One of the audit committee’s most critical functions is the oversight and review of financial reporting which requires the critical review of voluminous documents filled with complex accounting and reporting matters. Whether or not you’re a financial expert, you should understand the basic components of the company’s financial close process and the key financial reporting matters and related judgments.
A brief history

Oversight of a company’s financial reporting is one of the audit committee’s most critical responsibilities. For public companies, that includes the quarterly Form 10-Q and annual Form 10-K filed with the SEC and also the earnings release, which may not be filed concurrently with the 10-Q and 10-K. But there can be challenges:

• The press release and the filing document can be long and the issues complex.

• Audit committees typically have limited time to review the drafts and other materials prior to the audit committee meeting.

Are there techniques to help audit committees review reported results effectively? Are there ways the entire process can be more efficient? The answer to both questions is yes. Here are some ideas to help.
What should you know before you start reviewing?

Understanding the financial reporting process

To be better prepared to review financial information, having a firm understanding of the company’s financial reporting process is important. Here are a few areas to consider:

Disclosure controls and procedures

Public companies are required to maintain disclosure controls and procedures (DC&P). The CEO and CFO are required to certify the effectiveness of DC&P quarterly. DC&P controls include all controls relating to the preparation of Exchange Act documents. It is broader than internal controls over financial reporting. (For more information on DC&P, read our Disclosure committee essentials publication.)

Audit committees should understand how management maintains DC&P and supports the quarterly certifications. This understanding can be particularly important when it comes to information not typically covered by the company’s internal control over financial reporting, such as non-GAAP measures that are not included within the financial statements. (For more information about audit committee oversight of non-GAAP measures, read our To GAAP or non-GAAP? The SEC is watching publication.)

The closing process—how difficult is it?

At the end of each reporting period, there are a series of processes to accumulate financial data across the company and transform it into financial information to be reported to the public. Highly-automated processes may result in a faster close and have less risk of error, but committees still need to understand if overrides to the systems or processes are possible and where they might occur. Audit committees should ask about any significant adjustments (most likely through manual journal entries) management made late in the closing process. These can be red flags for higher risk of error or potential fraud. The audit committee should also ask about any changes in personnel key to the close process (e.g., controller) and how those changes (e.g., personnel may have been on vacation, changed roles in the company or left the company) were managed to ensure that the closing process operated as designed.

The committee could also consider asking what adjustments management determined not to make (i.e., what was deemed immaterial).
Key estimates and complex accounting areas—taking the “deep dive”

Management uses varying degrees of judgment in developing estimates as inputs in scenario modeling or to record estimates that impact reported results. Audit committees should understand key estimates and how they were developed. This typically requires a robust discussion about the judgment/estimation process, key inputs to determining estimates, the sensitivity of changing an input and management’s historical accuracy. Audit committees should also consider when and how the external auditors should be part of the discussion.

Certain areas of a company’s accounting and reporting may be more complex (e.g., revenue recognition, warranty liabilities or accounting for income taxes). Companies should consider providing their audit committee with a “deep dive” into higher risk areas periodically. Such a “deep dive” can also be helpful when onboarding new directors.

Materiality—what’s the big deal?

Management uses materiality in a number of ways, including the evaluation of the extent of disclosures and control deficiencies, and determining whether a restatement needs to occur. Materiality also is important in how external auditors plan the audit, determine whether audit adjustments should be recorded and evaluate control deficiencies. Because materiality often involves significant judgment, the audit committee should understand management and the external auditor’s materiality considerations and framework.

Internal control over financial reporting—worth a second look

The Sarbanes-Oxley Act requires certain public companies and their auditors to report on the effectiveness of internal control over financial reporting each year. Any significant deficiencies or material weaknesses are required to be reported to the audit committee. Because companies’ internal controls are embedded in processes that generate the financial statements, the audit committee needs to be comfortable with management’s process, the results of management’s and the external auditors’ testing, and evaluation of the significance of control deficiencies and management’s remediation plans.
Related party transactions—did any take place?

Typically, review of related party transactions occurs at the board level by the audit committee. No matter where it sits, directors should have a process and policy established to outline how related party transactions are identified and approved. Companies that are listed on the New York Stock Exchange also have to comply with specific requirements to review each related party transaction. NYSE suggests it be the “Audit Committee or another comparable body in its Listed Company Manual.” In 2014, the PCAOB released Auditing Standard 18: Related Parties (superseded by AS 2410), which requires auditors to evaluate the company’s process for identifying, accounting for and disclosing related party transactions. Although auditors are required to look at the process for reviewing related party transactions, the audit committee should be performing their own review.

SEC comment letters—be aware

The SEC staff periodically reviews company filings and may send a comment letter with accounting or disclosure questions. Audit committees should be informed by management or the external auditor can provide insights on the likely areas of focus by the SEC staff based on trends of comment letters received by others in the industry. If the company gets an SEC comment letter, management should communicate with the audit committee in a timely manner regarding questions raised and how management plans to respond.

Once resolved, the SEC staff’s comment letters and the company’s response letters are posted on the SEC’s website where investors, competitors and the media can see them. Accordingly, management should respond in a measured, appropriate manner. Hurried or inadequate responses could generate additional comment letters and could even lead to an SEC investigation. Additionally, the audit committee should understand whether a comment letter the company received has not been closed by the SEC. This may impact the impending filings and delay a company from accessing the capital markets.

SEC comment letter trends

<table>
<thead>
<tr>
<th>Year of origination</th>
<th>Average length of conversation (in days)</th>
<th>Average number of letters per conversation</th>
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</thead>
<tbody>
<tr>
<td>2018</td>
<td>50.1</td>
<td>3.8</td>
</tr>
<tr>
<td>2019</td>
<td>43.7</td>
<td>3.8</td>
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<tr>
<td>2020</td>
<td>39.3</td>
<td>3.6</td>
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<tr>
<td>2021*</td>
<td>31.5</td>
<td>3.5</td>
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*2021 only includes letters between January 1 and June 30, as of October 5, 2021


For a list of the top ten areas of SEC comment letters, see SEC comment letter trends.
Earnings releases of preliminary results deserve full attention

Typical earnings releases are short and sweet compared to SEC filings. They generally include the basics: balance sheet, income statement and sometimes a statement of cash flows for the quarter and year-to-date, with comparisons to the relevant prior periods with no footnote disclosures. There is limited discussion of financial results; instead, the earnings release focuses on revenue, net income, earnings per share, key non-GAAP measures and “special items” impacting the reported results and sometimes forward-looking guidance or updates thereto, if applicable.

Analysts pay a great deal of attention to earnings releases; frequently, the company’s stock price moves if reported earnings vary from what “the Street” expected. Once the stock price has reacted to the earnings announcement, there can be pressure not to adjust those reported results in the forthcoming SEC filing for the period.

Sometimes, an event occurs or new information becomes known after the date of the earnings release, but before the actual SEC filing for the period. If this happens and it relates to facts and circumstances existing at the balance sheet date, management will need to evaluate whether to adjust the preliminary results in the SEC filing.

Audit committees typically hold a meeting to discuss and approve the draft earnings release. As part of its oversight, the audit committee should understand the status of management’s reporting process and inquire about significant estimates that were based on preliminary inputs that could change prior to the SEC filing. Audit committees also need to understand the status of the external auditor’s work: what procedures are still open and what additional procedures still need to be performed after the earnings release but prior to the SEC filing.
What could cause earnings to change between the earnings release date and the SEC filing date? Beyond an unforeseen event or transaction, there are a few common reasons estimates could change. For example, new material information could come to light, causing an adjustment to the financial statements. Or management may identify a more reliable source of information than what was used in the initial estimates. Material audit adjustments arising from the completion of work not yet finalized as of the earnings release, such as an impairment of an asset or adjustment of a liability, could also lead to changes in earnings after the earnings release date.

Astute audit committees do not wait until the SEC filing date to inquire about any potential issues associated with the preparation of the reported results. Why not? The earnings release is too significant to investors. Finally, forward-looking guidance is often included in earnings releases and is particularly important financial information to stakeholders. Audit committees of NYSE-listed companies are required to discuss forward-looking guidance provided to analysts and rating agencies, but all audit committees should consider doing so. (For more information about audit committee oversight of forward-looking guidance, read our Forward-looking guidance publication.)

Once the stock price has reacted to the earnings announcement, there can be pressure not to adjust those reported results in the forthcoming SEC filing.
The audit committee should develop a process with the company for communicating its comments on the SEC filing document draft. Some audit committees delegate this to the chair, while others have each member submit comments. The process should also address when the committee needs to see revised copies of filing—e.g., material changes only? All changes?

Consider the impact of current developments in the business

Many CEOs regularly communicate with directors about the current state of the business. This includes developments in the competitive and economic environment and how they are impacting the company. Such communications can be helpful to audit committees to provide some context as they form their own expectations of the current period’s financial results. Audit committees should then compare their expectations to the reported financial results and disclosures—much like auditors do.

Although some areas of review may also happen earlier during a review of an earnings release, here are some suggestions for enhancing the review of filings, but still keeping it efficient.

Governance Insights Center

Reviewing actual filings

Although some areas of review may also happen earlier during a review of an earnings release, here are some suggestions for enhancing the review of filings, but still keeping it efficient.
Focus on changes to enhance efficiency and effectiveness

Some management teams do a great job helping audit committees understand what has changed in the current SEC filing. They also emphasize how significant new events and developments are reflected in the filings. We’ve seen this done a few ways. One is to highlight disclosures and accounting policies that are new or different. Another is to provide a summary of material, unusual, special or nonrecurring items each quarter with explanatory comments and their quantitative impact, and referencing the page in the filing that includes the new or altered disclosures. For additional examples on dashboard reporting, see Audit committee dashboard reporting.
Remember that changes to estimates can significantly impact reported results

Even if the audit committee understands how key accounting estimates and judgments are developed—through periodic deep dives or other means—management should inform the committee of any changes to key assumptions or the process(es) by which the assumptions are derived. This includes discussing the reason for the change(s) and when the information became available that indicated the need for the change(s). It is helpful to include a summary of the impact of such changes, including their impact on period-over-period earnings and earnings per share, in the audit committee materials.

Be aware of unusual or nonrecurring transactions

Quarterly results might include significant transactions that are not of an ongoing or recurring nature. Although these transactions may or may not be included in the analysts’ models, the audit committee should understand the impact of these items on the period’s results. This helps them evaluate the appropriateness of disclosures and better understand management’s performance compared to expectations. To help facilitate the audit committee’s review, management can provide a summary of material, unusual, special or nonrecurring items each period with explanatory comments and the quantitative impact of the items (see Focus on changes to enhance efficiency and effectiveness on page nine for an example summary reporting document).
How does the audit committee meet the challenge?

The high volume of information and ever-changing and highly-technical rules may make oversight of financial reporting a daunting task for audit committees. Yet oversight by audit committees is an essential element to building trust with stakeholders in reported financial information.

Here are some ways audit committees can effectively and efficiently exercise this oversight:

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<thead>
<tr>
<th>Action</th>
<th>Description</th>
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<tbody>
<tr>
<td>Ask management for help in better understanding what has changed</td>
<td>Have management prepare a summary memo highlighting areas of change (e.g., risk factors, disclosures, accounting policies, new events and developments) from the prior period. Consider having management highlight these areas within the draft filing document(s) as well. Request schedules quantifying the impact of both unusual transactions and significant changes in estimates impacting the current period.</td>
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<td>in the current filing.</td>
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<td>Pay attention to “special items” and non-GAAP measures—particularly</td>
<td>Transparent disclosure of non-GAAP measures can be useful to investors. In particular, audit committees should ensure that both positive and negative adjustments are included. But recent focus and interpretive guidance by the SEC staff warrant additional focus to ensure management’s use of non-GAAP measures is appropriate. Refer to To GAAP or non-GAAP? The SEC is watching.</td>
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<td>in the earnings release.</td>
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<td>If the company maintains a disclosure committee, understand how it</td>
<td>Have management describe significant transactions or events that were discussed in the quarterly meeting, as well as the issues that were discussed and a conclusion made that additional disclosure was not warranted—this could be part of the summary memo described above.</td>
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<td>functions and who attends the meetings.</td>
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<td>Understand any nonstandard representations in management’s letter</td>
<td>In addition to normal ongoing representations, external auditors sometimes add nonstandard items to address unusual transactions or events that occurred during the period. Request that these special representations be highlighted and explained by management.</td>
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<td>of representation to the external auditors.</td>
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<td>Discuss the status of the external auditors’ work before the</td>
<td>External auditors may indicate that they are “comfortable” with the results the company is about to release, but the reality is that auditors cannot provide final approval until their work is completed—so understanding what work is left to be completed is important.</td>
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<td>earnings release.</td>
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<td>Assess the risk that some event or finding could come to light before</td>
<td>Audit committees should consider the company’s history, management experience, and the facts and circumstances. Some companies are focusing on decreasing the gap between earnings release and SEC filing dates—narrowing the possibility of something coming up. That might mean moving back the release or moving forward the SEC filing.</td>
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<td>the actual filing date that could impact the preliminary results to</td>
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<td>be reported in the earnings release.</td>
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<td>Consider having the audit committee do a deep dive on a particular</td>
<td>Many audit committees have periodic deep dives on specific accounting focused topics periodically—for example, tax, significant estimates/expouses, intangibles, etc.</td>
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<td>area of significant judgment on a rotational basis.</td>
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How PwC can help

To have a deeper discussion about how this topic might impact your business, please contact your engagement partner or a member of PwC’s Governance Insights Center.

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