UNITED STATES OF AMERICA
BEFORE THE
SECURITIES & EXCHANGE COMMISSION

Implementation of Sarbanes-Oxley Section 404 Internal Control Provisions		File Number 4-497

COMMENTS OF THE EDISON ELECTRIC INSTITUTE

The Edison Electric Institute (EEI) respectfully submits these comments to assist the Securities and Exchange Commission (SEC or Commission) in framing the issues for discussion at the April 13, 2005 Roundtable Discussion on Sarbanes-Oxley Section 404 Implementation Issues. EEI also requests the opportunity to participate in the Roundtable Discussion.

EEI is the association of the United States investor-owned electric companies, international affiliates, and industry associates worldwide. Our U.S. members serve almost 95 percent of the ultimate customers in the shareholder-owned segment of the industry and nearly 70 percent of all electric utility ultimate customers in the nation, and generate over 70 percent of the electricity produced in the United States.

EEI embraces the concepts of accuracy, reliability, integrity and transparency for the financial reporting process as well as the general improvement of corporate governance processes embodied in the Sarbanes-Oxley legislation. EEI believes that improvements have been made in all these areas. Specifically, EEI believes that the assessment and remediation of internal controls over financial reporting required under

Section 404 provided its member companies valuable insights regarding these controls and resulted in an overall improvement in the understanding, documentation, and performance of those controls. However, EEI also believes that the guidance provided by the SEC and the Public Company Accounting Oversight Board (PCAOB) and the interpretation of that guidance by the independent auditors can be made far more effective by implementation of the following changes.

Key Recommendations

1. Rely on Internal Audit Activity to a Greater Extent.

In Auditing Standard No. 2 (AS 2), the PCAOB currently requires that a company's independent auditor must provide the principal evidence for the auditor's opinion on internal controls over financial reporting. To avoid unnecessary, wasteful duplication of effort, the PCAOB should modify this requirement and allow independent auditors to rely to a greater extent on work performed by a company's internal audit activity. In particular, the PCAOB rules should allow greater reliance on the work of qualified, competent internal auditors practicing in accordance with The International Standards for the Professional Practice of Internal Auditing (Standards) as promulgated by the Institute of Internal Auditors. Such qualification and competence could be evidenced by an external quality assessment as more fully described in the Standards.

In practice, the "principal evidence" portion of AS 2 has been interpreted to mean that the independent auditor must perform more than 50% of the total procedures upon which it bases its opinion. We believe that such a threshold is artificial and unnecessarily increases both the inefficiency and the cost of an audit of internal controls over financial reporting by requiring the independent auditor to duplicate work that already has been done. The process of controls testing would be more efficient if the PCAOB guidance were to encourage independent auditors to rely to a greater extent on internal audit activity.

Many internal auditors report to the Audit Committee of the Board of Directors directly, just like the independent auditors, and thus are sufficiently independent to merit direct reliance on their work product. But even if an internal auditor does not report directly to the Audit Committee or the Board, the independent auditor should be able to rely on the internal auditor's work if the independent auditor is satisfied that the work meets certain indicia of reliability. The independent auditor simply needs to review and agree with the internal auditor's testing approach (scope, timing, sample size, etc.), review and sign off on the internal auditor's documentation, and assess and concur with the qualifications and objectivity of those performing the work. If those requirements are met, the independent auditor should be permitted and encouraged to utilize the internal auditor's work as their own. Internal audit work has properly been relied on in the past for financial statement purposes – it should equally be relied on for Section 404 purposes.

2. Rely on Work Performed in Prior Periods to a Greater Extent, And Allow More Testing Prior to Year End.

Independent auditors should be allowed to rely on work performed in prior periods/years that still remains relevant. EEI believes that it is appropriate and necessary to perform some level of testing of all key controls on an annual basis. However, we believe that management and auditors should be permitted to target their testing based on relative risks and should be able to give consideration to the results of prior years' testing in determining the nature and extent of testing in the current year. For example, certain transactions/processes such as payroll or expense processing, barring a system or other significant change, are static from period to period. If a company's controls in a certain area have worked effectively for several years without exception and there have been no significant changes in those controls during the year, it would seem appropriate that one could limit the sample tested in the current year or perform such testing earlier in the year.

EEI also believes it would be appropriate to permit more extensive reliance on testing prior to the end of the fiscal year in certain circumstances. Our experience has been that auditors have required all testing to occur after a specified date, such as June, in order for management to rely on such testing as the basis for its assessment of the effectiveness of internal controls over financial reporting. We believe that this type of artificial deadline unnecessarily raises the cost of performing management's assessment and the audit of internal controls by forcing all such work into the latter half of an entity's fiscal year. We also believe that this is counterproductive to the objective of having internal controls operating effectively throughout the year. Rather than extensively retesting controls at year-end, greater reliance should be placed on interim testing where the process does not change. This approach would have numerous benefits, including bringing deficiencies to light in a more timely manner, facilitating Section 302 attestations, supporting consistent performance of controls throughout the year due to the possibility of testing at any time, and reducing costs by allowing both management and auditors to spread their evaluation of internal controls throughout the year rather than clustering such work during the same periods in which the financial statement audit, of necessity, must be performed.

3. Allow Independent Auditors to Discuss Proper Accounting Treatment of Business Transactions Without Jeopardizing Their Independence or Creating Section 404 Concerns.

The PCAOB’s guidance should provide a safe harbor whereby the independent auditors are allowed to discuss the proper accounting treatment of complex business transactions with management without fear of jeopardizing their independence with respect to their audit of internal controls over financial reporting. Likewise, company management and staff should be able to seek advice from independent auditors without fear of triggering a “significant deficiency” or “material weakness” finding by the auditor or otherwise running afoul of Section 404.

Such a change would help improve the quality of accounting and reduce the cost of compliance with generally accepted accounting principles (GAAP). The current climate gives management less of a chance to “get it right” in the first place and causes much greater consequences when there is later disagreement. Currently, management is limited in its ability to get advice from their independent auditor, due to independence concerns. After management has reached a decision on the accounting treatment, there is a concern that if the independent auditor believes the management decision was in error, it is a de facto deficiency and potentially a material weakness in the control process for reaching that decision. Providing a safe harbor so the independent auditor can provide earlier advice without compromising independence would be a tremendous benefit to management and investors.

Companies hire accounting firms with significant resources and expertise, in part, because of the accountants’ ability to understand and assist in the interpretation of increasingly complex accounting standards. Certainly, management must take responsibility for their ultimate judgments on how to interpret accounting pronouncements and must have appropriately qualified staff in order to understand these requirements and apply them to their specific circumstances. However, the current environment in which accounting firms believe they are prohibited from giving input until management provides a "white paper" or other formal assessment of a complex rule or transaction is inefficient and conflicts with the objective of Section 404 – having controls that assure that the financial statements are materially correct. We believe that the quality of financial reporting is enhanced when there is an open dialogue between a company and its independent accountant on the application of complex GAAP pronouncements. Such consultations are necessary in order to "get it right the first time" and should not be limited by concerns that such consultations may, after the fact, be deemed to violate the auditor's independence.

4. Allow Companies to Comply With Section 404 on Their Behalf and on Behalf of Their Subsidiaries.

Companies with multiple registrants – in particular, a parent and one or more subsidiaries – may incur an unnecessarily heavy burden by being forced to comply with Section 404 at the much lower materiality level of each such registrant. Recognizing that a parent company can fully oversee the operations of its subsidiaries, the SEC already has granted an exemption regarding the requirement that companies must have audit committees, so such committees are not required at both the parent and subsidiary registrant level. A comparable exemption should apply to the provisions of Section 404.

Given that governance oversight is handled by the parent, as evidenced by the lack of a separate audit committee, the Section 404 assessment of entity-level controls at the subsidiaries is redundant. Additionally, because of the lower materiality thresholds that apply to a subsidiary, companies must perform more extensive detailed testing of controls that have already been tested as part of the parent level assessment. We do not believe this additional documentation and testing burden adds any substantive value to the shareholders or debt-holders of those registrants.

Therefore, EEI recommends that subsidiary registrants that meet all of the following criteria should be exempt from the requirements of Section 404:

- The parent company registrant has successfully complied with the requirements of both Sections 404 and 302;
- The registrant is a wholly owned subsidiary of the parent;
- The registrant meets the SEC audit committee exemption; and
- The parent has included in its management assessment those corporate allocation processes, systems and controls that significantly impact the subsidiary filers.

Additional Suggestions

1. Clarify That Company Management, Not the Independent Auditor, Makes Ultimate Decisions Regarding Implementation of Section 404.

EEI is concerned that the implementation of Section 404 to date has not given company management sufficient latitude to develop and evaluate its own reasonable internal controls. Instead, independent auditors are driving the Section 404 process, often asserting that they have discussed what is required with the SEC or PCAOB directly, albeit without the opportunity for input by companies or the general public.

We encourage the SEC and PCAOB to help remedy this imbalance by clarifying that company management, not the independent auditor, is principally responsible for developing, evaluating, and approving the internal controls being reviewed under Section

404. Further, we encourage the Commission and PCAOB to ensure that any guidance they provide is developed through an open process with opportunity for input by affected companies and the public, and that such guidance is provided in a timely fashion, allowing companies adequate lead time to adopt the guidance.

Little guidance currently exists from the SEC and/or PCAOB to help management structure its approach to documenting, testing and evaluating internal controls under Section 404. The existing guidance is tailored to what procedures the independent auditor needs to perform to render an opinion. The result is that the independent auditor effectively has become the sole and final judge of the sufficiency of documentation and testing according to the particular audit firm's standards. This infringes on management's responsibility to implement and document its internal controls over financial reporting and creates inconsistency in the evaluation of those controls when there is no objective standard for making such judgments. Without some means to balance the independent auditors' judgments, the result is that companies may be forced to incur unnecessary costs, which in turn are borne by company customers (in our industry's case, electricity consumers) and the investing public.

2. Clarify that Only Truly Consequential Deficiencies in Control Systems Must Be Further Evaluated and Addressed by Company Management.

EEI believes that the AS 2 definition of a "significant deficiency" is appropriate. However, the SEC should provide further guidance as to materiality when assessing whether an internal control deficiency is "inconsequential" under the provisions of AS 2. In our view, too many trivial deficiencies are being sent to company management for further evaluation. The goal should be to identify pervasive internal control failures, not to focus so heavily on minor, immaterial, or technical deficiencies.

Paragraph 23 of AS 2 states that "the same conceptual definition of materiality that applies to financial reporting applies to information on internal control over financial reporting." And in fact, financial statement preparers and auditors have significant experience in assessing materiality for the purposes of financial reporting. However, the application of these concepts in evaluating control deficiencies under AS 2 is relatively undeveloped, and independent auditors are being too inclusive.

For example, during the first round of Section 404 audits of internal controls over financial reporting, independent auditors have interpreted the term "inconsequential" almost exclusively using quantitative thresholds, with little or no consideration of qualitative factors. The SEC's guidance on assessing materiality, SAB 99, clearly requires consideration of both qualitative and quantitative factors. But this is not being applied in the Section 404 context, resulting in inappropriate classification of control deficiencies as significant when, in fact, they are inconsequential.

Furthermore, an established "floor" for deficiencies should exist under which the findings would be considered so trivial that they need not be considered for aggregation purposes. Many deficiencies are so trivial that few reviewers would pay attention, if not for the "requirement" that all deficiencies be communicated to management and considered for aggregation. PCAOB Release No. 2004-001 (March 9, 2004), "Concept of Reasonable Assurance," suggests that the PCAOB is looking for reasonable rather than absolute assurance. However, this has not been sufficiently adopted by independent auditors in practice. Better guidance should be provided in the near future, especially for accelerated filers who are currently facing the consequences of having to address all deficiencies rather than those that are truly significant.

3. Require Documentation Only for Key Controls, Not Minutia.

EEI believes that it is important to document activities where there exists some chance of misinterpretation regarding the execution of the control, not to document controls for the sake of documentation itself. We agree that appropriate, verifiable documentation of all key controls should be the standard to which management aspires in performing internal controls over financial reporting. Of course, many controls are performed by individuals and thus are susceptible to error, either in the performance of the control itself or in the documentation of performance. While an error in performance of the controls may indicate that the control is not operating effectively, an error in or absence of certain documentation does not necessarily indicate that the operation of the control is deficient.

AS 2 recognizes and allows for this in the auditor's testing of controls. Specifically, Paragraph 97 of AS 2 states in part that "the quality of the evidence regarding the effective operation of the control might not be sufficiently persuasive. If that is the case, the auditor should re-perform the control…as part of the test of the control." Thus, AS 2 appears to contemplate that a control may be deemed to exist and be operating effectively, even in the absence of sufficient documentation of its performance, if the auditor is able to test its effectiveness through re-performance.

Our experience, however, has been that independent auditors have applied a more stringent threshold for documentation of performance of controls than that required by AS 2. They have effectively enforced a standard that "absence of evidence [i.e., inadequate documentation] is evidence of absence." As a result, controls that are being performed effectively may be deemed to be deficient solely due to an absence of certain evidence, some of which may be trivial (such as signatures in specific locations, etc.). We believe it would be helpful, and would promote the objectives of Section 404 of the Sarbanes-Oxley Act, if the SEC or the PCAOB were to provide additional clarification regarding this aspect of the testing of internal controls over financial reporting.

Conclusion

In closing, EEI is deeply concerned that the process for developing and issuing AS 2 and associated interpretation was inefficient and in many ways ineffective. The final standard was not approved until four months into the year in which it was to be applied. Significant interpretations were issued with less than three months left in the year. Further, a number of matters were not sufficiently well addressed, as discussed above. This has led to a chaotic, costly, and frustrating outcome for all involved.

If the comments EEI has set out in this letter are addressed, we believe that the result will be a more efficient and effective Section 404 compliance process. Compliance costs would be reduced without compromising results by (1) increasing reliance on internal audit activity, (2) increasing reliance on prior testing, (3) spreading management and independent auditor testing throughout the year, (4) allowing independent auditors to discuss proper accounting treatment of transactions without jeopardizing their independence or otherwise running afoul of Section 404, (5) allowing companies to comply with Section 404 on their behalf and behalf of their subsidiaries, (6) clarifying that company management makes ultimate decisions regarding implementation of Section 404, (7) clarifying that only truly consequential deficiencies in control systems must be further evaluated, and (8) requiring documentation only for key controls.

Again, EEI requests the opportunity to participate in the Commission's April 13, 2005 Roundtable Discussion.

If the Commission, PCAOB, or their staff have any questions about these comments, please contact any of the following EEI staff: Julia Valliere, Senior Industry Accounting Analyst, at (202) 508-5449; David Stringfellow, Director, Accounting, at (202) 508-5494; or Henri Bartholomot, Director, Regulatory Legal Issues, at (202) 508-5622.

Respectfully submitted,

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March 31, 2005