



Northrop Grumman Corporation
2980 Fairview Park Drive
Falls Church, Virginia 22042-4511

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

R.E. Release No. 2011-006: Concept Release on Auditor Independence and Audit Firm Rotation

PCAOB Rulemaking Docket No. 37

Dear Board Members:

We appreciate the opportunity to provide our comments on the Concept Release issued by the Public Company Accounting Oversight Board (the "PCAOB" or the "Board") entitled "Auditor Independence and Audit Firm Rotation" (the "Concept Release").

Northrop Grumman Corporation is a multi-national aerospace and defense technology company with operations in 25 countries and annual revenues of over \$26 billion. As prime contractor, principal subcontractor, partner, or preferred supplier, we participate in many high-priority defense and non-defense technology programs in the U.S. and abroad. We conduct most of our business with the U.S. Government, principally the Department of Defense although the company also conducts business with local, state, and foreign governments and generates domestic and international commercial sales. We report to the SEC as an accelerated filer with XBRL requirements. We have engaged the same audit firm for over 25 years for services including our domestic consolidated audit as well as numerous international statutory audits.

While we support the Board's efforts to increase the level of independence, objectivity, and professional skepticism of auditors, we do not believe that mandatory auditor rotation is an effective way to achieve this objective. Conversely, we believe that mandatory auditor rotations could have a negative impact on audit quality and audit failures. Additionally, we believe that the cost of complying with such a requirement would be substantial. Instead, we believe that many of the desired outcomes can be more readily obtained through allowing more time for the auditor oversight responsibilities established by the Sarbanes-Oxley Act to prove their effectiveness. We offer the following rationale to support our position, as well as other suggestions that we believe would better serve to achieve the stated objectives of the Board.

Affects on audit quality

We believe overall audit quality would suffer under the proposals outlined in the Concept Release. Associated with any new audit is an initial learning curve, which for larger multi-national entities could amount to tens of thousands of hours incurred across a global audit team. This learning curve and distraction will cause a significant reduction in audit effectiveness during the initial years of an auditor's prescribed term, as it places more demands on the auditors' time; time that could otherwise be spent on technical accounting and auditing matters and disclosure considerations. This reduction in effectiveness will be more pronounced for companies in specialized industries such as Aerospace & Defense, where the learning curve is even greater. Requiring that the entire audit team be replaced will increase the risk that the new audit team may not have sufficient knowledge of the company's business and operations, particularly in specialized industries such as ours, in order for the engagement team to adequately meet auditing standards by performing an informed and thorough risk assessment and properly planning/executing the audit in the initial years of its new assignment.

Additionally, we believe that the audit profession as a whole would suffer, further reducing audit quality. Audit firms make significant investments in training their people to enable them to serve public companies in general and certain specialized industries in particular. Audit firms will be less incentivized to make investments in training and staff development if mandatory rotation requirements were in place unless they could be assured of having a sufficient level of public company audits to support the investment. Similarly, because auditing public registrants is more complex and requires a great deal more effort than what is required for non-public entities, audit firms with only a few public companies would be less likely to make the investments necessary to serve public registrants if mandatory rotation requirements could expose them to losing their public clients. These pressures would likely lead to less competition in the marketplace, as opposed to the increase in competition contemplated in the Concept Release. While this is not a significant issue for large companies such as ours, it is an issue for the competitive landscape as a whole.

Furthermore, audit firms, like any other business, hire employees based on projected utilization and forecasted operating needs. Mandatory rotations could cause a significant disruption in a firm's ability to attract and retain the best talent given the challenge to reasonably forecast their client mix and overall business needs. This in turn would have a direct effect on the quality of the firm's audits. Additionally, because of the increased effort required in the initial years of a new audit, firms would have a difficult time planning their staffing needs if they could not reasonably predict their expected level of first year assignments. There may also be situations, particularly in specialized industries requiring specific expertise, where a change in auditors would precipitate an exodus of partners and staff from the predecessor audit firm to the successor audit firm. Large, multi-national companies such as ours are served by numerous partners around the country and the world, supplemented by up to hundreds of staff. Expecting a new firm to be able to manage audit rotations of multi-national companies without some level of staffing up from the predecessor firm is likely unrealistic, watering down the benefit of the Concept

Release. These unintended consequences would place added risks on the potential for audit failures that would be introduced solely because of the decision to rotate audit firms.

The Concept Release suggests that the successor auditor will serve as another de facto regulator/ inspector of the predecessor's audit work and thereby provide a deterrent to performing deficient audit work. While this potential may exist, we believe the cost of this "hoped for" benefit will far outweigh its potential values. We believe that the current PCAOB inspection process serves that role adequately. Furthermore, we believe that sufficient additional deterrents already exist in the form of SEC filing reviews and comment letters, regulatory sanctions and potential restatements; all of which incentivize audit firms to perform quality audits. Overall, we believe the risks to audit quality outlined above would more than outweigh the potential for increased independence, objectivity and professional skepticism contained in the Concept Release.

Affects on audit cost and auditor availability

The costs of implementing such a proposal would be substantial. For large multi-national companies, thousands, if not tens of thousands, of audit hours are spent in the initial years of an audit engagement acquiring and documenting a basic understanding of the client's business processes and controls. In addition to these auditor costs, there are significant costs that are borne by the company to support this initial audit effort, and these costs have little recurring value to the company. There would likely also be additional costs of relocating and staffing engagements with suitable personnel having the requisite expertise to perform the audit as the auditor's clients change over time due to rotation. Further, a significant part of our business requires that the auditors obtain special security clearances which can take six to twelve months to obtain, also at substantial cost.

As a practical matter, most large multi-national companies are generally served by one of the "Big Four" audit firms because of the need for the auditor to provide a worldwide service capability to its clients. In addition, for companies in a specialized industry such as ours, the number of firms with substantial expertise in our industry is likely to be reduced. Because of existing independence concerns related to non-audit services, most large companies utilize one or more of the remaining three large audit firms to perform many non-audit services. Furthermore, these non-audit services may be of greater economic value to the auditor than an audit engagement. The need to rotate firms periodically could either upset the course of non audit work in process, or at a minimum further limit the number of potential firms (possibly down to even just one firm) that could, or would be willing to, participate in the rotation process.

Alternatives to consider

We believe the evaluation of the external audit firm and the decision of whether or not to replace the auditors rests with the Audit Committee. The corporate governance changes that came about as a result of the Sarbanes-Oxley Act of 2002 included a provision requiring a five-year rotation of the lead audit partner. Since the effective date of the Act,

there has been insufficient time to adequately assess whether that requirement has had a meaningful effect on the concerns expressed by the Concept Release. We believe that, before any action is considered to mandate auditor rotation, an evaluation should be made as to whether or not this rotation requirement is having the desired effects.

Notwithstanding the foregoing, we also believe that the current structure could be further improved through formalizing auditors' communication requirements to audit committees. While current auditing standards require that the auditor make certain written communications to those in governance including the Audit Committee, we believe an enhanced requirement for direct dialog between these parties on certain key issues would better enable the Audit Committee to assess and evaluate auditor independence, objectivity and professional skepticism. While many of these items are currently communicated through an in-person meeting, as a best practice, formalizing the requirement and discussion agenda items would enhance the process.

This could be implemented through the addition of standards requiring a meeting (or a series of meetings, if necessary) between the Audit Committee and the external auditors with agendas established to address the critical concerns expressed in the Concept Release. Specific meeting agendas could be established to provide for face-to-face meetings to discuss the following topics:

- the auditor's assessment of the estimates and judgments made by management in preparing the financial statements, including how the auditor arrived at that assessment
- areas of significant financial statement and audit risk and the auditor's approach to addressing such risk areas
- unusual transactions, restatements, and other significant changes in the financial statements and internal controls over financial reporting
- the auditor's assessment of the quality (not just acceptability) of management's accounting practices and policies
- the auditor's views on the adequacy and completeness of the company's disclosures in the financial statements
- discussion of contentious issues including "close calls" and any other concerns

These meetings will also create a forum to enable the audit firm and the Audit Committee to discuss the audit firm's approach to ensuring that they maintain an adequate and appropriate degree of professional skepticism during the performance of their work. Further, the Audit Committee will be provided the opportunity to gain a much better understanding of how the auditor perceives risks in the company and how their procedures are designed to address those risks.

Another improvement to the auditors reporting responsibility would be to have the auditor present a periodic in-depth review of the qualifications of the audit firm to retain the

assignment as the company's auditor, as well as the steps that it takes to ensure independence from the company, as well as training and other tools it uses to ensure its partners and staff exercise objectivity and professional skepticism. This review could consist of a formal written and/or oral presentation by the existing audit firm of their overall qualifications to continue serving as the company's auditor, and could include participation by senior management of the audit firm. Where deemed appropriate, the Audit Committee could seek to obtain a similar statement of qualifications to serve as the company's auditor by one or more additional firms. These statements of qualifications submittals could be limited to qualifications only with no discussion of the cost of services or the specific approach that would be utilized in serving the company. By periodically conducting such a review, the Audit Committee would be able to depart from the normal work-flow cycle and objectively look at the qualifications, independence and objectivity of its audit firm and make a judgment as to whether or not to take the next step of seeking to change their audit firm. In order for this process to work, the PCAOB may have to modify the standards that govern the audit firms and allow them to provide statements of qualifications to non-clients without the concern that such submissions could be viewed as "opinion shopping".

The PCAOB can also better serve companies by providing the results of their reviews of a company's auditor directly to the Audit Committee on a timely basis. Today, audit committees receive feedback on their auditor's PCAOB examination directly from the audit firm and indirectly by reading the publicly available report from the PCAOB, but this reporting is long after the review has been conducted and therefore in large part loses its relevance. We believe that audit committees could benefit from a more timely communication directly from the PCAOB describing emerging issues and concerns that are identified in examinations that have been recently completed (no accounting firm or issuer need be identified). This information would be useful to audit committees in conducting their face-to-face discussions with their auditors about the conduct of the audit that is currently in process. Timely feedback would allow the Audit Committee to better evaluate the real time performance of its auditors and determine whether any conditions existed that would warrant a rotation evaluation.

Independence, objectivity and professional skepticism are attributes that are typically associated with individual auditors rather than audit firms. We believe a better alternative to audit firm rotation would be to expand the current requirement for rotation of the lead client service partner to also include the lead audit manager at the headquarters location. If the desire is for the audit firm to take a "fresh look" at the audit's scope and work approach, rotation of the audit leadership team at the headquarters location would contribute to the ability to fulfill that requirement. We further believe that most of the issues highlighted in the Concept Release as items identified through PCAOB reviews could be addressed through cooperation between the PCAOB and the accounting industry to design better training on the objective and professionally skeptic mindset.

In summary, we believe the Board's proposal to require the periodic rotation of audit firms will result in an increase in audit costs, degradation in audit quality and the likelihood for

greater audit failures. All of these issues, in our view, outweigh the potential benefit of enhanced independence, objectivity, and professional skepticism. Further, given the limited number of firms able to serve large multi-national corporations, no firm is likely to be incentivized to be more skeptical or objective as another as they will continue to want to be in the rotation mix going forward, watering down if not completely degrading the benefit of the Concept Release.

As stated in the Concept Release, the notion of mandatory audit firm rotation has been proposed numerous times in the past and rejected each time based on what we believe to be sound reasoning and good business sense. We do not believe the Concept Release presents any new compelling evidence to warrant such a disruptive and risky response, given the relatively small number of audit failures in the current environment, and given the lack of evidence that these failures are tied to issues with auditor independence, objectivity, and professional skepticism. Moreover, we believe that there are a number of less onerous and risky alternative courses of action that could be adopted to substantially overcome and mitigate the concerns expressed by the PCAOB regarding the relationship that develops between the auditor and their client over the long term.

We would be happy to discuss our comments with you in more detail if you so desire. Thank you again for the opportunity to comment on these matters and for your consideration of our points of view.

Respectfully,



Stephen E. Frank
Director and Chair,
Audit Committee of
the Board of Directors



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