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**NATIONAL ASSOCIATION OF
REAL ESTATE INVESTMENT TRUSTS®**

December 11, 2013

Ms. Phoebe W. Brown
Office of the Secretary
PCAOB
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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 The Auditor’s Responsibilities Regarding Other Information in Certain Documents Containing Audited Financial Statements (PCAOB Release No. 2013-005, August 13, 2013, PCAOB Rulemaking Docket Matter No. 034)* (the Proposal).

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 193 companies representing an



equity market capitalization of \$659.6 billion¹ at September 30, 2013. Of these companies, 154 were Equity REITs representing 90.7% of total U.S. listed REIT equity market capitalization (amounting to \$598.5 billion). The remainder, as of September 30, 2013, was 39 publicly traded Mortgage REITs with a combined equity market capitalization of \$61.1 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 *Concept Release on Possible Revisions to PCAOB Standards Related to Reports on Audited Financial Statements and Related Amendments to PCAOB Standards, Notice of Roundtable*, (PCAOB Release No. 2011-003, June 21, 2011, PCAOB Rulemaking Docket Matter No. 34²) (the Concept Release) that discussed alternatives for changing the auditor's reporting model. In particular, NAREIT supports the PCAOB's decisions to retain the current pass/fail model of auditor reporting and to reject the requirement for an auditor's discussion and analysis. However, NAREIT does not support a requirement for the auditor to report on "critical audit matters" (as that term is defined in the Proposal). In our view, such a requirement would not meet the PCAOB's objective of providing users of financial statements with additional meaningful information. As discussed further below, it is our view that the PCAOB's proposal for auditor reporting of critical audit matters would largely result in generic disclosures that are duplicative of information that is provided by management while simultaneously increasing audit cost.

NAREIT Comments on Critical Audit Matters

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 mislead users with a piecemeal discussion of audit procedures that readers of the financial statements have no context or basis to understand;
- Introduce situations when the auditor is disclosing sensitive information that is not otherwise required to be disclosed by the issuer;
- Duplicate information already disclosed by the issuer;

¹ <http://returns.reit.com/reitwatch/rw1310.pdf> at page 21

² http://pcaobus.org/Rules/Rulemaking/Docket034/Concept_Release.pdf



- Increase audit fees for, among other things, the senior level time the auditor would incur describing the critical audit matters for purposes of drafting the proposed disclosure and incremental time discussing those matters and the related disclosure with management and the audit committee; and,
- Exacerbate existing time pressures to meet financial reporting deadlines.

Each of these concerns is further discussed below.

Confuse and mislead users with a piecemeal discussion of audit procedures that readers of the financial statements have no context or basis to understand

In reporting critical audit matters, auditors would likely feel compelled to describe the audit procedures they performed, consistent with the examples in the proposal. NAREIT questions whether the substantial majority of financial statement users are likely to understand a discussion of audit procedures. When the auditor discusses its audit process with the audit committee, the auditor has the opportunity to answer questions and provide additional information to the audit committee members, thus limiting the risk of confusion or misunderstanding about the nature and extent of audit procedures performed. Further, when the audit committee and auditor are discussing the audit work in discrete areas, they are doing so in the context of the audit taken as a whole. In this context, there is no potential for confusion about whether the auditor is, in some way, effectively providing a piecemeal opinion on an individual line item within the financial statements.

NAREIT believes that users would likely be confused by the discussion of audit procedures in an audit report not only because they lack an understanding of the audit process as a whole but because they lack the context for the discussion of discrete audit procedures on an individual financial statement line item. We are therefore concerned that the Proposal would widen the existing expectation gap regarding the nature and extent of audit work required by the PCAOB's auditing standards.

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

One of the examples in the Proposal (Hypothetical Auditing Scenario #3) 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."³ 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.

³ http://pcaobus.org/Rules/Rulemaking/Docket034/Release_2013-005_ARM.pdf at page A5-77



The Proposal acknowledges a fact pattern whereby control deficiencies that are not material weaknesses would be disclosed by the auditor. For example, Appendix V of the Proposal states:

Because a deficiency or deficiencies in the company's internal control over financial reporting could have a significant effect on the conduct of the audit and on the level of difficulty in gathering audit evidence or forming an opinion on the financial statements, an internal control deficiency might be an indicator of a critical audit matter.⁴

This would mean that the auditor would be disclosing sensitive information that is not otherwise required to be reported by the issuer. Furthermore, unlike the existing audit requirement to discuss such matters with the audit committee, the information is being presented to users of financial statements with limited context and no opportunity for the clarifying discussion that occurs during most audit committee meetings.

We strongly believe 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 Proposal, we believe the auditor should be prohibited from disclosing any information that is not otherwise required to be disclosed by the issuer.

Duplicate information already disclosed by the issuer

We believe that the most difficult, subjective and complex audit matters encountered by the auditor are highly likely to be the critical accounting policies and estimates that the issuer is already disclosing in its Management Discussion and Analysis (MD&A). Given that the sections of MD&A that cover critical accounting policies and estimates 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 Financial Accounting Standards Board (FASB) evaluate this aspect of financial reporting and provide additional guidance through the comment letter process. Another possibility would be to request that the FASB evaluate these disclosures as part of its Disclosure Framework Project.

Increase audit fees for, among other things, the senior level time the auditor will incur describing the critical audit matters for purposes of drafting the proposed disclosure and incremental time discussing those matters and the related disclosure with management and the audit committee

⁴ http://pcaobus.org/Rules/Rulemaking/Docket034/Release_2013-005_ARM.pdf at page A5-32



NAREIT acknowledges that the current audit standards require the auditor to identify and communicate significant audit matters to the audit committee. However, NAREIT believes that requiring the auditor to report critical audit matters in the audit opinion would lead to increased audit fees. At a minimum, each and every audit engagement team would incur additional senior level time in order to determine the critical audit matters (CAMs) for purposes of drafting the proposed disclosure and discussing both the CAMs and the related disclosure with management and the audit committee.

Further, given the significant degree of subjectivity involved in determining which significant audit matters are “the most critical” and the inevitable second guessing of that determination by audit committees, management, PCAOB inspection teams, SEC staff and litigators, NAREIT anticipates that audit partners would need to consult others in the firm regarding both the selection of CAMs as well as the report language. The added time and related increased risk incurred by the audit firm would directly translate into an unnecessary and avoidable increase in annual audit fees. Further, we believe that there is a risk of inconsistent disclosure of CAMs both within and among the audit firms. We sense that the added disclosure in the audit report would open both audit firms and issuers to increased litigation risk, the cost of which will be passed on to issuers (and thus investors) in the form of increased audit fees.

Exacerbate existing time pressures to meet reporting deadlines

Given the nature of the audit process, auditors are unlikely to be able to conclude definitively on “the most” significant, judgmental or complex audit matters until substantially all the audit work has been completed. That necessarily places the decisions and discussions surrounding CAMs into the very final stages of the audit and just prior to the release of the audited financial statements on Form 10-K. If the Board moves forward with this Proposal, NAREIT foresees the addition of a very time consuming step into the late stages of what is already a tight deadline for many issuers.

In light of time pressures, liability concerns and fee issues, audit firms may feel compelled to develop standardized audit report language for common critical audit matters. Thus, stepping back and looking at the sum total of our concerns, we believe there is a significant risk that the PCAOB’s proposal will result in boilerplate, duplicative disclosures that add to the cost of the audit without adding to the information available to users of financial statements.

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 Proposal that auditors 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 does 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. A statement regarding auditor tenure placed in the audit report would provide no information about how the audit committee assesses the quality of the audit work and determines that 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.

Therefore, NAREIT recommends that information regarding auditor tenure continue to be excluded from the audit report. If users of financial statements believe this information would provide significant value, 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.⁵

NAREIT Comments on Other Information

We do not understand the purpose of expanding the audit report to explicitly address information that is not audited and that is often outside the expertise of an auditor. More importantly, NAREIT believes the proposed language that would be included in the audit report regarding other information would mislead users into believing that the auditor has an authoritative basis to conclude on the sufficiency, accuracy or completeness of the other, unaudited information. This, in turn, would cause auditors to do additional work and invest additional resources into the reading of the unaudited information beyond what may be required by the standard because they would be perceived as being more closely associated with that information. Inevitably, this exercise would increase the cost of the audit as well as the cost of preparing the unaudited information. The result would be more cost to shareholders without additional assurance to those same shareholders.

In NAREIT's view, there is no need to change the existing audit standard related to other information contained in a report that includes audited financial statements. We are unaware of any evidence indicating that auditors are either not meeting their existing (albeit very limited) responsibilities for other information or that users are misinformed about which elements of an SEC filing are audited and which are not. In fact, in its Proposal, the PCAOB notes that "investors generally were not supportive of auditor assurance on other information outside the financial statements."⁶ To the extent that the audit committee or external third parties (*e.g.*, underwriters, institutional investors, or analysts) believe it is appropriate to obtain additional assurance on other information included in SEC filings, the PCAOB's existing standards provide auditors with the tools to meet those requests. Accordingly, nothing more is needed.

⁵ In its Proposal, the PCAOB notes that the UK-listed companies are "required to provide information about auditor tenure in a separate section of the annual report" (page A5-16.) The approach used by the UK is consistent with our view that information about auditor tenure, while potentially of interest to investors, is a matter of corporate governance.

⁶ http://pcaobus.org/Rules/Rulemaking/Docket034/Release_2013-005_ARM.pdf at page 25



The PCAOB states that

The required procedures under the proposed other information standard would focus the auditor's attention on the identification of material inconsistencies between other information and the company's audited financial statements and on the identification of material misstatements of fact, based on relevant evidence obtained and conclusions reached during the audit.⁷

NAREIT views these requirements as largely consistent with the existing audit standard which states that the auditor "should read the other information and consider whether such information, or the manner of its presentation, is materially inconsistent with information, or the manner of its presentation appearing in the financial statements."⁸ However, the proposed changes to the standard, and the related proposed language in the audit report, suggest that the auditor's responsibility should extend beyond what has been historically required. Specifically, under the Proposal the auditor would be required to state that, "in addition to auditing the financial statements and the Company's internal controls over financial reporting," the auditor would also be required to "evaluate" the other information in the filing, an evaluation that was "based on relevant audit evidence obtained and conclusions reached during the audit." What level of assurance is provided by an "evaluation?" Absent clarification by the PCAOB, users of financial statements could mistakenly perceive the audit firm's work and the level of assurance provided surrounding other information as something substantial, with no meaningful understanding as to the distinction between an "evaluation" and an "audit." This perception gap could have severe ramifications on the investment community as well as the audit profession. Instead of adding more clarity to the audit report and narrowing the expectation gap, we view this Proposal as significantly obfuscating the nature and scope of an audit and dramatically widening the expectation gap.

In NAREIT's view, this aspect of the Proposal is fraught with many issues involving each financial statement users' perspectives, and would likely lead auditors by default to performing a far more significant amount of unnecessary work on other information than under current standards due to the lack of clarity regarding the nature and scope of the auditor's responsibility. This would cause increases in audit fees when there is absolutely no demand or requirement for any type of assurance on this information and could lead to less useful information being provided to investors.

Summary

NAREIT does not believe that the changes recommended by the Proposal with respect to the audit report, disclosure of auditor tenure, and the auditor's responsibility for other information 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

⁷ http://pcaobus.org/Rules/Rulemaking/Docket034/Release_2013-005_ARM.pdf at page 7

⁸ See AU 550.04



Ms. Phoebe W. Brown

December 11, 2013

Page 8

financial statements. Therefore, NAREIT recommends that the PCAOB suspend its efforts on the Proposal, 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.

In the event that the PCAOB decides to move forward with the Proposal, 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 in order to fully assess both the costs and the benefits of the Proposal. This would provide the Board with evidential matter in evaluating whether the Proposal is operational, whether additional guidance is needed, whether the implementation costs outweigh the perceived benefits, and if the Proposal'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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