



# **An Approach to Effective Audit Committee Self-Evaluation**

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The Sarbanes-Oxley Act of 2002 defined the audit committee as “a committee (or equivalent body) established by and amongst the board of directors of an issuer for the purpose of overseeing the accounting and financial reporting processes of the issuer and audits of the financial statements of the issuer.”

Audit committees are faced with increased expectations from many groups, including shareholders, shareholder and governance activists, regulators, the media, and fellow board members. The New York Stock Exchange, in its listing standards proposals, has suggested that a formal evaluation process be established for the board as a whole and for each major committee of the board.

Based on the responses to a survey conducted by KPMG’s Audit Committee Institute (ACI) during our Fall 2002 Audit Committee Roundtable series, it appears that this practice has yet to be widely adopted. When we asked 1,400 respondents if audit committees performed an overall self-evaluation of their effectiveness, only 8.3 percent said yes and that the process was effective, 20.3 percent said an evaluation was performed but the process needed improvement, and 71.4 percent said no, there was no evaluation. Based on feedback at this and previous roundtables, these evaluations are performed in a variety of ways, some on a self-evaluation basis and others that are more formal and coordinated by the governance committee of the board or the lead independent director.

A number of resources regarding the board and audit committee evaluations process are available, including:

- National Association of Corporate Directors (NACD) – “Report of the NACD Blue Ribbon Commission on Board Evaluation: Improving Director Effectiveness” (report can be ordered at <http://www.nacdonline.org>).
- Frank M. Burke and Dan M. Guy, Aspen Publishers – *Audit Committees: A Guide for Directors, Management and Consultants, 2<sup>nd</sup> Edition* (2002) – Appendix 28 Audit Committee Self-Assessment, pp 342 - 348 (book can be ordered at <http://www.aspenpublishers.com> [search for “audit committee”]).
- AuditNet Web portal - Audit Committee Effectiveness -- Self Assessment Tool (go to <http://www.auditnet.org> [search for "audit committee performance"]).
- Marsh & McLennan Companies, Inc. -- Audit Committee Checklist -- Draft June 6, 2002 (go to the Web site for Financial Executives International, at <http://www.fei.org>, [search for "audit committee checklist"]).

The purpose of this document is to suggest a straightforward evaluation approach for the audit committee based on some of the broad expectations of shareholders, the ultimate group whose interests the board and the audit committee represent. We have based this

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approach on ACI's *Basic Principles for Audit Committees*, published in mid-2002 (see KPMG's Audit Committee Institute's Web site at <http://www.kpmg.com/aci>) which is summarized below:

1. Recognize that the dynamics of each company, board, and audit committee are unique—one size does not fit all.
2. The board must ensure the audit committee comprises the “right” individuals to provide independent and objective oversight.
3. The board and audit committee must continually assert that, and assess whether, the “tone at the top” embodies insistence on integrity and accuracy in financial reporting.
4. The audit committee must demand and continually reinforce the “direct responsibility” of the external auditor to the board and audit committee as representatives of the shareholders [as is now required by Sarbanes-Oxley].
5. Audit committees must implement a process that supports their understanding and monitoring of the:
  - Specific role of the audit committee in relation to the specific roles of the other participants in the financial reporting process (oversight),
  - Critical financial reporting risks,
  - Effectiveness of financial reporting controls,
  - Independence, accountability, and effectiveness of the external auditor, and
  - Transparency of financial reporting.

We encourage the members of the audit committee to consider the elements included in this document, as well as other approaches, and then develop their own tailored approach to evaluating the effectiveness of their audit committee. Any approach developed should also take into consideration the responsibilities of the audit committee described in the audit committee charter. We believe that evaluation processes should focus on the effectiveness of the audit committee and not consist of a checklist of compliance with rules and regulations. A well-thought-out evaluation approach conducted in an open and constructive manner will allow a company, and its shareholders, to benefit from the collective insight and experience of each member of the audit committee.

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If you have any questions about this document please contact KPMG's Audit Committee Institute (ACI) toll-free at 1-877-KPMG-ACI (1-877-576-4224), or via e-mail at [auditcommittee@kpmg.com](mailto:auditcommittee@kpmg.com). KPMG's Audit Committee Institute (ACI) has been communicating with audit committee members since our formation in 1999. ACI's initiatives include semiannual roundtables, publication of KPMG's *Audit Committee Quarterly*, conference and board presentations, a toll-free hotline, periodic distribution of time-sensitive information, and our Web site, <http://www.kpmg.com/aci>. Wholly sponsored by KPMG International, the ACI communicates with audit committee members and senior officers to enhance their awareness, commitment, and ability to implement effective audit committee processes.

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### Overview

The purpose of this audit committee self-evaluation approach is to assist committee members in assessing the effectiveness of the audit committee. We believe that a self-evaluation process can be very helpful to the committee in identifying possible improvement areas and we suggest that if an “evaluation form” is adopted by the audit committee, it should only be one step in the process. The following is an overview of possible steps in an evaluation process:

1. Discuss the self-evaluation process that will be adopted, decide who will coordinate the process, and compile the evaluation form and results.
2. Determine who will participate in providing initial input to the audit committee – this will include the audit committee members and chair and might also include the chairman of the board, CEO, chairs of other board committees, CFO, director of internal audit, independent auditor, corporate secretary, in-house counsel, and others that interact with the audit committee.
3. Provide the evaluation form to all participants and have them returned to the coordinator for compilation.
4. Use compiled reports that reflect each response and the average rating (possibly reflecting (1) the overall average, and the averages of (2) the audit committee members and (3) other participants) as the basis of a conversation concerning the committee’s effectiveness and areas for improvement.

**The company’s in-house or external counsel should be consulted on how this process should be documented and the information that should be retained in the audit committee’s files.**

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	<b><u>RATINGS</u></b> 5 Very Strong 4 Strong 3 Satisfactory 2 Adequate, but needs improvement 1 Significant improvement needed	<b><u>COMMENTS</u></b> <i>(Please attach additional pages for comments, if needed.)</i>
<b>Organizations</b>		
1 The audit committee charter clearly sets forth the nature and scope of responsibilities, and has been approved by the committee and the full board.	<input type="checkbox"/> <input type="checkbox"/> <input type="checkbox"/> <input type="checkbox"/> <input type="checkbox"/> <b>5 4 3 2 1</b>	
2 The audit committee membership meets regulatory requirements, members have the right background and skills, and they actively provide input.	<input type="checkbox"/> <input type="checkbox"/> <input type="checkbox"/> <input type="checkbox"/> <input type="checkbox"/> <b>5 4 3 2 1</b>	
3 The board was active in its consideration of audit committee composition, including the designation or consideration of an “audit committee financial expert.”	<input type="checkbox"/> <input type="checkbox"/> <input type="checkbox"/> <input type="checkbox"/> <input type="checkbox"/> <b>5 4 3 2 1</b>	
4 The audit committee’s actions reflect independence from management, ethical behavior, and the best interests of shareholders.	<input type="checkbox"/> <input type="checkbox"/> <input type="checkbox"/> <input type="checkbox"/> <input type="checkbox"/> <b>5 4 3 2 1</b>	
5 The audit committee’s meeting packages are complete, are received with enough lead-time, and include the right information to allow meaningful discussion.	<input type="checkbox"/> <input type="checkbox"/> <input type="checkbox"/> <input type="checkbox"/> <input type="checkbox"/> <b>5 4 3 2 1</b>	
6 Audit committee meetings are well organized, efficient, and effective, and they occur often enough and are of appropriate length to allow discussion of relevant issues consistent with the audit committee’s responsibilities.	<input type="checkbox"/> <input type="checkbox"/> <input type="checkbox"/> <input type="checkbox"/> <input type="checkbox"/> <b>5 4 3 2 1</b>	
7 The committee members are open, honest, and effective in their communication with management, internal and external auditors, and each other.	<input type="checkbox"/> <input type="checkbox"/> <input type="checkbox"/> <input type="checkbox"/> <input type="checkbox"/> <b>5 4 3 2 1</b>	
8 Appropriate internal or external support and resources are available to the audit committee.	<input type="checkbox"/> <input type="checkbox"/> <input type="checkbox"/> <input type="checkbox"/> <input type="checkbox"/> <b>5 4 3 2 1</b>	
9 Minutes and reports to the full board reflect the significant activities, actions, and recommendations of the committee.	<input type="checkbox"/> <input type="checkbox"/> <input type="checkbox"/> <input type="checkbox"/> <input type="checkbox"/> <b>5 4 3 2 1</b>	
10 The audit committee chair’s leadership is effective.	<input type="checkbox"/> <input type="checkbox"/> <input type="checkbox"/> <input type="checkbox"/> <input type="checkbox"/> <b>5 4 3 2 1</b>	

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<b>Audit Committee Agenda Setting and Oversight of the Financial Reporting Process</b>		
1 The audit committee helps to establish the right “tone from the top,” which embodies insistence on integrity and accuracy in financial reporting.	<input type="checkbox"/> <input type="checkbox"/> <input type="checkbox"/> <input type="checkbox"/> <input type="checkbox"/> <b>5 4 3 2 1</b>	
2 The audit committee has achieved the right balance of proactive oversight and has neither infringed upon management’s responsibility nor provided less than effective oversight.	<input type="checkbox"/> <input type="checkbox"/> <input type="checkbox"/> <input type="checkbox"/> <input type="checkbox"/> <b>5 4 3 2 1</b>	
3 The audit committee sets clear expectations and provides feedback concerning the competency of the company’s CFO and senior financial management staff.	<input type="checkbox"/> <input type="checkbox"/> <input type="checkbox"/> <input type="checkbox"/> <input type="checkbox"/> <b>5 4 3 2 1</b>	
4 There is appropriate consideration of the company’s financial reporting risks and the related internal controls, which are reflected in the audit committee’s discussions and agenda items.	<input type="checkbox"/> <input type="checkbox"/> <input type="checkbox"/> <input type="checkbox"/> <input type="checkbox"/> <b>5 4 3 2 1</b>	
5 The audit committee’s agenda-setting process is thorough and lead by the audit committee chair.	<input type="checkbox"/> <input type="checkbox"/> <input type="checkbox"/> <input type="checkbox"/> <input type="checkbox"/> <b>5 4 3 2 1</b>	
6 There is a meaningful discussion and consideration of the company’s external financial reporting (including the annual report, quarterly financial filings, and press releases).	<input type="checkbox"/> <input type="checkbox"/> <input type="checkbox"/> <input type="checkbox"/> <input type="checkbox"/> <b>5 4 3 2 1</b>	
7 There is appropriate consideration of related-party transactions, including disclosure of these transactions in financial reports.	<input type="checkbox"/> <input type="checkbox"/> <input type="checkbox"/> <input type="checkbox"/> <input type="checkbox"/> <b>5 4 3 2 1</b>	
8 The audit committee’s oversight of “whistleblower” procedures is appropriate.	<input type="checkbox"/> <input type="checkbox"/> <input type="checkbox"/> <input type="checkbox"/> <input type="checkbox"/> <b>5 4 3 2 1</b>	

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<b>Oversight of Audit Processes</b>		
1 The audit committee's actions demonstrate its direct responsibility for the appointment, compensation, and oversight of the work of the independent auditor.	<input type="checkbox"/> <input type="checkbox"/> <input type="checkbox"/> <input type="checkbox"/> <input type="checkbox"/> <b>5 4 3 2 1</b>	
2 There is active consideration of the audit plan and results of the independent audit.	<input type="checkbox"/> <input type="checkbox"/> <input type="checkbox"/> <input type="checkbox"/> <input type="checkbox"/> <b>5 4 3 2 1</b>	
3 The pre-approval process over non-audit services provided by the independent auditor is effective and reinforces the auditor's independence.	<input type="checkbox"/> <input type="checkbox"/> <input type="checkbox"/> <input type="checkbox"/> <input type="checkbox"/> <b>5 4 3 2 1</b>	
4 There is an effective procedure in place for the evaluation of the independent auditor's qualifications, performance, and independence.	<input type="checkbox"/> <input type="checkbox"/> <input type="checkbox"/> <input type="checkbox"/> <input type="checkbox"/> <b>5 4 3 2 1</b>	
5 There is appropriate consideration of the management letter and other communications from the independent auditor.	<input type="checkbox"/> <input type="checkbox"/> <input type="checkbox"/> <input type="checkbox"/> <input type="checkbox"/> <b>5 4 3 2 1</b>	
6 The internal audit reporting lines and interaction with the audit committee foster an environment where issues that might involve management will be brought to the attention of the audit committee.	<input type="checkbox"/> <input type="checkbox"/> <input type="checkbox"/> <input type="checkbox"/> <input type="checkbox"/> <b>5 4 3 2 1</b>	
7 There is appropriate consideration of the internal audit department's plan, resources, and ability.	<input type="checkbox"/> <input type="checkbox"/> <input type="checkbox"/> <input type="checkbox"/> <input type="checkbox"/> <b>5 4 3 2 1</b>	
8 There is appropriate consideration of the internal audit department's reports, management's response, and improvement actions.	<input type="checkbox"/> <input type="checkbox"/> <input type="checkbox"/> <input type="checkbox"/> <input type="checkbox"/> <b>5 4 3 2 1</b>	
9 Executive sessions held with the internal and independent auditor result in candid discussion of relevant issues.	<input type="checkbox"/> <input type="checkbox"/> <input type="checkbox"/> <input type="checkbox"/> <input type="checkbox"/> <b>5 4 3 2 1</b>	

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<b>Continuous Improvement</b>		
1 The audit committee provides an effective orientation of new audit committee members.	<input type="checkbox"/> <input type="checkbox"/> <input type="checkbox"/> <input type="checkbox"/> <input type="checkbox"/> <b>5 4 3 2 1</b>	
2 The audit committee provides or encourages ongoing education of audit committee members.	<input type="checkbox"/> <input type="checkbox"/> <input type="checkbox"/> <input type="checkbox"/> <input type="checkbox"/> <b>5 4 3 2 1</b>	
3 The audit committee's self-evaluation process is in place and effective.	<input type="checkbox"/> <input type="checkbox"/> <input type="checkbox"/> <input type="checkbox"/> <input type="checkbox"/> <b>5 4 3 2 1</b>	
4 Any and all matters identified that require follow-through are resolved.	<input type="checkbox"/> <input type="checkbox"/> <input type="checkbox"/> <input type="checkbox"/> <input type="checkbox"/> <b>5 4 3 2 1</b>	
<b>Overall Evaluation</b>		
What is your overall assessment of the performance of the audit committee?	<input type="checkbox"/> <input type="checkbox"/> <input type="checkbox"/> <input type="checkbox"/> <input type="checkbox"/> <b>5 4 3 2 1</b>	
<b>Audit Committee Members Only</b>		
<i>The following concluding questions are meant for audit committee members, as representatives of the shareholders, to gauge their confidence regarding elements of the audit committee process.</i>		
As a member of the audit committee, I would feel comfortable addressing the annual shareholders' meeting to respond to the following questions concerning the approach and effectiveness of our audit committee:		
1 What specific activities or additional inquiries have been incorporated into the audit committee process since the Sarbanes-Oxley Act of 2002 was passed? What is the nature of these activities and additional inquiries?	<input type="checkbox"/> <input type="checkbox"/> <input type="checkbox"/> <input type="checkbox"/> <input type="checkbox"/> <b>5 4 3 2 1</b>	
2 Are you satisfied that the company has devoted the appropriate amount of internal resources to ensuring the adequacy of its financial reporting process?	<input type="checkbox"/> <input type="checkbox"/> <input type="checkbox"/> <input type="checkbox"/> <input type="checkbox"/> <b>5 4 3 2 1</b>	
3 Since the audit committee is now directly responsible for the oversight of the independent auditor, how does the audit committee demonstrate and reinforce this reporting relationship?	<input type="checkbox"/> <input type="checkbox"/> <input type="checkbox"/> <input type="checkbox"/> <input type="checkbox"/> <b>5 4 3 2 1</b>	
4 What involvement does the audit committee have in the "whistleblower" communication process?	<input type="checkbox"/> <input type="checkbox"/> <input type="checkbox"/> <input type="checkbox"/> <input type="checkbox"/> <b>5 4 3 2 1</b>	

*The information contained herein is of a general nature and is not intended to address the circumstances of any particular individual or entity. Although we endeavor to provide accurate and timely information, there can be no guarantee that such information is accurate as of the date it is received or that it will continue to be accurate in the future. No one should act on such information without appropriate professional advice after a thorough examination of the particular situation.*

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