New Corporate Governance Principles Include Novel Audit Committee Provision

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Recently, a group of prominent corporate executives, including Warren Buffett and Jamie Dimon, as well as investment managers and institutional investors, issued a set of "Commonsense Principles of Corporate Governance." While most of the recommendations fall within the mainstream of governance best practices, the principles include the following novel proposition regarding audit committees:

> In addition to its other responsibilities, the Audit Committee should focus on whether the company's financial statements would be prepared or disclosed in a materially different manner if the external auditor itself were solely responsible for their preparation.

SEC and PCAOB rules currently require external auditors to communicate with the audit committee regarding the auditor's views about critical accounting policies and practices and alternative accounting treatments to those adopted by management. SEC Regulation S-X, Item 2-07(a), which implements Section 204 of the Sarbanes-Oxley Act, requires the issuer's independent registered public accounting firm to report to the audit committee about critical accounting policies and practices, alternative treatments of financial information within GAAP that have been discussed with management, ramifications of the use of such alternatives and the treatment preferred by the accounting firm. PCAOB Auditing Standard 16 prescribes similar communications with respect to alternative accounting treatments, as well as communications about qualitative aspects of significant accounting policies and practices, assessment of critical accounting policies and practices, conclusions regarding critical accounting estimates, significant unusual transactions, and the auditor's evaluation of the presentation of financial statements and related disclosures.

This principle, if read literally, might suggest that both the accounting firm and the audit committee should disregard management's accounting judgments, even where the accounting firm has concluded that management's accounting treatments and disclosure satisfy GAAP, if the auditor for any reason prefers a different treatment. If that is what is intended, such an approach would radically reorient the established roles and responsibilities of management, the audit committee, and the external auditor in the financial reporting process. Read more broadly, however, the principle can be viewed as a reaffirmation of the important role played by the audit committee in overseeing the company's financial reporting and the need for the audit committee to take into account the information communicated to it by the external auditor pursuant to the applicable rules.

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