



### **Item 3: Committee Education on Current Issues Confronting Finance and Audit Committees: New Auditor Reporting Standard**

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# ERCOT Audit Committee Educational Session October 7, 2019



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## Brian P. Collins, CPA, MBA

- Audit partner; member of firm's professional practice group
- Member of the Professional Practice Executive Committee of the CAQ
- Member of the PCAOB Data and Technology Task Force
- Chaired the Assurance Services Executive Committee / Audit Standards Board Audit Analytics Guide Task Force
- Former member of the AICPA's Technical Issues Committee of the Private Companies Practice Section





## New Auditor Reporting Standard

*AS 3101, The Auditor's Report on an Audit of Financial Statements When the Auditor Expresses an Unqualified Opinion*





## Topics

Overview: AS 3101, The Auditor's Report on an Audit of Financial Statements When the Auditor Expresses an Unqualified Opinion

Report format changes

What is a critical audit matter (CAM) and how are they determined? When is it effective?

Things to consider



## Overview: AS 3101

In 2017, the PCAOB adopted a new auditing standard aimed at making the auditor's report more relevant and informative for investors and other financial statement users.

The new standard:

- Retains the pass/fail audit opinion;
- Standardizes the format of the auditor's report;
- Adds additional independence and other language, and
- Requires communication of CAMs for most entities.





The standard requires an auditor's reports to include:

1

Statement that auditors are required to be independent

2

The phrase 'whether due to error or fraud' in the description of the auditor's responsibilities to obtain reasonable assurance

3

Information on auditor tenure

4

Discussion of CAMs

1 through 3 have already been implemented




# Overview

CAMs not required for audits of:  
Brokers and dealers  
Registered investment companies (other than BDCs)  
Employee benefit plans  
Emerging growth companies (but may be reported voluntarily)







# What is a CAM and how are they determined?





# What is a CAM?

A CAM is any matter arising from the audit of an entity's financial statements that meets all of the following criteria:

A matter that was communicated or is required to be communicated to the audit committee

A matter that relates to accounts or disclosures that are material to the financial statements; and

A matter that involved especially challenging, subjective or complex auditor judgment





In determining whether a matter involved especially challenging, subjective or complex auditor judgment, the auditor is required to take into account, alone or in combination, factors including:

- I Auditor's assessment of the risks of material misstatement, including significant risks
- II Degree of auditor judgment related to areas in the F/S that involved the application of significant judgment or estimation by management, including estimates with significant measurement uncertainty
- III Nature and timing of significant unusual transactions and the extent of audit effort and judgment related to these transactions
- IV The degree of auditor subjectivity in applying audit procedures to address the matter or in evaluating the results of those procedures
- V Nature and extent of audit effort required to address the matter, including the extent of specialized skill or knowledge needed or the nature of consultations outside the engagement team regarding the matter
- VI Nature of audit evidence obtained regarding the matter



- The standard doesn't:
  - List required CAMs or
  - Set an expectation that certain items will be CAMs in all cases

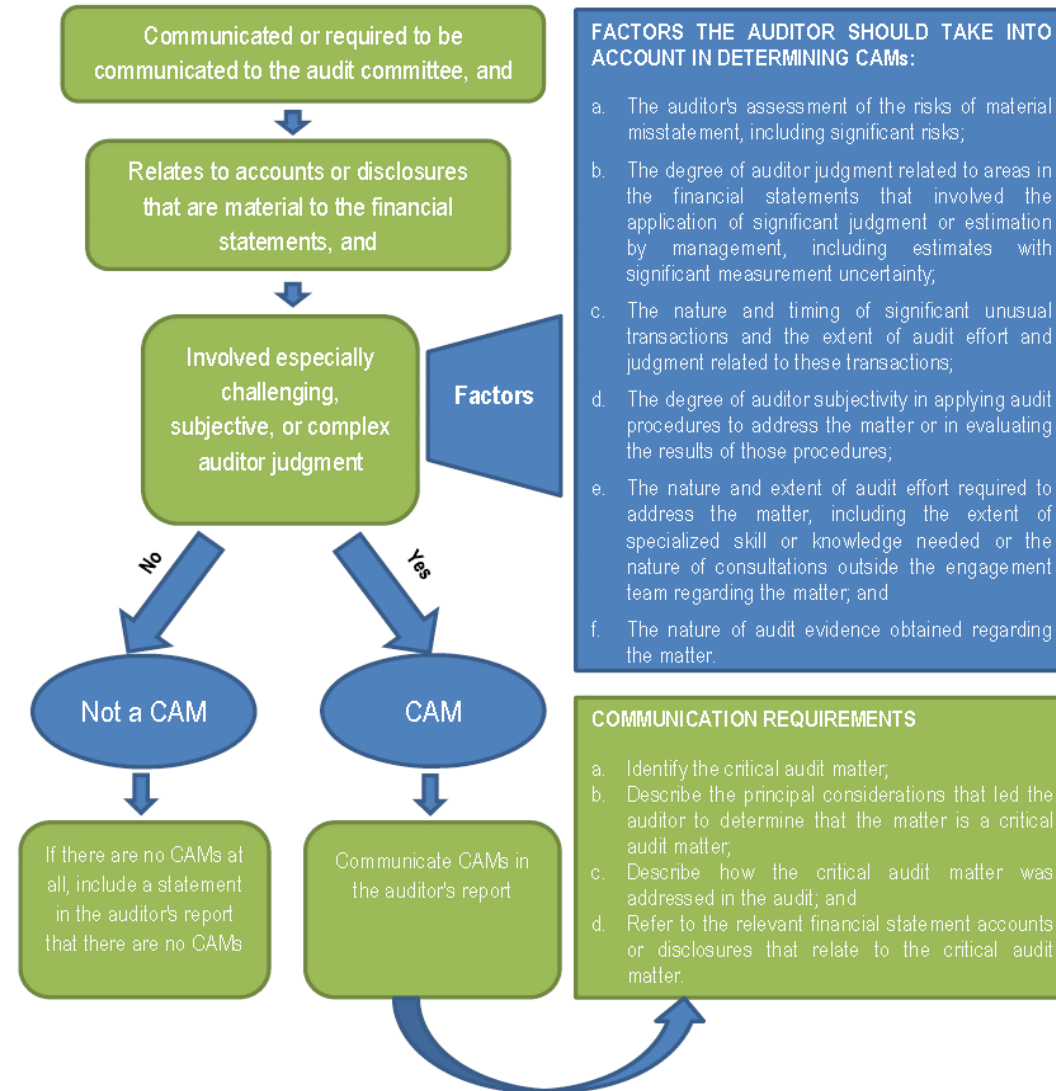
For example, while revenue recognition is presumed to be a fraud risk and all fraud risks are significant risks under PCAOB standards, a matter related to revenue recognition that did not involve especially challenging, subjective or complex auditor judgment will not be considered a CAM under the standard.



- The standard requires auditors to document their reasons for determining whether each matter communicated or required to be communicated to the audit committee is a CAM
- An auditor that does not identify any CAMs is required to include a statement to that effect in the 'Critical Audit Matters' section of the auditor's report.
- The PCAOB noted in the standard that it generally expects that, in most audits, the auditor will identify at least one CAM



# PCAOB's flowchart for determining and communicating CAMs





For each CAM, auditors are required to:

- I Identify the matter
- II Describe the principal considerations in determining that the matter was a CAM
- III Describe how the matter was addressed in the audit
- IV Refer to the relevant financial statement accounts or disclosures





Auditors could satisfy the requirement to describe how they addressed each CAM by:

- I Describing their response or approach that was most relevant to the matter
- II Providing a brief overview of procedures performed
- III Providing an indication of the outcome of those procedures
- IV Providing key observations with respect to the matter or
- V A combination of these elements



- The standard does not intend for the auditor to be the original source of information about the entity.
- In the adopting release, the PCAOB discussed the application of the standard to matters that don't relate to accounts or disclosures that are material to the financial statements and therefore cannot be CAMs. The discussion included examples related to matters shown on the following slide.



A potential loss contingency that was communicated to the audit committee but was determined to be remote and was not recorded in the financial statements or disclosed

A potential illegal act that the company wasn't required to disclose

The determination, by itself, that there is a significant deficiency in internal control over financial reporting



- The discussion of the items on the previous slide included in the adopting release should help mitigate the possibility that auditors might disclose original information
- The standard notes that the language used to communicate a CAM should not imply that the auditor is providing a separate opinion on the CAM or on the accounts or disclosures to which it relates
- It would not be appropriate for the auditor to use language that could call into question the auditor's responsibility for the CAMs or the auditor's opinion on the financial statements, taken as a whole



- Similar changes have already been made by other standard-setting bodies around the world. International Standards on Auditing (ISA) require discussion of key audit matters (KAMs) for periods ending on or after December 15, 2016
- The PCAOB's definition of a CAM is largely aligned with the ISA definition of a KAM, but there are differences that may result in different outcomes

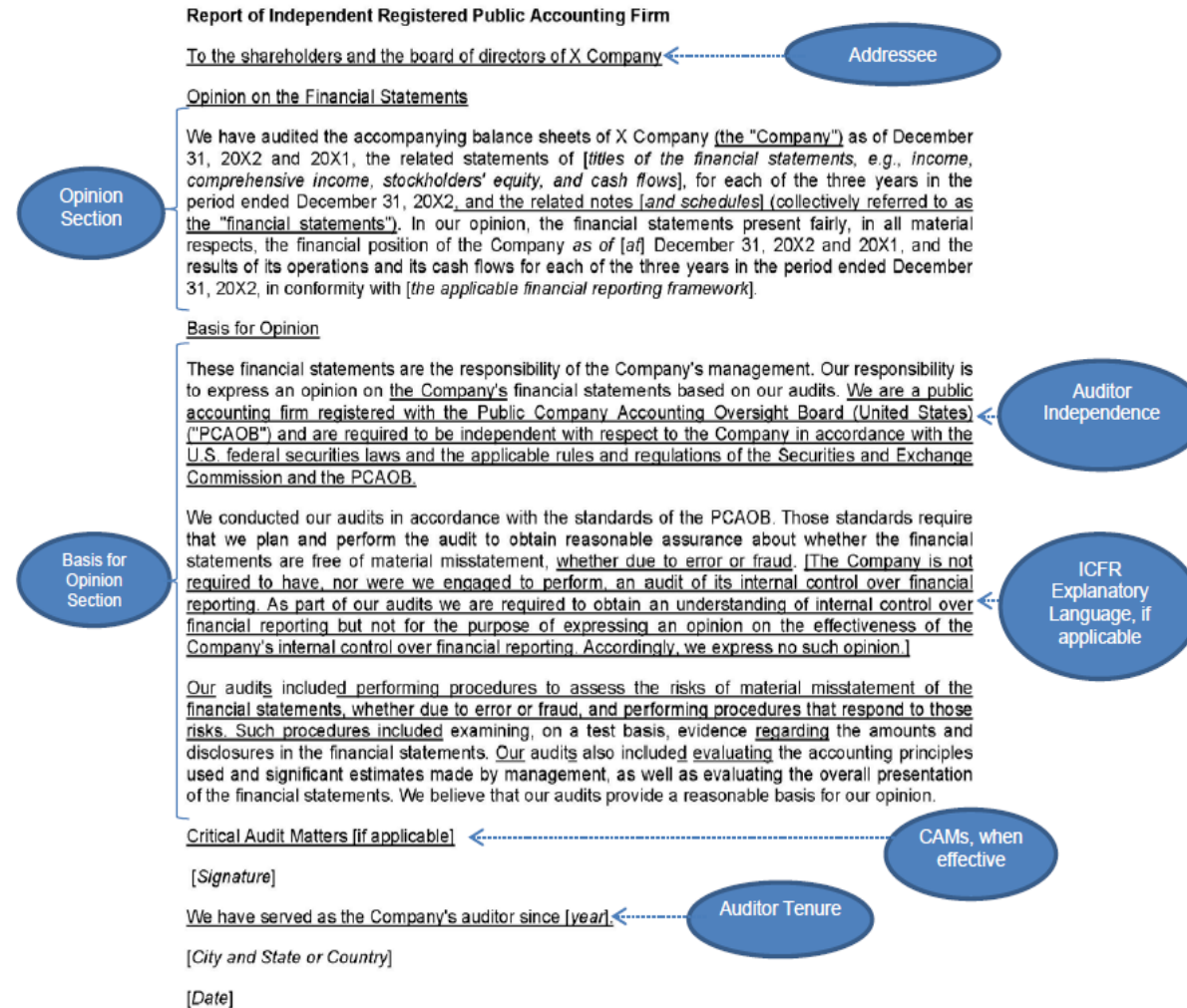


## Form of the Auditor's Report

- The standard requires the "**Opinion on the Financial Statements**" section to be the first section of the auditor's report, immediately followed by the "**Basis for Opinion**" section
- The standard does not specify an order for the remaining sections of the auditor's report, which would include explanatory paragraphs and critical audit matters
- The standard also required titles for all sections of the auditor's report to provide consistency and assist users in identifying the individual sections of the auditor's report



# Sample auditor's report





## Sample auditor's report – CAM

### Critical Audit Matters

The critical audit matters communicated below are matters arising from the current period audit of the consolidated financial statements that were communicated or required to be communicated to the audit committee and that: (1) relate to accounts or disclosures that are material to the consolidated financial statements and (2) involved our especially challenging, subjective, or complex judgments. The communication of critical audit matters does not alter in any way our opinion on the consolidated financial statements, taken as a whole, and we are not, by communicating the critical audit matters below, providing separate opinions on the critical audit matters or on the accounts or disclosures to which they relate.

We determined that our evaluation of the Company's estimate for unbilled revenue was a critical audit matter in the audit of the Company's consolidated financial statements as of and for the year ended December 31, 2019. Considerations that led to our determination included: (1) the complexity of the calculation; (2) the significant inputs and estimates used within the calculation; and (3) the calculation, inputs and estimates being subject to management bias.

Because of these considerations, our assessment of the Company's estimate for unbilled revenue: (1) involved subjective auditor judgments in evaluating whether management's judgments were adequately supported by relevant and reliable audit evidence and appropriate; (2) involved difficult auditor judgments in designing audit procedures to test the data underlying management's inputs and estimates used within the calculation; (3) required significant audit effort to perform our designed procedures to address the matter; and (4) posed challenges in obtaining sufficient appropriate evidence to support management's calculations due to the nature of the estimate.

The audit team (1) designed and performed audit procedures to adequately test management's inputs and estimates used within the calculation; (2) tested the operating effectiveness of internal control over financial reporting related to the determination of unbilled revenue; and (3) evaluated the results of our procedures including an assessment of the reasonableness of management's judgments in light of independent assessments. The Company's accounting policy for unbilled revenue is included in Note 2 to the consolidated financial statements.



When is it effective?



New auditor's report format, tenure, and other information: audits for fiscal years ending on or after **December 15, 2017**



Communication of CAMs for large accelerated filers: audits for fiscal years ending on or after **June 30, 2019**



Communication of CAMs for all other filers: audits for fiscal years ending on or after **December 15, 2020**



## Things to consider

- > Auditor's implementation plan
- > Nature and number of potential CAMs
- > Process and timing of review of CAMs with management and the audit committee
- > Company's consideration of potential questions from investors, regulators, etc. and whether their own disclosures are sufficient
  - Note: It remains the responsibility of management, with the oversight of the audit committee, to communicate relevant information to users about the entity and its financial performance, including providing adequate disclosures in accordance with the applicable financial reporting framework



A solid green horizontal bar.

## PREPARING FOR CAMS

Wes Bricker, on November 14, 2017:

“As part of getting started, I encourage auditors to update their methodologies, provide training, and, at the engagement team level, use the transition period to engage in dialogue with audit committees so that audit committees have time to understand the types of matters that may be communicated as critical audit matters in the audit reports.”



PARTIAL LIST OF CAMS FROM JUNE 30, 2019 FORM 10-KS

- > Goodwill impairment
- > Intangible asset impairment
- > Business combinations
- > Aspects of revenue recognition
- > Income taxes
- > Legal contingencies
- > Hard-to-value financial instruments



# Questions



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