NATIONAL ASSOCIATION OF
REAL ESTATE INVESTMENT TRUSTS®

February 26, 2007

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

RE: Rulemaking Docket 021: Proposed Auditing Standard – An Audit of Internal Control Over Financial Reporting that is Integrated with an Audit of Financial Statements

Dear Members of the Board:

The National Association of Real Estate Investment Trusts® (NAREIT) welcomes this opportunity to respond to the request for comments from the Public Company Accounting Oversight Board (PCAOB) on the concepts and questions contained in Rulemaking Docket 021: Proposed Auditing Standard – An Audit of Internal Control Over Financial Reporting that is Integrated with an Audit of Financial Statements (proposed standard or AS5).

NAREIT is the representative voice for U.S. real estate investment trusts (REITs) and publicly traded real estate companies worldwide. Members are REITs and other businesses that develop, own, operate and finance income-producing real estate, as well as those firms and individuals who advise study and service those businesses. We are proud to report that the real estate/REIT industry has been consistently ranked in the top three of 24 industry groups for corporate governance according to the Corporate Governance Quotient rankings published by Institutional Shareholder Services.

This letter offers certain general and specific comments in response to the proposed standard. NAREIT has previously participated in and been very supportive of efforts to provide additional guidance to reduce the burden of compliance while maintaining effective controls over financial reporting.

Summary Comments

NAREIT and its members strongly support the need for effective internal controls over financial reporting. We believe that, on balance, the proposed standard would continue to improve the effectiveness and efficiency of public company financial reporting.

We believe it is appropriate and more efficient for the auditor to integrate its audit procedures and opine on a company's internal controls over financial reporting and financial statements without issuing a separate opinion on management's annual internal control evaluation process. We are hopeful that this will lead to more efficiency and reduced audit expenses.

It should be noted, however, that our members expressed concern regarding alignment of management's process with their auditors. Due to the highly subjective nature of the Sarbanes-Oxley compliance process, it is possible that both parties could approach this effort differently with equally valid positions. For example, a company may use a sampling methodology that is different from that used by its audit firm. In these cases, it would be helpful if AS5 stated specifically that each party can individually determine the effectiveness of the internal control framework as long as the conclusions reached are in fact the same.

In cases where a company and its audit firm have different views on implementation and/or conclusions with respect to Sarbanes-Oxley, it would be particularly helpful for PCAOB guidance to be more specific. Although AS5 goes a long way in this regard, many topics still need additional clarification. Examples include the following:

- *Scoping methodologies.* Based on paragraphs 24 - 29, auditors have given member companies guidance that they must redo their risk assessments and not only map each of the entity level controls into the individual business cycles, but additionally 'risk rate' every control within each cycle. This would require them to essentially recreate the Sarbanes-Oxley process and spend a significant amount of time and money to completely overhaul documentation as well as incur additional audit fees with no real benefit.

- *Materiality methodologies.* We suggest that some conservative "safe harbor" thresholds be incorporated into the guidance to serve as examples in providing guidance to assist management in determining whether certain controls could have a material impact on the financial statements. For example, if a breakdown in a specific control, taking into consideration potential skews in performance measures from one-time events, is estimated to have an impact of less than:

  - 2.5% of Revenues,
  - 2.0% of Operating Income,
  - 1.5% of Income before Income Taxes, or
  - 1.0% of Total Assets
  - 1 cent of EPS

  and would not:

- Change net earnings to net loss or vice versa,
- Affect the company's compliance with regulatory requirements, or
- Affect the company's compliance with debt covenants or other contractual arrangements,

then such control would be deemed to be immaterial.

- *Sample size determinations.* Many of NAREIT's member companies use a standard testing methodology that incorporates risk as well as volume when determining sample size. It would be helpful if the PCAOB would provide an illustration of a sample size methodology similar to the example below.

Annual Sample Sizes for Manual Controls

	Low Risk	Medium Risk	High Risk
Annual control	1	1	1
Quarterly control	1	2	3
Monthly control	4	5	6
Weekly control	10	15	20
Once daily control	20	30	40
Multiple times daily control	30	45	60

We support the PCAOB's position that the auditor should consider the size and complexity of a company, and consider ways of streamlining and eliminating unnecessary procedures while planning and performing the audit of internal controls. We applaud the PCAOB for acknowledging that smaller, less-complex companies should have smaller, simpler audits, and that the auditors should expect and accept that a smaller company's control activities may be different and documentation of those controls less formal than found in some larger companies.

While we believe that AS5 is a significant step in the right direction, as with Accounting Standard No. 2, the accounting firms must apply the rules and interpret the guidelines. We believe that the anticipated increase in audit efficiencies and reductions in work effort and cost from adopting AS5 will only be achieved if the PCAOB's evaluation of audit firms discontinues the detailed compliance-based approach to enforcing the standards that it has taken thus far. The audit firms will implement AS5 based on how they are evaluated by the PCAOB.

In this regard, we encourage the PCAOB to take the lead and adopt the spirit and philosophy of the proposed standard while conducting its inspections of audit firms. To this end, we recommend that the PCAOB issue a statement to the auditing profession describing the steps it will take to ensure its evaluation of audit performance will be consistent with the top-down, risk based approach discussed in AS5. Only with this change to the PCAOB's inspections can we hope to see any increase in efficiencies and reduction in audit fees.

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Specific Comments

- Auditing standards consider inquiry, observation, inspection of documentation, and appropriate reperformance of tests of controls. However, most of our members found that while completing their Section 404 procedures, their auditors focused largely on the inspection of documentation. Essentially, many auditors had taken the position that in the absence of documentary evidence, controls must be presumed to be ineffective. This is a significant Section 404 compliance issue for most companies and will continue to increase costs if reasonable guidance is not adopted. For example, the absence of supervisory sign-off on an account reconciliation may be deemed a deficiency, even though the supervisory review had, in fact, been performed and could have been verified by inquiry and observation. In addition, our members have noted that the current system for auditing internal controls has no tolerance for the type of human error that could reasonably be expected to occur in situations involving the compilation of large amounts of data.

- The PCAOB standards establish reporting requirements for material weaknesses and significant deficiencies. While we believe the PCOAB's proposal to replace the reference to "more than remote likelihood" with "reasonable possibility" within the definitions of material weakness and significant deficiency would be an improvement, we suggest that the reporting and remediation requirements be modified based on an even higher threshold level, *i.e.* only control deficiencies that would "likely" result in material misstatements would be required to be reported externally.

- It would be helpful if the PCAOB would provide additional explanation on the role and importance of information technology (IT) general controls as they relate to internal controls over financial reporting. Additional guidance also would be helpful that explains the relationships or dependencies between IT general controls and application controls, particularly in smaller companies, including examples of situations when an IT general control deficiency could result in an application control breakdown, in turn leading to a material misstatement. Some guidance or examples of the relationships between application controls in prepackaged software and IT general controls necessary to support them would also be helpful.

- Paragraph 15 indicates that "the auditor must consider the possibility of misstatement to both annual and interim financial statements" but paragraph 14 states that materiality should be based on annual financial statements. Some additional guidance would be helpful in understanding considerations of interim financial statements misstatements while using the annual financial statements as a basis for judging materiality.

- Paragraph 22 indicates that the auditor *should* assess specific activities as part of a company's period end reporting process. However, this list of activities may not be all inclusive and there may be other controls that are more important and on which management places greater reliance, such as period-to-period comparisons, actual-to-budget comparisons, trend analysis, performance metrics, etc. Accordingly, we recommend that the PCAOB indicate that the auditor should *consider* assessing (rather than "should assess") the specific activities shown in paragraph 22 and also should consider whether there are other controls that should be included in the auditor's assessment of a company's period end reporting process.

- Paragraphs 45 and 78 refer to antifraud "programs and controls." Many companies' antifraud provisions include a governance policy and a mix of fraud prevention and detection controls that are embedded into various operational processes, but don't have a separate and discrete antifraud program. We encourage the PCAOB to explain its expectations for an antifraud program if indeed companies are expected to have a specifically defined antifraud program. The current wording may cause the auditor to seek an undefined yet specific antifraud "program" above and beyond the company's controls to prevent and detect fraud.

- Appendix 2, paragraph 4 indicates that tests performed by others that provide evidence that controls are working "typically are similar in nature, timing, and extent to the procedures that the auditor would have performed himself or herself." The guidance, however, does not explain that the auditor should also consider that tests performed by others may include other effective procedures to determine if controls are operating effectively, and even though the test may include different test procedures than the auditor would have designed, the results of these other tests may still be considered relevant activities to support the auditor's reliance and conclusions.

  Without additional clarification, the guidance for using the work of others may result in the external auditors directing the work of others, such as the company's internal auditors, to perform the tests precisely as the auditor would design and execute them. This would be inefficient and costly, and moving in the opposite direction of the stated goals of enhancing the effectiveness and efficiency of control evaluations.

- Many companies, including the early adopters, have already completed their assessments of internal controls over financial reporting and their assessments have been successfully audited as part complying with the Section 404 requirements. While some interpret the SEC's Proposed Rule – Management's Report on Internal Control Over Financial Reporting as requiring a complete re-work of their risk assessment and control mapping exercises, others may see it as a "relaxing of the rules." We request that the PCOAB explicitly state that changes a company makes as part of adopting the SEC's Proposed Rule should not be interpreted as a derogation or weakening of controls that could jeopardize management's or the auditor's assessment of internal controls over financial reporting.

- Some companies have been reluctant to consult with their auditors and other advisors about internal controls due to fear that such a conversation might be construed as evidence that a material weakness exists. We encourage the PCAOB to further clarify that it is acceptable for management to consult with auditors and others without fear of retribution and to encourage management and their auditors to be able to have an open dialogue on all matters including seeking advice that will assist in maintaining sound internal controls.

Conclusion

NAREIT strongly supports the need for effective internal controls over financial reporting. We believe that, on balance, the proposed new rules would continue to improve the effectiveness and efficiency of public company financial reporting. We look forward to further guidance from the PCOAB, and will continue to participate in the positive evolution of corporate practices that promote ethical and effective financial reporting.

Respectfully submitted,

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