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Nancy M. Morris, Secretary
U.S. Securities and Exchange Commission
100 F Street, N.E.
Washington, DC 20549-1090

Submitted via e-mail to: rule-comments@sec.gov

RE: Release No. 34-54122; File No. S7-11-06; RIN 3235-AJ58

Dear Secretary Morris:

The Edison Electric Institute (EEI) respectfully submits these comments in response to the *Concept Release Concerning Management's Reports on Internal Control Over Financial Reporting* (Concept Release) that the Securities and Exchange Commission (SEC or the Commission) published at 71 Fed. Reg. 40865 on July 18, 2006. The Concept Release seeks input on a variety of issues relating to implementation of Section 404 of the Sarbanes-Oxley Act of 2002.

We appreciate the opportunity to comment on Section 404 implementation again. We submitted comments on Section 404 issues on March 31, 2005, in anticipation of the first Section 404 roundtable held by the Commission and the Public Company Accounting Oversight Board (PCAOB or the Board) on April 13, 2005. We have noted some positive progress since then, including the Commission and Board's May 16, 2005 guidance, which encouraged external auditors to use reasonable approaches to implementing Section 404. We also submitted comments on Section 404 issues on May 1, 2006, in anticipation of the Commission and Board's second roundtable held on May 10, 2006.

We hope that these current comments will provide the Commission, the Board, and others involved in implementing Section 404 with helpful suggestions for further improvements in implementing the section. Because the Commission has issued the Concept Release, we are addressing our comments to the Commission. But we encourage the Board and others involved to take these comments into account as well.

Our comments are organized as follows: After the next section describing EEI's interest in this proceeding, the comments are grouped under the same headings (which we have underlined and bolded) that the SEC has used in its Concept Release. Under each of those main headings, we offer some general comments (using bolded, non-underlined sub-headings of our own) drawn largely from our May 2006 roundtable comments, followed by responses to certain of the numbered questions raised in the Concept Release. Where we do not have separate thoughts to offer on other of the numbered questions, we simply say "no comment."

EEI's Interest in This Proceeding

EEI is the association of the United States shareholder-owned electric companies, international affiliates, and industry associates worldwide. Our U.S. members serve 97 percent of the ultimate customers in the shareholder owned segment of the industry, and 71 percent of all electric utility ultimate customers on the nation, and generate almost 60 percent of the electricity produced in the United States.

Many of EEI's members are registered with the SEC as publicly-held companies and as such are subject to Section 404 and the Board's rules and guidance for implementing it. Furthermore, a number of our members, especially parent companies, are among the "accelerated" filers who have been required to comply with the Commission and Board's Section 404 assessment and reporting requirements for the past two years. As a result, EEI has a direct interest in implementation of Section 404.

Our members have found the Section 404 assessment, auditing, and reporting process to be more burdensome than necessary and less well focused on significant issues of concern. In these comments, EEI draws from that experience to offer suggestions on ways to improve the Section 404 implementation process.

Introduction

Strengthen and Promote Reliance on the May 2005 Guidance

Companies often refer to the Commission's and the PCAOB's May 2005 guidance when discussing control issues with their external auditors. But it has been our members' experience that the external auditors often point to the rigors and fear of a PCAOB examination, instead of the published guidance, and express concern about "not doing enough" or "testing enough controls" and subsequently receiving an adverse PCAOB audit opinion. In other words, the external auditors appear to hedge their PCAOB audits by requiring their clients to document or test more controls than necessary and by taking extreme and often overly conservative views of evaluating control deficiencies. In turn, EEI members are bearing increased costs because the fear of PCAOB review has resulted in unnecessary procedures.

External auditors are stating that even though the revised guidelines appear less stringent, the auditors are still being held to rigorous standards by the PCAOB's own audits of them and that the requirements imposed on the external auditors have not become less stringent in accordance with the revised guidelines. For example, the May 2005 guidance stressed the importance of tailoring the audit using a risk-based approach placing more emphasis on high risk areas over low risk areas. But the guidance still states that all areas should be tested and included in the scope of Sarbanes-Oxley reviews. As a result, the recommendation to use a risk assessment approach did not result in a significant amount of change in the audit approach taken by external auditors.

Because of this, companies are being required to do substantially more reviews and documentation than the guidance appears to require, creating unnecessary company workload. Furthermore, any efficiencies gained in processes from multi-year experiences are being offset by additional efforts to document risk assessments. We concur with the risk focus of the May 2005 guidance, but we need to have tools to reduce or eliminate work in low risk areas and to leverage the risk based work.

The PCAOB's May 2005 guidance and Release 2005-23 dated November 30, 2005 ("November release") related to implementation of Auditing Standard No. 2 (AS 2) contained useful clarification of many aspects of the application of AS 2. The additional guidance should have created efficiencies in the audits of internal controls for fiscal years ended in 2005. However, as just discussed, in practice, external auditors have not modified their approaches to incorporate this guidance.

<u>Therefore, EEI recommends that the Commission strengthen and reiterate several points made in the May 2005 guidance and November release such that the intended efficiencies can be achieved</u>. Areas where further efficiencies can be gained include:

- Integration of internal control audits with audits of financial statements – Redundant testing, particularly during the year-end closing and financial reporting process, can be particularly inefficient.

- Use of a top-down, risk-based approach – The level of focus on a lower risk area should be different than that of a higher risk area.

- An audit of internal control over financial reporting should be designed to provide reasonable assurance as to whether material weaknesses exist – Performing tests to find anything that aggregates to less than a material weakness or to obtain absolute certainty is inefficient.

- In classifying possible misstatements, "more than remote" means "at least reasonably possible" – The intent is to determine what a "prudent official" would conclude. The evaluation of possible misstatements involves a qualitative assessment, not just reliance on a mechanical, quantitative approach.

- In the May 16, 2005 guidance and subsequent report issued on November 30, 2005 the Board explicitly states in many areas that the auditor use "Professional Judgment" in their planning and evaluations and not always rely on checklists and/or frameworks. This should continue to be reiterated especially in the area of evaluating deficiencies. The use of frameworks rather than unguided professional judgment would lead a more efficient and effective process.

1. Would additional guidance to management on how to evaluate the effectiveness of a company's internal control over financial reporting be useful? If so, would additional guidance be useful to all reporting companies subject to the 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?

   We believe that additional guidance to management on how to evaluate the effectiveness of a company's internal control over financial reporting would be useful and should be provided for all reporting companies subject to the Section 404 requirements. Such guidance could incorporate the May 16, 2005 "Staff Statement on Management's Report on Internal Control Over Financial Reporting."

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 control over financial reporting? If so, what are these? Are such considerations applicable to all foreign private issuers or only to a sub-group of these filers?

   No comment

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

   Guidance in the form of broad principles generally allows more flexibility in the application of the guidance, and this would be preferable.

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?

   The Commission should consider issuing guidance on how to apply materiality thresholds to errors related to different types of financial reports. It is unreasonable to apply the same materiality thresholds derived from income statement accounts to errors that would only be reflected in balance sheet accounts.

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

   No comment

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?

   No comment

7. Are there potential drawbacks to or other concerns about providing additional guidance that the Commission should consider? If 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?

   Most companies seem to believe they are doing more work than should be necessary to achieve the intended goals of Section 404. Any additional guidance, unless it is carefully written, has the potential to increase the already heavy burden of compliance. The drawbacks of providing additional guidance include the potential to: (1) Further change and confuse the relationship between management and the external auditor; (2) Increase testing volume; (3) Increase the scope of existing audits; (4) Increase the control documentation requirements. To mitigate these and other unintended consequences, the guidance should focus on easing the burden of the Section 404 process and should clearly state what is expected and what is not expected to result from the existing Section 404 rule and guidance, in keeping with EEI input to date, especially our May 2006 pre-roundtable comments.

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?

   No comment

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's 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? (Footnote not included.)

   The guidance should incorporate and endorse the May 2005 "Staff Statement," which itself provided helpful guidance. One topic that needs additional clarification is the concept that testing should be designed to focus on controls that will prevent or detect material errors in the financial statements. This topic was mentioned in the PCAOB May 16, 2005 "Staff Statement on Management's Report on Internal Control Over Financial Reporting", and was expanded upon in the November 30, 2005 "Report of Initial Implementation of Auditing Standard No. 2." Implementation of this concept by the external auditors relative to the selection of specific controls to test is still lagging. If properly written, additional guidance on this topic has the potential to significantly reduce testing requirements.

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?

    Please see the above answer to question 9. The Commission should encourage external auditors to be more flexible and reasonable in applying Section 404, in keeping with the Commission, Board, and staff rules and guidance. One clear area for improvement, as discussed further on pages 9-11 of these comments, is the need for greater reliance by external auditors on management and internal auditor work product, if supported by indicia of reliability or otherwise comparable to work the external auditor otherwise would repeat unnecessarily.

Risk and Control Identification

Implementation of Section 404, including external auditor reviews and Commission and Board guidance, should focus on issues of relative importance and not on issues that are not material. A key means of accomplishing this goal is for all parties involved in implementing Section 404 to rely on a risk-based approach to evaluating internal controls. The Commission should specifically allow companies to identify those areas within their internal accounting systems where the consequence of error would be relatively significant, and to focus on instituting and testing internal controls in those areas. Commission guidance to promote this risk-based approach will help to ensure that the major issues related to accuracy of financial statements are addressed. Such guidance also will help to ensure that limited company, auditor, and agency resources are used to best advantage. For further discussion of this issue, please see "material concern" subsection of the "management evaluation" section on pages 8-10 of these comments.

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?

    Provide guidance on the relationship of entity-wide controls to transaction level controls and the relative levels of testing that need to be performed to meet the intent of Section 404. Include their relative significance in providing coverage over financial reporting risks and the likelihood of detecting or preventing a material error.

12. Does the 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 these risks be helpful?

    No comment

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

    No comment

14. In areas where companies identified significant start-up efforts in the first year (e.g., documentation of the design of controls and remediation of deficiencies) 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 yet been addressed or need further emphasis?

    No comment

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?

    Same response as in question 11.

16. Should guidance be given about the appropriateness of and extent to which quantitative and qualitative factors, such as likelihood of an 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?

    In many cases, qualitative input by a company's management, internal auditors, and operating staff can be valuable in evaluating a company's internal control system. Yet external auditors often will not rely on such input simply because it is not quantitative, even when a quantitative analysis is not warranted. EEI encourages the Commission to support reliance on useful qualitative information and to identify at least some settings where such information clearly would be appropriate, for example as to immaterial items and as to application of entity-wide controls.

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? (Footnote not included.)

    No comment

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?

    No. This is done during the scoping process and no additional guidance is needed.

Management's Evaluation

Focus Section 404 Implementation on Issues of Material Concern

A. Information Technology

EEI recommends that the Commission examine implementation by external audit firms of Section 404 in the context of information technology (IT) general controls. External audit firms have been imposing in-depth testing and other detailed requirements for these controls. This has made Section 404 compliance extremely burdensome to company IT organizations and has even forced some companies hire outside firms to assist with the reviews. Furthermore, the burden has often been out-of-proportion to the benefits because IT controls have not often resulted in material weaknesses.

At a minimum, as we will discuss in the testing section of these comments below, the Commission should allow cyclical or rotational testing of IT controls and should focus the scope and extent of testing of the controls to keep the review in proportion to the risk involved. We believe that the Commission could reduce the currently required scope of IT general control reviews without significantly increasing risks that would impact financial reporting.

Furthermore, the Commission should examine alternatives for addressing data base administrator (DBA) access to production data bases and data, an issue raised during last year's roundtable. DBA access is essential to ensure that IT general controls are properly in place and operating. But some external auditors continue to view this very normal scenario as a "control deficiency" because clients cannot prove that DBA access is directly monitored. Clients have referred to other IT general controls and controls at the business process level to provide assurance and comfort to the external auditors. However, the auditors have viewed these as being only "mitigating controls." Additionally, the auditors have appeared to disregard other aspects of the IT control environment, existing change controls, etc. in concluding whether DBA access to production was a control deficiency.

Similarly, the Commission should review handling of technical support identifications (IDs) for production applications, also known as "firefighter IDs" or "emergency IDs." Again, some external auditors have raised concerns when clients could not track the IDs for routine maintenance and fixes, viewing the IDs as being "high risk" to the financial statements because logging of the IDs could not be initiated or monitored. However, client acceptance and approval of changes made by the IDs existed in addition to business process controls.

The overarching position that the external auditors have taken is that IT general controls are pervasive and can impact all aspects of financial reporting. But this position ignores the supporting role that IT general controls play, and it ignores the mitigating controls that companies have in place to ensure the accuracy and validity of financial statements.

<u>To address these concerns, the Commission should clarify that external auditors need to keep the role of IT general controls in proper perspective as a supporting function that may have relatively low independent risk to the financial statements. In addition, the Commission should describe the reasonable extent that companies should document and test IT general controls and the extent of reliance that can be placed on mitigating controls. Again, the guidance should allow for cyclical or rotational testing, focus the scope and extent of testing of IT general controls, and clarify evidence required to demonstrate effectiveness of the IT controls. We also request guidance as to how the top-down approach should be applied to evaluating IT general controls and any deficiencies therein.</u>

B. Immaterial Items

The PCAOB's November Release acknowledged that an audit in accordance with AS 2 should not be designed to detect deficiencies that are less severe than a material weakness. Yet we are aware of situations where immaterial deficiencies are being documented and reported to management and the audit committee as Sarbanes-Oxley control deficiencies even when the transaction cycle was considered below scope for Sarbanes-Oxley testing.

In many cases, the only supporting evidence of a deficiency is a passed audit adjustment (i.e., internal and external judgment has deemed the item as not material to the financial statement audit opinion). Such a narrow focus on these types of immaterial items leads to unnecessary efforts by companies and their auditors and undercuts a more appropriate focus on ensuring that key, material controls are in fact in place and operating. The message to line personnel becomes everything is material, and they are unable to focus upon imbedding appropriate control philosophies.

EEI requests that the SEC reiterate and provide additional guidance that an audit designed in accordance with AS 2 should not be designed to detect deficiencies that, individually or in the aggregate, are less severe than a material weakness. In fact, the Commission should explicitly exclude from AS 2 low-risk areas of a company's financial control system. Significant time is being consumed by both the issuers and the audit firms addressing items of a lesser nature.

Review Reporting of Changes Under Regulation S-K

Section 209.308 of Regulation S-K requires the reporting of material changes that impact internal controls over financial reporting. However, this requirement appears to duplicate the reviews and disclosures provided under Sarbanes-Oxley Section 404, in particular through management assessments and auditor reviews. Furthermore, the lack of clarity of reporting under Regulation S-K has caused confusion and unproductive work for many companies. Many disclosures related to this requirement appear to go beyond truly material changes. For example, companies have made disclosures about extraordinary accounting transactions, changes in enterprise risks, potential litigation, and changes of an operational nature. The disparate nature of these disclosures suggests that confusion exists and leads us to question the value of the disclosures to investors.

To avoid duplication and to eliminate confusion, the SEC should consider removing the separate Regulation S-K requirement. If, however, the SEC retains the requirement: (a) the SEC should provide more detailed guidance that would explain the intent and purpose of the disclosure and should provide specific criteria and examples to help companies identify the changes to internal controls that would be classified as material; and (b) the SEC should clarify that companies are required to report only material changes that have a negative impact on internal controls over financial reporting, though companies may wish to report positive changes especially if coming off of a material weakness.

Promote Reliance on the Competent Work of Others

In its May 2005 guidance, in Questions and Answers No. 46-49, the PCAOB stated that auditors should take advantage of the significant flexibility that the Board's Section 404 standard allows to use the work of others to reduce redundant testing. The Board also indicated that auditors were not using the work of others to the extent permitted by AS 2. However, the guidance focuses on work performed by internal auditors, not others within a company. Furthermore, external auditors do not appear to be relying on work performed by corporate internal auditors and others, even when that work is competent and reliable, because of the lack of guidance encouraging them to rely on such work.

As a result, external auditors are duplicating the work of internal auditors and management, producing unnecessary inefficiency and wasting limited resources. EEI hopes that the SEC can help reduce this duplication of effort by encouraging external auditors to place greater reliance on competent work performed by company personnel, including management and internal auditors.

If a company can demonstrate that self-assessments, peer assessments, and other such evaluations by company management, auditors, and operations staff have been done objectively and with adequate oversight, external auditors should rely on these evaluations and related work. By emphasizing that external auditors can rely only on internal audit testing, the SEC encourages companies to keep the testing effort in their respective audit groups, which de-emphasizes ownership by control process owners. A self-assessment model would encourage control owners to understand their control environment and monitor it regularly on an ongoing basis rather than waiting for internal auditors to come test controls once a year.

<u>Therefore, EEI encourages the Commission either to work with the Board to modify AS 2 or to provide explicit guidance that allows and encourages external auditors to rely on the work performed by others, including company management and staff and not just internal auditors, provided the auditors are comfortable that the work has been done competently and objectively</u>. External auditors should specifically rely on competent work by company management and staff as to financial reporting, computer and IT controls, controls in low risk areas, and testing of controls, including walk-throughs.

<u>Further, the rule changes or guidance should explicitly address the reasonable extent of testing that management must perform in order to conclude its assessment and enable the external auditor to rely upon this work</u>. This would help provide management with greater certainty that work a company undertakes will not be wasted or later duplicated by external auditors.

Encourage Selective, Rotational Testing and Allow Late-in-Year Changes

A. Rotational Testing, a Risk-Based Approach

The PCAOB's rules state that each year's audit must stand on its own. Although the Board's May 2005 guidance, in Question & Answer No. 44, indicates that audit knowledge obtained in prior years should not be ignored in subsequent years' audits, the guidance does not sufficiently encourage targeted, risk-based techniques such as rotating tests of controls over a number of years. As a result, the rules tend to govern, leading external auditors to require that each control or key control must be extensively tested every year.

However, this approach results in excessive, unnecessary testing. While such rigorous testing of key controls may be needed in the first year of implementing Section 404 to provide a baseline, auditors should be encouraged not to repeat such broad testing of controls in subsequent years.

Instead, the SEC should strongly encourage auditors to focus primarily on testing key controls that have changed during the year, where the changes are likely to have a significant impact on financial statements. Beyond that, if auditors are inclined to test other controls, they should do so only as warranted, on a rotating basis. In particular, such selective, rotational testing should be used for controls that are relatively static, low risk, or routine, as well as in areas where a company has demonstrated historically strong and effective controls. This approach would be consistent with the PCAOB's May 2005 guidance as to use of benchmarking for testing automated application controls.

Furthermore, the Commission should specify that auditors can rely on testing performed earlier in a year or in prior years, as long as the control tested has not significantly changed. This would encourage auditors to allow testing throughout a year and from year to year, thus spreading out the testing requirements and avoiding year-end spikes in the testing workload.

B. Late-in-Year Changes

AS 2 paragraphs 147-151 state that the auditor's opinion reflects internal control over financial reporting as of a point in time and taken as a whole, thereby requiring the auditor to obtain evidence that internal control over financial reporting has operated effectively for a sufficient period of time. The May 2005 guidance, in Question and Answer No. 52, states "it would be inappropriate for the auditor to conclude, as a rule, that management should not implement changes to IT for some arbitrary period of time before year end."

We fully agree with this statement because companies do not make changes in their accounting systems without first testing to ensure that the changes will accurately reflect company operations and finances and will function as planned, and the Section 404 review process ensures that internal controls will be further tested and adjusted as necessary to ensure the continued accuracy of financial statements and adequacy of the internal controls.

However, for some EEI members, external auditors have continued to indicate that if a control has not operated for a requisite period of time, the companies and the auditors cannot rely on the operating effectiveness of the control. As a result, companies often avoid making changes in important business processes and systems for an extended period (up to six months in the case of a quarterly control that is required to run for two quarters) rather than risk a scope limitation or deficiency designation from their external auditors. In turn, by effectively discouraging such changes, AS 2 as applied is interfering with the practicality of running businesses and is preventing companies from making changes that would produce economic benefits and more efficient operations. Moreover, it is discouraging companies from implementing new technologies that could actually improve the control environment.

<u>To remedy this situation, EEI encourages the SEC to specify that late-in-year changes in control systems can be tested the following year, and meanwhile external auditors can issue opinions with "no material weaknesses" stemming from such changes.</u> <u>At most, if warranted, external auditors should simply note that a late-in-year change has not yet been tested, rather than identifying it as a material weakness in their opinions.</u> Again, company management and auditors should be able to rely on the testing that has been done prior to implementing the accounting system changes and on the Section 404 review process, which will ensure prompt further adjustments as warranted. This approach is similar to the approach used by the SEC in the context of late-in-year mergers and acquisitions. In that context, the SEC allows management to exclude an acquired business from scope if there is insufficient time to complete an assessment of internal controls, provided the reviews are undertaken in the following year. Such an approach in the Section 404 context would encourage companies to make improvements in their processes and systems at any time, without fear of triggering a qualified opinion because the improvements come too late in the year.

<u>At a minimum, the SEC should clarify that external auditors can rely on: (a) interim internal control audit testing as to late-in-year changes, whether performed by the external auditor, internal auditor, or management; and (b) year-end internal control audits by company management as to such changes, while the external auditor is simultaneously performing substantive financial statement audits.</u> By promoting reliance on such work, the Commission would help avoid discouraging late-in-year improvements in control systems.

19. What type of guidance would help explain how entity-level controls can reduce or eliminate the need for testing at 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.

    Same response as in #11 and #15 above.

20. Would guidance on how management's assessment can be based on evidence other than that derived from separate evaluation-type testing of controls, such as on-going 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?

    Yes. Guidance would be helpful on how monitoring controls can be used to satisfy the testing requirements for controls that are currently satisfied by transaction level testing. The guidance should address the impact of the relationship between the monitoring control and the account, and between the control and the related financial report. Also, the guidance should address the impact of the relative strength of the monitoring controls and the nature of the controls. This may improve the application of the top-down approach to testing.

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?

    No comment

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?

    Risk assessment should play a large role in determining the different evaluation procedures used. The guidance should address the latitude available in determining the evaluation procedures and should include descriptions, or examples, of when different procedures may be employed.

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?

    Yes. Guidance describing the available methods to use prior year evidence to support current year testing would be helpful. This could include when and how prior year testing is relevant for current year testing support and when can it be used to limit current year testing.

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?

    General computer controls generally have only an indirect impact on financial statement accounts. Although general computer controls are considered pervasive, arguments used by external auditors to quantify the impact of general computer control errors often use assumptions that are extremely unlikely or require levels of technical computer system knowledge that are not generally available. Additional guidance on the evaluation of general computer control deficiencies would be helpful.

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.

    This comment is similar to the response to question #4. Additional guidance is needed about how the materiality levels apply to different account types, i.e., income statement accounts vs. balance sheet accounts. The guidance could be included in the definitions or in supporting information.

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

    EEI encourages the Commission to provide guidance in this area. AS 2 says that a restatement of a company's financial statement is a *strong indicator* of a material weakness. But in practice, that provision is being treated as saying a restatement automatically *means* there is a material weakness. In fact, a company may need to restate a portion of a financial statement for any number of reasons that do not demonstrate a material weakness in internal controls. For example, under the Commission's new executive compensation disclosure regulations, companies may need to revise financial statements to reflect stock options that the new rule requires to be disclosed. Such revisions are simply driven by new regulations, not an inadequacy of internal controls. The Commission should provide guidance that draws this distinction and allows companies to demonstrate that a restatement does not in fact involve a material weakness.

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?

    No comment

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

    No comment

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 IT application controls directly related to the preparation of financial statements?

    Please see our answer to question 24 above.

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

No comment

Documentation to Support the Assessment

Documentation

External auditors appear to apply a worst-case scenario in determining whether a control is in place and operating effectively. Specifically, if a control is not fully documented, the auditors often will assume that the control does not exist, thus frequently overstating the potential financial reporting error that could occur as a result of the control "failing." This approach has been applied to, among others, application/ data base access issues. In turn, it has promoted documentation for the sake of documentation rather than based on significant risk to investors. This focus on documentation has taken the focus away from the real issue, namely whether key controls are in place and operating effectively.

EEI encourages the Commission to clarify that documentation requirements should be reasonable and should recognize the need for companies to focus primarily on business efficiency rather than audit efficiency. The important issue is that the investors are informed whether controls are operating effectively. This requires reasonable documentation, not rigid and exhaustive documentation requirements
In addition, we encourage the Commission to specify that the lack of documentation even for a key control does not represent a control deficiency if the key control is in operation and simply was not documented. If the actual key control is operating effectively and the company can demonstrate the control is working, the audit opinion should not be affected.

Inventory Reviews

Some utilities experienced natural disasters or other abnormal service interruptions in their service territories during 2005. These events caused some controls to be temporarily postponed, primarily in the area of inventory. Wall-to-wall physical counts were performed in order to gain comfort over the ending inventory balance. Yet, in some cases, external auditors applied stringent thresholds approaching a 99% accuracy rate over inventory counts. One methodology employed included selecting and validating 65 items from count sheet to storeroom floor and 65 items from storeroom floor to count sheet. Any error that exceeded 2 deviations could require a recount of the entire storeroom, though the auditor did consider the nature of the item being counted. For example, the deviation rate for counting bolts was higher than the deviation rate for counting transformers. This methodology was construed as a "statistical approach" to validating the accuracy of inventory counts and is presented as the norm adopted by the "Big 4" firms. We are concerned that such a stringent approach to inventory review is neither reasonable under the circumstances, nor in keeping with professional guidance on the use of statistical measures for conducting audits. We certainly would not want such stringent approaches used to conclude that a control deficiency exists.

<u>EEI advocates that a more reasonable approach to inventory validation is needed, allowing management to apply estimates based on the information known at the time regarding inventory valuations as opposed to requiring wall-to-wall physical counts that are conducted during compressed time periods.</u>

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 (<u>e.g</u>., 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?

    Control documentation quality varied substantially from process to process. The most common types of control documentation weaknesses were: (1) including descriptions of processes rather than controls; and (2) not fully describing the critical controls. The causes of these documentation weaknesses included inexperience, inattention to detail, and insufficient training. It is unlikely that additional guidance would have helped to avoid these errors.

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 (<u>e.g</u>., entity factors, process, or account complexity factors)? If so, what are they?

    No comment

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?

    The IIA International Standards for the Professional Practice of Internal Auditing are sufficient. Section 2300 "Performing the Engagement," and the associated practice advisories, provide adequate guidance.

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?

For documentation of general computer controls testing, the IIA International Standards for the Professional Practice of Internal Auditing are sufficient. Section 2300 "Performing the Engagement," and the associated practice advisories, provide adequate guidance.

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?

No comment

Additional Comments

Exempt Substantially Owned Subsidiaries and Subsidiaries Without Registered Securities from Separate Section 404 Requirements

EEI supports the Commission's efforts to improve the financial reporting of publicly traded companies. We believe that implementation of the Sarbanes-Oxley Act has improved corporate governance and financial disclosure in this country. Our publicly traded members have successfully complied with Section 404 as accelerated filers at the parent level for the years ended December 31, 2004 and 2005.

However, the deadline is approaching for non-accelerated filers to begin complying with Section 404, starting with the year ending December 31, 2007. A whole new suite of companies will face filing requirements under this deadline, including subsidiaries of parents that already have met the Section 404 requirements. EEI encourages the Commission to modify its Section 404 requirements to exclude two categories of these subsidiaries.

First, EEI encourages the Commission to exempt substantially owned subsidiaries of a parent that is subject to the Section 404 requirements (e.g. where the parent owns 95% or more of the subsidiary) from separate Section 404 auditing and reporting requirements. This would reflect that parent companies exercise control over their subsidiaries and already assess financial controls throughout the overall company in order to satisfy Section 404. Furthermore, in our industry, most of these subsidiaries are heavily regulated public utilities.

Requiring the subsidiaries to comply separately with Section 404, in addition to compliance by their parents, will result in internal and external costs that will far exceed the additional benefits if any for company investors and other stakeholders. Given that governance and financial oversight of substantially owned subsidiaries are handled by the parent company, Section 404 assessments and attestations at the subsidiary level are redundant to those done at the parent level. Applying Section 404 to the subsidiaries will duplicate the auditing and reporting requirements applicable to the parent companies. Further, applying the section to the subsidiaries will not provide sufficient additional benefits in terms of improved financial reporting and fraud risk mitigation to justify the substantial additional costs. By the very nature and size of subsidiaries, applying Section 404 to them will involve much lower levels of materiality than for the parent companies.

Second, the SEC should exempt from separate Section 404 compliance subsidiaries that do not have registered securities. The SEC already has granted an exemption from the audit committee requirement for such subsidiaries. The rationale for this exemption is provided in SEC Release No. 33-8220; 34-47654, "Standards Relating to Listed Company Audit Committees," dated April 9, 2003, under the heading, F2, Application and Implementation of the Standards, Securities Affected, Multiple Listings. A comparable exemption should apply to the provisions of Section 404. The purpose of Section 404 is to ensure that financial information provided to investors in publicly-traded companies is based on accounting systems with proper controls and management oversight. Therefore, Section 404 should not be applied to companies without registered, publicly-traded securities.

Without relief in these two areas, such subsidiaries will face significant costs to implement Section 404 beginning with years ending December 31, 2007, with little corresponding benefit from a risk mitigation perspective. In turn, these costs would likely be borne by company shareholders and customers, the latter of whom could face higher bills due to the Section 404 compliance costs.

Conclusion

EEI appreciates this opportunity to provide comments to the SEC about opportunities for further improvements in implementation of Sarbanes-Oxley Section 404. We appreciate the work the Commission and Board already have undertaken to streamline compliance with Section 404.

We encourage the SEC to exempt from Section 404 regulations subsidiaries that are substantially owned by parents which themselves must comply with Section 404 and subsidiaries that do not have registered securities. This would avoid unnecessary duplicative effort by parents and their subsidiaries and compliance by subsidiaries that do not have publicly-traded securities.

We also encourage further efforts to ensure that the Section 404 reviews of financial controls performed by company management and internal and external auditors are as efficient as possible. In particular, we fully support use of a risk-based approach to evaluating the controls – low risk areas should either be exempted or de-emphasized, and the Commission should promote use of rotational testing for low-risk or static areas, so the emphasis can properly be on significant controls that have changed and are likely to affect financial reporting. In addition, we encourage the Commission to promote reliance on prior reviews when valid, controls that actually are in place even if not fully documented, other persons' work if competently performed, most-likely rather than worst-case scenarios, and other such measures to keep the Section 404 reviews and reporting focused and efficient. We also encourage the Commission to recognize the substantial burdens that Section 404 reviews and reporting can impose on companies, in particular if pushed to year's end, and to look for ways to minimize the burden, again with an eye on value of each requirement to the investor.

If the Commission has any questions relating to these comments, please contact either me or on EEI staff David Stringfellow at 202/ 508-5494 or Henri Bartholomot at 202/ 508-5622. Thank you.

Sincerely,

David K. Owens

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