FINANCIAL SERVICES COMMISSION

DISCUSSION PAPER
GUIDELINES ON AUDIT COMMITTEES
AUGUST 27, 2004

1.0 BACKGROUND

Most supervisory agencies including the Financial Services Commission ("FSC") are moving towards a supervisory approach that relies on strong corporate governance. One of the areas of corporate governance that the FSC is seeking to strengthen is the supervision role that is performed by Audit Committees.

The Securities Act requires, through section 59 (A)(1) of the Securities Act, that "*every company which is licensed under section 7 or 8 of the Act shall establish an audit committee*". In addition, section 59 (A)(2) of the Securities Act states that the FSC shall make rules in respect to the functions of Audit Committees. Section 4 of this document, outlines the proposed rules governing the establishment of Audit Committees by companies licensed as securities dealers or investment advisors. These rules will be drafted into regulations. Once these regulations have been promulgated, a breach of them shall be an offence.

It is intended that the guidelines on Audit Committee should be adopted not only by licensees under the Securities Act but by the issuers of outstanding issues of securities as well.

In developing the proposed guidelines we examined the documents listed under the caption "Information Sources" at the end of the paper.

2.0 THE PURPOSE OF THE AUDIT COMMITTEE

The Audit Committee is appointed by the Board of Directors to ensure the integrity of the financial statements on which various stakeholders rely and which are critical to the efficiency of capital markets. The function of the Audit Committee is based in part, on the ability of its members to carry out the necessary level of due diligence, cautiously placing reliance on experts such as the chief financial officer, the internal auditor, and the external auditors. The main purpose of the Audit Committee is to assist the Board in monitoring:

1. The integrity of the financial statements of the company by providing an oversight of the accounting and financial reporting functions.
2. The external auditors' qualifications, independence, and performance.
3. The performance of the company's internal audit function
4. The compliance by the company with legal and regulatory requirements.

The Audit Committee should be directly responsible for the oversight of the external auditor's work, and the auditor must report directly to the Audit Committee. The requirement of the external auditor to report directly to the Audit Committee will reinforce the external auditor's independence from management. However, the work of the committee cannot replace the routine responsibilities of management in ensuring the accuracy of the financial statements.

3.0 PRINCIPLES THAT PROVIDE THE FRAMEWORK FOR EACH AUDIT COMMITTEE

The FSC would encourage directors and others to consider the following seven (7) Basic Principles for their Audit Committees. Principles one (1) to five (5) were developed by the KPMG's United States ("US") Audit Committee Institute. The FSC believes that these seven (7) principles will provide the foundation for each Audit Committee to develop and adopt its own "best practices".

3.1 Principle 1: One size does not fit all

The organization and operational approach followed by the Audit Committee should take into account the unique aspects of the organizational and governance structures of the company that the committee serves.

3.2 Principle 2: The board must ensure the Audit Committee comprises the "right" individuals to provide independent and objective oversight.

If Audit Committees are to provide meaningful protection for investors, they must be in a position to challenge executive management and draw sufficient attention to inappropriate practices, even in apparently successful companies. In order to do this, Audit Committee members must be diligent, truly independent, and knowledgeable. The Audit Committee members must be prepared to invest the time necessary to understand why critical accounting policies were chosen, how they are applied, and why the end result fairly presents their company's actual status. In essence, the Audit Committee needs to understand the business processes, the substance of complex transactions, and ensure that the financial statements fairly reflect the substance of these complex transactions.

3.3 Principle 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.

The company must have the right "tone at the top" and the Audit Committee, which should serve as a check and balance on management, is the guardian of the company's financial reporting integrity. The highest standards of objectivity, integrity and judgement cannot be the exception but must be the rule for members of the Audit Committee.

3.4 Principle 4: The Audit Committee must demand and continually reinforce the accountability of the external auditor to both the board and the Audit Committee as representatives to shareholders.

The external auditor's accountability to the board and the Audit Committee, as representatives of shareholders, must be more than words in the Audit Committee's terms of reference. The Audit Committee, external auditor, and senior management must all acknowledge this reporting relationship by their actions and deeds.

3.5 Principle 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**
- **Critical financial reporting risks (and other risks where considered appropriate)**
- **Effectiveness of financial reporting controls (and other controls where considered appropriate)**
- **Independence, accountability and effectiveness of external auditor**
- **Transparency of financial reporting**

The Audit Committee process provides a framework for coordinating the activities of, and information provided by, the participants in the financial reporting process that support the Audit Committee's understanding, of the key risks and controls. A strong Audit Committee process allows a company, including the shareholders to benefit from collective insight and experience of each member of the committee.

3.6 Principle 6: Independent communication and information flow between the Audit Committee and internal auditor, and the Audit Committee and the external auditors

1. The internal auditor should have an unobstructed and clear communication channel to the Audit Committee.

2. Internal auditor should evaluate the adequacy and effectiveness of the company's internal controls and report on his / her findings to the Audit Committee.

3. The external auditors must be able to perform their service without being affected by economic or other interests that would call into question their objectivity and accordingly, the reliability of their attestation.

3.7 Principle 7: Candid discussions between the Audit Committee, and management, internal and external auditors.

1. The Audit Committee must be proactive in discussing and understanding the critical accounting policies of the entity

2. Discussions regarding key accounting judgements, corporate disclosures and connected transactions must be actively pursued

4.0 RULES GOVERNING THE FUNCTIONS OF AUDIT COMMITTEE

The rules developed by the FSC to govern the functions of Audit Committees of licensees under the Securities Act and issuers of outstanding issues of securities are based on the rules outlined in an Audit Committee charter prepared by a company that is regulated by the United States SEC.

4.1 Audit Committee Membership

The Audit Committee should consist of at least three (3) members. The Board of Directors should appoint one of the members as the chairman of the committee.

a. *Audit Committee Chairman:*

The Chairman should ensure that the members of the Audit Committee provide effective oversight of financial reporting processes and current issues.

The Chairman should ensure that required protocols are established to facilitate interactions between members of the Audit Committee, management, the internal auditors, and the external auditors. The Chairman should ensure that a high level of expectation is set with respect to management oversight, external and internal auditors' roles and responsibilities.

The Chairman should encourage full participation from each member of the committee, keeping in mind the level of education and experience of each member of the committee.

b. *The members of the Audit Committee:*

Two thirds of the members of the Audit Committee should be independent that is, these members should not have an ownership, employment, or relationship with the company or its subsidiaries. In addition, independent members of the Audit Committee should not maintain business and personal relationships with management, and independent members may not receive any compensation from the company other than for board service as these arrangements could impact their judgment and objectivity.

The composition of the committee should also reflect the complexity of the financial transactions in which an entity engages. The skills needed on an Audit Committee should be commensurate with the types of transactions in which the company engages. Therefore, if a company engages in complex financial transactions, the appointments should include individuals with specialist backgrounds in those types of complex financial transactions.

If a member of the Audit Committee simultaneously serves on the Audit Committee of more than two other companies, the company's board is required to determine whether such simultaneous service would impair the ability of such a member to effectively serve the company's Audit Committee.

The company should disclose to the FSC whether at least one of the members of the Audit Committee is an "**audit committee financial expert**" as defined by the FSC. The FSC's definition of an audit committee financial expert is the same as that used by the United States SEC when it issued the final rules to implement Section 407 of the Sarbanes-Oxley Act, which requires disclosure of whether a financial expert is resident on the Audit Committee. An audit committee financial expert is a person with the following attributes:

i. An understanding of generally accepted accounting principles ("GAAP") and financial statements;

ii. The ability to assess the general application of such principles in connection with accounting for estimates, accruals, and reserves;

iii. Experience preparing, auditing, analysing, or evaluating financial statements that present accounting issues of a breadth and level of complexity generally comparable to the breadth and complexity of issues that can reasonably be expected to be raised by the licensee's or issuer's financial statements, or experience actively supervising one or more persons engaged in such activities;

iv. An understanding of internal controls and procedures for financial reporting;

v. An understanding of Audit Committee functions.

The experience that might qualify an "**audit committee financial expert**" includes:

i. Education and experience as a principal accounting officer, controller, public accountant, or auditor, or experience in one or more positions that involve the performance of similar functions.

ii. Experience actively supervising a principal financial officer, principal accounting officer, controller, public accountant, auditor, or person performing similar functions.

iii. Experience overseeing or assessing the performance of companies or public accountants with respect to the preparation, auditing, or evaluation of financial statements or

iv. Any other relevant experience

The FSC suggests that the designation of a person as an audit committee financial expert does not impose duties, obligations, or liability greater than that borne by a member of the Audit Committee without the designation.

4.2 Meeting Schedule

1. Audit Committees should meet at least four times a year.

2. Additional or extended meetings may be needed based on special circumstances as may be required by the company's Audit Committee Charter.

4.3 Audit Committee Authority and Responsibilities

1. Authority to appoint or replace the external auditors (subject to shareholder ratification)

2. Authority to appoint and replace the company's chief internal auditor

3. Responsible for the compensation and oversight of the work of the independent auditors (including resolution of disagreements between management and the independent auditors regarding financial reporting)

4. Responsible for pre-approving all auditing services and permitted non-audit services (including the fees and terms thereof) to be performed for the company by its external auditors in order to ensure that they do not impair the auditors' independence from the Corporation. In order to implement the role of pre-approving non-audit services, the Audit Committee can establish an "**Audit and Non-audit Services Pre-approval Policy**", which sets out the procedures and the conditions pursuant to which services proposed to be performed by the external auditor may be pre-approved. The Audit and Non-audit Services pre-approval Policy requires ratification by the Board of Directors. If a policy is not implemented, pre-approval of non-audit service should be done by the Audit Committee on a case-by-case service.

   In addition, the Audit Committee may choose to determine, for a particular calendar year, the appropriate ratio between the total amount of fees for audit, audit-related and tax services and the total amount of fees for certain permissible non-audit services classified as all other services.

5. Authority to the extent it deems necessary or appropriate, to retain independent legal, accounting, or other advisors.

The Audit Committee responsibility relating to financial statements and disclosure matters:

1. Review and discuss with management and the external auditors the annual audited financial statements, including disclosures made in the management's discussion and analysis ("MD&A").

2. Where applicable, review and discuss with management and the external auditors the company's quarterly financial statements and C-1 Forms prior to filing it with the FSC.

3. Discuss with management and the external auditors significant financial reporting issues and judgement made in connection with the preparation of the company's financial statements, including any significant changes in the company's selection or application of accounting principles, any major issues as to the adequacy of the company's internal controls and any special steps adopted in light of the deficiencies.

4. Review the quarterly summary of intra-group transactions prepared by members of management. The review should ensure that transactions were carried out at fair market value.

5. Discuss with management the company's major financial risk exposures and the steps that management has taken to monitor and control such exposures, including the company's risk assessment and risk management policies and procedures.

a. *Management letter*

1. The Audit Committee should request a copy of all management letter comments from the external auditors. It is important that this be obtained at the completion of each audit.

2. Management letter comments from interim audit procedures or reviews of the quarterly financial statements should also be submitted to Audit Committee for their review.

3. The Audit Committee should hold in-depth discussions with the external auditors regarding what changes or improvements should be made in internal controls, policies or financial reporting and disclosure processes

4. The Audit Committee should discuss with management how changes or improvements may be implemented and the committee should monitor the timeline set by management to implement these changes.

b. *Engagement Letter:*

1. The audit services engagement terms and fees should be subject to the specific pre-approval of the Audit Committee. The annual engagement letter with the external auditor should contain a reasonably detailed description of the services proposed to be provided by the external auditor during the period covered by the engagement letter and related estimated fees, which are supported by reasonably detailed analyses.
2. The audit partner and the members of the Audit Committee should have a clear understanding of the terms of the engagement, scope of the audit and responsibilities of the auditor for reporting to the Audit Committee

c. *Performance Review*:

1. Review and evaluate the engagement partner of the external auditors.

2. Obtain and review a report from the external auditors at least annually regarding the following:

   i. All relationships between the external auditors and the company

   ii. Evaluate the qualifications, performance, and independence of the external auditors.

3. Consider whether the auditors' quality controls are adequate and the non-audit services rendered by the external auditors are compatible with maintaining the auditor's independence. If the company has established an Audit and Non-Audit Services Pre-approval policy, the Audit Committee should ensure that the amount and nature of non- audit related work performed by the external auditors are consistent with the guidelines of the policy.

   The Audit Committee shall present its conclusions with respect to its evaluation of the external auditors to the board of directors.

4. Ensure the rotation of the lead (engagement) audit partner who has the primary responsibility for the audit.

5. Consider whether, in order to assure the auditor's independence, it is appropriate to adopt a policy for rotating the external independent auditing firm on a regular basis.

d. *Staffing of the Audit Assignment:*

The Audit Committee should meet with the external auditors prior to the audit to discuss the planning and the adequacy of staffing of the audit including the number of persons on the audit team, and the experience levels of the auditors assigned to the audit such as their experience with the company and the industry.

After the completion of the audit, the Audit Committee should meet with the members of the external audit team to discuss the following:

1. The percentage of the total audit hours actually spent by the more experienced partner and manager. (A small percentage may raise a red flag for the Audit Committee that sufficient experience and expertise is not being devoted to judgmental issues, high risk business and financial reporting issues).

2. The total number of hours spent on the engagement by the partner and manager.

3. The adequacy of the total hours spent on areas that require significant judgment and that have the greatest inherent risk when it comes to the numbers

4. The number of hours being spent by the partner and manager on the more judgmental and high risk business and financial reporting issues.
5. Review the summary of unadjusted audit differences relating to each major section of the audit.

e. *Compensation:*

1. It is the responsibility of the Audit Committee to ensure the external auditors are compensated fairly for performing an effective audit of suitable quality
2. The Audit Committee hires the external auditors, evaluates their performance and, when necessary, fires them.

The Audit Committee oversight of the company's Internal Audit Function:

1. Review the appointment and replacement of the senior internal auditing executive.

2. Review and approve the annual internal audit plan for the company

3. Review the progress of the internal audit work in relation to the annual plan.

4. Review the significant issues raised in reports to management prepared by the internal auditing department and management's responses.

5. Review at least annually the internal audit department and its mission, responsibilities, independence, budget and staffing and any recommended changes in the planned scope of the internal audit.

6. Review on a regular basis the relationships between management and the internal and external auditors

The Audit Committee oversight of the company's regulatory functions:

1. Review all reports that are required to be filed with the FSC and ensure their timely submission.

2. Review any other reports, transactions, or matters as determined by the FSC.

3. Where applicable, review the examination deficiency letter and any directives received by the company from the FSC and ensure that an appropriate response is made by the company.

5. The members of the Audit Committee should keep abreast of regulatory changes and other emerging issues.

The Audit Committee Oversight of the Company's Compliance Responsibilities:

1. Obtain from the external auditors assurance that no illegal acts have come to their attention during the period of the audit.

2. Discuss with management and the external auditors any correspondence with the regulators or government agencies which raised material issues regarding the company's financial statements, accounting policies, risk management practices, and capital adequacy requirements.

3. Discuss with the company's General Counsel legal matters that may have material impact on the financial statements or the company's compliance policies.

4. Discuss with management and the external auditors the effect of applicable regulations and accounting profession initiatives as well as off-balance sheet structures on the company's financial statements

4.4 Whistleblower Communications

The Audit Committee must establish and implement procedures for receipt, retention, and treatment of complaints received by the company regarding, accounting, internal accounting controls, or auditing matters, and the confidential, anonymous submission by employees of concerns regarding questionable accounting or auditing matters[1].

Audit Committees should consult with the Company's General Counsel as to the best approach to take to establish the whistleblower communication process.

[1] The Securities Act does not offer protection for whistleblowers.

4.5 Continued Education and Self Evaluation

The board of directors should ensure that there are company-specific educational programmes that are developed and conducted in-house for the members of the Audit Committee. The members of the Audit Committee should attend at least one company-specific in-house educational training per the company's financial year. The Audit Committee should attend general educational programmes put on by Regulatory agencies, Accounting bodies and any other professional bodies.

It is generally held that best practice by an Audit Committee includes the execution of an annual evaluation. As part of this evaluation, the committee would carry out a self-assessment of its performance and obtain input from the full board of directors aimed amongst other things at determining whether it fulfilled its responsibilities and the identification of opportunities for follow up activities. Other functionaries such as internal and external auditors and the general counsel may be able to assist in the design of such an evaluation program.

Information Sources:

i) Website of The US SEC (www.sec.gov)

ii) Excerpts from selected speeches (USSEC)

iii) Ernst & Young International presentation to FSC Corporate Governance Seminar November 2002

iv) Website of the Bank for International Settlements (www.bis.org)

v) Website of the Financial Services Authority (www.fsa.gov.uk)

vi) KPMG's Audit Committee Institute Publications
- KPMG's Audit Committee Quarterly - Fall 2003
- December 2003 - Directorship - "Financial Reporting Risks Should Drive Audit Committee Agenda"
- Fall 2003: Institutional Investor, Corporate Governance - - "A Guide to Corporate Accountability"
- 2002 KPMG-Basic Principles for Audit Committees

vii) Website of Dow Home: investor Relations: 2003 Proxy Statement (www.dow.com/financial/2003prox/app/)

viii) Mellon Financial Corporation Board Policies (www.mellon.com/governance/audit.html)

ix) Deloitte - Audit Committee Financial Expert Designation and Disclosure Practices Survey - November 2003

The FSC invites comments on these draft guidelines from interested parties. Comments and queries may be emailed to securities@fscjamaica.org or directly to the Senior Director, Securities, Financial Services Commission. All comments and queries should reach the FSC by November 25, 2004.