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NATIONAL ASSOCIATION OF
REAL ESTATE INVESTMENT TRUSTS®

October 31, 2014

Ms. Phoebe W. Brown
Office of the Secretary
PCAOB
1666 K Street, N.W.
Washington, D.C. 20006-2803
comments@pcaobus.org

Delivered Electronically

Re: Staff Consultation Paper, *Auditing Estimates and Fair Value Measurements*

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 the Staff Consultation Paper, *Auditing Estimates and Fair Value Measurements, August 19, 2014* (the Staff Paper).

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 209 companies representing an equity market capitalization of \$789 billion¹ at September 30, 2014. Of these companies, 169 were Equity REITs representing

¹ <http://www.reit.com/sites/default/files/reitwatch/RW1410.pdf> at page 21

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91.8% of total U.S. listed REIT equity market capitalization (amounting to \$724.5 billion). The remainder was 40 publicly traded Mortgage REITs with a combined equity market capitalization of \$64.5 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. However, NAREIT has significant concerns with the Staff Paper as drafted.

Why is a change to the existing audit framework for auditing estimates warranted?

NAREIT is not persuaded that a change to the audit framework for auditing estimates is necessary. In NAREIT's view, a single standard for auditing estimates and fair value measurements is an unworkable solution given the multiple iterations of accounting estimates in U.S. Generally Accepted Accounting Principles (GAAP). Additionally, NAREIT's member companies observe that external auditors currently perform a significant amount of audit work surrounding estimates pursuant to existing audit standards. For example, multiple member companies have indicated that the audit fees for auditing fair value estimates of real estate and auditing purchase price allocations in business acquisitions *exceed* the fees paid to the third party valuation companies that develop the estimates. In NAREIT's view, the suggestions in the Staff Paper would not pass a cost benefit test. The suggestions in the Staff Paper would only expand the work that auditors perform today, with no increase in the reliability or credibility of the audited financial statements. Further, as discussed below, there is no evidence that the existing auditing standards related to auditing estimates fail to detect significant errors in financial statements. In short, NAREIT sees no basis to conclude that increased audit work (and thus audit fees) would provide any measurable benefit.

What is the underlying problem that the Staff Paper is trying to solve?

NAREIT does not believe that the Staff Paper articulates a pervasive problem that would be solved by a change in auditing standards. The Staff Paper seems to be justifying a significant increase in audit work (and cost) based on the number of deficiencies found in the inspections process. While NAREIT acknowledges that PCAOB inspection reports have identified shortcomings in the audit work surrounding estimates, we observe that these criticisms could be caused by a number of factors:

- Auditors are not following the current standards;
- Auditors are performing the required procedures but are not adequately documenting the work that they perform;

- Auditors lack sufficient knowledge with respect to quantitatively sophisticated methods of developing estimates used by their clients or third party specialists and therefore are not capable of designing appropriate audit procedures to test the estimates; or,
- The expectations of the PCAOB inspection teams do not reflect the inherent uncertainties and imprecision that underlies estimates, including estimates of fair value measurements.

NAREIT is not aware of any significant audit failures (with “audit failures” defined as restatements of financial statements) driven by erroneous estimates in recent history that would necessitate standard setting by the PCAOB. NAREIT questions whether the PCAOB’s inspection findings in the areas of estimates, including estimates of fair value measurements, are more likely driven by auditor shortcomings relative to existing standards rather than problems with the auditing standards themselves.

As illustrated by FASB Member Larry Smith and former FASB Chairman Robert Herz² at the October 2, 2014 PCAOB Standing Advisory Group Meeting, estimates are prevalent throughout financial statements prepared under U.S. GAAP. Further, accounting estimates extend above and beyond fair value measurements and the GAAP hierarchy for fair value measurements that was introduced by FAS 157 *Fair Value Measurements*. Examples of accounting estimates within the real estate industry include: depreciation and amortization, asset impairment, reserves for tenant receivables, accrued expenses, deferred revenues, commitments and contingencies, contingent rental revenue, unrealized gains and losses on derivatives, foreign currency translation adjustments, changes in value for available-for-sale securities, etc. Developing estimates and fair value measurements is not new to the accounting profession. NAREIT fails to see where audits have failed to assess the reasonableness of the financial statements in accordance with U.S. GAAP.

Why should external third parties be considered an extension of management?

NAREIT strongly objects to the portions of the Staff Paper that suggest expanding the scope of audit work in the evaluation of processes and controls when management uses a third party specialist or pricing services. NAREIT continues to believe that the auditor’s testing of the accuracy of information provided to the third party is appropriate. Additionally, NAREIT considers the evaluation of information provided by third parties to be sufficient in accordance with current audit literature. However, we disagree with requiring the auditor to “test the information provided by the specialist as if it were produced by the company”³ or to “evaluate the audit evidence obtained [from the third-party source] as if it were produced by the company.”⁴ The idea that either management (in its assessment of the adequacy of the company’s internal controls over financial reporting) or the external auditor (in its evaluation of management’s assessment) could evaluate third parties’ processes and controls is simply not operational. NAREIT notes that existing audit guidance in AU 342.04 *Auditing Accounting*

² http://pcaobus.org/News/Events/Documents/10022014_SAG/Herz_slides.pdf

³ Staff Paper, page 38, Management’s Use of a Specialist

⁴ Staff Paper, page 44, Use of Third Parties

Estimates acknowledges that “[a]s estimates are based on subjective as well as objective factors, it may be difficult for management to establish controls over them.”⁵ Finally, third party specialists and pricing services are separate entities from the companies that engage them. To assume otherwise is not factual.

By suggesting that the auditor treat third party specialists as part of the entity that they are auditing, the Staff Paper seems to be requiring management to understand and evaluate the operating effectiveness and sufficiency of controls at third party vendors. There are two clear business reasons why companies engage third parties to assist in the development of estimates: (i) the company does not have the requisite expertise or time to perform the work in-house; or (ii) the company’s management believes that the use of third parties enhances the objectivity and reliability of its estimates. Requiring management and the auditor to evaluate the third parties’ processes and controls as if they were part of the company itself would exacerbate the company’s resource constraints in the first scenario and potentially discourage the company’s efforts in the second scenario. As indicated earlier, in NAREIT’s view, the costs of implementing such audit requirements would far outweigh any incidental benefits.

Isn’t an accounting estimate, by its very nature, merely one possibility in a range of reasonable outcomes?

While NAREIT understands the importance of auditing estimates, we have to wonder whether the Staff Paper is attempting to reach a level of precision via the audit process that contradicts the inherent nature of the subject being audited.

Estimates, including fair value measurements, are used extensively in the preparation of real estate entities’ financial statements. Preparers, auditors and, most importantly, investors and other users of this financial information understand the imprecision that results from the use of estimates. In the context of financial reporting, management’s responsibility is to use its judgment regarding available information in making accounting estimates. AU 342.03 notes that “[m]anagement’s judgment is normally based on its knowledge and experience about past and current events and its assumptions about conditions it expects to exist and courses of action it expects to take.” The auditor’s responsibility is *not* to conclude whether the estimate is right or wrong, but to assess whether management’s accounting estimate is *reasonable*. Auditing Standard No. 14 *Evaluating Audit Results* states: “If an accounting estimate is determined in conformity with the relevant requirements of the application financial reporting framework and the amount of the estimate is reasonable, a difference between an estimated amount best supported by the audit evidence and the recorded amount of the accounting estimate ordinarily would not be considered to be a misstatement.”⁶

⁵ <http://pcaobus.org/standards/auditing/pages/au342.aspx>

⁶ http://pcaobus.org/Standards/Auditing/Pages/Auditing_Standard_14.aspx

NAREIT's recommendation: Focus on targeted improvements to identified problems

In the event that the PCAOB decides to move forward with some change to existing auditing standards, NAREIT recommends that the PCAOB use a targeted approach instead of wholesale changes to the audit framework for estimates. For example, if there are shortcomings in the use of the work of specialists, the PCAOB might consider focusing on auditing the work of specialists to further evaluate the expertise and/or objectivity of the specialist or auditing the inputs provided by the company to the specialist. Alternatively, if the shortcomings stem from inadequate documentation or insufficient subject matter knowledge, the PCAOB could consider steps that would target those issues.

As a starting point, NAREIT recommends that the PCAOB address how proposed changes to auditing literature would impact the auditor's consideration of materiality. NAREIT observes that the Staff Paper is silent on the assessment of materiality. The intersection of where estimates and materiality meet would appear to be a fundamental starting point for the PCAOB's focus in making targeted improvements to audit literature.

Summary

NAREIT appreciates the PCAOB's staff efforts in their endeavor to further audit quality. However, NAREIT does not believe that the PCAOB has identified the root cause that would necessitate further amendments to auditing standards. While the PCAOB cites fair value as a common area of "significant audit deficiencies"⁷, NAREIT fails to see where these deficiencies have translated into restatements of previously reported financial results. Thus, NAREIT questions whether the Staff Paper simply represents rule-making for the sake of rule-making, without a clearly articulated underlying problem. As indicated above, in the event that the PCAOB concludes that further standard setting is required, NAREIT recommends that the Board make targeted improvements to specific sections of audit guidance as opposed to wide-ranging changes to the entire audit framework.

* * *

We thank the PCAOB for the opportunity to comment on the Staff Paper. 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 Drula, NAREIT's Vice President, Financial Standards, at cdrula@nareit.com or 1-202-739-9442.

⁷ Staff Paper, page 3, Introduction

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Respectfully submitted,

A handwritten signature in black ink that reads "George L. Yungmann" followed by a horizontal line.

George L. Yungmann
Senior Vice President, Financial Standards
NAREIT

A handwritten signature in black ink that reads "Christopher T. Drula" in a cursive style.

Christopher T. Drula
Vice President, Financial Standards
NAREIT