

August 10, 2016

Office of the Secretary
PCAOB
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comments@pcaobus.org

Delivered Electronically

Re: PCAOB Rulemaking Docket Matter No. 034

Dear Board Members:

This letter is submitted by the National Association of Real Estate Investment Trusts[®] (NAREIT) in response to the solicitation for public comment by the Public Company Accounting Oversight Board (PCAOB or Board) with respect to its *Proposed Auditing Standards – The Auditor’s Report on an Audit of Financial Statements When the Auditor Expresses an Unqualified Opinion and Related Amendments to PCAOB Standards (PCAOB Release No. 2016-003, May 11, 2016, PCAOB Rulemaking Docket Matter No. 034)* (the Reproposal).

NAREIT is the worldwide representative voice for real estate investment trusts (REITs) and publicly traded real estate companies with an interest in U.S. real estate and capital markets. NAREIT's members are REITs and other businesses throughout the world that own, operate and finance income-producing real estate, as well as those firms and individuals who advise, study and service those businesses.

REITs are generally deemed to operate as either Equity REITs or Mortgage REITs. Our members that operate as Equity REITs acquire, develop, lease and operate income-producing real estate. Our members that operate as Mortgage REITs finance housing and commercial real estate, by originating mortgages or by purchasing whole loans or mortgage backed securities in the secondary market.

A useful way to look at the REIT industry is to consider an index of stock exchange-listed companies like the FTSE NAREIT All REITs Index, which covers both Equity REITs and Mortgage REITs. This Index contained 220 companies representing an equity market capitalization of \$1.10 trillion at July 31, 2016. Of these companies, 179 were Equity REITs representing 94.5% of total U.S. listed REIT equity market capitalization (amounting to \$1.04



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trillion)¹. The remainder, as of July 31, 2016, was 41 publicly traded Mortgage REITs with a combined equity market capitalization of \$60.0 billion.

This letter has been developed by a task force of NAREIT members, including members of NAREIT's Best Financial Practices Council. Members of the task force include financial executives of both Equity and Mortgage REITs, representatives of major accounting firms, institutional investors and industry analysts.

NAREIT appreciates the PCAOB's efforts toward improving audit quality since its inception in 2002. NAREIT acknowledges the PCAOB's substantive consideration of the feedback it received on its *Proposed Auditing Standards – The Auditor's Report on an Audit of Financial Statements When the Auditor Expresses an Unqualified Opinion*, (PCAOB Release No. 2013-003, August 13, 2013, PCAOB Rulemaking Docket Matter No. 34) (the Proposal) that discussed proposed modifications to the auditor's reporting model and the auditor's responsibilities for other information in certain documents containing audited financial statements. In particular, NAREIT supports the PCAOB's decision to retain the current pass/fail model of auditor reporting. However, NAREIT fails to see where the PCAOB has made a compelling argument for why critical audit matters are needed in the auditor's report or how such a requirement would enhance the usefulness of the audit report for financial analysis purposes. Further, NAREIT does not see where there is convincing evidence for how the disclosure of audit tenure would translate into enhanced audit quality. Therefore, NAREIT does not believe that the PCAOB should proceed with issuing the Reproposal as a final audit standard.

NAREIT Recommendation: Suspend further work on the Reproposal

We understand that the PCAOB is trying to add value to the audit report and enhance its decision usefulness by requiring that the auditor identify and discuss critical audit matters as a part of the annual audit report. However, we believe that a requirement to disclose critical audit matters in the audit report would potentially:

- Confuse and potentially mislead users of financial statements by giving them a basis to question whether the opinion rendered by the audit firm is truly unqualified (*i.e.*, that the financial statements are presented fairly in accordance with U.S. GAAP);
- Introduce situations when the auditor is disclosing sensitive information that is not otherwise required to be disclosed by the issuer;
- Duplicate information that is already required by the SEC of known risks and uncertainties and critical accounting estimates, and FASB requirements for disclosure of accounting policies;
- Dampen effective communication between the audit firm and the audit committee;

¹ <https://www.reit.com/sites/default/files/returns/FNUSIC2016.pdf>.



- Add tension between management and auditors for the topics addressed and wording utilized in critical audit matters; and,
- Result in boilerplate disclosure of critical audit matters and how these matters were addressed in the auditor's report.

Additionally, we find no evidence of a direct correlation between auditor tenure and audit quality.

Each of these concerns is further discussed below.

NAREIT Discussion of Concerns with Disclosing Critical Audit Matters

Confuse and potentially mislead users of financial statements by giving them a basis to question whether the opinion rendered by the audit firm is truly unqualified (i.e., that the financial statements are presented fairly in accordance with U.S. GAAP);

Consistent with our prior submission² on the Proposal, NAREIT does not support a requirement for auditors to report on “critical audit matters” (as that term is defined in the Reproposal). **In our view, a requirement to disclose critical audit matters would have the unintended consequence of audit firms effectively qualifying unqualified opinions.** Investors would be left to question the auditor's judgment that the financial statements are prepared fairly in accordance with U.S. GAAP given the list of risks that would be included in the auditor's report. This would detract from the investor's true purpose in utilizing the audited financial statements as a basis for their financial analysis. By giving auditors the opportunity to disclose the risks that “keep them up at night,” analysts may be left with reduced confidence as to whether the financial information that serves as the basis for their capital allocation decisions is reliable.

Through our discussions with investors and buy-side and sell-side analysts that follow the REIT industry, investors and analysts are interested in whether the auditor has provided an unqualified opinion on the financial statements – period. When asked whether they would be interested in an auditor report like the often-cited Rolls-Royce³ example, they questioned how they could read and interpret a six page auditor report for the 80 companies they follow regularly in the REIT industry in addition to their analysis of the audited financial statements. To reiterate, we have seen no evidence that including critical audit matters in the audit report would be useful to financial analysis. The Reproposal itself acknowledges that the results of research on this matter are “ambiguous”.

² https://pcaobus.org/Rulemaking/Docket034/125b_NAREIT.pdf.

³ <http://www.rolls-royce.com/~media/Files/R/Rolls-Royce/documents/investors/annual-reports/2015-annual-report-v1.pdf> at pages 167 - 174.



Introduce situations when the auditor is disclosing sensitive information that is not otherwise required to be disclosed by the issuer;

In our previous submission on the Proposal, we highlighted an issue with Hypothetical Auditing Scenario #3 that illustrates a fact pattern in which the auditor discloses a “control deficiency less severe than a material weakness noted in the Company’s internal control system.”⁴ This information is part of the auditor’s required communication to the issuer’s audit committee, under current PCAOB standards, but there is nothing in securities law that requires public reporting of either significant deficiencies in internal controls or audit adjustments.

The Reproposal states that the PCAOB has addressed constituent concerns, but we continue to believe that this is an issue. The Reproposal

...adds a note to address commenters' concerns about the auditor becoming the source of original (and potentially confidential) information about the company. The note indicates that when describing critical audit matters in the auditor's report, the auditor is not expected to provide information about the company that has not been made publicly available by the company unless such information is necessary to describe the principal considerations that led the auditor to determine that a matter is a critical audit matter or how the matter was addressed in the audit.⁵

NAREIT does not believe that the commenters’ concern is addressed due to the words “unless such information is necessary.” The Reproposal goes on to explain that the auditor’s disclosure of a matter could trigger disclosure on the part of management. However, this would appear to have the auditors then act in the capacity of management in situations when management declines to disclose information that is not required by securities laws.

NAREIT strongly believes that an audit firm should not report sensitive information that is not required to be disclosed under existing securities laws and/or generally accepted accounting principles. We believe that existing U.S. securities laws and existing U.S. GAAP are sufficient to provide users with the appropriate amount of information to make investment decisions. Further, the expansion of existing disclosure requirements is the purview and responsibility of the SEC and the FASB. Accordingly, if the PCAOB were to go forward with this Reproposal, we believe the auditor should be prohibited from disclosing any information that is not otherwise required to be disclosed by the issuer.

Dampen effective communication between the audit firm and the audit committee

NAREIT believes that the Reproposal’s requirement that auditors evaluate whether required communications to the audit committee represent critical audit matters, will have the unintended

⁴ http://pcaobus.org/Rules/Rulemaking/Docket034/Release_2013-005_ARM.pdf at page A5-77.

⁵ <https://pcaobus.org/Rulemaking/Docket034/Release-2016-003-ARM.pdf> at page 37.



consequence of dampening open communication between the audit firm and the audit committee. We believe that standard setting that serves as an impediment to open and candid dialogue between the auditor and the audit committee should be avoided at all costs.

Duplicate information that is already required by the SEC of known risks and uncertainties and critical accounting estimates, and FASB requirements for disclosure of accounting policies

We believe that the most difficult, subjective and complex audit matters encountered by the auditor are highly likely to be the risks and uncertainties and critical accounting estimates that the issuer is already disclosing in its Management Discussion and Analysis (MD&A). Given that the sections of MD&A that cover risks and uncertainties and critical accounting estimates and the summary of accounting policies in the notes to the financial statements provide the reader with management's assessment of the most judgmental aspects of the financial statements, NAREIT questions why the Board would require auditors to duplicate this information. If the PCAOB believes that this existing information is not sufficiently robust or transparent, NAREIT recommends that SEC or the FASB evaluate this aspect of financial reporting and provide additional guidance through formal standard setting.

Add tension between management and auditors for the topics addressed and wording utilized in critical audit matters

Given the litigious business environment in the United States, we believe that the wording chosen for the critical audit matters would be highly scrutinized. Management may object to the risks included if, in their view, they do not mirror disclosures already made in MD&A. Additionally, management may take exception to the wording that the auditor uses in their audit report. NAREIT believes that the Reproposal will create unnecessary tension between management and the auditor over the auditor's report, and serve as a distraction from the auditor's role in auditing the financial statements and internal controls over financial reporting.

Result in boilerplate disclosure of critical audit matters and how these matters were addressed in the auditor's report

Similar to our previous comment on the legal framework in the United States, wording of critical audit matters will likely be streamlined by accounting firms to address potential litigation. Thus, the value that the PCAOB is seeking to achieve will not be realized when audit staff are left to utilize templates for standardized critical audit matters. NAREIT fails to see how requiring disclosure of critical audit matters will be an improvement in financial reporting, let alone audit quality.

NAREIT Comments on Auditor Tenure

NAREIT understands that there is some interest amongst financial statement users about auditor tenure. We observe that for many issuers, the tenure of an audit firm can be determined by a review of the issuer's public filings. However, NAREIT does not support the part of the Proposal



that requires auditors to report on their tenure because that information, placed in the audit report, infers a direct relationship between auditor tenure and the quality of the audit or the content of the audit report that may not exist. NAREIT is unaware of evidence indicating that auditor tenure has a direct correlation to audit quality.

Perhaps more importantly, NAREIT considers auditor tenure to be a corporate governance matter under the direct purview of the issuer's audit committee only.

Further, a statement regarding auditor tenure placed in the audit report would be severely out of context. There would be no information about how the audit committee assesses the quality of the audit work and determines whether or not a change in auditor is appropriate. It also would provide no information regarding the most recent tendering of the audit. Some users might incorrectly infer that longer auditor tenure indicates that the audit has not been retendered when, in fact, the audit committee's decision to retain the incumbent audit firm was made after an extensive retendering process.

The Reproposal acknowledges that views on whether auditor tenure corresponds to improved audit quality are inconclusive amongst past commenters and academic research⁶. Therefore, NAREIT recommends that information regarding auditor tenure continue to be excluded from the audit report.

If academic evidence can prove that there is a direct relationship between auditor tenure and audit quality, the SEC should consider adding relevant disclosure requirements to proxy statements that are filed coincident with audit committee reports or in connection with company shareholder ratification of auditor appointments. In our view, the proxy statement would be the better place for disclosure of auditor tenure, where proper context could be given. Companies could include a summary of the process that the audit committee completed to vet the audit firm, including whether or not the audit was out for bid.

Summary

NAREIT does not believe that the changes recommended by the Proposal with respect to the audit report and disclosure of auditor tenure are warranted. These requirements would add costs without improving the quality of the audit. Furthermore, these proposals would be likely to confuse and in some cases even mislead users of financial statements. Therefore, NAREIT recommends that the PCAOB suspend its efforts on the Reproposal, and instead focus its time and resources on improving aspects of the audit procedures that would enhance audit quality so as to provide investors with more confidence that the audited financial statements are, indeed, free of material misstatement.

At a time when both the Financial Accounting Standards Board and the Securities and Exchange Commission are focused on disclosure effectiveness initiatives to improve disclosure and

⁶ <https://pcaobus.org/Rulemaking/Docket034/Release-2016-003-ARM.pdf> at page 47.



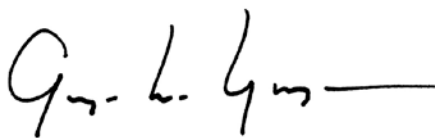
eliminate redundancy, we find it odd that the PCAOB would be exacerbating the “disclosure overload” phenomenon by expanding the auditor report. In our view, an expansion of the unqualified audit opinion to include critical audit matters would prove to be misleading to investors and would largely result in generic disclosures that are duplicative of information that is provided by management. Moreover, we do not see a direct correlation between auditor tenure and audit quality, and believe that disclosing auditor tenure could be misleading to investors as well.

In the event that the PCAOB decides to move forward with the Reproposal, NAREIT recommends that the Board consider conducting robust field testing. In our view, field testing should involve not only the preparer and auditor community, but also representatives from the investment community and related regulatory bodies like the SEC in order to fully assess both the costs and the benefits of the Reproposal. This would provide the Board with evidential matter in evaluating whether the Reproposal is operational, whether additional guidance is needed, whether the implementation costs outweigh the perceived benefits, and if the Reproposal’s objectives could actually be achieved.

* * *

We thank the PCAOB for the opportunity to comment on the Proposal. If you would like to discuss our views in greater detail, please contact George Yungmann, NAREIT’s Senior Vice President, Financial Standards, at gyungmann@nareit.com or 1-202-739-9432, or Christopher T. Drula, NAREIT’s Vice President, Financial Standards, at cdrula@nareit.com or 1-202-739-9442.

Respectfully submitted,



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