



**Remarks by Superintendent Julie Dickson  
Office of the Superintendent of Financial  
Institutions Canada (OSFI)  
to the  
Institute of Internal Auditors  
Toronto Chapter 2013 Conference**

**Toronto, Ontario  
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When I received the invitation to speak to you today, I was happy to accept, because it is clear that the role of audit, whether internal audit, external audit, or the audit committee of the board, is back in the spotlight. Audit was last in the spotlight in a big way after Enron failed in 2001, and now, a dozen years later, it is very much in the spotlight again.

This is not due to any particular incident, but rather seems to reflect a range of factors. Audit firm regulators such as the Canadian Public Accountability Board (CPAB), – and its counterparts around the world – which were largely set up in reaction to Enron, are up and running. And as usually happens when there is someone looking over your shoulder, these audit regulators are finding issues in external audits that require attention, such as a lack of professional skepticism on the part of external auditors.

The global financial crisis in 2008 also prompted a serious look at all aspects of financial regulation and financial stability. While the attention of all banks and regulators was initially focused on capital and liquidity rules, as well as the risk function and role of the Chief Risk Officer and the board, the spotlight is shifting to audit.

People involved in internal audit, external audit and audit committees need to take note of this shifting spotlight, the intensity of which can be seen in the flurry of papers that have been published in the last six months. These papers include:

- the Financial Stability Board's (FSB) Thematic Review on Risk Governance (a peer comparison of practices around the globe especially as they pertain to systemically important banks). This February 2013 report focused on Internal Audit and other aspects of risk governance;<sup>1</sup>
- the CPAB and Canadian Institute of Chartered Accountants' (CICA) recent joint paper on audit committees and how they can aid in the quality of external audit;<sup>2</sup>

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<sup>1</sup> Thematic Review on Risk Governance Peer Review Report, (FSB, Basel) February 2013. The report can be found at the following link: [http://www.financialstabilityboard.org/publications/r\\_130212.pdf](http://www.financialstabilityboard.org/publications/r_130212.pdf)

<sup>2</sup> Enhancing Audit Quality: The Role of the Audit Committee in External Auditor Oversight, (CPAB and CICA) January 2013. This discussion paper can be found at the following link: <http://www.cica.ca/enhancing-audit-quality-canadian-perspective/item71922.pdf>

- the International Forum of Independent Audit Regulators' (IFIAR) public report on inspection findings of audits;<sup>3</sup> and
- the Basel Committee on Banking Supervision's (BCBS) paper on external audits on the need for close relationships between bank supervisors and external auditors and the need for strong audit committees.<sup>4</sup>

This list does not include many European initiatives, some of which have not been received well in Canada, such as the idea that an external audit firm must be rotated off an account at least every five years.

Today I am going to discuss some of the changes that have already occurred or are under consideration, which are worthy of attention.

## **Internal Audit Trends**

I will begin with Internal Audit.

The FSB's paper on risk governance that I just mentioned focused on the framework through which the board and management of global banks establish the firm's strategy, how they articulate and monitor adherence to risk appetite and risk limits, and how they identify, measure and manage risks. Internal Audit was a big part of the report.

The paper notes that since the crisis began, many global banks have made changes to strengthen Internal Audit functions. Changes include: increasing both the number and skills of Internal Audit staff; expanding Internal Audit's responsibilities, including participating as observers at risk management committees and in decision-making processes. And since the crisis, many supervisors have elevated their expectations of Internal Audit functions to include more qualitative assessments of policies, procedures, risk limits, and risk exposures.

One area identified in the report as suggesting room for improvement is with respect to the chief audit executive's access to directors beyond those on the Audit Committee. This is in line with concerns that External Auditors have also raised about lack of access to the Risk Committee and decision-making processes outside the Audit Committee. OSFI agrees that both Internal Auditors and External Auditors need to be allowed beyond the confines of the Audit Committee.

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<sup>3</sup> International Forum of Independent Audit Regulators, 2012 Summary Report of Inspection Findings, December 2012. The report can be found at the following link: [https://www.ifiar.org/IFIAR/media/Documents/General/IFIAR-2012-Summary-Report-of-Members-Inspection-Findings-18-Dec-12-\(2\).pdf](https://www.ifiar.org/IFIAR/media/Documents/General/IFIAR-2012-Summary-Report-of-Members-Inspection-Findings-18-Dec-12-(2).pdf)

<sup>4</sup> External audits of banks - consultative document, (BCBS, Basel) March 2013. A link to the consultative document can be found at the following link: <http://www.bis.org/publ/bcbs244.htm>

A major recommendation coming out of the FSB's risk governance report was that the board should regularly obtain an independent assessment of the design and effectiveness of the risk governance framework. While such a report may be performed by Internal Audit or by third parties that are independent, generally, at this point, audit functions globally do not usually provide overall opinions regarding the risk governance framework (and neither do third parties).

The shift in expectations of Internal Audit is also seen in guidance being issued by global banking regulators. Comparing guidance issued by the Basel Committee on Banking Supervision (BCBS) in 2012 with that issued in 2001, one can see a marked change. Whereas in 2001, the BCBS talked about Internal Audit evaluating the bank's compliance with policies and risk controls, in 2012 the BCBS talked about Internal Audit independently evaluating risk management and governance systems in the context of both current and potential future risks.

The 2012 guidance talked about Internal Audit including (in its scope) evaluation of risk appetite, decisions taken by risk management, and the adequacy of risk management systems in identifying, measuring, assessing, controlling, responding to and reporting on all risks resulting from the bank's activities. It added that when a risk management function has not informed the Board of Directors about the existence of a significant divergence of views between senior management and the risk management function regarding the level of risk in a bank, the head of Internal Audit should inform the Board about this divergence.

The paper also noted that given many Risk Appetite Frameworks are in the early stages of evolution, Internal Audit's role and responsibilities related to the Risk Appetite Framework are still being defined and implemented. Globally, however, it is reported that some internal audit shops are opining on the appropriateness of limits and other tolerances established in the Risk Appetite Framework.

Clearly the trend is to require Internal Audit to do more than in the past (while not going so far as to actually design and implement controls) – and I think this trend is the right one.

While the role of Internal Audit is evolving and becoming more demanding, a focus on processes will help to support internal auditors as they perform their roles. In this regard, much is being discussed to strengthen audit committees and to focus supervisors. We saw the same thing when the focus was on the risk function.

Prior to the crisis in 2008, the role and stature of Chief Risk Officers (CROs) was not a big topic of conversation with boards and CEOs. But it is now, and this has been very positive for the CRO role. CROs now typically report administratively to the CEO, with direct access to the Risk Committee of the board. Separate Risk Committees (versus committees combining risk and audit) are now the norm (and indeed are required at complex banks and insurance companies in Canada).

We, at OSFI, have gone quite far in demanding that the risk function be independent of operational management, especially at large and complex financial institutions. This means that at a large and complex bank, the risk function is close to having a high level of independence and objectivity – very close to that of Internal Audit. We are also asking that institutions receive periodic benchmarking reports on how well they are doing in keeping up with best practices. In large and complex institutions, layers of protection are becoming the norm, and this sort of benchmarking can be valuable in ensuring that those layers are efficient and effective.

While Internal Auditors have long had a clear link with the Audit Committee, I would say that discussions between OSFI and the CEO and the board about the stature of the Chief Internal Auditor are less common than discussions about the stature of the Chief Risk Officer. I think this will change as the spotlight moves to audit matters. As noted by the BCBS 2012 guidance, Internal Auditors have to be able to make an impact at the highest level of the organization. As the expectations for Internal Audit grow, so must the calibre of the Chief Internal Auditor, especially in the largest most complex institutions. OSFI's Corporate Governance Guideline<sup>5</sup> also emphasizes the interface between the board and all oversight functions, including Internal Audit. Interestingly, the guideline devotes more pages to the CRO than to the Chief Internal Auditor, but this should not be interpreted as OSFI placing less emphasis on the Chief Internal Auditor going forward.

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<sup>5</sup> OSFI Corporate Governance Guideline, January 2013. The Guideline can be found at the following link: [http://www.osfi-bsif.gc.ca/app/DocRepository/1/eng/guidelines/sound/guidelines/CG\\_Guideline\\_e.pdf](http://www.osfi-bsif.gc.ca/app/DocRepository/1/eng/guidelines/sound/guidelines/CG_Guideline_e.pdf)

## **Audit Committee Trends**

Let me turn to Audit Committees.

Audit Committees play a key role in ensuring the internal audit group is effective, as well as in contributing to the quality of external audit. Recently, CPAB and the CICA jointly issued a discussion paper called “Enhancing Audit Quality: the Role of the Audit Committee in External Auditor Oversight”. It provides clarity to Audit Committees in discharging their responsibilities as well as guidance on activities that enhance audit quality.

My OSFI colleagues and I very much like the discussion paper; it includes a handy list of warning signs that may indicate that the culture of integrity of a firm being audited could be problematic. These signs include situations where communications with an audit committee are formal and carefully scripted, where management is unduly defensive of issues raised by auditors, where management does not view the auditors as being a source of useful input, or where management tries to control the relationship with external auditors, to name a few. There is also a list of factors Audit Committees should consider in undertaking an annual assessment of external auditors, such as the quality of insights and observations provided by the auditors on financial statements and internal controls. Ways to assess whether auditors have exercised professional skepticism are also discussed, such as how disagreements between auditors and management were resolved.

## **External Audit Trends**

External Audit is not an area that OSFI oversees. But we regularly meet CPAB to discuss any concerns, and we also place a great deal of importance on communications between the supervisor and the External Auditors. In that vein, OSFI contributed to the development of a recent BCBS paper, entitled “External Audits of Banks”, which is out for comment until June 21, 2013. This paper focuses on the role of the Audit Committee given the influence it – the Audit Committee – has on the quality of external audit. The paper covers issues including the need for professional skepticism on the part of External Auditors (a weakness that CPAB has identified in many inspection reports). It also refers to the Audit Committee assisting the external auditors in gaining access to any other committee meetings that the External Auditor deems relevant for the auditor’s work. Of course, it also covers the relationship between the financial institution supervisors and both the External Auditors and the audit regulators, as effective communication enhances the quality of audit and the effectiveness of bank supervision.

Similarly, the global regulators of External Audit firms, (CPAB in Canada and its counterparts in other countries), and IFIAR, which speaks for all global audit regulators, released their first global survey of audit inspection findings in late 2012. It covers common inspection findings across different jurisdictions, and focuses primarily on inspection findings related to the six largest international audit networks. Inspections of audits of major global financial institutions revealed that the largest number of common inspection findings were in the following areas: internal control testing; valuation of investments and securities; and audit of allowance for loan losses and loan impairments.

IFIAR also noted that findings in four areas – professional skepticism, group audits, revenue recognition, and the role of the engagement quality control reviewer – have been the subject of detailed discussion between IFIAR and the six largest international audit firms. Many members who responded to the survey also noted that a lack of auditors' professional skepticism on audit engagements was a significant performance issue.

Since OSFI relies on audited financial statements of financial institutions, and since sound audits are also important for financial stability, OSFI and, for that matter, the Financial Stability Board, are very interested in IFIAR's work, and in audit firms addressing the findings of audit regulators. Internal Auditors might also wish to focus on the types of weaknesses that IFIAR has identified, to the degree that some of the weaknesses may also be present in Internal Audit shops.

## **Conclusion**

In sum, the shifting spotlight to audit issues should be embraced by Internal Auditors, Audit Committees and audit firms, as it represents an opportunity to demonstrate clearly the tremendous value that all of you bring to risk management.

Indeed, I think the risk management functions of banks greatly benefited from the focus placed on them after the crisis, and the same benefit can be attained here. The result will be greater financial resiliency and stability.

Thank you for inviting me to speak to you today.