NORTHROP GRUMMAN

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

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Concept Release Concerning Management's Reports on Internal Control Over Financial Reporting

Executive Summary

Northrop Grumman Corporation ("NGC") welcomes the opportunity to provide our comments to the Securities and Exchange Commission ("SEC") in response to its Concept Release Concerning Management's Reports on Internal Control over Financial Reporting. We are generally satisfied with the guidance that has been issued to date by the SEC and Public Company Accounting Oversight Board ("PCAOB") with respect to management's responsibilities for documenting and evaluating internal controls over financial reporting ("ICFR") pursuant to the Sarbanes-Oxley Act of 2002 (the "Act").

Notwithstanding, we believe further guidance for practitioners would be beneficial with respect to various aspects of the ICFR assessment process, such as the practical application of a risk-based approach to management's ICFR assessment, the evaluation of control deficiencies and information technology controls, the role of outside auditors, and the application of Section 404 of the Act on smaller public companies. We believe opportunities exist in each of these areas to improve the Section 404 compliance process, while providing comparable levels of assurance to investors regarding the accuracy and reliability of financial statements. We have also found the illustrative examples provided by the SEC in its Frequently Asked Questions documents to be very helpful, and encourage the SEC to continue providing such examples in future guidance.

General Observations

We believe any additional guidance issued by the SEC or PCAOB should provide management with clarification of general principles; however, more prescriptive guidance may be useful in certain areas, such as those addressing required public disclosures. Additionally, modifications to Auditing Standard No. 2, *An Audit of Internal Control Over Financial Reporting Performed in Conjunction with an Audit of Financial Statements* ("AS2") and Section 404 of the Act may be necessary. We have found the interpretative guidance issued through the SEC's Frequently Asked Questions documents to be extremely helpful and do not believe a new Commission Rule for issuers would be appropriate at this time. Such a rule could result in a substantial burden on companies currently in compliance with prior implementation guidance. Specifically, many companies have invested substantial human capital and financial resources into developing documentation to support management's assessment. A new Commission Rule would require a reassessment of what has been performed to date to ensure existing work is compliant with any new requirements.

Risk-Based Audit Approach

Public company management is actively involved in day-to-day operations, and develops monitoring controls to ensure the effectiveness of its ICFR. These entity-level controls have been found to be robust and effective at most companies and we believe they are the primary controls to prevent or detect material misstatements in a timely manner. Notwithstanding, we believe most assessment efforts continue to be focused on testing routine transactional and information technology ("IT") general controls, regardless of the effectiveness of higher level controls that have been designed specifically to detect material errors.

While we believe the guidance provided by the SEC and PCAOB regarding a "top-down, risk based" approach to management's assessment is appropriate, we believe external auditors' procedures are often based on standard programs focused heavily on routine, transactional control testing designed to cover a substantial majority (e.g., two-thirds) of significant financial statement accounts. It is our view that auditors generally have placed limited reliance on management's oversight and self-assessment processes. Furthermore, when developing the timing and extent of testing, consideration is often not given to 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. Historical effectiveness of controls is also frequently not considered. We understand the auditors' approach in this area because existing guidance within AS2 focuses heavily on the identification and testing of controls over the initiation, authorization, processing and reporting of routine transactions. It also requires each year to be considered individually, with limited opportunities for auditors to consider previous control effectiveness.

We recommend guidance be enhanced to provide more clarification and illustrative examples regarding the extent to which management can rely on effective entity-level controls and related opportunities to reduce testing at the process level. In addition, we recommend the SEC and PCAOB provide more flexibility in the nature, timing, and extent of evaluation procedures for routine, transactional controls, such as placing more reliance on monitoring controls and self-assessments and considering the extent to which processes, key personnel and other qualitative factors have changed from an established (and effective) baseline.

Deficiency Evaluation

Management and its auditors spend too much time evaluating control deficiencies that may be *significant* deficiencies, although both parties agree the issues would not rise to the level of a material weakness. Those discussions can be time-consuming and typically occur during the critical time each quarter when management is finalizing its financial statements for public filing and preparing for discussions with the Audit Committee. Given that the Act was designed to ensure investors are informed of material weaknesses and provided assurance that corrective actions are performed timely, we do not believe it is cost beneficial to extensively evaluate deficiencies that are not potential material weaknesses. Historically, management and external auditors have informed the Audit Committee of control matters they believe are relevant to the evaluation of the company's financial statements, including matters that in the context of Section 404 would be evaluated as potential significant deficiencies.

We recommend the requirement to evaluate ICFR issues to determine if they constitute significant deficiencies be eliminated, while maintaining current requirements with respect to the evaluation of control deficiencies in the context of potential material weaknesses. We believe management can be relied upon to use professional judgment when determining information most appropriate to share with the company's Audit Committee regarding control deficiencies. To assist practitioners in this area, however, the SEC may consider providing illustrative examples of the types of information that should be shared with the Audit Committee such as issues that were considered to represent a greater risk to the company or multiple deficiencies that constitute a "theme" or "area" of control weakness.

IT General Controls

IT general controls comprise nearly half of the key controls tested at many companies, although the material weaknesses that prompted the Act and continue to be the source of major financial restatements have not been attributed to a failure in IT general controls. Certain IT general controls can be directly correlated to the preparation of financial statements, such as controls over changes to a financial system application; however, we believe many of the controls now tested do not directly impact the financial statements and are unlikely to result in a material misstatement due to the existence of higher level controls that operate at the transaction or entity-level.

AS2 guidance is limited with respect to IT general controls, referring auditors to AU Section 319, *Consideration of Internal Control in a Financial Statement Audit* ("AU 319"). This auditing standard, which was published before passage of the Act, does not provide clear direction with respect to materiality in consideration of IT general controls subject to ICFR testing, which we believe has contributed to more extensive testing than may be necessary to satisfy Section 404 compliance requirements.

Most external auditors appear to have interpreted AU 319 guidance to comprise six different components of the IT infrastructure and control activities tested include firewalls, physical access to computer facilities, job scheduling controls related to general computer operations, and network support. The relevance of IT general controls that appear to have only an indirect impact on the financial statements continues to be a topic of discussion.

Previous guidance indicates evaluations of the significance of a deficiency in IT general controls should be considered in conjunction with an evaluation of application controls. Accordingly, while performing tests on the effectiveness of an IT general control is clearly relevant should an application, process or entity-level control fail, testing in the absence of such a control failure may not be beneficial to management's assessment of ICFR.

We recommend the SEC provide further clarification on the nature and extent of testing required for IT general controls having only an indirect impact on the financial statements. Because we believe the most substantial IT-related risk lies within the financial application systems, we also recommend more detailed guidance be provided on requirements to test application-type IT controls. Topics to address would include the extent to which such controls should be tested if application, process and entity-level controls are adequate, as well as examples of indirect IT general controls both relevant and not generally relevant to management's assessment of ICFR.

The Role of Outside Auditors

While we welcome additional guidance to assist management with its assessment of ICFR, we believe it would also be appropriate for the SEC and PCAOB to reconsider the requirement for outside auditors to separately report on the effectiveness of a company's ICFR. Currently external auditors are required to opine on three areas for each of the registrants which they audit - (1) the effectiveness of management's assessment of ICFR, (2) the effectiveness of ICFR, and (3) the company's financial statements.

We believe that part of the significant increase in outside audit fees (nearly double annual fees prior to implementation of the Act) relates to the fact that under the current requirements, auditors are testing many of the same internal controls for the ICFR and financial statement audits, but for two different "effective" periods. As part of their financial statement audit, auditors must evaluate controls <u>throughout</u> the period of audit; however, for the evaluation of ICFR effectiveness, they must be evaluated <u>as of the end</u> of the respective period. While an initial goal of the outside auditors appears to have been "integration" of ICFR and financial statement audit efforts, we do not believe most companies are experiencing this in practice. It is our experience that controls are being tested twice in many cases, which is not surprising considering the two different periods for which auditors must ensure controls are effective.

We recommend that consideration be given to modifying the role of outside auditors to require only two annual opinions. The first would be an opinion regarding the effectiveness of management's assessment of its ICFR and the second would be an opinion on the company's financial statements. Because many of the same controls are being tested by the auditors in connection with their audit of the financial statements, we believe the investing public would get many of the same benefits from this approach as under the current model, but at a much reduced cost.

Smaller Public Companies

We believe each public company should have a responsibility to report on the effectiveness of its ICFR; therefore, we support the SEC's position regarding the enforcement of Section 404 requirements for smaller public companies. Because of the significant effort required of companies to comply with Section 404 of the Act, we believe a balanced approach to compliance for smaller companies is appropriate. We expect management of smaller companies to utilize their professional judgment to focus on areas having greater inherent risk based on the specific characteristics of their businesses. To this end, we have observed many large companies have introduced a scaled compliance approach across locations, which places reliance on entity-level controls and process level controls related to specific risks, rather than documenting and testing key controls for all business cycles. We believe a similar approach could be adopted by smaller companies. Guidance in the form of illustrative examples of risks which may be of more concern to smaller companies would be beneficial, and may prove useful to larger companies with multiple locations. For example, discussion of the extent to which reliance may be placed on the compilation and review of analytical data surrounding financial results may be useful to help evaluate the effectiveness of ICFR at a smaller company that is unable to achieve effective segregation of duties due to resource constraints.

Summary

Section 404 of the Act and related guidance provided by the SEC and PCAOB has resulted in enhancements to our company's controls over financial reporting. While we are generally satisfied with guidance provided to date, we believe there are opportunities to further assist companies and auditors in the adoption of a risk-based approach to Section 404 compliance. Areas which we believe provide opportunities to increase efficiency include clarification regarding the extent to which reliance can be placed on management's professional judgment and effectiveness of entity-level controls, the value of classifying audit findings as significant deficiencies, further guidance in the area of IT general controls, and the role of outside auditors. We also believe more illustrative examples would assist companies (including smaller companies) and external auditors in the practical application of such guidance.

We appreciate the opportunity to comment on this Concept Release 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 me at (310) 201-3312 or Kenneth.Heintz@ngc.com at your convenience.

NORTHROP GRUMMAN CORPORATION

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