

Friday, April 01, 2005

U.S. Securities and Exchange Commission
450 Fifth Street, NW
Washington, D.C. 20549

Re: File Number 4-497

We are pleased to be able to provide feedback on the implementation of Section 404 of the Sarbanes-Oxley Act of 2002. As a matter of public policy, FPL Group supports the enhanced emphasis on internal controls that has arisen as a result of the Act. Our company historically has maintained a strong emphasis on internal controls, and we believe this can have real value for shareholders. However, we believe that the specific way in which Section 404 has been implemented is not desirable from a public policy viewpoint and may in fact be detrimental to the long term efficiency and effectiveness of U.S. capital markets.

The fundamental problem, we believe, is that 404 as currently implemented dictates a uniform approach to internal controls, while the realities of the business world beg for differentiated approaches both across companies and in many cases within an individual company's portfolio. Fortunately, Section 404 of the Act is written in a sufficiently general fashion that changes to its implementation could be readily made.

While strong internal controls are desirable in the abstract, we must recognize that, like every other aspect of business that is desirable in the abstract, they require resource commitment, and those resources can only come at the expense of pursuing other desirable aims. Trade-offs are unavoidable. For economic efficiency, companies need to be able to balance and make trade-offs among all the many desirable objectives that confront them – and investors need to be able to evaluate those trade-offs. Different companies in different situations should make different choices about the degree of investment that is appropriate in internal controls.

Unfortunately, the current approach to 404 embodies the reverse of this and makes two basic errors. First, it is a "one size fits all" approach, and second (and derived from the first) it is implemented through a standard that is at the extreme end of risk reduction, best expressed in the required standard of "effectiveness," namely that there is "no more than remote likelihood of not preventing or not detecting a material misstatement in the financial statements."

This approach is not required by the wording of the Act. In fact, Section 404 has only two real requirements: (a) that management formally acknowledge its responsibility for internal controls, which is completely unobjectionable; and (b) that management report on the effectiveness of its internal controls in its annual filing. Nowhere is there a requirement that controls be deemed to be binary: either "effective" or "ineffective," – yet this is how the SEC has implemented the Act. And nowhere is there a requirement that "effective" should be read as requiring convincing demonstration that no individual line item in the financial statements or supporting footnotes could conceivably be in error by more than x% – yet this is the practical consequence of the PCAOB's rulemaking and the Audit firms' implementation.

We believe that the SEC and the PCAOB should re-examine both of these criteria. The following paragraphs explain why in more detail and make some suggestions for ways in which the implementation of 404 could be improved.

Dangers of the Requirement that Controls be Deemed Either "Effective" or "Ineffective"

A variety of problems are caused by the current SEC requirement that management state whether or not internal controls are "effective." Most basically, this standard potentially creates a false expectation among investors (and surely reinforces it to the extent it already exists) that financial statements are either correct or incorrect and that controls either work to allow surety that the financial statements are correct or they do not. Neither of these conditions holds true in the real world.

In reality, internal controls exist along a spectrum of effectiveness – or, more precisely, along multiple spectra. Controls vary in many different ways. There is no such thing as absolute effectiveness. Thus, on its surface, the standard conflicts with reality and obscures these very important differences. Investors would be better served if they were forced to confront and evaluate these realities rather than have them obscured.

However, the natural consequence of a black-and-white standard is that the implementation must be tight. It is clear that if we are to declare controls “effective” then we must make it *extremely* unlikely that anything could slip through. Thus, it should not be surprising that the resulting PCAOB implementation standards are very tight, and therefore very costly to demonstrate adherence to. Furthermore, because these standards must be attested to by the external auditor, implementation depends heavily upon testing adherence to written procedures – mechanical tests that can be mechanically checked. Yet good internal control cannot be reduced to mechanical procedures, and mechanical testing of compliance to those procedures does not ensure good control. At FPL Group we have frequently found ourselves asking two parallel questions: “What do we need to do to comply with 404?” and “What do we need for good internal control?” and finding that the answers are very different. In this connection it is noteworthy that the most important component of the COSO framework, the control environment, is extremely difficult to test. It does not readily adapt itself to simple evaluation, and it inherently begs for qualitative assessment, not a binary judgment.

The danger in this approach is that it is potentially misleading to investors. An assertion of effectiveness, measured against the current PCAOB standard, seems to provide a great deal of comfort when in fact it should not. Integrity cannot be legislated, and an ill-bent management team will still be able to perpetrate fraud despite 404 compliance, both because even properly operating controls are not absolute and because even good controls can be circumvented.

As important as sound controls are, they will not prevent business collapse and investor losses. It is important to bear in mind that in virtually every case among the wave of scandals that led to the Act, it was the failure of the underlying business model that caused the destruction of value. The best we can hope to do with improved controls is ensure the earlier revelation of those business models that are destined to fail. We must not leave investors with a false sense of confidence that business failure is merely a function of poor controls and that 404 has eliminated the risk.

Even within the general area of controls, the kinds of controls addressed by 404 form only a subset. There is an additional risk with the present approach, which is the implication that a company with an “effective” assessment is operating under good control overall. This may well not be true. A company may have very good controls over accounting and financial reporting yet be quite “out of control” from a fundamental business perspective. An “effective” assessment under 404 merely avers that if a company loses \$1 billion it will know with a high degree of certainty that it has lost \$1 billion – not that it will avoid the \$1 billion loss in the first place. While the blurring of this distinction in investors’ minds is not strictly a function of 404 itself, there can be little doubt that requiring an absolute “effective” or “not effective” assessment does not promote the kind of critical investor evaluation needed for sensible decision-making.

In addition to being potentially misleading, there is a more subtle – but perhaps more important – objection to the black-and-white standard as currently adopted.

Internal controls are simply one dimension of risk that investors take on when they buy into a position with a publicly traded company. We believe it is dangerous for investors to be led to believe that one entire dimension of risk has been essentially eliminated, which is what the current approach suggests, when in fact it hasn’t. The cultural message that is being sent is “don’t worry about the numbers; they’re good,” regardless of the company. Thus, investors are being given no encouragement – indeed are being subliminally dissuaded of the necessity – to dig in and analyze and assess the relative quality of a company’s accounting choices, financial reporting, or controls. This is likely to lead to poor evaluation and hence poor capital allocation, because in fact companies’ accounting, reporting and controls *do* differ.

Instead, we believe that good public policy should aim to *force* investors to make rational judgments about internal control as a dimension of risk, just as they have to make similar judgments about every other aspect of risk. *A corollary of this is that adequate disclosure about controls is vital.* Companies must provide investors with useful information, but we should expect investors to make the value judgments. In fact, this is where markets excel. Given any comparable information set, markets backed by investors with real wealth at stake will always outperform any system of “designed” assessments.

Encouraging investors actively to evaluate the interrelated areas of accounting, financial reporting and internal control rather than assume that all companies are equal will have a positive effect over time. However, it is even more important when we acknowledge that resource allocation issues are involved. Internal control is not free. Resources devoted to internal control are resources not devoted to other good corporate purposes, including all those that are necessary to create shareholder value – strategy development and implementation, new market or new product development, to name just a few.

The SEC will no doubt hear from many commentators that 404 is expensive. This, we believe, is not the issue. If the shift in resource allocation produced appropriate benefit the cost would be well worthwhile. Unfortunately, what many companies are witnessing is that the benefits are extremely modest, while the cost expressed not in direct dollars but in opportunity cost – the things that did not get done in 2004 because too many people were tied up documenting pre-existing controls so that they could be mechanically tested by both internal and external auditors – is very high.

This leads to the next observation. From a public policy viewpoint, we should *want* companies to make very different choices regarding resource allocation towards internal controls; yet the current implementation of 404 essentially dictates that this activity has first call on corporate resources. We have no doubt that many, if not most, investors would be willing to accept a much higher degree of internal control risk in a small, innovative, rapidly growing company with the potential for dramatic expansion than they would in a more mature, stable company. However, the current binary approach equates ineffectiveness with failure rather than the result of a reasoned choice regarding the assumption of risks and the priorities to be applied in allocating resources.

If this observation is true for companies as a whole, it is equally valid when considering different businesses within a larger company’s portfolio. Start-up or early stage businesses neither need nor can justify the level of internal control scrutiny that larger and more mature businesses find appropriate. Yet the current implementation of 404 makes no provision for this. When the critical issue is: “Will this business idea prove worthwhile in a competitive marketplace?” investors will and should take risks over other issues. It makes no more economic sense to invest in fine tuning production processes at this stage of a business’s development than it does to invest heavily in ensuring tight internal controls – and no less, either.

The natural consequence of this approach is to burden innovation overall and innovation within large, established companies in particular. Perversely, should the SEC choose to follow the path recommended by many, and establish different and “lighter” standards for small companies, this will in fact exacerbate the relative challenges of innovation within large companies. Even if small companies do not receive special relief, investors may well overlook declarations of “material weaknesses” – though the latent threat of shareholder lawsuits will surely give pause to some entrepreneurs at a time when risk of failure is high simply from normal competitive dynamics. But no such relief is available to large companies. In this connection, we should note with approbation the carve-out that has been provided for acquisitions, allowing extra time before attesting to effectiveness in these situations. However, this by itself is not enough to address the core issue, which is simply that in many cases it is economically not a sensible allocation of resources to insist upon controls comparable to those we would expect at Florida Power & Light Company, a mature, stable and well-established business.

The small, rapidly growing business is just one example of a more general point: situations differ, and we should want companies to be able to make different choices about how much to invest in internal controls at different points in time; and we should expect different outcomes to result. Investors should be free to evaluate *and value* different approaches. This could be accomplished by elimination of the requirement

that controls be declared either effective or ineffective, and requiring issuers to disclose a broader assessment of internal control effectiveness.

Disadvantages of an Overly Tight Standard

We believe the very tight standard currently being implemented through the PCAOB rulemaking follows naturally from the adoption of a black-and-white test, as noted above. Unfortunately, the specific implementation compounds the problems inherent in making “effectiveness” a binary variable.

There are conceptual problems inherent in applying traditional ideas of materiality to internal controls work. If management is already attesting – and the external auditor is already confirming – that the financial statements are not materially misstated, then what additional assurance is provided by the attestation that controls are “effective?” If a control was discovered to be deficient, but the resulting financials were nonetheless re-checked and found to be correct, what is the significance of the control deficiency?

As a practical matter, what has emerged is a requirement to demonstrate not only that the specific set of financials actually presented is in fact materially correct, but also that any possible material errors would have been caught prior to the release of those financials. This has meant applying a very low threshold of materiality to each line item in the financial statements, considered in isolation, and not just to the financial statements considered as a whole. This is particularly burdensome when it comes to the balance sheet. Our own experience has been that we have been required to demonstrate the same degree of control over the geography of the balance sheet (e.g. whether or not a particular item should be classified as a short- or long-term liability) as over the determination of net income. While this is understandable given the way the standards have been developed, we submit that this is not a useful application of resources for the typical investor.

Similarly, while the external auditors recognize that individual control deficiencies can be very minor in themselves, they nevertheless require that they be aggregated to test whether or not collectively they rise to the level of a significant deficiency, or worse. While there is no doubt some theoretical possibility of error in these situations, as a practical matter inordinate time has been spent contemplating situations that *might* in principle occur yet are so unlikely that a practical person would not worry about them. Again, if the requirement is to attest to a black-and-white definition of “effectiveness,” this is a logical approach; yet we submit that it is not a useful allocation of resources for many companies.

A related issue is that under the current rules controls are presumed ineffective unless documented even though the financial statement amounts have proven to be reliable over long periods of time. FPL Group spent an enormous amount of time documenting controls that have long been in place solely as a means of providing documentary evidence for purposes of being able to do the testing. Auditors have for many years assessed internal controls without the need for such extensive documentation. Such documentation adds no substantive value to the enterprise. It merely adds to the bureaucratic bulk of the enterprise, slowing both progress and innovation.

These problems are compounded by the requirement, which we acknowledge is written into the text of the Act, that the external auditor not only report on management’s internal control assessment but also “attest to” that assessment. Effectively, this means that the external auditor must perform a separate and independent assessment of internal controls. When the standard is very tight, as it now is, this requires an enormous additional expenditure of effort. Furthermore, certain issues which management can be comfortable with, through detailed knowledge of the actual operations of the company, must now be separately demonstrated to the external auditors, who of course are not familiar with the day-to-day operations. For example, at FPL Group over the past decade we have invested heavily in information systems to automate many routine processes. One of the side benefits has been that controls can be automatically incorporated, reducing the flow of paper. Now, however, we are required to print out and sign electronic authorization forms in order to evidence approval to the auditors. If the requirement for independent assessment of controls were modified, this wasted effort would not be necessary.

Level of Assurance

Both the COSO Framework and the auditing standards issued by the PCAOB recognize that the existence of effective internal controls do not provide absolute assurance regarding the accuracy of the financial statements and related disclosures. Even though the likelihood of an error is considered remote, there is still a real possibility for an error to occur and go undetected.

In practice, the mere existence of a material error would be viewed as conclusive evidence that the controls were not effective. We find this conclusion totally inconsistent with the notion of probabilities embedded in both the COSO Framework and in the PCAOB Standards. Further, it provides additional evidence of the potential for misleading inferences regarding the real meaning of effective internal controls. The resulting false sense of security will surely do more to harm investor confidence than would the complete absence of a report on internal control when the inevitable business failure occurs.

The existence of a material error should obviously raise concerns regarding the potential for ineffective internal controls but should not in and of itself represent conclusive evidence that the controls are ineffective.

Suggestions for Improvement

We would like you to consider the following proposals that we believe would significantly improve the current process.

Internal Control Rating

First, we would strongly suggest you remove the requirement that controls be deemed either “effective” or “ineffective.” As mentioned earlier, this standard potentially creates a false expectation among investors that financial statements are either correct or incorrect and that controls either work to allow surety that the financial statements are correct or they do not.

We recommend that the SEC and the PCAOB work with the preparers and users of financial statements to develop a less rigid, more informative communication concerning the status of internal controls over financial reporting. We would propose that you allow companies to self-grade using a series of ratings, similar perhaps to what is used by credit rating agencies. The value of that reporting could be further enhanced by applying it to each business segment reported by the company.

To standardize this process we recommend that the Commission, or the PCAOB, work with the preparers and users of financial statements to develop a framework that would provide specific reporting and disclosure guidelines. The disclosure should include a description of the steps taken by management to assess internal controls. Such a disclosure would have to be general but should include sufficient information for an informed reader to assess what activities have been addressed and what issues have been raised.

We also believe the Commission should consider establishing or promoting independent reviewers of internal controls, similar to credit rating agencies. Investors might find this type of independent review useful in assessing a company’s internal control environment.

We believe that reporting internal controls on a relative basis rather than as an absolute binary value would provide investors with information that should be useful to them in assessing a company’s risk profile relative to its standing along the business continuum. This should facilitate comparisons between companies as well as between business segments of a single company.

Internal Control Disclosures

We are supportive of enhancing internal control disclosure requirements if the issue of “effective – ineffective” is addressed. We believe that the report on internal controls should be modified to become

more useful to investors. This communication is important to ensure that the financial statement user is adequately informed as to what is being addressed and perhaps more to the point what is not being addressed in the evaluation. Specifically, the omission of compliance and operational controls needs to be carefully explained. Also, the business context of internal controls needs to be carefully described. As described in the COSO Framework document, the existence of effective internal controls does not ensure that good business decisions will be made or that business risks will be adequately identified. That represents a severe limitation that needs to be communicated or we risk creating significant expectations on the part of financial statement users that cannot be satisfied within an internal control framework.

Internal Control Audits

The requirement for auditors to audit and report separately on internal controls should be eliminated. We recognize that this would require legislation, however, we believe the Commission should request this authority or ask Congress to address this issue. We believe the external auditor should be required as an integral part of their financial statement audit to assess whether the conclusions expressed by management concerning internal controls are reasonable. This would eliminate a significant aspect of the current processes that add so much to the cost without adding significantly to the value derived from the process. Also, it would place the proper emphasis on the relative roles and responsibilities regarding internal controls. Specifically, it would highlight that management has the primary responsibility for creating, maintaining and communicating issues regarding internal controls and other financial matters while the auditor's role is one of assessing the fairness of the matters being communicated by management.

If the requirement for a separate internal control audit can not be eliminated, consideration should be given to establishing longer time periods (up to 5 years) between audits rather than requiring annual audits. The annual obligation for management to report on internal controls could be retained along with the requirement for the external auditor to consider the reasonableness of management's disclosures, as would disclosure of the time period since the last internal control audit and when the next one is scheduled. This would enable the financial statement user to make their own assessment as to whether the absence of the internal control audit or the time elapsed since the last audit pose a significant risk factor.

Increased Focus on the Control Environment

More emphasis should be placed by the auditor on assessing the control environment and less on time consuming walkthroughs and detail testing of internal control procedures. Virtually all of the most publicized business failures involved actions by management to conceal fundamental business failures. As such, the primary emphasis of audits should be on the propensity and motivation of management to perpetrate fraud and the environment that would enable them to conceal such activities. Such occurrences are unlikely to be detected in detailed testing of control activities surrounding routine activities.

In closing, FPL Group commends the Commission for its efforts to understand the consequences and ramifications that the implementation of Section 404 of the Act has had on public companies and the capital markets. We hope our thoughts are helpful as you evaluate improvement opportunities.

Sincerely,

Moray P. Dewhurst
Vice President, Finance and
Chief Financial Officer of FPL Group, Inc.