PCAOB
PUBLIC COMPANY ACCOUNTING OVERSIGHT BOARD

SPOTLIGHT

Auditing Considerations Related to Commercial Real Estate

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OVERVIEW

Economic downturns in certain industries, and changes in patterns of work, may have affected the use and valuation of commercial real estate (CRE). Combined with higher interest rates, this has generated concerns among financial institutions and other companies in many industries with CRE exposure. In December 2023, the Financial Stability Oversight Council (FSOC) of the U.S. Treasury released its 2023 Annual Report ("Annual Report"), which includes, among other things, the FSOC's assessment of current market vulnerabilities that contribute to financial stability risks. The report included a discussion of vulnerabilities related to CRE, specifically exposure to CRE debt (i.e., debt secured by CRE). On February 6, 2024, Janet L. Yellen, the Secretary of the Treasury and Chair of the FSOC, gave testimony to the House Financial Services Committee regarding the Annual Report and the risks described therein, which include CRE.

CRE debt is held primarily by banks and thrifts, but also by insurance companies and other lenders or investors. Any entity with an interest in CRE may be impacted by the current market conditions. The assessment of credit quality of public companies that hold CRE debt and of real estate investment trusts (REITs) may have also been negatively affected by these trends. Public companies in the real estate sector often require high levels of financing and may face challenges in obtaining new debt or refinancing existing debt due to high interest rates, and tightening credit due to falling demand for commercial space. These conditions mean that the assumptions underlying CRE assets and financial instruments based on real estate or loans, collateralized by such assets, are areas of increasing audit risk and require heightened auditor skepticism.

As part of the PCAOB's strategic objective of enhancing inspections and improving audit quality by delivering useful guidance to the audit profession, we are providing this Spotlight to highlight important considerations and examples for auditors relating to CRE, as they plan and conduct audits and reviews of interim financial information. Other stakeholders may find the information regarding potential issues and risks helpful.

CURRENT INDUSTRY ENVIRONMENT

CRE Vulnerabilities

As discussed further in the Annual Report, hybrid or remote work arrangements in many industries following the COVID-19 pandemic have reduced demand for office space, and many office property values have decreased as a result; the same may be true for retail space in surrounding neighborhoods. Higher interest rates have exacerbated declining property values of CRE by increasing initial financing and refinancing costs for borrowers.

Given these factors, the CRE industry faces vulnerabilities, which include:

- Defaults on commercial mortgages that could impact originators, mortgage servicers, securities purchasers, and providers of risk mitigation products (the ecosystem).
- Unusually competitive rental rates and/or lease incentives.
- Declining property values.
- A substantial volume of office property loans reaching maturity, without a market to refinance such loans.

Other challenges that may arise from the current environment include the following:

- The risk that the impact of these CRE market conditions may also spread to nearby retail space.
- Reduced desirability of living, socializing, and working in densely populated urban mixed-use centers, which may have long-term effects on such CRE.

The financial statements of public companies with exposure to CRE, including owners, lenders, lessors, holders of CRE-backed securities, mortgage servicers, property managers, and others in the ecosystem, may have a risk of material misstatement as a result of these conditions. These risks are likely to vary among public companies and industries. These effects may be longer lasting for some but only temporary for others.

Implications

CRE loans represent a significant portion of the assets of many banks and thrifts, and potential weakness in the real estate market may increase the complexity of valuation assumptions related to these loans and the associated allowances. Commercial mortgage-backed securities[1] (CMBS) are a significant asset for many institutional and other investors. While CRE vulnerabilities may pose the greatest challenge to financial institutions with direct exposure to CRE through their lending activities, these vulnerabilities could potentially affect other public companies and investors in CMBS.

The valuation assumptions of long-lived assets held by REITs and other public companies involved in real estate, such as residential developers, may also become more complex due to fluctuations in interest rates and changes in office space usage as hybrid work becomes part of many companies' normal occupancy models and uncertainty continues regarding long-term operating models.

Considerations for Auditors

When market vulnerabilities, including interest rate volatility, are present, a public company's industry and environment, including factors specific to the public company, may change quickly. As a result, knowledge obtained from past audits or interim reviews may no longer be as relevant. It is important for the auditor to understand how changes in the public company's industry, environment, and activities may affect risks of material misstatement and whether those changes give rise to other risks.

As the conditions in the CRE industry and its environment evolve, auditors are encouraged to monitor market developments and the potential for broader economic issues that could, in turn, affect a wider group of public companies, as noted above. When performing risk assessment procedures and designing and implementing audit responses, auditors are required to comply with PCAOB standards and exercise due professional care and professional skepticism. Planning is not a discrete phase of an audit but, rather, a continuous and iterative process that might begin shortly after (or in connection with) the completion of the previous audit and that continues until the completion of the current audit.

PCAOB staff provides the reminders and examples below for consideration by auditors and others on applying specific PCAOB requirements in light of the current CRE industry and environment.

[1] Fixed-income investments backed by mortgages on commercial properties.

AUDIT AND INTERIM REVIEW CONSIDERATIONS

Identifying and Assessing Risks

Auditors have a responsibility to (1) identify and assess risks of material misstatement, due to error or fraud and (2) design and implement overall audit responses that address those risks. Risks of material misstatement can arise from a variety of sources and have a further reach than solely the CRE owner and mortgagor. Banks holding mortgages with or without collateralization in the CRE, lessors of CRE, CMBS investors, CRE mortgage servicers, property managers, and others in the ecosystem may be affected. It is important for auditors to consider the quickly changing environment while performing risk assessment procedures during planning, and also iteratively through completion of the audit. Below are some example questions for consideration, as applicable depending on the particular facts and circumstances of the company under audit, related to the current CRE industry and environment:

1. How have interest rates affected the ability of the borrower to make repayment?
2. Would lower occupancy rates affect the ability of the borrower to make repayment?
3. Does the property depend on a limited number of tenants?
4. Are significant tenants experiencing financial difficulties or deciding not to renew their leases or deciding to reduce the square footage they are leasing?
5. How have interest rates affected the mortgaged property's value?
6. Would lower occupancy rates affect the mortgaged property's value?
7. Do advances in technology, such as ecommerce and self-service, impact the property's value or desirability to lessees and, as such, the marketability of the commercial space as currently configured? Can the property be economically reconfigured for other purposes?
8. Will evolving real estate needs and lessee preferences affect lease renewals?
9. Are significant portions of the property's tenants reaching lease maturity? If so, what are the prospects for renewals or new tenants?
10. Have there been significant lease terminations?
11. Have assumptions regarding lease renewals changed?
12. Have current conditions decreased the value of collateral?
13. Are borrowers either not meeting, or at risk of not meeting, covenant requirements?
14. Are borrowers able to refinance without a significant capital investment?
15. Have collectability issues concerning lease payments increased?
16. Is a lender's allowance for credit losses still reasonable given changes in the market?
17. Has CRE distress in the borrower's market resulted in tightened credit availability?
18. Could the lender's exposure to CRE result in liquidity issues and a reduction in CRE lending and/or refinancing should the CRE slowdown persist or worsen?
19. Is the ability of the public company to continue as a going concern at risk?

20. How have pricing and trading volume of CMBS affected investments held by the public company?

21. How have defaults on underlying mortgages impacted CMBS investments?

22. If the public company is a REIT, do conditions subject the public company to any tax-related risks or impair its ability to preserve its qualification as a REIT?

We encourage you to read our Spotlights – "Staff Priorities for 2024 Inspections and Interactions With Audit Committees" and "Professional Competence and Skepticism Are Essential to Quality Audits" - for other reminders and considerations.

Fraud Risks

The current conditions in the CRE industry and environment may also create opportunities, incentives, and pressures to commit fraud. For example, the management of a public company may be motivated to use unrealistic assumptions regarding collateral values, lease renewals, potential new tenants, the ability to refinance a loan, and/or required leasehold improvements necessary to attract or retain tenants. The engagement team may consider procedures to obtain and inspect appraisals of collateral and to make direct inquiries, in addition to written confirmation, with major lessees to corroborate assumptions being used by the public company. Communication among engagement team members about significant matters such as those affecting the risks of material misstatement involving CRE, whether due to error or fraud, should continue throughout the audit, including when conditions change. These factors highlight the importance of exercising professional skepticism when reviewing assumptions.

Planning and Performing Audit Procedures

Asset Impairment and Allowance for Credit Losses

When testing the public company's process for developing accounting estimates, PCAOB standards require auditors to evaluate the reasonableness of significant assumptions used, including whether the public company has a reasonable basis for those significant assumptions, and whether the assumptions are consistent with industry, regulatory, and other external factors, including economic conditions. The current conditions in the CRE industry and environment may affect a number of accounting estimates. Such conditions may give rise to triggering events or other indicators of impairment of the value of a public company's long-lived assets, including CRE. As conditions change, auditors may need to direct additional audit effort to evaluating the reasonableness of cash flow projections and other significant assumptions used by the public company in its impairment analyses to determine whether impairment is appropriately recognized, and impairment charges are not understated or overstated.

Allowance for credit losses could be affected when, for example, a public company has significant exposure to loans collateralized by underlying CRE or CMBS investment holdings, particularly with interest rate changes and changes in the way companies plan their office space requirements.

Going Concern

Auditors may identify conditions and events in the CRE industry and environment, giving rise to substantial doubt about the ability of a company to continue as a going concern for a reasonable period of time (not to exceed

one year beyond the date of the financial statements being audited). In addition, as conditions continue to change, management's initial plans to alleviate substantial doubt may no longer be viable. Under U.S. and international financial reporting frameworks, the continuation of a company as a going concern is presumed as the basis for preparing financial statements unless and until the company no longer reports under this basis, such as by changing to the liquidation basis of accounting. Preparation of financial statements under this presumption is commonly referred to as the going concern basis of accounting. The auditor is required to evaluate a company's ability to continue as a going concern under both federal securities law and PCAOB auditing standards.

Interim Review Considerations

Auditors are required to have sufficient knowledge of the public company's business and its internal control environment when planning and performing reviews of interim financial information to meet the objectives set out in PCAOB standards. New information or changes in circumstances may arise from one quarter to the next. Understanding the entity's business and its internal controls drives meaningful analytics. Examples of metrics used in analytics might include occupancy rate, turnover, lease-renewal rate, expected lease-renewal rate, loan-to-value ratio, and default rates, among others.

If, in performing a review of interim financial information, the auditor becomes aware of information that leads the auditor to believe that the interim financial information may not be in conformity with the applicable financial reporting framework, the auditor is required to make additional inquiries or to perform other procedures considered appropriate to provide a basis for communicating whether they are aware of any material modifications that should be made to the interim financial information. For example, inquiries about changes in a public company's business activities or financial condition may necessitate additional inquiries or other procedures, including, when applicable, inquiries concerning the public company's ability to continue as a going concern and events occurring subsequent to the date of the interim information. Changes in judgments regarding materiality may also affect the planning and performance of reviews of interim financial information.

The auditor is also responsible for making inquiries about whether significant changes in internal control (for example, as it relates to preparation of interim financial information) have occurred subsequent to the preceding year-end audit or prior review of interim financial information that may require disclosure of the changes in internal control over financial reporting in order for management's certifications to be accurate and to comply with the disclosure requirements. These inquiries include changes to the public company's policies (for example, this may include how a forecast is performed), procedures, and personnel, as well as the nature and extent of such changes.

COMMUNICATIONS WITH AUDIT COMMITTEES

The current conditions in the CRE industry and environment may necessitate increased communications between auditors and audit committees. For example, management may make changes to certain accounting policies, practices, or estimates as a result of the current industry and environment. These changes in turn may affect the planned audit strategy. The auditor should communicate to the audit committee significant changes to the planned audit strategy, or the significant

risks initially identified and the reasons for such changes, among other things. In addition to the required communications to the audit committee, auditors are also reminded of their responsibility to obtain information relevant to the audit from the audit committee. For example, auditors are required to inquire of the audit committee about the risks of material misstatement, including fraud risks.

In addition, these current conditions may be relevant to an auditor's determination of whether a matter is a critical audit matter (CAM) and if so, may also be relevant to the auditor's communication of that CAM.

EVALUATING THE RESULTS OF THE AUDIT

In closing, auditors are reminded of their responsibility to take into account all evidence obtained when evaluating the results of the audit, including information regarding potential bias in management's judgments about the amounts and disclosures in the financial statements. Examples of forms of management bias include bias in accounting estimates (considered individually and in the aggregate), bias in the selection and application of accounting principles, the selective correction of misstatements identified during the audit, and identification by management of additional adjusting entries that offset misstatements accumulated by the auditor. If the auditor identifies bias in management's judgments about the amounts and disclosures in the financial statements, the auditor should evaluate whether the effect of that bias, together with the effect of uncorrected misstatements, results in material misstatement of the financial statements. Also, the auditor should evaluate whether the auditor's risk assessments – including, in particular, the assessment of fraud risks – and the related audit responses remain appropriate.

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