

**United States of America**

**Public Company Accounting Oversight Board**

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**Proposed Auditing Standard** ) **PCAOB Release No. 2003-017**  
**An Audit of Internal Control Over** ) **PCAOB Rulemaking Docket Matter No. 8**  
**Financial Reporting Performed in** )  
**Conjunction with an Audit of** )  
**Financial Statements** )

**Comments of the Edison Electric Institute**

**I. Introduction and Executive Summary**

The Edison Electric Institute (EEI) appreciates the opportunity to comment on the Public Company Accounting Oversight Board's ("PCAOB's") Proposed Rulemaking<sup>1</sup> on Auditing Standard – An Audit of Internal Control Over Financial Reporting Performed in Conjunction with An Audit of Financial Statements.

EEI is the association of United States shareholder-owned electric companies, and international affiliates and industry associates worldwide. In 2001, our U.S. members served more than 90 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. They generated almost 70 percent of the electricity generated by U.S. electric utilities.

While EEI is supportive of much of the PCAOB's proposal, we have several concerns as outlined in these comments. The approach taken in our comments is to respond to questions posed by the PCAOB in the proposed auditing standard. In several instances, we have commented on two questions

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<sup>1</sup> Public Company Accounting Oversight Board, Proposed Rulemaking; Release No. 2003-017, Docket Matter No. 008, October 7, 2003.

together with one response. EEI commends the PCAOB for the thorough and detailed proposal submitted for public comment and is generally in agreement with many of the proposed rules. However, EEI is concerned that the proposed auditing standard represents a rules-based approach rather than providing a standards/principles-based document for consideration. Additionally, EEI believes there are several areas where the proposed auditing standard could be improved including:

- Extent and form of documentation required by management;
- The restrictive nature of certain key terms and definitions, such as “significant deficiency;”
- Reliance on the work of management and internal auditors by the independent auditors;
- Real or perceived conflicts of interest in evaluating the effectiveness of the Audit Committee; and
- The inability to issue a qualified “except for” opinion.

As a result, EEI would like to comment on the questions addressing these and other issues as put forth by the PCAOB in its proposal.

## **II. The PCAOB’s Proposed Standard**

### **a. Is it appropriate that the Board has provided criteria that auditors should use to evaluate the adequacy of management’s documentation? (Question 7)**

Paragraph 43 of the proposed auditing standard sets forth guidelines auditors should use to evaluate management’s documentation of internal

controls over financial reporting. EEI believes that the guidelines are overly prescriptive.

As properly noted in paragraph 44, management's documentation may take many forms and can include a variety of information. Management utilizes many different methods to document its internal controls; examples include policy and procedure manuals, flowcharts, etc. Management may also utilize formal and informal training courses to instruct employees on how to use systems or process transactions. The methods used to document controls are as varied as the controls themselves.

Paragraph 43 specifies, among other things, that management's documentation should include:

- The design of controls over relevant assertions related to significant accounts and disclosures;
- Information about how transactions are initiated, recorded, processed and reported;
- Enough information about the flow of transactions to identify where material misstatements due to error or fraud could occur.

Based on this guidance, existing internal control documentation in many companies may have to be substantially revised to meet the proposed requirements. Generally, documentation of internal control policies and procedures discusses what "must be done right" as compared to what "could go wrong." Documentation often does not include or refer to the five financial statement assertions. Management views controls in its policies and procedures as actions taken to achieve some general or

specific objective. It is rare to encounter a description of a control and its relationship to the relevant financial statement assertions. The documentation linking a control to an assertion and to a significant account is also a rare occurrence.

To accomplish what the proposed guidelines require, would require that each financial reporting control be linked to its relevant assertions as well as to a significant account. While this linkage could be accomplished, the effort to do so would require a significant amount of work and resources because, in a large company, there are likely several thousand controls over financial reporting.

Alternatively, on an overall basis, management could determine that the relevant assertions for each financial statement line item are adequately covered by controls. If the financial statement line items are linked to specific assertions and each line item is mapped to various financial statement cycles and controls, this documentation would serve as the link between financial statement assertions and the underlying controls supporting them. This approach would require a more reasonable effort to comply with the standard and would accomplish the same objective.

Further, the documentation requirement will necessitate a very large up-front effort and may be impractical to implement in a timely and meaningful manner for certain events, such as acquisitions of non-public companies, new system implementations and significant changes to

business procedures. The impact is magnified for those events that occur at or near end. The focus for these types of events has always been on controls that provide reasonable assurance that financial statements are reliable.

**b. Is it appropriate to state that inadequate documentation is an internal control deficiency, the severity of which the auditor should evaluate? Or should inadequate documentation automatically rise to the level of significant deficiency or material weakness in internal control? (Question 8)**

EEl believes that the guidance in paragraph 46 is adequate. The auditor should evaluate the documentation deficiency, which should take into consideration the significance of the deficiency. All facts and circumstances should be considered along with any mitigating controls the company may utilize to monitor information in the absence of clear and available documentation. Therefore, EEl believes that it is not appropriate to automatically raise inadequate documentation issues to the level of a significant deficiency or material weakness.

**c. Is it appropriate to require that the walkthrough be performed by the auditor himself or herself, rather than allowing the auditor to use walkthrough procedures performed by management, internal auditors, or others? (Question 10)**

EEl believes that it is not necessary to require that the walkthrough be performed solely by the auditor. Rather, the auditor should be permitted to use procedures performed by management. If management, internal auditors or others have sufficiently documented the company's processes to provide the same information that would be captured via a walkthrough, then the auditor should only be

required to review this documentation and apply professional judgment as to whether it is necessary to perform any independent walkthroughs.

The procedures performed by the auditor should be intended to be an audit of management's process to assess the design and operating effectiveness of controls. EEI believes that procedures, as required by the proposed auditing standard, are intended to "validate" work rather than repeat or replicate work previously performed by management of the company.

- d. Is it appropriate to require the auditor to obtain evidence of the effectiveness of controls for all relevant assertions for all significant accounts and disclosures every year or may the auditor use some of the audit evidence obtained in previous years to support his or her current opinion on management's assertions? (Question 11)**

Paragraph 74 states that "the auditor should obtain evidence about the effectiveness of controls (either by performing tests of controls himself or herself or by using the work of others) for all relevant assertions related to all significant accounts and disclosures in the financial statements." Paragraph 101 further states that "the auditor should vary from year to year the nature, timing, and extent of testing of controls to introduce unpredictability into the testing and respond to changes in circumstances."

EEI believes the auditor should be allowed to use some degree of the audit evidence obtained in the previous years to support the nature and extent of his or her testing for the current year's opinion on

management's assessment. In a subsequent year, the auditor should be allowed to incorporate the results of his or her testing in a previous year into the planning for the current year audit.

A requirement that the auditor perform its own testing of effectiveness of all controls over significant accounts and disclosures each year will eliminate some level of judgment in the auditor's planning process and make it more difficult to introduce variability in the auditor's plan from year-to-year, as is discussed in paragraph 101 of the PCAOB's proposed rules. Additionally, paragraph 101 seems to indicate that not all controls would be tested independently by the auditor each year. This requirement has the potential to focus a significant amount of testing in the same areas each year rather than appropriately identifying areas which should require more attention, such as those that are affected by other changes in the organization (e.g., employee turnover, increases in volume/nature of transactions, etc.).

EEl believes the draft auditing standard should allow the auditor to incorporate the results of its testing in previous years, along with the review of both management's and internal audit's (when applicable) testing of internal controls in the current year, in supporting his or her opinion on the effectiveness of internal control over financial reporting. Further, EEl believes the current guidance included in the draft auditing standard will result in an independent controls assessment by

the auditor which, in essence, duplicates management's assessment rather than resulting in an audit to express an opinion on management's assessment of the effectiveness of the company's internal control over financial reporting as required by paragraph 4 of the proposed rules.

**e. To what extent should the auditor be permitted or required to use the work of management and others? (Question 12)**

EEl believes that auditors should be permitted to use the work performed by management, internal auditors or by other professionals on behalf of management, based on the auditor's assessment of management's control environment and the competence and objectivity of the people performing the work. For most companies, substantial time and effort has been and will be devoted to documentation and testing of controls by management and internal audit.

The proposed restrictions on the auditor's use of the work of others for evaluating controls regarding (a) the control environment; (b) the period-end financial reporting process; (c) those with a pervasive effect on the financial statements; (d) those over significant non-routine and nonsystematic transactions; and (e) those over significant accounts are too restrictive. Tests of controls by other than external auditors can be documented to the extent that the auditor can review the documentation and then use professional judgment as to the extent of re-testing. As discussed throughout this letter, EEl does not believe



that the final auditing standard should impose absolute requirements upon the auditor to replicate and re-perform significant amounts of work previously performed by management. Rather, the requirements should provide the auditor sufficient latitude to exercise professional judgment regarding the nature and extent of testing necessary to audit management's assessment of the design and operating effectiveness of internal controls over financial reporting. Such latitude is permitted in conducting the audit of financial statements and is also appropriate for an audit of internal controls over the preparation of those financial statements.

**f. Does the proposed standard give appropriate recognition to the work of internal auditors? If not, does the proposed standard place too much emphasis and preference on the work of internal auditors or not enough? (Question 14)**

The discussion in paragraph 108 regarding using the work of internal auditors provides an appropriate level of recognition to the necessity of evaluating the competence and objectivity of internal auditors. The emphasis that reliance can be greater when those functions adhere to the Institute of Internal Auditor's Association's (IIA) Standards is appropriate.

However, EEI believes that the provisions of paragraphs 103 – 106 inappropriately fail to distinguish internal audit from the broad category of operating management and are likely to restrict the level of reliance that can be placed on the work of internal auditors, even those who exhibit the highest levels of independence, competence and objectivity.

In companies with a strong internal audit function, extensive work will be done by internal audit to evaluate and test (a) processes to prevent and detect fraud; (b) controls over the period-end financial reporting process; and (c) controls that have a pervasive effect on the financial statements, such as information technology general and application controls.

In most cases, the work of internal audit may be even more robust than that performed by the external auditors. Prohibiting reliance on the work of internal auditors in these areas will result in a failure to take advantage of significant on-point evaluations of internal control effectiveness.

Additionally, independent auditors currently evaluate and place some reliance on the work of internal auditors in order to perform an audit of a company's financial statements. Establishing a standard for auditing internal controls over the preparation of financial statements that is more restrictive than the current standards governing audits of financial statements is inconsistent and would confuse financial statement users. EEI agrees that the reliance on the work of internal auditors related to controls discussed in paragraphs 104 and 105 should be more limited than reliance on controls over routine processing as discussed in paragraph 106. However, the independent auditor should be given the flexibility to rely on the work of internal

auditors in all areas deemed appropriate in the exercise of his or her professional judgment.

The proposed standard's limitation on using the work of internal audit is also internally inconsistent with other aspects of its provisions. Specifically, paragraph 126 of the proposed standard indicates that an ineffective internal audit function should be a "strong indicator that a material weakness in internal control over financial reporting exists." As a result, most companies will determine that an effective internal audit function is necessary, and it seems appropriate that the independent auditor should be able to rely on the internal auditor's work to a significant degree.

Finally, EEI believes that those provisions of the proposed standard are at variance with existing Statement on Auditing Standards (SAS) No. 65, *The Auditor's Consideration of the Internal Audit Function in an Audit of Financial Statements*. SAS 65 permits the auditor to request direct assistance from the internal auditors. Direct assistance relates to work the auditor specifically requests the internal auditors to perform to complete some aspect of the auditor's work. It typically includes assisting the auditor in gaining an understanding of internal control, performing tests of controls and other substantive audit procedures. Internal auditors work under the direct supervision of the auditor and apply auditing procedures as prescribed by the auditor. The work is supervised and reviewed by the auditor. This direct assistance is used

as a means to leverage the skills and knowledge of the resident internal audit function and reduce the total cost of the audit.

Internal auditors historically have fulfilled an independent role in assisting the external auditors in connection with an audit of financial statements. Considering the implementation of the proposed internal control standard is expected to require substantial effort and significant cost. EEI believes the final standard should recognize explicitly that the internal auditors are permitted to assist the auditor in such examinations consistent with the direct assistance provisions in SAS 65. The position in the proposed standard is not consistent with the role internal auditors play in connection with an audit of financial statements.

- g. Is the flexibility in determining the extent of re-performance of the work of others appropriate, or should the auditor be specifically required to re-perform a certain level of work (for example, re-perform tests of all significant accounts or re-perform every test performed by others that the auditor intends to use)? (Question 15)**

Paragraph 103 states that “the auditor should evaluate whether to use the work performed by management and others.” However, paragraph 104 lists four major areas where the auditor should not use the results of testing performed by others and paragraph 105 lists two major areas where the auditor’s use of work performed by others is limited. The net result is to require the auditor to re-perform the majority of all tests of controls. Therefore, EEI believes that the final

standard should provide greater flexibility to the independent auditors in determining the extent of re-performance work required.

**h. Is the requirement for the auditor to obtain the principle evidence, on an overall basis, through his or her own work the appropriate benchmark for the amount of work that is required to be performed by the auditor? (Question 16)**

The key to this limitation is centered on the interpretation of the auditor's "own work." This term could be interpreted to mean that the auditor's documented review of the work of others would be sufficient; or, "own work" could be interpreted to mean that the auditor must either perform or re-perform all tests of controls. EEI believes the former would be the best interpretation.

**i. Will the definitions in the proposed standard of significant deficiency and material weakness provide for increased consistency in the evaluation of deficiencies? How can the definitions be improved? (Question 17)**

EEI has serious concerns regarding the definition of "significant deficiency" and "material weakness" centered on the use of the terms "more than a remote likelihood" and "more than inconsequential in amount." These phrases are likely to be interpreted to go beyond the "reasonable assurance" intent of COSO and the Securities & Exchange Commission ("SEC").

The COSO framework indicated the following regarding what internal controls cannot do: "An internal control system, no matter how well conceived and operated, can provide only reasonable – not absolute – assurance to management and the board regarding

achievement of an entity's objectives. The likelihood of achievement is affected by the limitations inherent in all internal control systems. These include the realities that judgments in decision-making can be faulty, and that breakdowns can occur because of simple error or mistake." EEI believes that controls designed and operated to meet the standards in COSO's "Internal Control – Integrated Framework" will not be adequate given the definitions of significant deficiency and material weakness in the proposed standard. Specifically, the phrases "more than a remote likelihood" and "more than inconsequential in amount" are too restrictive for most internal controls over financial reporting.

EEI believes it is critical that clear definitions are established - considering standards already in place such as those provided in the COSO framework – that describes the terms (a) deficiency; (b) significant deficiency; and (c) material weakness.

The definitions used in the final standard are critical to an investor's understanding of a company's internal controls over financial reporting and the related audit opinion. For example, with non-routine and non-systematic transactions, an evaluation of "likelihood" is not appropriate because, in this instance, the auditor must be concerned with the qualitative nature of the deficiency. One "remote" non-standard journal entry can materially affect the financial statements. While the chance of this event occurring may be "remote," when it does occur, the

consequences can be significant. Therefore, for non-recurring and non-standard transactions, EEI believes the evaluation of the significance of a control deficiency must take into account the qualitative aspects of the deficiency as opposed to its likelihood of occurrence.

EEI believes the term “more than inconsequential in amount” establishes a very low threshold of significance. Although it is not defined explicitly in the proposed standard, EEI interprets this term to mean an amount that is substantially less than that which would be considered “immaterial” to the financial statements. Consequently, a deficiency that could misstate the financial statements by an immaterial amount would still be considered significant in quantitative terms. As a result, EEI believes that using this definition will elevate, unnecessarily, many control deficiencies to the “significant” category and result in many unnecessary discussions between auditors, management and the Audit Committee on the resulting categorizations. Using overly restrictive criteria has the potential to take the focus away from those areas that are truly material to the company.

**j. Is it appropriate to require the auditors to evaluate the effectiveness of the audit committee's oversight of the company's external financial reporting and internal control over financial reporting? (Question 22) Will auditors be able to effectively carry out their responsibility to evaluate the effectiveness of the audit committee's oversight? (Question 23)**

EEl does not believe that it is appropriate to have the auditors evaluate the effectiveness of the Audit Committee's oversight of a company's external financial reporting and internal control over financial reporting.

This requirement presents a conflict of interest for the auditors due to the Audit Committee's responsibilities as defined in Section 301 of the Act which requires the Audit Committee to be directly responsible for the appointment, compensation, and oversight of the work of any registered public accounting firm employed by the company for the purpose of preparing or issuing an audit report or related work; the registered public accounting firm shall report directly to the Audit Committee.

Paragraph 57 of the proposed auditing standard requires the auditor to evaluate the Audit Committee's level of involvement and interaction with the auditors, including the Audit Committee's role in the appointment, retention and compensation of the auditor. EEl believes this conflict of interest will inhibit the auditor's ability to successfully evaluate the effectiveness of the Audit Committee's oversight.

Additionally, the auditor is currently required to evaluate the role of the Audit Committee as part of understanding the control environment



to appropriately plan the financial statement audit in accordance with SAS No. 55, *Internal Control in a Financial Statement Audit*. This evaluation is appropriate because it is for the auditor's own use in planning its work, rather than for reporting to the body responsible for engaging its services. EEI believes that the proposed rules should not impose a separate and more prescriptive requirement of an auditor's evaluation of the Audit Committee than is already established by the American Institute of Certified Public Accountant's generally accepted auditing standards.

**k. Is it appropriate that the existence of a material weakness would require the auditor to express an adverse conclusion about the effectiveness of the company's internal control over financial reporting, consistent with the required reporting model for management? (Question 25) Are there circumstances where a qualified "except for" conclusion would be appropriate? (Question 26)**

EEI does not believe it is appropriate that the existence of one material weakness would require management and the auditor to express an adverse conclusion about the effectiveness of the company's internal control over financial reporting.

By only allowing one type of audit opinion - an adverse audit opinion – there is no ability to differentiate the impact and/or severity of material weaknesses among various companies. As an example, a company that has one isolated material weakness, the effects of which are limited and can be compensated for by substantive testing, will have the same opinion as a company that has one material weakness

that is pervasive in its effect over financial reporting. EEI believes that such differentiation is critical to a financial statement user's understanding of a company's internal control over financial reporting and is necessary to provide a meaningful conclusion on the reliability and effectiveness of internal controls.

Given the proposed standard's definition of a material weakness in internal control and the broad spectrum of potential impacts of a material weakness in internal control, significant judgment is required for management's conclusion on the effectiveness of internal control and the independent audit opinion to be meaningful. EEI believes there are many circumstances where a qualified "except for" opinion would more accurately communicate relevant information about the existence and effectiveness of the entity's internal controls and would be more useful for investors and other users of the financial statements.

Investors and other users of financial statements are familiar with the types of audit opinions expressed for a financial statement audit. Most investors and other users of financial statements have a clear understanding of the potential ramifications of an adverse opinion and also understand the circumstances where a qualified "except for" opinion may be required. Consistent with that understanding, financial statement users view an adverse audit opinion as one where the effects of deviations from generally accepted accounting principles ("GAAP") are so material and pervasive that they overshadow the

fairness of the financial statements. Users also understand that a qualified “except for” opinion is issued when the financial statements are presented in accordance with GAAP, except for the matters to which the qualification relates.

With this understanding, the absolute requirement that a single material weakness requires management to conclude that internal controls over financial reporting are not effective and for the auditor to express an adverse opinion about the effectiveness of the company’s internal control over financial reporting, without provision for exercising judgment, has the potential to have significant negative implications in financial markets; it would create confusion and would be misleading to investors and other financial statement users and would potentially reduce investor confidence.

As mentioned previously, considerable professional judgment is required to effectively evaluate the significance of a material weakness and its impact on the opinion to be issued. By requiring management to conclude that controls are not effective and for the auditor to issue an adverse opinion for one material weakness, regardless of other circumstances surrounding the weakness, does not provide the ability to adequately communicate to the investing public the actual impact of the weakness to the company. EEI believes that the proposed rule should be modified to eliminate this absolute requirement to issue an adverse opinion on the audit of internal control over financial reporting

and to provide examples of circumstances in which management and the auditor should evaluate the impact of a material weakness. Some considerations which may result in a qualified “except for” opinion rather than an adverse opinion should include:

- A material control weakness that is isolated to one system or area;
- The significance and impact on the financial statements;
- The type of material control weakness and compensating controls;
- The nature of assets at risk;
- The presence of other control weaknesses;
- The extent, nature and timing of recent changes in the company’s accounting process or procedures, business practices, or regulatory requirements;
- Past experience with the entity.

An adverse opinion should be limited to those situations where control weaknesses are material and pervasive, where little or no reliance may be placed on the internal control structure, or where there is fraud committed by management or employees with a significant role in internal control over financial reporting.

In addition, under the proposed rules, it is possible for a company to obtain a clean audit opinion on the financial statements, yet obtain an adverse audit opinion on its internal controls over financial

reporting. This will certainly confuse investors as they believe that internal controls are designed to provide reasonable assurance regarding the reliability of financial statements.

**I. Should the Board provide specific guidance on independence and internal control-related non-audit services in the context of this proposed standard? (Question 28)**

EEl believes that the three broad principles as set forth by the SEC on auditor independence provide adequate, complete guidance regarding auditor independence.<sup>2</sup> These principles state that the auditor cannot function in the role of management, cannot audit his or her own work, and cannot serve as an advocate for management. These principles, when combined with the SEC's rules governing Audit Committee pre-approval of all services to be provided by the independent auditor constitute appropriate guidance in this area and no additional guidance is necessary.

**III. Conclusion**

EEl understands and acknowledges that, in order to restore broad investor confidence, most public companies will be required to make new investments to comply with many provisions of the Act, particularly to strengthen and report on internal control in accordance with section 404. EEl supports the spirit of the requirements of the Act and generally concurs with the provisions of the proposed rule on auditing internal controls. However, EEl also believes that the final standard should not impose any more requirements than are necessary in order to achieve the

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<sup>2</sup> Securities & Exchange Commission, Regulation SX Rule 2-01.

objectives of the Act. Thus, many of the comments in this letter focus on ensuring that the final standard does not mandate duplicative procedures that add little value and will place excessive burdens on companies working to comply with the Act. In particular, EEI recognizes the value of independent review and testing by the independent auditors; however, excessive duplication of efforts already performed by management and internal auditors will not enhance the value of the attestation process.

EEI appreciates the opportunity to provide comments on this proposal and respectfully requests that the PCAOB consider our concerns and recommendations.

Sincerely,

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Executive Vice President – Business Operations Group