



Office of the Superintendent of  
Financial Institutions Canada

Bureau du surintendant des  
institutions financières Canada

# **Office of the Superintendent of Financial Institutions**

## **Internal Audit Report on Supervision Sector: Deposit Taking Group - Conglomerates**

**June 2013**



**Canada**

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## 1. Background

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### Introduction

Internal Audit conducts assurance work to determine whether the Office of the Superintendent of Financial Institutions Canada's (OSFI's) risk management, control, and governance processes, as designed and represented by management, are adequate and functioning in a manner to ensure risks are appropriately identified and managed, and to ensure compliance with such requirements as policies, plans, procedures and applicable laws and regulations.

The audit of Supervision Sector: Deposit Taking Group - Conglomerates (DTG-C) was approved by the OSFI Audit Committee and the Superintendent for inclusion in the OSFI 2011-2012 Internal Audit Plan.

This report presents the results of that audit based on audit work completed at the end of March 2013. The audit recommendations will support DTG-C to continuously improve their control framework for assessing the risk profiles of the deposit-taking conglomerate federally regulated financial institutions.

This report was presented to the OSFI Audit Committee on June 20, 2013 and approved by the Superintendent on June 24, 2013. The Assistant Superintendent, Supervision Sector, and Supervision Sector Deposit Taking Group Senior Management, who have provided their management comments within this report, have also reviewed it.

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### Context

DTG-C is the division within OSFI's Supervision Sector responsible for the supervision of the large and complex conglomerate deposit taking financial institutions (FRFIs). Its mandate is to:

- supervise large and complex FRFIs to determine whether they are in sound financial condition and are complying with their governing law and supervisory requirements,
- promptly advise those institutions in the event there are material deficiencies and take, or require management or boards to take necessary corrective measures expeditiously, and
- monitor and evaluate system-wide or sectoral issues that may impact negatively the institutions within their portfolio.

OSFI supervises FRFIs in accordance with its Supervisory Framework, which is supplemented by the Supervisory Framework Rating Assessment Criteria and various supervisory guides and documentation templates (i.e. the "Methodology").

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## 1. Background, Continued

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**Context**  
(continued)

OSFI's supervisory process involves identifying material risks, assessing the sensitivities of a FRFI's activities to external factors, understanding how effectively the FRFI is managing its risks, making recommendations to strengthen management and governance, where required, and determining the extent of OSFI resources that should be applied to ongoing monitoring, on-site review work and other intervention activities. This process culminates in OSFI's assessment of the FRFI's risk profile, i.e. the Composite Risk Rating (CRR).

In accordance with the Supervisory Framework, the Supervision Sector summarizes its assessment of the FRFI's risk profile in one key document, the Risk Assessment Document (RAD), which includes the Risk Matrix.

The RAD provides a current view of the institution's business model, the impact of the operating environment on the institution's risks, and the risk assessments for the institution overall and its significant activities. It distills the essential facts supporting the FRFI's CRR and its underlying components (i.e. Overall Net Risk (ONR), capital, earnings and liquidity), so that the reader can understand OSFI's view and rationale for such a conclusion. The Risk Matrix records all of the supervisory ratings for the FRFI. The RAD and Risk Matrix are updated for any material changes in the risk profile of the FRFI as they occur.

This assessment in the RAD and Risk Matrix form the basis for OSFI's Supervisory Strategy for the FRFI, which is updated annually. The Supervisory Strategy identifies the supervisory work needed to keep the FRFI's risk profile current, so that OSFI may identify and intervene on a timely basis when significant potential for material loss is identified. When there are shifts in the risk assessment of the FRFI throughout the supervisory year, OSFI adjusts the work priorities set out in the Supervisory Strategy as necessary.

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## 2. Audit Objective, Scope and Approach

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**Audit Objective** The objective of the audit was to provide reasonable assurance that OSFI's Methodology is applied as intended when assessing the risk profile of a deposit-taking conglomerate FRFI. Specifically the audit assessed whether:

1. The logic and flow of the documentation clearly support the rationale for the FRFI's risk profile and underlying supervisory ratings,
  2. The intensity of planned supervisory work is appropriate for the FRFI's business model and risk profile,
  3. Quality control reviews are effective at detecting work quality issues and ensuring that OSFI's Methodology is consistently applied as intended.
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**Audit Scope** Recognizing that the supervisory process is a cumulative knowledge process and is continuously evolving, IA examined the RADs/Risk Matrices and Supervisory Strategies supporting supervisory plan years 2011-12 and 2012-13 for selected deposit-taking conglomerate FRFIs.

Where appropriate, IA reviewed subsequent plan year documents (work in progress) for evidence of any process improvements since our review period.

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**Scope exclusions** The scope of the audit excluded the assessment of the accuracy and completeness of the sources of information/inputs (e.g. section notes – used to document detailed assessments underlying ratings) into the RAD/Risk Matrix.

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**Audit Approach** The audit was conducted in accordance with the Institute of Internal Auditors' International Standards for the Professional Practice of Internal Auditing, consistent with the Treasury Board Policy on Internal Audit.

The audit criteria, as set out in Appendix A - DTG-C Audit Evaluation Criteria, were used for assessing DTG-C's application of OSFI's supervisory methodology. These criteria are based on the internationally recognized Enterprise Risk Management - Integrated Framework recommended by the Committee of Sponsoring Organizations of the Treadway Commission (COSO).

The audit approach included:

- A review of OSFI's Supervisory Framework, the Rating Assessment Criteria, and related guides and templates to update our understanding of the requirements.
  - Walkthroughs with the DTG-C supervisory teams and management to facilitate our understanding of the risk assessment process and its linkages to the Supervisory Strategy, as well as quality control.
  - Examination of supervisory documents to determine whether IA could follow the rationale supporting the risk assessments, and how the risk assessments impacted the planned supervisory work.
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### 3. Conclusion

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#### Conclusion

Overall, IA is reasonably assured that OSFI's Methodology is applied as intended when assessing the risk profile of a deposit-taking conglomerate FRFI. Specifically, we found that:

- The logic and flow of DTG-C's documentation generally supported the rationale for the FRFI's risk profile and underlying supervisory ratings. Importantly, supervisory teams continuously reviewed their assessments based on ongoing monitoring and on-site review work and adjusted them in a timely manner when needed. We also noted improvements in the RADs between the 2011-12 and 2012-13 plan years with respect to the quality of the analysis of the significant activities.
- The intensity of planned supervisory work was appropriate for the FRFI's business model and risk profile. The Supervisory Strategies had appropriate emphasis on higher net risk significant activities (while also taking into account information decay and the relative importance of each significant activity to the FRFI's ONR). We noted improvements in the Supervisory Strategies between the 2011-12 and 2012-13 plan years, particularly with respect to providing a clear rationale for, and description of, the supervisory work planned for each significant activity.
- Quality control reviews were generally effective at detecting work quality issues and ensuring that OSFI's Methodology was consistently applied as intended. DTG-C management was diligent in conducting risk-based reviews of the RADs and Supervisory Strategies.

In support of ongoing sustainability of effective DTG-C processes and continuous improvement, we noted that management has initiated a number of actions such as:

- A process to support succession planning for the Senior Director, who has a key role in providing oversight in the risk assessment process across DTG-C,
- The creation of DTG-C "working groups" that meet regularly to promote improved and consistent application of OSFI's Methodology across the teams, and
- The introduction of a "DTG-C Reference Book" that has enhanced supervisory teams' understanding of, and adherence to, certain requirements.

We encourage management to continue supporting these types of actions that promote sustainability in its processes.

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### 3. Conclusion, Continued

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As outlined in this report, we have four recommendations for management's action:

1. The Overall Net Risk (ONR) assessments, a component of a FRFI's Composite Risk Rating, should be better supported in the supervisory documentation and demonstrate compliance to OSFI's Methodology.
2. Supervision Sector should revisit supervisory documentation practices for efficiency opportunities.
3. DTG-C documentation practices need to be reinforced to ensure supervisory teams adequately demonstrate support for their assessments.
4. The inventory of FRFI activities should be sufficiently complete and the rationale for an activity's significance or not should be documented ensuring risk-based supervisory focus.

We recommend that management address these concerns through staff training, and reinforce them through coaching and feedback via its regular quality control review process for supervisory documents. We also recommend that DTG-C management work with the greater Supervision Sector to identify opportunities for improved efficiency in the supervisory documentation process while maintaining reasonably current and adequately supported assessments.

In my professional judgment as Chief Audit Executive, sufficient and appropriate audit procedures have been conducted and evidence gathered to support the accuracy of the opinion provided and contained in this report. The opinion is based on a comparison of the conditions, as they existed at the time, against pre-established audit criteria that were agreed on with management. The opinion is applicable only to the entity examined. The audit was conducted in conformance with the internal audit standards of the Government of Canada, as supported by the results of the Quality Assurance and Improvement Program.

We wish to recognize the excellent rapport and exchange of views with all involved in the audit. The depth of the review and focusing on what matters would not have been possible without the support received throughout the audit.

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Chief Audit Executive, IA

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Date

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## 4. Management Response

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### Overview

This report has been reviewed by the Senior Director, Supervision Sector Deposit Taking Group - Conglomerates, Senior Director, Supervision Sector Deposit Taking Group, and the Assistant Superintendent, Supervision Sector, who acknowledge its observations and recommendations.

The recommendations will support DTG-C with its work to put in place the appropriate processing, reviews, approvals, and monitoring controls as needed.

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### Responses / Comments

Deposit-Taking Group – Conglomerates (“DTG-C”) wishes to express its thanks to the audit team for the professional, clear, and transparent manner in which the audit was conducted. DTG-C Management is in agreement with the general themes as outlined in the audit report.

We are pleased to note the positive comments in response to DTG-C’s significant efforts to improve the sustainability of our processes. We also acknowledge audit’s overall conclusions that DTG-C is applying OSFI’s methodology as intended, and that the largest institutions have received the appropriate level of intensity of planned supervisory work. DTG-C is committed to continuous improvement in carrying out its supervisory work, including ensuring a robust quality control process is in place and is effective.

DTG-C is committed to addressing the areas outlined in the Report. Internal training sessions to reinforce the application of supervisory methodology are being initiated together with Practices Division.

With respect to ONR (Recommendation 1), DTGC will ensure that the ONR section of the RAD more clearly reflects how net risks of the higher importance significant activities, as well as enterprise-wide processes where applicable, affect the ONR rating. Training will be conducted, and corrective action to clarify the ONR Section in the RAD will be completed by October 31, 2013.

Responsibility: Senior Director, DTG-C

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## 4. Management Response, Continued

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**Responses /  
Comments**  
(continued)

With respect to Adequacy, Efficiency, and Flow of Documentation (Recommendation 2), Supervision believes that our documentation supports the rationale for the FRFIs' risk profiles and adequately supports the underlying supervisory ratings. We also recognize the need to regularly review our practices to identify opportunities for efficiency improvement. To that end Practices Division has almost completed a review of our documentation standards for all institutions except the DTG-C institutions. The training and implementation project plan will be finalized by June 26, 2013. The training and implementation project plan for DTG-C will be finalized by November 30, 2013 as noted below.

Responsibility: Assistant Superintendent, Supervision Sector

With respect to Compliance to OSFI's Methodology for Documentation for the DTG-C institutions (Recommendation 3), DTG-C provided input to revise the Supervision Working Agreement and Principles to ensure documentation expectations to achieve greater assimilation of specialist work into section notes are clearly outlined. To address IA's comments on the flow of information between the various supervisory documents, DTG-C will address these on a go-forward basis by providing recommendations towards the review of documentation practices being undertaken by Practices Division, by June 26, 2013. Following the conclusion of Supervision's review, DTG-C, in consultation with Practices Division, will finalize a training and implementation project plan based on updated standards by November 30, 2013.

Responsibility: Senior Director, DTG-C

With respect to the Inventory of Significant Activities (Recommendation 4), DTG-C believes that its approach has been effective in identifying all activities that are significant to the overall risk profile of the institution. DTG-C will undertake training together with Practices Division on the documentation of the Inventory of Significant Activities. Corrective actions to address audit recommendations, namely, to improve the transparency of how significant activities align to the institution's organization, to provide the basis for their significance, and to integrate a consideration of legal entities, will be incorporated in the 2014/15 Supervisory Strategy documents by October 31, 2013.

Responsibility: Senior Director, DTG-C

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## 5. Observations and Recommendations

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### Observation 1 Overall Net Risk Assessments

OSFI's assessment of a FRFI's Composite Risk Rating (CRR) is determined by combining the assessments of the FRFI's Overall Net Risk (ONR), earnings, capital, and liquidity. In order for the assessment of the CRR to be well supported, the assessments of these underlying components need to be well supported. Over or underrating any of these components may impact the overall risk profile assessment.

Generally, supervisory teams followed OSFI's Methodology appropriately to arrive at a FRFI's CRR. However, in the RADs reviewed, the determination of the ONR component was not always clearly supported or did not always demonstrate how OSFI's Methodology was followed.

The ONR should be determined by combining the net risk of the FRFI's significant activities, considering the relative importance of each activity. IA noted instances where we could not ascertain whether sufficient consideration was given to net risks of higher-importance significant activities, including enterprise-wide processes where applicable.

We also noted instances where the supporting rationale for the ONR considered overall ratings for oversight functions, which should not factor into the assessment. Under the Supervisory Framework, the quality of risk management impacts ONR through the net risk ratings of the significant activities considered to be the key drivers of ONR. Consideration of the overall ratings for oversight functions in ONR could result in 'double counting' of the impact of risk mitigation.

#### Recommendation 1:

1. Provide training to DTG-C staff on the ONR assessment, focusing on the need for a rationale to clearly identify the significant activities considered to be the key drivers of ONR (including enterprise-wide processes where applicable), and briefly describe how they affect ONR.
2. Reinforce the need for a well-supported ONR to staff through coaching and feedback in the quality control review process.

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## 5. Observations and Recommendations, Continued

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### Observation 2 Adequacy, Efficiency and Flow of Documentation

Under Supervision's documentation "architecture", the Risk Assessment Document (RAD) is intended to provide a summary of the FRFI's overall risk profile, giving broad justification for the risk assessments, and should be written in a synthesized fashion. Section notes should be used to document the full rationale for the assessments of significant activities (or sub-activities), capital, earnings, liquidity and oversight functions.

Section notes, and the RAD as needed, should be updated in a timely manner when there is a material change to the assessments documented therein.

If new information is documented in the RAD only and not the section note, there is the risk that the information is analyzed in isolation of all of the factors that are important to the assessment. This is especially a concern when integrating the work of specialists, which is often limited to certain aspects only of a significant activity or sub-activity. Furthermore, a high volume of detailed information in the RAD may detract from its purpose of clearly communicating (by summarizing) the support for the CRR and underlying ratings, may impact its logic and flow, and may make it more difficult for a reviewer to ascertain that the assessment of the overall risk profile is reasonable and adequately supported.

IA noted that supervisory teams view the RAD as the key supervisory document, and they updated the RAD in a timely manner (quarterly) so that risk assessments reflect the latest material information obtained through review work, monitoring and other sources. On the other hand, IA noted that section notes were not always kept sufficiently up to date. Some (e.g., capital, earnings, liquidity and oversight function section notes) were updated annually and well after the year-end RAD is updated, reviewed and approved. Others are updated after on-site reviews, which may occur as infrequently as every five years, and are not always updated for material information from regular monitoring. There were also section notes and review notes with ratings that IA could not map to the Risk Matrix. Supervisory teams attributed this in part to their difficulty integrating specialist work into the risk assessment process and section note.

IA recognizes that Supervision Sector management is aware of, and in the process of addressing, staff concerns over documentation (i.e. how much and when), and the integration of specialists' work into the risk assessment process. We encourage management to continue working on practical and effective solutions.

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## 5. Observations and Recommendations, Continued

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**Observation 2**  
(continued)

**Recommendation 2:**

Supervision Sector should undertake a review of supervisory documentation practices to identify opportunities for improved efficiency while maintaining reasonably current and adequately supported assessments. IA understands that the Supervisory Practices Division has been consulting with management from various Supervision groups, including specialists, to obtain agreement on appropriate supervisory documentation practices and updating guidance.

We recommend that:

- a. The Supervision Sector considers whether this initiative will meet the needs identified in this report. If it does not, then we recommend that an alternate initiative be undertaken to address these concerns, and
- b. Sufficient DTG-C resources should be dedicated to the review (whichever form it takes), so that any changes can be effectively implemented.

**Recommendation 3:**

In the meantime, DTG-C management should reinforce the need to be compliant with OSFI's Methodology:

- a. The RAD should not include details of supervisory work and analyses but summarize and communicate rationale supporting key conclusions. Effort should be made to eliminate documentation in the RAD that should be in section notes or the Supervisory Strategy only.
- b. There should be section notes for significant activities (or sub-activities) shown on the Risk Matrix. Specialist work should be assimilated into these section notes to ensure that findings are analyzed in the context of all of the factors that should be considered in arriving at assessments.
- c. When new material information impacts a rating on the Risk Matrix, the appropriate section note should be updated (and reviewed and approved as needed) before (or at the same time that) the RAD and Risk Matrix is updated (and reviewed and approved as needed), in order to ensure that the change is adequately supported.

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## 5. Observations and Recommendations, Continued

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### Observation 3    **Inventory of Activities**

Identifying and assessing a FRFI's significant activities is fundamental to the Supervisory Framework. It provides the foundation for the supervision of the FRFI. Accordingly, it is important that the identification of significant activities be adequately supported. In conjunction with updating the annual Supervisory Strategy for a FRFI, an inventory of activities should be prepared. The activities listed should align with the FRFI's own organization and management of its risks. The entire universe of a FRFI's activities, at an appropriately granular level, should be considered for their significance. The basis upon which it is determined that each activity is significant or not significant should be clearly indicated.

IA noted the following through testing:

- The inventory prepared by each team listed both activities and sub-activities. However, IA was unable to determine that the grouping of activities and sub-activities was aligned with the FRFI's own organization and management of its risks, and that the inventory – particularly at the sub-activity level – was sufficiently complete, based on the FRFI organization chart provided as support.
- Although all of the supervisory teams' inventories listed activities that were considered to be significant, not all inventories listed activities that were considered to be not significant.
- The basis for an activity being identified as significant or not was not always indicated. In limited instances, activities were moved from the list of significant activities to non-significant activities from one year to the next, or vice versa, without a clear rationale provided.
- Although the FRFI's legal entity structure was identified, legal entities were not assessed for their significance. IA acknowledges that the ongoing DTG-C crisis management work should help to inform this assessment.

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## 5. Observations and Recommendations, Continued

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**Observation 3**  
(continued)

**Recommendation 4:**

1. Provide training to DTG-C staff on the requirements of the inventory of activities, focusing on the following needs:
    - a. The inventory to be supported by an organization chart of the FRFI's universe of activities that demonstrates that the grouping of activities and sub-activities in the inventory is aligned with the FRFI's own organization and management of its risks and is sufficiently complete. Ideally the support would also include other corroborating sources such as the institution's Internal Audit universe,
    - b. There should be a clear rationale where there is a decision to group activities differently than the FRFI,
    - c. The inventory of activities to list both activities considered significant and activities considered non-significant. A clear basis for each activity being considered significant or not should be provided, and
    - d. There should be evidence that legal entities have been given sufficient consideration as to their significance.
  
  2. Reinforce the need for a complete and well-assessed Inventory of Activities to staff through coaching and feedback in the quality control review process.
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## Appendix A: Audit Evaluation Criteria

Deposit Taking Group – Conglomerates Audit Evaluation Criteria		
Element	Components	Audit Observations
<p>A. Process and Control Activities</p> <ul style="list-style-type: none"> <li>Application of OSFI's Supervisory Framework and Guides</li> </ul>	<ol style="list-style-type: none"> <li>Supervisory Framework and relevant guides and templates to assist supervisory teams in their responsibilities are accessible, formalized and effectively communicated to all teams.</li> <li>The RAD is periodically updated for significant changes in the institution and its operating environment on a consistent basis.</li> <li>Prudential issues that could potentially impact the risk profile of the institution are identified on a timely basis.</li> <li>The rationale for the institution's risk profile and underlying supervisory ratings contained in the RAD are reasonable, adequately supported and properly documented.</li> <li>The intensity of planned supervisory work is appropriate for the FRFI's business model and risk profile</li> <li>Quality control reviews are conducted by the appropriate level of management and issues are highlighted and disposed appropriately.</li> </ol>	<ol style="list-style-type: none"> <li>Supervisory Framework and relevant guides and templates are accessible, formalized and effectively communicated to all teams.</li> <li>The RAD is periodically updated for significant changes in the institution and its operating environment on a consistent basis.</li> <li>Prudential issues that could potentially impact the risk profile of the institution are identified on a timely basis.</li> <li>In general, the rationale for the institution's risk profile and underlying supervisory ratings contained in the RAD are reasonable, adequately supported and properly documented. However, for clarity, the FRFI's Overall Net Risk rating should be better supported in the supervisory documentation and demonstrate compliance to OSFI's Methodology (<i>Recommendation 1</i>). Furthermore, supervisory documentation practices need to be reinforced to ensure supervisory teams adequately support their assessments (<i>Recommendation 3</i>). Effort should be taken to identify opportunities to gain documentation efficiencies (<i>Recommendation 2</i>).</li> <li>The intensity of planned supervisory work is appropriate for the FRFI's business model and risk profile. However, for clarity, the inventory of FRFI activities should be sufficiently complete and the rationale for an activity's significance or not should be documented ensuring risk-based supervisory focus (<i>Recommendation 4</i>).</li> <li>Quality control reviews are conducted by the appropriate level of management and are generally risk-based. Most issues were</li> </ol>

<b>Deposit Taking Group – Conglomerates Audit Evaluation Criteria</b>		
<b>Element</b>	<b>Components</b>	<b>Audit Observations</b>
		adequately disposed.
B. Governance • Management Oversight	1. Management provides adequate oversight over FRFI risk assessments. 2. Quality control reviews of supervisory work are completed in a timely manner and consistently. 3. Training and coaching is provided to staff in a timely manner to address areas where the supervisory methodology is not being applied as intended.	1. Management provides adequate oversight over FRFI risk assessments. 2. Quality control reviews of supervisory work are completed in a timely manner and consistently, in accordance with OSFI's Methodology. 3. Training and coaching to staff is provided to staff in a timely manner to address areas where the supervisory methodology is not being applied as intended. Examples of means of coaching include the quality control review of supervisory documents, monthly DTG-C Working Group meetings, and the quarterly integrated monitoring meetings.



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## Appendix B Internal Audit Reporting Protocol

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### Introduction

The Internal Audit (IA) reporting protocol is designed to provide transparency and maximum participation of all involved. The reporting protocol is structured to answer several key questions. Were the appropriate client groups involved in reviewing the report? Was there open and ongoing dialogue? Do we have the facts straight? Was the Client given the opportunity to comment on the findings and comments and to set out action plans and timeframes as appropriate?

Generally, one Division will be identified as having primary accountability for the OSFI activity being reviewed. The Division is referred to as the “Client”.

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### Reporting on the Audit

1. Client senior management is briefed on the draft *Report* that incorporates *Observations and Recommendations* (step 4). Examples of observations are discussed with the Client senior management as necessary in order to clarify findings and recommendations.
  2. Client senior management provides a **draft management response** and draft detailed action plan for IA review and comment as to consistency of facts and to the degree it addresses the Report’s recommendation(s), if any. The action plan identifies who has accountability for each specific action plan with a proposed timeline. *N.B. The client should start formulating the management response and action plans as early as possible in order to report on these matters to the Audit Committee and the Superintendent in as timely a manner as possible.*
  3. A draft *Report* is provided to and discussed first with Client senior management and then with the Superintendent, and then with the Executive Committee. IA considers revision(s) of the *Report*. The draft *Final Report* is sent to the Audit Committee for its next meeting where they are briefed on the observations and recommendations contained in the *Final Report* by IA, and are briefed by the Client on the management response to the report and on their action plans. The Audit Committee then recommends approval of the *Final Report* by the Superintendent, and the Superintendent approves the *Final Report*.
  4. The *Final Report* is released to Treasury Board Secretariat Internal Audit and subsequently posted on the external OSFI web site.
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## Appendix B Internal Audit Reporting Protocol, Continued

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*Follow-Up on  
the Audit*

5. Client senior management provides quarterly status updates on their action plans to IA for Audit Committee and Superintendent briefing and communicates to IA when the action plans pertaining to an audit observation and recommendation are completed. Management provides all supporting documentation to evidence completion of the action plan. Audit verification of the completed actions is done within three to six months of the reported completion date.
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