November 26, 2003

Office of the Secretary
Public Company Accounting Oversight Board
1666 K Street, N.W.
Washington, D.C. 20006-2803

Subject: PCAOB Rulemaking Docket Matter No. 008

PCAOB:

I appreciate the opportunity to comment to the Public Company Accounting Oversight Board (the "Board" or "PCAOB") on the Proposed Auditing Standard, *An Audit of Internal Control Over Financial Reporting Performed in Conjunction With an Audit of Financial Statements* (the "Proposed Standard"). My responses to the questions put forth in the Proposed Standard are attached as an exhibit to this letter. My response is solely my own and does not necessarily reflect the views of Northrop Grumman Corporation, my employer.

I commend the Board in its efforts to provide guidance to help management of publicly traded companies and auditors comply with Section 404 of the Sarbanes-Oxley Act (the "Act"). While I agree with the principal objectives of the Act in restoring investor confidence in the American financial system, I have significant concern that the guidance as proposed will result in far too much redundant, valueless effort by the auditors caused by the over-application of mandated procedures. As a consequence the cost required to comply with Section 404 of the Act will be much greater than either Congress or the SEC envisioned with no basis, other than shear hope that somehow this will aid in the much-sought for restoration of investor confidence. I believe that the revisions needed to remedy the guidance so it will not have the consequences that I believe were not intended when the Act was passed are not extensive.

My principal concern is the massive amount of hours that the proposed guidance will require to comply with Section 404 of the Act. The effort and cost simply will be too much. I know of one instance in which a registrant has been provided an estimate by a Big Four accounting firm of between 60,000 and 80,000 hours, just for the testing phase related to control activities (i.e. not including the effort needed for organization, strategy and design efforts to date, hours required for addressing the other components of COSO, software costs, etc.). In addition, the independent auditors have provided tht registrant a 2004 audit estimate of approximately 30,000 hours. The resources needed to supply this many hours of effort will likely approach $15 million!

I believe in the importance of restoring investor confidence and I believe most registrants are willing to make reasonable efforts, but I do not believe the effort required to accomplish that goal requires anywhere near that effort or cost.

I believe that the Proposed Standard should set forth a scope of work designed to assess and test the tone at the top, i.e. the control environment. That belief is based on the overwhelming indicators that the scandals that resulted in the loss of investor confidence stemmed from control environments that were not conducive to effective internal control over financial reporting. I am unaware of any indications that breakdowns in internal controls related to control activities had anything to do with the scandals. In other words it wasn't poor control over such activities as payroll processing, bill collection, or accounts payable recording that were at fault. Rather, it was malfeasance and irregularities and, quite likely fraud, perpetrated at the highest levels that caused all the trouble. That is where the focus needs to be in the guidance. We believe the effort that would be required to assess and test the control environment would be far less than the effort required by the proposed guidance with no discernible lessening of the likelihood that compliance with 404 will have on the goal of restoring investor confidence.
Management's Assessment – Management would assess control environment, risk assessment, information and communication and monitoring each year. For control activities, management would document and assess the design effectiveness of all key controls associated with all processes of material (quantitatively and qualitatively) accounts and disclosures each year. The process associated with each account and disclosure would then be categorized as significant or non-significant based more on the qualitative factors such as importance to the business and an assessment of risk. For example at NGC the following accounts and processes would be considered significant and therefore addressed each year; any account or process related to contracts (revenue, cost, accounts receivable, loss provision, pricing, estimation), compensation, cash, goodwill, pension, taxes, general computer controls. Each control associated with a significant account, as well as those controls associated with non-significant accounts where a significant change had occurred, would be tested each year for operational effectiveness using a higher scope than controls related to non-significant accounts and disclosures. Controls associated with all other accounts and processes could be considered non-significant and would be tested each year for operational effectiveness using a much lower scope and, perhaps, relying to some degree on the results of prior year testing. Any non-significant area where deficiencies are identified would be tested using an increased scope in the current and subsequent year.

Auditor Scope - Assuming the work of management or others is performed by competent and objective individuals, the auditor should be allowed to place reliance on that work with the result that very little work should be required to be performed in areas other than the control environment. For those controls associated with processes, accounts or disclosures deemed significant, the auditor would perform tests sufficient to verify management's assessment each year. For those controls associated with processes, accounts or disclosures deemed non-significant, the auditor, depending on facts and circumstances, should be allowed the discretion to rely entirely on the work performed by management or, at most, verify the work of management or others by making random selections of that population.

Once again, I wish to express my appreciation to the Board for the opportunity to respond to the attached questions and respectfully ask the Board to consider my concerns and suggestions. I would be pleased to discuss these matters with the Board at any time.

Yours truly,

Steven J. Root
Director Finance Administration and Process
Northrop Grumman Corporation

EXHIBIT

PCAOB PROPOSED AUDITING STANDARD

Response to Questions Prepared By

Northrop Grumman Corporation

<u>Questions regarding an integrated audit of the financial statements and internal control over financial reporting:</u>

1. *Is it appropriate to refer to the auditor's attestation of management's assessment of the effectiveness of internal control over financial reporting as the audit of internal control over financial reporting?*

   Response: I believe it is acceptable to refer to the auditor's attestation of management's assessment of the effectiveness of internal control over financial reporting as the audit of internal control over financial reporting. However, I fail to understand why such a reference is desirable. In other words, I see no disadvantage to using the attestation reference regarding management's assessment of internal control. In fact, if the guidance were to be revised in accordance with my suggestions it might be more accurate to retain the attestation reference.

2. *Should the auditor be prohibited from performing an audit of internal control over financial reporting without also performing an audit of the financial statements?*

   Response: While I am concerned with a separate audit of internal control over financial reporting without the corroborative evidence obtained from performing the audit of the associated financial statements, I believe the auditor should not be prohibited from performing an audit of internal control over financial reporting without also performing an audit of the financial statements. I do believe the auditor should be prohibited from performing an audit of the financial statements without also performing an audit of the internal control over financial reporting.

3. *Rather than requiring the auditor to also complete an audit of the financial statements, would an appropriate alternative be to require the auditor to perform work with regard to the financial statements* ***comparable*** *to that required to complete the financial statement audit?*

   Response: I am unable to envision the frequency of instances where this requirement would come into play. Every SEC registrant must file annual audited financial statements and SO 404 applies to all registrants so it appears to me that reports on internal controls and reports on financial statements are entwined. While I do not believe the auditor who performs an audit of the internal control over financial reporting should be required to perform an audit of the associated financial statements, in such cases the Board may consider mandating additional audit procedures of key financial accounts in order to obtain additional corroborative evidence of operational effectiveness.

Question regarding the costs and benefits of internal control:

4. *Does the Board's proposed standard give appropriate consideration to how internal control is implemented in, and how the audit of internal control over financial reporting should be conducted at, small and medium-sized issuers?*

   Response: I have no comment regarding this issue.

Question regarding the audit of internal control over financial reporting:

5. *Should the Board, generally or in this proposed standard, specify the level of competence and training of the audit personnel that is necessary to perform specified auditing procedures effectively? For example, it would be inappropriate for a new, inexperienced auditor to have primary responsibility for conducting interviews of a company's senior management about possible fraud.*

   Response: I believe the AICPA Professional Standards adequately address the auditor's duties and responsibilities concerning the training, proficiency and supervision of the independent auditor. However, for reasons already set forth, I believe that the scope of work mandated by the proposed guidance will cause auditors to perform considerable work in areas related to processes for which they have scant knowledge, proficiency or experience. Much of the work, by necessity, will have to be performed by juniors and seniors. Even with supervision, it is difficult to see how this arrangement will result in quality assessments given the magnitude of processes and the bodies of knowledge requisite to operate them effectively. To illustrate, at one registrant of which the writer is aware, itwill be assessing more than 1200 processes in roughly 50 categories. The persons that "own" these processes each have several years of experience and considerable acumen with regard to the particular circumstances of their respective "worlds". These people are honest, professional, and competent. They are part of the management of the registrant. This proposed guidance will subject them to scrutiny by persons considerably less experienced and knowledgeable. It is difficult to see how this can be construed to be an exercise that will result in valuable insights, or even sound judgments by the auditors. But it is unmistakable that it will cost a great deal.

Questions regarding evaluation of management's assessment:

6. *Is the scope of the audit appropriate in that it requires the auditor to both evaluate management's assessment and obtain, directly, evidence about whether internal control over financial reporting is effective?*

   Response: I agree with the premise stated in the Proposed Standard that the more extensive and reliable management's assessment is, the less extensive and costly the auditor's work will need to be. I strongly believe that the auditor should be given greater flexibility than stated in the Proposed Standard to use the work of management or others who are competent and objective as evidence about whether internal control over financial reporting is effective. I am concerned, as indicated earlier, that the standard, as proposed, will result in a very significant and unnecessary, duplication of effort on the part of the auditor of work performed by management.

7. *Is it appropriate that the Board has provided criteria that the auditors should use to evaluate the adequacy of management's documentation?*

   Response: I believe the criteria to evaluate the adequacy of documentation as proposed to be appropriate.

8. *Is it appropriate to state that inadequate documentation is an internal control deficiency, the severity of which the auditor should evaluate? Or should inadequate documentation automatically rise to the level of a significant deficiency or material weakness in internal control?*

   Response: While I believe that inadequate documentation is not necessarily, of itself, a control deficiency, I agree that adequate documentation supports the evaluation of the effectiveness of the overall internal control system. A determination of the adequacy of documentation is a matter of judgment. The auditor's determination of whether inadequate documentation rises to the level of a significant deficiency or material weakness should be based on the attendant facts and circumstances; the significance as it relates to effectiveness, how pervasive the documentation inadequacies, the relevance to other COSO components, etc.

<u>Questions regarding obtaining an understanding of internal control over financial reporting:</u>

9. *Are the objectives to be achieved by performing walkthroughs sufficient to require the performance of walkthroughs?*

Response: WhileI believe walkthroughs are an important auditing tool, I do not believe they should be required. Once again, I believe the auditor should be allowed to use his or her professional judgment to determine what areas of a particular process to audit, the appropriate auditing procedure and the degree of reliance upon the work of management or others.

10. *Is it appropriate to require that the walkthrough be performed by the auditor himself or herself, rather than allowing the auditor to use walkthrough procedures performed by management, internal auditors, or others?*

    Response: I strongly believe the auditor should be allowed to use the walkthrough procedures performed by management, internal auditors, or others. As a determination of audit scope, I believe that the auditor should consider whether or not management has used walkthroughs as a part of their assessment process. The auditor should be permitted by the guidance to judgmentally select certain key processing procedures or controls associated with certain significant processes to verify the assessment made by management, internal auditors, or others.

Questions regarding testing operating effectiveness:

11. *Is it appropriate to require the auditor to obtain evidence of the effectiveness of controls for all relevant assertions for all significant accounts and disclosures every year or may the auditor use some of the audit evidence obtained in previous years to support his or her current opinion on management's assessment?*

    Response: I strongly disagree with the premise that the auditor must obtain evidence of the effectiveness of controls for all relevant assertions for all significant accounts and disclosures every year. The auditor should be allowed to consider the audit evidence obtained in previous years in deciding upon the scope of work needed in the current year to support his or her current opinion on management's assessment. I believe the Board should define the audit criteria to assess whether any significant changes to a particular process have occurred since the prior year. If the criteria indicate no significant changes, I believe the Board should define an appropriate minimum scope of procedures for the auditor to apply to verify the continued effectiveness based, in part on considering the work performed and the results of the previous year.

Questions regarding using the work of management and others:

12. *To what extent should the auditor be permitted or required to use the work of management and others?*

    Response: I agree with the premise stated in the Proposed Standard that the more extensive and reliable management's assessment is, the less extensive and costly the auditor's work will need to be. I believe the auditor should be permitted to use the results of testing for any control activity where those individuals performing the work are deemed by the auditor to be both competent and objective. For control activities, management would document and assess the design effectiveness of all key controls associated with all processes of material (quantitatively and qualitatively) accounts and disclosures each year. The process associated with each account and disclosure would then be categorized as significant or non-significant based more on the qualitative factors such as importance to the business and an assessment of risk. For those controls associated with processes, accounts or disclosures deemed significant, the auditor would reperform a sampling of tests initially performed by management sufficient to verify management's assessment. For those controls associated with processes, accounts or disclosures deemed non-significant, the auditor should be allowed, under the best circumstances, to rely entirely on the work of management or others.

13. *Are the three categories of controls and the extent to which the auditor may rely on the work of others appropriately defined?*

    Response: See my responses to questions 5, 9, 10 and 12 above.

14. *Does the proposed standard give appropriate recognition to the work of internal auditors? If not, does the proposed standard place to much emphasis and preference on the work of internal auditors or not enough?*

    Response: I believe the recognition to the work of internal auditors Should be expanded to enable reliance to be placed their work, even in areas such as the control environment and areas of significant disclosures.

15. *Is the flexibility in determining the extent of reperformance of the work of others appropriate, or should the auditor be specifically required to reperform a certain level of work (for example, reperform tests of all significant accounts or reperform every test performed by others that the auditor tends to use)?*

    Response: While I believe it appropriate for the auditor to have flexibility in determining the extent of reperformance procedures, more guidance is needed in this area. Assuming the work of management or others is performed by individuals who are determined to be competent and objective, we believe 1) for significant processes, accounts and disclosures, some level of reperformance should be required but that the work of others be taken into consideration by the auditor to reduce the work that otherwise would be called for, and 2) for non-significant processes, accounts and disclosures, the auditor should be allowed considerably more discretion and lower the scope of reperformance compared to significant processes, accounts and disclosures. See my response to question 5, 12, and 14.

16. *Is the requirement for the auditor to obtain the principal evidence, on an overall basis, through his or her own work the appropriate benchmark for the amount of work that is required to be performed by the auditor?*

    Response: I strongly disagree with the requirement for the auditor to obtain the principal evidence, on an overall basis, through his or her own work, as an appropriate benchmark for the amount of work required to be performed. I believe such a benchmark is unnecessary to achieve the audit objectives. I believe the additional hours required by such a benchmark above that necessary to form an opinion of management's assessment is detrimental to the entire process by focusing the auditor's attention on a quantitative measure of performance versus a qualitative, risk based approach. While a quantitative measure of audit scope may be appropriate in forming the opinion on the financial statements, I believe the principle of flexibility and the use of judgment, as discussed in question 15 above, to be the appropriate standards when forming an opinion on subjective matters such as the effectiveness of internal controls.

<u>Questions regarding evaluating results:</u>

17. *Will the definitions in the proposed standard of significant deficiency and material weakness provide for increased consistency in the evaluation of deficiencies? How can the definitions be improved?*

    Response: The definitions in the Proposed Standard of significant deficiency and material weakness appear appropriate.

18. *Do the examples in Appendix D of how to apply these definitions in various scenarios provide helpful guidance? Are there other specific examples that commenters could suggest that would provide further interpretive help?*

Response: Although the examples in Appendix D provide helpful guidance, I am concerned that such guidance will be misinterpreted or stringently applied without the use of judgment on the part of the auditor. The auditor should be reminded that professional judgment should be applied, and is the overriding factor, in all cases based on the specific facts and circumstances.

19. *Is it necessary for the auditor to evaluate the severity of all identified internal control deficiencies?*

Response: I believe it is necessary to evaluate the severity of all identified control deficiencies. As stated in the response to question 18 above, the auditor should use professional judgment in all cases when evaluating control deficiencies based on the specific facts and circumstances.

20. *Is it appropriate to require the auditor to communicate all internal control deficiencies (not just material weaknesses and significant deficiencies) to management in writing?*

21. ***Response:*** There is much practical difficulty with this proposed requirement. I believe that only significant deficiencies or material weaknesses should be communicated to management in writing. All other deficiencies, individually or in the aggregate, would be those that result in a remote likelihood that a misstatement of the annual or interim financial statements that is inconsequential in amount will not be prevented or detected. Based on such a definition, and as the determination of any deficiency is the result of judgmentI believe that a written communication of such deficiencies is not warranted and, in fact, may cause misleading inferences to be drawn, particularly in situations in which the writing becomes the subject of discovery in a subsequent legal proceeding against the company. *Are the matters that the Board has classified as strong indicators that a material weakness in internal control exists appropriately classified as such?*

Response: See my response to question 18.

22. *Is it appropriate to require the auditors to evaluate the effectiveness of the audit committee's oversight of the company's external financial reporting and internal control over financial reporting?*

Response: As the audit committee is also responsible for hiring the auditor, I believe the proposed requirement of the auditor to evaluate the effectiveness of the audit committee's oversight of the company's external financial reporting and internal control over financial reporting creates a conflict of interest. Such a conflict of interest is adverse to the relationship that must prevail between the auditor and the audit committee if the control environment is to be effective. As a practical matter, management must make an assessment, under COSO, of the effectiveness of the audit committee as part of the control environment. The auditor must then audit management's assessment. I believe the Board should address further this conflict and resolve it by eliminating the requirement.

23. *Will auditors be able to effectively carry out their responsibility to evaluate the effectiveness of the audit committee's oversight?*

Response: See my response to question 22 above. It is unrealistic to expect that this proposed duty can be carried out effectively.

24. *If the auditor concludes that ineffective audit committee oversight is a material weakness, rather than require the auditor to issue an adverse opinion with regard to the effectiveness of the internal control over financial reporting, should the standard require the auditor to withdraw from the audit engagement?*

Response: I have no comment regarding this issue because I oppose the proposed requirement in the first place.

<u>Questions regarding forming an opinion and reporting:</u>

25. *Is it appropriate that the existence of a material weakness would require the auditor to express an adverse conclusion about the effectiveness of the company's internal control over financial reporting, consistent with the required reporting model for management?*

Response: I believe an adverse conclusion about the effectiveness of the company's internal control over financial reporting should be based on the professional judgment of the auditor due to the existence of a material weakness or weaknesses that are of such significance and pervasiveness as to create a reasonable doubt about the company's ability to produce accurate and timely financial statements. I believe the fact that a material weakness exists is insufficient by itself to create the level of doubt that would necessitate an adverse opinion.

26. *Are there circumstances where a qualified "except for" conclusion would be appropriate?*

Response: I believe any conclusion about the effectiveness of the company's internal control over financial reporting should be based on the professional judgment of the auditor and only when an adverse opinion is issued (see my response to question 25 above). Where the facts and circumstances surrounding a material weakness or weaknesses are such that the auditor believes, on the whole, the company's system of internal controls are conducive to accurate and timely financial reporting, then the auditor should have the option to express a qualified "except for" conclusion on management's assessment and not on the effectiveness of internal control. The Board should consider additional guidance on this matter.

27. *Do you agree with the position that when the auditor issues a nonstandard opinion, such as an adverse opinion, that the auditor's opinion should speak directly to the effectiveness of the internal control over financial reporting rather than to whether management's assessment is fairly stated?*

Response: I believe that the auditor's opinion should speak directly to the effectiveness of the internal control over financial reporting only when an adverse opinion is issued. Only in this circumstance is the auditor drawing a conclusion as to effectiveness versus the assessment of management. In all other conclusions the report should speak to whether management's assessment is fairly stated.

<u>Questions regarding auditor independence:</u>

28. *Should the Board provide specific guidance on independence and internal control-related non-audit services in the context of this proposed standard?*

Response: I believe existing independence rules are sufficient subject to my response to question 29 below.

29. *Are there any specific internal control-related non-audit services the auditor should be prohibited from providing to an audit client?*

Response: I believe the auditor should be prohibited in performing any internal control-related non-audit services.

<u>Questions regarding auditor's responsibilities with regard to management's certifications:</u>

30. *Are the auditor's differing levels of responsibility as they relate to management's quarterly certifications versus the annual (forth quarter) certification, appropriate?*

Response: I believe the auditor's differing levels of responsibility as they relate to management's quarterly certifications versus the annual (forth quarter) certification are appropriate.

31. *Is the scope of the auditor's responsibility for the quarterly disclosures about the internal control over financial reporting appropriate?*

Response: I believe the scope of the auditor's responsibility for the quarterly disclosures about the internal control over financial reporting to be appropriate.

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