UNITED STATES OF AMERICA

Public Company Accounting Oversight Board

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PROPOSED AUDITING STANDARD	)	
	)	PCAOB Release No. 2006-007
AN AUDIT OF INTERNAL CONTROL	)	December 19, 2006
OVER FINANCIAL REPORTING	)	
THAT IS INTEGRATED WITH AN	)	PCAOB Rulemaking
AUDIT OF FINANCIAL STATEMENT	)	Docket Matter No. 021
AND RELATED OTHER PROPOSALS	)	
	)	

Comments of the Edison Electric Institute

Introduction

The Edison Electric Institute (EEI) respectfully submits these comments in response to the Public Company Accounting Oversight Board's (PCAOB) Proposed Auditing Standard – "An Audit of Internal Control Over Financial Reporting That is Integrated With an Audit of Financial Statements and Related Other Proposals".

EEI is the association of the United States shareholder-owned electric utility 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 nearly 70 percent of all electric utility ultimate customers in the nation, and generate over 70 percent of the electricity produced by U.S. electric utilities.

The proposed auditing standard is of vital importance to EEI, its member companies and their customers. We are therefore submitting our concerns with the hope that it leads to a clearer, more concise and simplified Auditing Standard for "An Audit of Internal Control Over Financial Reporting that is Integrated with an Audit of Financial Statements and Considering and Using the Work of Others"- that would supersede Auditing Standard No. 2.

We have several concerns as outlined in these comments. We have captured in our executive summary those concerns and suggestions that we feel will have the most significant impact in achieving the efficiency, enhancements, and cost reductions that are the goal of the proposed PCOAB's standard. Following the executive summary, we have provided a response to the specific questions posed by the PCAOB that are of primary concern to our members. We hope that these comments will prove helpful to the Board in codifying Auditing Standard No. 5.

Executive Summary

We propose that the following items be addressed in the future PCAOB standard:

- **Provide clarification to the scope of the audit of internal control to avoid unnecessary testing.** As long as there are definitions for both significant deficiencies and material weaknesses, auditors will test to identify both types of weaknesses. We advocate the removal of the significant deficiency definition and concentrate testing instead on the identification of material weaknesses.

- **Provide additional guidelines to tie-in effective company-level controls to an appropriately reduced amount of testing of lower risk controls.** Less time should be spent on lower risk controls. Lower risk areas may be satisfied with company level controls. The net effect should be that some financial statement assertions and internal control objectives would be satisfied through company level controls.

- **Hold public accountants responsible for failing to effectively utilize the work of others.** Use of the work of others should not be an option for the public accountant. Currently, the proposed standard identifies criteria that define when the public accountant can rely on the work of others. Instead, we advocate that the standard identify criteria that define when the public accountant should not rely on the work of others. In the absence of such criteria discouraging reliance, the public accountant would need to be able to show cause to PCAOB audit staff when they opted not to rely on the work of others. This process should become a routine part of PCAOB audits of public accounting firms. Based on our review of the publicly released audit reports from the PCAOB, this evaluation of the reliance on others is not readily apparent.

Additionally, we propose that the following items be addressed:

- **Define the scope of the Section 404 (a) Management Assessment to eliminate or reduce compliance requirements for subsidiary registrants.** We support the proposal to eliminate the external auditor's opinion on management's assessment. Many corporations have multiple registrants, each of which is required to certify their Internal Control Over Financial Reporting (ICFR) in 2007. This creates multiple certifications within the same corporation. This is redundant. Instead of helping investors, these multiple certifications will contribute to investors' confusion. We advocate rules that alleviate the requirement for multiple certifications within the same corporation.

- **Eliminate the Section 404 (b) requirement for a public accountant opinion on ICFR.** Regardless of the rules established by the PCAOB, the inherent tendency of the public accountant is to be conservative. Further, due to the litigious history experienced by public accounting, as well as the PCAOB's own audit results, the public accountant is likely to be reluctant to reduce scope to fully incorporate a risk based approach. They simply have no incentive to do so. Thus, the public accountant will consistently require processes that exceed those necessary in management's point of view. To relieve this situation, we advocate the elimination of the public accountant audit requirement under Section 404 (b) to perform an audit of both management's assessment as well as ICFR. To fill the void in guidance left by this elimination, we suggest that the PCAOB adopts the previously utilized auditing standard covering internal controls, that is, Statement of Auditing Standard No. 55, Consideration of Internal Control in a Financial Statement Audit.

Specific Questions & Answers

A. Focusing the Audit on the Matters Most Important to Internal Control

1. Directing the Auditor's Attention Towards the Most Important Controls:

1. Does the proposed standard clearly describe how to use a top-down approach to auditing internal control?

   Comment To some extent yes. However, it is unclear how the assessment of company level controls can be used to develop or limit the scope of the audit. Illustrative examples would be helpful in clarifying this area. It seems very subjective as to how much reliance the external auditor can have on the entity-level controls and how much reduction can occur. Also, the concern is that external auditors will exploit this loophole to push work and cost to management (paragraphs 16-17).

2. Does the proposed standard place appropriate emphasis on the importance of identifying and testing controls designed to prevent or detect fraud?

   Comment The new standard clarifies that the audit of internal control over financial reporting (ICFR) should ensure that controls are adequate to prevent or detect in a timely manner fraud that could cause a material misstatement (paragraphs 34 and 45). The standard also appropriately addresses the need to assess programs and controls that address risks related to fraud, and specifically those controls that address the risk of management override of controls. Additionally, the standard addresses the impact on the scope of the audit should controls related to fraud be found to be deficient.

3. Will the top-down approach better focus the auditor's attention on the most important controls?

   Comment We believe that it should, provided the auditor uses reasonable judgment in defining risk thresholds. However, some additional language emphasizing a focus on material controls should be included in paragraph 44, which discusses the process for selecting which controls to test. Alternatively, the definition of a relevant assertion could be reiterated in paragraph 44.

4. Does the proposed standard adequately articulate the appropriate consideration of company-level controls and their effect on the auditor's work, including adequate description of when the testing of other controls can be reduced or eliminated?

Comment Although the guidance does provide detail with regard to defining company-level controls and the control environment, it does not adequately provide details about ***how*** the assessment of company-levelcontrols specifically impacts the decisions as to which transactions and controls should be included in the scope of the audit. Please consider specifically addressing how the company-level controls will impact the selection of controls in paragraphs 41-46. The consideration is clearly outlined but more guidance is necessary on the application of the standard.

2. Emphasizing the Importance of Risk Assessment:

5. Does the proposed standard appropriately incorporate risk assessment, including in the description of the relationship between the level of risk and the necessary evidence?

Comment The proposed guidance does provide the auditor with a risk based approach to determining the adequacy of the evidence related to the effective operation of controls in paragraph 52. However, the note at the bottom of that paragraph states that: "***Generally, a conclusion that a control is not operating effectively can be supported by less evidence than is necessary to support a conclusion that a control is operating effectively*"**. Our concern is that the auditor may interpret this note to mean *less evidence means less effective*. This note may drive auditors to a more conservative approach with regard to the evidence required to be created and maintained by management. For example, we believe that an auditor would gain sufficient evidence about the effectiveness of a control activity involving a supervisor's review of a report by interviewing the individual who performs that review and looking at review notes on the report. We are concerned that an auditor may conclude that the evidence is not sufficient, and therefore the control is not effective, if the report is not signed and dated. Again, our opinion is that less evidence does not necessarily mean that a control is less effective.

6. Would the performance of a walkthrough be sufficient to test the design and operating effectiveness of some lower risk controls?

Comment The proposed standard should emphasize that for controls that have sufficient risk to require testing, but are on the lower end of the risk scale. A walkthrough could provide sufficient evidence at greater efficiency. Some lower risk areas might even be covered by company-level controls. The question will then be is the timing of the walkthrough close enough to the period end. The walkthrough is performed at the front of the assessment process. If it is determined through inquiry and observation that a control that mitigates a lower risk control is sufficient, no further testing should be required. This should be specifically stated in the proposed standard (AS5). A compromise would be that for roll-forward testing "inquiry only" is an acceptable test for low risk controls that have tested effective earlier in the testing cycle. This also would need to be explicitly stated in AS5.

3. Revising the Definitions of Significant Deficiency and Material Weakness:

7. Is the proposed definition of "significant" sufficiently descriptive to be applied in practice? Does it appropriately describe the kinds of potential misstatements that should lead the auditor to conclude that a control deficiency is a significant deficiency?

Comment The definition has improved more so than in the previous guidance. However, it remains an area of great subjectivity. We believe that additional clarity is needed in this area, such as examples to clarify what is important enough to merit attention by those responsible for oversight of the company's financial reporting. In practice, most firms have established a threshold for what they believe is significant. The new definition should not change those thresholds. Also, confusion and continued dialogue may occur since its application is unique to each company.

8. Are auditors appropriately identifying material weaknesses in the absence of an actual material misstatement, whether identified by management or the auditor? How could the proposed standard on auditing internal control further encourage auditors to appropriately identify material weaknesses when an actual material misstatement has not occurred?

Comment It appears that most material internal control weaknesses have been related to material misstatements. However, from that observation one cannot conclude that auditors are appropriately identifying weaknesses in the absence of actual material misstatements. The proposed standard, with its focus on using a top-down approach and scoping at the level to identify material weaknesses, will allow auditors to do a more thorough review of key controls as less effort will be expended on reviewing lower risk controls. This should increase the likelihood of the auditor detecting material weaknesses before a misstatement occurs.

9. Will the proposed changes to the definitions reduce the amount of effort devoted to identifying and analyzing deficiencies that do not present a reasonable possibility of material misstatement to the financial statement?

Comment The change to the definitions does not raise the auditor's threshold for classifying deficiencies. However, the concept of scoping to detect deficiencies that could result in a material misstatement should reduce the amount of effort dedicated to identifying and analyzing deficiencies. In addition, the concept should be reiterated in paragraph 43, which provides guidance related to selecting which controls to test.

4. Revising the Strong Indicators of a Material Weakness:

10. Should the standard allow an auditor to conclude that no deficiency exists when one of the strong indicators is present? Will this change improve practice by allowing the use of greater judgment? Will this change lead to inconsistency in the evaluation of deficiencies?

    Comment If one of the strong indicators exists, there is at least a deficiency. However, professional judgment should be exercised in evaluating whether a deficiency is classified as a significant deficiency or material weakness. For example, one strong indicator of a significant deficiency provided in the standard is the situation where the deficient control is related to period end financial reporting. In this situation, there could be varying degrees of a deficiency which range from a lower risk error (such as a missing signature on a work paper), to a higher risk error occurring in the analysis of the financial results. The above two examples of deficiencies should not be classified equally. The use of professional judgment will naturally produce some inconsistencies, but that is more acceptable than the inefficiency caused by utilizing a checklist evaluation approach that focuses on immaterial issues and does not incorporate the auditor's judgment. If a strong indicator is present, and management does not correct it or strengthen their controls, it should be reported as a deficiency.

5. Clarifying the Role of Materiality in the Audit

6. Clarifying the Role of Interim Materiality in the Audit

11. Are further clarifications to the scope of the audit of internal control needed to avoid unnecessary testing?

    Comment As long as there are definitions for both significant and material weaknesses, auditors will test to identify both types of weaknesses. Remove the significant deficiency definition and concentrate on material weakness. The definition of relevant assertions should be reiterated in the proposed standard numerous times. In addition, the message in paragraph 70, related to the level at which an auditor plans and performs an audit, should be reiterated in paragraph 6. Additional guidelines should be provided related to the tie-in of company-level controls to the scope of the audit of transactions. The testing is supposed to be as of the reporting date.

12. Should the reference to interim financial statements be removed from the definitions of significant deficiency and material weakness? If so, what would be the effect on the scope of the audit?

Comment Any reference to interim statements and materiality should be removed. The audit of internal controls provides an opinion on the effectiveness of those controls as of the fiscal year end. The assessment of the impact of control deficiencies should be limited to the annual financial reports. This could cause a lot of confusion and inconsistency in practice. The focus should be on annual financial statements.

B. Eliminating Unnecessary Procedures

1. Removing the Requirement to Evaluate Management's Process

13. Will removing the requirement for an evaluation of management's process eliminate unnecessary audit work?

Comment Currently the audit of management's assessment process is inefficient and redundant. Since the ultimate objective of SOX- 404 compliance is for registrants to have effective controls, the audit should focus on that objective. While there may be sound logic behind this requirement, the auditor performs his/her own work or reviews the work of others to make his or her opinion. How management comes to its conclusions should not, therefore, impact the auditor's ability to conclude on his/her own behalf.

14. Can the auditor perform an effective audit of internal control without performing an evaluation of the quality of management's process?

Comment If management has an ideal assessment process, but the controls are not effective, that assessment is not beneficial to the users of the financial reports. The elimination of the audit of management's assessment process will not make the audit less effective. Again, since the ultimate purpose of the audit is to determine that management maintains effective internal control over financial reporting (ICFR), an audit of management's assessment process is unnecessary. We are now into our third year of SOX. The auditor should know management's process and feel comfortable with it. The auditor should be able to use management's testing as well, especially for low risk areas. The auditor can perform an effective audit of internal controls without performing an evaluation of the quality of management's evaluation process. The auditor does it all the time in other audits, including Financial Statement auditing.

15. Will an opinion only on the effectiveness of internal control, and not on management's assessment, more clearly communicate the scope and results of the auditor's work?

Comment Eliminating the requirement for an opinion on management's assessment of ICFR provides for a clearer and more focused scope and therefore the results related to that focused scope will be more easily interpreted by the user of the company's financial reports. It is what is most relevant to the stakeholder i.e., the independent review, and not Management's own opinion of itself.

2. Permitting Consideration of Knowledge Obtained During Previous Audits

16. Does the proposed standard appropriately incorporate the value of cumulative knowledge?

Comment The auditors will be able to consider their cumulative audit knowledge and experience in determining the level of risk associated with a control. For lower risk controls, the auditor should be able to reduce the level of evidence needed to determine if the control is operating effectively. The annual rotation of test areas is acceptable - particularly for lower risk areas. Higher risk areas should be tested every year.

17. What are the circumstances in which it would be appropriate for the auditor to rely upon the walkthrough procedures as sufficient evidence of operating effectiveness?

Comment Consistent with paragraphs 52 and 66, a walkthrough should produce sufficient evidence of operating effectiveness in areas were the controls were effective in prior periods, the controls are low risk based upon the factors listed in paragraph 52, and where there have been no significant changes to ICFR. If the area has a history of effective internal controls, compensating controls exist, or the relative importance of the process is low. In lower risk areas - subsidiaries that are not major lines of business but have a separate management; lines of business that may marginally exceed the quantitative materiality threshold (higher revenue and expense), but the net effect to the consolidated company is very small. When the auditor uses these procedures to verify that nothing has changed and that those performing the controls have a clear understanding of what needs to be done and why - there is obvious ownership of the control by those performing it.

3. Refocusing the Multi-location Testing Requirement on Risk Rather than Coverage

18. Will the proposed standard's approach for determining the scope of testing in a multi-location engagement result in more efficient multi-location audits?

Comment Small, low risk locations may be addressed by management oversight and entity level controls, since the likelihood of a material misstatement should be remote. It eliminates the time required to test locations for business units that are clearly inconsequential (paragraphs B12-17). It also provides the auditor with the ability to coordinate work with the internal auditors, something the auditor should be able to do to a greater extent in most areas.

4. Removing Barriers to Using the Work of Others

19. Is the proposed standard's single framework for using the work of others appropriate for both an integrated audit and an audit of only financial statements? If different frameworks are necessary, how should the Board minimize the barriers to integration that might result?

    <u>Comment</u> A single standard will meet both the needs of the financial audit as well as the audit of ICFR. The proposed guidance is a substantial improvement over the limits that are established under the current guidance. This improvement should lead to significant cost reductions for many registrants. Although we believe only one framework is required, it should be made clear to the auditor that coordinating work with the internal auditor is permissible. Otherwise, the efficiencies in relying upon the work of others may not be maximized.

20. Does the proposed definition of relevant activities adequately capture the correct scope of activities, including activities that are part of the monitoring component of internal control frameworks?

    <u>Comment</u> Although the definition of relevant activities is adequate, it was not easily located in the text of the proposed standard. Perhaps consider adding it in Appendix A.

21. Will requiring the auditor to understand whether relevant activities performed by others identified control deficiencies, fraud, or financial statement misstatements improve audit quality?

    <u>Comment</u> Two points here - first, this would be reassessing the evaluation that management did, which supports the earlier point that eliminating the report does little to eliminate the work. Second, this statement needs to be qualified because it further leads to the disconnect. Paragraph 6 is what is stated above but the Note below 6 clarifies we are talking about risks of material misstatements. This should not be a note but rather included throughout the proposed standard. We are talking about material misstatements. Any time this is not identified as such, it will lead to more audit work. The auditor should have a full understanding of the relevant activities in order to efficiently plan and perform the audit.

22. Is the principal evidence provision that was in AS No. 2 necessary to adequately address the auditor's responsibilities to obtain sufficient evidence?

    <u>Comment</u> That provision limited the auditor's use of professional judgment when determining the level of reliance that could be placed on the work of others. There should be no difference between using the work of others in a financial statement audit or an audit of ICFR. This ends up being one of the most inefficient aspects of Sarbanes-Oxley Section 404 implementation as there is much duplicative work. If the work of others is sufficiently documented and the

evidence sound, there is no reason why the auditor should duplicate efforts. This strengthens the argument, however, for coordination with others (e.g., internal auditing) performing testing so that expectations can be managed. No one benefits from performance of work that could have been relied upon 'if only it had been taken a step further', for example.

23. Does the proposed standard provide an appropriate framework for evaluating the competence and objectivity of the persons performing the testing? Will this framework be sufficient to protect against inappropriate use of the work of others? Will it be too restrictive?

    Comment The proposed standard does provide very good guidelines for evaluating competence and objectivity in paragraphs 14-15 in Appendix 2. However, the guidance in paragraph 15, section b may cause the auditors to avoid using the work of others that are not part of a formal internal audit function. This is still too restrictive as the proposed standard does not do enough to incorporate the concept of self-assessment of key controls. Self-assessment, if managed properly, is still the most effective and efficient way for management to conduct its assessment. With proper oversight of the self-assessment program, external auditors should be allowed to rely on self-assessment testing. Currently, this is a big gap in the Board's guidance as it seems to suggest that internal auditors should do all of the management testing. Having internal audit do all of the testing is far from efficient and far from a best practice.

24. Has the Board identified the right factor for assessing competence and objectivity? Are there other factors the auditor should consider?

    Comment A missing factor is that effective oversight of the testers of key controls is an important element in improving objectivity and competence. Professional certification should not be a requirement. Instead, the quality of the work product and the process used by the client to evaluate risks and controls should be the key criteria.

25. What will be the practical effect of including, as a factor of objectivity, a company's policies addressing compensation arrangements for individuals performing the testing?

    Comment Factors related to compensation of individuals performing testing should be addressed only as a part of the assessment of the individuals' objectivity. The practical effect of including a company's policy addressing compensation arrangements helps to ensure that the entity recognizes areas that could impair objectivity and by establishing compensation guidelines helps to support an environment for unbiased assessment of the effectiveness of controls. However, it is unclear how much weight to assign to this factor and how the auditor should assess the objectivity of individuals performing tests in the absence of such policy.

5. Recalibrating the Walkthrough Requirements

26. Will requiring a walkthrough only for all significant processes reduce the number and detail of the walkthroughs performed without impairing audit quality?

    Comment The language in the proposed standard provides the auditor with the opportunity to use his or her professional judgment in limiting the walkthroughs to those processes that are material to the audit. This will eliminate unnecessary efforts and could have a significant effect in reducing the number and detail of the walkthroughs performed without impairing audit quality.

27. Is it appropriate for the auditor to use others as direct assistance in performing walkthroughs? Should the proposed standard allow the auditor to more broadly use the work of others in performing walkthroughs?

    Comment If the auditor applies the guidance in paragraph 21, the auditor should be able to rely on walkthroughs performed by other competent objective professionals.

Conclusion

EEI appreciates the opportunity to submit these comments in response to the PCAOB's Proposed Auditing Standard. We hope you find our comments relevant and timely towards a more effective, less cumbersome and less costly revised auditing standard.

Sincerely,

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