

PCAOB meeting on auditor independence, objectivity and professional skepticism

Jones Graduate School of Business, Rice University, Houston - October 18, 2012

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Thank you for the opportunity to participate in this PCAOB public meeting on auditor independence and professional skepticism. I am head of the team at BlackRock responsible for engagement with public companies on corporate governance matters. My team meets annually with approximately 1,500 companies globally and votes at 15,000 shareholder meetings. The perspective I represent here is based on our experience of engaging with board members and senior executives at a range of companies over many years. As you may recall, my colleague Steven Buller participated in the meeting on March 21 and set out BlackRock's overarching views based on input he had received from our firm's investment analysts, as well as our corporate and investment fund financial statement preparers. In my remarks, I will focus on enhancing the effectiveness of the audit committee from the shareholder perspective.

BlackRock has an active corporate governance program intended to help the firm meet its fiduciary duty to protect and enhance the value of clients' assets. Our approach to corporate governance, put simply, is to assess the quality and effectiveness of the board and management, which in large part comes down to their independence of mind and professional caliber. We have our own policies to frame that assessment but we place the onus on companies to explain the approach they take to governance and justify why that is in the best interests of long-term shareholders. Our preference for a 'comply or explain' approach to governance over a prescriptive or regulatory one is based on our observation that practice in this field has evolved significantly over a relatively short time and rule making has seldom kept up with the pace of change (executive compensation disclosures being but one example). In addition, we have observed a number of negative unintended consequences from well-intentioned rule making. Practitioner-developed guidance on good practices has, in our view, set a sound framework for corporate governance in many markets and has the advantage of being flexible.

In our corporate governance work, we focus on the board because it is the link between shareholders and management. Where we are concerned that shareholder interests are not being protected by the board, and engagement fails to elicit a satisfactory response, we are able in most markets to vote against the re-election of directors. In terms of audit, we seek information from the board and management as to the robustness of the process and how it protects shareholders' interests. We encourage companies to provide explanations in their disclosures that help build shareholder understanding of the oversight conducted by the board and that highlight for us the company-specific factors at play. (See below for extract from proxy policy for U.S. listed companies.)

Turning to the audit committee and its effectiveness, we share the view of others who have participated in this discussion, that expertise and independence are essential. Independence is, in practice, difficult to assess as an outside shareholder without direct access to the boardroom. Therefore, we use the independence criteria set out in listing standards and similar guidance as a benchmark. We believe that board independence generally is improved by a formal and transparent appointment process driven by the nominating and governance committee (or equivalent) of independent directors. We

believe that companies could improve their disclosures to shareholders about the process followed when appointing a new director, the qualities of the individual appointed which complement the profile of the incumbent directors and the board overall, and the particular contribution the new director is expected to make. Ideally, board evaluations and thoughtful succession plans will ensure that there will always be a choice of directors on the board for the audit committee chairman to select from when refreshment of the committee is required.

We are also interested to understand from boards that there is a formalized approach they take to providing an induction to incoming directors, both about the company and the work of the board, including detailed and specific briefing on the committees they join. Similarly, we expect directors to be committed to their own on-going development and knowledge building. This is not necessarily training on technical issues but things such as networking with peers on developing trends or good practices in their area of specialism, attending focused events about industry developments (potentially including presentations from shareholders), and reviewing reports and research provided by the advisors to the company to keep abreast of technical matters. It would arguably benefit many boards to have a clear understanding of the research on cognitive biases, framing and group dynamics as they pertain to decision-making.

Auditors' skepticism should, in our view, be matched by audit committee skepticism. Asking probing questions about the audit of both the auditor and the management should be a normal part of the process, but again, is difficult to assess at arm's length. The audit committee needs, in our view, to reinforce as often as is necessary the accountability of the auditor to it rather than to management. Our sense is that, despite the requirements of Sarbanes-Oxley, many outside observers are not convinced of the strength of that relationship. The audit committee should also ensure it has a good understanding of the efforts made by the audit firm to ensure the professionalism of its staff, an appropriate culture, the quality reviews undertaken and lessons learned from situations where the auditor was found wanting. To this end, the audit committee might ask its secretary to provide a summary briefing of news reports and PCAOB review findings related to the company's auditor from time to time.

In terms of reporting on the audit process, we believe that it is helpful for shareholders to understand the role and terms of reference of the committee and we would encourage companies to publish these on the governance section of their website. We suggest that U.S. companies might consider a practice observed in the U.K. and elsewhere by which the audit committee reports in the equivalent of the proxy statement its activities over the past year. This type of report could cover the number of meetings, the issues on which the committee focused, areas of policy change which the committee approved and significant projects. The committee could also explain their policy for auditor rotation and audit tendering, why it is appropriate and how that determination was reached. They should also justify a decision to retain the incumbent auditor where there has been a material financial restatement or serious control flaw.

We recommend that the board be willing to make the audit committee chairman available to meet with shareholders on request. It is unlikely that such a request would be made very often as, in our experience, shareholders tend to have faith that the directors are protecting the interests of long-term investors. When there have clearly been failings and investors have concerns they wish to express, we believe that it is

better that these are shared directly with the board through the audit committee chairman than through a public medium.

Auditing Standard 16 should help raise the standards of communication between auditors and the audit committee across the public company spectrum. We suggest the PCAOB might also use its convening power to establish a group of practitioners (i.e. corporate, investor, advisor, regulator) to draft non-regulatory guidance around other audit committee practices that might enhance the audit process and communication with shareholders. We are aware that several audit firms have published practical suggestions along these lines. We believe this type of advice would be stronger if developed by a group representing a broad range of constituents.

In summary, we believe that the current corporate governance and regulatory frameworks, including audit and professional standards, are sufficient to ensure high quality audits. The behavior of individuals and groups within the framework determine its success or otherwise. A commitment on the part of all the participants – executive management, directors, audit staff and audit firm partners, PCAOB, shareholders, amongst others – to continually improve their professional practices should further enhance the integrity of the output.

From BlackRock's Proxy Voting Guidelines for U.S. Securities

Accounting and audit-related issues

BlackRock recognizes the critical importance of financial statements that provide a complete and accurate portrayal of a company's financial condition. Consistent with our approach to voting on boards of directors, we seek to hold the audit committee of the board responsible for overseeing the management of the audit function at a company, and may withhold votes from the audit committee's members where the board has failed to facilitate quality, independent auditing. We take particular note of cases involving significant financial restatements or material weakness disclosures.

The integrity of financial statements depends on the auditor effectively fulfilling its role. To that end, we favor an independent auditor. In addition, to the extent that an auditor fails to reasonably identify and address issues that eventually lead to a significant financial restatement, or the audit firm has violated standards of practice that protect the interests of shareholders, we may also vote against ratification.

From time to time, shareholder proposals may be presented to promote auditor independence or the rotation of audit firms. We may support these proposals when they are consistent with our views as described above.