Audit committees and auditors

Berkshire letters: 2002, 1998 · Difficulty: Intermediate

Summary

Buffett says **audit committees can’t audit**; their job is to get the external auditors to tell them what they know. He proposes four questions the committee should ask the auditors, starting with whether the statements would differ if the auditor alone had prepared them.

2002 letter

I have another caveat to mention about last year’s results. If you’ve been a reader of financial reports in recent years, you ’ve seen a flood of “pro-forma” earning s statements – tabulations in which managers invariably show “earnings” far in excess of those allowed by their auditors. In these presentations, the CEO tells his owners “don’t count this, don’t count that – just count what makes earnings fat.” Often, a forget-all-this-bad-stuff message is delivered year after year without management so much as blushing. ∗All figures used in this report apply to Berkshire's A shares, the successor to the only stock that the company had outstanding before 1996.

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In extreme cases, mark-to-model degenerates into what I would call mark-to-myth. Of course, both internal and outside auditors review the numbers, but that’s no easy job. For example, General Re Securities at yearend (after te n months of winding down its operation) had 14,384 14 contracts outstanding, involving 672 counterparties around the world. Each contract had a plus or minus value derived from one or more reference items, including some of mind-boggling complexity.

Valuing a portfolio like that, expert auditors could easily and honestly have widely varying opinions. The valuation problem is far from academic: In recent years, some huge-scale frauds and near-frauds have been facilitated by derivatives trades.

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Our goal is to obtain new directors who are equally devoted to those principles. The Audit Committee 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 20 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.

1998 letter

The consequences of these miscalculations flow directly into earnin gs. An experienced observer can usually detect large-scale errors in reserving, but the general public ca n typically do no more than accept what's presented, and at times I have been amazed by the numbers that big-nam e auditors have implicitly blessed. As for Berkshire, Charlie and I attempt to be conservative in presenting its underwriting results to you, because we have found that virtually all surprises in insurance are unpleasant ones.

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If compensation isn't an expense, what is it? And, i f expenses shouldn't go into the calculation of earnings, where in the world should they go?" Accounting — Part 2 The role that managements have played in stock-option accounting has hardly been benign: A distressin g number of both CEOs and auditors have in recent years bitterly fought FASB's attempts to replace option fiction with truth and virtually none have spoken out in support of FASB. Its opponents even enlisted Congress in the fight, pushing the case that inflated figures were in the national interest.

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For those who prefer to cheat up fro nt, there would be a variant of this strategy. The golfer, playing alone with a cooperative caddy-auditor, should defer the recording of bad holes, take four 80s, accept the plaudits he gets for such athleticism and consistency, and then turn in a fifth card carrying a 140 score. After rectifying his earlier scorekeeping sins with this "big bath," he may mumble a few apologies but will refrain from returning the sums he has previously collected from comparing scorecards in the clubhouse.

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Getting this push from the pulpit, first-class people will frequently stoop 16 to third-class tactics. CEOs understandably do not find it easy to reject auditor-blessed strategies that lead t o increased future "earnings." An example from the property-casualty insurance industry will illuminate the possibilities. When a pc company is acquired, the buyer sometimes simultaneously increases its loss reserves, often substantially.

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Clearl y the attitude of disrespect that many executives have today for accurate reporting is a busines s disgr ace. And auditors, as we have already suggested, have done little on the positive side. Though auditor s should regard the investing public as their client, they tend to kowtow instead to the managers who choose them and dole out their pay. ("Whose bread I eat, his song I sing.") A big piece of news, however, is that the SEC, led by its chairman, Arthur Levitt, seems determined to get corporate America to clean up its act.

In a landmark speech last September, Levitt called for an end to "earnings management." He correctly observed, "Too many corporate managers, auditors and analysts are participants i n a ga me of nods and winks." And then he laid on a real indictment: "Managing may be giving way t o manipulating; integrity may be losing out to illusion." I urge you to read the Chairman's speech (you can find it on the Internet at www.sec.gov) and to support him in his efforts to get corporate America to deliver a straight story to its owners. Levitt's job will b e Herculean, but it is hard to think of another more important for him to take on.

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