A formalised performance assessment process to improve audit committee performance in South Africa: a conceptual exploration

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ABSTRACT
There is concern worldwide about corporate governance, director liability, litigations and business failures, the economic recession and the quality of financial reporting. Owing to these factors, new regulations and legislation affecting organisations and the related responsibilities imposed on audit committees, it is imperative that the performance of audit committees and individual members be enhanced and sustained. The King III Report and other corporate governance principles specify that the board, its committees and individual members should be evaluated regularly, which was not a requirement for individual committee members in King II. This article examines formal guidelines and requirements to identify the factors affecting the audit committee and individual members’ performance, to determine whether their performance could be improved by formalising the assessment process and to develop a framework for measuring their performance. The balanced scorecard as a method of assessment or evaluation is examined and proposed to help audit committees to meet their requirements and improve the quality of their oversight responsibilities. This article should be of value to boards of directors, audit committees and regulators in that the contributions of a more formalised performance assessment process as an internal governance mechanism towards facilitating the professional development of audit committee members are demonstrated.

Key words: audit committees, audit committee members, best practices, audit committee effectiveness, performance assessment, audit committee composition

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Introduction

“Just as the economic crisis and unprecedented uncertainty have placed tremendous stress on companies, so too have the demands and pressures on audit committees and boards increased” (ACI 2009: 6). Today’s business environment abounds with new challenges and complexities, such as an increase in global competition, significant levels of litigation, corporate re-engineering, the worldwide economic recession and rapid advances in technology. These all have a significant effect on business risk, which, to some extent, could be mitigated by more knowledgeable members on audit committees (Arthur Andersen 1998: 2; Howard 1998: 1; ICAEW 2004: 2). Organisations such as Enron, WorldCom and Parmalat failed partly because of a lack of corporate governance, and partly through an inability to be sustainable in the current competitive economic environment (Munzig 2003: 1). Prince (2002: 43) commented on the limited ability of regulators to make visible the effectiveness of boards and audit committees in the light of Enron’s board and audit committee being considered “one of the best corporate boards in the USA”.

These significant business failures and fraudulent financial reporting, both in South Africa and internationally, have led to an increased demand for regulation (DeZoort, Hermanson, Archambeault & Reed 2002: 38; Verschoor 2002: 4), especially with regard to governance, transparency, sustainability and accountability (Gaynor, McDaniel & Neal 2006: 874; IoD 2009b: 10–11). This increased demand for both regulation and guidance “to enhance corporate governance mechanisms and restore investor confidence in financial reporting” is reflected in the Public Company Accounting Reform and Investor Protection Act of 2002 (Sarbanes-Oxley Act) in the United States of America (USA) (Krishnan & Visvanathan 2008: 851), and in South Africa in the King Report on Corporate Governance (King II and III Reports) and the new Companies Act (Act No. 71 of 2008). The Blue Ribbon Report (1999), the Higgs Report (2003) and the Smith Report (2003) also suggested good practices for audit committees. The Blue Ribbon Committee’s (BRC) recommendations in the report, *Improving the Effectiveness of Corporate Audit Committees* (BRC 1999: 20) acknowledge that “good governance promotes relationships of accountability among the primary corporate participants to enhance corporate performance and that it holds management accountable to the board and the board accountable to the shareholders. The oversight function is typically delegated by the full board to the audit committee.” The report also indicates that audit committee members should recognise the significance of their responsibilities and should be willing to undertake necessary training and professional development.

The recent economic downturn, increased demand for good corporate governance and accountability (Braiotta 2004: xv) and additional regulations have increased the
A formalised performance assessment process to improve audit committee performance in SA

Responsibilities and expectations of audit committees to provide effective oversight (ACI 2009: 4–6; Bronson, Carcello, Hollingsworth & Neal 2009: 265; DeZoort et al. 2002: 38; Scholtz 2009: 68; Song & Windram 2004: 195; Terrell & Reed 2003: 63). In addition, the proliferation of corporate scandals, new legislation and stock exchange rules has created more complex and critical new roles and responsibilities for audit committees, over and above assuring financial integrity, which include overseeing risk management, control, compliance and ethics, governance, IT governance, sustainability and special investigations (Bromilow & Berlin 2005: xi–xiii; Burke & Guy 2002: 4; IoD 2009b: 57; Soltani 2007: 102). Engel, Hayes and Wang (2009: 136–137) anticipate that these factors that lead to the increased demand for monitoring will require a greater commitment of time and effort from committee members.

According to Arthur Levitt, former Chairman of the Securities and Exchange Commission (SEC) in the USA, effective oversight of the financial reporting process depends largely on strong audit committees, and qualified, committed, independent and tough-minded audit committees represent the most reliable guardians of the public interest (Braiotta 2004: 11; Bronson et al. 2009: 265; Levitt 1998: 6). In view of the added responsibilities assigned to audit committees, these characteristics have become even more significant, although previous research has not provided any answers on how much of the aforementioned factors is enough to ensure effective committees or how their effectiveness should be measured. DeZoort et al. (2002: 41) comment on the fact that because audit committees meet infrequently, deal with “complex but limited second-hand information” and have only some degree of knowledge of the organisation’s operations, this tends to limit the achievement of effective oversight. The risk of not staying abreast of the latest requirements was also described by Richard Thornburgh, a former US Attorney General and WorldCom investigator (Thornburgh 2002: 11), who expressed the view that the failure of WorldCom was partly due to “a number of deficiencies in the performance of the audit committee and the internal audit activity”. A survey conducted by the IoD in 2006 also revealed that audit committees might not be as effective as they need to be (Marx 2008: 568). Beasley et al. (2009: 69–70) add insight to this by suggesting that “ceremonial efforts may not be closely related to how a given task is actually accomplished” and that they are mostly “designed to create legitimacy outside the organization”.

This results in the need for audit committees to improve the internal corporate governance mechanisms in benchmarking their performance against leading best practices and global trends in order to enhance their performance. In effect, audit committees will also need to consider their current composition, systems and structure and decide whether they have access to adequate resources to perform their function.
According to the Russell Reynolds Association survey (1997) conducted in the USA, “the quality of the company’s board has now become an important evaluation factor for institutional investors” with a possible direct link between board effectiveness, good corporate governance and company profits (IoD 2002: 65). The question arises whether benchmarking the audit committee performance by conducting formal performance assessments of individual members and considering the composition and structure of the committee could also enhance audit committee effectiveness, although conducting performance assessments implies a further load on their time commitment.

There is, however, a need to specifically identify the skills shortages and professional development requirements of audit committee members, which could only be determined by formally assessing the performance of the committee as a whole and of individual members in particular. The research on which this article is based proposes the implementation of a formal performance assessment process for individual audit committee members as an internal governance mechanism to improve the performance of committees and their members in South Africa. The assessment of individual committee members has in fact recently become a requirement of the King III Report, although self-assessments have been recommended. The background and aim of the research and the research methodology are provided in the next sections of the article, after which the literature review, conclusion and recommendations are presented. A summarised example of the proposed framework for performance assessment is provided in Figure 5. For a complete version of the framework, the author could be contacted.

**Background**

South Africa has to contend with the problem that many audit committee members do not possess the necessary skills, knowledge and experience to act as audit committee members and perform their duties optimally (Cascarino & Van Esch 2005: 179; Hattingh 2000: 2; Njunga 2000: 8). There is also an apparent lack of available non-executive directors (NEDs) with the required business acumen and accounting background who are willing to serve on audit committees (Krishnan & Lee 2008:5; Wixley & Everingham 2002: 20). Linck, Netter and Yang (2008: 3292) claim that the increased time commitment, having to meet the ‘independence’ and ‘financial literacy’ requirements as well as the associated risk involved in serving on a board, cause candidates to be more reluctant to accept such a position. Mike Bourne (*Business Day* 2005: 2), Professional Practice Director of national audits at Ernst & Young, contends that it is difficult to find people with the required skills, experience
A formalised performance assessment process to improve audit committee performance in SA

and time to make audit committees work effectively. This challenging situation is exacerbated by the fact that the more experienced audit committee members tend to serve on too many audit committees, which could affect their time commitment and their contribution.

According to Temkin (2006: 1), there are approximately 1400 audit committee positions to be filled in about 685 companies listed on the JSE Limited. The apparent lack of available NEDs with the required skills and experience to serve on audit committees has been exacerbated by the requirement of the South African government that the audit committees of widely held companies consist only of independent NEDs under the Corporate Laws Amendment Act (Act No. 24 of 2006), and that the audit committees of widely owned public companies have at least two members who are NEDs and who must act independently (National Treasury 2006: s 269A). This is similar to the recommendation in the King II Report, which speaks of “a majority of independent NEDs” (IoD 2002: 39; Temkin 2006: 1). However, the King III Report and the new Companies Act now require that all listed and state-owned companies must establish an audit committee comprising at least three members and that all members should be independent NEDs, and all other companies should establish an audit committee (IoD 2009b: 57; Companies Act No. 71 of 2008: 174). The King III Report further recommends that members should have the necessary level of financial literacy, although not for individual members but collectively (IoD 2009b: 58).

The results of the survey conducted by Ernst & Young in 2005 suggest that continuing education for audit committee members in South Africa “is an area that needs significant improvement if they are to stay in line with best practice and keep up-to-date with technical developments”. Another significant concern raised from this research was that audit committees might not have had recent education with regard to International Financial Reporting Standards (IFRS) or the Companies Act (Ernst & Young 2005: 9). This matter will be complicated further in meeting the requirements of the King III Report in terms of sustainability, IT governance, risk management and corporate law for audit committee members to be sufficiently proficient in these matters (IoD 2009b: 57).

In 2004 Thayer pointed out a debate on whether a ‘standard’ should be introduced for non-executive board members in terms of their qualifications, such as a requirement that they possess a professional qualification similar to that of a chartered accountant (Thayer 2004: 2). This is similar to a recommendation by Prince (2002: 44) for a “more formal board certification process model”. Thayer (2004: 2) further commented that a curriculum, similar to that for the qualification of Chartered Director in the United Kingdom (UK), was already being developed in conjunction
with the Institute of Directors (South Africa). This situation has complicated the selection and recruitment process for new members and has created awareness that the composition and structure of the committee should be reconsidered.

Aim of the research

The aim of the research was to contribute to the literature on audit committee effectiveness by examining formal guidelines and requirements in this regard with the objective of developing a framework for assessing their performance and that of individual committee members. A secondary objective was to determine the factors affecting audit committee effectiveness that should be included in this framework. A limitation of the research is that it did not examine the enforcement or implementation of existing practices and requirements (such as the King III Report), which is a topic for further anticipated research. A recent study conducted by the Audit Committee Institute (ACI) in the UK reflected that just over half of the audit committee respondents indicated that a performance assessment of individual committee members would only ‘improve somewhat’ the overall effectiveness of the audit committee, but no reason was advanced for this result, nor were any measures suggested to improve their effectiveness (ACI 2008: 7). The King II Report required that “board committees should be subject to regular assessments by the board to ascertain their performance and effectiveness” (IoD 2002: 69), whereas the King III Report now specifically requires that the “evaluation of the board, its committees and individual directors should be performed every year” to improve board performance and effectiveness (IoD 2009b: 44). There was previously no mention of the assessment of individual committee members, and the King III Report now recommends self-assessment as the method for evaluating the performance of the board and its committees. Interviews with audit committee members from a study by Spira (2002: 53, 175) indicated that members generally believed that they had executed their responsibilities effectively, which is an indication of the need for more objective measures and methods of assessment. A study by Van der Nest (2008: 175) on audit committees in the South African public service concluded that the majority of audit committees were not perceived to be ineffective but that they could improve their effectiveness in all key areas. The question raised is whether the requirement that individual audit committee members be evaluated in terms of performance is necessary to realise the benefits of improved effectiveness and whether the formalisation of the assessment process is required.
A formalised performance assessment process to improve audit committee performance in SA

Research methodology

Based on the aim of the research, a review of the literature supported by secondary empirical studies was conducted. A literature review was performed to identify the performance assessment methods and practices followed and prescribed in the various corporate governance codes, practices and guidelines, and to determine the factors affecting audit committee effectiveness. The literature comprised articles published in accredited journals, articles in popular publications, master's and doctoral theses and industry frameworks, guidelines and regulations. Data were consulted from research conducted by the Institute of Directors (IoD), Ernst & Young (South Africa), KPMG’s Audit Committee Institute (ACI) and Audit Committee Forum (ACF), and Deloitte (Ferreira 2007) in terms of the composition, structure and performance assessment process of the audit committee. Ernst & Young conducted an audit committee benchmarking survey in 2005 among audit committee members in South Africa, and KPMG’s ACI undertook an international survey during 2005, 2006 and 2008 among ACI members in the Americas, Europe, South Africa, Asia, Australia and other unspecified countries (Ernst & Young 2005; ACI 2006; ACI 2008). The results of the reports from the research consulted were analysed to integrate the findings into the literature review and existing guidance in order to determine the requirements for the evaluation of individual audit committee members and whether such assessments could improve the performance of the audit committee as a whole.

Literature review

Performance assessment to measure audit committee effectiveness

Most organisations are trying their utmost to optimise all their activities, including those performed by audit committees, and according to Abbott, Park and Parker (2000: 55), it has become “important to develop more specific measures of audit committee effectiveness”. In 2006 Gendron and Bédard argued that there had been a considerable increase in and expectation of publicly demonstrated performance through objective measures (Gendron & Bédard 2006: 213). Concern about director liability is further justification for increased monitoring of audit committee effectiveness (Abbott et al. 2000: 56). Song and Windram (2004: 196), however, recognised the lack of objective measures as a limitation of previous studies on the effectiveness of audit committees.

DeZoort et al. (2002: 41) define an effective audit committee as follows: “An effective audit committee has qualified members with the authority and resources to protect stakeholder interests by ensuring reliable financial reporting, internal controls,
and risk management through its diligent oversight efforts.” However, numerous factors affecting the performance of audit committees need to be addressed in order to optimise their effectiveness and achieve their objectives. To improve the performance of audit committees and identify inefficiency and opportunities in order to enhance effectiveness, audit committees should adopt global best practices in meeting their financial oversight and governance responsibilities (Leblanc Diagnostics 2005: 6). Performance assessments should therefore be carried out to determine the individual members’ contributions, skills and knowledge. The effectiveness of audit committees could then be improved by benchmarking their performance against best practices of other audit committees. Benchmarking is defined as a continuous process of comparing or measuring performance and practices against the performance of organisations in a similar industry or organisations recognised as industry leaders (Harvey 2004).

**Figure 1:** Elements of audit committee oversight

Figure 1 depicts the important elements of audit committee oversight, reflected as a pyramid, representing the suggested flow of information in the oversight function of the audit committee to ensure that their objectives are achieved. It illustrates how their performance could be improved continuously through self-assessment.
A formalised performance assessment process to improve audit committee performance in SA

(performance evaluation) and education, at the same time adhering to the principles of corporate governance within the framework of their monitoring responsibilities. This requires individual assessments of audit committee members and not only an evaluation of the audit committee as a whole. All the elements should contribute to receiving “the right information, at the right time, from the right individuals, and in the right context to provide effective oversight” by the audit committee within the corporate governance framework (ACI 2003b: 5). The framework illustrates the importance of continuous improvement of performance in order to report effectively to all stakeholders.

After comparing the audit committee’s performance with best practices of other audit committees, input could also be obtained from the chairperson of the board of directors, senior management, the Chief Audit Executive (CAE) and the external auditor with regard to the committee’s efficiency and effectiveness. According to Burke and Guy (2002: 246), the main purposes of obtaining this information on the audit committee’s performance are firstly, to appraise the current status and performance of the audit committee in terms of their duties, responsibilities and activities as reflected in their charter; and secondly, to ascertain where the audit committee should be, after comparison with leading best practices and also with reference to the audit committee charter. The objective is to indicate the resources needed to achieve the objectives and execute the functions of the audit committee and to identify any shortcomings or obstacles in progressing from their current performance to the required performance. A final objective should be to develop a proposed action or strategic plan and set a timetable for the required changes as well as the people responsible for each activity and to present these findings and recommendations on the improvement of audit committee performance to the board of directors (Burke & Guy 2002: 246).

Wilkinson (2006: 12) contends that although conducting board, committee and director performance assessments is generally considered to be difficult, the process of performance assessment has the benefit of being the most effective way of making performance expectations clear, and clarifies whether board or committee composition is appropriate and whether members should be reappointed (IoD 2009b: 44). This suggests that individual assessments should be conducted. It also improves relations between the board, committees and management and prevents powerful personalities from exercising overall control and evading checks and balances. Performance assessments identify not only strengths and weaknesses but also shortcomings in the professional development and education of audit committee members (IoD 2009b: 44). It is therefore evident that performance assessment is
a vital factor in enhancing the performance of individual members and the audit committee as a whole (Wilkinson 2006: 12).

Factors or determinants of audit committee performance assessment

According to Epstein, Jones and Roy (2002: 16), audit committee performance is dependent on factors such as the committee’s composition, systems and structure and the feedback received through performance assessments and the training provided (see Figures 1 and 2).

Certain areas or factors for assessment that could be positively linked to effectiveness were extracted from the recommendations made by the Blue Ribbon Committee, the Public Company Accounting Oversight Board, the King III Report and the Institute of Internal Auditors (IIA) with regard to the audit committee’s performance. These reports emphasised that boards of directors are expected to evaluate certain factors or areas for assessment in terms of audit committee performance (Bromilow & Berlin 2005: 103; IIA 2005: 3; IoD 2009b: 56–68; PWC 2005: 14; Wixley & Everingham 2002: 51). Figure 2 shows the effect of these factors on the audit committee’s performance and ultimately the company’s overall performance (corporate performance) (Epstein et al. 2002: 6). Levy (1993: 60) demonstrated the synergy between the oversight responsibility of audit committees and the improvement in corporate governance. This correlation between audit committee performance and their governance contribution and corporate performance was also evident in Turley and Zaman’s (2004: 309 & 323) research. It demonstrates the importance of inputs and processes as well as adequate feedback information in order to improve the audit committee’s effectiveness. The only way to obtain sufficient and adequate feedback is to implement a formalised assessment process. Gendron and Bédard (2006: 213), however, noted the complexity of measuring performance in terms of corporate governance.

The critical success factors or keys regarding the ‘input’ or audit committee composition consist of the independence and objectivity of individual members, ethics, diligence, judgment, insight and tenacity, knowledge, skills and experience, communication skills, and the selection process for new audit committee members (Bromilow & Berlin 2005: 103; DeZoort et al. 2002: 42; Epstein et al. 2002: 16; IIA 2005: 3; PWC 2005: 14; Wixley & Everingham 2002: 51). Another crucial requirement relating to composition is that people from “diverse and complementary backgrounds” (Ernst & Young 2003: 6) should be selected to serve on the audit committee, which could include members with a diversity of experience, and of different genders, races, ages and even nationalities (Gregory 2000: 12).
The keys with regard to the ‘processes’ or the audit committee structure consist of the audit committee chairperson, NEDs, diversity of skills and knowledge, the size of the audit committee and rotation of members (Epstein et al. 2002: 16). As early as 2001, Gumede (2001: 38–39) suggested that some organisations select non-executive members as ‘token’ appointments or on the basis of their political alignment simply to fill vacant positions, and that this affects their ability to add value. However, research conducted by Ahwireng-Obeng, Mariano and Viedge (2005: 11) and reported on in the ‘Influences on the performance effectiveness of NEDs in South Africa’ indicated that only 16% of the respondents mentioned token appointments of black NEDs as one of the factors that influence the effectiveness of NEDs. Ahwireng-Obeng et al. (2005: 11) also cited the diversity of NEDs (43%), the work overload of NEDs (33%), the need to transform (26%) and matching expectations of the company with those of the NED (16%) as having an effect on the performance of audit committees.

All the factors cited by Ahwireng-Obeng et al. (2005: 11) should also be considered in the selection and recruitment process of audit committees. These factors ultimately impact on the performance of audit committees because new members,
in particular, have not yet acquired the necessary skills and experience to make a valuable contribution from the early stages of the discharge of their responsibilities to the committee. It is understandably difficult to meet all the requirements, adhere to regulations and governance principles and at the same time be able to fill the required vacant positions on audit committees. Some organisations often use representatives from stakeholders such as labour unions to be appointed as audit committee members. However, these members might not have received any financial or organisational management training prior to their appointment as audit committee members. Furthermore, they are often regarded as only “part-time participants in the company” (Bishop, Hermanson, Lapides & Rittenberg 2000: 51).

The ideal audit committee structure and composition for a company should therefore be determined and reviewed regularly to identify any necessary changes in membership. Term limits should also be addressed. Evident strengths and skills shortages in the composition should then be identified and corrective action taken (IIA 2005: 2). To ensure effective and efficient audit committee performance, the structure (formation, reporting structure, size and make-up) of the audit committee should first be established and formalised to maintain the committee’s independence. If the committee is to go forward, the composition of the audit committee (required qualifications, independence, skills sets, personal attributes and available time of individual committee members) should be considered, identified and formalised and these factors should also be considered in the selection and recruitment process (Ferreira 2008: 92).

Epstein et al. (2002: 16) identified the keys for the ‘processes’ or the audit committee systems as productivity and attendance of meetings, adequate induction and professional development process, information or resource availability, effective succession planning, open and independent communication, information flow and reporting systems, and effective performance assessment systems. Bromilow and Berlin (2005: 103) and ACI (2009: 8) report that the most effective audit committees also evaluate the performance of individual committee members by assessing their understanding of the company’s business, their understanding of and commitment to the duties and responsibilities of the audit committee and their willingness to devote the time necessary to prepare for and participate in the committee’s deliberations. The overall performance of the audit committee, executive sessions with management, the internal auditors and external auditors and the relationship, interaction and involvement with all the relevant parties are factors identified by Bromilow and Berlin (2005: 103), Epstein et al. (2002: 16), IIA (2005: 3), PWC (2005: 14) and Wixley and Everingham (2002: 51). The methods of evaluating these characteristics, however, have not been prescribed. After examining specific characteristics (as already
A formalised performance assessment process to improve audit committee performance in SA

mentioned) of committee members, Abbott et al. (2000: 55) provided evidence that there is a direct relationship between audit committee effectiveness, as opposed to the mere presence of members, and the incidence of financial misstatements. Abbott, Parker, Peters and Raghunandan (2003: 20), who further researched this matter, suggest that “key audit committee characteristics – rather than the mere presence of an audit committee – critically impact the audit committee’s ability to effectively execute its duties”. Other research studies whose results are consistent with this show that the audit committee’s effectiveness is affected by these characteristics (Abbott, Parker & Peters 2004; Beasley et al. 2000; Carcello & Neal 2000; DeZoort & Salterio 2001; Goodwin-Stewart & Kent 2006:8). This implies that the characteristics of individual members of the audit committee could also be important in ensuring an effective committee.

The output or result of performance assessment would then be reflected in the audit committee’s effectiveness in performing this oversight function and culminate in the organisation’s performance. To enhance or improve the committee’s performance, there should be a comprehensive assessment and adequate feedback process to ensure that inefficiencies can be addressed either through training or by changing the composition of the audit committee. This process should also ensure that the foundation is laid for future improvement (AICPA 2004: 103; IoD 2009b: 44). Benchmarking the monitoring role and the composition and structure of the audit committee enhances audit committee effectiveness (Ferreira 2008: 89–106; Song & Windram 2004: 196). Again, it is evident from the determinants of audit committee performance that individual assessments of audit committee members should be conducted in order to achieve the objectives of the audit committee and to contribute effectively to corporate performance.

According to Ernst & Young (2005: 1), adequate global benchmarks and measures are available for measuring audit committee performance and progress. However, in South Africa, the effects and implementation of the King II Report on audit committee performance and specifically that of individual members have not been clearly measured; nor have the results been reported. Mahadeva (2005: 8) indicates that formal board assessments, which used to be a rarity in most companies, are increasingly being made a requirement in the US and UK corporate arena, which was a specific requirement in the draft King III Report but then excluded from the final published King III Report (IoD 2009a: 40). This raises concerns. However, other regulatory bodies have also provided little guidance on how these assessments should be performed. Mahadeva (2005: 8) suggests that this process be customised for individual companies and that it should never be a case of ‘one size fits all’. The King II Report (IoD 2002: 27, 29) recommends that a substantial portion of executive directors’
compensation be performance-based and that performance should be evaluated at least annually through self-assessment. The draft King III Report recommended a formal evaluation process and that independent performance assessments should be considered (IoD 2009a: 39–40), whereas the final King III Report requires that a “yearly evaluation should be performed by the chairman or an independent service provider” (IoD 2009b: 45). The method of assessment is, however, not prescribed. KPMG’s Audit Committee Institute (ACI 2003a: 2) recommends that a well-devised assessment process to be conducted in an open and constructive manner in order to allow all the stakeholders to benefit from the individual and collective insight, knowledge and experience of all the audit committee members. The process should also determine how effectively and faithfully individuals have carried out their roles and responsibilities (Mahadeva 2005: 8). It should also identify the training needs of individual members and consider reappointing these members (IoD 2009b: 44). However, the assessment should not simply be a checklist for compliance with rules and regulations – it should focus instead on evaluating the effectiveness of the committee and the individual audit committee members (ACF 2006: 1).

In a survey conducted by Ernst & Young (2005: 2), more than half the respondents indicated that the compensation paid to audit committee members in South Africa is proportionate to their responsibilities and the risk associated with their position. King II suggested that share options be granted to NEDs, subject to prior approval by the shareholders (IoD 2002: 27), whereas the King III Report requires that share options should not be granted and NEDs’ fees should be fixed at a base fee and an attendance fee per meeting (IoD 2009b: 49). International recommendations reflect a preference for the granting of shares rather than share options.

**Performance assessment methods**

Research conducted by Ernst & Young in 2005 through their audit committee benchmarking survey indicated that one-third of the audit committees in South Africa did not evaluate their effectiveness. The remaining two-thirds of the respondents indicated that they used a combination of qualitative and quantitative means of assessment (Monteiro 2005: 2). This indicates that the practice of performance assessments is followed in some organisations but that the process is not formalised or regulated. Auditing Standard No. 2 of the Sarbanes-Oxley Act requires that the auditor “evaluate the effectiveness of the audit committee’s oversight of the external financial reporting as well as the internal control over financial reporting” (Rossiter 2009: 2). It will therefore be advisable for the audit committee members to evaluate themselves. Furthermore, a search on audit committee reports available on the
internet revealed that the performance assessment of individual committee members was not mentioned anywhere.

KPMG’s Audit Committee Forum (ACF 2006: 1) suggests that a structured and formal assessment can help to ensure that the audit committee delivers on its mandate or charter and continuously enhances its contribution to the functioning of the board. Performance assessment methods, singly or in combination, could be used to evaluate audit committee performance, say, to obtain formal feedback from the board, the chief executive officer (CEO), the chief financial officer (CFO), the compliance officer, as well as internal and external auditors. Additional assessment methods include completing self-assessment surveys and obtaining assessment of the contributions and performance of individual audit committee members by the chairperson of the audit committee (Auditnet 2006: 1). Monteiro (2005: 2) suggests comparing audit committee activities against the committee’s charter or formal written procedures and conducting peer reviews or comparisons. Bromilow and Berlin (2005: 101) and Song and Windram (2004: 196) recommend that the audit committee’s activities be compared with leading best practices (benchmarking), while the ACF (2006: 1) adds that assessments by the governance or nominating committee of the board should be obtained. Richards (2001: 2) proposes comparing current practices with a review of current literature on audit committee best practices, while Epstein et al. (2002: 3) suggest the use of the balanced scorecard approach. For the purposes of this article, the balanced scorecard approach will be further discussed, because this method has not yet been effectively utilised in performance assessments of audit committees.

The balanced scorecard approach as a method of assessment

Epstein et al. (2002: 3–4) suggest that the balanced scorecard approach, illustrated in Figure 3, is an effective method of measuring and managing corporate performance. They propose that it could be used in the same way to evaluate board performance in general. According to the author of this article, this approach could also be used to evaluate audit committee performance.

Epstein et al. (2002: 3–4) further indicate that the balanced scorecard is useful in “developing the objectives, goals, systems, and metrics to help align strategy, actions, and performance” with regard to the audit committee’s role and responsibilities. In effect, this will ensure accountability to the various stakeholders and improve corporate governance and transparency while also ensuring that all the dimensions of their responsibility will be assessed. To implement a successful performance assessment system, strategic objectives and critical success factors need to be identified in advance.
for the audit committee as a whole. Internal processes and learning and growth as dimensions of the monitoring and evaluating process of the balanced scorecard will also be further explored in terms of the performance assessment process (see Figure 4) (Epstein et al. 2002: 3–4).

Adapted from the framework of Epstein et al. (2002: 20–21), the schematic representation (Figure 3) shows the four dimensions of the audit committee’s responsibility with regard to the core values of the organisation. These are the governance and performance dimension, the stakeholder dimension, the internal business processes dimension and the learning and growth dimension.

For each of these dimensions of the balanced scorecard, the audit committee should identify strategic objectives, measures to accomplish these objectives and targets and key performance indicators (KPIs) or drivers to achieve the objectives. According to Ernst & Young (2004: 9), the audit committee’s value-adding activities could be assessed by measuring their performance against expected results. This would entail identifying specific decisions/dimensions deemed to be vital to the audit committee’s success in contributing to organisational performance (Figure 3) as well as the expected behaviours necessary to maintain constructive teamwork and sufficient balance between control and collaboration, setting target key performance indicators (KPIs) and measuring both the individual audit committee members’ performance and the team’s performance and progress against KPIs. Feedback should be given on the progress and results of assessment to ensure learning, growth and improvement.

The strategic objectives and performance drivers reflected in Figure 4 could be incorporated into Figure 3, the balanced scorecard framework for evaluating audit committee performance as proposed by this article. The progression or link between the different performance drivers starts with improving the audit committee’s skills and knowledge (strategic objective) through training programmes (performance driver), which would lead to improved audit committee processes. This would be followed by effective governance practices and stakeholder satisfaction, which would give rise to improved company performance and the achievement of the organisation’s objectives.

The suggested balanced scorecard framework set out in Figure 5 reflects the best practice components of an effective audit committee, derived from the strategic objectives (Figure 4), to be used as a performance assessment instrument by audit committees and individual members in the assessment process (ACI 2002; AICPA 2004; Apostolou & Jeffords 1990; Braiotta 2004; Burke & Guy 2002; Burrage 2003; IoD 2002; IoD 2009b; Steinberg 2000).
A formalised performance assessment process to improve audit committee performance in SA

Source: Adapted from Epstein et al. (2002: 21) and Kaplan & Norton (1996)

Figure 3: The balanced scorecard framework to evaluate audit committee performance
The suggested framework in Table 1 consists of the following columns: the best practice components of an effective audit committee based on the four dimensions of audit committee responsibilities, and the related strategic objectives (cf. Figure 4). For each strategic objective, performance drivers, as well as the related measure (evaluation by the Board) and the target (namely, the King III Report or Companies Act) should be determined by the committee as a whole. The effectiveness rating of performance, and the person responsible for addressing the follow-up steps and inefficiencies, should be indicated by the committee members. This is necessary to ensure optimal performance of the audit committee as well as of the individual committee members. The measures, targets, rating and follow-up steps should be completed by the audit committee according to their regulatory framework, organisational structure and specific requirements.
A formalised performance assessment process to improve audit committee performance in SA

Table 1: Balanced scorecard framework for audit committee performance assessment

<table>
<thead>
<tr>
<th>Best practice components of an effective audit committee</th>
<th>Measure Is practice followed? Yes/No/NA</th>
<th>Target</th>
<th>Effectiveness rating 1-5</th>
<th>Follow-up steps and person responsible</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>GOVERNANCE &amp; PERFORMANCE</strong></td>
<td></td>
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<tr>
<td><strong>STRATEGIC OBJECTIVES:</strong></td>
<td></td>
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<tr>
<td>The audit committee promotes long-term shareholder value</td>
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<tr>
<td>Drivers:</td>
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<tr>
<td>The audit committee plays a key role in the areas of comprehension, communication and oversight regarding financial reporting, internal auditing, external auditing and special investigations</td>
<td>Evaluation by all stakeholders</td>
<td>Number of contact meetings</td>
<td>Audit committee chair</td>
<td></td>
</tr>
<tr>
<td>The audit committee strives to increase shareholders' value with due regard to the interests of other stakeholders and the committee’s significant role</td>
<td>Evaluation by board, nomination committee</td>
<td>Conflict resolution</td>
<td></td>
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<tr>
<td>Audit committee members execute their oversight responsibility in the following manner:</td>
<td></td>
<td>As per King III, Companies Act etc.</td>
<td></td>
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</tr>
<tr>
<td>– Ensure that procedures and systems are in place to act as checks and balances on information received, ensuring preparation of annual budgets and forecasts against which performance can be monitored</td>
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<tr>
<td>– Obtain independent professional advice at the earliest opportunity, when necessary</td>
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<tr>
<td>The audit committee promotes a high level of corporate governance</td>
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<tr>
<td>The audit committee contributes to the long-term sustainability of company performance</td>
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<tr>
<td>Drivers:</td>
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<tr>
<td>To be developed by audit committee</td>
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<tr>
<td><strong>STAKEHOLDERS</strong></td>
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<tr>
<td><strong>STRATEGIC OBJECTIVES:</strong></td>
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<tr>
<td>The audit committee develops and manages appropriate relationships with all stakeholders</td>
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<tr>
<td>The audit committee demonstrates a high level of ethical behaviour and legal compliance</td>
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<tr>
<td>The audit committee promotes accountability, transparency and risk management</td>
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<tr>
<td>Drivers:</td>
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<tr>
<td>To be developed by audit committee</td>
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<tr>
<td>Best practice components of an effective audit committee</td>
<td>Measure Is practice followed? Yes/No/NA</td>
<td>Target</td>
<td>Effectiveness rating 1–5</td>
<td>Follow-up steps and person responsible</td>
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<tr>
<td><strong>INTERNAL PROCESSES</strong></td>
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<tr>
<td>STRATEGIC OBJECTIVE:</td>
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<tr>
<td>• Audit committee’s composition and structure contribute to the organisation's performance</td>
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<tr>
<td>• Maintaining effective processes and standards to execute audit committee oversight responsibilities</td>
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<tr>
<td><strong>Drivers:</strong></td>
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<tr>
<td>To be developed by audit committee</td>
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<tr>
<td><strong>LEARNING AND GROWTH</strong></td>
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<tr>
<td>STRATEGIC OBJECTIVES:</td>
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<td></td>
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<tr>
<td>• Adequate access to strategic information and resources</td>
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<tr>
<td>• Improving audit committee skills and knowledge</td>
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<tr>
<td>• Audit committee members’ characteristics contribute to the achievement of their responsibilities</td>
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<tr>
<td><strong>Drivers:</strong></td>
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<tr>
<td>• Audit committee members display a commitment in terms of the following:</td>
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<tr>
<td>− Finding the time and demonstrating a commitment to performing their duties and responsibilities properly</td>
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<tr>
<td>− Being diligent and motivated in discharging their responsibilities by regularly attending meetings and contributing to the company’s direction</td>
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<tr>
<td>− Striving to increase shareholders’ value with due regard for the interests of other stakeholders and the committee’s significant role</td>
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<tr>
<td>• Audit committee members conduct their fiduciary responsibility in the following manner:</td>
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<tr>
<td>− Exercise utmost good faith, honesty and integrity, a high level of ethical standards and act independently of any outside fetter or instruction</td>
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<tr>
<td>− Always act in the best interests of the company and not in ‘sectoral’ interests</td>
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<tr>
<td>− Avoid conflicts of duties and interests, disclosing potential conflicts at the earliest possible opportunity</td>
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</tbody>
</table>
A formalised performance assessment process to improve audit committee performance in SA

<table>
<thead>
<tr>
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<th>Measure Is practice followed?</th>
<th>Target</th>
<th>Effectiveness rating 1-5</th>
<th>Follow-up steps and person responsible</th>
</tr>
</thead>
<tbody>
<tr>
<td>(if need be) disagree with colleagues on the board, including the chairperson and chief executive, demonstrating a strong willingness both to question issues and to speak out at meetings</td>
<td>Yes/No/NA</td>
<td></td>
<td></td>
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</tr>
<tr>
<td>• Audit committee members should be emotionally intelligent, confident, influential and have excellent interactive skills as well as the ability to handle conflict</td>
<td>Yes/No/NA</td>
<td></td>
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</tr>
<tr>
<td>• Members should have analytical reasoning abilities, natural curiosity, a reasonable measure of healthy scepticism, and a willingness to devote the time necessary to do the job</td>
<td>Yes/No/NA</td>
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<tr>
<td>• Members should have sound process management skills and the capacity to absorb a fair degree of detail</td>
<td>Yes/No/NA</td>
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<tr>
<td>• Audit committee members should be vigilant and informed, with probing minds, to ensure effective oversight of their responsibilities</td>
<td>Yes/No/NA</td>
<td></td>
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</tbody>
</table>

The assessment process

The assessment process should be formalised, as was initially suggested by the draft King III Report (IoD 2009a: 39–40). KPMG’s ACF (2006: 2) suggests a structured audit committee performance assessment approach by discussing the performance assessment process that will be adopted, deciding who will coordinate the process and creating an assessment form that is accepted by all members. The approach should involve the following: determine who will participate in providing initial input to the audit committee – this will include the audit committee members and chairperson and possibly even the chairperson of the board, the CEO, the chairpersons of other board committees, the CFO, the CAE, the external auditor, the company secretary, in-house counsel and others who interact with the audit committee. The assessment forms should then be provided to all the participants and be returned to the process coordinator for analysis and compilation. The compiled reports should reflect each response and the average rating, possibly reflecting the overall average, the averages of the audit committee members (without losing sight of strongly conflicting views)
and other participants as the basis of a conversation concerning the audit committee’s effectiveness and areas for improvement. A final report should then be submitted to the board of directors on recommendations for improvement, if any, in terms of the audit committee charter or membership (ACF 2006: 2).

Conclusion

The research focused, *inter alia*, on the increased responsibilities of audit committees, derived from corporate governance codes, legislation and the audit committee charter, and described the potential effect of performance assessments on the overall performance of audit committees. The research emphasised how audit committee performance could be enhanced through the adoption of good governance principles and the benchmarking of performance against global trends and best practices. The principles of good governance and the elements of audit committee oversight were considered and examined for the purpose of discovering the factors or areas of assessment with regard to audit committee performance in ensuring transparent and objective internal governance mechanisms within an organisation. The conclusion drawn is that formalised performance assessment processes for the individual members of audit committees (to enable them to comply with the increased demands and governance principles) have become imperative.

It was acknowledged that the responsibilities of audit committees differ from organisation to organisation, based on the size, structure, nature and requirements imposed by the board of the organisation as well as legislature. A generic framework as suggested in this article could be suitable for all audit committees, but individual frameworks should be developed and adapted within each organisation to accommodate the unique dynamics and environment of the organisation. The research examined best practices in the audit committee performance assessment process. In addition, the importance of establishing and maintaining a charter to guide the committee in achieving its objectives was suggested. The audit committee charter should therefore form the basis on which the audit committee and the individual members are evaluated.

As derived from the literature, the effectiveness of audit committees may be influenced by several factors, such as performance assessment, diversity of skills, size, rotation of members and access to support and information. Best practices in all these areas should be considered and applied to assist the audit committee in the effective performance of its responsibilities.

This study emphasised the importance of complying with the composition requirements and the ideal structure for the committee to ensure effective and
A formalised performance assessment process to improve audit committee performance in SA

efficient performance of their oversight responsibilities. Selecting qualified and independent members to the audit committee will not necessarily ensure optimal performance. Hence the article emphasised the significance of the induction and professional development process of new and existing audit committee members, which is also evident from the balanced scorecard framework and the relevant key performance drivers to achieve organisational objectives.

In conclusion, the research investigated the importance of the assessment of individual members to improve the effectiveness of the audit committee as a whole. In discharging their oversight responsibilities, audit committees and individual members need to evaluate and improve their performance, and they should be empowered with the authority and necessary resources to protect stakeholder interests in terms of financial reporting, sustainability, internal control, risk management and governance processes.

Recommendations

It is suggested that from the individual audit committee appraisals, any shortcomings in the composition and structure of the committee in terms of knowledge and skills, independence or diversity could be determined. Either new members could be recruited or existing members could be counselled or even replaced. Any additional professional development requirements or resources required could also be identified and corrective action taken. It is therefore proposed that audit committees commit themselves to performance-based remuneration and that the performance of individuals as well as of the committee itself be reviewed regularly to enhance effectiveness. The effectiveness of audit committee performance also needs to be monitored continuously, and progress should be evaluated by means of a formalised process and framework, as proposed by the balanced scorecard framework. It is recommended that the audit committee charter form the basis of the framework and contain a comprehensive list of audit committee responsibilities but be customised to suit individual audit committees.

The current debate is whether a ‘standard’ should be introduced for non-executive board members in terms of their qualifications, such as a requirement that they possess a professional qualification similar to a qualification as a chartered accountant. The way in which this qualification would be awarded or implemented is not yet clear. The author supports the implementation of such a qualification, with the proposal that the performance assessment process suggested in this article be used in the process of awarding such qualification.
Further research is envisaged on examining existing practices in terms of performance evaluations of audit committees, the processes followed and the enforcement thereof and also the probability of boards and board committees recognising and establishing performance as a criterion on which to base remuneration.

“Real knowledge is to know the extent of one’s ignorance.” (Confucius in Quoteland.com 2005)

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A formalised performance assessment process to improve audit committee performance in SA


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A formalised performance assessment process to improve audit committee performance in SA


I. Morgan


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