United States of America
Securities and Exchange Commission

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Proposed Interpretation and	)	**SEC Release Nos.**
Proposed Rule Regarding	)	**33-8762 and 34-54976**
Management's Report on Internal	)	**File No. S7-24-06**
Control Over Financial Reporting	)	
	)	

Comments of the Edison Electric Institute

Introduction

The Edison Electric Institute (EEI) appreciates the opportunity to comment on the Security and Exchange Commission's (SEC's or the Commission's) proposed interpretive guidance (guidance) and proposed rule amendments (rule changes) regarding management's evaluation of internal control over financial reporting (ICFR) under Section 404 of the Sarbanes Oxley Act of 2002. The Commission published the proposed guidance and rule changes at 71 Fed. Reg. 77635 on December 27, 2006 and invited comments by February 26, 2007.

EEI is the association of the United States shareholder-owned electric companies, international affiliates, and industry associates worldwide. Our U.S. members serve 95 percent of the ultimate customers in the shareholder owned segment of the industry, and 68 percent of all electric utility ultimate customers in the nation, and generate almost 60 percent of the electricity produced in the United States.

General Remarks

EEI compliments the Commission for issuing the proposed interpretative guidance and rule changes regarding management's evaluation of ICFR. We especially appreciate the Commission's efforts in the guidance to provide company management and staff with the ability to exercise professional judgment as they strive to ensure that company internal controls are adequate to produce accurate financial statements. We also appreciate the Commission's goal of focusing on material issues of significant concern rather than low risk or immaterial issues in instituting and evaluating the adequacy of internal controls. The proposed guidance should allow companies to focus their efforts on those areas that management has identified as posing the greatest risk of material misstatements.

Many of EEI's members are registered with the SEC as publicly-held companies and as such are subject to Section 404 and the Commission's rules and guidance and the Public Company Accounting Oversight Board (PCAOB or the Board) standards for implementing the section. Furthermore, a number of our members, especially parent companies, are among the "accelerated" filers who have been required to comply with the Commission's and Board's Section 404 assessment and reporting requirements for the past three years. As a result, EEI has a direct interest in the Commission's proposed guidance and rule changes, which will affect implementation of Section 404.

EEI has some suggestions to improve the proposed interpretative guidance. Specifically, we encourage the Commission to amend the guidance so that it covers the following additional points not currently covered in the guidance.

First, the Commission should emphasize that discretion is provided to company management in the performance of their assessment of ICFR in order to avoid unnecessary deliberation between management and auditors. This would be especially helpful in instances where the audit firm might insist on a specific methodology that is contrary to a reasonable ICFR assessment approach taken by management. For example, footnote 50, which provides management with discretion to select the methodology for identifying risks and controls, should be more prominent. Our position is that external auditors should defer to reasonable choices that are made by management.

Second, the Commission should encourage the PCAOB to conform its standards to accommodate reliance on the guidance by company management and external auditors. The guidance *should* provide company management with a safe harbor to the extent company management relies on the guidance. But the Commission can achieve this goal only if the Board and external auditors also honor the guidance. The use of standard terminology and definitions in the SEC guidance and rules and PCAOB standards would also help to avoid confusion and differing interpretations.

Third, the guidance should provide greater clarity about ways in which company management and others can focus on relatively significant issues and not on relatively minor issues in implementing Section 404. For example, the guidance should explicitly exclude the need to test low risk control areas, to avoid misdirecting company and external audit resources to such areas. Also, especially for areas that have not changed or that are lower risk but still within the scope of management's control program, the guidance should endorse the use of rotational testing, so companies can rotate testing of controls over a number of years and eliminate excessive, unnecessary testing each year.

EEI believes that the guidance provided will assist management of public companies to conduct a more effective and efficient evaluation of controls over financial reporting. We also believe that it is essential to align the guidance and the final PCAOB Auditing Standard with one another in order to achieve the necessary cost savings/reductions that have prompted the need for guidance in the first place. If the actions of management conform to the guidance, but the auditor cannot rely on management's actions due to requirements of the auditing standard, the resultant costs to companies could actually be much greater than they if the two documents are consistent.

Certain points covered in the guidance should be clarified, as discussed in the next section of these comments.

Responses to SEC Questions About the Guidance

EEI wishes to provide feedback on the questions provided in the proposed interpretive guidance.

1) Will the proposed interpretive guidance be helpful to management in completing its annual evaluation process? Does the proposed guidance allow for management to conduct an efficient and effective evaluation? If not, why not?

The guidance for management will be helpful to management in completing its annual evaluation process. The guidance provides some helpful clarity as to management's responsibilities, such as the clarification that Section 404 focuses on internal controls relating to financial statements, not other internal controls. Further, the guidance provides management with the ability to exercise professional judgment and to focus on relatively important issues rather than relatively unimportant ones. We support promoting the use of a risk-based approach in the guidance. The key question is whether external audit firms and the Board will honor the guidance and management's reliance on it.

The guidance provides detailed information on identifying risk and controls, the purpose and use of evidence, and the role of IT controls. The guidance is especially helpful in the areas of assessing company level and IT controls, where excellent examples and ample explanation are provided.

The guidance as written provides management with some assistance in conducting an efficient and effective evaluation because of the risk-based approach. One specific area that is helpful is the section on page 25, paragraph 3, which provides management with flexibility in determining which redundant controls to assess based upon the attainability of evidence for the assessment of those controls.

Additionally, the section on page 25, paragraph 1 provides a good example of how companies can leverage the assessment of entity level controls in the financial reporting area to address specific transactions risks, such as the processing of interest expense.

There are several areas of the guidance where additional clarification is needed to help management to conduct and efficient and effective review. We will address those areas in our responses to the questions below.

2) Are there particular areas within the proposed interpretive guidance where further clarification is needed? If yes, what clarification is necessary?

   We believe that further clarification would be helpful in the following areas.

   Risk Assessment

   - The level of materiality that management should be concerned with in its testing should be clarified through more explicit guidance. For example, the guidance should note that the level of materiality differs for balance sheet and income statement items.

   - There is no guidance for management as to when there is a disagreement in the determination of risk areas with the auditor. Here again, the auditor may perform additional procedures in areas that management has deemed to be of a risk lower than that deemed by the auditor. As mentioned above, the Commission's guidance and PCAOB standard should be aligned to allow management to exercise professional judgment and to direct auditors to accept that judgment, both to make the guidance effective and to avoid unnecessary duplication of effort. Conversely, management should be able to rely on external auditor opinions, again to avoid unnecessarily having to duplicate work already done by the auditor.

   - On page 17, paragraph 1, the last sentence refers management's evaluation of controls in low risk areas. This seems to contradict the statement on page 26, paragraph 3, which states that management should identify for testing only those controls that are needed to adequately address the risk of a material misstatement. We believe that only controls that have a potential to materially impact financial reporting should be included in this guidance.

   - Additionally, in section A.2.a, the portion on page 33, paragraph 1 and page 34 includes beneficial information related to assessing the risk of financial reporting elements. This information would be better suited for section A.1.a, which discusses assessing risk to financial reporting elements. Similarly, the information on page 33, paragraph 2, and page 34, paragraph 2, which describe the controls risk assessment process, seems to better fit with section A.1.b, the section that discusses identifying controls for addressing financial reporting risk. If later reference to that information is warranted, it can be done by cross reference.

Testing

- The use of rotational testing needs to be allowed. Selective rotational testing should be used for controls that are relatively static or routine, as well as in areas where a company has demonstrated historically strong and effective controls.

- Also, on page 30, paragraph 2 indicates that in evaluating the sufficiency of evidence, management should consider the quantity of evidence (e.g. sample size) as well as the qualitative characteristics (including the nature of the evaluation procedures). Clarification is needed around what is meant by the "nature of the evaluation procedures." Specifically, the guidance should note that higher risk controls may require periodic retesting, while lower risk controls may simply require periodic observation.

Deficiency Evaluation

- Both materiality and deficiency evaluations should be done in connection with annual financial statements, not interim statements. Allowing management to scope its audits of internal control over financial reporting and to evaluate materiality just for the annual statements, only to have deficiencies evaluated by external auditors for interim financial statements, creates confusion and excess work on the part of management and the auditors.

- The Commission should clarify its discussion of "evaluation of control deficiencies" in section B.1 of the proposed guidance. Specifically, this section of the guidance should be modified: (a) to discuss the comment about the "magnitude of potential misstatement" and clarify that this is but one element of risk evaluation; (b) to define "significant deficiencies that have been identified and remain unaddressed after some reasonable period of time" and to clarify that this means unremediated deficiencies; (c) to specify that management should focus on controls needed to prevent material misstatements, not low risk controls; and (d) to note that the standards for determining materiality may differ depending on whether the focus is on the income statement or the balance sheet.

- The guidance is silent on significant deficiencies up to this point. The Commission should discuss the issue, in particular the threshold for the determination that a control breakdown is significant and/or material in nature. The discussion should align with the PCAOB standard.

- There is no mention in the guidance applicable to interim reporting under Sarbanes Oxley Section 302 and the evaluation and reporting of deficiencies applicable to those interim periods. EEI encourages the

Commission to move away from having to make interim materiality determinations in the quarterly reports. Also, the Commission guidance and PCAOB standard should align on this issue.

Service Providers

- Section B.5 of the guidance mentions service organizations. However, the guidance focuses on the absence of an SAS 70 Type 2 report and the potential that the vendor will not allow for audits by management. There is no guidance for the situations where a report is available as to the interpretation of the report. If there is a report available and the auditor's opinion is that the controls within the service organization are deemed effective, that should be sufficient for management without the need for additional procedures and/or evaluations. In these circumstances, management certainly should be able to rely on auditor opinions.

3) Are there aspects of management's annual evaluation process that have not been addressed by the proposed interpretative guidance that commenters believe should be addressed by the Commission? If so, what are those areas and what type of guidance would be beneficial?

Again, the use of rotational testing needs to be allowed. Selective rotational testing should be used for controls that are relatively static or routine, as well as in areas where a company has demonstrated historically strong and effective controls.

Also, footnote #53 on page 25 indicates that the design of controls would be deficient if a necessary control is missing or not designed appropriately. This could promote disagreements between company management and external auditors. Already, there have been instances where companies have disagreed with their auditors in situations where the design of the control is adequate and the control was effective, but the control was not specifically selected by management as a key control for the Section 404 assessment process, and the auditor argued that the control should have been selected as a key control. The guidance should specify that there is no deficiency in ICFR simply because management does not include a particular control in its Section 404 assessment, provided the control is operating effectively.

4) Do the topics addressed in the existing staff guidance (May 2005 Staff Guidance and Frequently Asked Questions (revised October 6, 2004)) continue to be relevant or should such guidance be retracted? If yes, which topics should be kept or retracted?

EEI recommends that the May 2005 Staff Guidance should be retained, but the new guidance should control in the event of a conflict between the two.

5) Will the proposed guidance require unnecessary changes to evaluation processes that companies have already established? If yes, please describe.

Unnecessary documentation will be prepared if the guidance is understood to require management to demonstrate their assessment of the effectiveness of low risk controls. Currently, companies only document their assessment of those controls that pose a risk of a material misstatement. Please see our comment on response to question # 2 above.

Also, from page 36, paragraph 2 through page 37, paragraph 1, the guidance indicates that controls which management assess as high risk should be directly tested (versus monitored), and the expectation is that the testing would include the fiscal year end. However, if companies change controls earlier in the year and test to ensure the effectiveness of the controls as part of instituting the change, that earlier-in-year testing should suffice, and the companies should not be required to re-perform the tests at year end. The language in this section of the guidance should be changed to reflect such instances.

6) Considering the PCAOB's proposed new auditing standards, *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 In an Audit*, are there any areas of incompatibility that limit the effectiveness or efficiency of an evaluation conducted in accordance with the proposed guidance? If so, what are those areas and how would you propose to revolve the incompatibility?

There are several areas where the proposed Audit Standard will be looked to for the prevailing guidance, in particular by external auditors. As a result, it is very important that the Commission and Board work cooperatively together to ensure that the audit standard reflects the guidance and preserves management's ability to rely on the guidance and to exercise professional judgment without inappropriate later second guessing of management decisions and duplication of effort by auditors.

In particular, there could be two views on the scope and method of testing. The guidance authorizes management to make informed decisions on these matters. But the auditors will look at the PCAOB audit standard and say whether they agree with the testing. EEI encourages the Commission to urge the PCAOB to conform its rules to the SEC guidance, to avoid such differences of view and to allow company management to rely on the SEC guidance in practice.

For example, the guidance advocates the use of self-assessments (on page 36, footnote 36), but the PCAOB Standard section on "Considering and Using the Work of Others" (page A2-6, paragraph 13) prohibits the use of others work if there is a determination that the individual performing the testing is not objective. If management employs the self-assessment strategy authorized by the guidance, even in low risk areas, the auditor is likely under to PCAOB standard to perform additional procedures in these areas. As mentioned above, in low-risk areas, management's judgment should prevail. But even as to higher risk areas, at a minimum, management and auditors should be able to confer with one another and reach agreed-upon decisions, to avoid duplication of effort.

As mentioned in our answer to question 3 above, lacking guidance to address differences in the determination of risk for a particular company, the procedures performed by management dealing with the nature, timing and scope of testing may vary greatly from what the auditor may deem necessary. This may result in additional procedures being performed by the auditor that may not be necessary.

The PCAOB Standard No. 5 provides an appendix with definitions for key terms. It would be useful if that terminology were also used in the SEC guidance for management in order to avoid confusion. For example, there is no mention in the SEC proposed guidance of "relevant financial statement assertions" or the "significant financial accounts" and "significant processes" in section A.1.a "Identifying Financial Reporting Risk" or A.1.b "Identifying Controls that Adequately Address Financial Reporting Risk." This is not consistent with the PCAOB's proposed Standard No. 5 and may cause conflicts between the registrant and their auditor with regard to what is included in the scope of the assessment of ICFR. Because the risk assessment and scoping procedures are the foundation of the assessment, both the auditor and management should be using the same approach.

Finally, the PCAOB standard should explicitly encourage external auditors to rely on the decisions and work of others if considered dependable, in particular company controls testing and management evaluations done in conformance with the Commission's guidance. This would avoid unnecessary duplication of effort and conflict of views on testing methodology and other issues left to management discretion under the guidance.

7) Are there any definitions included in the proposed interpretative guidance that are confusing or inappropriate and how would you change the definitions so identified?

In section B.1 of the proposed guidance, as mentioned above, there is a need to define "significant deficiencies that have been identified and remain unaddressed after some reasonable period of time." This should be clarified to mean unremediated deficiencies.

Also, on page 42, paragraph 3 provides a list of conditions that would impact management's assessment of the significance of a deficiency. One condition on page 43 speaks to the future consequences of the deficiencies. Given that the management's assessment is as of the fiscal year end, it seems incongruent to include potential future year misstatements in the assessment of a current year internal control deficiency.

Also, as noted in question #6 above, consistent use of terminology and definitions would help to better align the PCAOB Audit Standard No. 5 and the SEC guidance.

8) Will the guidance for disclosures about material weaknesses result in sufficient information to investors and if not, how would you change the guidance?

We believe that the guidance will provide sufficient information to investors. The proposed guidance provides a channel for management to comment on details related to the material weakness. In many cases, such disclosure would provide the investor with additional information that could potential lessen the interpretation of the weakness than if the disclosure simply provided the weakness.

9) Should the guidance be issued as an interpretation or should it, or any part, be codified as a Commission rule?

EEI recommends that the guidance should be issued as an interpretation. However, we encourage the Commission to promote conformance to the guidance by external auditors and the PCAOB, so company management can in fact rely on the guidance.

On the other hand, if the Commission wishes to help ensure that company management can rely on the guidance, including in discussions with external auditors, the Commission may wish to codify the guidance as a regulation. This could help to signal that the guidance is on par with the PCAOB AS 5 and is to be relied on by all parties.

10) Are there any considerations unique to the evaluation of ICFR by a foreign private issuer that should be addressed n the guidance? If yes, what are they?

No comment.

<u>Responses to SEC Questions About the Rule Changes</u>

1) Should compliance with the interpretive guidance, if issued in final form, be voluntary, as proposed, or mandatory?

The guidance should be voluntary, but companies that do act in conformance with the guidance should fully be able to rely on the guidance as discussed in our response to question #9 above. EEI supports the proposed changes to

Exchange Act Rules 13a-15(c) and 15d-15(c) to provide safe harbors under those rules for companies that rely on the guidance, without limiting companies to options set out in the guidance. Such safe harbors are very helpful in allowing companies to rely on the guidance as part of the effort to comply with Section 404 and related regulatory requirements.

2) Is it necessary or useful to amend the rules if the proposed interpretive guidance is issued in final form, or are rule revisions unnecessary?

The proposed revisions to Rules 13a-15(c) and 15(d)-15(c) to reference the interpretive guidance would be useful to enhance the authority of the guidance.

3) Should the rules be amended in a different manner in view of the proposed interpretive guidance?

We did not note any areas where different changes appear necessary.

4) Is it appropriate to provide the proposed assurance in Rules 13a-15 and 15d-15 that an evaluation conducted in accordance with the interpretive guidance will satisfy the evaluation requirement in the rules?

Yes, this will establish that the guidance in fact can be relied, thus giving it necessary authority to promote such reliance.

5) Does the proposed revision offer too much or too little assurance to management that it is conducting a satisfactory evaluation if it complies with the interpretive guidance?

The proposed revision provides the appropriate amount of assurance.

6) Are the proposed revisions to Exchange Act Rules 13a -15 and 15d -15(c) sufficiently clear that management can conduct its evaluation using methods that differ from our interpretive guidance?

Yes.

7) Do the proposed revisions to Rules 1-02(a) (2) and 2-02(f) of Regulations S-X effectively communicate the auditor's responsibility? Would another formulation better convey the auditor's role with respect to management's assessment and/or the auditor's reporting obligation?

The guidance together with the changes we have suggested including in it, along with aligning the guidance and PCAOB standard, should help to clarify the auditor's role under Section 404.

As to the proposed changes to Rules 2-02(f) and 1-02(a)(2) of Regulation S-X, we are concerned that the proposed changes would give the external auditor the role of "second guessing" reasonable management decisions under the guidance and Section 404. Instead, the Commission should clarify that the role of the auditor is to indicate whether – in light of the guidance and with appropriate reliance on the work of others – the auditor agrees with management's evaluation or not and if not why not.

8) Should we consider changes to other definitions or rules in light of these proposed revisions?

None noted.

9) The proposed revision to Rule 2-02(f) highlights that disclaimers by the auditor would only be appropriate in the rare circumstance of a scope limitation. Does this adequately convey the narrow circumstances under which an auditor may disclaim an opinion under our proposed rule?

The amendment to Rule 2-02 would require the external auditor to state its opinion "either unqualified or adverse, as to whether the registrant maintained, in all material respects, effective internal control over financial reporting, except in the rare circumstance of a scope limitation that cannot be overcome by the registrant or the registered public accounting firm which would result in the accounting firm disclaiming an opinion." This would require the external auditor to reach its own judgment about the internal controls, without reference to relying on the work of others. As a result, under this rule, the auditor could require its own separate regimen of testing of controls, for example, without regard to management's reliance on the guidance in selecting a reasonable regimen.

Again, under the language of Section 404, we believe that the external auditor should simply indicate whether it agrees with management's assessment of the adequacy of internal controls or not, and if not why not. Rule 2-02 should reflect this more limited role as to evaluation of the internal controls.

<u>Conclusion</u>

In closing, EEI appreciates the opportunity to submit these comments. We support the Commission's goal of providing management with the ability to exercise professional judgment in implementing Section 404, in particular to focus on relatively material, significant issues and relatively insignificant or immaterial ones. With modest changes suggested above, the guidance should be helpful in ensuring more reasonable implementation of Section 404. The proposed rule changes providing safe harbors for reliance on the guidance also will be helpful in this regard.

If the Commission has any questions about these comments, please contact either me, David Stringfellow at (202) 508-5494, or Henri Bartholomot at (202) 508-5622. Thank you.

Respectfully submitted,

David K. Owens

David K. Owens
Executive Vice President
Business Operations Group
Edison Electric Institute
701 Pennsylvania Avenue, NW
Washington, DC 20004
(202) 508-5000

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