



REAL ESTATE

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CPAB Industry Forum Highlights Real Estate

CPAB held its Real Estate Industry Forum on September 27, 2017 for audit committee chairs serving the boards of Canadian real estate companies.

Co-hosted by **Colum Bastable**, audit committee chair of Slate Retail REIT, the Forum featured a roundtable discussion about matters that are top of mind for audit committees of Canadian real estate companies. The Forum included discussions about current and emerging Canadian and international developments in audit quality, and audit partner perspectives from **Ciro DeCiantis**, Audit Partner and National Investment Properties Sector Leader at Deloitte.

Issues facing audit committees of real estate companies in Canada

The mandate of many audit committees continues to grow with some audit committees overseeing more strategic areas of the real estate business.

Operational focus

External Management

Several real estate companies in Canada are managed by external managers. Participants agreed that these arrangements introduce unique challenges that require the careful attention of audit committees. Discussions focused on the following:

- Oversight of effectiveness of internal controls of external managers.
- Compensation arrangements of external managers.
- Aligning the incentives of external managers and shareholders/unitholders.

Compliance with SIFT Rules

The *Income Tax Act in Canada* imposes a special taxation regime (SIFT Rules) applicable to certain publicly traded income trusts. The SIFT Rules are not applicable to Real Estate Investment Trusts (REITs) that meet certain specified criteria relating to the nature of their revenues and investments (REIT Exception).

Ensuring that REITs meet the REIT Exception was described as *top of mind* for management as challenges here would have material effect on unitholder returns. Participants discussed the complexities in the SIFT rules and considered the merits of engaging tax SIFT rule experts to assist management and the audit committee in this area.

Tenant Quality

Participants discussed the focus of management at their respective companies on tenant quality and implications on property valuation. Some participants highlighted an opportunity to improve public disclosures around how tenant quality is managed including diversification of tenants by industry, by industry maturity (i.e., emerging v. mature industries), and geography.

Financial reporting focus

Key performance indicators

Several key performance indicators (KPIs) are commonly disclosed by real estate companies including net operating income (NOI), funds from operations (FFO), and adjusted FFO (AFFO).

Participants discussed efforts of REALpac to standardize the definitions of these measures yet acknowledged that inconsistency remains between reporting issuers. For instance, judgment is required to define things like: *normalized leasing costs* or *building improvements costs* and definitions will vary depending on the unique operations and circumstances at each company.

Participants considered whether attention should be focused on improving the consistency in reporting of KPIs for real estate companies from one period to the next. Also discussed was whether there is an opportunity for the auditor to provide audit assurance to the audit committee on the quality of

disclosure controls over KPIs, consistency of KPI definitions period over period and assurance over whether the KPIs are calculated in accordance with management's disclosed definition.

Properties under development

Participants discussed the significant judgment associated with estimating the fair value of properties under development and the challenges this creates for investors. One participant highlighted the lack of comparability this creates among real estate companies.

Developments in audit quality

CPAB overview

- CPAB has a risk-based file selection process focused on industry and reporting issuer risks.
- Continued need for audit firms to improve consistency of execution as many files show a high level of audit quality but others require significant improvement.
- Audit firms provide CPAB's significant inspection findings in writing to audit committees under the Protocol for Sharing Inspection Findings with Audit Committees (Protocol).
- CPAB seeks to increase awareness of audit quality matters among audit committees through one-on-one meetings and presentations and publications that assist them in their oversight role.

Relevance of the audit

- The focus of investors and equity analysts on other information outside of the financial statements (i.e., KPIs including non-GAAP measures) raises questions about the relevance of the audited historical financial information.
- CPAB held an Audit Quality Symposium¹ in May 2017 to further explore this matter. Three key messages emerged:
 - The belief of stakeholders that all information disclosed by reporting issuers is equally reliable represents an expectations gap that creates a risk to the capital markets.

- Auditors and audit committees have an opportunity to engage increasingly with information outside the financial statements to enhance its reliability and reduce the expectations gap.
- Transformational change is required to ensure there is continued confidence in the information that drives the capital markets and the audit remains relevant.

Audit Quality Indicators (AQIs)

- Use of AQIs can positively impact audit quality.
- CPAB sponsored a pilot project in 2016 with audit committees of six public companies to explore the usefulness of applying an AQI framework.
- No predefined set of AQIs was prescribed; pilot participants selected AQIs based on specific circumstances and areas of focus; significant variation in AQIs was observed across pilot participants. Context is important in understanding and use of AQIs.
- Participants commented that the greatest benefit of an AQI framework was the dialogue it encouraged among audit committees, audit firms and management.
- AQI pilot is continuing in 2017 with 19 participants.

¹ A summary of the Audit Quality Symposium: Earning Investor Confidence is available on CPAB's website.

Expanded auditor reporting

- Expanded auditor reporting under the International Standard on Auditing would include a requirement for auditors to describe **key audit matters** (KAMs) that were of most significance in the audit.
- The PCAOB's expanded auditor reporting standard, approved by the SEC on October 13, 2017, requires the reporting of **critical audit matters** in the US for calendar-year large accelerated filers for audits of 2019 financial statements and 2020 financial statements for all other calendar-year companies.
- In Canada, the Auditing and Assurance Standards Board's (AASB) new auditor reporting standards currently treats the reporting KAMs as voluntary unless reporting is required by law or regulation. The voluntary reporting of KAMs may be reconsidered by the AASB now that the SEC has approved the PCAOB's auditor reporting standard.
- Audit committees in Canada are encouraged to discuss the impact of expanded auditor reporting with their auditors.

Audit partner perspectives on areas of audit focus

Ciro DeCiantis presented areas of focus in audits of real estate companies. Key areas include:

- **Investment property valuation / impairment** with a focus on:
 - Key inputs and assumptions used by management with a view to valuation methodology and asset type (i.e., residential, office, industrial, etc.).
 - Whether valuations are performed in-house or by third-party valuation experts.
 - Quality of internal controls.
 - Consideration of current and intense disruptive forces and their impacts on valuations.
- **Tax balances**
 - Ensuring REIT Exception status has been maintained throughout the year.
 - For entities in corporate entities, consideration of tax accounting given complexity of structures.
- **Joint arrangements**
 - Joint operations (i.e., co-ownerships) versus equity accounted joint ventures
- **Related party transactions**
 - Appropriateness, measurement, disclosure, and strength of corporate governance.

Thank You

CPAB thanks everyone for their participation. We encourage ongoing dialogue and look forward to continuing the audit quality discussion at future Industry Forum Series events across Canada.

Learn More

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