

Assessing Audit Committee Effectiveness

The audit committee is seen as a key fulcrum of any company. Being mandatory under Clause 49 of listing agreement with stock exchanges and Section 292A of the Companies Act, the audit committee can be of great help to the board in establishing, implementing, monitoring and sustaining good corporate governance practices for the benefit of the company and its stakeholders. The responsibility for assessing effectiveness of the audit committee is thus assuming more and more importance.

The assessment of performance and effectiveness of the audit committee is best accomplished through a self-assessment process, and a subsequent report thereon to the board of directors. This should be done bi-annually, or at least annually.

The board of directors also has responsibilities in this area. It must clearly enunciate in the board charter that it expects its committees to evaluate their effectiveness. The approach used by the board committees should, of course, be agreed among the board and the audit committee.

In assessing their performance, audit committees should address two fundamental questions:

- Is the committee satisfied that it has effectively discharged its responsibilities as set out in its charter?
- How can the committee improve its operating efficiency and effectiveness?

The factors that ensure an audit committee's effectiveness are its ability to:

Do the right things. A well-defined written charter spells out the role, duties and responsibilities of audit committee and the authority it derives from the law and board of directors. A mandate and charter helps audit committees keep a sharp focus on the most important corporate reporting issues and business risks, set their priorities clearly and know what they want to accomplish.

The audit committee should review and assess:

- The appropriateness of its charter annually, and recommend to the board of directors any changes that the committee determines to be appropriate
- The performance of the committee based on compliance of the audit committee with its charter

Have the right people. Audit committees comprise a chairman and group of directors (at least three directors, two thirds of whom are independent as required by Clause 49 II (A) of listing agreement with stock exchanges) with the requisite business experience, knowledge and financial expertise that are commensurate with the critical issues facing the company's business and corporate reporting.

Industry and other specialized experience. In some circumstances, it may be desirable and prudent for one or two members of the audit committee to have industry or other specialized experience (for example, a company heavily engaged in international financing may wish to have this kind of experience represented on the audit committee). As a rule, however, we do not advocate this as a requirement for audit committee membership. What is important, though, is that audit committee members have the capability of understanding the accounting they are being asked to approve, whatever the business of the company. Because audit committee members should never sign off on anything they do not understand, there is a clear benefit to them having a solid understanding of the business in which the company is engaged. Also, Clause 49 II (A) mandates that all members of audit committee shall be financially literate and at least one member shall have accounting or related financial management expertise.

The Audit Committee should review and assess the performance of its members periodically.

Manage critical relationships. Audit committees, led by their chairmen, need to manage a complex set of relationships, including those with the board of directors, the external auditor, management (including internal audit) and other parties, such as outside corporate counsel.

Do the right things right. It takes more than a well thought out mandate, good people and the ability to build and manage key relationships to make an audit committee effective. Audit committees also need to establish the right processes to guide their meetings and discussions. The chairman must be a strong leader who knows what information and assurances the committee needs to discharge its responsibilities - and ensures this information is provided on a timely basis and in appropriate detail.

Ask right questions. The importance of being prepared to ask questions cannot be stressed too strongly. Management always possesses more information than the directors will ever have and, therefore, it is important to have a diligent process for questioning management on a variety of matters.

No audit committee member should be afraid to ask a question that he or she feels may betray a lack of understanding of an issue. If a member does not understand something, the smart - indeed, prudent - thing to do is to ask. The failure to ask a question in such circumstances, which we call the "fear of looking stupid syndrome," can seriously cripple a board member's effectiveness, and every audit committee member is strongly cautioned not to succumb to it.

Board members who are members of audit committee must have the courage, discipline and authority (force of personality and credentials) to ask demanding questions of both management and the external auditor, and to expect and get appropriate answers. Their mind-set should be one of constructive scepticism.

Strive for continuous improvement. Audit committees must be accountable for their actions, and should report regularly through the chairman to the board of directors. They must also continually assess their performance and improve their effectiveness. Directors also have an obligation to devote the time required to carry out their duties at meetings, prepare for meetings and, if required, work between meetings.

In summary, the key to being a successful audit committee member is to:

- Devote the time
- Educate yourselves
- Be demanding
- Be diligent; and
- Insist on timely and appropriate briefings and responses both from management and the external auditor

**To explore these ideas further, contact your
Lead Client Service Partner**

or

Abhay Gupte

Director, Deloitte Center for Corporate Governance, India

Tel: + 91 (22) 6681 0600

E-mail: agupte@deloitte.com

In this material Deloitte refers to Deloitte Touche Tohmatsu India Private Limited (DTTIPL), a Company established under the Indian Companies Act, 1956, as amended.

DTTIPL is a member firm of Deloitte Touche Tohmatsu, a Swiss Verein, whose member firms are legally separate and independent entity. Please see www.deloitte.com/about for a detailed description of the legal structure of Deloitte Touche Tohmatsu and its member firms.

This material prepared by DTTIPL is intended to provide general information on a particular subject or subjects and are not an exhaustive treatment of such subject(s). Further, the views and opinions expressed herein are the subjective views and opinions of DTTIPL based on such parameters and analyses which in its opinion are relevant to the subject.

Accordingly, the information in this material is not intended to constitute accounting, tax, legal, investment, consulting, or other professional advice or services. The information is not intended to be relied upon as the sole basis for any decision which may affect you or your business. Before making any decision or taking any action that might affect your personal finances or business, you should consult a qualified professional adviser. None of Deloitte Touche Tohmatsu, its member firms, or its and their respective affiliates shall be responsible for any loss whatsoever sustained by any person who relies on this material.