

Reviewing and assessing financial statements

Audit Committee Questions
Audit Committee Institute

The audit committee has an important oversight role in providing the board with assurance as to the propriety of the financial reporting process. Reviewing and assessing the financial statements remains a critical last step in the committee's financial reporting oversight activities.



Audit committee oversight essentials ...

To effectively review and assess financial statements, the audit committee needs to understand the context for financial reporting, considering inter alia the impact of relevant accounting standards, financial reporting developments and the overall requirement that the financial statements present a “true and fair view”.

It is crucial that the audit committee is confident that they are being made aware of any relevant accounting policy or disclosure issues or changes, and that this information is communicated to them early enough to enable appropriate action to be taken. A regular two-way dialogue between the audit committee and the CFO should take place though the audit committee should also use the external auditor's insights to help to identify potential issues early.

The audit committee should assess the treatment of all significant unusual transactions. In this respect, the audit committee should understand the business rationale of the transaction, how it is recorded and disclosed in the financial statements and the impact

it might have on the comparability of financial position and performance.

Overall, the audit committee needs to assess the completeness, clarity and transparency of the financial statements and related disclosures.

The audit committee's review should factor in circumstances in which management may feel pressure to engage in inappropriate earnings management. It could be that: market expectations are unrealistic, targets are not being met, or management remuneration incentives are heavily weighted to earnings measures. The audit committee should recognise when these conditions are present and where necessary receive what they hear with professional scepticism.

Management and the external auditor can greatly assist the audit committee in understanding and assessing these matters by providing the committee with clearly written communications, augmented with face-to-face discussions.

Key questions for audit committees to consider:

General

- In case of a significant change in business and / or significant non-recurring events, how did this affect accounting, including judgments and estimates; recoverability of assets; segment reporting and potential classification issues?
- Were any known errors not recorded and why? How did management assess materiality and control implications?
- Have all significant subsequent events been properly reflected and / or disclosed in the financial statements?
- Are there any special purpose entities that require consolidation by the company? Have the company's relationships been properly disclosed?
- Have there been any disagreements between management and the independent auditors on accounting principles or how to account for a significant transaction? How were they resolved? What were the issues for which the auditor consulted with its national office?
- (If any) What was the focus of comment letters / requests for information received related to the company's filed financials from the financial markets regulator?

Income statement

- Has the company entered into new lines of business or product sales that require it to reconsider its existing revenue recognition policies? Has the company properly disclosed its policies relating to different classes of revenue transactions? What analyses have management performed to check if complex multiple element arrangements exist and how to properly account for them?
- Has the gross and net profit percentage changed significantly from the prior year or during the year? If so, why? Are any unusual or nonrecurring items included in the financial statements?
- Have the company's earnings-per-share calculations given effect to recent capital transactions or employment contracts that may involve dilutive securities?

Balance sheet

- Are the useful lives and methods of depreciation / amortization still appropriate? Have useful lives changed from the prior year and why?
- Were there any indicators of impairment during the period? If so, how were these evaluated, accounted for and disclosed?
- How is goodwill impairment testing performed and are the results and assumptions properly disclosed?
- What were the largest accounts receivable written off / inventory scrapped this year and were they included in the allowance at prior year-end?
- What procedures were performed to substantiate the valuation of investments?
- What procedures were performed to determine that there are no significant unrecorded liabilities?
- Is the company in compliance with all its debt covenant provisions of its loan and debt agreements?
- What assets are pledged to secure borrowings? Are they disclosed appropriately?
- Are guarantees issued properly disclosed in the financial statements?
- Are the assumptions used to value the post-employment benefit obligations reasonable? Were there any changes in the assumptions or in the underlying plans?
- Were any significant issues raised by legal counsel about litigation, contingencies, claims or assessments? If so, how have these matters been reflected in the financial statements or footnote disclosures?
- For any derivative financial instruments, how are fair values measured and disclosed in the financial statements?
- How was fair value determined for financial instruments that did not have a readily determinable market value? If third-party pricing services were used, what kind of independent checks have been performed?
- If applicable, has the company documented its hedges, and are the periodic assessments of ongoing effectiveness being performed?
- What is the effective tax rate this year, and how does it compare to the prior-year rate? What caused the difference versus prior year (if any) and is it reasonably explained?
- How does the company evaluate and continually reassess the likelihood that uncertain tax positions will be sustained by tax authorities?
- Is the realization of significant deferred tax assets supported by valid expectations of future taxable income?