November 21, 2003

Office of the Secretary
Public Company Accounting Oversight Board
1666 K Street, N.W.
Washington, D.C. 20006-2803

Re: PCAOB Rulemaking Docket no. 008, *Proposed Auditing Standard – An Audit of Internal Control Over Financial Reporting*

Reliant Resources, Inc. ("RRI") appreciates the opportunity to provide comments on the Public Company Accounting Oversight Board ("PCAOB") Proposed Auditing Standard – An audit of Internal Control Over Financial Reporting Performed in Conjunction with an Audit of Financial Statements.

RRI provides electricity and energy services with a focus on the competitive retail and wholesale segments of the electric power industry in the United States. With respect to the retail segment of the industry, we provide electricity and related energy services to residential, small commercial and large commercial, industrial and institutional customers primarily in Texas. Within the wholesale segment of the industry, we own and operate a substantial number of electric power generating units dispersed broadly across the United States. We also market electric energy, capacity and ancillary services and procure and, in some instances, resell energy-related commodities to optimize our physical assets and provide risk management services for our asset portfolio.

We support the PCAOB's issuance of a new standard on attestation engagements referred to in the Sarbanes-Oxley Act of 2002 ("SOA"). RRI is a member of the Edison Electric Institute ("EEI"), an association of United States investor-owned electric utilities. EEI has issued a comment letter, which we also support. Additionally, we are providing further comments to selected questions raised in the proposed standard below.

Question regarding the costs and benefits of internal control:

4. Does the Board's proposed standard give appropriate consideration to how internal control is implemented in, and how the audit of internal control over financial reporting should be conducted at, small and medium-sized issuers?

The proposed standard provides guidance to support different levels of internal control sophistication that may exist in various organizations. Generally, small and medium-sized issuers may have less complex internal control structures than large global multi-location companies. Smaller organizations may be able to place greater reliance on company-level controls rather than process level control activities.

However, all companies subject to SOA should be able to adequately demonstrate an effectively designed and operating internal control structure that has been tested by management. This requirement should be reinforced in the proposed standard to avoid an incorrect interpretation that small and medium-sized companies have any compliance exemptions.

Questions regarding evaluation of management's assessment:

7. Is it appropriate that the Board has provided criteria that auditors should use to evaluate the adequacy of management's documentation?

8. 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?

An appropriate level of process documentation is necessary to demonstrate that management has evaluated the design effectiveness of internal controls. The actual SOA 404 certification that will be signed by executive management requires an internal control framework to serve as a benchmark for evaluating effectiveness. COSO is a comprehensive framework for evaluating internal controls and is expected to be the default framework for most companies. The control attributes included in COSO for evaluating internal control design include: Objectives, Risks, and Points of Focus for Actions/Control Activities. Proactive companies seeking to improve internal controls may also elect to include other attributes such as Control Type (Preventive/Detective) and Control Technique (Manual/Automated); however, the attributes are not specifically required by COSO.

The criteria for evaluating documentation that is provided in the proposed standard significantly enlarges the volume and expands the depth of attributes beyond the scope of relevant guidance such the SEC Final Rule on Management’s Reports on Internal Control Over Financial Reporting, SOA sections 103 and 404 and COSO. Specifically, the proposed standard requires the design of controls over relevant assertions related to all significant <u>accounts</u> and disclosures in the financial statements. While this may provide some level of efficiency for financial statement audits by linking detailed account level lead schedules to relevant assertions and associated control activities, it adds an unnecessary and significant burden for management to capture relevant assertions at the account level. It would be more appropriate and worthwhile to map the relevant assertions at the financial statement line level, as many organizations already have done to define the processes in scope, rather than account level.

The proposed standard also states the documentation should include the five components of internal control over financial reporting which mirror the COSO components. This requirement may be misinterpreted by numerous organizations erroneously believing that a simple mapping to the five COSO components is adequate for compliance with COSO. Compliance with COSO will require organizations to document and test a control environment for all key processes similar to the defined control activities for the COSO generic business processes, as well as an evaluation of the five COSO components supporting at least the financial reporting category of internal control. Further, the compliance and operational categories must be also reviewed for elements that support the relevant financial statement line items and disclosures.

Sufficient documentation is required to demonstrate an effective control design; however, inadequate documentation should not immediately be deemed a significant deficiency or material weakness. The auditor should exercise judgment based on more refined criteria in making an assessment over the adequacy of documentation. The evaluation should include the extent of documentation, reasons for the potential deficiency and the existence of mitigating documentation. Management should have an opportunity to defend whether or not their documentation meets all material respects of the requirements and how it supports their assessment without a default assignment to significant deficiency or material weakness.

Questions regarding obtaining an understanding of internal control over financial Reporting and question regarding testing operating effectiveness:

6. Is the scope of the audit appropriate in that it requires the auditor to both evaluate management's assessment and obtain, directly, evidence about whether internal control over financial reporting is effective?

9. Are the objectives to be achieved by performing walkthroughs sufficient to require the performance of walkthroughs?

10. 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?

11. 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 assessment?

SOA 404 requires management to perform an assessment of the effectiveness of internal controls and requires the external auditor to attest on management's assertion. SOA 404 does not require the external auditor to perform an unnecessary duplicative assessment of the effectiveness of internal controls as required by the proposed standard. The external auditor should have the flexibility to reperform procedures such as walk-throughs over critical areas to the extent they deem necessary; however, this should not be a rules-based requirement.

The external auditor should not be prohibited from leveraging prior year evidence over the effective design of internal controls provided adequate procedures are performed to review significant changes.

Questions regarding using the work of management and others:

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

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

16. 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?

As indicated in the responses to questions 6, and 9 – 11 above, reperformance by the external auditor of internal control testing that has already been properly executed and documented with sufficient evidence is redundant and not specifically required by SOA 404.

The proposed standard allows the external auditor to exercise judgment for relying on the work of others based on the objectivity and competency of the company's staff performing the work. A review of the objectivity and competency of staff performing the work would help support the adequacy of management's review and better define the extent of work the external auditor would need to perform. In many cases, a company may have staff better suited, due to their company, industry and process knowledge, to evaluate the effectiveness of internal controls.

Questions regarding evaluating results:

17. 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?

19. Is it necessary for the auditor to evaluate the severity of all identified internal control deficiencies?

Perhaps the most important area requiring focus by the PCAOB in the proposed standard is the definition of control deficiencies, significant deficiencies and material weaknesses. Applying these definitions will require considerable judgment by management and the external auditor and may result in inconsistent interpretation with substantial consequences.

The proposed standard defines a significant deficiency as a single deficiency or combination of deficiencies that results in a more than remote likelihood that a misstatement "more than inconsequential" in amount will not be prevented or detected. This definition appears to be too broad since an amount that is "more than inconsequential" may very well not be material, yet will be deemed a "significant" deficiency. A broad interpretation could result in several companies having multiple "significant" deficiencies that are then inappropriately deemed as a material weakness in the aggregate because the extreme high-end of the range of error of each significant deficiency results in a material amount, even though it would be very unlikely the high-end of the range of error would be experienced for each individual deficiency.

The concept of reasonable assurance is stated in the proposed standard; however, it should be applied to the definitions of significant deficiency and material weakness. The proposed standard states that a high level of subjectivity, complexity, or extent of judgment required for something such as for an accounting estimate increases risk and is a factor affecting the likelihood that a deficiency could result in a misstatement. This guidance can potentially be misinterpreted in numerous situations. For example, if a company with sufficient internal controls to provide reasonable assurance over the accuracy of an estimate has a significant post-close audit adjustment because of new information, then there will be an inappropriate bias towards defining it as a material weakness because of this guidance.

Questions regarding forming an opinion and reporting:

25. 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?

26. Are there circumstances where a qualified "except for" conclusion would be appropriate?

The proposed standard should be modified to not immediately require an adverse opinion if a material weakness is identified. An “except for” opinion may be more appropriate in many circumstances provided the material weakness is properly disclosed and management is taking corrective actions including a successful evaluation evidencing the financial statements were not materially misstated.

The rules-based approach of requiring an adverse opinion when a single material weakness is identified does not provide sufficient distinction for other situations where there may multiple material weaknesses impacting several financial line items. The current requirements would assign both organizations the same adverse opinion.

The proposed standard would be improved by allowing the external auditor to exercise professional judgment in determining the type of opinion to express. For example, if a material weakness is detected, the auditor should be able to assess the impact on the entire internal control environment and consider other factors such as company-level controls.

RRI sincerely appreciates the PCAOB’s willingness to consider and respond to its concerns regarding the proposed standard. We would be pleased to answer any questions regarding the issues outlined in this comment letter.

Sincerely,

Christopher Lozier
Director Internal Control Effectiveness