Warren Buffett on the Challenge of the Audit Committee

Often called the "Oracle of Omaha," Warren Buffett, the largest shareholder and CEO of Berkshire Hathaway, is well known for his adherence to the value investing philosophy, his conservatism when it comes to issues of governance and accounting, and for his personal frugality, despite his immense wealth. On the subject of a board's audit committee, he writes,Buffett, annual letter to Berkshire Hathaway shareholders (2002).

Audit committees can't audit. Only a company's outside auditor can determine whether the earnings that a management purports to have made are suspect. Reforms that ignore this reality and that instead focus on the structure and charter of the audit committee will accomplish little.

As we've discussed, far too many managers have fudged their company's numbers in recent years, using both accounting and operational techniques that are typically legal but that nevertheless materially mislead investors. Frequently, auditors knew about these deceptions. Too often, however, they remained silent. The key job of the audit committee is simply to get the auditors to divulge what they know.

To do this job, the committee must make sure that the auditors worry more about misleading its members than about offending management. In recent years, auditors have not felt that way. They have instead generally viewed the CEO, rather than the shareholders or directors, as their client. That has been a natural result of day-to-day working relationships and also of the auditors' understanding that, no matter what the book says, the CEO and CFO pay their fees and determine whether they are retained for both auditing and other work. The rules that have been recently instituted won't materially change this reality. What *will* break this cozy relationship is audit committees unequivocally putting auditors on the spot, making them understand they will become liable for major monetary penalties if they don't come forth with what they know or suspect.

In my opinion, audit committees can accomplish this goal by asking four questions of auditors, the answers to which should be recorded and reported to shareholders. These questions are:

1. If the auditor were solely responsible for preparation of the company's financial statements, would they have in any way been prepared differently from the manner selected by management? This question should cover both material and nonmaterial differences. If the auditor would have done something differently, both management's argument and the auditor's response should be disclosed. The audit committee should then evaluate the facts.
2. If the auditor were an investor, would he have received—in plain English—the information essential to his understanding the company's financial performance during the reporting period?
3. Is the company following the same internal audit procedure that would be followed if the auditor himself were CEO? If not, what are the differences and why?
4. Is the auditor aware of any actions—either accounting or operational—that have had the purpose and effect of moving revenues or expenses from one reporting period to another?

If the audit committee asks these questions, its composition—the focus of most reforms—is of minor importance. In addition, the procedure will save time and expense. When auditors are put on the spot, they will do their duty. If they are not put on the spot... well, we have seen the results of that.[1]

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[1] https://saylordotorg.github.io/text_corporate-governance/index.html - page: https://saylordotorg.github.io/text_corporate-governance/s08-02-warren-buffett-on-the-challeng.html