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Comments on Release No. 34-54122; File No. S7-11-06

COMMENTS ON CONCEPT RELEASE CONCERNING MANAGEMENT'S REPORTS ON INTERNAL CONTROL OVER FINANCIAL REPORTING

We at Southern Company very much appreciate the opportunity to provide the Securities and Exchange Commission (SEC) with our comments regarding the need for additional guidance for management in the evaluation and assessment of internal control over financial reporting. We applaud efforts the SEC has made to date in seeking to achieve the goals of Congress in the implementation of the Sarbanes-Oxley Act, while at the same time being mindful of the significant impacts of the requirements on SEC registrants.

Southern Company has been complying with Section 404 of the Sarbanes-Oxley Act (Act) on a consolidated basis, since the year ended December 31, 2004, and has completed two years of management assessments on the effectiveness of internal control over financial reporting and is well underway to completing its third management assessment.

To establish the basis for our comments, it is important to note that the primary goal of the Act is the prevention of material corporate fraud. We believe that this goal was clearly achieved by those sections of the Act outside of Section 404. In spite of the difficulties encountered by SEC registrants in implementing Section 404, we feel that the Act has successfully addressed the corporate level internal control weaknesses which allowed material frauds such as those at Enron, WorldCom and Tyco to occur. With the disproportionate attention given to Section 404, the investing public might easily overlook how effective the other parts of the Act have been in improving corporate governance, improving internal control over financial reporting and preventing material fraud. We believe that the Act can continue to fully accomplish the intent of Congress without the detailed internal control evaluations required by Section 404. It is from this perspective that we advocate significant revision and reduction to the current compliance requirements associated with Section 404. We believe that the important improvements to internal control over financial reporting resulting from the portions of the Act beyond Section 404 will meet expectations without the overly burdensome and detailed compliance requirements of Section 404 as they currently exist.

In developing our specific recommendations, we considered the significant investments made to date on processes and tools used to facilitate compliance with Section 404. These investments have been made not only by SEC registrants like ourselves but also by public accounting firms and many other third parties. These significant investments create reluctance on the part of some, especially public accounting firms and third party vendors, to support significant reductions in the Section 404 compliance requirements. However, we believe that significant changes must be made. New guidance to management and Auditing Standard No. 2 (AS2) changes must be coordinated and sufficient time should be provided to implement each.

We recommend several specific changes to AS2 as well as some refinements in requirements for those accelerated filers that have already fully complied with Section 404. These are discussed in Attachment One.

We also have several recommendations for those entities that have been granted deferrals and have not yet complied with the Section 404 requirements. For these entities, we recommend that the SEC implement a reduced Section 404 compliance requirement. We list these recommendations in Attachment Two.

Lastly, we include in Attachment Three, our specific comments on the thirty-five questions posed by the SEC in its July 11, 2006 concept release. Our answers to these questions are consistent with our overall recommendations.

Thank you for allowing us the opportunity to provide comments regarding additional guidance for Sarbanes-Oxley 404 compliance. We look forward to the development of this guidance and thank the SEC for its continued efforts in this area.

Sincerely,

/s/Thomas A. Fanning

Thomas A. Fanning
Executive Vice President and
Chief Financial Officer

ATTACHMENT ONE

Specific refinements for accelerated filers that have already complied with Sarbanes-Oxley Section 404:

1) Revise AS2 to achieve reasonable consistency with the SEC's Management Guidance. In practice, greater reliance is placed on management testing by the public accountants when management testing reflects the prescriptive requirements and specific descriptions included in AS2. Previously issued guidance has been clear that the SEC seeks significant reliance by the public accountants on the work of others, including management and internal auditing. It is the reliance by the public accountants that drives management's compliance and assessment efforts to be in accordance with AS2 requirements. It is not the lack of SEC guidance. In practice, management's efforts to alter and reduce the nature, extent and timing of test procedures, based on a top-down risk assessment, have been limited due to advice from the public accountants who have strongly pushed a strict AS2 approach. For example, we were required to prepare specific proofs of financial statement assertion coverage and other documentation that clearly would not have been required from the public accountants were it not for the AS2 based guidance.
2) Revise AS2 to focus on the assessment of residual risk (high risk areas) instead of on the assessment of inherent risk (both high and low risk areas). The latest guidance from the PCAOB and SEC allowed registrants significant flexibility in their approach to management's assessment. This flexibility, however, did not extend to the public accountants, who are bound by AS2. Paragraph 145 of AS2 states that the public accountants must obtain evidence "about the effectiveness of controls over **all** relevant assertions related to **all** significant accounts and disclosures in the financial statements." The SEC should reinforce the concept of testing only the most relevant assertion for the

highest risk accounts and not all assertions for all significant accounts. The current prescriptive approach effectively eliminates the public accountant's ability to use professional judgment to alter the nature, extent, and timing of testing as described in paragraphs 93 through 104 of AS2. It prevents the public accountants from realizing the same type of assessment efficiencies as those provided to management by the latest SEC guidance.

3) Require SEC registrants to make a single management assessment and certification for a consolidated group. Many accelerated filers have subsidiaries that are also SEC registrants and non-accelerated filers. Some of these subsidiaries are debt-only registrants. Under current rules to be effective for 2007, each of these subsidiaries would require a separate management assessment, a separate management certification and a separate opinion from the public accountant in 2008. For Southern Company, this would result in our having to complete six individual management assessments and six individual management certifications and to pay for six individual audit reports from the public accountants. We believe the value of performing this exercise multiple times adds little value to investors, while costing them millions of dollars. We recommend entirely exempting wholly owned subsidiaries from individually certifying, given that they are covered already by the overall assessment for Southern Company which has fully complied with the Section 404 and 302 standards in the past and plans to going forward. These exemptions would be aligned with non-accelerated registrants that meet the SEC audit committee exemption. At a minimum, we recommend treating subsidiaries of larger certifying registrants under the rules being developed for small to medium sized companies. (See our recommendations in Attachment Two.)

4) Eliminate the requirement for a public accountant opinion on Management's Assessment process. When developing their

opinion on management's assessment, the public accountants perform audit procedures to evaluate management's assessment process. In practice, that process is based on AS2 auditing procedures since there is no other framework for the process. When management's assessment deviates from AS2 and instead relies on risk assessments and judgments based on day to day contact with controls, the public accountants have typically required additional otherwise unneeded documented evidence to support the assessment, consistent with AS2. The public accountant's audit of management's "audit," in our opinion, is a costly, burdensome and meaningless requirement. We recommend that the public accountant's role be limited to an opinion on the effectiveness of the controls themselves. Investors derive their value from assurance that internal controls over financial reporting are effective. They realize little, if any, value from an evaluation of how management reached this assessment. Additionally, investors would continue to receive two powerful opinions on internal control over financial reporting, one from management and one from the public accountant.

ATTACHMENT TWO

Recommended elimination of separate assessment requirements for those registrants that have not yet implemented the requirements of Sarbanes-Oxley Section 404:

1) Totally eliminate a separate assessment of internal control over financial reporting by management. Specifically we recommend that the SEC remove separate assessment requirements at the individual registrant level for non-accelerated filers meeting the following conditions:
   - The parent company registrant successfully complies with the Section 404 standards and Section 302 standards;
   - The non-accelerated filer is a wholly owned subsidiary of the parent company; and
   - The non-accelerated filer meets the SEC Audit Committee exemption

   Given the smaller size and costs of these registrants, a sole assessment at the consolidated level of internal control over financial reporting by the public accountants should provide adequate assurance for investors. This would also naturally eliminate any public accountant assessment of a management assessment, as it would not exist. If not eliminated, the management assessment for small to mid-sized companies should only be periodically required, e.g. every three years.

2) Focus any assessment that may be required of small to mid-sized registrants primarily on corporate level controls. Given the smaller size of these registrants, controls over lower level processes within those smaller companies quickly become de minimis. The effectiveness of the corporate level controls is the primary concern of investors.

3) Revise Auditing Standard No. 2 to become a generic guide as to **what** the public accountant **should consider** to perform the assessment of internal control over financial reporting, with a variety of procedures identified that could be selected based on the size of the registrant, risk and auditor judgment. Currently, AS2 is essentially a framework

itself that drives not only how to evaluate the controls but also how the documentation should look and what should be included (based on the financial statement assertions as applied to all key account balances). AS2 should simply establish a hierarchy of audit procedures that could be performed that would create adequate evidence for the public accountant's opinion. These procedures should clearly vary based on registrant size, risk and auditor judgment.

ATTACHMENT THREE

Specific Questions from SEC Concept Release:

1. Would additional guidance to management on how to evaluate the effectiveness of a company's internal control over financial reporting be helpful? If so, would additional guidance be useful to all reporting companies subject to Section 404 requirements or only to a sub-group of companies? What are the potential limitations to developing guidance that can be applied by most or all reporting companies subject to the Section 404 requirements?

   Southern Company suggests that additional guidance be provided which emphasizes those entity-level key controls and soft controls focused on the mitigation of residual risk. The guidance should be stratified, which would allow for management judgment to be applied using a scalable approach as individual registrants get smaller. The "one size fits all" approach is difficult to implement in practice.

2. Are there special issues applicable to foreign private issuers that the Commission should consider in developing guidance to management on how to evaluate the effectiveness of a company's internal controls over financial reporting? If so, what are these? Are such considerations applicable to all foreign private issuers or only to a sub-group of filers?

   Southern Company is not a foreign private issuer.

3. Should additional guidance be limited to articulation of broad principles or should it be more detailed?

   Additional SEC guidance should be more detailed. It should eliminate inconsistencies between PCAOB standards for external auditors and SEC guidance directed to management as it relates to Section 404 implementation. Additionally, both SEC and PCAOB guidance should consolidate the guidance contained in SAS No. 55 "Consideration of Internal Controls in a Financial Statement Audit" to avoid confusing investors with *multiple sets of rules regarding the "evaluation" or "consideration" of internal control over financial reporting.*

4. Are there additional topics, beyond what is addressed in this Concept Release that the Commission should consider issuing guidance on? If so, what are those topics?

   Companies would benefit from additional guidance which outlines the degree of reliance that can be placed on quarterly monitoring activities to support the annual assessment. In light of recent COSO guidance which promotes consideration of "the totality of internal control," Southern Company believes such additional guidance would be helpful. Additional guidance on how to apply materiality thresholds for errors related to different segments of a financial statement is also needed. It is unreasonable to believe that investors have the same degree of concern for errors on accounts that only affect the Balance Sheet as they would on accounts that impact the Income Statement or Cash Flow Statement. In addition, errors between line items within the same section on the Balance Sheet or Cash Flows Statement have the potential to be less concerning for a typical investor. A degree of subjectivity is needed in assessing the significance these types of issues.

5. Would additional guidance in the format of a Commission rule be preferable to interpretive guidance? Why or why not?

   A <u>rule</u> that makes clear management's ability to exercise judgment in determining the nature, extent and timing of management's own testing processes is preferable over interpretive guidance. This rule should make clear that management processes can and should differ from those employed by the external auditors. The rule should also make clear that these differences do not preclude external auditors from relying on the work of management even when underlying processes are different.

6. What types of evaluation approaches have managements of accelerated filers found most effective and efficient in assessing internal control over financial reporting? What approaches have not worked and why?

   The most efficient and effective testing approach has been to focus on entity-level key controls and soft controls (with reliance on quarterly monitoring activities to build evidence). This approach should be based on residual risk, not on inherent risk.

7. Are there potential drawbacks to or other concerns about providing additional guidance that the Commission should consider? Is so, what are they? How might those drawbacks or other concerns best be mitigated? Would more detailed Commission guidance hamper future efforts by others in this area?

   Potential drawbacks include the obsolescence factor on the part of accounting firms and third-party vendors who have already expended significant resources to develop and market software, consulting or outsourcing services to assist in Section 404 compliance efforts. Further, accelerated filers themselves have invested heavily in compliance programs as well. All of these services and programs would likely require review and revision. To mitigate any impact, a phased-in approach should be utilized to implement new rules. This phased-in approach would occur over a reasonable time, allowing management to absorb, respond and implement without being overly costly and disruptive to business operations; this would be consistent with previous SEC rulemakings.

8. Why have the majority of companies who have completed an assessment, domestic and foreign, selected the COSO framework rather than one of the other frameworks available, such as the Turnbull Report? Is it due to a lack of awareness, knowledge, training, pressure from auditors, or some other reason? Would companies benefit from the development of additional frameworks?

Since COSO was readily available and specifically mentioned in the guidance, it was the natural selection of most accelerated filers. Overall, familiarity with COSO is high. Also, the COSO framework has consistently evolved to meet the challenges of complying with Sarbanes-Oxley. COSO is also the only organization which has issued additional guidance for smaller corporations. Lastly, we do not advocate the development of additional frameworks.

9. Should the guidance incorporate the May 16, 2005 "Staff Statement on Management's Report on Internal Control over Financial Reporting?" Should any portions of the May 16, 2005 guidance be modified or eliminated? Are there additional topics that the guidance should address that were not addressed by that statement? For example, are there any topics in the staff's "Management Report on Internal Control over Financial Reporting and Certification of Disclosure in Exchange Act Periodic Reports Frequently Asked Questions (revised October 6, 2004)" that should be incorporated into any guidance the Commission might issue?

New SEC guidance <u>should</u> incorporate the ideas embodied in prior SEC Staff Statements. Those ideas recognized that companies had too many key controls, too much testing, and too much documentation, all resulting in an assessment that was focused on the areas with the highest inherent risks. Whereas appropriate identification of residual risks would facilitate devotion of resources to the most vulnerable components of business processes. The May 16, 2005 Staff Statement advocated a top-down risk based approach that placed emphasis on entity wide key controls and soft controls. These are the controls that, if failure occurs, would most likely result in a material misstatement.

10. We also seek input on the appropriate role of outside auditors in connection with the management assessment required by Section 404(a) of Sarbanes-Oxley, and on the manner in which outside auditors provide the attestation required by Section 404(b). Should possible alternatives to the current approach be considered and if so, what?

Would these alternatives provide investors with similar benefits without the same level of cost? How would these alternatives work?

The appropriate role of external auditors should be to attest only to the effectiveness of a company's internal control over financial reporting. Current provisions of AS2 require external auditors to opine on <u>*both*</u> *management's assessment and on the effectiveness of controls. Instead AS2 should require the independent auditor to opine only on the effectiveness of the registrant's controls. Investors and shareholders realize little value from the inefficient and expensive use of external auditor resources to review management's assessment process. This external review is in reality a logistical exercise primarily focused on internal control documentation – not on internal control effectiveness. At a minimum there should be only one assessment by the external auditors for a consolidated entity. (Also see the response to Question 3 regarding the alignment of guidance.)*

11. What guidance is needed to help management implement a "top-down, risk-based" approach to identifying risks to reliable financial reporting and the related internal controls?

A top-down, risk-based approach that begins with entity-level controls as the starting point and explains how to determine the need for additional testing of lower level, transactional controls when these high level controls fail and identification of controls linked to the highest residual risk would be most beneficial. This approach would limit the number of key controls tested by improving the alignment of such controls with material Internal Control over Financial Reporting (ICFR) risks. Limiting the number of key controls to be tested by adopting a top-down, risk-based approach will focus compliance efforts on those controls that could reasonably prevent or detect material errors, as intended by Section 404. Guidance should contain specific templates or examples of acceptable risk assessments. The PCAOB has already confirmed in its November 2005 report that management and the external auditors have tested controls that are not key with regard to complying with SARBANES OXLEY ACT.

Risk assessment guidance that emphasizes the need to exercise tailored judgment in relation to identifying significant risks and controls that mitigate such risks is warranted. Instead of using standardized check lists that may not appropriately allocate resources to applicable high risk areas, a tailored testing approach that addresses only the controls that represent a material risk of a financial reporting error should be utilized. This approach allows for greater flexibility when interpreting issues like the "COSO Totality" concept in that an entity should not have to identify and test each individual control over financial reporting, but evaluate the internal control structure collectively, and begin testing with the entity-level controls. Then, if warranted by failure of company level controls, test supporting transactional level controls. This approach should be used consistently during the financial reporting risk assessment process to provide a cost effective means for excluding insignificant control processes for the purposes of complying with the testing requirements driven by Section 404.

Other financial reporting control activities would continue to provide reasonable assurance of achieving financial reporting objectives; however, they could be declassified (excluded from SARBANES OXLEY documentation and testing) as key controls activities with respect to Section 404. This approach is also supported by this recent SEC Staff Statement, "While identifying control deficiencies and significant deficiencies represents an important component of management's assessment, the overall focus of internal controls reporting should be on those items that could result in material errors in the financial statements."

12. Does existing guidance, which has been used by management of accelerated filers, provide sufficient information regarding the identification of controls that address the risks of material misstatement? Would additional guidance on identifying controls that address risk be helpful?

Instead of focusing on controls that address the risk of "material misstatement," AS2 focuses on detection of potential misstatements in excess of "inconsequential" amounts. This establishes a very low *bar that leads to micro-control documentation and micro-control testing. Findings resulting from testing at this level of detail are typically far beneath the level that would be of interest to investors. Instead, new guidance should be established to focus on detection of potential misstatements that would aggregate to "material" amounts. This would yield results that are meaningful to investors. Significant guidance already exists on the concept of "materiality," e.g. Staff Accounting Bulletin 99.*

In addition, AS2 emphasizes detection of potential misstatements whose likelihood is more likely than "remote." The "remote" likelihood establishes a very low bar that leads to micro-control documentation and micro-control testing. Findings resulting from testing at this level of detail are typically far beneath the level that would be of interest to investors. Instead, new guidance should be established to focus on detection of potential misstatements whose likelihood is "reasonably possible" as defined in SFAS No. 5, Accounting For Contingencies. This revision would likely yield results that are more significant to investors which is the true intent of the regulation.

13. In light of new COSO guidance for smaller public companies, what additional guidance is necessary on risk assessment or identification of controls that address risks?

    Southern Company suggests that additional guidance be provided which emphasizes those entity-level key controls and soft controls focused on the mitigation of residual risk. The guidance should be stratified, which would allow for management judgment to be applied using a scalable approach as individual registrants get smaller. The "one size fits all" approach is difficult to implement in practice.

14. In areas where companies identified significant start-up efforts in the first year, will the COSO guidance for smaller public companies adequately assist companies that have not yet complied with Section 404 to efficiently and effectively conduct a risk assessment and identify

controls that address the risks? Are there areas that have not been addressed or need further emphasis?

Regardless of the size of the company, this guidance clarifies the COSO framework by explaining how to use a top-down, risk-based approach to identify and evaluate financial reporting risks that could result in a material misstatement. It also emphasizes the concept of evaluating the internal control structure as a whole and not on a control by control basis as a more cost effective means for achieving applicable control objectives. While this new guidance is helpful, its full value cannot be realized without the recommended revisions to AS2.

15. What guidance is needed about the role of entity level controls in evaluating and assessing the effectiveness of internal control over financial reporting? What specific entity-level control issues should be addressed (e.g. GAAP expertise, the role of the audit committee, using entity-level controls rather than low-level account and transactional controls)? Should these issues be addressed differently for larger companies and smaller companies?

    Entity-level controls should be identified, evaluated from a residual risk perspective and tested first. Additional detailed testing at the transactional level should only be performed when warranted by test failures of entity-level controls. In addition, because most of the more recent, significant financial frauds (Enron, WorldCom, etc.) resulted from the failure of entity-level controls, more emphasis should be placed on these high level controls and less on the more granular, transactional level controls. (See sample entity level controls in our response to question # 17)

16. Should guidance be given about the appropriateness of and extent to which quantitative and qualitative factors, such as likelihood of error, should be used when assessing risks and identifying controls for the entity? If so, what factors should be addressed in the guidance? If so, how should that guidance reflect the special characteristics and needs of smaller public companies?

Yes, the financial reporting risk assessment process should emphasize both quantitative and qualitative factors. It should also emphasize the use of a top-down, risk-based approach to identifying material risks and related controls. In addition, it should be driven by the impact and likelihood concepts of "material" accounts and "reasonably possible", as explained in our response to Question 24.

In addition, AS2 emphasizes detection of potential misstatements whose likelihood is more likely than "remote." The "remote" likelihood establishes a very low bar that leads to micro-control documentation and micro-control testing. Findings resulting from testing at this level of detail are typically far beneath the level that would be of interest to investors. Instead, new guidance should be developed to focus on detection of potential misstatements whose likelihood is "reasonably possible" as defined in SFAS No. 5, Accounting For Contingencies. This revision would likely yield results that are more significant to investors which is the true intent of the regulation.

17. Should the Commission provide management with guidance about fraud controls? If so, what type of guidance? Is there existing private sector guidance that companies have found useful in this area? For example, have companies found the 2002 guidance issued by the AICPA Fraud Task Force entitled "Management Antifraud Programs and Controls" useful in assessing these risks and controls?

    No additional guidance is needed relating to fraud controls. Current guidance provided by the private sector (AICPA, ACFE, IIA, etc.) is sufficient with regard to achieving applicable fraud prevention and detection control objectives. AS2 clearly states, "The auditor should evaluate all controls specifically intended to address the risks of fraud that have at least a reasonably possible likelihood of having a material effect on the company's financial statements." This statement emphasizes that management should focus on those fraud schemes that could result in a material misstatement. Although important, transactional level controls that mitigate fraud risk that is unlikely to result in a material misstatement should not be considered key controls. As an alternative, existing guidance could be either *referenced or incorporated directly using SEC releases, much like COSO is referenced in SARBANES OXLEY guidance.*

18. Should guidance be issued to help companies with multiple locations or business units to understand how those affect their risk assessment and control identification activities? How are companies currently determining which locations or units to test?

Additional guidance for locations or business units within a single registrant is not necessary. However, additional guidance should be issued that does not require individual certifications at certain wholly owned subsidiary registrants that are not material from the investor's perspective.

Specifically we recommend that the SEC remove separate assessment requirements at the individual registrant level for non-accelerated filers meeting the following conditions:

- *The parent company registrant has successfully complies with the Section 404 standards and Section 302 standards;*
- *The non-accelerated filer is a wholly owned subsidiary of the parent company; and*
- *The non-accelerated filer meets the SEC Audit Committee exemption*

Precedent for this exemption has been previously established by the SEC in their exemption of certain subsidiary registrants from the audit committee requirements of Section 404

19. What type of guidance would help explain how entity-level controls can reduce or eliminate the need for testing the individual account or transaction level? If applicable, please provide specific examples of types of entity-level controls that have been useful in reducing testing elsewhere?

Entity-level controls should be identified, evaluated from a residual risk perspective and tested first. Additional detailed testing at the transactional level should only be performed when warranted by test failures of entity-level controls. In addition, because most of the more *recent, significant financial frauds (Enron, WorldCom, etc.) resulted from the failure of entity-level controls, more emphasis should be placed on these high level controls and less on the more granular, transactional level controls. Specific examples of entity-level controls that have been relied on to reduce the need for more granular testing include (but not limited to):*

- *Budget to Actual Variance analysis*
- *Reconcile Key Account Balances to Subsidiary Ledgers*
- *Reconcile published financial data to General Ledger*
- *Conduct Physical Inventories*
- *Reconcile Bank Statements*
- *Reconcile cash disbursed to source systems*

20. Would guidance on how management's assessment can be based on evidence other than derived from separate evaluation-type testing of controls, such as ongoing monitoring activities, be useful? What are some of the sources of evidence that companies find most useful in ongoing monitoring of control effectiveness? Would guidance be useful about how management's daily interaction with controls can be used to support its assessment?

This type of guidance is essential to enhancing the efficiency of the ICFR evaluation <u>over time</u>. Additional guidance acknowledging that as effective internal control structures mature, greater reliance should be placed on ongoing monitoring processes rather than extensive separate evaluations or testing. The SEC should provide specific guidance or examples for what quarterly monitoring means and what constitutes acceptable evidence. Once the design and effectiveness of key controls is appropriately validated and supported by sufficient, competent evidential matter, only material changes to such controls should be tested and validated. Additional guidance in this area should emphasize the concept of increasing reliance on periodic monitoring processes as they mature and become more effective. The concept of basing every year's testing approach on inherent financial reporting risks is flawed and creates unnecessary work that provides limited assurance value. Management should be able to drive its separate evaluation and related testing approach *based on residual risk as supported by ongoing evidence resulting from an effective periodic monitoring process. This concept of driving management's risk mitigation strategy based on residual risk is clearly defined in both the original COSO Internal Controls Framework and COSO Enterprise Risk Management (ERM). One of the most significant inputs to the monitoring process is management's daily interaction with controls.*

21. What considerations are appropriate to ensure that the guidance is responsive to the special characteristics of entity-level controls and management at smaller public companies? What type of guidance would be useful to small public companies with regard to those areas?

    Southern Company suggests that additional guidance be provided which emphasizes those entity-level key controls and soft controls focused on the mitigation of residual risks. The guidance should be stratified, which would allow for management judgment to be applied using a scalable approach as individual registrants get smaller. The "one size fits all" approach is difficult to implement in practice.

22. In situations where management determines that separate evaluation-type testing is necessary, what type of additional guidance to assist management in varying the nature and extent of the evaluation procedures supporting its assessment would be helpful? Would guidance be useful on how risk, materiality, attributes of the controls themselves, and other factors play a role in the judgments about when to use separate evaluations versus relying on ongoing monitoring activities?

    When separate evaluation type testing is necessary, guidance is needed to provide management with a significant degree of flexibility in their approach to management's assessment. This flexibility, however, does not extend to the external auditor, who is bound by AS2. Paragraph 145 of AS2 states that the external auditor must obtain evidence "about the effectiveness of controls over <u>all</u> relevant assertions related to <u>all</u> significant accounts and disclosures in the financial statements." The SEC needs to reinforce the concept of *testing <u>only the most relevant assertions</u> and not all assertions to each significant account. The external auditors typically test all assertions for each account selected through a benchmarking approach.*

This prescriptive approach effectively eliminates the external auditor's judgment to alter the nature, extent, and timing of testing as described in paragraphs 93 through 104 of AS2. It prevents the external auditor from realizing the same type of assessment efficiencies as those sought by management through implementation of the latest guidance. As we have seen, AS2 has become the framework that management has defaulted to. It therefore also drives management's approach when separate type testing is deemed necessary.

*If a top down risk assessment is truly in place, effectively done, and focused on only the **<u>most</u>** relevant assertion(s), the amount of internal control testing necessary would decrease significantly. Judgment should be allowed and utilized. Consistent guidance from both the SEC and the PCAOB should recognize that judgment cannot be put into an objective format and standardized.*

23. Would guidance be useful on the timing of management testing of controls and the need to update evidence and conclusions from prior testing to the assessment "as of" date?

Additional guidance is needed to clearly explain the concept of increasing reliance on periodic monitoring processes and prior years testing results as they mature and become more effective. The monitoring component of COSO is designed to provide ongoing assurance of control design and effectiveness. Monitoring includes a wide range of activities routinely performed by management to reasonably ensure accomplishment of applicable business objectives. In addition, the results of testing done in prior years provide a cumulative basis for concluding the degree of compliance with a control. These activities should be fully considered when developing a testing strategy that defines the nature, timing and extent of actual tests required to demonstrate reasonable assurance. In other words, <u>as the level of reliance on periodic monitoring processes and testing</u>

results increases, less separate-evaluation type testing is needed to provide reasonable assurance of achieving financial reporting control objectives.

24. What type of guidance would be appropriate regarding the evaluation of identified internal control deficiencies? Are there particular issues in evaluating deficient controls that have only an indirect relationship to a specific financial statement account or disclosure? If so, what are some of the key considerations currently being used when evaluating the control deficiency?

    Currently AS2 focuses on detection of potential misstatements in excess of "inconsequential" amounts. This establishes a very low bar that leads to micro-control documentation and micro-control testing. Findings resulting from testing at this level of detail are typically far beneath the level that would be of interest to investors. Instead, new guidance should be developed to focus on detection of potential misstatements that would aggregate to "material" amounts. This would yield results that are meaningful to investors. Also, significant guidance already exists on the concept of "materiality," e.g. Staff Accounting Bulletin 99.

    In addition, AS2 emphasizes detection of potential misstatements whose likelihood is more likely than "remote." The "remote" likelihood establishes a very low bar that leads to micro-control documentation and micro-control testing. Findings resulting from testing at this level of detail are typically far beneath the level that would be of interest to investors. Instead, new guidance should be developed to focus on detection of potential misstatements whose likelihood is "reasonably possible" as defined in SFAS No. 5, Accounting For Contingencies. This revision would likely yield results that are more significant to investors which is the true intent of the regulation.

25. Would guidance be helpful regarding the definitions of the terms "material weakness" and "significant deficiency"? If so, please explain any issues that should be addressed in the guidance.

Given that applicable guidance clarifying the definition of potential internal control deficiencies is amended as stated in our response to Question 24, the definitions of "material weakness" and "significant deficiency" should be appropriately aligned with the recommended impact and likelihood concepts defining "material" amounts and "reasonably possible".

26. Would guidance be useful on factors that management should consider in determining whether management could conclude that no material weaknesses in internal control over financial reporting exists despite the discovery of a need to correct a financial statement error as part of the close process? If so, please explain.

    Guidance is needed to clearly allow management flexibility to use professional judgment when determining whether a material weakness exists in internal controls over financial reporting when a financial statement correction is warranted. Guidance should include specific templates or examples for a deficiency evaluation process that is acceptable. In addition, AS2 is too prescriptive in nature and not appropriately aligned with similar regulatory and private sector guidance. New guidance should not be prescriptive and thereby not identify examples that represent strong indicators of a material weakness. This approach would give management the ability to correct errors that are immaterial to the investor and use judgment to assess the severity of internal control deficiencies, on a case by case basis.

27. Would guidance be useful in addressing the circumstances under which a restatement of previously reported financial information would not lead to the conclusion that a material weakness exists in the company's internal control over financial reporting?

    Guidance is needed to clearly allow management flexibility to use professional judgment when determining whether a material weakness exists in internal controls over financial reporting when a restatement of previously reported financial information is warranted. In addition, AS2 is too prescriptive in nature and not appropriately aligned with similar regulatory and private sector *guidance. New guidance should not be prescriptive and thereby not identify examples that represent strong indicators of a material weakness.*

28. How have companies been able to use technology to gain efficiency in evaluating the effectiveness of internal controls (e.g. by automating the effectiveness testing of automated controls or through benchmarking strategies)?

    Southern Company has attempted to leverage technology to gain efficiency in evaluating the effectiveness of internal controls over financial reporting; however, many promising market driven technology solutions have fallen short of our expectations. Any additional guidance in this area should emphasize using technology as a means for improving automated testing processes and continuous monitoring activities. For example, a robust continuous monitoring process that automatically identifies unusual or material transactions and significant fluctuations in key ratios within a given accounting period is a very efficient approach to mitigating residual risk.

29. Is guidance needed to help companies determine which IT general controls should be tested? How are companies determining which IT general controls could impact application controls directly related to the preparation of financial statements?

    *Specific guidance focused solely on IT general controls (ITGCs) is needed. IT general controls generally have only an indirect impact on financial statements and should be included as an integrated component of the overall testing strategy and subjected to the appropriate level of scrutiny when determining whether such controls are significant in relation to achieving applicable financial reporting business objectives. The challenge for management is to determine the ITGC scope (e.g. should firewalls be in scope for SARBANES OXLEY testing). Specific guidance for what controls **must be** tested, along with examples of circumstances when testing should be* *performed. A high materiality threshold should be applied when determining specific applications and computer systems for testing to provide for a more efficient and effective assessment of internal controls. Additional guidance for evaluating ITGC failures would be beneficial.*

30. Has management generally been utilizing proprietary IT frameworks as a guide for conducting the IT portion of their assessments? If so, which frameworks? Which components of those frameworks are most useful? Which components of those frameworks go beyond the objectives of reliable financial reporting?

Management should consider only those framework components that specifically address management's ability to achieve financial reporting business objectives. Although very important to the overall success of a company, other framework components that are primarily focused on the achievement of strategic, operational or compliance business objectives are not within the scope of financial reporting as defined by the SEC. Though Southern Company uses COBIT (Control Objectives for Information and Technology) to supplement the COSO based framework, the scope of these controls is generally below the entity-level that the company advocates for the Section 404 assessment.

31. Were the levels of documentation performed by management in the initial years of completing the assessment beyond what was needed to identify controls for testing? If so, why (e.g., business reasons, auditor required, or unsure about "key" controls)? Would specific guidance help companies avoid this issue in the future? If so, what factors should be considered?

The levels of documentation far exceeded that necessary to identify Key Controls. Much of the documentation was focused on transaction level controls deep within the organization. The documentation levels have been driven largely by external auditors. As currently applied, AS2 focuses on detection of potential misstatements in excess of "inconsequential" *amounts. This established a very low bar that leads to micro-control documentation and micro-control testing, thus the excess documentation.*

AS2 should be revised to focus on detection of potential misstatements aggregating to "material" amounts. This would yield results that are meaningful to investors and reduce unnecessary levels of documentation. Also, significant guidance already exists on the concept and application of "materiality," e.g. Staff Accounting Bulletin 99.

32. What guidance is needed about the form, nature, and extent of documentation that management must maintain as evidence for its assessment of risks to financial reporting and control identification? Are there certain factors to consider in making judgments about the nature and extent of documentation (e.g., entity factors, process, or account complexity factors)? If so, what are they?

Southern Company advocates documentation guidance which is more surgical and focuses on documenting entity-level key controls and soft controls based on materiality and residual risk. A "macro" versus the current "micro" level of documentation is simply a more efficient and effective manner to serve the needs of investors.

33. What guidance is needed about the extent of documentation that management must maintain about its evaluation procedures that support its annual assessment of internal control over financial reporting?

Same as the response to question 32.

34. Is guidance needed about documentation for information technology controls? If so, is guidance needed for both documentation of the controls and documentation of the testing for the assessment?

Guidance on the nature, timing and extent for testing IT controls would be beneficial. IT controls are an integral component of companies' total internal control structure. If IT controls are a subset of entity-level key *controls, then they should be consistently documented as such. External audit firms have been imposing in-depth testing and other detailed requirements for IT controls. This has made Section 404 compliance extremely burdensome in the IT areas. Furthermore, the burden has often been out-of-proportion to the benefits because IT controls have not often resulted in material weaknesses and none of the corporate failures that gave rise to SARBANES OXLEY ACT have been directly linked to IT general control failures.*

35. How might guidance be helpful in addressing the flexibility and cost containment needs of smaller public companies? What guidance is appropriate for smaller public companies with regard to documentation?

Documentation requirements should match the scalability of assessment recommendations proposed by our response to Question 1. Additional guidance for smaller public companies should focus on reducing documentation efforts around controls that mitigate risks that are less than material. As currently applied, AS2 focuses on detection of potential misstatements in excess of "inconsequential" amounts and whose likelihood is more likely than "remote". To assist in addressing the flexibility and cost containment needs of smaller public companies, AS2 should be revised to address controls focused on detection and documentation of potential misstatements aggregating to "material" amounts and where the likelihood is "reasonably possible" as defined in SFAS No. 5, Accounting for Contingencies. This change would allow smaller companies greater flexibility and increased opportunities for cost containment.