



## **Item 3: Committee Education on Financial Statement Materiality and Disclosure**

*Sean Taylor*  
Controller

Finance & Audit Committee Meeting

ERCOT Public  
April 18, 2016

# Committee Education on Financial Statement Materiality and Disclosure

- Agenda
  - Materiality
  - Leases Accounting Standards Update (ASU)
  - Audit Committee Oversight of External Auditors

# Materiality

# Materiality



(Getty Images-Rob Carr)

# What is Materiality?

*FASB Statement of Financial Accounting Concepts 2 (CON 2): Qualitative characteristics of accounting information defines materiality as:*

“The magnitude of an omission or misstatement of accounting information that, in the light of surrounding circumstances, makes it **probable** that the judgment of a **reasonable person** relying on the information would have been **changed or influenced** by the omission or misstatement.”

# Determining Materiality

Primarily  
Quantitative

Qualitative

Large Enough  
to Influence

Relative vs.  
Absolute

Normality

Context

Cost - Benefit

**CONTINUOUS JUDGMENT**

# Quantitative guidelines applied to ERCOT

Typical Base Quantitative Guidelines	2015 ERCOT Financials (M=Millions)	Computed Quantitative Materiality
<b>½ - 2% of total revenue or total expenses for <u>not-for-profits</u></b>	<b>\$181 M revenue \$181 M expenses</b>	<b>\$0.9 M - \$3.6 M \$0.9 M - \$3.6 M</b>
½ - 1% of total revenue	\$181 M	\$0.9 M - \$1.8 M
½ - 1% of total assets	\$811 M	\$4.1 M - \$8.1 M
3 - 5% of net income (normalized)	N/A for not-for-profits	N/A
2 - 5% of current assets (CA) or current liabilities (CL)	\$693 M CA \$740 M CL	\$13.9 M - \$34.6 M \$14.8 M - \$37.0 M



# Pending Materiality Guidance

## Proposed ASU (Topic 235) Assessing Whether Disclosures Are Material

- Issued September 24, 2015
- Objective: improve effectiveness of disclosures in the notes to financial statements
- Amendments to Topic 235 by proposed ASU:
  1. State that materiality is applied to quantitative and qualitative disclosures individually and in the aggregate in the context of the financial statements taken as a whole; therefore, some, all, or none of the requirements in a disclosure section may be material.
  2. Refer to materiality as a legal concept.
  3. State specifically that an omission of immaterial information is not an accounting error.

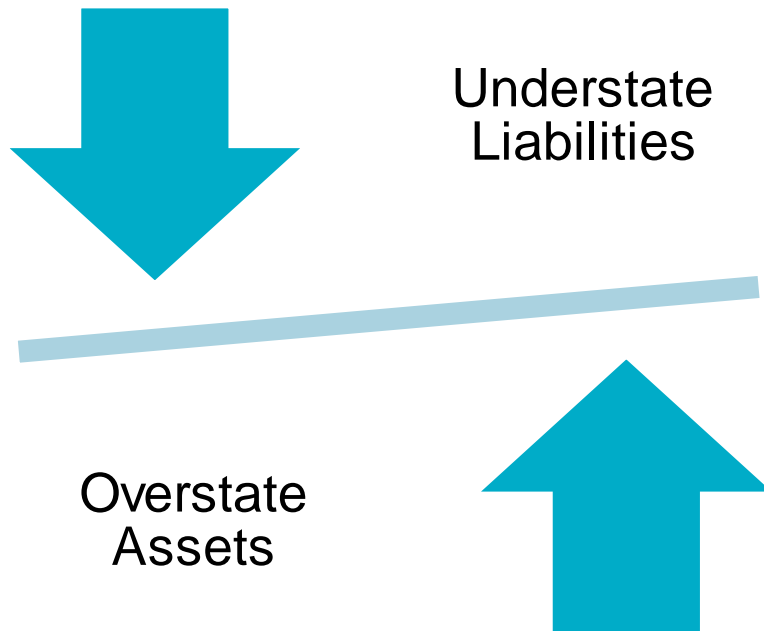


# Leases Accounting Standards Update (ASU)

# FASB ASU 2016-02: Leases (Topic 842)

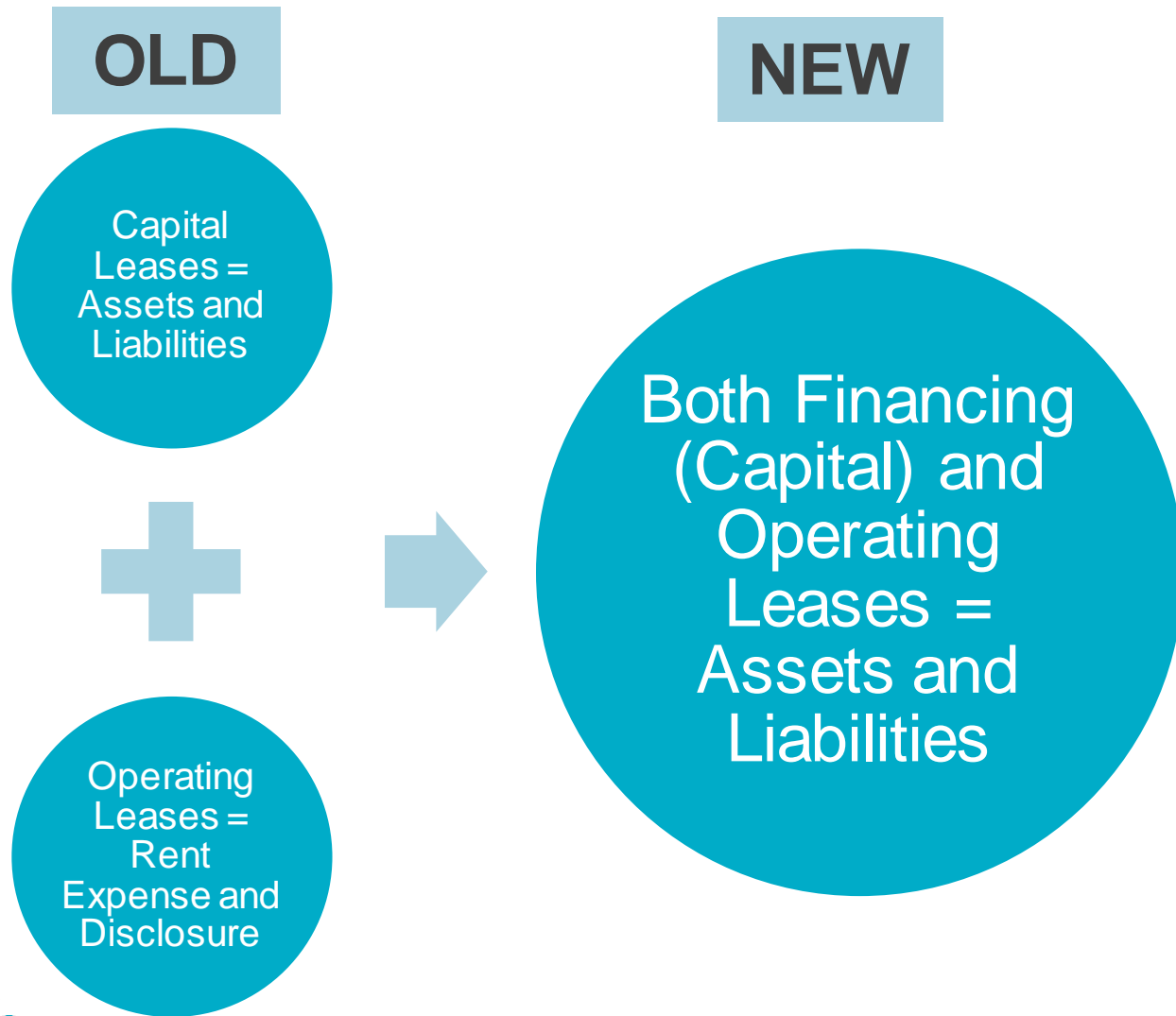
- Released February 2016
- Convergence project between the Financial Accounting Standards Board (FASB) and the International Accounting Standards Board (IASB)
- Objective:
  - Increase transparency
  - Increase comparability among organizations by recognizing lease assets and lease liabilities on the balance sheet and disclosing key information about leasing arrangements
  - Improve financial reporting
- Effective date (can early adopt)
  - Fiscal years beginning after December 15, 2018 (public companies)
  - Fiscal years beginning after December 15, 2019 (nonpublic)

# Which type of risk do you prefer to avoid on the balance sheet?



*Could change the intended use of financial ratios and other measurements used for debt covenants or other commitments.*

# Eliminates Lease Off-Balance-Sheet Financing



# ERCOT Lease Obligations – December 31, 2015

Minimum payments due (\$ in thousands)	
2016	\$ 439
2017	395
2018	387
2019	380
2020	374
Thereafter	454
Total minimum lease payments	\$ 2,429

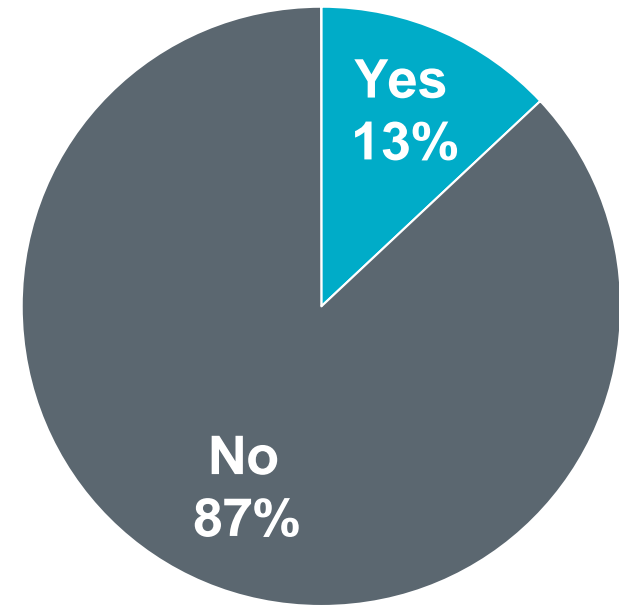
*\$2.4 million is approximately 0.3% of ERCOT's total assets. Moving these leases has minimal impact to ERCOT's balance sheet.*

# Compliance Recommendations

*(Journal of Accountancy)*

- Start right away
- Update lease inventories
- Review legal agreements and debt covenants
- Maintain transparency with stakeholders
- Evaluate leasing processes
- Identify cost savings
- Review system requirements
- Reach out for help

*Does your company have a clear plan for implementing the new leases standard?*



Source: KPMG's 25<sup>th</sup> Annual Accounting & Financial Reporting Symposium

# Audit Committee Oversight of External Auditors

# The Audit Committee Collaboration

- The Audit Committee Collaboration is a partnership of nationally recognized U.S. corporate governance and policy organizations that work together to expand audit committee member access to useful tools and materials with the goal of strengthening audit committee performance and transparency.
- Originated in 2012.
- Partnership includes the Center for Audit Quality which is affiliated with the American Institute of CPAs.





# A Call to Action

- Enhancing the Audit Committee Report – A Call to Action
  - The Audit Committee Collaboration encourages all public company audit committees to thoughtfully reassess their reporting and communication with stakeholders and, if need be, to strengthen them in the future.
- Leading disclosure examples pulled from proxy statements that provide benchmarks for other audit committees.
  - Clarify the scope of the audit committee’s duties
  - Clearly define the audit committee’s composition
  - Provide relevant information about:
    - Factors considered when selecting or reappointing an audit firm
    - Selection of the lead audit engagement partner
    - Factors considered when determining auditor compensation
    - How the committee oversees the external auditor
    - The evaluation of the external auditor

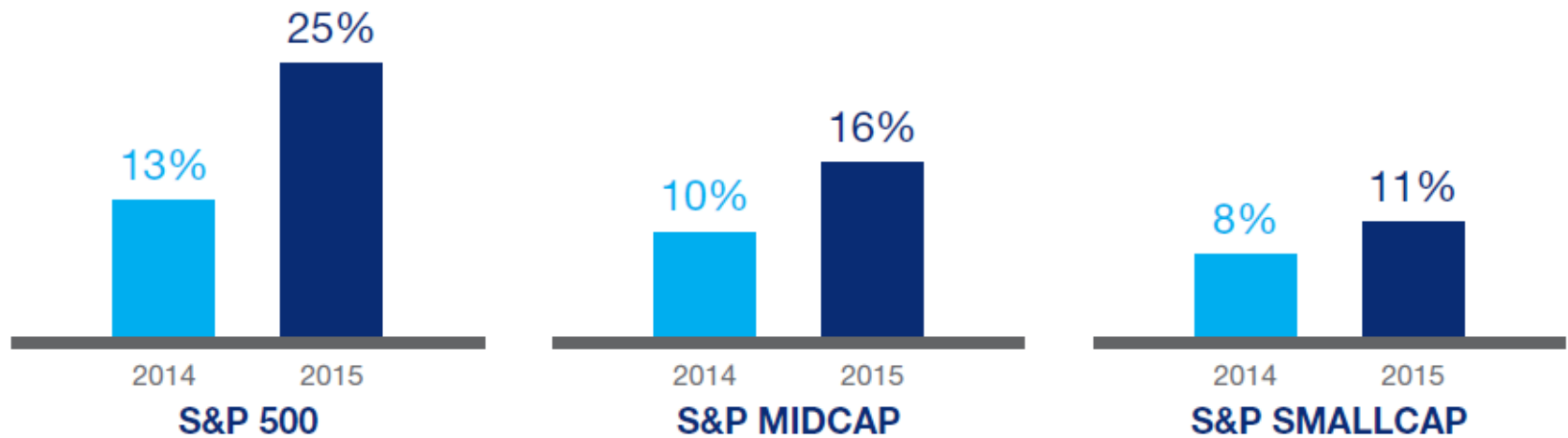
# The Audit Committee Collaboration Resources

- **Audit Committee Transparency Barometer**
  - Published jointly by the Center for Audit Quality and Audit Analytics, the Audit Committee Transparency Barometer presents findings from extensive analysis of audit committee disclosures in proxy statements, measuring the robustness of these disclosures among S&P Composite 1500 companies.
- **External Auditor Assessment Tools (US and Worldwide)**
  - Designed to assist audit committees in evaluating the external auditor to assess the quality of the audit, or select or recommend the retention of the audit firm.
- **SEC Disclosure Concept Release**
  - Outlines important considerations for audit committees regarding the SEC's 2015 Audit Committee Disclosure Concept Release.
- **PCAOB AQI Concept Release**
  - Outlines important considerations for audit committee members regarding the Public Company Accounting Oversight Board's 2015 Audit Quality Indicator Concept Release.

<http://www.auditcommitteecollaboration.org/resources.html>

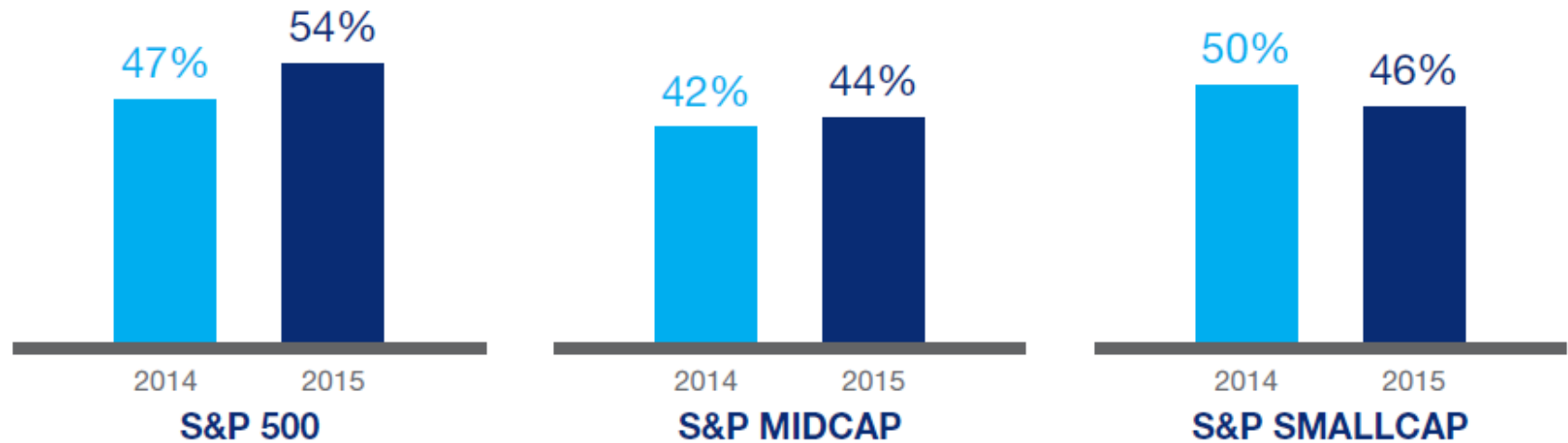
# 2015 Audit Committee Transparency Barometer

Figure 1: Audit Committee's Considerations in Appointing Audit Firm



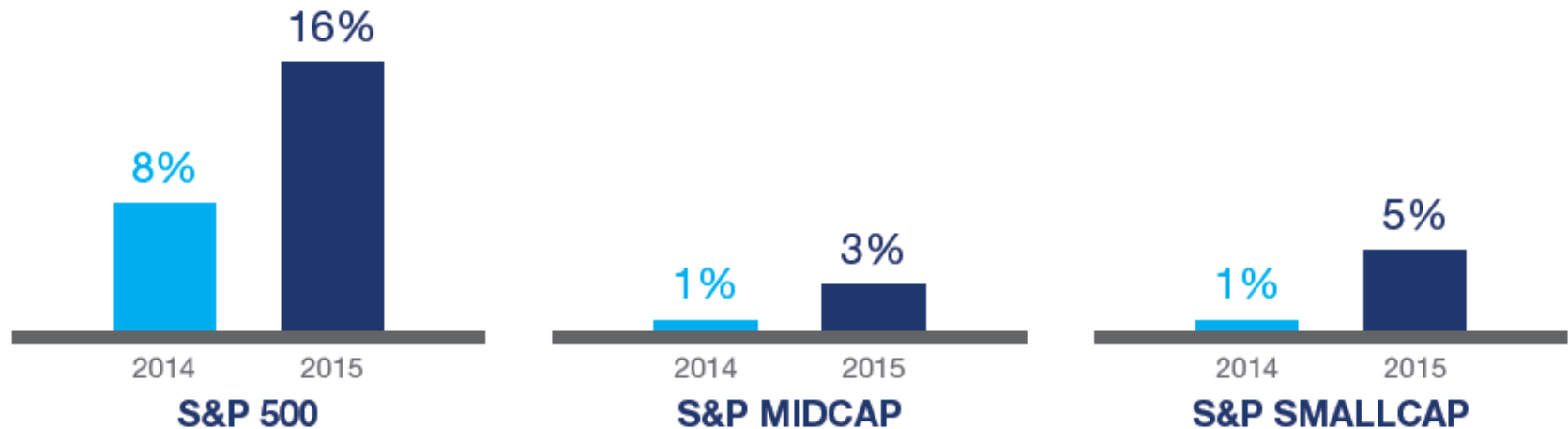
# 2015 Audit Committee Transparency Barometer

Figure 2: Disclosure of Length of Time Audit Firm Engaged



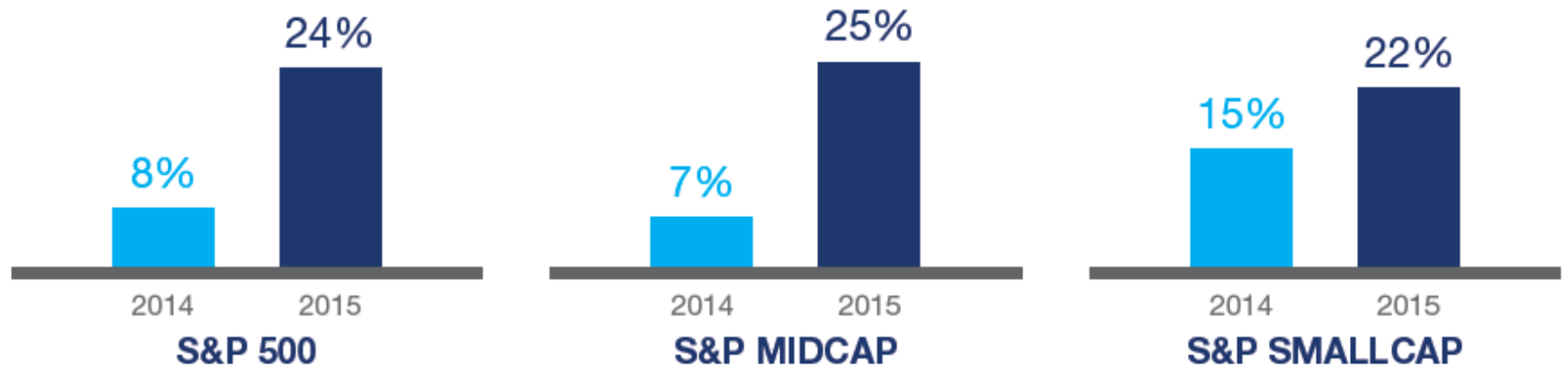
# 2015 Audit Committee Transparency Barometer

Figure 3: Audit Committee Responsible for Audit Firm Compensation



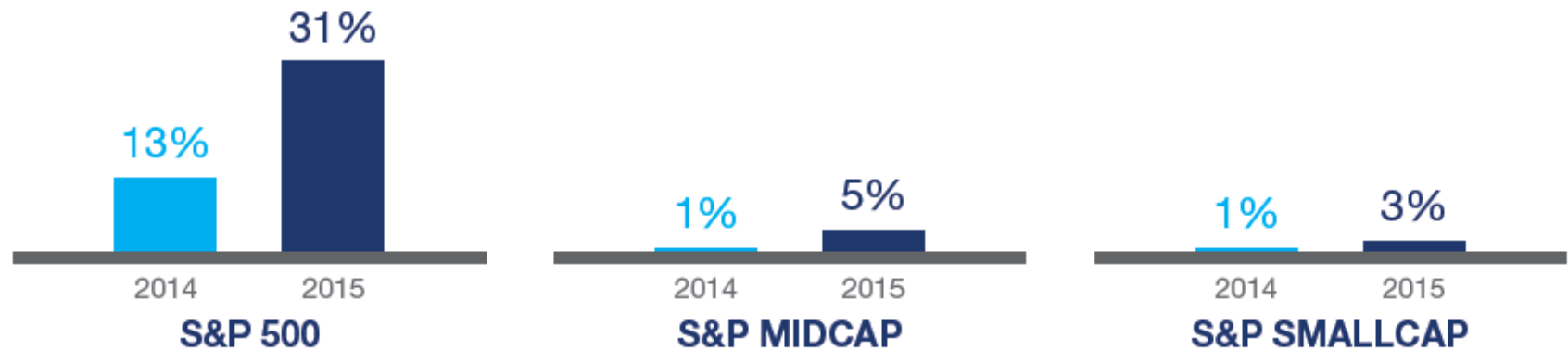
# 2015 Audit Committee Transparency Barometer

Figure 4: Discussion of Criteria Considered When Evaluating Audit Firm



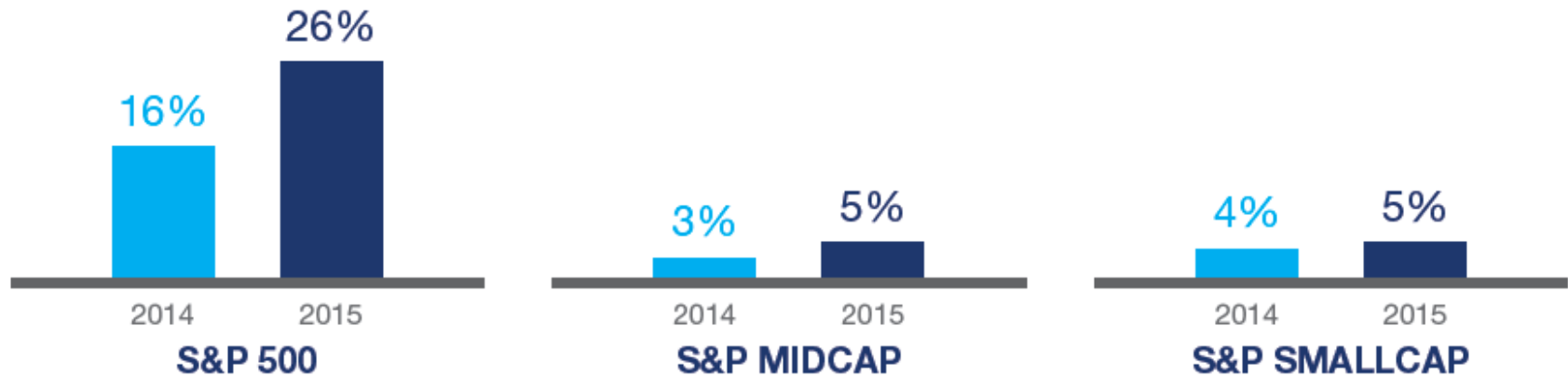
# 2015 Audit Committee Transparency Barometer

Figure 5: Statement That Audit Committee Is Involved in Audit Partner Selection



# 2015 Audit Committee Transparency Barometer

Figure 6: Statement That Audit Partner Rotates Every Five Years





# Audit Committee Oversight of External Auditors

- Tools and other resources to aid audit committees continue to evolve
- While still not pervasive, more public company audit committees appear to be providing disclosures about their roles
- Disclosure is voluntary

# Questions?