NORTHROP GRUMMAN

February 26, 2007

Nancy M. Morris
Secretary
Securities and Exchange Commission
100F Street, NE
Washington, D.C. 20549-1090

Reference: File Number S7-24-06
Proposed Interpretation and Rule Concerning Management's Report on Internal Control Over Financial Reporting

and

Office of the Secretary
Public Company Accounting Oversight Board
1666 K Street, NW
Washington, DC 20006-2803

Reference: PCAOB Rulemaking Docket Matter No. 021

Executive Summary

Northrop Grumman Corporation ("NGC") welcomes the opportunity to provide our comments to the Securities and Exchange Commission ("SEC") in response to its proposed interpretation and rule concerning *Management's Reports on Internal Control over Financial Reporting* ("ICFR") (the "Proposed Rules"). Given the important interrelationship between management's assessment of ICFR and the independent audit process, we are also providing comments with respect to the Public Company Accounting Oversight Board ("PCAOB") proposed auditing standard, *An Audit of Internal Control over Financial Reporting that is Integrated with an Audit of Financial Statements*.

We appreciate the effort made by both the SEC and PCAOB to codify previous guidance with respect to a top-down, risk-based approach to the evaluation of ICFR. We believe the Proposed Rules present management with a practical approach in carrying out its responsibilities in the evaluation of ICFR. We also believe the proposed PCAOB auditing standard affords accounting firms the opportunity to apply a less prescriptive, though sufficiently robust, methodology as well.

Our primary concern is that the effectiveness of the Proposed Rules is dependent on the extent to which auditors modify their approach under the proposed PCAOB auditing standard, as. auditor behavior appears to be driven by the PCAOB inspection process, regardless of the written standards. Secondly, we are concerned that a top down risk-based approach may be difficult for the auditors to implement and consequently, specific guidance and examples may be necessary.

<u>Alignment of PCAOB Examinations with a Risk-based Approach</u>

Accounting firms have already expended significant resources and adapted staffing levels to implement an audit approach that meets the requirements of Auditing Standard No. 2, *An Audit of Internal Control over Financial Reporting Performed in Conjunction with an Audit of Financial Statements* ("AS2"), and we believe results of PCAOB inspections may have been an important consideration in developing their methodology. While the proposed PCAOB auditing standard should permit the accounting firms to modify their audit approach to accommodate the more practical intent of the new rules, including a greater emphasis on the top-down, risk-based approach to evaluating ICFR, we think it is unlikely accounting firms will change their audit approach until they are confident PCAOB inspections will be similarly focused.

From a practical standpoint, continuation of existing audit practices by accounting firms will impact management's ability to implement the Proposed Rules as companies will continue to support the auditor's work and are unlikely to be comfortable with potential divergences from auditors' reports with respect to the nature and number of deficiencies reported to the Audit Committee. It is also possible that differences in approach may *increase* audit work if accounting firms decrease reliance on management testing solely because of dissimilar reductions in testing by management in certain areas.

Based on our review of PCAOB inspection reports and discussions with accounting firms, it appears that up to now a prescriptive and detailed approach is followed during most inspections, with equal attention to all aspects of the audit. While we believe such inspections are intended to provide a valuable service to investors, many of the reported findings do not appear to reflect inadequacies in the overall quality of audit work performed, but rather differences in professional judgment.

To date, we believe there may not have been sufficient dialogue between the PCAOB and accounting firms with respect to the PCAOB's inspection approach. We recommend such communication be initiated as soon as practicable to ensure firms have a clear understanding of the effect the proposed PCAOB auditing standard will have on the PCAOB's inspection process. We also recommend the PCAOB adopt a more timely and focused, risk-based approach to its inspections, which should enable inspectors to vary their procedures based on specific circumstances, similar to the approach recommended in the proposed PCAOB auditing standard.

<u>Clarification of Reliance on Certain Process and Company Level Controls</u>

We are pleased with the PCAOB's proposed change in its auditing standard to emphasize that strong company level controls ("CLCs"), with a direct link to process level controls, are likely to reduce auditors' testing of controls at the process level. We also appreciate that the PCAOB has modified its description of control selection to direct auditors' attention toward controls that sufficiently address the risk of material misstatement, regardless of the nature of the control.

It has been our experience that the audit plans of the independent auditors are developed with the expectation that routine transactional controls, general IT controls, higher level detective controls, and CLCs will be evaluated concurrently and, therefore, results of testing one control are unlikely to influence testing of a complementary control. Furthermore, CLCs are typically evaluated too late in the process to influence the auditor's testing of other controls. We believe a more efficient, cost-effective audit could be achieved if higher level detective controls within business cycles and CLCs, especially those providing direct assertion-level comfort such as controls to monitor results of operations and the period end financial reporting process, were tested early in the audit cycle, and their effectiveness considered when determining the scope of any remaining testing requirements.

We agree that CLC's can have a pervasive effect on the entire control structure, but do not believe accounting firms place sufficient reliance on certain CLCs, such as detailed analytic reviews, when considering their overall scope of work. As a result, management may not have fully developed these controls. The Proposed Rules appear to support increased reliance on effective higher level controls, and with assistance by accounting firms, we believe management can develop more meaningful controls in this area. Once such controls are established and utilized by management, we would expect that the accounting firms would be able to place reliance on these controls and thereby reduce their testing requirements for controls operating at a lower level of materiality.

We also believe auditors could better demonstrate a risk-based approach in their selection of individual controls to test within processes. For example, when determining their scope of work, auditors do not appear to evaluate the likelihood of failure for a routine control based on the extent to which a process, key personnel, and other qualitative factors have remained consistent between annual tests. In addition to the historical effectiveness of routine controls, complementary or redundant detective controls which operate at a higher level of materiality are also frequently not considered. We recommend further clarification and examples be provided within the Proposed Rules with respect to the correlation between effective CLCs and required testing of certain routine transactional controls.

With the advent of AS2, each accounting firm interpreted the rules and developed materials independently at a significant cost; these materials were also used by issuers in the absence of other guidance. We expect a similar effort may be expended with the release of the Proposed Rules. Consideration should be given to a joint effort between issuers, the PCAOB, and accounting firms to identify areas in which further clarification and examples may be helpful to develop tools to assist with consistent compliance. We believe resulting supplemental information in the form of checklists, guidelines or templates should be published with the Proposed Rules to enable management and accounting firms to better understand and take advantage of key changes that could increase efficiency in their approach, while ensuring all compliance requirements are met.

Summary

Although we are generally satisfied with the interpretative guidance provided by the SEC and believe the PCAOB has made a significant effort to direct the auditor's attention toward the most important controls which can prevent or detect a material misstatement, significant concerns remain as to the implementation of the Proposed Rules and the proposed PCAOB auditing standard.

Areas which we believe provide opportunities for further improvement include increased coordination between auditors and the PCAOB in the inspection process, further clarification of the relationship between CLCs and process level testing, and a collaborative approach to the development of tools to assist management and auditors in their compliance activities.

We appreciate the opportunity to share our comments and would be pleased to discuss these matters with you further. If you have any questions regarding the information included in this letter, please contact Ken Heintz, NGC's Chief Accounting Officer, at (310) 201-3312 or Kenneth.Heintz@ngc.com at your convenience.

NORTHROP GRUMMAN CORPORATION

By: /s/ KENNETH N. HEINTZ
Kenneth N. Heintz
Corporate Vice President, Controller and Chief Accounting Officer

cc: Office of the Secretary, PCAOB