proposals. The competitive bidding process entails substantial costs and managerial time to prepare bids and proposals for contracts that may not be awarded to us or may be split among competitors. Following award, we may encounter significant expenses, delays, contract modifications, or even loss of the contract if our competitors protest or challenge contracts that are awarded to us. Multi-award contracts require that we make sustained efforts to obtain task orders under the contract. We are facing increased competition, particularly in information technology and cyber security at our Information Systems & Global Solutions business segment, from non-traditional competitors outside of the aerospace and defense industry. At the same time, our customers are facing budget constraints, trying to do more with less by cutting costs, identifying more affordable solutions, and reducing product development cycles. To remain competitive, we consistently must provide superior performance, advanced technology solutions, and service at an affordable cost and with the agility that our customers require to satisfy their mission objectives.

International sales may pose different risks.

In 2012, our sales to international customers accounted for 17% of our total consolidated net sales. As a company, we have a strategy to grow international sales over the next several years, inclusive of sales of F-35 aircraft to our international partners and other countries. International sales are subject to numerous political and economic factors, regulatory requirements, significant competition, and other risks associated with doing business in foreign countries. Our exposures to such risks may increase if our international sales grow as we anticipate.

Our international business is conducted through foreign military sales (FMS) contracted through the U.S. Government or direct commercial sales (DCS) with international customers. In 2012, approximately half of our sales to international customers were FMS while the other half were DCS. These transaction types differ as FMS transactions represent sales by the U.S. Government to other governments and our contract with the U.S. Government is subject to FAR. By contrast, DCS transactions represent sales by us directly to another government or international customer. All sales to international customers are subject to U.S. and foreign laws and regulations, including, without limitation, regulations relating to import-export control, technology transfer restrictions, taxation, repatriation of earnings, exchange controls, the Foreign Corrupt Practices Act, and certain other anti-corruption laws, and the anti-boycott provisions of the U.S. Export Administration Act. We frequently team with international subcontractors and suppliers who are also exposed to similar risks. While we have stringent policies in place to comply with such laws and regulations, failure by us, our employees, or others working on our behalf to comply with these laws and regulations could result in administrative, civil, or criminal liabilities, including suspension or debarment from government contracts or suspension of our export privileges, which could have a material adverse effect on us.

While international sales, whether contracted as FMS or DCS, present risks that are different, and potentially greater, than those encountered in our domestic business, DCS may impose even greater risks as such transactions involve commercial relationships with parties with whom we have less familiarity and where there may be significant cultural differences. Additionally, international procurement rules and regulations, contract laws and regulations, and contractual terms differ from those in the U.S., are less familiar to us, may be interpreted differently by foreign courts, are officially documented in the local language and, therefore, potentially subject to errors in translation, and frequently have terms less favorable to us than the FAR. Export and import, tax, and currency risk may also be increased for DCS transactions.

Our international business is highly sensitive to changes in regulations, political environments, or security risks may affect our ability to conduct business in foreign markets, including those regarding investment, procurement, taxation, and repatriation of earnings. Our international business may also be impacted by changes in foreign national priorities and government budgets and may be further impacted by global economic conditions and fluctuations in foreign currency exchange rates. Sales of military products are also affected by defense budgets (both in the U.S. and abroad) and U.S. foreign policy.

In international sales, we face substantial competition from both domestic manufacturers and foreign manufacturers whose governments sometimes provide research and development assistance, marketing subsidies, and other assistance for their products. Additionally, the timing of orders from our international customers can be less predictable than for our domestic customers and may lead to fluctuations in the amount reported each year for our international sales.

In conjunction with defense procurements, some international customers require contractors to provide additional incentives or to comply with industrial cooperation regulations, including entering into industrial cooperation agreements, sometimes referred to as offset agreements. Offset agreements may require in-country purchases, technology transfers, local manufacturing support, and financial support projects as an incentive, or as a condition to a contract award. In some countries, these offset agreements may require the establishment of a joint venture with a local company, which must control the venture. In these and other situations, Lockheed Martin could be liable for violations of law for actions taken by these entities such as laws related to anti-corruption, import and export, anti-boycott restrictions, or local laws with which we are not familiar. Offset agreements generally extend over several years and may provide for penalties in the event we fail to perform in accordance with the offset requirements which are typically subjective.

Our business involves significant risks and uncertainties that may not be covered by indemnity or insurance.

A significant portion of our business relates to designing, developing, and manufacturing advanced defense and technology systems and products. New technologies may be untested or unproven. Failure of some of these products and services could result in extensive loss of life or property damage. Accordingly, we also may incur liabilities that are unique to our products and services, including combat and air mobility aircraft, missile and space systems, command and control systems, air traffic control management systems, cyber security, homeland security, and training programs. In some, but not all circumstances, we may be entitled to certain legal protections or indemnifications from our customers, either through U.S. Government indemnifications under Public Law 85-804, qualification of our products and services by the Department of Homeland Security under the SAFETY Act provisions of the Homeland Security Act of 2002, contractual provisions, or otherwise. The amount of insurance coverage that we maintain may not be adequate to cover all claims or liabilities, existing coverage may be cancelled while we remain exposed to the risk, and it is not possible to obtain insurance to protect against all operational risks and liabilities.

Substantial claims resulting from an accident, failure of our products or services, or other incident, or liability arising from our products and services in excess of any indemnity and our insurance coverage (or for which indemnity or insurance is not available or not obtained) could adversely impact our financial condition, cash flows, or operating results. Any accident, even if fully indemnified or insured, could negatively affect our reputation among our customers and the public, and make it more difficult for us to compete effectively. It also could affect the cost and availability of adequate insurance in the future.

Our profitability and cash flow may vary based on the mix of our contracts and programs, our performance, our ability to control costs, and evolving U.S. Government procurement policies.

Our profitability and cash flow may vary materially depending on the types of long-term government contracts undertaken, the nature of the products produced or services performed under those contracts, the costs incurred in performing the work, the achievement of other performance objectives, and the stage of performance at which the right to receive fees is finally determined (particularly under award and incentive-fee contracts).

Our backlog includes a variety of contract types which are intended to address changing risk and reward profiles as a program matures. Contract types include cost-reimbursable, fixed-price incentive-fee, fixed-price, and time-and-materials contracts. Contracts for development programs with complex design and technical challenges are typically cost-reimbursable. Under cost-reimbursable contracts, we are reimbursed for allowable costs and paid a fee, which may be fixed or performance-based. In these cases, the associated financial risks primarily relate to a reduction in fees, and the program could be cancelled if cost, schedule, or technical performance issues arise.

Other contracts in backlog are for the transition from development to production (e.g., low-rate initial production (LRIP)), which includes the challenge of starting and stabilizing a manufacturing production and test line while the final design is being validated. These generally are cost-reimbursable or fixed-price incentive-fee contracts. Under a fixed-price incentive-fee contract, the allowable costs incurred are eligible for reimbursement, but are subject to a cost-share arrangement, which affects profitability. Generally, if our costs exceed the contract target cost or are not allowable under the applicable regulations, we may not be able to obtain reimbursement for all costs and may have our fees reduced or eliminated.

There are also contracts for production as well as operations and maintenance of the delivered products that have the challenge of achieving a stable production and delivery rate, while maintaining operability of the product after delivery. These contracts are mainly fixed-price, although some operations and maintenance contracts are time and materials-type. Under fixed-price contracts, we receive a fixed price despite the actual costs we incur. We have to absorb any costs in excess of the fixed price. Under time-and-materials contracts, we are paid for labor at negotiated hourly billing rates and for certain expenses.

The failure to perform to customer expectations and contract requirements may result in reduced fees or losses and affect our financial performance in that period. Under each type of contract, if we are unable to control costs, our operating results could be adversely affected, particularly if we are unable to justify an increase in contract value to our customers. Cost overruns or the failure to perform on existing programs also may adversely affect our ability to retain existing programs and win future contract awards.

The U.S. Government is currently pursuing and implementing policies that could negatively impact our profitability. Changes in procurement policy favoring more incentive-based fee arrangements, different award fee criteria, or government contract negotiation offers that indicate what our costs should be may affect the predictability of our profit rates. Our customers are under pressures that may result in a change in contract types referenced above earlier in program maturity than is traditional. An example of this is the use of fixed-price incentive-fee contracts for the LRIP 4 and LRIP 5 contracts on the F-35 program while the development contract is running concurrently. Our customers may also pursue non-traditional contract provisions in negotiation of contracts. For example, changes resulting from the F-35 development contract may need to be implemented on the production contracts, a concept referred to as concurrency, which may require us to pay for a portion of the concurrency costs. Other examples include, but are not limited to, the government in certain circumstances requiring that bid and proposal costs be included in general and administrative costs, rather than charged directly to contracts, and potentially lowering the cap on the recoverability of executive compensation.

Other policies could negatively impact our working capital and cash flow. For example, the government has expressed a preference for requiring progress payment provisions on new fixed-price contracts, which if implemented, delays our ability to recover a significant amount of costs incurred on a contract and thus affects the timing of our cash flows.

We are the prime contractor on most of our contracts and if our subcontractors, suppliers, or teaming agreement or joint venture partners fail to perform their obligations, our performance and our ability to win future business could be harmed.

Most of our contracts involve subcontracts or teaming arrangements with other companies upon which we rely to perform a portion of the services that we must provide to our customers. We also sometimes bid on contracts through joint ventures that award work through these entities, rather than through subcontract or teaming arrangements. There is a risk that we may have disputes with our subcontractors, teammates, or venture members, including disputes regarding the quality and timeliness of work performed, the workshare provided to that party, customer concerns about the other party s performance, our failure to extend existing task orders or issue new task orders, or our hiring of the personnel of a subcontractor, teammate, or venture member, or vice versa. In addition, the contracting parties on which we rely may be affected by changes in the economic environment and constraints on available financing to meet their performance requirements or provide needed supplies on a timely basis. A failure by one or more of those contracting parties to provide the agreed-upon supplies or perform the agreed-upon services on a timely basis may affect our ability to perform our obligations. Contracting party performance deficiencies may affect our operating results and could result in a customer terminating our contract for default. A default termination could expose us to liability and affect our ability to compete for future contracts and orders.

The funding and costs associated with our pension and postretirement medical plans are dependent on economic factors such as discount rates and long-term rates of return on our plan assets as well as other actuarial assumptions which may cause our earnings, cash flows, and stockholders equity to fluctuate significantly from year to year.

Many of our employees are covered by defined benefit pension plans, and we provide certain health care and life insurance benefits to eligible retirees. The impact of these plans on our U.S. generally accepted accounting principles (GAAP) earnings may be volatile in that the amount of expense we record for our postretirement benefit plans may materially change from year to year because those calculations are sensitive to funding levels as well as changes in several key economic assumptions, including interest rates, rates of return on plan assets, and other actuarial assumptions including expected rates of increase in future compensation levels, employee turnover and mortality, as well as the timing of funding. Changes in these factors also affect our plan funding, cash flow, earnings, and stockholders equity. In addition, the funding of our plans and recovery of costs on our contracts, as described below, may also be subject to changes caused by legislative or regulatory actions.

With regard to cash flow, in the past few years we have made substantial cash contributions to our plans in excess of the amounts required by the Employee Retirement Income Security Act of 1974 (ERISA) and Pension Protection Act (PPA). We generally are able to recover these costs related to our plans as allowable costs on our U.S. Government contracts, including FMS, but there are delays between when we contribute cash to the plans under pension funding rules and recover it under government cost accounting rules. Effective February 2012, the cost accounting rules were revised to harmonize the

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measurement and period assignment of the pension cost allocable to government contracts with the PPA (CAS Harmonization). The cost impact of CAS Harmonization will be phased in beginning in 2013 with the goal of better aligning the CAS cost and ERISA funding requirements being fully achieved in 2017.

For more information on how these factors could impact earnings, financial position, cash flow and stockholders equity, see Critical Accounting Policies Postretirement Benefit Plans in Management s Discussion and Analysis of Financial Conditions and Results of Operations and Note 9 Postretirement Plans of our consolidated financial statements.

If we fail to manage acquisitions, divestitures, and other transactions successfully, our financial results, business, and future prospects could be harmed.

In pursuing our business strategy, we routinely conduct discussions, evaluate targets, and enter into agreements regarding possible acquisitions, divestitures, joint ventures, and equity investments. We seek to identify acquisition or investment opportunities that will expand or complement our existing products and services, or customer base, at attractive valuations. We often compete with others for the same opportunities. To be successful, we must conduct due diligence to identify valuation issues and potential loss contingencies, negotiate transaction terms, complete and close complex transactions, and manage post-closing matters (e.g., integrate acquired companies and employees and realize anticipated operating synergies) efficiently and effectively. Acquisition, divestiture, joint venture, and investment transactions often require substantial management resources and have the potential to divert our attention from our existing business. Unidentified pre-closing liabilities could affect our future financial results.

Joint ventures or equity investments operate under shared control with other parties. Under the equity method of accounting for nonconsolidated joint ventures and investments, we recognize our share of the operating results of these ventures in our results of operations. Our operating results may be affected by the performance of businesses over which we do not exercise control. The most significant impact of our equity investments is in our Space Systems business segment where approximately 24% of its 2012 operating profit was derived from its equity investments in three joint ventures (see Space Systems above). Management closely monitors the results of operations and cash flows generated by these investees.

Our business could be negatively affected by cyber or other security threats or other disruptions.

As a U.S. defense contractor, we face cyber threats, threats to the physical security of our facilities and employees, and terrorist acts, as well as the potential for business disruptions associated with information technology failures, natural disasters, or public health crises.

We routinely experience cyber security threats, threats to our information technology infrastructure and attempts to gain access to our company sensitive information, as do our customers, suppliers, subcontractors and joint venture partners. We may experience similar security threats at customer sites that we operate and manage as a contractual requirement.

Prior cyber attacks directed at us have not had a material impact on our financial results, and we believe our threat detection and mitigation processes and procedures are adequate. The threats we face vary from attacks common to most industries to more advanced and persistent, highly organized adversaries who target us because we protect national security information. If we are unable to protect sensitive information, our customers or governmental authorities could question the adequacy of our threat mitigation and detection processes and procedures. Due to the evolving nature of these security threats, however, the impact of any future incident cannot be predicted.

Although we work cooperatively with our customers, suppliers, subcontractors, joint venture partners, and acquisitions to seek to minimize the impact of cyber threats, other security threats or business disruptions, we must rely on the safeguards put in place by these entities, which may affect the security of our information. These entities have varying levels of cyber security expertise and safeguards and their relationships with government contractors, such as Lockheed Martin, may increase the likelihood that they are targeted by the same cyber threats we face.

The costs related to cyber or other security threats or disruptions may not be fully insured or indemnified by other means. Occurrence of any of these events could adversely affect our internal operations, the services we provide to our customers, loss of competitive advantages derived from our research and development efforts or other intellectual property, early obsolescence of our products and services, our future financial results, our reputation or our stock price.

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Environmental costs could affect our future earnings as well as the affordability of our products and services.

Our operations are subject to and affected by a variety of federal, state, local, and foreign environmental protection laws and regulations. We are involved in environmental responses at some of our facilities and former facilities, and at third-party sites not owned by us where we have been designated a potentially responsible party by the U.S. Environmental Protection Agency (EPA) or by a state agency. In addition, we could be affected by future regulations imposed in response to concerns over climate change, other aspects of the environment, or natural resources, and by other actions commonly referred to as green initiatives. We have an ongoing comprehensive program to reduce the effects of our operations on the environment.

We manage various government-owned facilities on behalf of the government. At such facilities, environmental compliance and remediation costs historically have been the responsibility of the government, and we have relied, and continue to rely with respect to past practices, upon government funding to pay such costs. Although the government remains responsible for capital and operating costs associated with environmental compliance, responsibility for fines and penalties associated with environmental noncompliance typically are borne by either the government or the contractor, depending on the contract and the relevant facts. Some environmental laws include criminal provisions. An environmental law conviction could affect our ability to be awarded future, or perform existing, U.S. Government contracts.

We have incurred and will continue to incur liabilities under various federal, state, local, and foreign statutes for environmental protection and remediation. The extent of our financial exposure cannot in all cases be reasonably estimated at this time. Among the variables management must assess in evaluating costs associated with these cases and remediation sites generally are the status of site assessment, extent of the contamination, impacts on natural resources, changing cost estimates, evolution of technologies used to remediate the site, and continually evolving governmental environmental standards and cost allowability issues. Both the EPA and the California Office of Environmental Health Hazard Assessment announced plans in January 2011 to regulate two chemicals, perchlorate and hexavalent chromium, to levels in drinking water that are expected to be substantially lower than the existing public health goals or standards established in California. The rulemaking processes are lengthy and may take years to complete. If substantially lower standards are adopted, we would expect a material increase in our estimates for environmental liabilities and the related assets for the portion of the increased costs that are probable of future recovery in the pricing of our products and services for the U.S. Government. The amount that would be allocable to our non-U.S. Government contracts or that is determined to be unallowable for pricing under U.S. Government contracts would be expensed, which may have a material effect on our earnings in any particular interim reporting period. For information regarding these matters, including current estimates of the amounts that we believe are required for remediation or cleanup to the extent probable and estimable, see Critical Accounting Policies Environmental Matters in Management s Discussion and Analysis of Financial Condition and Results of Operations and Note 12 Legal Proceedings, Commitments, and Contingencies of our consolidated financial statements.

We are involved in a number of legal proceedings. We cannot predict the outcome of litigation and other contingencies with certainty.

Our business may be adversely affected by the outcome of legal proceedings and other contingencies that cannot be predicted with certainty. As required by GAAP, we estimate loss contingencies and establish reserves based on our assessment of contingencies where liability is deemed probable and reasonably estimable in light of the facts and circumstances known to us at a particular point in time. Subsequent developments in legal proceedings may affect our assessment and estimates of the loss contingency recorded as a liability or as a reserve against assets in our financial statements. For a description of our current legal proceedings, see Item 3 Legal Proceedings and Note 12 Legal Proceedings, Commitments, and Contingencies of our consolidated financial statements.

In order to be successful, we must attract and retain key employees and manage leadership transitions effectively.

Our business has a continuing need to attract large numbers of skilled personnel, including personnel holding security clearances, to support the growth of the enterprise and to replace individuals who have terminated employment due to retirement or other reasons. To the extent that the demand for qualified personnel exceeds supply, we could experience higher labor, recruiting, or training costs in order to attract and retain such employees, or could experience difficulties in performing under our contracts if our needs for such employees were unmet. We increasingly compete with commercial technology companies outside of the aerospace and defense industry for qualified technical and scientific positions as the number of qualified domestic engineers is decreasing. To the extent that these companies grow faster than our industry, or face fewer cost and product pricing constraints, they may be able to offer higher compensation to job candidates or our existing employees. To the extent that we lose experienced personnel through wage competition, normal attrition, or specific actions such as workforce reductions, we must successfully manage the transfer of critical knowledge from those individuals.

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We also must manage leadership development and succession planning throughout our business and have processes in place for management transition, which was critical during our recent executive management changes. To the extent that we are unable to attract, develop, retain, and protect leadership talent successfully, we could experience business disruptions and impair our ability to achieve business objectives.

Historically, where employees are covered by collective bargaining agreements with various unions, we have been successful in negotiating renewals to expiring agreements without any material disruption of operating activities. This does not assure, however, that we will be successful in our efforts to negotiate renewals of our existing collective bargaining agreements when they expire. If we were unsuccessful in those efforts, there is the potential that we could incur unanticipated delays or expenses in the programs affected by any resulting work stoppages.

Our estimates and projections may prove to be inaccurate.

The accounting for some of our most significant activities is based on judgments and estimates, which are complex and subject to many variables. For example, accounting for sales using the percentage-of-completion method requires that we assess risks and make assumptions regarding schedule, cost, technical, and performance issues for each of our thousands of contracts, many of which are long-term in nature. Another example is the $10.4 billion of goodwill assets recorded on our Balance Sheet as of December 31, 2012 from previous acquisitions over time, which represent greater than 25% of our total assets, and are subject to annual impairment testing. If we experience changes or factors arise that negatively affect the expected cash flows of a reporting unit, we may be required to write off all or a portion of the related goodwill assets.

Changes in U.S. or foreign tax laws, including possibly with retroactive effect, and audits by tax authorities could result in unanticipated increases in our tax expense and affect profitability and cash flows. For example, recent proposals to lower the U.S. corporate income tax rate would require us to reduce our net deferred tax assets upon enactment of the related tax legislation, with a corresponding material, one-time increase to income tax expense, but our income tax expense and payments would be materially reduced in subsequent years. Actual financial results could differ from our judgments and estimates. Refer to Critical Accounting Policies in Management s Discussion and Analysis of Financial Condition and Results of Operations, and Note 1 Significant Accounting Policies of our consolidated financial statements for a complete discussion of our significant accounting policies and use of estimates.

ITEM 1B. UNRESOLVED STAFF COMMENTS

None.

ITEM 2. PROPERTIES

At December 31, 2012, we operated in 523 locations (including offices, manufacturing plants, warehouses, service centers, laboratories, and other facilities) throughout the U.S. and internationally. Of these, we owned 45 locations aggregating approximately 29.0 million square feet, and leased space at 478 locations aggregating approximately 23.7 million square feet. Consistent with our cost reduction initiatives, we reduced our leased space by approximately 1.5 million square feet during 2012. We also manage or occupy various government-owned facilities under leases and various other arrangements. The U.S. Government also furnishes equipment that we use in some of our businesses.

At December 31, 2012, our business segments occupied facilities at the following major locations:

Aeronautics Palmdale, California; Marietta, Georgia; Greenville, South Carolina; and Fort Worth and San Antonio, Texas.
Information Systems & Global Solutions Goodyear, Arizona; Sunnyvale, California; Colorado Springs and Denver, Colorado; Gaithersburg and Rockville, Maryland and other locations within the Washington, D.C. metropolitan area; Valley Forge, Pennsylvania; and Houston, Texas.
Missiles and Fire Control Camden, Arkansas; Orlando, Florida; Lexington, Kentucky; and Grand Prairie, Texas.
Mission Systems and Training Orlando, Florida; Baltimore, Maryland; Moorestown/Mt. Laurel, New Jersey; Owego and Syracuse, New York; Akron, Ohio; and Manassas, Virginia.
Space Systems Huntsville, Alabama; Sunnyvale, California; Denver, Colorado; Albuquerque, New Mexico; and Newtown, Pennsylvania.
Corporate activities Lakeland, Florida and Bethesda, Maryland.

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The following is a summary of our square feet of floor space by business segment at December 31, 2012 (in millions):

	Owned	Leased	Government-Owned	Total
Aeronautics	5.2	3.5	14.7	23.4
Information Systems & Global Solutions	2.5	6.3		8.8
Missiles and Fire Control	3.9	5.3	1.3	10.5
Mission Systems and Training	5.7	5.9	0.4	12.0
Space Systems	8.7	1.7	7.9	18.3
Corporate activities	3.0	1.0		4.0
Total	29.0	23.7	24.3	77.0

Some of our owned properties are leased to third parties. In the area of manufacturing, most of the operations are of a job-order nature, rather than an assembly line process, and productive equipment has multiple uses for multiple products. Management believes that all of our major physical facilities are in good condition and are adequate for their intended use.

ITEM 3. LEGAL PROCEEDINGS

We are a party to or have property subject to litigation and other proceedings, including matters arising under provisions relating to the protection of the environment, and are subject to contingencies related to certain businesses we previously owned. We believe the probability is remote that the outcome of these matters will have a material adverse effect on the Corporation as a whole, notwithstanding that the unfavorable resolution of any matter may have a material effect on our net earnings in any particular quarter. We cannot predict the outcome of legal proceedings with certainty. These matters include the proceedings summarized in Note 12 Legal Proceedings, Commitments, and Contingencies of our consolidated financial statements.

From time-to-time, agencies of the U.S. Government investigate whether our operations are being conducted in accordance with applicable regulatory requirements. U.S. Government investigations of us, whether relating to government contracts or conducted for other reasons, could result in administrative, civil, or criminal liabilities, including repayments, fines, or penalties being imposed upon us, or could lead to suspension, proposed debarment, or debarment from eligibility for future U.S. Government contracting. U.S. Government investigations often take years to complete and many result in no adverse action against us.

We are subject to federal and state requirements for protection of the environment, including those for discharge of hazardous materials and remediation of contaminated sites. As a result, we are a party to or have our property subject to various lawsuits or proceedings involving environmental protection matters. Due in part to their complexity and pervasiveness, such requirements have resulted in us being involved with related legal proceedings, claims, and remediation obligations. The extent of our financial exposure cannot in all cases be reasonably estimated at this time. For information regarding these matters, including current estimates of the amounts that we believe are required for remediation or clean-up to the extent estimable, see Critical Accounting Policies Environmental Matters in Management s Discussion and Analysis of Financial Condition and Results of Operations, and Note 12 Legal Proceedings, Commitments, and Contingencies of our consolidated financial statements.

ITEM 4. MINE SAFETY DISCLOSURES

Not applicable.

ITEM 4(a). EXECUTIVE OFFICERS OF THE REGISTRANT

Our executive officers as of February 28, 2013 are listed below, as well as their age at December 31, 2012, positions and offices currently held, and principal occupation and business experience over at least the past five years. There were no family relationships among any of our executive officers and directors. All officers serve at the pleasure of the Board of Directors.

Dale P. Bennett (56), Executive Vice President Mission Systems and Training

Mr. Bennett has served as Executive Vice President Mission Systems and Training since December 31, 2012. He previously served as President, Electronic Systems Mission Systems & Sensors from August 2011 to December 30, 2012, and President, Global Training and Logistics from July 2005 to July 2011.

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Richard H. Edwards (56), Executive Vice President Missiles and Fire Control

Mr. Edwards has served as Executive Vice President Missiles and Fire Control since December 31, 2012. He previously served as Executive Vice President, Program and Technology Integration, Electronic Systems Missiles and Fire Control from June 2012 to December 30, 2012, and Vice President Tactical Missiles and Combat Maneuver Systems, Electronic Systems Missiles and Fire Control from July 2005 to June 2012.

Linda R. Gooden (59), Executive Vice President Information Systems & Global Solutions

Ms. Gooden has served as Executive Vice President Information Systems & Global Solutions (IS&GS) since January 2007. Effective April 1, 2013, Ms. Gooden will step down as Executive Vice President IS&GS, but will remain employed with the Corporation through May 1, 2013 when she will retire. Sondra L. Barbour, Senior Vice President and Chief Information Officer, will succeed Ms. Gooden as the new Executive Vice President IS&GS effective April 1, 2013.

Christopher J. Gregoire (44), Vice President and Controller (Chief Accounting Officer)

Mr. Gregoire has served as Vice President, Controller, and Chief Accounting Officer since March 2010. He previously was employed by Sprint Nextel Corporation from August 2006 to May 2009, most recently as Principal Accounting Officer and Assistant Controller, and was a partner at Deloitte & Touche LLP from September 2003 to July 2006.

Marillyn A. Hewson (59), Chief Executive Officer and President

Ms. Hewson has served as Chief Executive Officer and President since January 2013. She previously served as President and Chief Operating Officer from November 2012 to December 2012 and Executive Vice President Electronic Systems from January 2010 to December 2012; President, Systems Integration Owego from September 2008 to December 2009; Executive Vice President Global Sustainment for Aeronautics from February 2007 to August 2008; President, Lockheed Martin Logistics Services Company from January 2007 to February 2007; and President and General Manager, Kelly Aviation Center, L.P. from August 2004 to December 2007.

Maryanne R. Lavan (53), Senior Vice President, General Counsel and Corporate Secretary

Ms. Lavan has served as Senior Vice President and General Counsel since June 2010 and Corporate Secretary since September 2010. She previously served as Vice President Internal Audit from February 2007 to June 2010, and Vice President Ethics and Business Conduct from October 2003 to February 2007.

Larry A. Lawson (54), Executive Vice President Aeronautics

Mr. Lawson has served as Executive Vice President Aeronautics since April 2012. He previously served as Vice President and General Manager, F-35 Program, from June 2010 to March 2012, and Vice President and General Manager, F-22 Program, from September 2004 to June 2010.

Joanne M. Maguire (58), Executive Vice President Space Systems

Ms. Maguire has served as Executive Vice President Space Systems since July 2006. Effective April 1, 2013, Ms. Maguire will step down as Executive Vice President Space Systems, but will remain employed with the Corporation through May 1, 2013 when she will retire. Richard F. Ambrose, Vice President and Deputy, Space Systems, will succeed Ms. Maguire as the new Executive Vice President Space Systems effective April 1, 2013.

Kenneth R. Possenriede (52), Vice President and Treasurer

Mr. Possenriede has served as Vice President and Treasurer since July 2011. He previously served as Vice President of Finance and Business Operations for Electronic Systems from July 2008 to June 2011, and as Vice President of Finance and Business Operations for Space Systems from September 2007 to June 2008.

Robert J. Stevens (61), Executive Chairman and Strategic Advisor to the Chief Executive Officer

Mr. Stevens has served as Executive Chairman and Strategic Advisor to the Chief Executive Officer since January 2013. He previously served as Chairman of the Board and Chief Executive Officer from January 2010 to December 2012, and Chairman of the Board, President and Chief Executive Officer from April 2005 to January 2010.

Bruce L. Tanner (53), Executive Vice President and Chief Financial Officer

Mr. Tanner has served as Executive Vice President and Chief Financial Officer since September 2007. He previously served as Vice President of Finance and Business Operations for Aeronautics from April 2006 to August 2007, and Vice President of Finance and Business Operations for Electronic Systems from May 2002 to March 2006.

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PART II

ITEM 5. MARKET FOR REGISTRANT S COMMON EQUITY, RELATED STOCKHOLDER MATTERS AND ISSUER PURCHASES OF EQUITY SECURITIES

At January 31, 2013, we had 34,400 holders of record of our common stock, par value $1 per share. Our common stock is traded on the New York Stock Exchange (NYSE) under the symbol LMT. Information concerning the stock prices based on intra-day trading prices as reported on the NYSE composite transaction tape and dividends paid during the past two years is as follows:

Common Stock Dividends Paid Per Share and Market Prices

	Dividends Paid Per Share		Market Prices (High-Low)			
Quarter	2012	2011	2012		2011	
First	**$1.00**	$ .75	**$ 91.01**	**$79.05**	$ 82.43	$69.62
Second	**1.00**	.75	**92.24**	**80.14**	81.92	75.10
Third	**1.00**	.75	**93.99**	**83.15**	82.23	66.36
Fourth	**1.15**	1.00	**95.92**	**87.08**	81.86	70.37
Year	**$4.15**	$3.25	**$ 95.92**	**$79.05**	$ 82.43	$66.36

Stockholder Return Performance Graph

The following graph compares the total return on a cumulative basis of $100 invested in Lockheed Martin common stock on December 31, 2007 to the Standard and Poor s (S&P) 500 Index, S&P Aerospace & Defense (S&P Aero) Index, and the S&P Industrials Index.

The S&P Aero Index comprises General Dynamics Corporation, Honeywell International, Inc., L3 Communications Holdings, Inc., Lockheed Martin Corporation, Northrop Grumman Corporation, Precision Castparts Corporation, Raytheon Company, Rockwell Collins, Inc., Textron Inc., The Boeing Company, and United Technologies Corporation. The stockholder return performance indicated on the graph is not a guarantee of future performance.

The S&P Industrials Index comprises those companies included in the S&P 500 Index that are classified as members of the industrials sector as defined by the Global Industry Classification Standard.

This graph is not deemed to be filed with the U.S. Securities and Exchange Commission or subject to the liabilities of Section 18 of the Securities Exchange Act of 1934 (the Exchange Act), and should not be deemed to be incorporated by reference into any of our prior or subsequent filings under the Securities Act of 1933 or the Exchange Act.

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Issuer Purchases of Equity Securities

The following table provides information about our repurchases of common stock during the three-month period ended December 31, 2012.

Period	Total Number of Shares Purchased	Average Price Paid Per Share	Total Number of Shares Purchased as Part of Publicly Announced Program [(a)]	Amount Available for Future Share Repurchases Under the Program [(b)]
				(in millions)
October 1, 2012 October 28, 2012	842,445	$ 93.38	842,445	$ 2,522
October 29, 2012 November 25, 2012	872,973	90.86	872,973	2,443
November 26, 2012 December 31, 2012	1,395,288	92.02	1,395,288	2,315
Total	3,110,706	$ 92.07	3,110,706	$ 2,315

(a) We repurchased a total of 3.1 million shares of our common stock for $286 million during the quarter ended December 31, 2012 under a share repurchase program that we announced in October 2010.

(b) Our Board of Directors has approved a share repurchase program for the repurchase of our common stock from time-to-time, authorizing an amount available for share repurchases of $6.5 billion. Under the program, management has discretion to determine the dollar amount of shares to be repurchased and the timing of any repurchases in compliance with applicable law and regulation. The program does not have an expiration date. As of December 31, 2012, we had repurchased a total of 54.3 million shares under the program for $4.2 billion.

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ITEM 6. SELECTED FINANCIAL DATA

(In millions, except per share data)	**2012**	**2011**	**2010**	**2009**	**2008**
OPERATING RESULTS					
Net sales	**$ 47,182**	$ 46,499	$ 45,671	$ 43,867	$ 41,212
Operating profit [(a)]	**4,434**	4,020	4,105	4,477	4,829
Net earnings from continuing operations [(a)(b)]	**2,745**	2,667	2,614	2,967	3,127
Net earnings [(c)]	**2,745**	2,655	2,878	2,973	3,185
EARNINGS PER COMMON SHARE					
Net earnings from continuing operations					
Basic [(a)]	**$ 8.48**	$ 7.94	$ 7.18	$ 7.71	$ 7.82
Diluted [(a)]	**8.36**	7.85	7.10	7.63	7.64
Net earnings					
Basic [(c)]	**8.48**	7.90	7.90	7.73	7.97
Diluted [(c)]	**8.36**	7.81	7.81	7.64	7.78
CASH DIVIDENDS PER COMMON SHARE	**$ 4.15**	$ 3.25	$ 2.64	$ 2.34	$ 1.83
BALANCE SHEET					
Cash, cash equivalents and short-term investments [(d)]	**$ 1,898**	$ 3,582	$ 2,777	$ 2,737	$ 2,229
Total current assets	**13,855**	14,094	12,893	12,529	10,736
Goodwill	**10,370**	10,148	9,605	9,948	9,526
Total assets [(e)]	**38,657**	37,908	35,113	35,167	33,495
Total current liabilities	**12,155**	12,130	11,401	10,910	10,702
Long-term debt, net [(d)]	**6,158**	6,460	5,019	5,052	3,563
Total liabilities [(e)]	**38,618**	36,907	31,616	31,201	30,742
Stockholders equity [(e)]	**39**	1,001	3,497	3,966	2,753
COMMON SHARES AT YEAR-END	**321**	321	346	373	393
CASH FLOW DATA					
Net cash provided by operating activities [(f)]	**$ 1,561**	$ 4,253	$ 3,801	$ 3,487	$ 4,724
Net cash used for investing activities	**(1,222)**	(813)	(573)	(1,832)	(1,210)
Net cash used for financing activities	**(2,023)**	(2,119)	(3,358)	(1,432)	(3,994)
BACKLOG	**$ 82,300**	$ 80,700	$ 78,400	$ 77,300	$ 80,200

(a) Our operating profit and net earnings from continuing operations included severance charges of $48 million ($31 million or $.09 per share, after tax) in 2012 (Note 13); $136 million ($88 million or $.26 per share, after tax) in 2011 (Note 13); charges for the Voluntary Executive Separation Program and facilities consolidation totaling $220 million ($143 million or $.38 per share, after tax) in 2010 (Note 13); and non-cash FAS/CAS pension adjustment of $(830) million, $(922) million, $(454) million, $(456) million, and $128 million in 2012, 2011, 2010, 2009, and 2008. Earnings per common share benefited from the significant number of shares repurchased under our share repurchase program (Note 10).

(b) Our net earnings from continuing operations included an $89 million reduction in income tax expense in 2011 through the elimination of liabilities for unrecognized tax benefits; tax expense of $96 million in 2010 as a result of health care legislation that eliminated the tax deduction for company-paid retiree prescription drug expenses to the extent they are reimbursed under Medicare Part D; and a $69 million income tax benefit in 2009 for the resolution of certain tax matters (Note 7).

(c) Our net earnings were affected by the items in notes (a) and (b) above, as well as items related to discontinued operations such as a $184 million gain ($.50 per share) in 2010 on the sale of Enterprise Integration Group, and $73 million ($.20 per share) of benefits in 2010 for certain adjustments related to Pacific Architects and Engineers in 2010 (Note 14).

(d) The decrease in our cash from 2011 to 2012 primarily was due to an increase of $1.4 billion in contributions to our qualified defined benefit pension plans during 2012. The increase in our cash and long-term debt from 2010 to 2011 primarily was due to the issuance of $2.0 billion of long-term notes in 2011, partially offset by our redemption of $584 million in long-term notes in 2011 (Note 8). The increase in our long-term debt from 2008 to 2009 primarily was due to the issuance of $1.5 billion of long-term notes in 2009.

(e) The increase in our total assets and total liabilities and decrease in stockholders equity from 2011 to 2012 and from 2010 to 2011 primarily was due to the annual remeasurement of the funded status of our postretirement benefit plans at December 31, 2012 and 2011 (Note 9).

(f) The decrease in our net cash provided by operating activities from 2011 to 2012 primarily was due to changes in working capital of $1.7 billion and increased pension contributions of $1.1 billion, net of CAS recoveries. See Liquidity and Cash Flows in Management s Discussion and Analysis of Financial Condition and Results of Operations for more information.

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ITEM 7. MANAGEMENT S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

Business Overview

We are a global security and aerospace company principally engaged in the research, design, development, manufacture, integration, and sustainment of advanced technology systems and products. We also provide a broad range of management, engineering, technical, scientific, logistic, and information services. We serve both domestic and international customers with products and services that have defense, civil, and commercial applications, with our principal customers being agencies of the U.S. Government. In 2012, 82% of our $47.2 billion in net sales were from the U.S. Government, either as a prime contractor or as a subcontractor (including 61% from the Department of Defense (DoD)), 17% were from international customers (including foreign military sales (FMS) contracted through the U.S. Government), and 1% were from U.S. commercial and other customers. Our main areas of focus are in defense, space, intelligence, homeland security, and information technology, including cyber security.

We organize our business segments based on the nature of the products and services offered. Effective December 31, 2012, we operate in five business segments: Aeronautics, Information Systems & Global Solutions (IS&GS), Missiles and Fire Control (MFC), Mission Systems and Training (MST), and Space Systems. This structure reflects the reorganization of our former Electronic Systems business segment into the new MFC and MST business segments in order to streamline our operations and enhance customer alignment. In connection with this reorganization, management layers at our former Electronic Systems business segment and our former Global Training and Logistics (GTL) business were eliminated, and the former GTL business was split between the two new business segments. In addition, operating results for Sandia Corporation, which manages the Sandia National Laboratories for the U.S. Department of Energy, and our equity interest in the U.K. Atomic Weapons Establishment (AWE) joint venture were transferred from our former Electronic Systems business segment to our Space Systems business segment. The amounts, discussion, and presentation of our business segments reflect this reorganization for all years presented in this Annual Report on Form 10-K.

We are operating in an environment that is characterized by both increasing complexity in global security, as well as continuing economic pressures in the U.S. and globally. A significant component of our strategy in this environment is to focus on program execution, improving the quality and predictability of the delivery of our products and services, and placing more security capability quickly into the hands of both our domestic and international customers at affordable prices. Recognizing that our customers are resource constrained, we are endeavoring to develop and extend our portfolio in a disciplined manner with a focus on adjacent markets close to our core capabilities. Despite the challenges we face, we expect to continue to invest in technologies to fulfill new mission requirements for our customers, invest in our people so that we have the technical skills necessary to be successful in this environment, and return at least 50% of free cash flow[1] to investors in the form of dividends and share repurchases.

Our outlook for 2013 is premised on the assumption that sequestration does not occur, that the U.S. Government continues to support and fund our programs, which is consistent with the continuing resolution funding measure through March 27, 2013, and that Congress approves defense budget legislation for government fiscal year (GFY) 2013 at a level consistent with the President s proposed defense budget for the second half of the U.S. Government s fiscal year 2013. With these assumptions, we expect 2013 net sales will decline at a mid single digit percentage rate from the record 2012 net sales amount, due to an anticipated reduction in net sales at four of five of our business segments as discussed in the Business Segment Results of Operations section below. We expect our 2013 segment operating profit will also decrease from 2012 levels at a slightly higher percentage rate than the decline in net sales due to the factors mentioned in the Business Segment Results of Operations section below, and 2013 segment operating profit margin will accordingly be slightly lower than 2012 levels. If sequestration or other budgetary cuts in lieu of sequestration occur, we expect these budget reductions would have a material effect on our corporation as discussed in the Industry Considerations section below and Item 1A- Risk Factors.

Industry Considerations

U.S. Government Business

Budget Priorities

The U.S. Government continues to focus on discretionary spending, entitlements, tax, and other initiatives to stimulate the economy, create jobs, and reduce the deficit. The Administration and Congress are attempting to balance decisions

[1] We define free cash flow as cash from operations as determined under U.S. generally accepted accounting principles (GAAP), less capital expenditures as presented on our Statements of Cash Flows.

regarding defense, homeland security, and other federal spending priorities in a constrained fiscal environment imposed by the Budget Control Act of 2011 (Budget Act), which reduced defense spending by a minimum of $487 billion over a ten-year period that began in GFY 2012. In light of the Budget Act and deficit reduction pressures generally, it is likely that discretionary spending by the federal government will remain constrained for a number of years.

Notably, should Congress and the Administration fail to change or further delay the pending sequestration of appropriations in GFY 2013 imposed by the Budget Act, currently scheduled to take effect on March 1, 2013 as adjusted by the American Taxpayer Relief Act of 2012 (Taxpayer Relief Act), both our DoD and non-DoD customers budgets would be reduced significantly and there would be a direct and significant reduction in our customers contract awards. Although the Taxpayer Relief Act delayed sequestration two months from January 2, 2013, to March 1, 2013, and reduced the amount of the GFY 2013 budget cuts, the impacts to our customers remain significant with limited time to implement spending reductions required under sequestration.

In addition, Congress passed a continuing resolution funding measure for GFY 2013 to finance all U.S. Government activities through March 27, 2013. Under this continuing resolution, partial-year funding at amounts consistent with appropriated levels for GFY 2012 are available, subject to certain restrictions, but new spending initiatives are not authorized. Our key programs continue to be supported and funded under the continuing resolution financing mechanism. However, during periods covered by continuing resolutions (or until the regular appropriation bills are passed), and pending decisions related to sequestration we may experience delays in the receipt of orders for our products and services due to lack of funding, and those delays may affect our results of operations and cash flows.

While the specific effects of sequestration still cannot be determined, automatic across-the-board cuts would approximately double the amount of the ten-year $487 billion reduction in defense spending that began in GFY 2012 already required by the Budget Act, including the budget for Overseas Contingencies Operations (OCO) and any unobligated balances from prior years, and would have significant consequences to our business and industry. Non-DoD agencies would also have significantly reduced budgets. There would be disruption of ongoing programs, impacts to our supply chain, contractual actions (including partial or complete terminations), potential facilities closures, and thousands of personnel reductions across the industry that would severely impact advanced manufacturing operations and engineering expertise, and accelerate the loss of skills and knowledge.

Current estimates suggest that sequestration would reduce total GFY 2013 non-military personnel defense funding by 9% to approximately $500 billion. In addition, general estimates suggest that sequestration could result in an approximate 5% reduction to the total GFY 2013 non-defense budget. However, if sequestration goes into effect on March 1, 2013, government agencies will have already expended funds for several months of GFY 2013. Therefore, in order to achieve the across-the-board cuts imposed by sequestration over a shorter time period, the effective percentage reductions for the remaining months of GFY 2013 would be higher than the above percentages. While current DoD planning for the ongoing continuing resolution has focused on operating accounts in lieu of other accounts such as procurement and research, development, training, and evaluation due to the ability to quickly adjust activities and programs funded in these accounts, we understand that sequestration related cuts are likely to be applied across-the-board at the individual program, project, and activity level, thus impacting all defense programs and contractors regardless of how they align to our country s most critical national priorities and mission areas. Consequently, we expect that sequestration, or other budgetary cuts in lieu of sequestration, would have a material effect on our corporation.

Our current sales outlook for 2013 is a mid single digit percentage rate decline from our record 2012 net sales amount, presuming sequestration does not occur, the continuing resolution ends on March 27, 2013, and other factors. Based on our preliminary understanding of sequestration and noting that it is difficult to estimate how sequestration would be implemented, we believe that, should Congress and the Administration fail to change or further delay sequestration, our 2013 net sales would be lower than 2012 net sales by more than the mid single digit outlook noted above. Future years could be materially impacted. However, subject to the uncertainty described above, we expect that the impact of sequestration on our operating results may lag in certain of our businesses with longer cycles such as our Aeronautics and Space Systems business segments, and our products businesses within our MFC and MST business segments, due to our production contract backlog being funded with money from the U.S. Government s GFY 2012 and prior budgets. We expect that earnings and cash flow reductions, prior to restructuring activities, would generally follow a pattern similar to the net sales reductions. We are unable to reasonably estimate the cost and cash flow impact of any restructuring initiatives (potentially including but not limited to severance payments made to employees, facility closure expenses, and impairments of assets, including goodwill) to align our cost structure to a lower sales base.

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Sequestration likely would result in significant rescheduling or termination activity with our supplier base. Such activity likely would result in claims from our suppliers, which may include both the amount established in any settlement agreements, the costs of evaluating the supplier settlement proposals, and the costs of negotiating settlement agreements. We expect that these costs would be recovered from our customers.

Lockheed Martin is committed to the fair treatment of its employees and compliance with law. Accordingly, if sequestration or other budget cuts intended to avoid sequestration occur, we will provide affected employees the notice required by the federal and applicable state Worker Adjustment and Retraining Notification (WARN) Acts when we conclude, based on the circumstances and those laws, that notice is required or otherwise appropriate. The Office of Management and Budget and DoD have issued guidance intended to assure that the costs of complying with federal and state WARN Acts are recoverable, and we expect to recover these costs.

Despite the continuing uncertainty on U.S. Government budgets, the investments and acquisitions we have made in recent years have sought to align our businesses with what we believe are the most critical national priorities and mission areas. The possibility remains, however, that our programs could be materially reduced, extended, or terminated as a result of the government s continuing assessment of priorities, changes in government priorities, the implementation of sequestration, or other budget cuts intended to avoid sequestration.

Department of Defense Business

The passage of the Budget Act imposed specific limits on security and non-security spending beginning in GFY 2013. The GFY 2013 DoD base budget is the first to reflect the reduced spending limits imposed by the Budget Act and is consistent with its limits on discretionary spending. The GFY 2014 request has been delayed as a result of the ongoing federal budgetary negotiations. The GFY 2014 request will likely reflect a continuation of the spending limits with some variation as a result of sequester negotiations.

In prior years, the Administration has requested and Congress has provided funds for U.S. military operations in Afghanistan and Iraq, and other unforeseeable contingency or peacekeeping operations, through a separate OCO funding outside of the base DoD budget. The OCO funding for GFY 2012 totaled $115 billion, and the Administration requested $88 billion for GFY 2013. We expect that the fiscal 2014 request will continue these reductions, reflecting the completion of U.S. military operations in Iraq and reduced operations in Afghanistan. Our net sales historically have not been significantly dependent on overseas contingency or supplemental funding requests and, therefore, we continue to focus our attention on the DoD s base budget for support and funding of our programs.

The GFY 2013 budget proposal reflected the Administration s new national security strategy and is consistent with the lower spending levels imposed by the Budget Act. We have no specific indications that the GFY 2014 budget will deviate significantly, other than the reduction due to the sequester delay as described above, from the estimated spending levels in the GFY 2013 request. Despite these reduced defense spending levels, we believe our broad mix of programs and capabilities continues to position us favorably to support the current and future needs of the DoD and our programs were well supported in the GFY 2013 budget request. For example, the budget supported continuation of all three variants of the F-35 and maintains the same ultimate inventory objective of 2,443 aircraft for the U.S. Government. Additionally, the DoD has specifically cited continued support for a broad spectrum of our programs.

Given the Administration s emphasis on affordability and the need to find further efficiencies in the management and operations of DoD, the need for more affordable logistics and sustainment, expansive use of information technology and knowledge-based solutions, and vastly improved levels of network and cyber security, all remain national priorities. To address these priorities, we continue to focus on growing our portfolio in these areas, diversifying our business, and expanding into adjacent businesses and programs that include surface naval vessels, unmanned aerial systems, rotary wing aviation, and land vehicles.

Non-Department of Defense Business

Our experience in the defense arena, together with our core information technology and services expertise, has enabled us to provide products and services to a number of government agencies, including the Departments of Homeland Security, Justice, Commerce, Health and Human Services, Transportation, and Energy, the U.S. Postal Service, the Social Security Administration (SSA), the Federal Aviation Administration, the National Aeronautics and Space Administration, the Veterans Administration, National Science Foundation, and the Environmental Protection Agency (EPA).

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As with the DoD, all other departments and agencies were impacted by the Budget Act. The result would be that budgets for GFY 2013 and beyond will be reduced further below the GFY 2012 budget. Should sequester go into effect on March 1, 2013, our non-DoD customers will also be significantly affected as the across-the-board reductions will also be applied to their available GFY 2013 discretionary funds. Our businesses with smaller, short-term contracts that work with our non-DoD customers could be significantly impacted by the across-the-board reductions, such as our IS&GS business segment.

We have continued to expand our capabilities in critical intelligence, knowledge management, and Government information technology solutions for our customers, including the SSA and the Centers for Medicare and Medicaid Services. We also provide program management, business strategy and consulting, complex systems development and maintenance, complete life-cycle software support, information assurance, and enterprise solutions. We believe that there will be continued demand by federal and civil government agencies for upgrading and investing in new information technology systems and solutions in order to reduce costs of operations, but at a slower pace in the near term. In addition, we believe there are opportunities in the health care and energy space.

Consistent with our DoD business, a more expansive use of information technology and knowledge-based solutions, and improved levels of network and cyber security all appear to be priorities in our non-DoD business as well. Homeland security, critical infrastructure protection, and improved service levels for civil government agencies also appear to be high customer priorities.

Other Business Considerations

International Business

We remain committed to growth in our sales to international customers. We conduct business with other governments primarily through our Aeronautics, MFC, and MST business segments. Our international sales are comprised of FMS transactions contracted through the U.S. Government and direct commercial sales transactions in which we sell directly to the international customer.

In Aeronautics, the U.S. Government and eight other government development partners are working together on the design, testing, production, and sustainment of the F-35 Lightning II, and Israel and Japan have selected the F-35 as their next generation combat aircraft. The first international deliveries of the F-35 were made in 2012, with two aircraft delivered to the United Kingdom. The number of aircraft for international customers in the more recent and future low-rate initial production (LRIP) contracts continues to increase. The F-16 Fighting Falcon has been selected by 26 customers worldwide, including recent orders from Iraq and Oman, with 54 follow-on buys from 15 countries. We continue to expand the C-130J Super Hercules air mobility aircraft s international footprint with customers in 15 countries. In global sustainment, we are leveraging our value as the original equipment manufacturer (OEM) for our major platforms, such as our agreement to upgrade 145 F-16 aircraft for Taiwan. We have also set up new production capabilities to provide service life extension, including new wings and support for the U.S., Norway, Canada, and Taiwan s P-3 fleet.

Our MFC business segment produces the Patriot Advanced Capability-3 (PAC-3) missile, an advanced defensive missile designed to intercept incoming airborne threats, for international customers including Japan, Germany, the Netherlands, Taiwan, and the United Arab Emirates (UAE). Additionally, the UAE entered into a FMS agreement with the U.S. Government for the first international sale of the Terminal High Altitude Area Defense (THAAD) missile defense system, with expectations for further production awards. Other countries in the Middle East as well as those in the Asia-Pacific region have also expressed interest in our air and missile defense systems.

In MST, with regard to the Aegis Combat System (Aegis), we perform activities in the development, production, ship integration and test, and lifetime support for ships of international customers such as Japan, Spain, Korea, and Australia. The system also has been selected to be used as a ground-based missile defense system in Europe, referred to as Aegis Ashore. This business segment has contracts with the Canadian Government for the upgrade and support of combat systems on Halifax class frigates. The Littoral Combat Ship (LCS) is another program generating interest from potential international customers. We are responsible for integrating mission systems and sensors, including the digital cockpit and weapons, for the MH-60 maritime helicopter produced for the Royal Australian Navy, and in 2012 the Danish government signed an official letter of offer and acceptance formalizing its intent to buy nine MH-60R helicopters. We continue to upgrade the United Kingdom s Warrior fighting vehicles, an award received in 2011.

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Status of F-35 Program

The F-35 program consists of multiple contracts. The development contract is being performed concurrently with the LRIP contracts. Concurrent performance of development and production contracts is used for complex programs to test airplanes, shorten the time to field systems, and achieve overall cost savings. We expect the development portion of the F-35 program will be substantially complete in 2017, with less significant efforts to continue into 2019. Production of the aircraft is expected to continue for many years given the U.S. Government s current inventory objective of 2,443 aircraft for the Air Force, Marine, and Navy variants of the aircraft, commitments from our eight international partners and two international customers, as well as expressions of interest from other countries.

On the development contract, our flight tests and test points were ahead of our goals for the year and the aircraft also surpassed 5,000 flight hours. The development contract currently has $530 million of incentive fees remaining; however, we expect to have the opportunity to earn approximately $350 million of this amount over the remainder of the contract. This amount includes about $100 million of fees that we expect will be allocated to specific milestones with the remainder allocated to a customer assessment of performance at the end of the development contract. After updating our estimates at completion on the contract in 2012, we reduced the profit booking rate to reflect lower expected estimated fees at completion. The inception to date impact of the revised booking rate reduced profit by approximately $85 million during 2012. We will continue to record profit at the revised booking rate for the duration of the contract unless further adjustments are necessary.

We continue to make progress on our production tempo with the delivery of 30 aircraft to our domestic and international customers during the year, bringing the cumulative deliveries total to 58, which includes 20 development aircraft and 38 production aircraft. We also made significant contractual progress recently with the completion of negotiations on the LRIP 5 aircraft contract, award of an undefinitized contract for certain LRIP 6 aircraft, and received long lead funding for LRIP 7 aircraft. We have 88 production aircraft in backlog as of December 31, 2012.

Given the size and complexity of the F-35 program, we anticipate that there will be continual reviews related to aircraft performance, program schedule, cost, and requirements as part of the DoD, Congressional, and international partners oversight and budgeting processes. Current program challenges include, but are not limited to, supplier and partner performance, software development, receiving funding for LRIP contracts on a timely basis, contractual withholds, executing future flight tests, and findings resulting from testing.

Portfolio Shaping Activities

We continuously strive to strengthen our portfolio of products and services to meet the current and future needs of our customers. We accomplish this in part by our independent research and development activities, and through acquisition, divestiture, and internal realignment activities. Internal realignments are designed to more fully leverage existing capabilities and enhance development and delivery of products and services.

We selectively pursue the acquisition of businesses and investments at attractive valuations that will expand or complement our current portfolio and allow access to new customers or technologies. We have made a number of niche acquisitions of businesses and investments in affiliates during the past several years. We also may explore the divestiture of businesses. In pursuing our business strategy, we routinely conduct discussions, evaluate targets, and enter into agreements regarding possible acquisitions, divestitures, joint ventures, and equity investments.

We used $304 million and $649 million for the acquisitions of businesses in 2012 and 2011. In 2012, we acquired Chandler/May, Inc. (Chandler/May) and CDL Systems Ltd. (CDL) in the fourth quarter and Procerus Technologies, L.C. (Procerus) in the first quarter. These companies specialize in the design, development, manufacturing, control, and support of advanced unmanned systems, which expand our offerings in support of our customers increased emphasis on advanced unmanned systems and are consistent with our strategy to maintain a portfolio of technology advanced options. These companies are part of our MST business segment where they have been integrated into our portfolio of unmanned systems and technologies to align their product and service offerings to the U.S. Army.

In 2011, we acquired QTC Holdings Inc. (QTC) and Sim-Industries B.V. (Sim Industries) in the fourth quarter. QTC provides outsourced medical evaluation services to the U.S. Government and has been included in our IS&GS business segment. Sim Industries designs, develops, and manufactures full-motion and fixed-based civil aviation flight simulators for a wide range of airline customers and independent pilot training centers worldwide and has been included in our MST business segment. These companies complement our core capabilities and align with our strategy to expand into closely related markets and expand our customer base.

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In pursuing our business strategies, we have also divested certain businesses over the past three years. Recent divestitures consisted of Savi Technology, Inc. (Savi) in 2012, Pacific Architects and Engineers, Inc. (PAE) in 2011, and Enterprise Integration Group (EIG) in 2010. For additional information, see Note 14 Acquisitions and Divestitures of our consolidated financial statements.

Consolidated Results of Operations

Since our operating cycle is long-term and involves many types of contracts for the design, development, and manufacturing of products and related activities with varying delivery schedules, the results of operations of a particular year, or year-to-year comparisons of recorded sales and profits, may not be indicative of future operating results. The following discussions of comparative results among years should be viewed in this context. All per share amounts cited in these discussions are presented on a per diluted share basis, unless otherwise noted. Our consolidated results of operations were as follows (in millions, except per share data):

	2012	2011	2010
Operating results			
Net sales	**$ 47,182**	$ 46,499	$ 45,671
Cost of sales [(a)]	**(42,986)**	(42,755)	(41,827)
Other income, net	**238**	276	261
Operating profit [(a)]	**4,434**	4,020	4,105
Interest expense	**(383)**	(354)	(345)
Other non-operating income (expense), net [(a)]	**21**	(35)	18
Income tax expense	**(1,327)**	(964)	(1,164)
Net earnings from continuing operations	**2,745**	2,667	2,614
Net (loss) earnings from discontinued operations		(12)	264
Net earnings	**$ 2,745**	$ 2,655	$ 2,878
Diluted earnings (loss) per common share			
Continuing operations	**$ 8.36**	$ 7.85	$ 7.10
Discontinued operations		(.04)	.71
Total	**$ 8.36**	$ 7.81	$ 7.81

(a) In the fourth quarter of 2012, gains and losses on investments used to fund our deferred compensation plan liabilities were reclassified from other non-operating income (expense), net to other unallocated costs within cost of sales for all years presented on our Statements of Earnings in order to align the classification of changes in the market value of investments held for the plan with changes in the value of the corresponding plan liabilities. The amounts in the above table and all prior year amounts included in Management s Discussion and Analysis of Financial Condition and Results of Operations reflect, as appropriate, this reclassification. Net gains on these investments in 2012, 2011, and 2010 were $67 million, $40 million, and $56 million.

The following provides an overview of our consolidated results of operations. Product sales are predominantly generated in the Aeronautics, MFC, MST, and Space Systems business segments, and most of our services sales are generated in our IS&GS and MFC business segments. Our consolidated net sales were as follows (in millions):

Net Sales

	2012	2011	2010
Net sales			
Products	**$ 37,817**	$ 36,925	$ 36,380
Services	**9,365**	9,574	9,291
Total	**$ 47,182**	$ 46,499	$ 45,671

Substantially all of our contracts are accounted for using the percentage-of-completion (POC) method of accounting. Under the POC method, we record net sales on contracts based upon our progress towards completion on a particular contract, as well as our estimate of the profit to be earned at completion. The following discussion of material changes in our consolidated net sales should be read in tandem with the following discussion of changes in our consolidated cost of sales and our Business Segment Results of Operations section because, due to the nature of POC accounting, changes in our sales are typically accompanied by a corresponding change in our cost of sales.

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Product Sales

Our product sales represent about 80% of our net sales for both 2012 and 2011. Product sales increased $892 million, or 2% in 2012 compared to 2011 due to production volume and deliveries, as well as higher risk retirements on certain programs. Product sales increased about $555 million at Aeronautics (e.g., F-35 LRIP contracts, F-16 deliveries); about $510 million at MST (e.g., ship and aviation system programs); about $225 million at Space Systems (e.g., commercial satellites, Orion Multi-Purpose Crew Vehicle (Orion) program); and about $100 million at MFC (e.g., tactical missile programs and air and missile defense programs). These increases partially were offset by lower product sales of about $495 million at IS&GS (e.g., Joint Tactical Radio System (JTRS), U.K. Census).

Our product sales represent about 80% of our net sales for both 2011 and 2010. Product sales increased $545 million, or 1%, in 2011 compared to 2010 due to production volume and deliveries, as well as higher risk retirements on certain programs. Product sales increased about $1.2 billion at Aeronautics (e.g., F-35 LRIP contracts, C-130 programs) and about $320 million at MFC (e.g., air and missile defense programs). These increases partially were offset by lower product sales of about $700 million at IS&GS (e.g., Decennial Response Integration System (DRIS) program that supported the 2010 U.S. census, JTRS); about $260 million at MST (e.g., ship and aviation system programs); and about $60 million at Space Systems (e.g., Orion program and the National Aeronautics and Space Administration (NASA) External Tank program).

Services Sales

Our services sales represent about 20% of our net sales for 2012 and 2011. Our services sales decreased $209 million, or 2%, during 2012 compared to 2011. Services sales at MFC decreased about $105 million primarily due to lower volume and risk retirements on various services programs. Services sales at MST decreased about $60 million primarily due to lower volume on various training services programs. Services sales at IS&GS decreased about $40 million primarily due to the substantial completion of the Outsourcing Desktop Initiative for NASA (ODIN) during 2011 and lower volume on the Hanford Mission Support (Hanford) contract, partially offset by higher net sales from QTC, which was acquired in the fourth quarter of 2011.

Our services sales represent about 20% of our net sales for 2011 and 2010. Our services sales increased $283 million, or 3%, during 2011 compared to 2010. The increase in services sales was attributable to higher services sales at both our MFC and IS&GS business segments. Services sales at MFC increased about $215 million primarily due to growth on the Special Operations Forces Contractor Logistics Support Services (SOF CLSS) program, partially offset by decreased volume on various services programs. Services sales at IS&GS increased about $155 million due to activities on a number of smaller contracts.

Cost of Sales

Cost of sales, for both products and services, consist of materials, labor, and subcontracting costs, as well as an allocation of indirect costs (overhead and general and administrative). For each of our contracts, we monitor the nature and amount of costs at the contract level, which form the basis for estimating our total costs at completion of the contract. Our consolidated cost of sales were as follows (in millions):

	2012	**2011**	**2010**
Cost of sales			
Cost of product sales	**$ 33,495**	$ 32,968	$ 32,539
% of product sales	**88.6%**	89.3%	89.4%
Cost of services sales	**8,383**	8,514	8,382
% of services sales	**89.5%**	88.9%	90.2%
Severance and other charges	**48**	136	220
Other unallocated costs	**1,060**	1,137	686
Total	**$ 42,986**	$ 42,755	$ 41,827

Due to the nature of POC accounting, changes in our cost of product and services sales are typically accompanied by changes in our net sales. The following discussion of material changes in our consolidated cost of sales should be read in tandem with the preceding discussion of changes in our consolidated net sales and with our Business Segment Results of Operations section. We have not identified any developing trends in cost of sales that would have a material impact on our future operations.

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Cost of Product Sales

The increase of $527 million, or 2%, in cost of product sales during 2012 compared to 2011 was attributable to higher cost of product sales at our Aeronautics, MST, and Space Systems business segments, partially offset by lower cost of product sales at our IS&GS and MFC business segments. Cost of product sales at Aeronautics increased by about $520 million primarily due to increased production volume on various programs, including F-35 LRIP contracts, and the impact of additional aircraft deliveries. Cost of product sales at MST increased by about $485 million primarily due to increased volume on ship and aviation system programs partially offset by reserves of about $55 million for contract cost matters on ship and aviation system programs recorded in the fourth quarter of 2011 (including the terminated presidential helicopter program). Cost of product sales at Space Systems increased by about $180 million primarily due to increased volume on commercial satellites programs, Orion, and various strategic and defensive missile programs. Cost of product sales at IS&GS decreased by about $530 million primarily due to the substantial completion of various programs during 2011 as well as lower volume on numerous other programs. Cost of product sales at MFC decreased by about $70 million primarily due to higher risk retirements from tactical missile programs and fire control systems programs as well as the favorable resolution of contractual matters, partially offset by volume on air and missile defense programs. The 0.7% decrease in the percentage of cost of product sales relative to product sales in 2012 compared to 2011 primarily was due to higher risk retirements (primarily tactical missile programs) as well as the favorable resolution of contractual matters at MFC and higher risk retirements and lower reserves on ship and aviation system programs at MST.

The increase of $429 million, or 1%, in cost of product sales during 2011 compared to 2010 was attributable to higher cost of product sales at our Aeronautics and MFC business segments, partially offset by lower cost of product sales at our IS&GS, MST, and Space Systems business segments. Cost of product sales at Aeronautics increased by about $1.1 billion primarily due to higher production volume on various programs, including F-35 LRIP contracts, and the impact of additional aircraft deliveries. Cost of product sales at MFC increased about $260 million primarily due to production on air and missile defense programs. Cost of product sales at IS&GS decreased about $560 million primarily due to the absence of the DRIS program and lower volume on the JTRS program. Cost of product sales at MST decreased about $230 million primarily due to decreased volume on certain ship and aviation system programs and recording of reserves on certain undersea systems programs in 2010. Cost of product sales decreased at Space Systems by about $120 million primarily due to lower volume on the NASA External Tank and Orion programs.

Cost of Services Sales

Our cost of services sales decreased $131 million, or 2%, during 2012 compared to 2011. Most of our cost of services sales are in the IS&GS and MFC business segments. The decrease in cost of services sales primarily was attributable to lower cost of services sales at our MFC and MST business segments, partially offset by higher cost of services sales at our IS&GS business segment. Cost of services sales at MFC decreased approximately $105 million primarily due to lower volume on various services programs. Cost of services sales at MST decreased approximately $90 million primarily due to lower volume on various training services programs. Cost of services sales at IS&GS increased approximately $80 million primarily due to higher net sales from QTC, which was acquired in the fourth quarter of 2011, and various other services programs partially offset by lower costs from the substantial completion of ODIN in 2011 and lower volume on the Hanford contract. The 0.6% increase in the percentage of cost of services sales relative to services sales in 2012 compared to 2011 primarily was due to risk retirements on the ODIN and Hanford contracts in 2011.

Our cost of services sales increased $132 million, or 2%, during 2011 compared to 2010. The increase in cost of services sales primarily was attributable to higher cost of services sales at our MFC business segment, partially offset by lower cost of services sales at our IS&GS business segment. Cost of services sales at MFC increased approximately $190 million primarily due to growth on the SOF CLSS program. Cost of services sales at IS&GS decreased by about $55 million primarily due to higher margins as the result of risk retirements on various programs (including ODIN) during 2011 and the recording of reserves on various programs in 2010. The 1.3% decrease in the percentage of cost of services sales relative to services sales in 2011 compared to 2010 primarily was due to the retirement of risks and other factors on numerous programs at IS&GS, partially offset by volume on SOF CLSS, which provides a lower margin relative to other MFC programs.

Severance and Other Charges

During 2012, we recorded charges related to certain severance actions totaling $48 million, net of state tax benefits, of which $25 million related to our Aeronautics business segment and $23 million related to the reorganization of our former Electronic Systems business segment (Note 3). These charges reduced our net earnings by $31 million ($.09 per share) and consisted of severance costs associated with the elimination of certain positions through either voluntary or involuntary actions. The severance actions at our Aeronautics business segment resulted from cost reduction initiatives, including the consolidation of selected program support activities among certain Aeronautics locations.

During 2011, we recorded severance charges related to various severance actions totaling $136 million, net of state tax benefits, of which $49 million, $48 million, and $39 million related to our Aeronautics business segment, Space Systems business segment, and our IS&GS business segment and Corporate Headquarters. These charges reduced our net earnings by $88 million ($.26 per share) and consisted of severance costs associated with the elimination of certain positions through either voluntary or involuntary actions. These severance actions resulted from a strategic review of these businesses and our Corporate Headquarters to better align our organization and cost structure with changing economic conditions. The workforce reductions at the business segments also reflect changes in program lifecycles, where several of our major programs are either transitioning out of development and into production or are ending.

During 2010, we recorded a charge of $178 million, net of state tax benefits, related to the Voluntary Executive Separation Program (VESP). The charge, which included lump-sum special payments for qualifying executives, reduced our net earnings by $116 million ($.31 per share). The amounts of the VESP attributable to our business segments were $25 million at Aeronautics, $42 million at IS&GS, $17 million at MFC, $21 million at MST, and $41 million at Space Systems. The remaining $32 million was attributable to our Corporate Headquarters. Also, in 2010, our MST business segment decided to consolidate certain of its operations, including the closure of a facility in Eagan, Minnesota. Accordingly, we recorded a charge to cost of sales of $42 million, net of state tax benefits, which reduced our net earnings by $27 million ($.07 per share). The majority of the charge was associated with the accrual of severance payments to employees, with the remainder associated with impairment of assets.

We expect to recover a substantial amount of these severance charges, including the charge related to the VESP, in future periods through the pricing of our products and services to the U.S. Government and other customers. While the VESP is expected to be recovered over several years, the other severance charges are typically expected to be recovered within a one-year period after the charge has been incurred, with the impact included in the respective business segment s results of operations.

Other Unallocated Costs

Other unallocated costs principally include the non-cash FAS/CAS pension adjustment, stock-based compensation, and other corporate costs. These costs are not allocated to the business segments and, therefore, are excluded from the costs of product and services sales (see Note 3 Information on Business Segments of our consolidated financial statements for a description of these items). The $77 million decrease in other unallocated costs between 2012 and 2011 primarily was due to a decrease in the non-cash FAS/CAS pension adjustment of $92 million, partially offset by fluctuations in costs associated with various corporate items, none of which were individually significant. Other unallocated costs increased $451 million between 2011 and 2010, primarily attributable to an increase in the non-cash FAS/CAS pension adjustment of $468 million, which included increased FAS pension expense in 2011 compared to 2010 due primarily to the decrease in the discount rate in 2011. For more information, see the related discussion in Critical Accounting Policies - Postretirement Benefit Plans.

Other Income, Net

Other income, net for 2012 was $238 million, compared to $276 million in 2011 and $261 million in 2010. The changes between years primarily were due to fluctuations in equity earnings in investees in our Space Systems business segment.

Interest Expense

Interest expense for 2012 was $383 million, compared to $354 million in 2011 and $345 million in 2010. The increase between the years primarily was due to increased interest expense from the $2.0 billion issuance of long-term debt on September 9, 2011, partially offset by the redemption of $500 million in certain long-term notes in the fourth quarter of 2011.

Other Non-Operating Income (Expense), Net

Other non-operating income (expense), net was $21 million in 2012, compared to $(35) million in 2011 and $18 million in 2010. The change between years primarily was due to premiums of $48 million on early extinguishments of debt that occurred in 2011 (Note 8).

Income Tax Expense

Our effective income tax rate from continuing operations was 32.6% for 2012, 26.5% for 2011, and 30.8% for 2010. The rates for all periods benefited from tax deductions for dividends related to certain of our defined contribution plans with an employee stock ownership plan feature and tax deductions for U.S. manufacturing activities.

The effective income tax rate for 2012 included a reduction in the income tax benefit of the U.S. manufacturing deduction primarily caused by the $2.5 billion discretionary pension contributions in the fourth quarter of 2012, which increased income tax expense by $59 million ($.18 per share). As a result of the accelerated pension contributions in 2012, we expect to capture most of the reduced manufacturing deduction over the next two years through higher taxable income. The effective income tax rate for 2011 included a reduction to income tax expense of $89 million, or $.26 per diluted share, through the elimination of liabilities for unrecognized tax benefits as a result of the U.S. Congressional Joint Committee on Taxation completing its review of the Internal Revenue Service Appeals Division s resolution of adjustments related to tax years 2003 through 2008. The effective income tax rates for 2011 and 2010 also included the U.S. research and development (R&D) tax credit that expired on December 31, 2011.

On January 2, 2013, the President signed into law the American Taxpayer Relief Act of 2012, which retroactively reinstates the R&D credit for two years, from January 1, 2012 through December 31, 2013. Since tax law changes are recognized in the period in which new legislation is enacted, the Corporation did not recognize the tax benefit of the R&D tax credit in 2012. The effective tax rate for 2010 was affected by the enactment of the Patient Protection and Affordable Care Act and the Health Care and Education Reconciliation Act of 2010, which eliminated the tax deduction for company-paid retiree prescription drug expenses to the extent they are reimbursed under Medicare Part D, beginning in 2013. As a result, we recorded additional income tax expense of $96 million in 2010.

Net Earnings from Continuing Operations

We reported net earnings from continuing operations of $2.75 billion ($8.36 per share) in 2012, $2.67 billion ($7.85 per share) in 2011, and $2.61 billion ($7.10 per share) in 2010. Both net earnings from continuing operations and earnings per share were affected by the factors discussed above. In addition, earnings per share in 2011 and 2010 benefited from a net decrease of common shares outstanding as a result of shares repurchased, which were partially offset by share issuances under our stock-based awards and certain defined contribution plans. Net decreases of 25.1 million and 27.0 million in 2011 and 2010 represented 7% and 7% of our shares outstanding at the beginning of each year.

Net (Loss) Earnings from Discontinued Operations

Amounts related to discontinued operations in 2012 were not significant and, accordingly, were included in operating profit. Discontinued operations for 2011 include the operating results and other adjustments of Savi, a logistics business that was in our former Electronic Systems business segment sold in the third quarter of 2012 , and PAE, a business formerly within our IS&GS business segment sold in the second quarter of 2011. Discontinued operations for 2010 include the operating results of Savi, PAE, and EIG through the date of its sale in the fourth quarter of 2010. Net loss from discontinued operations were $12 million ($.04 per share) in 2011, and net earnings from discontinued operations of $264 million ($.71 per share) in 2010.

Net earnings from discontinued operations for 2011 included a deferred tax asset of $66 million that we expected to realize on the sale of Savi because our tax basis was higher than our book basis. This tax benefit was largely offset by operating losses and other adjustments. Net earnings from discontinued operations for 2010 included a gain, net of income taxes, of $184 million ($.50 per share) from the sale of EIG. Additionally, as a result of our decision to sell PAE in 2010, we recorded net adjustments that increased 2010 earnings from discontinued operations by $73 million ($.20 per share). For more information, see Note 14 Acquisitions and Divestitures of our consolidated financial statements.

Business Segment Results of Operations

We organize our business segments based on the nature of the products and services offered. We operate in five business segments: Aeronautics, IS&GS, MFC, MST, and Space Systems.

Net sales of our business segments exclude intersegment sales, as these activities are eliminated in consolidation. Intercompany transactions are generally negotiated under terms and conditions similar to our third-party contracts.

Operating profit of our business segments includes equity earnings or losses from investees because the operating activities of the investees are closely aligned with the operations of those business segments. Operating profit of our business segments excludes the non-cash FAS/CAS pension adjustment described below; expense for stock-based compensation programs; the effects of items not considered part of management s evaluation of segment operating performance, such as charges related to significant severance actions in 2012 and 2011 and the charges in 2010 related to the VESP and the facilities consolidation within MST (Note 13); gains or losses from divestitures (Note 14); the effects of certain legal settlements; corporate costs not allocated to our business segments; and other miscellaneous corporate activities. These items are included in the reconciling item Unallocated expenses, net between operating profit from our business segments and our consolidated operating profit.

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The results of operations of our business segments include pension expense only as determined and funded in accordance with U.S. Government Cost Accounting Standards (CAS). The non-cash FAS/CAS pension adjustment represents the difference between pension expense calculated in accordance with GAAP and pension costs calculated and funded in accordance with CAS. CAS governs the extent to which pension costs can be allocated to and recovered on U.S. Government contracts. The CAS expense is recovered through the pricing of our products and services on U.S. Government contracts and, therefore, is recognized in each of our business segments net sales and cost of sales.

The operating results in the following tables exclude businesses included in discontinued operations (Note 14) for all years presented. Summary operating results for each of our business segments were as follows (in millions):

	2012	2011	2010
Net sales			
Aeronautics	**$ 14,953**	$ 14,362	$ 13,109
Information Systems & Global Solutions	**8,846**	9,381	9,921
Missiles and Fire Control	**7,457**	7,463	6,930
Mission Systems and Training	**7,579**	7,132	7,443
Space Systems	**8,347**	8,161	8,268
Total net sales	**$ 47,182**	$ 46,499	$ 45,671
Operating profit			
Aeronautics	**$ 1,699**	$ 1,630	$ 1,498
Information Systems & Global Solutions	**808**	874	814
Missiles and Fire Control	**1,256**	1,069	973
Mission Systems and Training	**737**	645	713
Space Systems	**1,083**	1,063	1,030
Total business segment operating profit	**5,583**	5,281	5,028
Unallocated expenses, net:			
Non-cash FAS/CAS pension adjustment:			
FAS pension expense	**(1,941)**	(1,821)	(1,442)
Less: CAS expense	**1,111**	899	988
Non-cash FAS/CAS pension adjustment [(a)]	**(830)**	(922)	(454)
Severance and other charges [(b)]	**(48)**	(136)	(220)
Stock-based compensation	**(167)**	(157)	(168)
Other, net [(c)]	**(104)**	(46)	(81)
Total unallocated expenses, net	**(1,149)**	(1,261)	(923)
Total consolidated operating profit	**$ 4,434**	$ 4,020	$ 4,105

(a) FAS pension expense increased in 2012 compared to 2011, and in 2011 to 2010, primarily due to the decrease in the discount rate in 2012 and 2011. The segment operating profit includes pension expense only as determined and funded in accordance with CAS. The non-cash FAS/CAS pension adjustment is expected to be about $(485) million in 2013. For more information, see the related discussion in Critical Accounting Policies - Postretirement Benefit Plans).

(b) Severance and other charges include the severance charges recorded in 2012 associated with our Aeronautics business segment and the reorganization of our former Electronic Systems business segment; for 2011, include the severance charges associated with our Aeronautics, IS&GS, and Space Systems business segments, and Corporate Headquarters; and for 2010, include the charges related to the VESP and the facilities consolidation within our MST business segment (Note 13). Severance charges for initiatives that are not significant are included in business segment operating profit.

(c) The change between years primarily was due to fluctuations in expense associated with various corporate items, none of which were individually significant.

The following segment discussions also include information relating to backlog for each segment. Backlog was approximately $82.3 billion, $80.7 billion, and $78.4 billion at December 31, 2012, 2011, and 2010. These amounts included both funded backlog (unfilled firm orders for which funding has been both authorized and appropriated by the customer Congress in the case of U.S. Government agencies) and unfunded backlog (firm orders for which funding has not yet been appropriated). Backlog does not include unexercised options or task orders to be issued under indefinite-delivery, indefinite-quantity contracts. Funded backlog was approximately $54.8 billion at December 31, 2012.

Management evaluates performance on our contracts by focusing on net sales and operating profit, and not by type or amount of operating expense. Consequently, our discussion of business segment performance focuses on net sales and operating profit, consistent with our approach for managing the business. This approach is consistent with the overall life cycle of our contracts, as management assesses the bidding of each contract by focusing on net sales and operating profit, and monitors performance on our contracts in a similar manner through their completion.

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We regularly provide customers with reports of our costs as the contract progresses. The cost information in the reports is accumulated in a manner specified by the requirements of each contract. For example, cost data provided to our customer for a product would typically align to the subcomponents of that product (such as a wing-box on an aircraft) or for services, the type of work being performed (such as help-desk support). Our contracts generally are cost-based, which allows for the recovery of costs in the pricing of our products and services. Most of our contracts are bid and negotiated with our customers under circumstances in which we are required to disclose our estimated costs to provide the product or service. This approach for negotiating contracts with our U.S. Government customers generally allows for the recovery of our costs. We also may enter into long-term supply contracts for certain materials or components, to coincide with the production schedule of certain products and to ensure their availability at known unit prices.

Many of our contracts span several years and include highly complex technical requirements. At the outset of a contract, we identify and monitor risks to the achievement of the technical, schedule, and costs aspects of the contract, and assess the effects of those risks on our estimates of total costs to complete the contract. The estimates consider the technical requirements (for example, a newly-developed product versus a mature product), the schedule and associated tasks (for example, the number and type of milestone events), and costs (for example, material, labor, subcontractor and overhead). The initial profit booking rate of each contract considers risks surrounding the ability to achieve the technical requirements, schedule, and costs in the initial estimated costs at completion. Profit booking rates may increase during the performance of the contract if we successfully retire risks surrounding the technical, schedule and costs aspects of the contract. Conversely, our profit booking rates may decrease if the estimated costs to complete the contract increase. All of the estimates are subject to change during the performance of the contract and may affect the profit booking rate.

We have a number of programs that are designated as classified by the U.S. Government which cannot be specifically described. The operating results of these classified programs are included in our consolidated and business segment results, and are subjected to the same oversight and internal controls as our other programs.

Our net sales are primarily derived from long-term contracts for products and services provided to the U.S. Government as well as FMS contracted through the U.S. Government. We account for these contracts, as well as product contracts with non-U.S. Government customers, using the POC method of accounting, which represent substantially all of our net sales. We derive our remaining net sales from contracts to provide services to non-U.S. Government customers, which we account for under the services method of accounting.

Under the POC method of accounting, we record sales on contracts based upon our progress towards completion on a particular contract as well as our estimate of the profit to be earned at completion. Cost-reimbursable contracts provide for the payment of allowable costs plus a fee. For fixed-priced contracts, net sales and cost of sales are recognized as products are delivered or as costs are incurred. Due to the nature of the POC method of accounting, changes in our cost of sales are typically accompanied by a related change in our net sales.

In the discussion of comparative segment results, changes in net sales and operating profit generally are expressed in terms of volume. Changes in volume refer to increases or decreases in sales resulting from varying production activity levels, deliveries, or service levels on individual contracts. Volume changes typically include a corresponding change in segment operating profit based on the current profit booking rate for a particular contract.

In addition, comparability of our segment operating profit may be impacted by changes in estimated profit booking rates on our contracts accounted for using the POC method of accounting. Increases in the estimated profit booking rates, typically referred to as risk retirements, usually relate to revisions in the total estimated costs at completion that reflect improved conditions on a particular contract. Conversely, conditions on a particular contract may deteriorate resulting in an increase in the estimated costs at completion and a reduction of the estimated profit booking rate. Increases or decreases in estimated profit booking rates are recognized in the current period and reflect the inception-to-date effect of such changes. Segment operating profit may also be impacted, favorably or unfavorably, by other matters such as the resolution of contractual matters, reserves for disputes, asset impairments and insurance recoveries, among others. Segment operating profit and items such as risk retirements, reductions of profit booking rates, or other matters are presented net of state income taxes.

Our consolidated net adjustments not related to volume, including net profit rate adjustments and other matters, increased segment operating profit, net of state income taxes, by approximately $1.9 billion, $1.6 billion, and $1.4 billion for 2012, 2011, and 2010. The increase in our consolidated net adjustments for 2012 as compared to 2011 primarily was due to an increase in profit booking rate adjustments and resolution of contractual matters at our MST and MFC business segments. The consolidated net adjustments for 2012 are inclusive of approximately $500 million in unfavorable items, about $100 million higher than 2011. The variance is primarily due to an adjustment on our F-35 program as described in our

Aeronautics business segment s results of operations discussion. The increase in our consolidated net adjustments for 2011 as compared to 2010 primarily was due to an increase in profit booking rate adjustments at our IS&GS and Aeronautics business segments.

Aeronautics

Our Aeronautics business segment is engaged in the research, design, development, manufacture, integration, sustainment, support, and upgrade of advanced military aircraft, including combat and air mobility aircraft, unmanned air vehicles, and related technologies. Aeronautics major programs include the F-35 Lightning II Joint Strike Fighter, F-22 Raptor, F-16 Fighting Falcon, C-130 Hercules, and the C-5M Super Galaxy. Aeronautics operating results included the following (in millions):

	2012	2011	2010
Net sales	**$ 14,953**	$ 14,362	$ 13,109
Operating profit	**1,699**	1,630	1,498
Operating margins	**11.4%**	11.3%	11.4%
Backlog at year-end	**30,100**	30,500	27,500

2012 compared to 2011

Aeronautics net sales for 2012 increased $591 million, or 4%, compared to 2011. The increase was attributable to higher net sales of approximately $745 million from F-35 LRIP contracts principally due to increased production volume; about $285 million from F-16 programs primarily due to higher aircraft deliveries (37 F-16 aircraft delivered in 2012 compared to 22 in 2011) partially offset by lower volume on sustainment activities due to the completion of modification programs for certain international customers; and approximately $140 million from C-5 programs due to higher aircraft deliveries (four C-5M aircraft delivered in 2012 compared to two in 2011). Partially offsetting the increases were lower net sales of approximately $365 million from decreased production volume and lower risk retirements on the F-22 program as final aircraft deliveries were completed in the second quarter of 2012; approximately $110 million from the F-35 development contract primarily due to the inception-to-date effect of reducing the profit booking rate in the second quarter of 2012 and to a lesser extent lower volume; and about $95 million from a decrease in volume on other sustainment activities partially offset by various other Aeronautics programs due to higher volume. Net sales for C-130 programs were comparable to 2011 as a decline in sustainment activities largely was offset by increased aircraft deliveries.

Aeronautics operating profit for 2012 increased $69 million, or 4%, compared to 2011. The increase was attributable to higher operating profit of approximately $105 million from C-130 programs due to an increase in risk retirements; about $50 million from F-16 programs due to higher aircraft deliveries partially offset by a decline in risk retirements; approximately $50 million from F-35 LRIP contracts due to increased production volume and risk retirements; and about $50 million from the completion of purchased intangible asset amortization on certain F-16 contracts. Partially offsetting the increases was lower operating profit of about $90 million from the F-35 development contract primarily due to the inception-to-date effect of reducing the profit booking rate in the second quarter of 2012; approximately $50 million from decreased production volume and risk retirements on the F-22 program partially offset by a resolution of a contractual matter in the second quarter of 2012; and approximately $45 million primarily due to a decrease in risk retirements on other sustainment activities partially offset by various other Aeronautics programs due to increased risk retirements and volume. Operating profit for C-5 programs was comparable to 2011. Adjustments not related to volume, including net profit booking rate adjustments and other matters described above, were approximately $30 million lower for 2012 compared to 2011.

2011 compared to 2010

Aeronautics net sales for 2011 increased $1.3 billion, or 10%, compared to 2010. The growth in net sales primarily was due to higher volume of about $850 million for work performed on the F-35 LRIP contracts as production increased; higher volume of about $745 million for C-130 programs due to an increase in deliveries (33 C-130J aircraft delivered in 2011 compared to 25 during 2010) and support activities; about $425 million for F-16 support activities and an increase in aircraft deliveries (22 F-16 aircraft delivered in 2011 compared to 20 during 2010); and approximately $90 million for higher volume on C-5 programs (two C-5M aircraft delivered in 2011 compared to one during 2010). These increases partially were offset by a decline in net sales of approximately $675 million due to lower volume on the F-22 program and lower net sales of about $155 million for the F-35 development contract as development work decreased.

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Aeronautics operating profit for 2011 increased $132 million, or 9%, compared to 2010. The increase primarily was attributable to approximately $115 million of higher operating profit on C-130 programs due to increased volume and the retirement of risks; increased volume and risk retirements on F-16 programs of about $50 million and C-5 programs of approximately $20 million; and about $70 million due to risk retirements on other Aeronautics sustainment activities in 2011. These increases partially were offset by a decline in operating profit of approximately $75 million on the F-22 program and F-35 development contract primarily due to lower volume and about $55 million on other programs, including F-35 LRIP, primarily due to lower profit rate adjustments in 2011 compared to 2010. Adjustments not related to volume, including net profit rate adjustments described above, were approximately $90 million higher in 2011 compared to 2010.

Backlog

Backlog decreased in 2012 compared to 2011 mainly due to lower orders on F-35 contracts and C-130 programs, partially offset by higher orders on F-16 programs. Backlog increased in 2011 compared to 2010 mainly due to higher orders on F-35 contracts, which partially were offset by higher sales volume on the C-130 programs.

Trends

We expect Aeronautics will experience a mid single digit percentage range decline in net sales for 2013 as compared to 2012. A decrease in net sales from a decline in F-16 and C-130J aircraft deliveries is expected to be partially offset by an increase in net sales volume on F-35 LRIP contracts. Operating profit is projected to decrease at a high single digit percentage range from 2012 levels due to the expected decline in net sales as well as changes in aircraft mix, resulting in a slight decline in operating margins between the years.

Information Systems & Global Solutions

Our IS&GS business segment provides management services, integrated information technology solutions, and advanced technology systems and expertise across a broad spectrum of applications for civil, defense, intelligence, and other government customers. IS&GS has a portfolio of many smaller contracts as compared to our other business segments. IS&GS has been impacted by the continuing downturn in the federal information technology budgets and the impact of the continuing resolution that was effective on October 1, 2012, the start of the U.S. Government s fiscal year. IS&GS operating results included the following (in millions):

	2012	2011	2010
Net sales	**$ 8,846**	$ 9,381	$ 9,921
Operating profit	**808**	874	814
Operating margins	**9.1%**	9.3%	8.2%
Backlog at year-end	**8,700**	9,300	9,700

2012 compared to 2011

IS&GS net sales for 2012 decreased $535 million, or 6%, compared to 2011. The decrease was attributable to lower net sales of approximately $485 million due to the substantial completion of various programs during 2011 (primarily JTRS; ODIN; and U.K. Census); and about $255 million due to lower volume on numerous other programs (primarily Hanford; Warfighter Information Network-Tactical (WIN-T); Command, Control, Battle Management and Communications (C2BMC); and Transportation Worker Identification Credential (TWIC)). Partially offsetting the decreases were higher net sales of approximately $140 million from QTC, which was acquired early in the fourth quarter of 2011; and about $65 million from increased activity on numerous other programs, primarily federal cyber security programs and Persistent Threat Detection System (PTDS) operational support.

IS&GS operating profit for 2012 decreased $66 million, or 8%, compared to 2011. The decrease was attributable to lower operating profit of approximately $50 million due to the favorable impact of the ODIN contract completion in 2011; about $25 million due to an increase in reserves for performance issues related to an international airborne surveillance system in 2012; and approximately $20 million due to lower volume on certain programs (primarily C2BMC and WIN-T). Partially offsetting the decreases was an increase in operating profit due to higher risk retirements of approximately $15 million from the TWIC program; and about $10 million due to increased activity on numerous other programs, primarily federal cyber security programs and PTDS operational support. Operating profit for the JTRS program was comparable as a decrease in volume was offset by a decrease in reserves. Adjustments not related to volume, including net profit booking rate adjustments and other matters described above, were approximately $20 million higher for 2012 compared to 2011.

2011 compared to 2010

IS&GS net sales for 2011 decreased $540 million, or 5%, compared to 2010. The decrease primarily was attributable to lower volume of approximately $665 million due to the absence of the DRIS program that supported the 2010 U.S. census and a decline in activities on the JTRS program. This decrease partially was offset by increased net sales on numerous programs.

IS&GS operating profit for 2011 increased $60 million, or 7%, compared to 2010. Operating profit increased approximately $180 million due to volume and the retirement of risks in 2011 and the absence of reserves recognized in 2010 on numerous programs (including among others, ODIN (about $60 million) and TWIC and Automated Flight Service Station programs). The increases in operating profit partially were offset by the absence of the DRIS program and a decline in activities on the JTRS program of about $120 million. Adjustments not related to volume, including net profit rate adjustments described above, were approximately $130 million higher in 2011 compared to 2010.

Backlog

Backlog decreased in 2012 compared to 2011 primarily due to the substantial completion of various programs in 2011 (primarily ODIN, U.K. Census, and JTRS). The decrease in backlog during 2011 compared to 2010 mainly was due to declining activities on the JTRS program and several other smaller programs.

Trends

We expect IS&GS net sales to decline in 2013 in the mid single digit percentage range as compared to 2012 primarily due to the continued downturn in federal information technology budgets. Operating profit is expected to decline in 2013 in the mid single digit percentage range consistent with the expected decline in net sales, resulting in margins that are comparable with 2012 results.

Missiles and Fire Control

Our MFC business segment provides air and missile defense systems; tactical missiles and air-to-ground precision strike weapon systems; fire control systems; mission operations support, readiness, engineering support, and integration services; logistics and other technical services; and manned and unmanned ground vehicles. MFC s major programs include PAC-3, THAAD, Multiple Launch Rocket System (MLRS), Hellfire, Javelin, Joint Air-to-Surface Standoff Missile (JASSM), Apache Fire Control System (Apache), Sniper®, Low Altitude Navigation and Targeting Infrared for Night (LANTIRN®), and SOF CLSS. MFC s operating results included the following (in millions):

	2012	2011	2010
Net sales	**$ 7,457**	$ 7,463	$ 6,930
Operating profit	**1,256**	1,069	973
Operating margins	**16.8%**	14.3%	14.0%
Backlog at year-end	**14,700**	14,400	12,800

2012 compared to 2011

MFC s net sales for 2012 were comparable to 2011. Net sales decreased approximately $130 million due to lower volume and risk retirements on various services programs, and about $60 million due to lower volume from fire control systems programs (primarily Sniper®; LANTIRN®; and Apache). The decreases largely were offset by higher net sales of approximately $95 million due to higher volume from tactical missile programs (primarily Javelin and Hellfire) and approximately $80 million for air and missile defense programs (primarily PAC-3 and THAAD).

MFC s operating profit for 2012 increased $187 million, or 17%, compared to 2011. The increase was attributable to higher risk retirements and volume of about $95 million from tactical missile programs (primarily Javelin and Hellfire); increased risk retirements and volume of approximately $60 million for air and missile defense programs (primarily THAAD and PAC-3); and about $45 million from a resolution of contractual matters. Partially offsetting these increases was lower risk retirements and volume on various programs, including $25 million for services programs. Adjustments not related to volume, including net profit booking rate adjustments and other matters described above, were approximately $145 million higher for 2012 compared to 2011.

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2011 compared to 2010

MFC s net sales for 2011 increased $533 million, or 8%, compared to 2010. The increase was attributable to higher volume of about $420 million on air and missile defense programs (primarily PAC-3 and THAAD); and about $245 million from fire control systems programs primarily related to the SOF CLSS program, which began late in the third quarter of 2010. Partially offsetting these increases were lower net sales due to decreased volume of approximately $75 million primarily from various services programs and approximately $20 million from tactical missile programs (primarily MLRS and JASSM).

MFC s operating profit for 2011 increased $96 million, or 10%, compared to 2010. The increase was attributable to higher operating profit of about $60 million for air and missile defense programs (primarily PAC-3 and THAAD) as a result of increased volume and retirement of risks; and approximately $25 million for various services programs. Adjustments not related to volume, including net profit rate adjustments described above, were approximately $35 million higher in 2011 compared to 2010.

Backlog

Backlog increased in 2012 compared to 2011 mainly due to increased orders and lower sales on fire control systems programs (primarily LANTIRN® and Sniper®) and on various services programs, partially offset by lower orders and higher sales volume on tactical missiles programs. Backlog increased in 2011 compared to 2010 primarily due to increased orders on air and missile defense programs (primarily THAAD).

Trends

We expect MFC s net sales for 2013 will be comparable with 2012. We expect low double digit percentage growth in air and missile defense programs, offset by an expected decline in volume on logistics services programs. Operating profit and margin are expected to be comparable with 2012 results.

Mission Systems and Training

Our MST business segment provides surface ship and submarine combat systems; sea and land-based missile defense systems; radar systems; mission systems and sensors for rotary and fixed-wing aircraft; littoral combat ships; simulation and training services; unmanned technologies and platforms; ship systems integration; and military and commercial training systems. MST s major programs include Aegis, MK-41 Vertical Launching System (VLS), TPQ-53 Radar System, MH-60, LCS, and PTDS. MST s operating results included the following (in millions):

	2012	2011	2010
Net sales	**$ 7,579**	$ 7,132	$ 7,443
Operating profit	**737**	645	713
Operating margins	**9.7%**	9.0%	9.6%
Backlog at year-end	**10,700**	10,500	10,600

2012 compared to 2011

MST s net sales for 2012 increased $447 million, or 6%, compared to 2011. The increase in net sales for 2012 was attributable to higher volume and risk retirements of approximately $395 million from ship and aviation system programs (primarily PTDS; LCS; VLS; and MH-60); about $115 million for training and logistics solutions programs primarily due to net sales from Sim Industries, which was acquired in the fourth quarter of 2011; and approximately $30 million as a result of increased volume on integrated warfare systems and sensors programs (primarily Aegis). Partially offsetting the increases were lower net sales of approximately $70 million from undersea systems programs due to lower volume on an international combat system program and towed array systems; and about $25 million due to lower volume on various other programs.

MST s operating profit for 2012 increased $92 million, or 14%, compared to 2011. The increase was attributable to higher operating profit of approximately $175 million from ship and aviation system programs, which reflects higher volume and risk retirements on certain programs (primarily VLS; PTDS; MH-60; and LCS) and reserves of about $55 million for contract cost matters on ship and aviation system programs recorded in the fourth quarter of 2011 (including the terminated presidential helicopter program). Partially offsetting the increase was lower operating profit of approximately $40 million from undersea systems programs due to reduced profit booking rates on certain programs and lower volume on an international combat system program and towed array systems; and about $40 million due to lower volume on various other programs. Adjustments not related to volume, including net profit booking rate adjustments and other matters described above, were approximately $150 million higher for 2012 compared to 2011.

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2011 compared to 2010

MST s net sales for 2011 decreased $311 million, or 4%, compared to 2010. The decrease was attributable to decreased volume of approximately $390 million for certain ship and aviation system programs (primarily Maritime Patrol Aircraft and PTDS) and approximately $75 million for training and logistics solutions programs. Partially offsetting these decreases was higher sales of about $165 million from production on the LCS program.

MST s operating profit for 2011 decreased $68 million, or 10%, compared to 2010. The decrease was attributable to decreased operating profit of approximately $55 million as a result of increased reserves for contract cost matters on various ship and aviation system programs (including the terminated presidential helicopter program) and approximately $40 million due to lower volume and increased reserves on training and logistics solutions. Partially offsetting these decreases was higher operating profit of approximately $30 million in 2011 primarily due to the recognition of reserves on certain undersea systems programs in 2010. Adjustments not related to volume, including net profit rate adjustments described above, were approximately $55 million lower in 2011 compared to 2010.

Backlog

Backlog increased in 2012 compared to 2011 mainly due to increased orders on ship and aviation system programs (primarily MH-60 and LCS), partially offset decreased orders and higher sales volume on integrated warfare systems and sensors programs (primarily Aegis). Backlog decreased slightly in 2011 compared to 2010 primarily due to higher sales volume on various integrated warfare systems and sensors programs.

Trends

We expect MST s net sales to decline in 2013 in the low single digit percentage range as compared to 2012 due to the completion of PTDS deliveries in 2012 and expected lower volume on training services programs. Operating profit and margin are expected to increase slightly from 2012 levels primarily due to anticipated improved contract performance.

Space Systems

Our Space Systems business segment is engaged in the research and development, design, engineering, and production of satellites, strategic and defensive missile systems, and space transportation systems. Space Systems is also responsible for various classified systems and services in support of vital national security systems. Space Systems major programs include the Space-Based Infrared System (SBIRS), Advanced Extremely High Frequency (AEHF) system, Mobile User Objective System (MUOS), Global Positioning Satellite (GPS) III system, Geostationary Operational Environmental Satellite R-Series (GOES-R), Trident II D5 Fleet Ballistic Missile, and Orion. Operating results for our Space Systems business segment include our equity interests in United Launch Alliance (ULA), which provides expendable launch services for the U.S. Government, United Space Alliance (USA), which provided processing activities for the Space Shuttle program and is winding down following the completion of the last Space Shuttle mission in 2011, and a joint venture that manages the U.K. s Atomic Weapons Establishment program. Space Systems operating results included the following (in millions):

	2012	2011	2010
Net sales	**$ 8,347**	$ 8,161	$ 8,268
Operating profit	**1,083**	1,063	1,030
Operating margins	**13.0%**	13.0%	12.5%
Backlog at year-end	**18,100**	16,000	17,800

2012 compared to 2011

Space Systems net sales for 2012 increased $186 million, or 2%, compared to 2011. The increase was attributable to higher net sales of approximately $150 million due to increased commercial satellite deliveries (two commercial satellites delivered in 2012 compared to one during 2011); about $125 million from the Orion program due to higher volume and an increase in risk retirements; and approximately $70 million from increased volume on various strategic and defensive missile programs. Partially offsetting the increases were lower net sales of approximately $105 million from certain government satellite programs (primarily SBIRS and MUOS) as a result of decreased volume and a decline in risk retirements; and about $55 million from the NASA External Tank program, which ended in connection with the completion of the Space Shuttle program in 2011.

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Space Systems operating profit for 2012 increased $20 million, or 2%, compared to 2011. The increase was attributable to higher operating profit of approximately $60 million from commercial satellite programs due to increased deliveries and reserves recorded in 2011; and about $40 million from the Orion program due to higher risk retirements and increased volume. Partially offsetting the increases was lower operating profit of approximately $45 million from lower volume and risk retirements on certain government satellite programs (primarily SBIRS); about $20 million from lower risk retirements and lower volume on the NASA External Tank program, which ended in connection with the completion of the Space Shuttle program in 2011; and approximately $20 million from lower equity earnings as a decline in launch related activities at ULA partially was offset by the resolution of contract cost matters associated with the wind-down of USA. Adjustments not related to volume, including net profit booking rate adjustments described above, were approximately $15 million higher for 2012 compared to 2011.

2011 compared to 2010

Space Systems net sales for 2011 decreased $107 million, or 1%, compared to 2010. The decrease in net sales was attributable to a decline of about $90 million related to the NASA External Tank program, which ended in connection with the completion of the last Space Shuttle mission in July 2011; a decline in volume of about $90 million related to the Orion program; and lower volume of approximately $30 million related to government satellites. These decreases partially were offset by higher volume for fleet ballistic and defensive missile systems of about $80 million and commercial satellites of approximately $45 million (one commercial satellite delivery in both 2011 and 2010).

Space Systems operating profit for 2011 increased $33 million, or 3%, compared to 2010. The increase in operating profit principally was attributable to retirement of risks on government satellite programs of about $60 million, partially offset by decreased equity earnings of about $15 million primarily due to the wind-down of USA. Adjustments not related to volume, including net profit rate adjustments described above, were approximately $15 million higher in 2011 compared to 2010.

Equity earnings

Total equity earnings recognized by the Space Systems segment from ULA, USA, and AWE represented approximately $265 million, or 24% of this segment s operating profit during 2012. During 2011 and 2010, total equity earnings recognized by the Space Systems segment from ULA, USA, and AWE represented approximately $285 million and $300 million, or 27% and 29% of this segment s operating profit.

Backlog

Backlog increased in 2012 compared to 2011 mainly due to higher orders on government satellites activities, partially offset by lower orders on the Orion program. Backlog decreased in 2011 compared to 2010 mainly due to higher sales volume associated with the Orion program and on government satellite activities.

Trends

We expect Space Systems net sales to decline in 2013 in the mid single digit percentage range as compared to 2012 due primarily to the absence of any commercial satellite deliveries in 2013. Operating profit is expected to decline in the low double digit percentage range in 2013 primarily due to lower equity earnings from USA, as no further significant activity is expected due to its wind-down in 2012, and lower sales volume, resulting in a decline in operating margins between the years.

Liquidity and Cash Flows

We have a balanced cash deployment strategy to enhance stockholder value and position ourselves to take advantage of new business opportunities when they arise. Consistent with that strategy, we have invested in our business, including capital expenditures and independent research and development, returned cash to stockholders through dividends and share repurchases, made selective acquisitions of businesses, and managed our debt levels.

We have generated strong operating cash flows, which have been the primary source of funding for our operations, debt service and repayments, capital expenditures, share repurchases, dividends, acquisitions, and postretirement benefit plan funding. We have accessed the capital markets on limited occasions, as needed or when opportunistic. We expect our cash from operations will continue to be sufficient to support our operations and anticipated capital expenditures for the

foreseeable future. We have financing resources available to fund potential cash outflows that are less predictable or more discretionary, as discussed in the Capital Structure, Resources, and Other section. We have access to the credit markets, if needed, for liquidity or general corporate purposes, including letters of credit to support customer advance payments and for other trade finance purposes such as guaranteeing our performance on particular contracts.

Cash received from customers, either from the payment of invoices for work performed or for advances in excess of costs incurred, is our primary source of cash. We generally do not begin work on contracts until funding is appropriated by the customer. Billing timetables and payment terms on our contracts vary based on a number of factors, including the contract type. We generally bill and collect cash more frequently under cost-reimbursable and time-and-materials contracts, which together represent approximately half of the sales we recorded in 2012, as we are authorized to bill as the costs are incurred or work is performed. By way of contrast, we generally do not bill our fixed-price contracts until milestones, including deliveries, are achieved. A number of our fixed-price contracts may provide for performance-based payments, which allow us to bill and collect cash as we perform on the contract. The amount of performance-based payments and the related milestones are encompassed in the negotiation of each contract. Such payments may precede our incurrence of costs related to our contract performance, thereby increasing our cash flows.

The U.S. Government has indicated that it would consider progress payments as the baseline for negotiating payment terms on fixed-price contracts, rather than performance-based payments. In contrast to negotiated performance-based payment terms, progress payment provisions correspond to a percentage of the amount of costs incurred during the performance of the contract. While the total amount of cash collected on a contract is the same, performance-based payments have had a more favorable impact on the timing of our cash flows. In addition, our cash flows may be affected if the U.S. Government decides to withhold payments on receivables. The amount of withholds increased to approximately $200 million as of December 31, 2012, primarily at our Aeronautics business segment related to U.S. Government audits of our business systems and certain delivered F-35 aircraft. While the impact of withholding delays the receipt of cash, the cumulative amount of cash collected during the life of the contract will not vary.

The majority of our capital expenditures for 2012 and those planned for 2013 can be divided into the categories of facilities infrastructure, equipment, and information technology. Expenditures for facilities infrastructure and equipment are generally incurred to support new and existing programs across all of our business segments. For example, we have projects underway in our Aeronautics business segment for facilities and equipment to support production of the F-35 combat aircraft. In addition, we have projects underway to modernize certain of our facilities, inclusive of our efforts to consolidate and reduce leased facilities. We also incur capital expenditures for information technology to support programs and general enterprise information technology infrastructure as well as for the development or purchase of internal-use software.

The following table provides a summary of our cash flow information (in millions) followed by a discussion of the key elements:

	2012	2011	2010
Operating activities			
Net earnings	**$ 2,745**	$ 2,655	$ 2,878
Non-cash adjustments	**2,133**	1,194	1,721
Changes in working capital	**(1,061)**	674	138
Other, net	**(2,256)**	(270)	(936)
Net cash provided by operating activities	**$ 1,561**	$ 4,253	$ 3,801
Net cash used for investing activities	**$ (1,222)**	$ (813)	$ (573)
Net cash used for financing activities	**$ (2,023)**	$ (2,119)	$ (3,358)
Cash and cash equivalents at end of year	**$ 1,898**	$ 3,582	$ 2,261

Operating Activities

2012 compared to 2011

Net cash provided by operating activities decreased $2.7 billion in 2012 as compared to 2011 primarily due to changes in working capital of $1.7 billion and increased pension contributions of $1.1 billion, net of CAS recoveries. The decrease of $1.7 billion in cash provided by working capital (defined as accounts receivable and inventories less accounts payable and customer advances and amounts in excess of costs incurred) was driven by higher payments of accounts payable due to timing as well as the timing of production and billing cycles affecting customer advances and progress payments applied to

inventories. Additionally, growth in accounts receivable, primarily due to the timing of finalizing contract negotiations on the F-35 LRIP contracts in the fourth quarter of 2012, which delayed our billings, as well as the impact of U.S. Government withholdings on the F-35 program reduced the cash provided by operating activities.

2011 compared to 2010

Net cash provided by operating activities increased by $452 million in 2011 as compared to 2010 primarily due to changes in working capital. Cash provided by working capital increased by $536 million due to increases in accounts payable resulting from the timing of payments and an increase in customer advances due to the timing of production and billing schedules. This improvement in cash from working capital partially was offset by an increase in accounts receivable primarily due to the timing of contract negotiations and billing activities on the F-35 program. Partially offsetting the increase in cash provided by working capital was higher pension contributions, net of CAS recoveries of $134 million.

Investing Activities

Capital expenditures Capital expenditures amounted to $942 million in 2012, $987 million in 2011, and $1.1 billion in 2010.

Acquisitions, divestitures and other activities Acquisition activities include both the acquisition of businesses and investments in affiliates. We paid $304 million in 2012 for acquisition activities, primarily related to the acquisitions of Chandler/May, CDL, and Procerus (Note 14). In 2011, we paid $649 million for acquisition activities, primarily related to the acquisitions of QTC and Sim-Industries (Note 14). In 2010, we paid $148 million primarily related to investments in affiliates. In 2010, we received proceeds of $798 million from the sale of EIG (Note 14). During 2011, we decreased our short-term investments by $510 million compared to an increase of $171 million in 2010.

Financing Activities

Dividends and share activity We paid dividends totaling $1.4 billion ($4.15 per share) in 2012, $1.1 billion ($3.25 per share) in 2011, and $969 million ($2.64 per share) in 2010. We have increased our quarterly dividend rate in each of the last three years, including a 15% increase in the quarterly dividend rate in the fourth quarter of 2012. We declared quarterly dividends of $1.00 per share during each of the first three quarters of 2012 and $1.15 per share for the last quarter; $.75 per share during each of the first three quarters of 2011 and $1.00 per share for the last quarter; and $.63 per share during each of the first three quarters of 2010 and $.75 per share for the last quarter.

We paid cash totaling $1.0 billion, $2.5 billion, and $2.4 billion for share repurchases during 2012, 2011, and 2010. Pursuant to our share repurchase program, we are authorized to repurchase up to $6.5 billion of our common stock. Under the program, we have discretion to determine the dollar amount of shares to be repurchased and the timing of any repurchases in compliance with applicable law and regulation. As of December 31, 2012, we had repurchased a total of 54.3 million shares of our common stock under the program for $4.2 billion, and there remained $2.3 billion authorized for additional share repurchases.

Cash received from the issuance of our common stock in connection with stock option exercises during 2012, 2011, and 2010 totaled $440 million, $116 million, and $59 million. Those activities resulted in the issuance of 6.7 million shares, 2.3 million shares, and 1.4 million shares during the respective periods.

Long-term debt In 2012, we paid $225 million to complete an exchange of debt (Note 8) to take advantage of the low interest rate environment. In 2011, we issued a total of $2.0 billion of long-term notes with fixed coupon rates ranging from 2.13% to 4.85%. We used a portion of the proceeds from the long-term notes that were issued in 2011 to redeem all of our $500 million long-term notes due in 2013 with a fixed coupon rate of 4.12%. In 2011, we also repurchased $84 million of our long-term notes through open-market purchases and paid premiums of $48 million in connection with the early extinguishments of certain long-term notes.

Capital Structure, Resources, and Other

At December 31, 2012, we held cash and cash equivalents of $1.9 billion. As of December 31, 2012, approximately $500 million of our cash and cash equivalents was held outside of the U.S. by foreign subsidiaries. Although those balances are generally available to fund ordinary business operations without legal or other restrictions, a significant portion is not immediately available to fund U.S. operations unless repatriated. Our intention is to permanently reinvest earnings from our foreign subsidiaries. While we do not intend to do so, if this cash was repatriated at the end of 2012, we estimate that about $45 million of U.S. federal income tax would have been due after considering foreign tax credits.

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Our long-term debt, net of unamortized discounts, amounted to $6.2 billion, and mainly is in the form of publicly-issued notes that bear interest at fixed rates. As of December 31, 2012, we were in compliance with all covenants contained in our debt and credit agreements.

In August 2011, we entered into a $1.5 billion revolving credit facility with a group of banks and terminated our existing $1.5 billion revolving credit facility that was to expire in June 2012. The credit facility expires August 2016, and we may request and the banks may grant, at their discretion, an increase to the credit facility by an additional amount up to $500 million. There were no borrowings outstanding under either facility through December 31, 2012. Borrowings under the credit facility would be unsecured and bear interest at rates based, at our option, on a Eurodollar rate or a Base Rate, as defined in the credit facility. Each bank s obligation to make loans under the credit facility is subject to, among other things, our compliance with various representations, warranties and covenants, including covenants limiting our ability and certain of our subsidiaries ability to encumber assets and a covenant not to exceed a maximum leverage ratio, as defined in the credit facility. The leverage ratio covenant excludes the adjustments recognized in stockholders equity related to postretirement benefit plans. As of December 31, 2012, we were in compliance with all covenants contained in the credit facility, as well as in our debt agreements.

We have agreements in place with banking institutions to provide for the issuance of commercial paper. There were no commercial paper borrowings outstanding during the year ended December 31, 2012. If we were to issue commercial paper, the borrowings would be supported by the credit facility. We also have an effective shelf registration statement on Form S-3 on file with the U.S. Securities and Exchange Commission through August 2014 to provide for the issuance of an indeterminate amount of debt securities.

We actively seek to finance our business in a manner that preserves financial flexibility while minimizing borrowing costs to the extent practicable. We review changes in financial market and economic conditions to manage the types, amounts, and maturities of our indebtedness. We may at times refinance existing indebtedness, vary our mix of variable-rate and fixed-rate debt, or seek alternative financing sources for our cash and operational needs.

Our stockholders equity was $39 million at December 31, 2012, a decrease of $962 million from December 31, 2011. The decrease was due to the annual December 31 re-measurement adjustment related to our postretirement benefit plans of $3.2 billion, which was partially offset by the amortization of net actuarial gains and losses of $858 million in 2012; dividends declared of $1.4 billion during the year; and the repurchase of 11.3 million common shares for $1.0 billion. These decreases partially were offset by net earnings of $2.7 billion and employee stock activity of $900 million. As we repurchase our common shares, we reduce common stock for the $1 of par value of the shares repurchased, with the excess purchase price over par value recorded as a reduction of additional paid-in capital. Due to the volume of repurchases made under our share repurchase program, additional paid-in capital was reduced to zero, with the remainder of the excess of purchase price over par value of $108 million recorded as a reduction of retained earnings.

If in the future we were to have a deficit in stockholders equity as a result of further adjustments associated with the funded status of postretirement benefit plans, the deficit would not affect our ability to comply with our debt covenants. The debt-related financial covenants in our revolving credit facility exclude the effect of adjustments to stockholders equity resulting from re-measuring the funded status of postretirement plans. In addition, as a Maryland corporation, so long as we are able to pay our indebtedness as it becomes due in the usual course of business, we anticipate that we would be able to pay dividends and make stock repurchases in an amount limited to our net earnings in either the current or the preceding fiscal year or from the net earnings for the preceding eight quarters.

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Contractual Commitments and Off-Balance Sheet Arrangements

At December 31, 2012, we had contractual commitments to repay debt, make payments under operating leases, settle obligations related to agreements to purchase goods and services, and settle tax and other liabilities. Capital lease obligations were not material. Payments due under these obligations and commitments are as follows (in millions):

		Payments Due By Period			
		Less Than	Years	Years	After
	Total	1 Year	2 and 3	4 and 5	5 Years
Long-term debt [a]	$ 7,165	$ 150	$	$ 952	$ 6,063
Interest payments	6,243	355	698	633	4,557
Other liabilities	2,628	271	430	365	1,562
Operating lease obligations	859	229	279	151	200
Purchase obligations:					
Operating activities	24,837	14,859	8,127	1,697	154
Capital expenditures	216	102	78	36	
Total contractual cash obligations	$ 41,948	$ 15,966	$ 9,612	$ 3,834	$ 12,536

(a) Long-term debt includes scheduled principal payments only.

Amounts related to other liabilities represent the contractual obligations for certain long-term liabilities recorded as of December 31, 2012. Such amounts mainly include expected payments under non-qualified pension plans, environmental liabilities, and deferred compensation plans.

Purchase obligations related to operating activities include agreements and contracts that give the supplier recourse to us for cancellation or nonperformance under the contract or contain terms that would subject us to liquidated damages. Such agreements and contracts may, for example, be related to direct materials, obligations to subcontractors, and outsourcing arrangements. Total purchase obligations for operating activities in the preceding table include approximately $22.8 billion related to contractual commitments entered into as a result of contracts we have with our U.S. Government customers. The U.S. Government generally would be required to pay us for any costs we incur relative to these commitments if they were to terminate the related contracts for convenience under the FAR, subject to available funding. This also would be true in cases where we perform subcontract work for a prime contractor under a U.S. Government contract. The termination for convenience language also may be included in contracts with foreign, state, and local governments. We also have contracts with customers that do not include termination for convenience provisions, including contracts with commercial customers.

Purchase obligations in the preceding table for capital expenditures generally include amounts for facilities and equipment related to customer contracts.

We also may enter into industrial cooperation agreements, sometimes referred to as offset agreements, as a condition to obtaining orders for our products and services from certain customers in foreign countries. These agreements are designed to enhance the social and economic environment of the foreign country by requiring the contractor to promote investment in the country. Offset agreements may be satisfied through activities that do not require us to use cash, including transferring technology, providing manufacturing and other consulting support to in-country projects, and the purchase by third parties (e.g., our vendors) of supplies from in-country vendors. These agreements also may be satisfied through our use of cash for such activities as purchasing supplies from in-country vendors, providing financial support for in-country projects, establishment of joint ventures with local companies, and building or leasing facilities for in-country operations. We typically do not commit to offset agreements until orders for our products or services are definitive. The amounts ultimately applied against our offset agreements are based on negotiations with the customer and typically require cash outlays that represent only a fraction of the original amount in the offset agreement. At December 31, 2012, the remaining obligations under our outstanding offset agreements totaled $9.3 billion, which primarily relate to our Aeronautics, MFC, and MST business segments, some of which extend through 2026. To the extent we have entered into purchase obligations at December 31, 2012 that also satisfy offset agreements, those amounts are included in the preceding table. Offset programs usually extend over several years and may provide for penalties in the event we fail to perform in accordance with offset requirements. While historically we have not been required to pay material penalties, resolution of offset requirements are often the result of negotiations and subjective judgments.

In connection with our 50% ownership interest of ULA, we and The Boeing Company (Boeing) have each received distributions totaling $494 million (since ULA s formation in December 2006) which are subject to agreements between us, Boeing, and ULA, whereby, if ULA does not have sufficient cash resources or credit capacity to make payments under the

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inventory supply agreement it has with Boeing, both we and Boeing would provide to ULA, in the form of an additional capital contribution, the level of funding required for ULA to make those payments. Any such capital contributions would not exceed the amount of the distributions subject to the agreements. We currently believe that ULA will have sufficient operating cash flows and credit capacity, including access to its $560 million revolving credit agreement from third-party financial institutions, to meet its obligations such that we would not be required to make a contribution under these agreements.

In addition, both we and Boeing have cross-indemnified each other for guarantees by us and Boeing of the performance and financial obligations of ULA under certain launch service contracts. We believe ULA will be able to fully perform its obligations, as it has done through December 31, 2012, and that it will not be necessary to make payments under the cross-indemnities or guarantees.

We have entered into standby letters of credit, surety bonds, and third-party guarantees with financial institutions and other third parties primarily relating to advances received from customers and the guarantee of future performance on certain contracts. Letters of credit and surety bonds generally are available for draw down in the event we do not perform. In some cases, we may guarantee the contractual performance of third parties such as joint venture partners. At December 31, 2012, we had the following outstanding letters of credit, surety bonds, and guarantees (in millions):

		Commitment Expiration By Period			
	Total Commitment	Less Than 1 Year [(a)]	Years 2 and 3 [(a)]	Years 4 and 5 [(a)]	After 5 Years
Standby letters of credit	$ 1,074	$ 759	$ 236	$ 79	$
Surety bonds	357	357			
Guarantees	816	2	98	170	546
Total commitments	$ 2,247	$ 1,118	$ 334	$ 249	$ 546

(a) Approximately $609 million, $23 million, and $3 million of standby letters of credit in the Less Than 1 Year, Years 2 and 3, and Years 4 and 5, periods, and approximately $34 million of surety bonds, are expected to renew for additional periods until completion of the contractual obligation.

At December 31, 2012, third-party guarantees totaled $816 million, of which approximately 85% related to guarantees of the contractual performance of joint ventures to which we currently are or previously were a party. This amount represents our estimate of the maximum amount we would expect to incur upon the contractual non-performance of the joint venture partners. In addition, we generally have cross-indemnities in place that may enable us to recover amounts that may be paid on behalf of a joint venture partner. We believe our current and former joint venture partners will be able to perform their obligations, as they have done through December 31, 2012, and that it will not be necessary to make payments under the guarantees. In determining our exposures, we evaluate the reputation, technical capabilities, and credit quality of our current and former joint venture partners.

Critical Accounting Policies

Contract Accounting / Sales Recognition

Substantially all of our net sales are accounted for using the POC method, which requires that significant estimates and assumptions be made in accounting for the contracts. Our remaining net sales are derived from contracts to provide services to non-U.S. Government customers, which we account for under the services accounting model.

We evaluate new or significantly modified contracts with customers other than the U.S. Government, to the extent the contracts include multiple elements, to determine if the individual deliverables should be accounted for as separate units of accounting. When we determine that accounting for the deliverables as separate units is appropriate, we allocate the contract value to the deliverables based on their relative estimated selling prices. The contracts or contract modifications we evaluate for multiple elements typically are long term in nature and include the provision of both products and services. Based on the nature of our business, we generally account for components of such contracts using the POC accounting model or the services accounting model, as appropriate.

We classify net sales as products or services on our Statements of Earnings based on the predominant attributes of the underlying contract. Most of our long-term contracts are denominated in U.S. dollars, including contracts for sales of military products and services to other governments conducted through the U.S. Government. We record sales for both products and services under cost-reimbursable, fixed-price, and time-and-materials contracts.

Contract Types

Cost-reimbursable contracts

Cost-reimbursable contracts, which accounted for about 45%, 50%, and 60% of our total net sales in 2012, 2011, and 2010, provide for the payment of allowable costs incurred during performance of the contract plus a fee, up to a ceiling based on the amount that has been funded. We generate revenue under two general types of cost-reimbursable contracts: cost-plus-award-fee/incentive fee which represent a substantial majority of our cost-reimbursable contracts; and cost-plus-fixed-fee contracts.

Cost-plus-award-fee contracts provide for an award fee that varies within specified limits based on the customer s assessment of our performance against a predetermined set of criteria, such as targets based on cost, quality, technical, and schedule criteria. Cost-plus-incentive-fee contracts provide for reimbursement of costs plus a fee which is adjusted by a formula based on the relationship of total allowable costs to total target costs (incentive based on cost) or reimbursement of costs plus an incentive to exceed stated performance targets (incentive based on performance). The fixed fee in a cost-plus-fixed-fee contract is negotiated at the inception of the contract and that fixed fee does not vary with actual costs.

Fixed-price and other contracts

Under fixed-price contracts, which accounted for about 50%, 45%, and 35% of our total net sales in 2012, 2011, and 2010, we agree to perform the specified work for a pre-determined price. To the extent our actual costs vary from the estimates upon which the price was negotiated, we will generate more or less profit, or could incur a loss. Some fixed-price contracts have a performance-based component under which we may earn incentive payments or incur financial penalties based on our performance.

Under time-and-materials contracts, which accounted for about 5% of our total net sales in each of 2012, 2011, and 2010, we are paid a fixed hourly rate for each direct labor hour expended, and we are reimbursed for allowable material costs and allowable out-of-pocket expenses. To the extent our actual direct labor and associated costs vary in relation to the fixed hourly billing rates provided in the contract, we will generate more or less profit, or could incur a loss.

POC Method of Accounting

We record net sales and an estimated profit on a POC basis for cost-reimbursable and fixed-price contracts for product and services contracts with the U.S. Government.

The POC method for product contracts depends on the nature of the products provided under the contract. For example, for contracts that require us to perform a significant level of development effort in comparison to the total value of the contract and/or to deliver minimal quantities, sales are recorded using the cost-to-cost method to measure progress toward completion. Under the cost-to-cost method of accounting, we recognize sales and an estimated profit as costs are incurred based on the proportion that the incurred costs bear to total estimated costs. For contracts that require us to provide a substantial number of similar items without a significant level of development, we record sales and an estimated profit on a POC basis using units-of-delivery as the basis to measure progress toward completing the contract. For contracts to provide services to the U.S. Government, sales are generally recorded using the cost-to-cost method.

Award and incentive fees, as well as penalties related to contract performance, are considered in estimating sales and profit rates on contracts accounted for under the POC method. Estimates of award fees are based on past experience and anticipated performance. We record incentives or penalties when there is sufficient information to assess anticipated contract performance. Incentive provisions that increase or decrease earnings based solely on a single significant event are not recognized until the event occurs.

Accounting for contracts under the POC method requires judgment relative to assessing risks, estimating contract sales and costs (including estimating award and incentive fees and penalties related to performance), and making assumptions for schedule and technical issues. Due to the number of years it may take to complete many of our contracts and the scope and nature of the work required to be performed on those contracts, the estimation of total sales and cost at completion is complicated and subject to many variables.

Contract costs include material, labor, and subcontracting costs, as well as an allocation of indirect costs. Our estimates of costs at completion of the contract are based on assumptions we make for variables such as labor productivity and

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availability, the complexity of the work to be performed, the availability of materials, the length of time to complete the contract (to estimate increases in wages and prices for materials), performance by our subcontractors, and the availability and timing of funding from our customer, among other variables. When estimates of total costs to be incurred on a contract exceed total estimates of revenue to be earned, a provision for the entire loss on the contract is recorded in the period in which the loss is determined.

Many of our contracts span several years and include highly complex technical requirements. At the outset of a contract, we identify and monitor risks to the achievement of the technical, schedule, and cost aspects of the contract, and assess the effects of those risks on our estimates of total costs to complete the contract. The estimates consider the technical requirements (for example, a newly-developed product versus a mature product), the schedule and associated tasks (for example, the number and type of milestone events), and costs (for example, material, labor, subcontractor and overhead). The initial profit booking rate of each contract considers risks surrounding the ability to achieve the technical requirements, schedule, and costs in the initial estimated costs at completion. Profit booking rates may increase during the performance of the contract if we successfully retire risks surrounding the technical, schedule and costs aspects of the contract. Alternatively, our profit booking rates may decrease if the estimated costs to complete the contract increase. All of the estimates are subject to change during the performance of the contract and may affect the profit booking rate.

In addition, comparability of our segment operating profit may be impacted by changes in estimated profit booking rates on our contracts accounted for using the POC method of accounting. Increases in the estimated profit booking rates, typically referred to as risk retirements, usually relate to revisions in the total estimated costs at completion that reflect improved conditions on a particular contract. Conversely, conditions on a particular contract may deteriorate resulting in an increase in the total estimated costs at completion and a reduction of the estimated profit booking rate. Increases or decreases in estimated profit booking rates are recognized in the current period and reflect the inception-to-date effect of such changes. Segment operating profit may also be impacted, favorably or unfavorably, by other matters such as the resolution of contractual matters, reserves for disputes, asset impairments and insurance recoveries, among others. Segment operating profit and items such as risk retirements, reductions of profit booking rates, or other matters are presented net of state income taxes.

Services Method of Accounting

Under a fixed-price service contract, we are paid a predetermined fixed amount for a specified scope of work and generally have full responsibility for the costs associated with the contract and the resulting profit or loss. We record net sales under fixed-price service contracts to non-U.S. Government customers on a straight-line basis over the period of contract performance, unless evidence suggests that net sales are earned or the obligations are fulfilled in a different pattern. For cost-reimbursable contracts for services to non-U.S. Government customers that provide for award and incentive fees, we record net sales as services are performed, exclusive of award and incentive fees. Award and incentive fees are recorded when they are fixed or determinable, generally at the date the amount is communicated to us by the customer. This approach results in the recognition of such fees at contractual intervals (typically every six months) throughout the contract and is dependent on the customer s processes for notification of awards and issuance of formal notifications. Costs for all service contracts are expensed as incurred.

Other Contract Accounting Considerations

The majority of our sales are driven by pricing based on costs incurred to produce products or perform services under contracts with the U.S. Government. Cost-based pricing is determined under the FAR. The FAR provides guidance on the types of costs that are allowable in establishing prices for goods and services under U.S. Government contracts. For example, costs such as those related to charitable contributions, interest expense, and certain advertising and public relations activities are unallowable and, therefore, not recoverable through sales. In addition, we may enter into advance agreements with the U.S. Government that address the subjects of allowability and allocability of costs to contracts for specific matters. For example, most of the environmental costs we incur for environmental remediation related to sites operated in prior years are allocated to our current operations as general and administrative costs under FAR provisions and supporting advance agreements reached with the U.S. Government.

We closely monitor compliance with, and the consistent application of, our critical accounting policies related to contract accounting. Costs incurred and allocated to contracts are reviewed for compliance with U.S. Government regulations by our personnel, and are subject to audit by the Defense Contract Audit Agency.

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Postretirement Benefit Plans

Overview

Many of our employees are covered by defined benefit pension plans, and we provide certain health care and life insurance benefits to eligible retirees (collectively, postretirement benefit plans see Note 9). In recent years, we have taken certain actions to mitigate the effect of our defined benefit pension plans on our financial results, including no longer offering a defined benefit pension plan to new, non-represented employees starting in January 2006. Over the last few years, we have negotiated similar changes with our union represented population and as a result substantially all represented employees hired after June 2012 do not participate in a defined benefit pension plan. We have also made substantial cash contributions over the years to our defined benefit pension plans including $3.6 billion in 2012. Additionally, during 2012 lump settlement payments of $310 million were made from the defined benefit pension trust to certain former employees who had not commenced receiving their vested benefit payments, and the corresponding benefit obligation that was released was $375 million. Notwithstanding these actions, the impact of these plans and benefits on our GAAP earnings may be volatile in that the amount of expense we record and funded status for our postretirement benefit plans may materially change from year to year because those calculations are sensitive to funding levels as well as changes in several key economic assumptions, including interest rates, rates of return on plan assets, and other actuarial assumptions including expected rates of increase in future compensation levels, employee turnover and mortality, as well as the timing of funding.

We recognize on a plan-by-plan basis the funded status of our postretirement benefit plans under GAAP as either an asset or a liability on our Balance Sheets. There is a corresponding non-cash adjustment to accumulated other comprehensive loss, net of tax benefits recorded as deferred tax assets, in stockholders equity. The GAAP funded status is measured as the difference between the fair value of the plan s assets and the benefit obligation of the plan. The GAAP benefit obligation represents the present value of the future benefits to be paid to plan participants. The present value is calculated using a discount rate that is determined at the end of each year. Historically low interest rates over the last few years have significantly increased our benefit obligation. This has contributed to a lower funded status of our defined benefit pension plans as determined by GAAP.

The funding of our pension plans is determined in accordance with the Employee Retirement Income Security Act of 1974 (ERISA), as amended by the Pension Protection Act of 2006 (PPA). Our goal has been to fund the pension plans to a level of at least 80%, as determined by the PPA. This ERISA funded status is calculated on a different basis than under GAAP. The ERISA liability does not reflect anticipated future pay increases for plan participants as required under GAAP and is currently measured using a higher discount rate than for GAAP, primarily due to The Moving Ahead for Progress in the 21st Century Act of 2012 (MAP-21) which provides temporary funding relief due to the historically low interest rate environment. By way of contrast, under ERISA our plans are about 90% funded at December 31, 2012 and 2011, while for GAAP our defined benefit pension plans are about 67% funded at December 31, 2012 and 2011. The U.S. Government Cost Accounting Standards (CAS) governs the extent to which our pension costs are allocable to and recoverable under contracts with the U.S. Government, including FMS.

Actuarial Assumptions

GAAP requires that the amounts we record related to our plans be computed using actuarial valuations. The primary year-end assumptions used to determine the funded status and estimate postretirement benefit plan expense for the following calendar year are the discount rate, the expected long-term rate of return on plan assets, and employee turnover and mortality for all postretirement benefit plans; funding levels; the expected rates of increase in future compensation levels for the participants in our defined benefit pension plans; and the health care cost trend rates for our retiree medical plans. These assumptions we make impact both the calculation of the benefit obligation at the end of the year and the calculation of net postretirement benefit plan cost in the subsequent year. The difference between the long-term rate of return on plan assets assumption we select and the actual return on plan assets as well as funding levels in any given year affects both the funded status of our benefit plans and the calculation of net postretirement benefit plan cost in subsequent years. When reassessing these assumptions each year we consider past and current market conditions and make judgments about future market trends. We also have to consider factors such as the timing and amounts of expected contributions to the plans and benefit payments to plan participants.

We selected 4.00% as the discount rate for calculating our benefit obligations at December 31, 2012 related to our defined benefit pension plans, compared to 4.75% at the end of 2011 and 5.50% at the end of 2010. We selected 3.75% as the discount rate for calculating our benefit obligations at December 31, 2012 related to our retiree medical plans, compared to 4.50% at the end of 2011 and 5.50% at the end of 2010. We evaluate several data points in order to arrive at an appropriate discount rate, including results from cash flow models, quoted rates from long-term bond indices, and changes in long-term bond rates over the past year. As part of our evaluation, we calculate the approximate average yields on corporate bonds rated AA or better that were selected to match our projected postretirement benefit plan cash flows.

We concluded that 8.00% was a reasonable estimate for the expected long-term rate of return on plan assets assumption at December 31, 2012, consistent with the rate used at December 31, 2011, and we used 8.50% at December 31, 2010. The long-term rate of return assumption represents the expected average rate of earnings on the funds invested, or to be invested, to provide for the benefits included in the plan obligation. This assumption is based on several factors including historical market index returns, the anticipated long-term allocation of plan assets, the historical return data for the trust funds, plan expenses, and the potential to outperform market index returns. The actual return in any specific year likely will differ from the assumption, but the average expected return over a long-term future horizon should be approximately equal to the assumption. As a result, changes in this assumption are less frequent than changes in the discount rate.

Our stockholders equity has been reduced cumulatively by $13.5 billion from the annual year-end measurements of the funded status of postretirement benefit plans, inclusive of the December 31, 2012 adjustment of $3.2 billion. These non-cash, after-tax amounts primarily represent net actuarial losses resulting from declines in discount rates and differences between actual experience and our actuarial assumptions, which will be amortized to expense over the average future service period of employees expected to receive benefits under the plans of approximately 10 years. During 2012, $858 million of these amounts was recognized as a component of postretirement benefit plans expense and $1.0 billion is expected to be recognized as expense in 2013. If in the future we were to have a deficit in stockholders equity as a result of further adjustments associated with the funded status of postretirement benefit plans, the deficit would not affect our ability to comply with our debt covenants nor do we anticipate the deficit to hinder our ability to pay dividends and make stock repurchases as further described in the Capital Structure, Resources, and Other section above.

We expect that our 2013 pension expense will be $1.9 billion, which is comparable to our 2012 pension expense. An increase in the amortization of net actuarial gains and losses caused by the decrease in the discount rate mentioned above was offset by an increase in the expected dollar amount of return on plan assets primarily due to the $2.5 billion of discretionary contributions to the qualified defined benefit plans in the fourth quarter of 2012.

The discount rate and long-term rate of return on plan assets assumptions we select at the end of each year are based on our best estimates and judgment. A change of plus or minus 25 basis points in the 4.00% discount rate assumption at December 31, 2012, with all other assumptions held constant, would have decreased or increased the amount of the qualified pension benefit obligation we recorded at the end of 2012 by approximately $1.5 billion, which would result in an after-tax increase or decrease in stockholders equity at the end of the year of approximately $1.0 billion. If the 4.00% discount rate at December 31, 2012 that was used to compute the expected 2013 expense for our qualified defined benefit pension plans had been 25 basis points higher or lower, with all other assumptions held constant, the amount of expense projected for 2013 would be lower or higher by approximately $145 million. If the 8.00% expected long-term rate of return on plan assets assumption at December 31, 2012 that was used to compute the expected 2013 expense for our qualified defined benefit pension plans had been 25 basis points higher or lower, with all other assumptions held constant, the amount of expense projected for 2013 would be lower or higher by approximately $80 million.

Funding Considerations

The PPA became applicable to us and other large U.S. defense contractors beginning in 2011 and had the effect of accelerating the required amount of annual pension plan contributions. We made contributions related to our qualified defined benefit pension plans of $3.6 billion in 2012, $2.3 billion in 2011, and $2.2 billion in 2010, inclusive of amounts in excess of our required contributions. We recovered $1.1 billion in 2012, $899 million in 2011 and $988 million in 2010 as CAS costs. Amounts funded under CAS are recovered over time through the pricing of our products and services on U.S. Government contracts, including FMS, and are recognized in our cost of sales and net sales. Amounts contributed in excess of the CAS funding requirements, over $8.0 billion inclusive of interest as of December 31, 2012, are considered to be prepayment credits under the CAS rules.

We would expect our required contributions to be temporarily lowered beginning in 2013 through 2015 as a result of MAP-21. We expect to make contributions of $1.5 billion related to our qualified defined benefit pension plans in 2013 and anticipate recovering $1.5 billion as CAS cost on our contracts in 2013.

The CAS Board published its revised pension accounting rules (CAS Harmonization) with an effective date of February 27, 2012 to better align the recovery of pension contributions, including prepayment credits, on U.S. Government

contracts with the accelerated funding requirements of the PPA. The CAS Harmonization rules increase our CAS cost beginning in 2013. There is a transition period during which the cost impact of the new rules is phased in, with the full impact occurring in 2017. The incremental impact of CAS Harmonization in 2013 is a very modest CAS cost increase, and we expect much larger increases will occur successively in years 2014 through 2017.

Based upon current assumptions which may change, we expect that the increase in CAS costs caused by CAS Harmonization should result in increased earnings a few years from now, as our CAS costs would be in excess of the pension expense we record under GAAP. Accordingly, we expect our non-cash FAS/CAS pension adjustment, discussed further in the Business Segment Results of Operations section above, will soon increase earnings rather than decrease earnings as it has the past few years. In addition, we expect that our future CAS pension recoveries will soon be equal to or greater than our required pension contributions, which should increase our cash flow from operations.

Environmental Matters

We are a party to various agreements, proceedings, and potential proceedings for environmental cleanup issues, including matters at various sites where we have been designated a potentially responsible party (PRP) by the EPA or by a state agency. At December 31, 2012 and 2011, the total amount of liabilities recorded on our Balance Sheet for environmental matters was $950 million and $932 million. We have recorded receivables totaling $821 million and $808 million at December 31, 2012 and 2011 for the portion of environmental costs that are probable of future recovery in pricing of our products and services for agencies of the U.S. Government, as discussed below. The amount that is expected to be allocated to our non-U.S. Government contracts or that is determined to be unallowable for pricing under U.S. Government contracts has been expensed through cost of sales. We project costs and recovery of costs over approximately 20 years.

We enter into agreements (e.g., administrative orders, consent decrees) that document the extent and timing of our environmental remediation obligation. We also are involved in remediation activities at environmental sites where formal agreements either do not exist or do not quantify the extent and timing of our obligation. Environmental cleanup activities usually span many years, which makes estimating the costs more judgmental due to, for example, changing remediation technologies. To determine the costs related to cleanup sites, we have to assess the extent of contamination, effects on natural resources, the appropriate technology to be used to accomplish the remediation, and evolving regulatory environmental standards.

We perform quarterly reviews of environmental remediation sites and record liabilities and receivables in the period it becomes probable that a liability has been incurred and the amounts can be reasonably estimated (see the discussion under Environmental Matters in Note 1 Significant Accounting Policies and Note 12 Legal Proceedings, Commitments, and Contingencies to our consolidated financial statements). We consider the above factors in our quarterly estimates of the timing and amount of any future costs that may be required for remediation activities, which results in the calculation of a range of estimates for a particular environmental site. We do not discount the recorded liabilities, as the amount and timing of future cash payments are not fixed or cannot be reliably determined. Given the required level of judgment and estimation, it is likely that materially different amounts could be recorded if different assumptions were used or if circumstances were to change (e.g., a change in environmental standards or a change in our estimate of the extent of contamination).

Both the EPA and the California Office of Environmental Health Hazard Assessment announced plans in January 2011 to regulate two chemicals, perchlorate and hexavalent chromium, to levels in drinking water that are expected to be substantially lower than the existing public health goals or standards established in California. The rulemaking processes are lengthy and may take years to complete. If substantially lower standards are adopted, we would expect a material increase in our estimates for remediation at several existing sites.

Under agreements reached with the U.S. Government, most of the amounts we spend for environmental remediation are allocated to our operations as general and administrative costs. Under existing government regulations, these and other environmental expenditures relating to our U.S. Government business, after deducting any recoveries received from insurance or other PRPs, are allowable in establishing prices of our products and services. As a result, most of the expenditures we incur are included in our net sales and cost of sales according to U.S. Government agreement or regulation, regardless of the contract form (e.g. cost-reimbursable, fixed-price). We continually evaluate the recoverability of our environmental receivables by assessing, among other factors, U.S. Government regulations, our U.S. Government business base and contract mix, and our history of receiving reimbursement of such costs.

As disclosed above, we may record changes in the amount of environmental remediation liabilities as a result of our quarterly reviews of the status of our environmental remediation sites, which would result in a change to the corresponding environmental receivable and a charge to earnings. For example, if we were to determine that the liabilities should be increased by $100 million, the corresponding receivables would be increased by approximately $87 million, with the remainder recorded as a charge to earnings. This allocation is determined annually, based upon our existing and projected business activities with the U.S. Government.

We reasonably cannot determine the extent of our financial exposure at all environmental sites with which we are involved. There are a number of former operating facilities we are monitoring or investigating for potential future remediation. In some cases, although a loss may be probable, it is not possible at this time to reasonably estimate the amount of any obligation for remediation activities because of uncertainties (e.g., assessing the extent of the contamination). During any particular quarter, such uncertainties may be resolved, allowing us to estimate and recognize the initial liability to remediate a particular former operating site. The amount of the liability could be material. Upon recognition of the liability, a portion will be recognized as a receivable with the remainder charged to earnings.

If we are ultimately found to have liability at those sites where we have been designated a PRP, we expect that the actual costs of remediation will be shared with other liable PRPs. Generally, PRPs that are ultimately determined to be responsible parties are strictly liable for site cleanup and usually agree among themselves to share, on an allocated basis, the costs and expenses for investigation and remediation. Under existing environmental laws, responsible parties are jointly and severally liable and, therefore, we are potentially liable for the full cost of funding such remediation. In the unlikely event that we were required to fund the entire cost of such remediation, the statutory framework provides that we may pursue rights of cost recovery or contribution from the other PRPs. The amounts we record do not reflect the fact that we may recover some of the environmental costs we have incurred through insurance or from other PRPs, which we are required to pursue by agreement and U.S. Government regulation.

Goodwill

Our goodwill balances were $10.4 billion and $10.1 billion at December 31, 2012 and 2011. We test goodwill for impairment at least annually in the fourth quarter or more frequently upon the occurrence of certain events or significant changes in circumstances that indicate the carrying value of goodwill may not be recoverable. Such events or changes in circumstances may include a significant deterioration in overall economic conditions, changes in the business climate of our industry, a decline in our market capitalization, operating performance indicators, competition, reorganizations of our business, or the disposal of all or a portion of a reporting unit. Our goodwill has been allocated to and is tested for impairment at a level referred to as the reporting unit, which is our business segment level or a level below the business segment. The level at which we test goodwill for impairment requires judgment to determine whether the operations below the business segment constitute a self-sustaining business for which discrete financial information is available and segment management regularly reviews the operating results.

We initially test goodwill for impairment by comparing the fair value of each reporting unit with its carrying value, including goodwill. If the fair value of a reporting unit exceeds its carrying value, goodwill of the reporting unit is considered not impaired. If the carrying value of a reporting unit exceeds its fair value, we compare the implied fair value of the reporting unit s goodwill with the carrying value of its goodwill. If the carrying value of the reporting unit s goodwill exceeds the implied fair value of that goodwill, an impairment loss is recognized in an amount equal to that excess.

The carrying value of each reporting unit includes the assets and liabilities employed in its operations, allocations of amounts held at the business segment and corporate levels as well as goodwill. The corporate allocations include our postretirement benefit plans liabilities as determined in accordance with CAS in order to align the basis of the carrying values with the fair values of our reporting units. CAS expense is recovered through the pricing of our products and services on U.S. Government contracts and, therefore, is allocated to and recognized in the estimated fair value of each reporting unit. The discount rate used for CAS is currently higher than the discount rate used for GAAP, but is expected to trend downward over the next few years and would increase the amount of CAS liabilities allocated to each reporting unit, contributing to a decline in the carrying value of each reporting unit.

We estimate the fair value of each reporting unit using a combination of a discounted cash flow (DCF) analysis and market-based valuation methodologies such as comparable public trading values and values observed in market transactions. Determining fair value requires the exercise of significant judgments, including judgments about the amount and timing of expected future cash flows, discount rates, perpetual growth rates, and relevant comparable company earnings multiples and transaction multiples. The cash flows employed in the DCF analyses are based on our best estimate of future sales and operating costs, based primarily on existing firm orders, expected future orders, contracts with suppliers, labor agreements, and general market conditions; changes in working capital; long-term business plans; and recent operating performance. The