（Provisional translation）

On the Revision of the Standards and Practice Standards for Management Assessment and Audit concerning Internal Control Over Financial Reporting (Council Opinions)

Released on March 30, 2011

Business Accounting Council

The original texts of the Standards are prepared in the Japanese language, and these translations are to be used solely as reference material to aid in the understanding of the Standards.

For all purposes of interpreting and applying the Standards in practice, users should consult the original Japanese texts available on the following website: http://www.fsa.go.jp

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1. History

(1) General Background of Discussions

By way of the Financial Instruments and Exchange Act, which was enacted in June 2006, the management of listed companies shall implement assessments of internal controls over financial reporting, and this assessment shall be audited by certified public accountants (Internal Control Report System). This system came into effect in the fiscal years starting on or after April 1, 2008.

This system aims to maintain internal controls, without creating excessive burdens for financial statement preparers, auditors, and other related parties. The Business Accounting Council published “On the Setting of the Standards and Practice Standards for Management Assessment and Audit concerning Internal Control Over Financial Reporting (Council Opinions)” (“Standards and Practice Standards of Internal Control” hereinafter) in February 2007. This document also examined current operations in the United States, which previously implemented the system and decided to take measures such as using a top-down and risk-based approach while not adopting direct reporting, so that the burden of costs relating to assessment and audit would not be excessive. Since the Standards and Practice Standards of Internal Control was published, actions have been taken for an efficient and effective system, such as publishing “FAQs on the Internal Control Report System” (FSA) and the establishment of Internal Control Reporting System consultation and inquiry desk in related institutions.

On the other hand, two years have passed since the system was introduced, and the FSA, etc. have received requests and opinions on further simplification and clarification of the Standards and Practice Standards of Internal Control, etc., from parties such as listed companies which have actually implemented the system, based on their experience. Especially from among the small and medium listed companies, which address the assessment of the internal control under limited resources etc, many requests were received regarding standards for internal control assessment procedures, seeking simplification and clarification, etc. to match the actual situations of small and medium listed companies.

For Smooth Implementation of the Internal Control Report System, which began in March 2008, it was decided to do timely reviews “after system introduction and based on the results, to consider revision and further clarification of Standards and Practice Standards of Internal Control” as needed.

Moreover, the "New Growth Strategy" decided in the cabinet in June 2010, requires a review of the Internal Control Report System, etc. for small and medium companies as a specific implementation item.

Therefore, it was decided to study further simplification and clarification of the Standards and Practice Standards of Internal Control created by the Council, and to review the operation of the Internal Control Report System.

(2) History of Discussions

In order to review the operation of the Internal Control Report System, the Business Accounting Council began discussion and study of simplification and clarification of the Standards and Practice Standards of Internal Control at the Internal Control Committee meetings held in May 2010. This Committee analyzed requests and opinions, etc. on the Internal Control Report System, received from parties such as listed companies which have actually implemented the system. It also studied the actual situations of internal control audits in foreign countries. In addition, it examined cases of various innovative efforts to efficiently assess internal control, while maintaining the effectiveness of internal control.

In December 2010, the Committee issued an exposure draft of the revision of Standards and Practice Standards of Internal Control over financial reporting. In consideration of the public comments submitted for the exposure draft, the Committee has undertaken discussion and the following document entitled, "On the Revision of the Standards and Practice Standards for Management Assessment and Audit concerning Internal Control Over Financial Reporting (Council Opinions)."

2. Main Revision Points and their Concepts

(1) Obtaining Audits' respect for the Innovative Efforts of Companies

Under the Financial Instruments and Exchange Act, the Internal Control Report System aims to strengthen internal controls over financial reporting of listed companies, and ensure the reliability of corporate disclosure. However, it is not appropriate to explain herein how to design and operate the internal controls in a uniform manner since such controls shall be specific to each individual company, depending on its environment, the characteristics of its business, its size, etc. The management is expected to undertake appropriate innovative efforts to fulfill the functions and the roles of internal controls in accordance with the specific circumstances.

However, the actual situation is that opinions have been received from companies to the effect that auditors do not respect their innovative internal controls they have developed. Therefore, the practice standards now clearly state that, "Auditors should implement internal control audits considering the content and intent of Standards and Practice Standards of Internal Control, etc., and appropriately understand and respect the methods of assessing internal control which the management selected in consideration of the company's situation. There are differences between the management's methods and the audit procedures and techniques determined by each auditor, but auditors should keep in mind that they should avoid automatically forcing those approaches onto the management."

On the other hand, a smaller and less-complex organization, etc., has to allocate the limited business resources to establishment and assessment of that organization's internal control. Therefore, this organization may need to consult the auditors regarding how to efficiently handle internal control, etc. In doing so, from the viewpoint of independence, there could be cases in which the auditor does not respond to inquiries from the management, to maintain the auditor's standpoint. Regarding such consultations, etc., it was decided to have the auditor fulfill the function of education, such as appropriately pointing out items. However, this aims to maintain the effectiveness of internal control, and does not seek to create excessive burdens on companies.

Also, in order to improve efficiency by more sophisticated integration of internal control audit with financial statement audit, auditors should consider the need to sufficiently understand: the status of the management's design, operation, and assessment of internal controls; the situation of internal control design; and the operation and assessment situation by the management. They should also execute effective and efficient practice of audits by integrating internal control audit with financial statement audit, while considering audit materiality.

(2) Review to Establish Efficient Operating Methods for Internal Control Report System

[1] Simplification and Clarification Possible on the side of Companies

a. Clarification of Scope of Assessment of Company-level Controls

For "locations and business units that do not have a material effect on financial reporting," which can be excluded from assessment, the scope is clarified by giving an example of consolidated subsidiaries which comprise less than 5% of total sales.

b. Simplified Methods of Assessment of Company-level Controls

It is clarified that among assessment points for company-level controls (excluding assessment items with particularly significant impacts on the reliability of financial reporting), for points indicated as effective in the previous fiscal year's assessment results and without significant changes to the previous fiscal year's design, the management can continue using the results of the previous year's operation assessment.

c. Further Narrowing Down the Scope of Assessment of the Design and Operating Effectiveness of Process-level Controls

Among significant locations or business units within the scope of the previous fiscal year's assessment, if the assessment results were effective the previous fiscal year, and if there were no significant changes to the previous fiscal year's design, etc, then the management can exclude those locations or business units from the current fiscal year's assessment scope. In this case, the rule is that as a result, these significant locations or business units within the scope of the current fiscal year's assessment scope may comprise less than 2/3 of consolidated sales to some extent.

Among those business processes that impact the accounts that are closely associated with the company's business objectives in the significant locations or business units within the scope of assessment, it is clarified which business processes can be thought as those with no material impact and which can therefore be outside the assessment scope.

d. Simplification and Clarification of Assessment Procedures of Process-level Controls

It is clarified that controls are effective at the company-level, then except for items with particularly significant impacts on the reliability of financial reporting, if there were no significant design changes, the management can also continue using the results of the previous fiscal year's assessment of the operating effectiveness.

Under the current practice standards, if the auditor judges that the scope of assessment determined by the management is inappropriate, then it was generally understood that the auditor must require the management to perform additional work, such as reconsideration of the scope of assessment. It is clarified that the auditor needs to require the management to make additional responses corresponding to the degree of impact on financial reporting, and that the auditor does not need to require the management to make additional responses.

e. Rationalization and Simplification of Sampling

In the expanded extent of samples from the sampling performed by the management, it is clarified which ones auditors can utilize in their own samples. It is also clarified that the assessment results by the management can also be utilized in the assessment results of the auditor.

f. Clarification of Methods of Assessment and Audit for Equity Method Affiliated Companies

For equity method affiliated companies, due to factors such as the existence of other controlling shareholders, etc., it may not be possible to do assessments in the same manner as that of a subsidiary. In such a case, it was stipulated that the management should focus on company-level controls and perform appropriate procedures such as sending a questionnaire to those affiliates, and interviewing or reviewing reports prepared by those affiliates. However, it is pointed out that even such methods are difficult, especially for some overseas affiliates. Therefore, it is clarified that in special situations, assessing the management processes to confirm investment profit from such affiliates is also classified in appropriate methods.

[2] Clarification of Standards for Determining "Material Weaknesses", etc.

a. Clarification of Standards for Determining "Material Weaknesses"

Regarding quantitative materiality, it is clarified that it could be possible to use average values for certain periods in the past, or to exclude special factors.

b. Clarification of Methods of Assessment and Audit of Internal Control for Companies Newly Added to the Group by M&A, etc.

If assessment procedures cannot be executed within the usually required period due to "unavoidable circumstances," such as a purchase or merger with another company, or the occurrence of a disaster, then the management can explain that fact in the Internal Control Report, and the failure to execute such procedures can be excluded from the assessment scope. However, it is usually considered that the explanation of not-performing sufficient assessment procedures for a certain part of the internal controls due to unavoidable circumstances could only be used when that situation occurred immediately prior to the fiscal year end date. This revision gives an example of the "second half of the fiscal year" as the period in which "unavoidable circumstances" occurred, but if found to be rational, the "unavoidable circumstances" do not always have to have occurred in the "second half of the fiscal year."

[3] Simplification and Clarification for Small and Medium Listed Companies

a. Rationalization of Assessment Procedures of Business Processes

In assessment of the operation of internal controls of a smaller and less-complex organization, etc., it is especially allowed to devise and efficiently execute assessment methods depending on the situation of each organization. Specifically, it is clarified that assessment is not always required throughout the entire year or at every level in the organization (e.g. department manager level, person in charge level, etc.).

b. Approval of Alternative Procedures

For a smaller and less-complex organization, etc., it is clarified that it is possible to use the results of direct monitoring by the management, and the results of direct observation of inventories by a corporate auditor in internal control audits.

c. Simplification and Clarification of Recording and Retention concerning Assessment Procedures and Other Matters

It is clarified that a smaller and less-complex organization, etc. can have various formats and methods of records, and examples are given of usable internally prepared documents (internal notices from the company's management, documents communicating to successors, documents prepared when receiving orders, etc.). It is clarified that the auditors can also use such records.

(3) Review of Terminology of "Material Weaknesses"

"Material weakness" is a deficiency that has a reasonable possibility of having a material effect on financial reporting. If there is a "material weakness" in internal controls, it may have material impacts on financial reporting, but it does not necessarily mean that financial reports written in the company's annual securities report are not fairy stated. Also, if there is "material weakness" as of the fiscal year end date, the management shall write in the Internal Control Report their details and the reasons why such weakness have not been remediated. This signifies disclosure to investors of "significant issues which must be improved" regarding internal control over financial reporting, as items which should be considered when using the content of financial reports written in the annual securities report.

Regarding this “material weakness” term (*Juyo-na-kekkan* in Japanese), in this system, it is already established as a term under the standard, but it is pointed out that this invites the misunderstanding that there is a “defect” in the company itself. Therefore, this was changed to “material weakness” (*Kaiji-subeki-juyo-na-fubi* in Japanese). However, with this history of the Japanese term’s replacement, one must keep in mind that there are no changes in the term’s definition, nor in the decision criteria of “material weakness,” and that this differs from “significant deficiency” as used in a financial statement audit.

C.f. The English expression “material weakness” has not been revised.

(4) Preparation of Examples for Efficient Internal Control Reporting Practices

An aim of the Internal Control Report System is that the establishment, assessment, and audit of internal controls are devised corresponding to the enterprise’s situation and match the situation in order to design and operate efficient internal controls while maintaining effectiveness.

For a smaller and less-complex organization, etc., there are limited business resources to allocate to establishment and assessment of that organization’s internal controls. Therefore, its internal control reporting practices could be inefficient. Consequently, two years since the system was introduced, and amidst the implementation of the Internal Control Report System based on the standards and practice standards, and limited resources of smaller and less-complex organizations, etc., people involved have made various innovations, efficiently assessing internal controls while maintaining the effectiveness there of. It is appropriate to collect such examples and provide them as reference practices.

These examples are basically for a smaller and less-complex organization, etc. But it is hoped that they can also prove useful for organizations which are not smaller and less-complex.

3. Effective Date, etc.

1 The revised standards and revised standard practices apply to the assessment and audit of internal controls over financial reporting for fiscal years beginning on or after April 1, 2011. In applying the revised standards and revised practice standards, it will be appropriate to make required revisions in related laws and ordinances, to accompany the revisions of standards and standard practices.

2 The Japanese Institute of Certified Public Accountants is requested to urgently prepare guidelines for the internal control audit practices required when the revised standards and revised practice standards are applied, following appropriate procedures after discussions with related parties.

Standards for Management Assessment and Audit concerning Internal Control Over Financial Reporting

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Standards for Management Assessment and Audit concerning Internal Control Over Financial Reporting

I Basic Framework of Internal Control

This framework provides the conceptual framework for internal control that underlies the standards used by the management to assess and report on internal control over financial reporting and the standards used by external auditors to audit internal control over financial reporting.

Note: In this standard, the management is assumed to include representative directors, representative officers and other representatives of an executive level.

1. Definition of Internal Control

Internal control is defined as a process performed by everyone in an organization and incorporated in the organization's operating activities in order to provide reasonable assurance of achieving four objectives: effectiveness and efficiency of business operations, reliability of financial reporting, compliance with applicable laws and regulations relevant to business activities, and safeguarding of assets. Internal control consists of six basic components: control environment, risk assessment and response, control activities, information and communication, monitoring, and response to IT (Information Technology).

- Effectiveness and efficiency of business operations means promoting effective and efficient operations in order to achieve the objectives of business activities.
- Reliability of financial reporting means ensuring the reliability of financial statements and the information that could have a material effect on financial statements.
- Compliance with applicable laws and regulations relevant to business activities means promoting compliance with laws, ordinances and other codes relevant to business activities.
- Safeguarding of assets means to ensure that assets are acquired, used and disposed of in accordance with proper procedures and approvals.

(Note) The above objectives of internal control are distinct but overlap each other.

To achieve the objectives of internal control, the management is required to design and effectively operate processes in where all internal control components are in place. The relationship between the objectives and the components is one wherein all components are to be present and function effectively for the achievement of each control objective, and each individual component is necessary for the achievement of every objective of the internal control.

As internal controls are built into companies' internal rules and regulations, they thus translate into reality and everyone within the organization is able to understand and act on them in accordance with his/her own individual responsibilities. In addition, the design and operation status of Internal Control should be recording and retention in an appropriate manner.

It is impossible to provide an approach for the actual design and operation of internal control that is uniformly applicable to all organizations, because individual organizations will find themselves in different environments with different business characteristics. Nonetheless, the management, and indeed everyone in the organization, must take appropriate actions so that the functions and roles of internal control discussed in these standards are achieved effectively.

2. Basic Components of Internal Control

Basic components of internal control are those required to achieve the objectives of internal control and set the criteria for assessment of internal control.

(1) Control Environment

The control environment determines the tone of an organization; influences the awareness of its people toward control; lays the foundation for all other components; and influences risk assessment and response, control activities, information and communication, monitoring and response to IT.

The control environment encompasses the factors outlined below.

1) Integrity and ethical values

2) Management philosophy and operating style

3) Management policies and strategies

4) Functions of the Board of Directors and Corporate Auditors or Audit Committee

5) Organizational structure and practices

6) Authority and responsibilities

7) Policies and the management of human resources

Note: In relation to the reliability of financial reporting, this might include, for example: attitudes towards posting profits and other aspects of financial reporting; ability of the board of directors and corporate auditors or audit committee to appropriately monitor the reasonable financial reporting processes and the effectiveness of internal control systems; and the organization and staffing of financial reporting processes and internal control systems.

(2) Risk Assessment and Response

“Risk assessment and response” is a series of processes aimed at 1) identifying, analyzing and assessing factors that represent risks that could adversely affect the achievement of the organization’s objectives in regards to events affecting the achievement of an organization’s objectives and 2) selecting appropriate responses to those risks based on the risk assessment.

1) Risk Assessment

Risk assessment is a process to identify, analyze, and assess factors from the events that affect an organization’s achievement of its objectives as risk that could adversely affect the achievement of such objectives.

When assessing risks, risks occurring externally and internally at the organization are categorized as “Company-Level Risks” relating to the objectives of the entire organization and “Process-Level Risks” relating to the objectives of individual function and activity units, and then are analyzed as to their potential impact, likelihood, frequency, etc. of risks identified to assess their impact on the objectives according to their nature.

2) Response to Risk

Response to risk is a process to select appropriate responses to those risks based on the risk assessment.

When responding to risks, an appropriate action such as avoiding, reducing, transferring, and accepting is taken regarding assessed risks.

Note: In relation to the reliability of financial reporting, the risks associated, for example, with the development of new products or the startup of new businesses and the risks associated with the manufacturing / sales of major products are also generally related to the effectiveness and efficiency of business operations among the risks that could adversely affect the achievement of the organization’s objectives, but in many cases they also ultimately have a direct impact on the figures in financial reports through the mechanisms of accounting estimates and forecasts. It is therefore important to appropriately identify and assess their impact on the reliability of financial reporting and select the necessary action.

(3) Control Activities

Control activities are policies and procedures established to ensure that the orders and instructions of the management are followed in an appropriate manner.

Control activities include a wide range of policies and procedures, such as assignment of authority and responsibilities and segregation of duties. These policies and procedures should be incorporated into the business process and function effectively when performed by everyone in the organization.

Note: In relation to the reliability of financial reporting, policies and procedures that have the potential to influence the contents of financial reports must ensure that operations are performed as intended by the management. For this purpose, it is important to establish activities such as clear segregation of duties, checks and balances, continuous maintenance of records, timely physical inventory tabulation and other types of physical asset management, and appropriate analysis/monitoring of these activities at each level of the organization

(4) Information and Communication

Information and communication involves ensuring that necessary information is identified, understood, processed and accurately communicated throughout the organization and to relevant parties. The information required by everyone to carry out his or her responsibilities must be identified, understood, processed and communicated within the organization in a timely and appropriate manner. In addition to communicating necessary information, it is important that the information be understood properly by information receivers and shared with all of the people to whom it is relevant.

Generally, information is identified, encapsulated, processed and communicated through manual and computerized information systems.

1) Information

Achieving the objectives of the organization and the objectives of Internal Control requires that everyone in the organization identify the information required in order to carry out their individual responsibilities in a timely and appropriate manner, sufficiently understand the contents and reliability of the information and convert the information into an applicable form.

2) Communication

a. Internal Communication

Achieving the objectives of the organization and the objectives of Internal Control requires that the necessary information be conveyed to the appropriate personnel within the organization in a timely manner. Additionally, when using the organization's information systems to communicate management policies to everyone within the organization, the management must also provide the means of conveying important information, to the upper levels of the organization in particular, in a timely and appropriate manner.

b. External Communication

Information must also be disseminated externally in a timely and appropriate manner, not just internally. This includes disclosures of financial information mandated by laws and regulations. Furthermore, communications from external parties, such as customers, provide important information, and therefore it is necessary to establish a process of identifying, encapsulating and processing information from outside the organization in a timely and appropriate manner.

Note: In relation to the reliability of financial reporting, "information", for example, refers to the creation of integrated accounting systems that appropriately recognize, measure, and account for economic activities and provide the accounting information that is at the core of financial reporting. On the other hand, "communications" refers to the maintaining of systems to report this accounting information to relevant parties inside and outside the organization in a timely and appropriate manner.

(5) Monitoring

Monitoring is a process that continuously assesses the effectiveness of internal control. Monitoring provides a means of continually observing, assessing and correcting internal control. Monitoring includes ongoing monitoring that is performed in the course of business operations and separate evaluations that are conducted from perspectives independent of business operations. In some cases, both of the above will be conducted independently; in others, they will be coordinated.

1) Ongoing Monitoring

"Ongoing monitoring" consists of activities that are performed in the ordinary course of operations such as business management and operational improvement in order to monitor the effectiveness of internal control.

2) Separate Evaluations

"Separate evaluations," which are different from ongoing monitoring, consists of assessments of internal control that are performed periodically or as needed by parties such as the management, the board of directors, corporate auditors or audit committee, and internal auditors. Separate evaluations have perspectives independent from those of normal operations.

3) Assessment Process

The assessment of internal control is itself a process. The assessors of internal control must sufficiently understand organizational activities and all components of internal control to be assessed in advance.

4) Reporting on Control Deficiencies

It is necessary to establish mechanisms for reporting information to the appropriate personnel within an organization, according to the nature and degree of the control deficiencies identified through ongoing monitoring or separate evaluations to be appropriately addressed. These mechanisms include procedures for reporting to the management, the board of directors, corporate auditors and other parties.

Note: In relation to the reliability of financial reporting, ongoing monitoring might include, for example, individual operational departments checking ledger against actual volumes of products manufactured, of inventory, or of products sold; or relevant personnel monitoring the accuracy and completeness of the inventory counts determined through regular inventory procedures. Separate evaluations would include financial accounting audit performed by the internal audit department, corporate auditors or audit committee and other parties that serve as the monitoring functions within an organization to verify the reliability of all or a part of financial reporting.

(6) Response to IT

Response to IT refers to establishing appropriate policies and procedures in advance to achieve organizational objectives and to responding appropriately to IT inside/outside the organization during the course of business activities based on the policies and procedures.

Response to IT is not always independent from other components of internal control, but if the business of the organization heavily relies on IT or the information systems highly utilize IT, it serves as the assessment criteria for internal control effectiveness as an essential part to achieve the internal control objectives.

Response to IT consists of response to IT environment and use of IT and IT controls.

1) Response to IT Environment

The IT environment is the internal/external use of IT that is needed for the organization's activities, the level of IT penetration the society and the market, the use of IT for the company's transactions, a series of information systems on which the organization selectively relies and so on. In regards to the IT environment, the organization should establish appropriate policies and procedures in advance within the areas under the auspices of the organization in order to achieve the objectives of internal control and respond appropriately based on the policies and procedures.

Response to the IT environment is not only linked to the control environment but is assessed as a whole together with other components of internal control at each business process.

2) Use of IT and IT controls

Use of IT and IT controls means to utilize IT effectively and efficiently in order to ensure the effectiveness of other basic components of internal control, and to establish, in advance, appropriate policies and procedures for IT that are systematically incorporated into the business and used in various ways within the organization to achieve organizational objectives and make other basic components of internal control operate more effectively.

The "use of IT and IT controls" refers to the integral parts of other components of Internal Control and are assessed as a whole. In addition, the use of IT and IT controls is assessed based on the vulnerability and impact on the business thereof as well as the convenience of the implemented IT.

Note: In relation to the reliability of financial reporting, IT cannot be disregarded in any discussion of today's corporate environments. Therefore, the IT environment, which has a significant impact on the financial reporting process, and the use of IT controls built into the financial reporting process itself, must be taken into account. In addition the component of internal control required to ensure the reliability of financial reporting must be established. For example, control activities would include processes in all of the company's information processing systems to ensure that data relevant to financial reporting is appropriately collected and processed; other control activities would include processes to ensure that data in the computers used in specific operational areas is appropriately collected, processed and reflected in financial reports.

3. Limitations of Internal Control

Internal control cannot provide absolute assurance with respect to the achievement of objectives due to the following inherent limitations, but it aims at achieving the objectives to a reasonable extent with the organized and integrated function of individual components as a whole.

(1) Internal control may not operate effectively due to misjudgments, carelessness or collusion among two or more individuals.

(2) Internal control may not necessarily respond to unexpected changes in internal or external environments when controls were designed for non-routine transactions.

(3) The design and operation of internal control needs to consider relative costs and benefits.

(4) The management can ignore or override internal control for illegitimate objectives.

4. Roles and Responsibilities of Relevant Persons

(1) Management

The management has the ultimate responsibility for all the activities of an organization, and as part of this, it has roles and responsibilities in the design and operation of internal control based on the basic policies determined by the board of directors.

The management designs and operates internal control (including monitoring) through the company's organization as a means to satisfy its responsibility.

The management more significantly influences the tone of the organization that affects the factors of the control environment and the other basic components of internal control than any other individuals in an organization.

(2) Board of Directors

The board of directors decides the preliminary policies related to the design and operation of internal control.

The board of directors supervises the performance of the management, including the design and operation of internal control by the management.

The board of directors is an important part of company-level controls and a part of the control environment for process-level controls.

(3) Corporate Auditors or Audit Committee

Corporate auditors (auditor's board) or the audit committee is responsible for auditing the performance of the directors and officers. As a part of this, they have the role and responsibility to independently monitor and verify the design and operation of internal control.

(4) Internal Auditors

Internal auditors are responsible for examining and assessing the design and operation of internal control, and they urge remedial action as a part of their monitoring functions, a basic component of internal control to ensure more effective achievement of the internal control objectives.

Note: In this standard, the term "internal auditor" means any person or unit with the responsibility for examining, assessing, and recommending the design and operation of internal control regardless of how their affiliation is termed within the organization.

(5) Other Personnel within the Organization

Internal control is a process carried out by everyone within an organization. All personnel other than those listed above play a role in the design and operation of effective internal control concerning their own work duties.

II Assessment and Report on Internal Control Over Financial Reporting

1. Definitions related to the Assessment of Internal Control Over Financial Reporting

The management has the role and responsibility to design and operate internal control. Out of the internal control discussed in the “basic framework of internal control,” it is particularly vital for the management to assess the internal control over financial reporting in accordance with generally accepted assessment standards for internal control and report its conclusion externally in order to ensure the reliability of financial reporting.

For the purposes of these standards, the terms below and their meanings are used:

(1) “Financial reporting” and “financial reports” are external reporting of both 1) financial statements and 2) disclosure information and others that could have a material effect on the reliability of financial statements.

(2) “Internal control over financial reporting” is an internal control that is necessary to ensure the reliability of financial reporting.

(3) “Effective internal control over financial reporting” means that the internal control is designed and operated in accordance with an appropriate internal control framework and is free of material weakness.

(4) “Material weakness” is a deficiency in internal control over financial reporting, that has a reasonable possibility of having a material effect on financial reporting.

2. Assessment of Internal Control Over Financial Reporting, and Scope of Assessment

(1) Assessment of the effectiveness of Internal Control Over Financial Reporting

The management must assess the effectiveness of internal control over financial reporting to the extent necessary in light of their degree of impact on the reliability of financial reporting.

Prior to making such assessments, the management must establish policies and procedures for designing and operating internal control over financial reporting, and must record and maintain their status. The assessment of internal control over financial reporting effectiveness should be, in principle, performed on a consolidated basis.

(Note) The internal controls over outsourced processes should be within the scope of the assessment.

(2) Determination of the Scope of Assessment

In assessing the effectiveness of internal controls, the management should decide on the reasonable scope of assessment for the following matters in light of their degree of quantitative and qualitative impact on financial reporting, and should keep appropriate records of the approach and grounds related to the scope of assessment for relevant internal controls.

- Presentation and disclosure of financial statements
- Businesses and business operations comprising the company's activities
- Transactions and events as the basis of financial reporting
- Important business processes

The management should, based on the determination of significant locations or business units, examine the scope of assessment for these items from the perspective of their degree of quantitative and qualitative impact on the presentation and disclosure of financial statements.

Based on these considerations, they should then think of the degree of quantitative and qualitative impact on overall financial reporting from the businesses and business operations comprising the company's activities, the transactions and events as the basis of financial reporting and important business processes, to arrive at a reasonable scope of assessment.

Note: With regards to "presentation and disclosure of financial statements," this could include, for example, examining the scope of assessment by setting, from the perspective of degree of quantitative impact, threshold amounts for each account within the financial statements, and then examining the degree of qualitative impact on financial statements to determine the accounts that should be included within the scope of assessments. Accounts with a significant degree of impact by either measure would be included within the scope of assessments of internal controls.

In addition to this, for "businesses and operations comprising the company's activities" and other matters on the list, reasonable scopes of assessment would be determined in light of the relevance thereof to the scope of assessment studied with regards to "presentation and disclosure of financial statements" and degree of quantitative and qualitative impact on overall financial reporting.

3. Method of Assessing Internal Control Over Financial Reporting

(1) Internal Control Assessment by Management

The management, as the entity responsible for the design and operation of effective internal control, assesses internal control over financial reporting. In evaluating internal controls, the management should first assess internal controls that have a material impact on overall consolidated financial reporting ("company-level controls" hereinafter) and, based on the results, assess the internal control incorporated into business processes ("process-level controls" hereinafter).

The management's assessment of internal controls should be conducted as of the end of the fiscal year.

Note: What kind of internal controls are actually designed and operated by companies varies in accordance with the individual circumstances and business characteristics of individual companies. Management should design and operate appropriate internal controls in accordance with the circumstances of their companies in light of the internal controls framework and assessment standards.

(2) Assessment of Company-Level Controls

The management should assess the design and operation of company-level controls and the degree of impact they have on process-level controls. In doing this, the management should sufficiently assess risks occurring inside/outside the organization and should fully consider all events that could have a significant impact on overall financial reporting. This would include, for example, company-level accounting policies and financial policies, management decisions related to the structuring and operation of organizations, and the decision-making process at the management level.

(3) Assessment of Process-Level Controls

Based on the assessment of company-level controls, the management should analyze business processes within the scope of the internal controls to be assessed, identify a key control that would have a material impact on the reliability of financial reporting ("key control" hereinafter), and assess whether the basic components of internal control are operating with regard to the key control.

(4) Judgment of the Effectiveness of Internal Controls

If the assessment of internal control over financial reporting effectiveness reveals that deficiencies relating to key controls, etc. are very likely to have a material impact on financial reporting, the management should conclude that there are material weaknesses in internal control over financial reporting.

(5) Remediation of Material Weaknesses in Internal Controls

Control deficiencies over financial reporting and material weaknesses identified in the course of the management's assessment should be recognized on a timely basis and appropriately dealt with.

Even when material weaknesses are identified, internal control over financial reporting can be judged to be effective as long as the weaknesses are remediated by the assessment date in the Internal Control Report (the fiscal year end date).

Note: Remedial actions taken after the fiscal year end date may be stated in the Report as Supplementary Information.

(6) Limitation of the Scope of Assessment

The management, when assessing the effectiveness of internal control over financial reporting, may not be able to perform sufficient assessment procedures for a certain part of the internal controls due to unavoidable circumstances. In such cases, the management may assess the effectiveness of internal control over financial reporting, excluding the parts where assessment procedures could not be performed, after fully comprehending the impact of the exclusion on the financial reporting.

Note: Cases in which adequate assessment procedures could not be performed due to unavoidable circumstances include, for example, a case when, due to a company acquiring another company in the second half of the fiscal year end date, the management could not perform sufficient assessment procedures for the effectiveness of the acquired company's internal controls.

(7) Recording and Retention of Assessment Procedures and Others

The management should record and retain the information on the assessment of Internal control over financial reporting, including its procedures, results, identified deficiencies and remedial actions.

4. Management's Report on Internal Control Over Financial Reporting

(1) Management's Report on Internal Control

Management should prepare a report on its assessment of the effectiveness of internal control over financial reporting ("Internal Control Report" hereinafter).

(2) Matters to be included in Internal Control Report

The Internal Control Report should include the following matters:

1) Matters related to design and operation

2) Assessment scope, timing and procedures

3) Results of assessment

4) Supplementary information

(3) Matters Related to Design and Operation

1) The name of the person responsible for financial reports and internal control over financial reporting

2) A statement denoting the responsible of the management regarding the design and operation of internal control over financial reporting

3) Generally accepted framework of internal control

4) Inherent limitations of internal control

(4) Assessment Scope, Timing and Procedures

1) Scope of assessment of internal control over financial reporting (including approach and grounds used to determine scope)

2) Timing of assessment of internal control over financial reporting

3) A statement denoting that assessments of internal control over financial reporting was performed in accordance with generally accepted assessment standards for internal control

4) Outline of the assessment procedures of internal control over financial reporting

(5) Results of Assessment

Below are methods for presenting the results of assessments on internal control over financial reporting:

a. A statement denoting that the internal control over financial reporting is effective

b. A statement denoting that although some assessment procedures could not be performed, internal control over financial reporting is effective, as well as what assessment procedures could not be performed and the reasons why

c. A statement denoting that internal control over financial reporting are not effective due to the material weaknesses identified, the details of material weaknesses and the reasons why they have not been remediated

d. A statement denoting that the results of assessments of internal control over financial reporting cannot be presented because significant assessment procedures could not be performed, as well as the assessment procedures that could not be performed and the reasons why

(6) Supplementary Information

1) Subsequent events that would have a material impact on assessments of the effectiveness of internal control over financial reporting

2) Remediation and other matters pertaining to material weaknesses implemented after the end of the fiscal year

III Audit on Internal Control Over Financial Reporting

1. Objective of the Internal Control Audit by Financial Statement Auditor

The objective of an audit of the management's assessments of the effectiveness of Internal Control Over Financial Reporting ("Internal Control Audit" hereinafter) by an external auditor of financial statements is to have external auditors express their opinions, based on audit evidence obtained themselves, as to whether the management's Internal Control Report fairly states the results of the assessment, in all material respects, in accordance with generally accepted assessment standards for internal control.

Such opinions on the Internal Control Report are expressed in the Audit Report on Internal Control Assessment ("Internal Control Audit Report" hereinafter).

Unqualified opinions expressed by external auditors include the judgment that they have obtained reasonable assurance that the Report does not include any material misstatements.

The "reasonable assurance" means that external auditors have obtained sufficient competent evidence to express such opinions.

2. Relationship between the Internal Control Audit and the Financial Statement Audit

The Internal Control Audit and the Financial Statement Audit are, in principle, performed integrally by the same external auditor. The audit evidence obtained in the process of the Internal Control Audit may be used as audit evidence for the Financial Statement Audit, and vice versa.

Notes: In this context, "the same external auditor" means not only the same audit firm but also the same engagement partner that conducts the audit.

Generally, when internal control over financial reporting is ineffective due to material weaknesses, for the purpose of the Financial Statement Audit, the external auditor cannot apply sampling testing where he/she relies on Internal Control in accordance with the Audit Standards.

In performing the Internal Control Audit, external auditors must comply with not only the standards in this guideline, but also with general standards under the "Audit Standards" and "Quality Control Standards for audit."

3. Performance of the Internal Control Audit

(1) Audit Planning

External auditors must establish the audit plan based on the audit materiality, considering the company's environment, business characteristics and others and fully understanding the status of the management's design, operation and assessment of internal controls.

External auditors must update the audit planning on a timely basis, by performing procedures including the assessment of the improvement of internal controls, when there have been changes in the events or circumstances based upon which the plan was developed or when control deficiencies (including material weaknesses) have been identified in the audit process.

(2) Evaluation of the Appropriateness of the Scope of Assessment

External auditors must evaluate the reasonability of the methods and grounds used by the management, in order to verify the adequacy of the scope of assessment determined by the management.

In the case when the management has prepared an Internal Control Report that excludes a certain scope of internal controls for which sufficient assessment procedures could not be performed due to unavoidable circumstances, it is particularly important that external auditors fully evaluate whether the reasons for the management’s exclusion of the scope are justified and the impact of the exclusion on the financial statements.

(3) Evaluation of the Assessment of Company-Level Controls

External auditors must evaluate the appropriateness of the management’s assessment of company-level controls.

In the evaluation, external auditors must fully consider the status of the design and operation of internal controls at the management level, including the board of directors, corporate auditors or audit committee, internal auditors, etc.

(4) Evaluation of the Assessment of Process-Level Controls

External auditors must evaluate the appropriateness of the management’s assessment of process-level controls. In the evaluation, external auditors must evaluate whether the management has appropriately selected key controls, considering the status of the management’s assessment of company-level controls and with a full understanding of the company’s business processes.

In order to judge whether basic components of internal controls are properly functioning in regards to each key control assessed by the management, external auditors must obtain audit evidence for key audit objectives such as existence or occurrence, completeness, rights and obligations, valuation, allocation and presentation and disclosure.

In evaluating the effectiveness of basic components of process-level controls, external auditors must also fully evaluate the status of the design and operation of internal controls (including response to IT).

(5) Reporting and Remediation of Material Weaknesses in Internal Controls

When identifying material weaknesses in internal controls in the course of the Internal Control Audit, external auditors must report such material weaknesses to the management, request remediation, and assess the remediation status on a timely basis. External auditors must also report the details of such material weaknesses and the remediation results to the board of directors, corporate auditors or audit committee.

External auditors must report to appropriate personnel when identifying deficiencies in internal controls.

External auditors must report the results of the Internal Control Audit to the management, board of directors, corporate auditors or audit committee.

Note: External auditors may be required to report the material weaknesses in internal controls identified in the course of the Internal Control Audit to the management, board of directors, corporate auditors or audit committee by the final date of the Companies Act Audit.

(6) Reporting of Fraud and Others

When identifying fraud or significant illegal facts in the course of an Internal Control Audit, external auditors must report it to the management, the board of directors and corporate auditors or the audit committee and request the appropriate remediation, at the same time evaluating the impact on the effectiveness of internal controls.

(7) Coordination with Corporate Auditors or Audit Committee

External auditors should determine the scope and degree of coordination with the corporate auditors or audit committee, in order to perform effective and efficient audits.

(8) Use of Other Auditors, etc.

When using the results of the Internal Control Audit performed by other auditors, external auditors must assess the appropriateness of such results and accordingly determine the degree and method of using them, considering their significance and the reliability of other auditors.

External auditors must evaluate the status of the internal audit performed by the company, which is a part of its monitoring activities that comprise the basic components of internal controls, and decide the scope and degree of its use.

4. Auditor’s Report

(1) Expression of Opinion

In the Internal Control Audit Report, external auditors must express an opinion on whether the management’s assessment of internal control over financial reporting in the Internal Control Report is fairly stated, in all material respects, in accordance with the generally accepted assessment standards for internal control. Note that this opinion is to be expressed to the assessment of the effectiveness of internal control over financial reporting as of the end of the fiscal year.

Note: An unqualified opinion may be deposed if the material weakness in question has been remediated by the end of the fiscal year. If the material weakness is remediated after the end of the fiscal year, the implemented remediation must be included as additional information in the Internal Control Audit Report.

(2) Structure of Report

1) In the Internal Control Audit Report, the external auditor must include clear and concise statements which separate the Internal Control Audit Subject matter, the Management's Responsibility, the External auditor's Responsibility, and the External auditor's Opinion. If the external auditor disclaims its opinion, the statement must be included in the Internal Control Audit Report.

2) When the external auditor includes as additional information in the Internal Control Audit Report items which must be emphasized regarding statements in the Internal Control Report, or items which require additional explanations, these information must be clearly segregated from the expression of opinion.

3) The Internal Control Audit Report should in principle be combined with the Financial Statement Audit Report.

(3) Description of Unqualified Opinion

When concluding that the management's assessment of internal control over financial reporting in the Internal Control Report is fairly stated, in all material respects, in accordance with the generally accepted assessment standards for internal control, external auditors must express an "Unqualified Opinion".

When management, in the Internal Control Report, includes details of a material weakness in internal control over financial reporting and reasons why it has not been remediated, and the external auditor concludes that these statements are fairly stated and therefore expresses an unqualified opinion, then the external auditor must include additional explanatory information in the Internal Control Audit Report on the material weakness and its impact on the Financial Statement Audit.

When expressing an unqualified opinion, external auditors should include the following descriptions in the Internal Control Audit Report:

1) Internal Control Audit Subject matter
Scope of Internal Control Audit

2) Management's Responsibility

a. A statement denoting that the management is responsible for the design and operation of internal control over financial reporting and the preparation of the Internal Control Report

b. Inherent limitations of internal control

3) External Auditor's Responsibility

a. A statement denoting that the responsibility of an external auditor who performed an Internal Control Audit is to express an independent opinion on the Internal Control Report

b. A statement denoting that the external auditor performed the Internal Control Audit in accordance with generally accepted audit standards for internal control over financial reporting

c. A statement denoting that the standards for the Internal Control Audit for financial reporting require that the external auditor has obtained reasonable assurance that the Internal Control Report is free from material misstatements

d. A statement denoting that the Internal Control Audit involves performing procedures to obtain audit evidence on results of the assessment of internal controls over financial reporting in the Internal Control Report

e. A statement denoting that the Internal Control Audit includes evaluating the overall presentation of the Internal Control Report, including the scope, procedures and results of the assessment determined by the management

f. A statement denoting that the audit procedures selected and applied of the Internal Control Audit depend on the auditor’s judgment

g. A statement denoting that audit evidence obtained as result of the Internal Control Audit is sufficient and appropriate to provide a basis for the auditor’s opinion

4) External auditor’s Opinion

a. An identification of management’s conclusion

b. A statement denoting that the management’s assessments of internal control over financial reporting in the Internal Control Report is fairly stated, in all material respects, in accordance with the generally accepted assessment standards for internal control

(4) Exceptions to Opinions

1) When external auditors identify inappropriate parts in the Internal Control Report regarding the scope, procedures or results of the assessment determined by the management, and judge that the impacts are significant to the extent that the external auditors may not be able to express an unqualified opinion, but not significant to the extent that the Internal Control Report is misstated as a whole, they should express a qualified opinion with exceptive items. In such cases, a separate section must be established, and the inappropriate parts that have been excluded and their impact on the Financial Statement Audit must be described in the external auditors’ opinion on the Internal Control Report.

2) When external auditors identify inappropriate parts in the Internal Control Report regarding the

scope, procedures or results of the assessment determined by the management and judge that the impacts are significant that the Report is misstated as a whole, they must express an opinion that the Internal Control Report is not fairly stated. In such cases, a separate section should be established, and the fact that the Report is not fairly stated, relevant reasons and its impact on the Financial Statement Audit should also be described.

(5) Limitation of the Scope of Assessment

1) When external auditors cannot express an unqualified opinion, for example because they were unable to perform some of the important audit procedures, they must express a qualified opinion with exceptive items, unless they judge that the impact is significant to the extent that they cannot express any opinion on the Internal Control Report as a whole. In such cases, external auditors must establish a separate section, and state the audit procedures that could not be performed in the summary of the audit performed, and its impact on the Financial Statement Audit in their opinion on the Internal Control Report.

2) External auditors must not express any opinions on the Internal Control Report as a whole when they have not been able to obtain a basis for expressing opinions, for example as a result of not being able to perform some of the important audit procedures. In such cases, external auditors should establish a separate section, and state the fact that they do not express their opinion on the Internal Control Report and relevant reasons.

(6) Additional Information

External auditors should create an Emphasis and Matter paragraph in the Internal Control Audit Report that includes the following matters which they judge appropriate for emphasise or explanation:

1) The fact that there are material weaknesses and their impact on the Financial Statement Audit, if the management has written in the Internal Control Report a description of material weaknesses in internal controls over financial reporting and the reasons why they have not been remediated

2) Subsequent events that would have a material impact on the assessment of internal control over financial reporting effectiveness

3) Remedial and other actions taken after the fiscal year end date

4) The scope for which sufficient assessment procedures could not be performed and relevant reasons, when external auditors judge that the management could not perform a certain part of the assessment procedures due to unavoidable circumstances and therefore express an unqualified opinion

Practice Standards for Management Assessment and Audit concerning Internal Control Over Financial Reporting

Practice Standards for Management Assessment and Audit concerning Internal Control Over Financial Reporting

Table of Contents

(Note) In this practice standard excerpts of corresponding standards are enclosed in box.

I Basic Framework of Internal Control

1. Definition of Internal Control (objectives)

Internal control is defined as a process performed by everyone in an organization and incorporated in the organization's operating activities in order to provide reasonable assurance of achieving four objectives: effectiveness and efficiency of business operations, reliability of financial reporting, compliance with applicable laws and regulations relevant to business activities, and safeguarding of assets. Internal control consists of six basic components: control environment, risk assessment and response, control activities, information and communication, monitoring, and response to IT (Information Technology).

Internal control is established in an organization to achieve the four objectives, which support its operating activities. Internal control is intended to provide reasonable, but not absolute, assurance as to the achievement of the four objectives, in terms of the organization, in particular the management responsible for establishing internal control, by taking measures to reduce the risk of failing to achieve the four objectives to a certain level.

Internal control should not be established separately from the organization or its daily business operations, but should be incorporated into its business operations and be conducted by every person in the organization in the course of performing their duties. Accordingly, not only permanent employees, but also short-term or temporary employees who undertake certain roles and perform their duties in the organization should conduct internal control.

Internal control is defined as a set of dynamic processes to be effected by everyone in the organization, and is not a mere event, situation, rule, or mechanism. Therefore, establishment of internal control does not automatically mean its completion. Internal control should be constantly revised and reviewed during the course of its operation in response to changes in the organization itself or the environment surrounding the organization.

It is impossible to provide an approach for the actual design and operation of internal control that is uniformly applicable to all organizations, because individual organizations will find themselves in different environments with different business characteristics. Nonetheless, the management, and indeed everyone in the organization, must take appropriate actions so that the functions and roles of internal control discussed in these standards are achieved effectively.

It is impossible to provide an approach that is uniformly applicable to all organizations for the establishment of internal control, because individual organizations will find themselves in different environments.

The management of an organization should design and operate internal control suited to the organization, in accordance with its business environment, characteristics, size, etc. Examples of the matters to be considered in designing and operating internal control include product market conditions, characteristics of products and customers, geographic scope of activities, intensity of competition, speed of technological innovation, size of business, labor market conditions, IT environment, and consideration for the natural environment.

On the other hand, there is a basic framework that is commonly applicable to all organizations, irrespective of their size and type of business. Chapter I, “Basic framework of internal control,” is designed to provide a basic internal control framework, which constitutes a prerequisite for evaluating, reporting, and auditing internal control over financial reporting as required by the Financial Instruments and Exchange Act.

(1) Effectiveness and Efficiency of Business Operations

Effectiveness and efficiency of business operations means promoting effective and efficient operations in order to achieve the objectives of business activities.

The term “operations” refers to the activities performed by all individuals in an organization on a daily basis to achieve the objectives of the organization’s business activities. "Effectiveness of business operations" refers to the extent to which an organization achieves the objectives set for its business activities and operations. “Efficiency of business operations” refers to the extent to which an organization reasonably utilizes time, human, financial, and other internal and external resources in the course of its efforts to achieve its objectives.

While effectiveness and efficiency of business operations can be recognized at the level of the entire organization, it is recommended to classify business activities according to the type of operation and set reasonable objectives for each type of operation. Internal control should be designed and operated in each of the operations performed by the organization to achieve these individual objectives, and, through their achievement, ultimately help achieve effective and efficient operations within the entire organization.

Internal control over effectiveness and efficiency of business operations helps an organization to achieve its goals related to effectiveness and efficiency by providing a system designed for measuring/evaluating the level of achievement in operations and reasonable use of resources and taking appropriate measures.

(2) Reliability of Financial Reporting

Reliability of financial reporting means ensuring the reliability of financial statements and the information that could have a material effect on financial statements.

Because financial reporting provides information that is quite important for both internal and external persons to verify the organization’s activities, ensuring the reliability of financial reporting will contribute to the organization’s efforts to maintain and improve its social credibility. On the other hand, erroneous information contained in financial reporting will cause not only unexpected loss to a number of stakeholders, but also significant damage to the organization’s credibility.

Financial reporting includes those required by the Financial Instruments and Exchange Act, Companies Act, and other laws and regulations, those required by contracts or agreements with banks or business partners, and voluntary disclosure to stakeholders. In the context of this standard, the term “financial reporting” refers to the financial statements and information that could have a material effect on the financial statements described in the disclosure documents (Annual Securities Report and Securities Registration Statement) required by the Financial Instruments and Exchange Act. (For details, refer to “1.[1]. Scope of financial reporting” in “II. Assessment and Report on Internal Control Over Financial Reporting.”)

Internal control over the reliability of financial reporting helps prevent misstatements in material components of the financial statements and supports the trustworthiness of the organization’s financial reporting.

(3) Compliance with Applicable Laws and Regulations Relevant to Business Activities

Compliance with applicable laws and regulations relevant to business activities means promoting compliance with laws, ordinances and other codes relevant to business activities.

If an organization or a person in the organization fails to comply with laws and regulations or acts in disregard of social norms, the organization or the person will be punished and criticized in proportion to the severity of the incompliance or act, and consequently may jeopardize the organization’s ability to continue as a going concern. On the other hand, when an organization’s sincere efforts to comply with laws and regulations (e.g., compliance with product safety standards or ensuring of operational safety) are recognized, such recognition will contribute to an improvement in the organization’s business performance and share price.

As above, when an organization wants to continue operating and growing, it is indispensable for the organization to implement a system designed to ensure appropriate compliance with laws, regulations and other norms governing its business activities.

Applicable laws and regulations relevant to business activities consist of the following:

[1]. Laws and regulations

Domestic and foreign laws, orders, ordinances, rules, etc., with which an organization should comply in the course of conducting its business activities.

[2]. Standards, etc.

Norms other than laws and regulations that an organization is compelled to comply with by an external authority. For example, rules of a stock exchange, accounting standards, etc.

[3]. Code of conduct existing internally or externally

Norms other than the above, with which an organization should voluntarily comply or agree to comply. For example, articles of incorporation and other internal rules, code of conduct set by the industry, etc.

Internal control over compliance with laws and regulations means designing and operating a system to conduct business activities in compliance with applicable laws and regulations. An organization can continue operating and expanding through these efforts.

(4) Safeguarding of Assets

Safeguarding of assets means to ensure that assets are acquired, used and disposed of in accordance with proper procedures and approvals.

When an asset is fraudulently or wrongly acquired, used, or disposed of, this may cause significant damage or have an adverse impact on an organization's property or social credibility. In the case where an organization conducts its business by using assets contributed by investors or any other party, the organization's management is responsible for safeguarding the assets in a proper manner. Furthermore, its corporate auditor or audit committee is entitled by the Companies Act to examine the organization's operational and financial conditions. They therefore play an important role and assume significant responsibilities for the safeguarding of assets.

Assets include not only tangible assets, but also intangible assets, such as intellectual property and customer information.

In order to prevent any fraudulent or erroneous acquisition, use, or disposal of assets, organizations are required to establish a system by which assets are acquired, used, and disposed of through proper procedures and approvals. They are also required to design and operate a system by which any acquisition, use, or disposal of assets that has not undergone the proper procedure or approval process is identified immediately and by which appropriate measures are taken.

(5) Relationship among Four Objectives

Although the four objectives of internal control - effectiveness and efficiency of business operations, reliability of financial reporting, compliance with applicable laws and regulations relevant to business activities, and safeguarding of assets - are inherent to the internal control, they are not independent of each other, but rather are closely connected.

Internal control is a process that is incorporated in an organization’s operating activities and executed by everyone in the organization. Even if an internal control is established to achieve one of the four objectives, it may operate in conjunction with another internal control established to achieve another objective, or two or more controls may complement each other.

The internal control reporting system, which is introduced as a requirement of the Financial Instruments and Exchange Act, aims to assure the effectiveness of internal control over financial reporting through the management’s evaluation and reporting of, and external auditor’s audit on, internal control. It does not directly require organizations to design and operate internal control to achieve objectives other than the reliability of financial reporting. However, given that financial reports summarize financial information that is relevant to the entire range of an organization’s business operations, they are closely connected to the entire range of those operations. Therefore, when the management wants to establish internal control over financial reporting in an effective and efficient way, it should first understand the relationship among the four objectives before designing and operating internal controls.

2. Basic Components of Internal Control

Basic components of internal control are those required to achieve the objectives of internal control and set the criteria for assessment of internal control.

To achieve internal control objectives in an organization, it is important that all of the six basic components be properly designed and operated.

(1) Control Environment

The control environment determines the tone of an organization; influences the awareness of its people toward control; lays the foundation for all other components; and influences risk assessment and response, control activities, information and communication, monitoring and response to IT.

The control environment is a concept that encompasses an organization's standard of values and basic systems of human resources, duties and the like.

The tone of an organization refers to the awareness generally observed in the organization and behaviors based on the awareness, as well as the strength and characteristics specific to the organization. The tone of the organization often reflects its top management's intentions and attitudes. The values and basic systems held by an organization define the awareness and behaviors unique to the organization and affect its people's views on internal control.

The control environment is the most important component that serves as the prerequisite for, and exerts influence on, other components.

Examples of general elements of the control environment include:

[1]. Integrity and ethical values

Integrity and ethical values of an organization are the important factors that shape its tone, and have a significant impact on all persons in the organization when they make ethical decisions.

There may be various types of efforts regarding integrity and ethical values. For example, an organization may develop its basic philosophy and code of ethics or code of conduct based on the philosophy, and establish internal control to ensure compliance with them. Its management may be directly involved in the efforts to ensure the operating effectiveness of such internal controls.

[2]. Management's philosophy and operating style

The management's philosophy and operating style have a significant impact not only on the organization's basic policies, but also on determining the tone of the organization. The manner of communicating the management's philosophy and operating style also affects the behaviors of the people in the organization. For example, the management's attitude to uphold proper accounting and financial reporting practices, clearly defining the policies and principles to ensure the proper practices, communicating them to internal and external parties, and establishing appropriate systems to achieve them would provide a solid foundation for the achievement of reliable financial reporting.

The management's internal or external announcements, daily activities, decisions on the budget, human resource policies, and the like will affect internal control in the organization through the awareness of the people in the organization. Moreover, its philosophy and operating style will be reflected, directly or indirectly, in in-house rules such as the corporate motto or credo, management principles, management plan, code of ethics, and code of conduct. Internal control systems are designed and operated in order to achieve the goals set in these rules or to comply with these rules.

[3]. Management policies and strategies

Management policies and strategies employed by an organization to achieve its goals have a significant impact not only on its people's values, but also on other components, because they determine the amount of resources allocated to each operation. Organization-wide goals established for the management policies and strategies contribute to the achievement of internal control goals when they are broken into smaller steps and specific activities through preparing annual or divisional budgets or business plans that are included in the scope of internal control.

[4]. Functions of board of directors and corporate auditors or audit committee

The board of directors and corporate auditors or audit committee is the mechanisms responsible for monitoring directors' performance. Individual companies are required to establish this mechanism within the company by the Companies Act. For example, effectiveness of the activities undertaken by the board of directors and corporate auditors or audit committee (e.g., whether the board or committee members are actually able to express their opinions independently of the management or certain stakeholders; whether they can obtain accurate information necessary for the monitoring in a timely and appropriate manner; whether they can communicate with the management, internal auditors and the like in a timely and appropriate manner; and whether their reports and comments are treated in an appropriate manner in the organization) is an important factor to determine whether the monitoring of the organization as a whole is effective.

[5]. Organizational structure and practices

In order to achieve an organization's goals and ensure the effectiveness of information and communication systems in the organization, it is important that the organization has a structure that is suitable for its goals and capable of providing the flow of information necessary for the control of business activities. It is important that an organizational structure, scope of authorities and responsibilities, human resources and compensation systems, etc., be appropriately established by the management in accordance with its size, line of business, type of product or service, geographic diversification, employee makeup, the nature of its market and the like.

An organization's customary practice often serves as a guideline to determine whether an activity is good or bad within the organization.

For example, if an organization has a customary practice of not pointing out problems, such practice will have a significant negative impact on the effectiveness of control activities, information and communication, and monitoring. An organization's customary practice is often formed by internal factors such as its history, size, line of business, and employee makeup, as well as external factors, such as market, business partners, shareholders, parent company, local characteristics, and restrictions specific to the industry.

Accordingly, those who attempt to change an organization's long-existing customary practice may face significant difficulties. However, if the management evaluates that such customary practice may be a factor that hinders the continuity and development of the organization, it is important for the management to provide appropriate principles, plans, personnel policies, and the like.

[6]. Authority and responsibility

The term "authority" refers to the right to perform the organization's activities. The term "responsibility" refers to the responsibility or obligation to perform assigned activities. It is important for the achievement of control objectives that authorities and responsibilities be consistent with the goals of the organizations business activities and assigned to appropriate personnel.

[7]. Policies and management for human resources

The term "human resources" refers to the human-related part of an organization's management resources. The term "policies for human resources" refers to the policies established as part of the management policies and those relevant to personnel affairs, such as employment, promotion, payroll, and employee training. When an organization attempts to achieve its objectives, it is important to make highly efficient use of existing human resource capacities, and, to that end, it is essential to develop appropriate human resource policies.

(2) Risk Assessment and Response

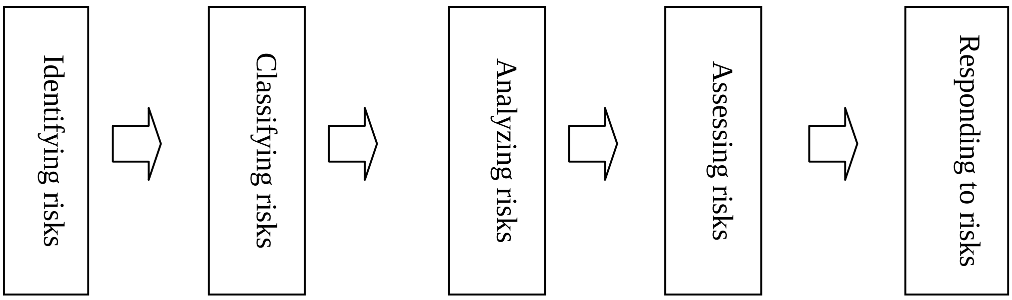
[1]. Risk assessment

Risk assessment is a process to identify, analyze, and assess factors from the events that affect an organization’s achievement of its objectives as risk that could adversely affect the achievement of such objectives.

Risk is a factor that could adversely affect the achievement of the organization’s objectives. Specifically, risks include a wide variety of factors, both external factors surrounding the organization (e.g. natural disasters, theft, intensification of market competition, and fluctuations in foreign currency or resource markets) and internal factors (information system errors and troubles, occurrence of accounting errors, fraud, or leaks of personal information or information relevant to high-level management decisions). The “risks” referred to herein are limited to the risks that have a negative effect on, or cause a loss to, the organization. They do not include the risks that have a positive effect on, or bring profits to, the organization.

Although it is impossible to provide a uniformly applicable procedure for risk assessment and response because individual organizations will find themselves in different environments with different business characteristics, the following is one example of the risk assessment process flow:

Risk assessment flow



A. Identifying risks

The first step of the risk assessment and response process is to identify risks in an appropriate way. In the first step, it is necessary to identify events that may affect the achievement of the organization’s goals and determine what potential risks are involved in the events. As risks are involved at various levels from company-level to individual process-level, it is important to identify risks at each level in an appropriate way.

B. Classifying risks

To analyze and assess risks in an appropriate manner, it is important to classify the identified risks from the viewpoint of, for example, whether they are company-level or process-level risks, or whether they are known or unprecedented risks.

a. Company-level risks and process-level risks

Company-level risks are the risks that could adversely affect the achievement of the organization's objectives.

Company-level risks include, for example: an unusual change in financial position, operating results, or cash flows; dependency on particular customers, products, or technologies; regulatory requirements, business practices, and management policies specific to the organization; filing of any material legal proceedings; and dependency on a particular member of top management. Regarding the reliability of financial reporting, when an organization attempts to, for example, make accurate accounting estimates or projections, it is an important factor for the organization to respond properly to its company-level risks.

Process-level risks are the risks that could adversely affect the achievement of the objectives set for individual business processes in the organization.

Process-level risks are usually managed through control activities incorporated in the business operations, while company-level risks should be managed by designing and operating internal controls covering the entire organization, including the development of clear management policies and strategies, strengthening of board of director, corporate auditor or audit committee functions, and enhancement of monitoring undertaken by the internal audit function.

b. Known and unprecedented risks

Risks can be divided into known risks and unprecedented risks. While the effects of known risks can be estimated, those of unprecedented risks are often unpredictable, and therefore must be considered more cautiously. It must be remembered, however, that the significance of the effects of known risks may change as situations change with the passage of time.

C. Analyzing/assessing risks

Once risks are identified and classified as described above, then they must be analyzed for the likelihood of occurrence and the potential magnitude of their impact to estimate their significance. After that, the risks are evaluated, in accordance with the estimated significance, to determine whether any countermeasures should be taken.

An organization should only take countermeasures for those risks identified and classified as significant, not for all risks.

[2]. Response to risk

Response to risk is a process to select appropriate responses to those risks based on the risk assessment. When responding to risks, an appropriate action such as avoiding, reducing, transferring, and accepting is taken regarding assessed risks.

[Types of responses to risk]

Responses to risk include the avoiding, reducing, transferring, and accepting of risk and any combination of them.

"Avoiding risk" refers to the postponement or discontinuation of activities that give rise to the risk. When the likelihood of occurrence of the risk is very high, the impact of the risk is greatly magnified, or the management of the risk is difficult, "avoiding risk" may be selected.

"Reducing risk" refers to taking such measures as establishing a new internal control procedure to reduce the likelihood of occurrence or the magnitude of the impact.

"Transferring risk" refers to transferring all or part of the risk to a third party to reduce the magnitude of the impact. Included are, for example, subscription to insurance products and entering into a hedge transaction.

"Accepting risk" refers to not taking actions that may affect the likelihood of occurrence or the magnitude of the impact; i.e., deciding to accept the risk. An organization may accept a risk as it is, if the impact of the risk is below their acceptable level, when it is estimated that the cost of precautionary risk management measures exceeds the benefit, or that the risk can be managed even after its occurrence.

(3) Control Activities

Control activities are policies and procedures established to ensure that the orders and instructions of the management are followed in an appropriate manner. Control activities include a wide range of policies and procedures, such as assignment of authority and responsibilities and segregation of duties. These policies and procedures should be incorporated into the business process and function effectively when performed by everyone in the organization.

To reduce the risk of occurrence of fraud or errors, it is important for the management to clarify the authority and responsibility assigned to each person in charge, and to establish a system in which each person in charge performs his or her duties in an appropriate manner within the scope of his or her authority and responsibility. In that process, duties and responsibilities should be divided or segregated between two or more persons. For example, duties of authorizing transactions, recording transactions and managing assets are respectively assigned to different individuals so that they are mutually supervised by each other in an appropriate way.

Appropriate segregation of duties can prevent problems, such as a failure, as an organization, to perform duties without disruption, which is caused by assigning duties to a single particular person. Furthermore, by clearly defining the authority and responsibilities and segregation of duties, an organization will increase the visibility of internal control and prevent the occurrence of fraud and errors.

A. Integration with risk assessment and response

When an organization decides to take a countermeasure against a certain risk during the course of risk assessment and response, particularly on a business-process level, the organization uses, in most cases, control activities incorporated into the business process. In this regard, risk assessment and response and control activities are closely connected. It is important for an organization to understand whether risk response measures are appropriately taken in the course of control activities, and to improve its control activities when necessary.

B. Policies and procedures for control activities

Policies on control activities, which should be standardized and integrated throughout the entire organization, can be developed, for example, in the form of company-level job descriptions. In addition, policies, which should be decided by each division or activity unit, can be developed into their own procedure manuals and the like.

It is also advisable that, in order to achieve the control activity policy goals, divisions and activity units should set, if necessary, appropriate procedures (e.g.; authorization, inspection, recording) in their business processes.

(4) Information and Communication

Information and communication involves ensuring that necessary information is identified, understood, processed and accurately communicated throughout the organization and to relevant parties. The information required by everyone to carry out his or her responsibilities must be identified, understood, processed and communicated within the organization in a timely and appropriate manner. In addition to communicating necessary information, it is important that the information be understood properly by information receivers and shared with all of the people to whom it is relevant.

[1]. Identification, understanding, and processing of information

An organization identifies the truthful and unbiased information of the information recognized (identification). When the information is determined to be necessary for the organization, it is entered into the organization's information system (understanding). An "Information system" is a manual or automated mechanisms designed to process and communicate information. Information entered into an information system is processed according to the purpose. (e.g.; classification, organization, selection, and calculation (processing))

[2]. Communicating information

It is important for an organization to establish a system by which the identified, understood, and processed information is communicated in an appropriate manner within the organization or to external parties. Within an organization, policies developed by the management, for example, should be communicated in a timely and appropriate manner to all individuals in the organization. It is also important to establish a system through which information about an occurrence of fraud, an error or other material information concerning internal control is communicated to the management and the appropriate level of control in the organization is conducted in a timely and appropriate manner.

At the same time, information must also be communicated or reported to external parties in an appropriate manner. It must be properly provided, for example, through a report or disclosure for shareholders, supervisory authorities, and other external parties.

Information on significant issues, such as a fraud or errors may sometimes be provided by an external party through customers and business partners. Accordingly, it is important to establish not only a system to communicate and report information to external parties, but also a system to collect information from external parties.

[3]. Whistleblower System and others

An organization may establish a Whistleblower System as one of the information and communication systems as well as a monitoring system in the organization, separate from the normal communication channels. The Whistleblower System is designed to allow every member of the organization to inform the management, the board of directors, corporate auditors or the audit committee, or in some cases, people outside the company, such as a lawyer or other independent counsel, of regulatory compliance and other issues. When introducing a Whistleblower System, it is important for the management to ensure effective operation of the system by establishing a mechanism to protect whistleblowers as well as policies and procedures for taking necessary corrective measures.

In addition, because an external party may sometimes provide information on the organization’s internal control, it is also important to establish policies and procedures for actions to be taken when such information is provided by external sources.

[4]. Relationship with other basic components

Information and communication has the function of connecting the components of internal control with each other and enabling effective operation of internal control.

For example, when a new the management policy is developed under a control environment and its details are communicated to, and accurately understood by, appropriate individuals in the organization, risk assessment and response procedures are performed in a timely manner and appropriate control activities are conducted.

On the other hand, if any significant information on control deficiencies is found through a control activity or monitoring, such information is communicated to the management or the appropriate level of controller, and as a result the company-level plans and policies in the control environment are changed as necessary.

In order to ensure the effectiveness of internal controls, it is important for an organization to establish its information systems appropriately and provide quality information and appropriate communication channels.

(5) Monitoring

Monitoring is a process that continuously assesses the effectiveness of internal control. Monitoring provides a means of continually observing, assessing, and correcting internal control. Monitoring includes ongoing monitoring that is performed in the course of business operations and separate evaluations that are conducted from perspectives independent of business operations. In some cases, both of the above will be conducted independently; in others, they will be coordinated.

[1]. Ongoing monitoring

Ongoing monitoring is a process that continuously reviews and assesses the effectiveness of internal control by performing a series of procedures in the course of daily business operations. Ongoing monitoring includes self-inspection or assessment of internal control conducted within the department that performs business activities.

For financial reporting, for example, an appropriate controller may, on a regular or as-needed basis, monitor the performance of the process of confirmation and analysis/reconciliation of identified discrepancies, performed by the person in charge, for significant balances among account receivables. This procedure is effective to confirm the accuracy of financial information and existence of assets. It also leads not only to the correction of any discrepancy identified, but also may lead to the finding of an issue in the sales process and promoting of remedial actions to address the issue.

[2]. Separate evaluations

Separate evaluations are conducted on a regular or as-needed basis to assess, from a different point of view, whether there is any the management issue that is not identified in the ongoing monitoring.

A. Separate evaluation by management

The management is ultimately responsible for the design and operation of internal control, as the representative of the organization, and performs separate evaluations from that viewpoint. However, there is a limit on the direct actions by the management. Therefore, the management usually completes its separate evaluation process by directing the internal audit function or other personnel and monitoring the results.

B. Separate evaluation by the board of directors

The board of directors establishes basic policies on the design and operation of internal control. It is also responsible for supervising directors' performance of their duties.

It is considered that in order to fulfill these functions, the board of directors is responsible for monitoring whether the management designs and operates internal control appropriately in accordance with the decisions of the board of directors.

C. Separate evaluation by corporate auditors or the audit committee

Corporate auditors or the audit committee audit the performance of duties by directors and other personnel.

For effective monitoring, corporate auditors or the audit committee may use persons who assist in investigations. In that case, it is important for corporate auditors or the audit committee to ensure such assistants' independence from the business activities, directors, or other factors subject to the investigation.

D. Separate evaluation by internal audit function or other personnel

In general, an internal audit means that an internal auditor under the direct control of the management investigates the design and operation of internal control, from a standpoint that is independent from the performance of business activities, and reports issues to be remediated.

[3]. Reporting on control deficiencies

Deficiencies identified through monitoring must be reported to an appropriate person, depending on the content of the deficiency. Policies and procedures must be established for the reporting of the deficiencies.

Usually, deficiencies identified through ongoing monitoring are analyzed and addressed by the department that performed the monitoring. At the same time, it is recommended that deficiencies and corrective measures are reported to a higher-level controller and, if necessary, to the management, the board of directors, the corporate auditors or the audit committee.

For the deficiencies identified by the internal auditor through separate evaluations, it is important to ensure that a system is in place to report such deficiencies to the management and, if necessary, to the board of directors and corporate auditors or audit committee, in a timely manner. The results of separate evaluations conducted by the board of directors, corporate auditors or audit committee must be reported to the meeting of the board of directors to requesting the management to take appropriate measures.

The management should classify, analyze, and assess the risks that the reported deficiencies may pose and take appropriate responses.

It is often the case that information regarding a control deficiency represents a sign that a control deficiency exists over a wide range of operations. Therefore, if the management receives a report regarding a deficiency in a specific transaction or event, it should issue an order to perform a wider-ranging investigation, if necessary.

(6) Response to IT (Information Technology)

Response to IT refers to establishing appropriate policies and procedures in advance to achieve organizational objectives and to responding appropriately to IT inside/outside the organization during the course of business activities based on the policies and procedures. Response to IT is not always independent from other components of internal control, but if the business of the organization heavily relies on IT or the information systems highly utilize IT, it serves as the assessment criteria for internal control effectiveness as an essential part to achieve the internal control objectives. Response to IT consists of response to IT environment and use of IT and IT controls.

Considering the current situation where the IT environment is developing rapidly, under which IT has deeply penetrated organizations, response to IT has been included in the basic components of internal control under Chapter I, “Basic framework of internal control,” herein. Currently, organizations’ businesses heavily rely on IT, or their information systems have incorporated information technology to a high degree. Consequently, most organizations are unable to conduct their businesses without using IT. The reason why response to IT is included in the basic components of internal control is to emphasize the fact that, under the current circumstances where IT has deeply penetrated into organizations, an appropriate response to IT inside/outside the organization during the course of business activities is indispensable for the achievement of internal control objectives. This is not intended to force organizations to introduce a new IT system or upgrade existing IT systems.

[1]. Response to IT environment

The IT environment is the internal/external use of IT that is needed for the organization’s activities, the level of IT penetration the society and the market, the use of IT for the company’s transactions, a series of information systems on which the organization selectively relies and so on.

An organization should appropriately understand the IT environment surrounding the organization, and, based on that understanding, take appropriate measures for the usage and control of IT. The following are examples of the factors surrounding the IT environments of individual organizations that need to be considered by an organization:

A. Pervasiveness of IT into society and markets

B. Use of IT in transactions and other activities by organizations

C. The series of information systems on which the organization selectively relies (whether the organization relies on an information system; if so, what kind of information system it is).

D. Stability of IT-based information systems

E. Outsourcing relating to IT

[2]. Use of IT and IT controls

Use of IT and IT controls means to utilize IT effectively and efficiently in order to ensure the effectiveness of other basic components of internal control, and to establish, in advance, appropriate policies and procedures for IT that are systematically incorporated into the business and used in various ways within the organization to achieve organizational objectives and make other basic components of internal control operate more effectively.

[Use of IT]

IT is useful for enhancing the effectiveness and efficiency of information processing. When it is used for internal control purposes, it will contribute to establishing more effective and efficient internal control.

A. Use of IT for ensuring control environment effectiveness

The following are examples of IT-related factors in the control environment.

a. The management's degree of interest in and attitude toward IT

b. Development of IT-related strategies, plans, and budgets; establishment of necessary structures

c. Members' basic knowledge about IT and ability to make use of IT

d. Policies on IT-related education and training

The use of IT is also important in order to efficiently design and operate the control environment. For example, the use of e-mail, which is a part of IT, will make it possible to communicate the management's intentions and the organization's basic policies and decisions to appropriate personnel in a timely manner, consequently contributing to the designing and operation of the control environment.

On the other hand, the use of IT may also allow, for example, the management, key executives, and other members of the organization to easily conspire to commit fraud via e-mail or some other means of IT. To avoid such an incident, it should be noted that it is necessary to implement appropriate control activities.

B. Use of IT for ensuring the effectiveness of risk assessment and response

The use of IT as a means of recognizing events inside/outside the organization or a means of sharing risk information will allow risk assessment and response to function in a more effective and efficient way. For example, by establishing a system in which its sales administration department or accounting department can recognize the occurrence and collection of accounts receivables without delay and apply different controls to overdue accounts through the use of IT, an organization can manage accounts receivables in an effective and efficient manner.

It would also be possible for an organization to design an internal control system whereby it uses IT to understand how risk information is shared within the organization, then analyze it to reconsider the scope of shared risk information or whether the risk is shared among appropriate personnel, and then reconsider the scope of shared risk information based on the results of that analysis.

C. Use of IT for ensuring effectiveness of control activities

Control activities can be automated when IT-based control activities are appropriately designed and integrated into business processes. For example, an organization can immediately recognize any difference between book and physical inventory to identify problems if it develops an appropriate production control system in which a physical inventory inspection program is installed and such procedures as input of released amounts of raw materials according to production order by the production department and input of physical amounts of raw materials on a daily basis by warehouse personnel are incorporated into business processes.

Automated controls are capable of not only processing information faster than manual control procedures, but also preventing human errors. As a result, they make it easier to perform procedures in the internal control assessment and audit process. On the other hand, however, automated controls may pose certain problems. For example, in the case of an unauthorized change to a program or unauthorized use of a program, such unauthorized change or use may not be discovered in a timely manner because only people with a good understanding of the program can deal with it. The taking of appropriate access control measures should therefore be considered.

D. Use of IT for ensuring the effectiveness of information and communication

The use of IT enables an organization to incorporate a tool to communicate information within the organization into its business processes. When an IT-based information system – a network, in particular – is used, a function to communicate the information necessary for business administration can be incorporated into the business processes. Examples of such functions include sending a message to a responsible supervisor to indicate a failure to obtain necessary approval or complete work within a specified timeframe.

The use of IT also enables an organization not only to provide timely information to external parties (for example, by posting a message on its corporate website) but also to collect information regarding product complaints or other matters from external parties. However, when using IT to disclose to or collect information to/from external parties, it would be necessary to ensure that appropriate measures are taken to prevent hacking or other threats from outside the organization.

E. Use of IT to ensure the effectiveness of monitoring

Ongoing monitoring on the effectiveness of control activities can be performed in a more comprehensive way when incorporated into a system for administering daily business activities and automated within the system. As a result, the organization could reduce the level of risks in separate evaluation and consequently perform a separate evaluation less frequently with a smaller number of staff members.

On the other hand, the implementation of an IT-based monitoring system should be prepared in an orderly manner from the design phase, because it requires the establishment and coding of a monitoring benchmark in advance.

As described above, the use of IT enables organizations to establish internal control in a more effective and efficient manner; on the other hand, in a highly IT-dependent system, unlike in a manual-based information system, it is difficult to make a drastic change to its procedures after it is released.

In addition, depending on the system specifications, sometimes procedures performed or data changes made through the use of IT are not traced. In such cases, it is difficult to examine the incident after the fact.

Therefore, when designing and operating internal control, organizations should, based on a full understanding of the characteristics of the IT-based information systems, undertake preparations in an orderly manner, and, at the same time, consider how incidents could be examined appropriately after the fact.

In the case where internal control is operated on a manual basis without any use of IT, it would be necessary to establish a separate internal control to prevent, for example, errors inherent in manual procedures; however, it should be noted that the fact is not necessarily indicative of a deficiency in internal controls.

[IT controls]

IT controls mean controls over IT-based information systems. They are mainly automated, but sometimes include manual based control.

A. IT control objectives for the achievement of organizational objectives

Objectives set by the management for operating IT control effectively are called IT control objectives. Examples of IT control objectives include the following.

a. Effectiveness and efficiency: Information is provided in an effective and efficient way

b. Compliance: Information is processed in compliance with applicable rules and regulations, accounting standards, in-house rules, etc.

c. Reliability: Information is approved according to the organization's will and intention, and accurately recorded/processed without omission (validity, completeness, accuracy)

d. Availability: Information is available when necessary

e. Confidentiality: Information is protected from unauthorized use

IT controls for reliability of financial reporting are performed to ensure validity, completeness, and accuracy of transactions recorded in accounting records.

Validity refers to the fact that transactions are approved and executed in accordance with the organization's will and intent.

Completeness refers to the fact that all of the transactions are recorded without omission or duplication. Accuracy refers to the fact that transactions that occurred are recorded accurately in the financial/accounting classifications and other major data elements.

The internal control reporting system required by the Financial Instruments and Exchange Act is intended to ensure the reliability of financial reporting in IT control; it is not intended to directly require organizations to design and operate IT control for the achievement of objectives other than the reliability of financial reporting.

B. Developing IT controls

The management develops IT controls to achieve the IT control objectives that it has set.

Control activities over IT consist of general controls and application controls. In order to ensure complete and accurate information processing, it is important that the two types of controls work in an integrated manner.

a. IT general controls

IT general controls refer to control activities intended to ensure an environment in which application controls function effectively. Usually, they are policies and procedures associated

with multiple business process controls. Examples of IT general controls include the following.
- Control of system development and maintenance
- System operation and administration
- Ensuring system security, including access control from inside/outside the organization
- Control of outsourcing contract management

In an IT-based information system, once an appropriate internal control (application control) is incorporated, it will continue functioning unless an intentional change is made. However, if a general control does not function effectively (for example, a necessary control is not incorporated at the time of a system change at a later stage, or unauthorized change or access is made to the program), the effectiveness of the incorporated internal control (application control) may be impaired even if the control itself is appropriate.

In order to address such issues, it is important to ensure an appropriate designing of general control activities, which include the following.

[1]. When developing a new system or changing an existing system, fully examine whether the development or change is consistent with the existing system. At the same time, maintain development or change logs appropriately.

[2]. Take appropriate access control measures to prevent unauthorized use of, and changes to, the program.

Usually, an IT general control is established for each unit of IT infrastructure (hardware, software, network, etc.) that supports business process management systems. For example, when three business process management systems–purchase, sales, and distribution–are centrally controlled by a single host computer and operate on the same IT infrastructure, the establishment of an effective general control over the infrastructure will contribute to a higher reliability of information relevant to the three business processes.

On the other hand, if the three business process management systems are operating on separate IT infrastructures, it would be necessary to establish a general control for each of the infrastructures, because these infrastructures are likely to be administered by different departments and based on different approaches.

b. IT application controls

IT application controls refer to the control activities that are incorporated into business processes to ensure that all of the authorized business activities are accurately processed and recorded in the business process management system.

Examples of IT application controls include the following.

- Controls to ensure completeness, accuracy, and validity of entry data
- Correction and reprocessing of errors
- Maintenance and control of master data
- Access control (user authentication, limiting the scope of operation, etc.)

These application controls can be performed manually. However, when being incorporated into a system, they can be operated in a more effective and accurate manner.

3. Limitations of Internal Control

Internal control cannot provide absolute assurance with respect to the achievement of objectives due to the following inherent limitations, but it aims at achieving the objectives to a reasonable extent with the organized and integrated function of individual components as a whole.

(1) Internal control may not operate effectively due to misjudgments, carelessness or collusion among two or more individuals.

(2) Internal control may not necessarily respond to unexpected changes in internal or external environments when controls were designed for non-routine transactions.

(3) The design and operation of internal control needs to consider relative costs and benefits.

(4) The management can ignore or override internal control for illegitimate objectives.

"Limitations of internal control" refers to the fact that internal control (even that appropriately designed and operated) may not operate effectively due to inherent limitations and does not provide an absolute assurance as to the achievement of its objectives.

Internal control may not operate effectively due to misjudgments, carelessness or collusion among two or more individuals. However, the designing of internal control will significantly reduce the risk of misjudgments and carelessness as well as the chances of collusion among two or more individuals.

Internal control may not necessarily respond to unexpected changes in internal or external environments when controls were designed for non-routine transactions. However, the appropriate design of internal control will contribute to widening the scope of unexpected environmental changes and non-routine transactions for which internal control is capable of response. One example is to assign knowledgeable and experienced personnel selectively to the processes that are likely to be subject to the unexpected environmental changes or non-routine transactions.

Internal control is designed and operated based on the management's decision and in terms of cost versus benefit. When making a decision on whether an internal control procedure should be introduced or maintained, an organization compares necessary costs with benefits that can be obtained by the use of the procedure for risk management purposes.

In addition, management can ignore or override internal control for illegitimate objectives. However, if the management has established appropriate company-level or process-level controls in the organization, the potential of such acts by the management will be reduced significantly because multiple individuals will be involved in the fact. In addition, as a result, it will serve as reasonable deterrence against the management's conduct.

Meanwhile, when the management addresses unexpected changes in internal or external environments or non-routine transactions outside the framework of existing internal control, or, when an authorized person performs, based on a managerial decision, separate procedures in excess of the limitation of existing internal control, such activities do not constitute ignorance or overriding of internal control.

4. Roles and Responsibilities of Relevant Persons

(1) Management

The management has the ultimate responsibility for all the activities of an organization, and as part of this, it has roles and responsibilities in the design and operation of internal control based on the basic policies determined by the board of directors.

The management designs and operates internal control (including monitoring) through the company's organization as a means to satisfy its responsibility.

The management more significantly influences the tone of the organization that affects the factors of the control environment and the other basic components of internal control than any other individuals in an organization.

Note: In this standard, the management is assumed to include representative directors, representative officers and other representatives of an executive level.

The management, as it represents an organization (Article 349, Companies Act), is authorized to perform business operations. At the same time, it has roles and responsibilities to design and operate the organization's internal control based on the basic policies determined by the board of directors.

Representing its company, the management is in a position to submit the Annual Securities Report, and ultimately responsible for the reliability of disclosure documents.

In addition, in the internal control reporting system under the Financial Instruments and Exchange Act, the management is likely to be required to sign the Internal Control Report. Accordingly, the management must properly assess and report the designing and operation of internal control over financial reporting.

If the company has a Chief Financial Officer, his/her signature may also be required in addition to that of the representative of the company.

(2) Board of Directors

The board of directors decides the preliminary policies related to the design and operation of internal control.

The board of directors supervises the performance of the management, including the design and operation of internal control by the management.

The board of directors is an important part of company-level controls and a part of the control environment for process-level controls.

The board of directors is a decision-making body on the organization's business operations and determines basic policies on internal control. The board of directors is also a body that supervises management's performance of duties and is authorized to appoint and discharge the management. (Articles 362, 416, and 420 of the Companies Act)

Therefore, the board of directors is also responsible for supervising the management's designing and operation of internal control.

(3) Corporate Auditors or Audit Committee

Corporate auditors (auditor's board) or the audit committee is responsible for auditing the performance of the directors and officers. As a part of this, they have the role and responsibility to independently monitor and verify the design and operation of internal control.

Corporate auditors or the audit committee audits the performance of duties by directors and other personnel (Article 381, paragraph 1, the Companies Act and Article 404, paragraph 2, item 1 thereof). Corporate auditors or the audit committee conducts operational audits including financial audits.

As part of its operational audit, corporate auditors or the audit committee monitor whether internal control is appropriately designed and operated, including the system to ensure the reliability of financial reporting. Under the Companies Act, corporate auditors or the audit committee is required to evaluate the relevance of the approach employed by the external auditor on the financial audit of the statutory accounts (in compliance with the Companies Act), as well as the results of the financial accounting audit conducted by the external auditor.

On the other hand, in the Internal Control Audit as described herein, the external auditor does not examine the details of the operational audit performed by the corporate auditor. However, when evaluating the appropriateness of the assessment on the company-level controls over financial reporting, the external auditor takes into consideration the designing and operation of internal controls at the management level including corporate auditors or the audit committee, as part of the control environment, monitoring, etc.

(4) Internal Auditors

Internal auditors are responsible for examining and assessing the design and operation of internal control, and they urge remedial action as a part of their monitoring functions, a basic component of internal control to ensure more effective achievement of the internal control objectives.
Note: In this standard, the term “internal auditor” means any person or unit with the responsibility for examining, assessing and recommending the design and operation of internal control regardless of how their affiliation is termed within the organization.

Internal auditors investigate, examine and assess the design and operation of internal control, and report the results to appropriate personnel within the organization. Internal auditors, who are often assigned to report directly to the management, play an important role in the separate evaluation of internal control.

To perform their duties, internal auditors must be free from any constraints imposed by the organization’s other business units that are subject to an internal audit so that they can maintain their objectivity. To this end, the management must provide an environment in which internal auditors can be independent of business processes and units subject to an internal audit, and have no direct authority or responsibility for the function or business units.

Furthermore, it is also important that, in order to improve the effectiveness of internal control, the management establish a system through which it can receive reports from internal auditors in a timely and appropriate manner.

(5) Other Personnel within the Organization

Internal control is a process carried out by everyone within an organization. All personnel other than those listed above play a role in the design and operation of effective internal control concerning their own work duties.

Internal control is a process carried out by everyone within an organization. All personnel other than those listed under (1) to (4) above are also engaged in, for example, control activities, information and communication within the organization, and ongoing monitoring, in the course of their duties. In this sense, they play a role in the design and operation of effective internal control within the scope of the authorities and responsibilities they have. “Other personnel in the organization” includes not only permanent employees but also short-term or temporary employees who undertake certain roles and perform their duties in the organization.

5. Establishing Internal Control Over Financial Reporting

(1) Key Points for Establishing Internal Control Over Financial Reporting

The following are the key points for the practical implementation of internal control over financial reporting based on the basic framework of internal control mentioned herein before. The management should ensure that the following points are in place. Any deficiencies must be remediated as necessary.

Company-wide policies and procedures that ensure proper financial reporting are provided, and are properly designed and operating effectively

- Announcing the aim to conduct proper financial reporting; establishment of policies and principles to realize such aim
- Effective performance by the board of directors and corporate auditors or audit committee
- Establishment of appropriate organizational structure

Appropriate assessment is performed on misstatement risk and action plans to manage such risks are developed

- Identification and analysis of material misstatement risk
- Establishment of company-level and process-level controls to mitigate risks

Controls to mitigate material misstatement risk in the financial reporting are appropriately designed and operated

- Clear definition of responsibilities and segregation of duties
- Development of company-wide job description; individual procedure manuals on an as needed basis
- Necessary improvements of control activities based on the actual performance

A process is designed and operated to identify and handle truthful and objective information and communicate such information to appropriate personnel in a timely manner

- Development of a structure that enables the management to communicate intentions clearly and instructions properly
- Development of a process in which material information on internal control is communicated in a timely and proper manner
- Development of a structure that would allow for the collection of material information on internal control from the external organization

Monitoring of financial reporting is designed and operated appropriately

- Development of a process to assess the effectiveness of internal control over financial reporting on a regular or as-needed basis
- Development of a structure to respond appropriately to information provided by a party within or outside the company
- Development of a process for the timely and proper reporting of internal control issues (deficiencies) identified via monitoring

Appropriate response to IT relating to internal control over financial reporting
- Proper understanding of the IT environment and effective and efficient use of IT based on the understanding
- Development of general controls and application controls relevant to IT

(2) Process for Establishing Internal Control Over Financial Reporting

Different organizations have different procedures for establishing internal control. However, it was considered possible to provide general procedures that are necessary as a preliminary step before the assessment and reporting of internal control. The following are examples of such procedures:

[1]. Determining basic plans and policies

It is important for internal control to be established based on a consistent policy developed by the management. The Companies Act requires that the board of directors determines basic internal control policies. The management should, based on the policies determined by the board of directors, develop basic plans and policies for operating internal control over financial reporting at both company level and process level.

Examples of basic plans and procedures to be developed by the management include the following.
- Policies, principles, scope, and level of internal control to be established for proper financial reporting
- Responsible persons at the management or lower level for establishing internal control and entity-wide control structure
- Scope and level of internal control that is necessary for the organization to establish
- Procedures and schedule necessary for establishing internal control
- Personnel who will be involved in the individual procedures necessary for the establishment of internal control; organization of the personnel; method of preliminary education and training for the personnel

[2]. Understanding design of internal controls

When basic plans and policies on internal control are determined in an organization, design of internal controls is understood and the results are recorded and maintained. It is effective to undertake these works as a company-wide project supervised by the management and a person who is responsible for establishing internal controls.

The design of company-level controls over financial reporting should be understood, recorded, and maintained based on the rules and practices on the existing internal control, as well as compliance with such rules and practices. In particular, it is important to make a record if there are any implicit, unwritten rules in force within the company.

To understand the design of company-level control, it would be effective to refer to the items listed in Exhibit # 1 (“Examples of Assessment Items for Company-Level Controls Over Financial Reporting”) included in “II. Assessment and Report on Internal Control Over Financial Reporting” accordingly.

The following is an example of the flow of procedures for understanding, recording, and maintaining the design of internal control over financial reporting within key business processes:

a. Sort out and understand the organization’s key business processes for the flow of transactions and accounting processes, using charts and diagrams as necessary.

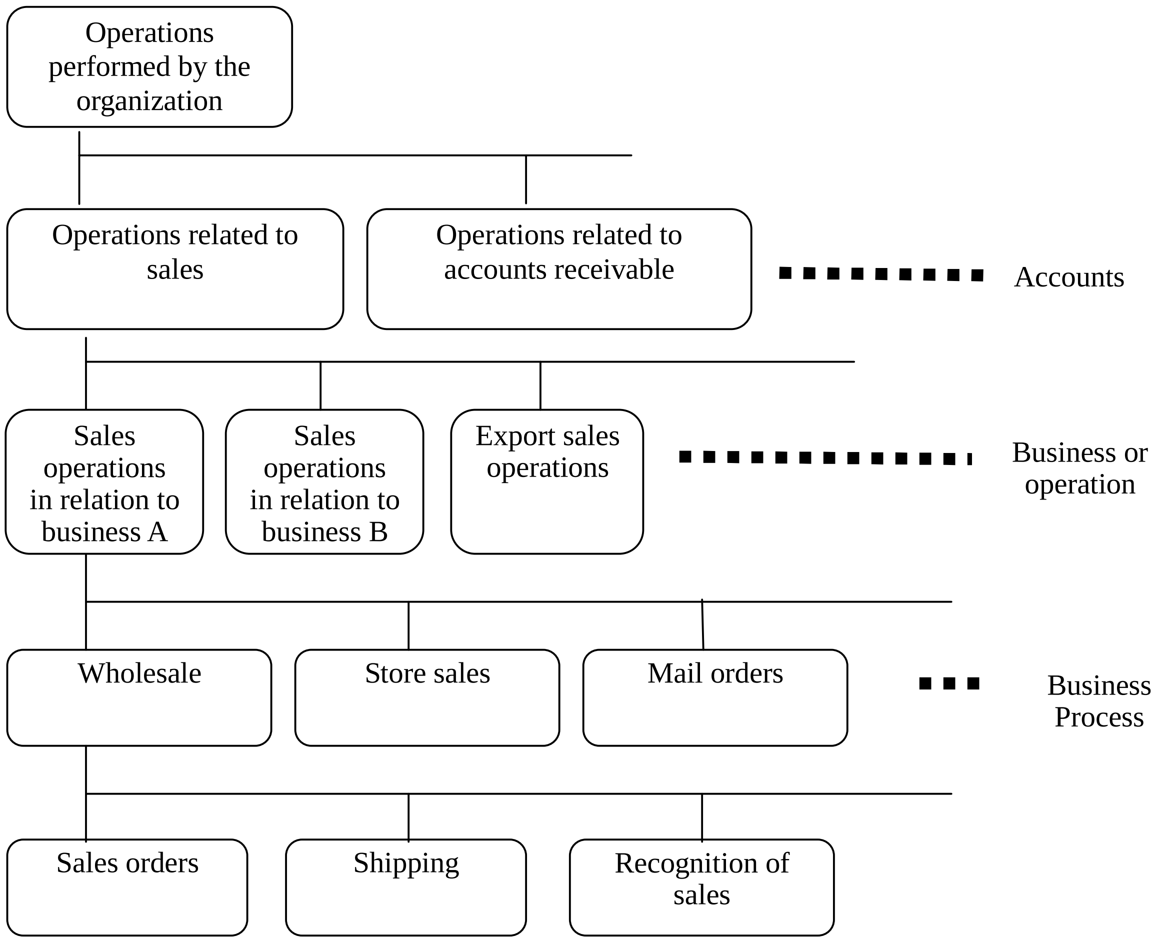
b. Identify the risk of misstatement for these business processes. Examine the financial statements and accounts to which the risk relates, and examine whether the internal control incorporated into the process is effective enough to reduce the identified risk, using charts and diagrams as necessary.

For the examples of the charts and diagrams described above, refer to Exhibit 2, “Business process flowchart (sample)” and “Business process description (sample),” and Exhibit 3, “Relationship between risks and controls (sample),” included in “II. Assessment and Report on Internal Control Over Financial Reporting.”

Once the internal control design is recorded and visualized, internal control effectiveness can be assessed.

Note: The following is an example of the identification of business processes. As different organizations have different types of business operations, individual organizations are encouraged to determine for themselves how the business processes should be identified and sorted.

Example of business process classification



[3]. Addressing and remedying identified deficiencies

Control deficiencies identified during the control design understanding process must be addressed in a proper manner. The management and persons responsible for establishing internal control should, based on the basic plans and policies on internal control, take measures to remedy the deficiencies.

Deficiencies in company-level controls, if any, should be remediated while referring to, for example, Exhibit 1, ("Examples of Assessment Items for Company-Level Controls Over Financial Reporting") included in "II. Assessment and Report on Internal Control Over Financial Reporting."

Deficiencies in process-level controls should be remediated by following, for example, the procedures described below:

a. If internal controls incorporated in the business process are not effective to reduce the risk of misstatements sufficiently, measures should be taken to correct the controls.
b. If any new flow of transactions or accounting processes is added as a result of the procedure above, update the charts and diagram shown in [2]. a. and b.

The objective of the internal control reporting system required by the Financial Instruments and Exchange Act is to ensure the reliability of financial reporting. Any deficiencies in internal control over financial reporting should be addressed and remediated appropriately prior to submitting the Internal Control Report. The management is required to improve and ensure the effectiveness of internal control placed in operation at their organizations before the enforcement of the internal control reporting system.

II. Assessment and Report on Internal Control Over Financial Reporting

1. Definitions Related to the Assessment of Internal Control Over Financial Reporting

The management has the role and responsibility to design and operate internal control. Out of the internal control discussed in the "basic framework of internal control," it is particularly vital for the management to assess the internal control over financial reporting in accordance with generally accepted assessment standards for internal control and report its conclusion externally in order to ensure the reliability of financial reporting.
For the purposes of these standards, the terms below and their meanings are used:
(1) "Financial reporting" and "financial reports" are external reporting of both 1) financial statements and 2) disclosure information and others that could have a material effect on the reliability of financial statements.
(2) "Internal control over financial reporting" is an internal control that is necessary to ensure the reliability of financial reporting.
(3) "Effective internal control over financial reporting" means that the internal control is designed and operated in accordance with an appropriate internal control framework and is free of material weakness.
(4) "Material weakness" is a deficiency in internal controls over financial reporting, that has a reasonable possibility of having a material effect on financial reporting.

[1]. Scope of financial reporting

A. "Financial statements" means the consolidated financial statements stipulated in the "Regulations Concerning Terminology, Forms, and Preparation Methods of Consolidated Financial Statements" (Ministry of Finance Regulation No.28, 1976) and the financial statements stipulated in the "Regulations Concerning Terminology, Forms, and Preparation Methods of Financial Statements" (Ministry of Finance Regulation No.59, 1963).

B. "Disclosure information and others that could have a material effect on the reliability of financial statements" means the disclosure information and others (except financial statements) included in the Annual Securities Report and others, specifically listed as follows:

a. Disclosure information to be provided as a summary, excerpt, or breakdown, or by use of the amounts and values presented in, or notes to, the financial statements (hereinafter referred to as "information derived from data presented in financial statements and others").

Examples include the following information included in the Annual Securities Report:

1) "Major financial data proceedings" under the "company overview" section;
2) "Business results," "production, orders received, and sales," "risks of business, etc.," "research and development" and "analysis of financial position, operating results, and cash flows" under the "business condition" section;
3) "Facilities and equipment";
4) "Stock information," "treasury stock repurchases," "dividend policy" and "corporate governance" under the "company information" section;

5) “Major assets and liabilities” and “other” under the “financial information” section;
6) “Corporate bonds guaranteed” under the “information on guarantors” section;
7) Information derived from data presented in the financial statements in “information on indices and others.”

It should be noted that, with regard to this point, the management should assess whether a system to summarize, excerpt, break down, or use the information presented in financial statements appropriately is designed and operated.

b. Matters that are closely related to the decision of whether an entity is an affiliate, decision on the scope of consolidation or the necessity to apply the equity method, determination of whether a party is a related party and other decisions involved in preparing the financial statements.

Examples include the following information in the Annual Securities Report.

1) “Overview of business” and “affiliated companies” under the “corporate information” section
2) Affiliates, related parties, big shareholders in “big shareholders” under the “company information” section

It should be noted that, with regard to this point, the management’s assessment is undertaken with consideration for the significance of the impact these factors may have on the significant judgments in preparing financial statements, and that the assessment does not necessarily consider all of the information included in the disclosure information described above.

[2]. Guidelines for determining material weakness

This guidance shows the guideline for determining material weakness in terms of impact on the reliability of financial reporting. The guideline for determining material weakness cannot be presented uniformly because it varies based on the environment or business nature of the companies. Basically, it should be determined based on the likelihood and impact of misstatements relating to financial reporting. It is therefore noted that the following guideline for determining material weakness is used not for determining each business process to be added to the scope at II. 2. (2) [2], “identifying business processes to be assessed,” but for judging whether each deficiency is deemed as a material weakness.

A. Control deficiencies

Control deficiencies are classified into design deficiencies and operating effectiveness deficiencies. Deficiencies in design arise when a control is missing or an existing control is not properly designed and the control objective is not always met. Deficiencies in operating effectiveness arise when a properly designed control does not operate as designed, when there are many errors in operation or when the person performing the control does not properly understand the nature and objectives of the control.

A single control deficiency or combination of different kinds of control deficiencies adversely affect the company’s ability to record, process, or report transactions in compliance with generally accepted accounting principles (“GAAP”) and regulations for financial reporting. As a result, they may constitute a material weakness.

A. Material weakness

A material weakness is a deficiency that has a reasonable possibility of resulting in a misstatement above a certain amount, or a possibility of being a qualitatively material misstatement.

In determining whether a control deficiency constitutes a material weakness, the management should evaluate both quantitative and qualitative aspects.

The effectiveness of internal control over financial reporting should be assessed, in principle, on a consolidated basis. Accordingly, the level of material effect should be considered based on consolidated financial statements.

a. Determining quantitative materiality

Quantitative materiality can be calculated as a percentage of consolidated total assets, consolidated sales, consolidated income before income taxes and minority interests, and other factors. These percentages are not defined as set amounts; rather, the percentage should be determined based on the company’s situation, such as its type of business, size, and characteristics.

(Note 1) Keep in mind that in addition to actual values of consolidated total assets, consolidated sales, consolidated income before income taxes and minority interests, etc. of the fiscal year being assessed, average actual values for a certain period of history shall also be included.

(Note 2) For example, the materiality threshold using consolidated income before income taxes and minority interests may be set at approximately 5% of the consolidated income before income taxes and minority interests. However, ultimately, the materiality amount should be considered in the context of its relationship to the quantitative materiality amount of the Financial Statement Audit.

Also, if the amount of consolidated income before income taxes and minority interests is negative or remarkably less than in an average year, keep in mind that it is possible to discuss with the external auditor as needed, and for example instead of 5% (of consolidated income before income taxes and minority interests), revise the ratio or change the index as needed, or exclude special factors etc. in the consolidated income before income taxes and minority interests.

b. Determining qualitative materiality

Qualitative materiality is determined based on the extent of impact on:

1) investment decisions, for example, on information relating to a delisting criteria or financial covenants; and

2) the reliability of financial reporting, such as information relating to the related party transactions and big shareholders.

2. Assessment of Internal Control Over Financial Reporting, and Scope of Assessment

(1) Assessment of the Effectiveness of Internal Control Over Financial Reporting

The management must assess the effectiveness of internal control over financial reporting to the extent necessary in light of their degree of impact on the reliability of financial reporting. Prior to making such assessments, the management must establish policies and procedures for designing and operating internal control over financial reporting, and must record and maintain their status. The assessment of internal control over financial reporting effectiveness should be, in principle, performed on a consolidated basis. Internal control that has a significant impact on consolidated financial statements in their entirety throughout the company group is hereinafter referred to as "company-level controls." (Note) The internal controls over outsourced processes should be within the scope of the assessment.

[1]. Scope of assessment on a consolidated basis

"The assessment of internal control over financial reporting effectiveness should be, in principle, performed on a consolidated basis" refers to the requirement that the entities included in a set of consolidated financial statements (i.e., the company issuing the Annual Securities Report and its subsidiaries and affiliates) should be subject to the process for determining the scope of internal control over the financial reporting effectiveness assessment. In that process, the following points should be noted:

A. Consolidated subsidiaries and others (including partnerships) should be made subject to the process of determining the scope of assessment. When assessing the effectiveness of a subsidiary's internal control over financial reporting, the parent company may use the subsidiary's report on internal control over financial reporting (including reports received from the subsidiary in the course of preparation), provided that the subsidiary:

1) is a listed company;

2) has prepared its internal control report based on this standard and the report has been audited by an external auditor.

B. Equity method affiliated companies should be included in the scope of the management's assessment of internal control. In that case, however, where the affiliated company has prepared its report on internal control based on this standard, and the report has been audited by an external auditor; or where the affiliated company is a subsidiary of another company, and the parent of the affiliate has prepared its report on internal control based on this standard, and the report has been audited by an external auditor, these affiliated companies should be treated the same as the listed subsidiaries under the preceding paragraph. When an affiliate cannot be assessed in the same manner as that of a subsidiary due to factors such as the existence of other controlling shareholders, investment interest and equity method profit or loss in the affiliate, or dispatched or interlocking officers (directors, corporate auditors, etc.), the management should focus on company-level controls and perform appropriate procedures such as sending out questionnaires, conducting interview , reviewing reports prepared by the affiliate, or assessing management processes for that affiliate.

(Note 1) If an equity method affiliated company is a subsidiary of another company, and that affiliate's parent prepares an Internal Control Report and is audited based on these standards, then the management can use [1] that parent company's Internal Control Report or [2] a document indicating that the parent company is assessing the effectiveness of internal controls over that affiliate's financial reporting.

(Note 2) Due to dispatched or interlocking officers at an equity method affiliated company, it may not be possible to do assessments in the same manner as that of a subsidiary. The basic policy is that in such a case, the management should focus on company-level controls and perform appropriate procedures such as sending out questionnaires, conducting interview, or reviewing reports prepared by the affiliate. If such an assessment cannot be done or in other special situations, keep in mind that the management can conduct an assessment by using appropriate methods, such as assessing management processes to such affiliates including understanding investment profit or loss from them.

C. Foreign subsidiaries should also be considered in the scope of the management's assessment of internal control.

However, if the country in which the subsidiary is located has an appropriate internal control reporting regulation, it is permissible to use that internal control reporting regulation. In addition, even if the country does not have an internal control reporting regulation, an appropriate internal control reporting regulation of another country (other than Japan) may be used, depending on its historical or geographical background. In those cases, it is permissible to use that internal control reporting regulation.

[2]. Assessment of outsourced processes

A. Scope of assessment of outsourced processes

Examples of processes that a company may outsource to a third party outside the group include authorization, execution, calculation, aggregation, and recording of transactions that form the basis for the preparation of financial statements or disclosure information.

The company is responsible for the outsourced processes, and should include internal control of them in the scope of assessment. If an outsourced process constitutes a significant business process of the company, the management should assess the effectiveness of the internal controls within the process operated by the service organization.

B. Assessment of internal controls over outsourced processes

The management should understand and appropriately assess the design and operating effectiveness of internal controls performed by the service organization over the outsourced process. In the assessment, one of the following procedures may be used to assess the effectiveness of internal controls.

a. Validation via sampling

This method is to examine the consistency between the reported results of the outsourced processes and basic data. At the same time, a portion of the outsourced processes must be re-performed by the company to validate the consistency.

For example, the payroll calculation process can be examined by comparing the number of employees included in the payroll data outsourced to the service organization with the number of records included in the calculation data received from the service organization, and at the same time, by recalculating, within the company, a part of the calculation data selected at random.

b. Use of service organization assessment results

In evaluating the design and operating effectiveness of internal controls over outsourced processes, the management may, at its own discretion, use reports and other documents on the organization's own assessment of the internal control over the processes that the company outsources to the service organization.

In that case, the management should examine whether the reports and other documents are supported by sufficient evidence.

(2) Determination of the Scope of Assessment

In assessing the effectiveness of internal controls, the management should decide on the reasonable scope of assessment for the following matters in light of their degree of quantitative and qualitative impact on financial reporting, and should keep appropriate records of the approach and grounds related to the scope of assessment for relevant internal controls.

- Presentation and disclosure of financial statements
- Businesses and business operations comprising the company's activities
- Transactions and events as the basis of financial reporting
- Important business processes

The management should, based on the determination of significant locations or business units, examine the scope of assessment for these items from the perspective of their degree of quantitative and qualitative impact on the presentation and disclosure of financial statements.

Based on these considerations, they should then think of the degree of quantitative and qualitative impact on overall financial reporting from the businesses and business operations comprising the company's activities, the transactions and events as the basis of financial reporting and important business processes, to arrive at a reasonable scope of assessment.

The management should assess company-level controls and use that as a basis to determine what business process should be in the scope for internal control assessment.

It should be noted that company-level controls are not included in the controls for which the scope of assessment should be determined in accordance with the procedures described under "determining the scope of assessment of business processes" below. In principle, the management should assess company-level controls for all locations and business units from a company-wide perspective.

However, locations and business units that do not have a material effect on financial reporting may be excluded from the scope of assessment.

(Note 1) For the decision on "locations and business units that do not have a material effect on financial reporting," for example, this could be handled by treating any consolidated subsidiary which sum up less than 5% of total sales as not material, and excluding them from the scope of assessment. Keep in mind that the management should discuss this decision with the external auditor as needed, and is not required to apply a specific ratio automatically.

(Note 2) For the decision on "locations and business units that do not have a material effect on financial reporting," for example, instead of a standard with a fixed percentage of sales applied to all consolidated subsidiaries, one could apply a different measurement basis corresponding to the content of each consolidated subsidiary's business.

[Determining the scope of assessment of business processes]

It should be noted that the period-end financial reporting process (primarily performed by the accounting department) to be assessed from a company-wide perspective should be assessed in a similar manner as company-level controls.

Note: Example tasks of the period-end financial reporting process to be assessed from the company-wide perspective include:

- Preparing financial statements from the general ledger
- Entry to prepare consolidated financial statements (consolidation adjustments, aggregation, reclassification, etc.) and recording the contents
- Stating disclosure items relevant to financial statements

However, the preceding paragraph is not intended to prevent the exclusion of those processes relating to locations and business units with no material effect on financial reporting from the scope of assessment.

The scope of assessment for business processes other than the above should be determined by following the procedures below:

[1]. Selecting significant locations or business units

When a company has multiple locations and business units, the selection of locations or business units to be assessed should be based on the degree of materiality of their sales or other factors. For example, locations or business units are selected in descending order of sales (or other factors) until their combined amount reaches a certain ratio of the consolidated sales (or other factors).

(Note 1) Locations or business units are not necessarily limited by geography. They may be classified, in accordance with the form of the company, as headquarters, subsidiaries, local offices, branches, or business units.

Although the basic criteria for selecting locations or business units is sales, different or additional criteria may be used depending on the company's business environment or characteristics. For example, in the case of banks, ordinary income would generally be used instead of sales.

(Note 2) It is difficult to provide a "certain ratio" that is uniformly applicable to all organizations, because individual organizations will find themselves in different environments with different business characteristics. If, however, company-level controls are operating effectively, then the "certain ratio" may be, for example, two-thirds of total sales on a consolidation. In addition, individual business processes that have a high degree of materiality (as described below) may be included in the scope. Instead of two-thirds of total sales on a consolidation basis, a certain ratio may be applied to aggregated sales (before elimination of inter-company transactions).

For this certain ratio, if that location or business unit was in the assessment scope as a material location or business unit in the previous fiscal year, and if it is confirmed that a) the assessment result indicated effective internal control over that location in the previous fiscal year, b) there were no material changes in the design of internal controls over that location or business unit, c) among the material locations and business units, it is not a particularly material location or business unit, e.g. it is not a core company in the group, then that location or business unit could be excluded from the assessment scope. In that case, as a result, the certain ratio may be less than 2/3 of consolidated sales, etc. to some extent

(Note 3) As sales amounts of affiliated companies are not included in a company's consolidated sales, the management cannot use the certain ratio of consolidated sales for affiliates. Instead, the management should evaluate the degree of the affiliate's impact on the company's financial statements and determine whether the affiliate should be deemed to be in the scope or not based on its financial statement.

If a significant location or business unit has a reason that precludes the assessment (e.g. acquisition, merger, or natural disaster in the second half of the fiscal year), such a location or business unit may not be subject to the assessment. In such a case, however, it should be borne in mind that it is necessary to disclose in an addendum to the Internal Control Report that there is a limitation on the scope of assessment.

[2]. Identifying business processes to be assessed

A. In general, in the locations and business units (except for equity method affiliates) selected in [1] above, all business processes which impact the accounts that are closely associated with the company's business objectives should be in the scope (for example, in the case of a generic company, the accounts that would be in the scope are, in principle, sales, accounts receivable, and inventory).

However, a business process should be deemed outside the scope if it only has a remote association with significant businesses or operations performed in a significant location or business unit and has no material impact on the financial statements. In that case, the management should keep the record of the business processes that are deemed outside the scope and the explanations behind such decisions.

The business processes leading to inventories include sales, inventory management, period-end physical inventory count procedures, the purchasing process, the costing process and others. To determine which processes should be in the scope, the company needs to evaluate its industry's characteristics and assess the risk of misstatements in these areas.

It is noted that, in general, the management is not required to assess the entire costing process, but enough of the process for end-of-period inventory valuation.

(Note 1) "Accounts that are closely associated with the company's business objectives" (sales, sales accounts receivable and inventory assets are only examples) must be decided appropriately, corresponding to the individual industry, the environment faced by the company, characteristics of the business, etc.

For example, in the case of banks, many banks focus on deposit and loan business. Business processes related to three accounts (deposits, loans, and securities) would generally be in the assessment scope.

(Note 2) For the assessment scope of business processes related to accounts that are closely associated with the company's business objectives at a significant location or business unit, the management should consider the risks of a material misstatement occurring, and appropriately decide for each company. For the criteria of this decision, it may not be appropriate to say uniformly, but for example, if sales is an "account that is closely associated with the company's business objectives," then the total monetary amounts of a business process related to sales, and if it is approximately less than 5% of consolidated sales, weakly related to material business and operations, with no material impacts on financial reporting, then it could be handled by exclusion from the scope of assessment. Keep in mind that this "approximately 5%" should not be applied automatically.

B. When locations and business units selected pursuant to [1] above or any other locations and business units have a business process with a significant effect on financial reporting, such a business process should be in the scope. In that case, the following points should be noted:

a. Business processes relating to a business or operation dealing with high-risk transactions.

Examples include business locations or business operations that have a high-risk business likely to result in a misstatement in significant components of the financial statements (for example, businesses that have financial and/or derivatives transactions, or those that have inventory with volatile pricing), or those engaged in transactions that require complex accounting treatment. In such cases, business processes relating to the business or business operation should be examined to determine whether they should be in the scope.

b. Business processes relating to significant accounts involving estimates and the management's judgment.

If it is a business process that relates to a significant account involving estimates and the management's judgment (for example, allowances, loss on impairment of fixed assets, and deferred tax assets or liabilities), and is likely to ultimately have a significant effect on the financial reporting, an examination should be undertaken to determine whether the business process should be in the scope.

c. Business processes requiring special attention because of the involvement in non-routine or irregular transactions that have a high risk of misstatement.

For example, when a business process involves non-routine or irregular transactions (for example, transactions under irregular business conditions and terms, transactions concentrated around the period-end, significant increase in the number of transactions compared to the prior year, etc.), and as a result has a high risk of misstatement, special attention must be paid to such process and an examination should be undertaken to determine whether the process should be in the scope.

d. When a business process is included in the scope for a reason such as that noted above, after considering the materiality to the financial reporting it may be sufficient to address only certain transactions or events (or certain key business processes), rather than the entirety business or operation.

[Communication with external auditor(s)]

A scope of assessment determined by the management may be judged as inappropriate by an external auditor as a result of the external auditor's procedures. In such a case, the management should conduct the assessment procedures again for the new scope of assessment. However, such conducting again may sometimes be difficult due to a limited timeframe. Therefore, soon after the management determines the scope of assessment, it should discuss the basis and the results of the scope with the auditor, as appropriate.

3. Method of Assessing Internal Control Over Financial Reporting

(1) Internal Control Assessment by Management

The management, as the entity responsible for the design and operation of effective internal control, assesses internal control over financial reporting. In evaluating internal controls, the management should first assess internal controls that have a material impact on overall consolidated financial reporting and, based on the results, assess the internal control incorporated into business processes ("process-level controls" hereinafter).

The management's assessment of internal controls should be conducted as of the end of the fiscal year.

[1]. Internal control assessment structure

"The management's assessment" means primarily performing the assessment and reporting of the assessment results by the management. The management is ultimately responsible for the assessment of internal controls, and it is required to assume the responsibility for the planning, performance, and results of the assessment.

However, as it is difficult for the management to perform the entire work of assessment, it is advisable to appoint a responsible person to help the management perform the assessment, under the direction of the management, and establish a department or a mechanism that performs the assessment under the management's direction. Alternatively, it is also advisable to use, for example, the accounting department, internal audit department, or any other existing department, as long as the department does not assess its own business.

The department or body that helps the management perform the assessment, as well as individual staff members of the department or the body, should be independent of the business operations being assessed, and are required to maintain objectivity. In addition, they also need to be sufficiently capable of performing the tasks required for the assessment. In other words, they must be fully competent in relation to the design and assessment of internal controls, have a solid understanding of assessment approaches and procedures, and be able to make proper judgments.

A self-assessment of internal controls by persons who perform the day-to-day business operations or by the department that executes the business operation is not to be considered a "separate assessment". However, such self-assessment is beneficial for improving the design and operation of internal controls and may result in a more effective use of the separate assessment. The company can use self-assessment as the basis of judgments to be made during the assessment of internal controls when independent monitoring is performed on the results of the self-assessment.

[2]. Use of work of experts

The management can perform part of the assessment of internal control over financial reporting by using an expert outside the company.

The judgment as to whether an expert's work provides sufficient evidence in support of the assessment must be made by the management on its own responsibility. The management should bear the ultimate responsibility for assessment results.

To this end, the following points should be kept in mind.

A. The expert possesses not only professional expertise of the business, but also the knowledge and experience necessary to provide work requested by the management in regard to the assessment of internal controls.

B. When asking an expert for an assessment, the management should clarify the basic requirements for the assessment to be performed by the expert. This understanding should cover the details of the assessment procedures, the period of time for which the assessment is performed, the scope of assessment, number of samples, and so forth.

C. In order to clarify the details of the assessment procedures and the work content, the management should clearly define the matters to be included in the expert's report.

D. The management should check the progress of the expert's work on a regular basis.

E. The management should review the expert's work to assess whether the basic requirements have been fulfilled.

(2) Assessment of Company-Level Controls

The management should assess the design and operation of company-level controls and the degree of impact they have on process-level controls. In doing this, the management should sufficiently assess risks occurring inside/outside the organization and should fully consider all events that could have a significant impact on overall financial reporting. This would include, for example, company-level accounting policies and financial policies, management decisions related to the structuring and operation of organizations, and the decision-making process at the management level.

[1]. Company-level controls

Company-level controls are internal controls that have a pervasive impact on the company and cover the entire company group (more specifically, the company issuing the Annual Securities Report and its subsidiaries and affiliates). However, if it is deemed appropriate to perform a separate assessment of internal controls at a specific subsidiary and/or business unit because of its unique history, practice, or organizational structure, company-level controls to be applicable to only a specific subsidiary and/or business unit may be assessed. In that case, the management should appropriately determine subsidiaries and business units for which internal controls are identified and assessed separately, by taking their degree of impact on the financial reporting into account.

[Assessment items for company-level controls]

The type of company-level controls varies depending on the business environment and characteristics of the company, and individual companies are required to design and operate internal controls that suit them. Nevertheless, each basic component of internal control has specific items to be assessed. Examples of such items are shown in Exhibit 1 (Examples of assessment items for company-level controls over financial reporting). However, it should be noted that the list of examples shown in Exhibit 1 is not intended to be a complete list of items to be assessed, and that a company is required to make additions, deletions, and amendments as necessary.

Note: Among assessment items for company-level controls (excluding assessment items with particularly significant impacts on the reliability of financial reporting), for items indicated as effective in the previous fiscal year's assessment results, and without significant changes to the previous fiscal year's design, the management can record such fact and continue using the results of the previous year's operation assessment. Keep in mind that consequently, assessment of the operating effectiveness of assessment items for company-level controls may be performed once within a certain number of accounting periods. Keep in mind that if assessment of company-level controls is performed at the level of an individual subsidiary or business unit, etc., then the management can consider the extent to which the assessment item at each assessment unit impacts the reliability of consolidated financial reporting, and decide whether to continue using the previous fiscal year's results of the operating effectiveness of assessment items.

[2]. Methods for evaluating company-level controls

When evaluating company-level controls, procedures such as inquiries and verification of records should be performed, as necessary, after appropriately understanding and analyzing the internal controls to be assessed as a whole.

[3]. Company-level controls and process-level controls

The management should assess process-level controls based on the results of the assessment of company-level controls. Company-level controls and process-level controls affect and complement each other. The management should perform the assessment of internal controls by ensuring an appropriate balance between the two.

[Different balances among companies due to different business characteristics]

A company’s focus (company-level controls or process-level controls) may differ depending on the characteristics of the business performed or other factors. For example, company-level controls may have a greater significance if the company’s organizational structure is relatively simple.

On the other hand, if the ratio of a company’s business operations performed in accordance with in-house rules, policies or procedures is high, process-level controls may have a relatively greater significance. For example, it is necessary for a retail company with multiple outlets to standardize its operational procedures. As a result, a variety of manuals for process-level controls are prepared, including a sales manual, a cash-handling manual, an employee education manual and a manual for responding to exceptional events.

The management should determine the scope and approaches for assessment of process-level controls based on the results of the assessment of company-level controls. For example, if the assessment of company-level controls concluded that they are not operating effectively, the scope of assessment should be expanded or additional assessment should be performed for the process-level controls affected by the ineffective company-level controls. On the other hand, if the company-level controls are assessed as operating effectively, the assessment of process-level controls may be simplified by, for example, reducing the scope of sampling. Alternatively, by taking into account the materiality or other factors, the frequency of assessment of certain controls can be reduced to a predetermined number of accounting periods.

Note: For the certain number of accounting periods, the management must consider the significance of that business process, and decide appropriately.

It should be noted that the scope and approaches for the assessment of process-level controls may be adjusted under the circumstances where, as mentioned under [1] above, a separate assessment of company-level controls is performed for individual subsidiaries or business units in the group in light of their characteristics and materiality.

(3) Assessment of Process-Level Controls

Based on the assessment of company-level controls, the management should analyze business processes within the scope of the internal controls to be assessed, identify a key control that would have a material impact on the reliability of financial reporting (“key control” hereinafter), and assess whether the basic components of internal control are operating with regard to the key control.

Based on the assessment of company-level controls, the management should analyze the business processes within the scope of the internal control to be assessed, and then identify the controls that would have a material impact on the reliability of financial reporting as key controls. In the second step, the management should assess whether the key controls are sufficient to mitigate the risk of material misstatement. By evaluating the design and operation of the key controls, the management will obtain the base for the assessment of process-level controls effectiveness.

[1]. Identify/determine business processes in the scope

The management should recognize the flow of transactions in business processes within the scope of assessment, including initiation, authorization, recording, processing, and reporting of transactions. It should also understand the accounting procedures from the origination of transactions to computing and journalizing transactions, etc. It would be useful to utilize charts and diagrams, as necessary, to clarify and record the outline of the recognized business processes.

Note: Examples of the charts and diagrams are shown in Exhibit 2, "Business process flowchart (sample)" and "Business process description (sample)." However, these are merely examples of charts and diagrams that may be prepared as necessary. Companies are not necessarily required to use these examples, but are encouraged to use their own that have been prepared separately (if any exist) and make additions to them as necessary.

[2]. Identify the risk of misstatement and controls that mitigate the risk in business processes

A. The management should identify the risk of misstatement due to fraud or error in the business processes within the scope of assessment.

When identifying the risk, it is important to understand which of the financial statement assertions (existence or occurrence; completeness; rights and obligations; valuation or allocation; and presentation and disclosure) is affected by the fraud or error.

a. Existence or occurrence: Whether assets or liabilities of the entity exist and whether recorded transactions or accounting events have actually occurred

b. Completeness: Whether all assets, liabilities, transactions, and accounting events that should be presented in the financial statements are duly recorded

c. Rights and obligations: Whether assets are the rights of the entity and liabilities are the obligations of the entity

d. Valuation: Whether assets and liabilities have been recorded in the financial statements in appropriate amounts

e. Allocation: Whether transactions and accounting events are recorded in appropriate amounts and whether revenues and expenses are allocated to appropriate accounting periods.

f. Presentation and disclosure: Whether transactions and accounting events are properly presented and disclosed.

B. Identify the key controls implemented to mitigate the risk of misstatement

The management should identify internal controls implemented to mitigate the risk of misstatement. In doing this, the management should, focusing on the internal controls over initiating, authorizing, recording, processing, and reporting, identify the key controls from the viewpoint of what types of internal controls are necessary to ensure financial statement assertions, i.e., existence or occurrence, completeness, rights and obligations, valuation, allocation, and presentation and disclosure.

The management should determine whether the basic components of internal control over financial reporting are operating effectively by determining whether the individual key controls related to individual significant accounts are operating effectively and provide reasonable assurance over the financial statement assertions, i.e., existence or occurrence, completeness, rights and obligations, valuation, allocation, and presentation and disclosure.

It would be useful to utilize charts and diagrams as necessary for clarification and recording in the assessment of the design and operation of process-level controls.

Note: Examples of the charts and diagrams are shown in Exhibit 3, "Relationship between risks and controls (sample)." However, these are merely examples of charts and diagrams that may be prepared as necessary. Companies are not necessarily required to use these examples, but are encouraged to use their own that are prepared separately (if any) and make additions to them as necessary.

[3]. Assessing design effectiveness of process-level controls

The management should determine, by taking such measures as review of relevant records, inquiries to the employees and monitoring, whether the individual key controls related to individual significant accounts identified pursuant to [2] above are properly designed and provide reasonable assurance of achieving the financial statement assertions, i.e. existence and occurrence, completeness, rights and obligations, valuation, allocation, and presentation and disclosure. In doing this, if internal controls are operating in accordance with prescribed policies, the management should assess the effectiveness of the internal controls based on whether they are adequate to sufficiently mitigate the risk of misstatements in significant components of the financial statements.

The following are examples of matters to be kept in mind during the assessment.

- Whether internal controls are operating effectively to prevent or detect any fraud or error on a timely basis

- Whether an appropriate segregation of duties is in place
- Whether persons in charge possess the knowledge and experience necessary to operate internal controls
- Whether information concerning internal control is appropriately communicated, analyzed, and used
- Whether any measures are in place to address, on a timely basis, a fraud or error identified by internal control

Note: Assessment of the design of internal controls identified as key controls must in principle be performed every period. However, if assessment results indicate that company-level controls are effective, then among those internal controls identified as key controls (excluding those with particularly significant impacts on the reliability of financial reporting) indicated as effective in the previous fiscal year's assessment results, and without significant changes to the previous fiscal year's design, the management can record such fact and continue using the results of the previous year's design assessment. Keep in mind that consequently, assessment of the design of internal controls over business processes may be performed once within a certain number of accounting periods.

[4]. Assessing operating effectiveness of process-level controls

A. Contents of operating effectiveness assessment

The management should assess the operation of process-level controls to determine whether they are operating effectively.

The management should check the operation of process-level controls by applying procedures that include reviewing relevant records, making inquiries to appropriate staff personnel on internal controls, observing the application of specific controls, examining records regarding the operation of internal controls, and investigating the progress in the self-assessment of the operation of internal controls, etc.

B. Method of evaluating operation

In principle, the management should obtain sufficient and appropriate evidence via sampling when evaluating the operation. The scope of sampling may be reduced when company-level controls are assessed to be operating effectively or it is deemed that a consistent and standardized procedure is applied to multiple locations and business units in the company.

For example, when a company has multiple business locations and outlets, its company-level controls are assessed to be operating effectively if 1) the business is performed based on common rules, 2) information and communication are sufficient to make decisions during the course of business, and 3) an internal audit is conducted to monitor the integrity of internal controls.

In such a case, the management categorizes locations and business units by characteristics, assesses the operation at a certain number of business locations in each category, and uses the results of those assessments to estimate and assess the operation of internal controls for the entire group instead of performing an assessment of operation at each business location.

When selecting business locations to be included in the scope of assessment, an effective method for selection (e.g., introducing a random sampling method) should be considered at the planning stage, bearing in mind that all business locations should be covered at least once within a certain period of time.

(Note 1) Assessment of the operation of internal controls identified as key controls must in principle be performed every period. However, if assessment results indicate that company-level controls are effective, then among those internal controls that have been identified as key controls (excluding those with particularly significant impacts on the reliability of financial reporting) were indicated as effective in the previous fiscal year’s assessment results, and have not undergone significant changes compared with the previous fiscal year’s design, the management can record such fact and continue using the results of the previous year’s assessment of operation. Keep in mind that consequently, assessment of the operation of internal controls over business processes may be performed once within a certain number of accounting periods.

(Note 2) In assessment of the operation of a smaller and less-complex organization, etc., it is especially allowed to devise and efficiently execute assessment methods corresponding to the situation of the organization. For example, keep in mind that assuming that appropriate company-level controls are designed and operated, it is not required to uniformly assess operation for internal controls over business processes for all through the year, and that assessment is not necessarily required for every level in the organization (e.g. department manager, person in charge, etc.).

C. Timing to assess operation

To determine internal control effectiveness as of the assessment date (period-end date), it is necessary to assess the operating effectiveness at an appropriate time.

When the assessment of the operation is conducted on an interim date and a significant change is made to internal control before the period-end date, it is necessary to consider taking additional measures. Examples of the additional measures include:

a. Identifying and understanding the details of the significant change

b. Assessing the design effectiveness of internal controls after the change, including the misstatement risk and controls to mitigate the risk in the business process associated with the change
c. Assessing the operating effectiveness of internal controls after the change
It should be noted that internal controls that do not exist as of the period-end date following the change need not be assessed.

It is efficient and effective to assess the operation of internal controls over the period-end financial reporting process in the early part of the fiscal period, using the prior period's operation as a starting point (in that case, it is a precondition that if any significant change is made to internal control before the period-end date, appropriate additional measures are taken). This is because any deficiency in internal controls over the period-end financial reporting process must be remediated as early as possible in order to ensure the proper functioning of these processes during the period, and it is likely that assessment of the operating effectiveness of internal controls over the period-end financial reporting process will largely overlap the assessment of internal control in the Financial Statement Audit.

D. Matters to be kept in mind in determining the method of assessment

The following matters are to be kept in mind in determining the method (sample size, sample period, etc.) of operation assessment:
a. Types and characteristics of internal controls
The management should determine the method (sample size, sample period, etc.) for evaluating the operation of internal controls after considering their materiality and complexity, the nature of decisions to be made by persons in charge, the capability of the personnel involved in internal control, the previous year's results of assessment and the changes made afterward, etc.
Because IT-based controls are a repetition of consistent transactions, when such internal control is assessed to be designed effectively, procedures for evaluating the operation of IT-based controls may be less extensive than those for manual controls (by reducing the sample size, shortening the sample period, etc.), provided that IT general controls are designed and operating effectively.
b. Period-end financial reporting process
As described under 2 (2) above, if it is deemed appropriate to assess a period-end financial reporting process from a company-wide viewpoint, it should be so assessed in a manner analogous to that of company-level controls.

However, other period-end financial reporting processes should be assessed as specific business processes.

In such a case, internal control over the period-end financial reporting process is extremely significant for the reliability of financial reporting, and there will be a small number of processes to be assessed, because they are less frequently performed compared to those business processes relating to day-to-day transactions. Therefore, in general, the operating effectiveness of internal controls over the period-end financial reporting process should be assessed in a more cautious manner than that of other internal controls.

[5]. Assessing IT-based controls

A. Assessing IT-based controls

When IT is used in a company's information systems, information is, in general, processed and prepared through various types of application systems and then reflected in the accounting system. Therefore, the management should assess internal controls designed to ensure the reliability of financial information prepared by these application and accounting systems. Such internal controls include automated controls built into computer programs and controls in which manual and computerized systems are operated in an integrated manner.

IT controls are categorized as general controls and application controls. The management should assess both types of controls.

B. Determining scope of assessment

a. Scope of business processes and systems

The first step in evaluating IT controls over financial reporting should be to clarify the scope of assessment for the systems related to internal control over financial reporting. When checking accounting procedures performed in a business process, from the origination of transactions to computing and journalizing transactions, it is necessary to identify business processes and systems that are associated with significant financial statement accounts, and the outline of the functions of the systems and departments in which the systems are used, etc.

In doing this, it would be useful to utilize charts and diagrams, as necessary, in order to recognize and clarify not only the accounting procedures performed in the business process, from the origination of transactions to computing and journalizing transactions, but also the flow of data among systems. It would also be useful to prepare a list of the systems being used in each business process.

Note: Above Exhibit 2, “Business process flowchart (sample),” the column on the right side is provided to allow users to draw their own system flowchart.

b. Understanding IT infrastructure

In addition to the systems used in each business process, an overview of the IT infrastructure supporting those systems should also be understood. For example, it is encouraged to obtain an understanding of the following points.

- Structure of the organizations involved in IT
- Rules and procedure manuals regarding IT
- Hardware configuration
- Configuration of basic software
- Networking
- Outsourcing to external organizations

C. Identifying assessment unit

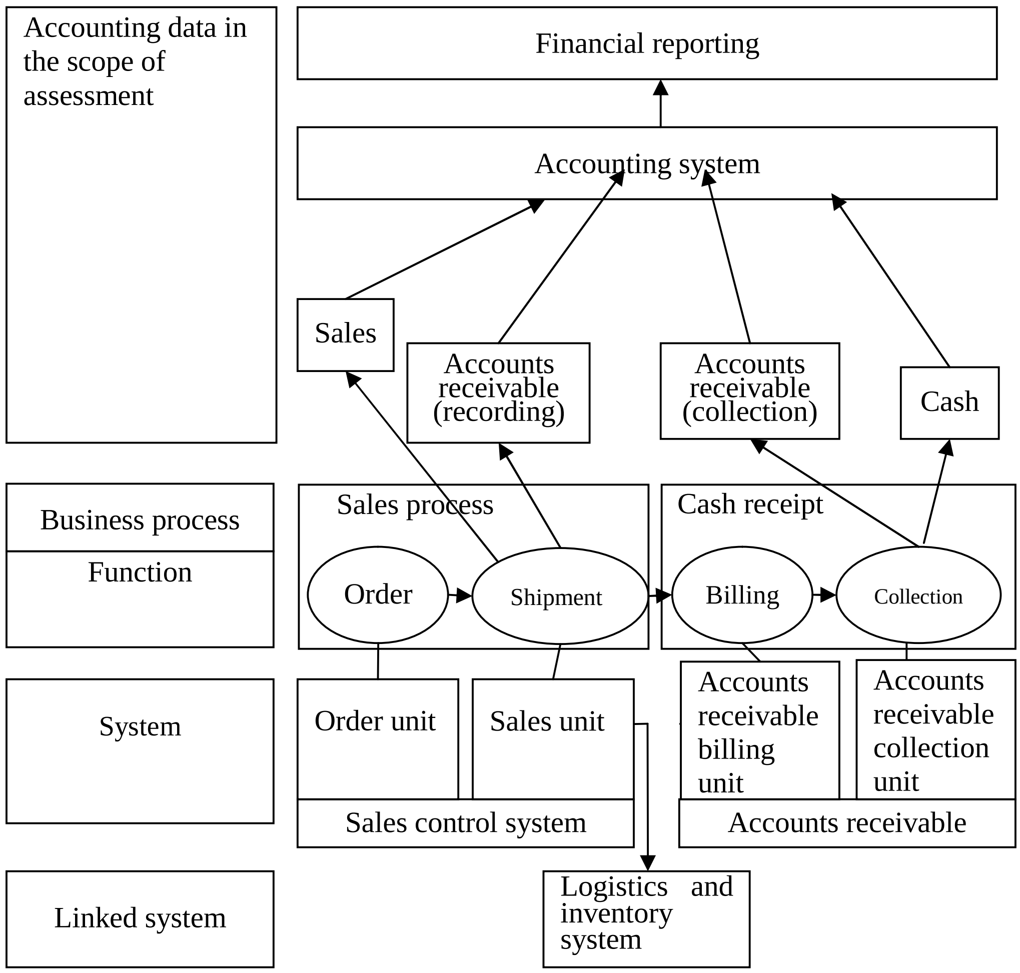
When evaluating IT general controls, assessment units should be determined based on the overview of the IT infrastructure. For example, when the sales, purchasing, and logistics systems are developed in-house and controlled by the information systems department, while off-the-shelf packaged accounting software is introduced and controlled by the accounting department, the units should be the “information systems department” and the “accounting department.”

On the other hand, IT application controls should basically be assessed for each system. The management should identify the application controls used in each system by using flowcharts or other tools as necessary.

Note: In the “Business process flowchart (sample)” shown before in Exhibit 2, a column is provided on the right side to allow users to draw their own system flowchart. It is useful, for example, to describe the details of the application controls in the notes to the column, or in the “Business process description (sample)” prepared separately.

The following diagram is an illustrated example of the relationship among the sales process, cash receipts process, and accounting data in a sales transaction. It is often the case that a company’s business processes are categorized by function and systemized based on the function. For example, the sales process is categorized into the function group of sales orders, shipping, and so forth, and systemized as necessary.

The management should understand the relationship among the financial statement accounts, transactions, business processes and systems to be able to identify which type of accounting data is supported by which system for major transactions.



D. Assessing effectiveness of design and operation of IT-based controls

a. IT general controls

The management should assess the effectiveness of design and operation of IT general controls by focusing on the following points.

- Development and maintenance of information systems
- Operation and administration of information systems
- Security of information systems, including access control from inside/outside the organization
- Outsourcing contract management

In assessing the operating effectiveness of internal controls as a part of the assessment of internal control effectiveness, the management should assess the operating effectiveness of general controls in conjunction with the assessment of the operating effectiveness of related application controls. By expanding the scope of the assessment of the operation of application controls, the management may still obtain sufficient assurance that internal controls are operating effectively without evaluating the operation of general controls.

Note: Among the IT general control items (excluding those with particularly significant impacts on the reliability of financial reporting), for those items that have been indicated as effective in the previous fiscal year’s assessment results, and have not undergone significant changes compared with the previous fiscal year’s design, the management can record such fact and continue using the results of the previous year’s the assessment of operation. Keep in mind that consequently, assessment of the operation of general controls over IT may be performed once within a certain number of accounting periods.

b. Assessment of IT application controls

The management should assess whether the identified IT application controls are appropriately integrated into business processes and operating effectively. Specifically, the following examples are to be considered in evaluating the effectiveness of design and operation of application controls.

- Whether completeness, accuracy, and validity of entry information are secured
- Whether functions to correct and reprocess erroneous data are secured
- Whether the accuracy of master data is secured
- Whether an appropriate access control (user authentication, limiting the scope of operation, etc.) is applied

c. Use of previous period's results of assessment

In principle, IT-based controls must be assessed on an annual basis, as is the case with manual controls. However, once an internal control is automated by using IT, it operates continually unless a change is made or an error has occurred.

Therefore, if an automated control was assessed in the previous periods as operating effectively without control deficiencies, the management may continuously use those results, provided the following conditions are met and recorded.

1) No changes have been made to the control since the last assessment
2) No failures or errors have occurred
3) Related general controls have been assessed and found to be designed appropriately and operating effectively

Note: Among the assessments of IT application controls, for automated internal controls using IT, in accordance with the above, if the management can continue using past fiscal years’ assessment results, this can include performing a test of operation once in a certain number of accounting periods.

(4) Judgment of the Effectiveness of Internal Controls

If the assessment of internal control over financial reporting effectiveness reveals that deficiencies relating to key controls, etc. are very likely to have a material impact on financial reporting, the management should conclude that there are material weaknesses in internal control over financial reporting.

[1]. Judgment of the effectiveness of company-level controls

A. Evaluation of deficiencies

Deficiencies in company-level controls will have a pervasive impact directly or indirectly on not only process-level controls, but also, ultimately, on the contents of financial reporting.

Therefore, if deficiencies exist in company-level controls, careful consideration is required to determine the likelihood of their causing material misstatements in the financial reporting, as well as their impact on process-level controls.

B. Judgment of the effectiveness

In order to judge company-level controls to be effective, it is important that the company-level controls satisfy the following conditions in order to mitigate the risk of causing false statements and disclosures in the financial reporting.

・Company-level controls have been designed and operating in accordance with the generally accepted internal control framework

・Company-level controls support the effective design and operation of process-level controls, and adequately compose the overall structure of the company's internal controls

C. Deficiencies in company-level controls

Deficiencies in company-level controls are very likely to have a material impact on the effectiveness of internal controls. The following are examples of deficiencies in company-level controls that may constitute material weaknesses.

a. The management does not perform risk assessment associated with the reliability of financial reporting, nor does it respond to such risks.

b. The board of directors, corporate auditors or audit committee does not supervise, monitor nor examine the design and operating effectiveness of internal controls for securing the reliability of financial reporting.

c. The department that shall be responsible for the assessment of internal control over financial reporting effectiveness is not clear.

d. Deficiencies existing in internal controls over IT relating to financial reporting are left unimproved.

e. The board of directors, corporate auditors or audit committee cannot supervise, monitor or examine internal control over financial reporting effectiveness due to the lack of records on the design of internal controls, such as records on the process flow, identification of misstatement risks or internal controls over risks.

f. Deficiencies in company-level controls reported to the management, board of directors or corporate auditors or audit committee are not remediated within a reasonable period of time.

Even if deficiencies exist in company-level controls, it is sometimes the case that process-level controls function effectively on an independent basis. However, deficiencies in company-level controls mean deficiencies in the design of basic internal controls, and therefore internal controls as a whole would be less likely to function effectively.

[2]. Judgment of the effectiveness of process-level controls

A. Assessment of the control design effectiveness

In assessing the design effectiveness of internal controls, it is necessary to check whether they are designed to mitigate misstatement risks in accounts, notes and disclosures in financial statements to a reasonable level.

B. Assessment of the control operating effectiveness

The management should assess whether internal controls are operating as effectively as expected. In the assessment, the management should confirm that internal controls are operating as intended to mitigate each of the misstatement risks.

C. Assessment of the impact and likelihood of misstatements

When misstatements occur in accounts, etc. due to control deficiencies, it is necessary to estimate the scope of their impact in order to determine whether such deficiencies would constitute material weaknesses. In addition, when estimating the quantitative impact of control deficiencies, the likelihood of misstatements should also be examined.

When there are multiple deficiencies in internal controls, the issue of whether the deficiencies, either individually or in combination with other deficiencies, constitute material weaknesses should be assessed. In other words, whether control deficiencies related to the same account would constitute material weaknesses or not should be judged based on whether the aggregate impact of such deficiencies is likely to cause misstatements in the material components of the financial reporting. For example, the balance of accounts receivable is affected by credit sales in the sales process and by collections in the cash receipt process, so when there are deficiencies in internal controls over both processes, the aggregate impact of such deficiencies on the balance of accounts receivable must be considered.

It is sometimes the case that the aggregate impact of deficiencies on a single account may not constitute material misstatements at the financial statement level, but such impact on multiple accounts may. Such deficiencies also constitute material weaknesses.

Furthermore, when estimating the likelihood and impact of misstatements in accounts, etc., the focus should be placed on how individual controls interact with each other to mitigate the risk of misstatements, rather than how each control operates on an individual basis. To this end, it is necessary to examine whether there is any internal control that compensates for deficiencies in another control (compensating control), and if there is, to what extent the compensating control can reduce the likelihood of misstatements in accounts, etc. and mitigate the quantitative impact.

For the detailed method for calculating the quantitative impact of control deficiencies, you may refer to “Evaluation of deficiencies in process-level controls” in Section 4(2)[4] of Chapter III “Audit on Internal Control Over Financial Reporting.” This should also serve as a useful reference in the assessment process as well.

[3]. Judgment of the effectiveness of IT controls

A. Deficiencies in IT general controls

When there are deficiencies in IT general controls, whether the objective of the reliability of financial reporting is achieved by alternative or compensating controls should be examined.

Deficiencies in IT general controls may not immediately be determined to be material weaknesses since they are not directly related to misstatement risks in the significant components of the financial reporting. However, deficiencies in IT general controls may prevent continuous and effective operation of IT application controls even if they have been designed to function effectively, and therefore misstatement risks would increase.

B. Deficiencies in IT application controls

When there are deficiencies in IT application controls, their impact and likelihood of causing misstatements should also be assessed, as is the case with deficiencies in process-level controls.

When there are deficiencies in IT application controls that use both manual work and an IT function, the management should determine whether the deficiencies result from the manual work or the IT function. It should be noted that the same type of errors may have repeatedly occurred when they result from the IT function.

[4]. Report of deficiencies and others

When identifying control deficiencies (including material weaknesses) in the assessment of internal control over financial reporting, the person should report them to the appropriate personnel, such as his or her supervisor, together with their details, quantitative impact on the entire financial statements, countermeasures to be taken and other information considered useful, and request remedial actions. At the same time, he or she must report material weaknesses (and control deficiencies when deemed necessary) to the management, the board of directors, corporate auditors or audit committee and external auditors. If material weaknesses remain as of the fiscal year end date, the details of the material weaknesses and the reasons why they have not been remediated should be stated in the Internal Control Report.

(5) Remediation of Material Weaknesses in Internal Controls

Control deficiencies over financial reporting (including material weaknesses) identified in the course of the management's assessment should be recognized on a timely basis and appropriately dealt with.

Even when material weaknesses are identified, internal control over financial reporting can be judged to be effective as long as the weaknesses are remediated by the assessment date in the Internal Control Report (the fiscal year end date).

Note: Remedial actions taken after the fiscal year end date may be stated in the Report as Supplementary Information.

[1]. Remedial procedures for material weaknesses and others

When developing a plan for the assessment and reporting of internal controls, it is advisable to leave some additional time before the final assessment date (fiscal year end date), so that control deficiencies (including material weaknesses) identified in the assessment can be remediated in time.

[2]. Assessment procedures for remedial actions taken after the fiscal year end date

The assessment date of internal controls is the fiscal year end date, so remedial actions taken after the fiscal year end date do not affect the assessment results of internal control over financial reporting.

However, if remedial actions have been taken before the Internal Control Report issue date, the management can state their details in the Internal Control Report as Supplementary Information.

If, prior to the issue date, it has been confirmed that internal controls are designed and operating effectively, the management can also include the details of remedial actions and the fact that such actions have been completed in the Report.

(6) Limitation of the Scope of Assessment

The management, when assessing the effectiveness of internal control over financial reporting, may not be able to perform sufficient assessment procedures for a certain part of the internal controls due to unavoidable circumstances. In such cases, the management may assess the effectiveness of internal control over financial reporting, excluding the parts where assessment procedures could not be performed, after fully comprehending the impact of the exclusion on the financial reporting.

Note: Cases in which adequate assessment procedures could not be performed due to unavoidable circumstances include, for example, a case when a company acquired another company in the second half of the fiscal year, the management could not perform sufficient assessment procedures for the effectiveness of the acquired company's internal controls.

[Acceptable limitations]

"Unavoidable circumstances" are, for example, circumstances where it is deemed difficult to perform assessment procedures in accordance with this guidance within the period of time usually required for financial statements to be prepared and approved by the board of directors, due to the acquisition or merger of other companies in the second half of the fiscal year, an occurrence of natural disasters, or other reasons.

Note: "Second half of the fiscal year" is only an example. If deemed reasonable, it is not necessary for the event to have occurred in the second half of the fiscal year if the assessment cannot be completed by the Internal Control Report preparation date.

When excluding a certain scope of assessment, the subject scope and reasons for the exclusion must be included in the Internal Control Report. It should be noted that if the exclusion of the scope of assessment may have a significant impact on the reliability of financial reporting, the assessment results of internal controls cannot be expressed.

(7) Recording and Retention of Assessment Procedures and Others

The management should record and retain the information on the assessment of Internal control over financial reporting, including its procedures, results, identified deficiencies and remedial actions.

[1]. Recording of internal controls

The scope, format, and method of recording the information on internal controls cannot be uniformly defined. However, it may be appropriate to record and retain, for example, the following information.

A. Policies and procedures for the design and operation of internal control over financial reporting

B. The design and operation status of each assessment item adopted by the management in the assessment of company-level controls

C. Overview of business processes related to significant accounts and disclosures (including the system flow, overview of IT application controls, and a list of systems being used in each business process)

D. Material misstatement risks in each business process, and the contents of internal controls designed to mitigate such risks (including the relationship with existence or occurrence, completeness, rights and obligations, valuation, allocation, presentation and disclosure, as well as the details of IT-based controls)

E. The design and operation status of internal controls over the areas described under D above

F. Procedures and results of the internal control assessment, identified deficiencies and relevant remedial actions

*Records on the assessment plan

*Records on the determination of the scope of assessment (including the method and grounds for the determination)

*Records on the procedures and results of the internal control assessment performed, remedial actions taken, etc.

The format, method, etc. of the records cannot be uniformly defined. Companies should note that they can utilize records prepared and used internally, making additions when necessary.

Especially for smaller and less-complex organizations, etc., there could be various formats and methods of records. Keep in mind that it is sufficient to suitably use and supplement records as needed. For example, internal notices from that company's management, questionnaires that management prepared for people within and outside the organization, documents in which predecessors describe to successors the content of operations, documents prepared when salespeople receive orders, software manuals, original documents such as vouchers and receipts, and shipping instructions output from a sales management system after orders are input, etc.

[2]. Retention of records

The scope, format and period of retention of prepared records on internal control over financial reporting should be determined by individual companies, in the light of the requirements under applicable laws and regulations. However, based on the Financial Instruments and Exchange Act, companies may be required to retain the appropriate scope and format of records (digital media, paper, film, and other formats that can be visualized on a timely basis when necessary) for the period of time equivalent to the inspection period for the Annual Securities Report and the Exhibits therefore (five years).

Associated supporting records should be appropriately retained so that a third party can inspect them at a later date.

(Exhibit 1)

Examples of Assessment Items for Company-Level Controls Over Financial Reporting (Note)

Control Environment

- Does the management recognize the importance of reliable financial reporting and clearly define basic financial reporting policies, including the role of internal control over financial reporting?
- Are systems of the company designed and operated based on an appropriate management philosophy and code of ethics so that detected behaviors deviating from the principles would be adequately remediated?
- Does the management select appropriate accounting principles and retain objective procedures for the determination of accounting estimates and others?
- Does the board of directors and corporate auditors or audit committee understand and fulfill its responsibilities for appropriately supervising and monitoring the management in regard to the financial reporting and relevant internal controls?
- Do corporate auditors or the audit committee maintain an appropriate level of cooperation with internal and other auditors?
- Does the management take appropriate measures to improve problematic organizational structures or practices, in which, for example, it is difficult to point out existing problems?
- Does the management adequately assign roles in regard to each function (e.g., production, sales, information and accounting) and activity unit in the company?
- Does the management identify the competencies necessary to support the preparation of reliable financial reporting and procure/dispatch qualified personnel?
- Are the competencies necessary for the preparation of reliable financial reporting reviewed regularly and maintained appropriately?
- Are the assignment of responsibilities and delegations of authority made clear to all employees?
- Is the delegation of responsibilities and authority to employees, etc. kept at appropriate levels, not without limitation?
- Does the management provide employees, etc. with the means, training, etc. necessary to fulfill their duties and support them in the improvement of their abilities?
- Is the performance evaluation of employees, etc., conducted in a fair and appropriate manner?

Risk Assessment and Response

- Is there an effective risk assessment system that involves appropriate levels of the management and managers to ensure the reliability of financial reporting?
- Are internal and external factors and their impact on the preparation of reliable financial reporting adequately considered in the process of risk identification?
- Does the management establish a system to reassess the risk and take appropriate measures whenever changes occur that may have a significant impact on the reliability of the financial reporting (e.g., organizational changes, development of information technologies, etc.)?

(Note: This is a list of examples of the assessment items for company-level controls. It should be noted that companies might adopt other assessment items or make additions, eliminations and amendments to this list, since company-level controls may vary depending on each company's business environment and characteristics.

- Does the management appropriately assess and address fraud risks based on not only superficial facts regarding fraud, but also incentives, causes, backgrounds and other factors that may result in fraud?

Control Activities

- Are policies and procedures established to ensure the performance of control activities that sufficiently mitigate and address the risks to the reliability of the financial reporting?
- Does the management clarify segregation of duties and appropriately delegate authority and responsibilities to personnel in charge, in respect to the preparation of reliable financial reporting?
- Are responsibilities and accountability regarding control activities properly allocated to managers of business units or business processes where risks exist?
- Are company-wide job regulations and individual business procedures properly established?
- Are control activities faithfully performed over entire operations?
- Are errors, etc. detected through the performance of control activities appropriately investigated and properly addressed?
- Is the adequacy of control activities regularly examined based on their implementation status? Are necessary remedial actions taken?

Communication and Information

- Is a system set in place to ensure that the management's policies and instructions regarding the preparation of reliable financial reporting are communicated to all of the people in the company, especially to those who are engaged in the preparation of financial reporting?
- Is a system set in place to ensure that the accounting and financial information is appropriately communicated from relevant business processes to the information system and adequately made available?
- Is a system set in place to ensure that the important information on internal controls is smoothly communicated to the management and appropriate level of managers in the organization?
- Is the information appropriately communicated and shared among the management, board of directors, corporate auditors or audit committee and other relevant parties?
- Are there any communication routes that can be used independently from ordinary communication routes, such as the Whistleblower System, etc.?
- Is a system set in place to ensure that external information on internal controls is properly utilized and adequately communicated to the management, board of directors, corporate auditors or audit committee?

Monitoring

- Are ongoing monitoring activities appropriately embedded within the company's overall business operations?
- Does the management appropriately adjust the scope and frequency of independent assessments in accordance with the magnitude of the risks, significance of internal controls and effectiveness of ongoing monitoring activities?
- Does the person assigned to oversee monitoring activities have sufficient knowledge and competency for fulfilling the task?
- Does the management receive the monitoring results on a timely basis and take adequate account of them?

- Is the important information on internal controls communicated from within and outside the company appropriately considered? Are necessary remedial actions taken?
- Is the information on control deficiencies obtained through the monitoring activities appropriately reported to senior managers involved in such activities and persons who are responsible for managing such activities and relevant internal controls and taking remedial actions?
- Is the information on material weaknesses, etc. of internal controls appropriately communicated to the management, board of directors, corporate auditors or audit committee?

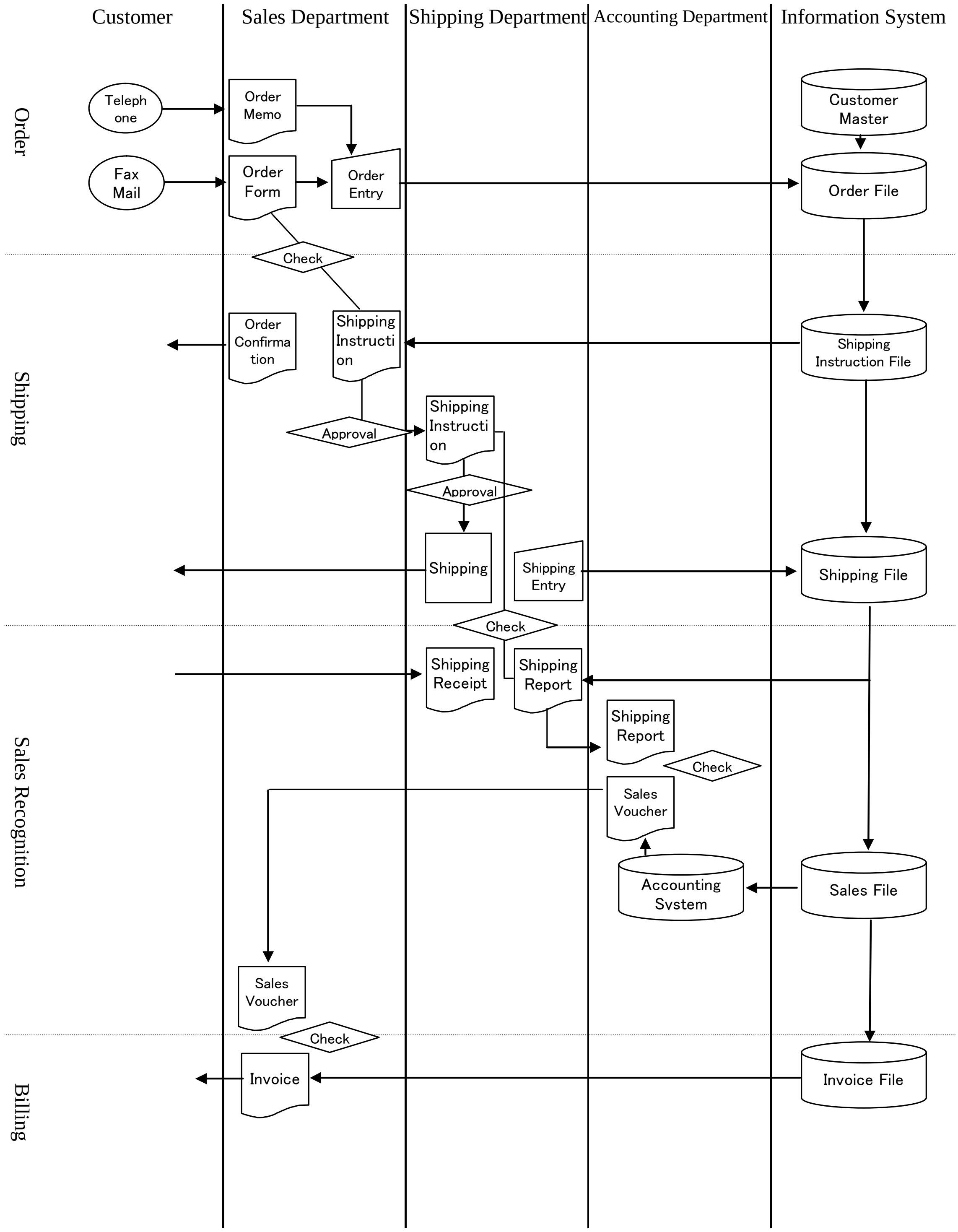
Response to IT

- Does the management establish appropriate strategies, plans, etc. in regard to IT?
- Does the management, when designing internal controls, adequately understand the company's IT environment and clearly present policies based on such knowledge?
- Does the management make proper judgments as to the areas in which to use IT-based controls and the areas in which to use manual controls in order to mitigate the risks to achievement of the reliability of financial reporting?
- When using IT for the design of control activities, are the risks that accompany the use of IT taken into account?
- Does the management adequately establish policies and procedures regarding IT general controls and IT application controls?

(Exhibit2)

Process Flow(Example)

Wholesale process relating to Business A



(Note) When a more detailed description is needed, you may add notes in the flow chart or separately prepare narratives, as shown in the example on the next page.

Narratives(Example)

Wholesale process relating to Business A

1.Order

(1) Sales representatives prepare “order memos” for orders received by telephone.

(2) Order entry into the sales management system is effective only for orders from customers registered in the customer master.

(3) After the order entry, “shipping instructions” and “order confirmations” are printed out from the sales management system, which will be checked against “order memos” or “order forms” and then approved by sales managers.

(4) “Shipping instructions” are forwarded to the shipping department with “order memos” or “order forms” attached.

2.Shipping

(1) Shipping clerks ship the goods based on “shipping instructions” which have been approved by shipping managers.

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3.Sales recognition

(1) Entered shipping data are converted to sales data. Sales data are transferred to the accounting system and the sales vouchers are printed out.

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4.Billing

(1) Printed-out invoices are forwarded to sales clerks and checked against sales vouchers.

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(Exhibit3)

Risk Control Matrix(Example)

Business	Risks	Contorols	Assertion						Evaluation	Comment
			Existence or Occurrence	Completeness	Rights and Obligations	Valuation	Allocation	Presentation and Disclosu		
Order	Entry of wrong amounts for orders	Order entry clerks in the sales department check “order confirmations” and “shipping instructions” against “order forms”. All “order forms” and “shipping instructions” have been approved by sales managers.	○	○					○	–
Order	Receipt of orders exceeding the credit limit	Order entry is effective only for orders that match customers’ registered conditions.				○			○	–
・ ・ ・										
Shipping	Shipping of a smaller number of goods than requested	Shipping clerks check whether the numbers of goods correspond to those in shipping instructions.	○		○				△	Shipping clerks could not respond to irregular shipping.
Shipping	Goods are not shipped as scheduled in the shipping instruction	The dates in shipping instructions are checked against the dates in shipping reports.					○		○	–
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III. Audit on Internal Control Over Financial Reporting

1. Objective of the Internal Control Audit

The objective of an audit of the management's assessments of the effectiveness of Internal Control Over Financial Reporting ("Internal Control Audit" hereinafter) by an external auditor of financial statements is to have external auditors express their opinions, based on audit evidence obtained by themselves, as to whether the management's Internal Control Report fairly states the results of the assessment, in all material respects, in accordance with generally accepted assessment standards for internal control.

Such opinions on the Internal Control Report are expressed in the Audit Report on Internal Control Assessment ("Internal Control Audit Report" hereinafter).

Unqualified opinions expressed by external auditors include the judgment that they have obtained reasonable assurance that the Report does not include any material misstatements.

The "reasonable assurance" means that external auditors have obtained sufficient competent evidence to express such opinions.

[Objective of Internal Control Audit]

The objective of the Internal Control Audit based on this guideline is to have external auditors express their opinions as to whether the management's Internal Control Report is fairly stated, in all material respects, in accordance with generally accepted assessment standards for internal control.

In other words, in the Internal Control Audit, external auditors express their opinions on the management's assertions, which are expressed in the assessment results of the effectiveness of internal controls. They do not directly evaluate the design and operating effectiveness of internal controls, aside from those relating to the management's assertions.

Note: In the United States, in addition to the Internal Control Audit stated above, companies currently adopt direct reporting, which is not adopted in Japan.

However, external auditors need to obtain sufficient competent audit evidence to form the basis for expressing their opinions in the Internal Control Audit; therefore, to that extent, they shall obtain audit evidence directly from companies, etc.

[Understanding and Respecting Management's Assessments of Internal Controls Over Financial Reporting]

In the Internal Control Audit, external auditors express their opinions on the management's assertions, which are expressed in the results of the internal control effectiveness assessment. In this assessment by the management of the effectiveness of internal controls, the management is expected to verify the design and operation of internal controls, while designing its own appropriate methods corresponding to each company's situation.

The external auditor should perform the Internal Control Audit based on the content and intent of standards and practice standards of internal controls, appropriately understanding and respecting the internal control assessment methods which take into account the company's situation according to the management environment. Keep in mind that different audit procedures and techniques determined by each external auditor should not be automatically forced on the management.

(Note) Keep in mind that unless the external auditor uses management's assessment results, he/she is not required to specifically verify the management's assessment methods.

However, in performing an Internal Control Audit of a smaller and less-complex organization, etc., the external auditor should consider that there may be large restrictions on the allocation of business resources to the construction and assessment of internal controls of that organization, etc. Keep in mind that the external auditor should provide appropriate advice in response to inquiries from the management, especially for effective and efficient establishment and assessment of internal controls, while maintaining the effectiveness thereof.

2. Relationship between the Internal Control Audit and the Financial Statement Audit

The Internal Control Audit and the Financial Statement Audit are, in principle, performed integrally by the same external auditor. The audit evidence obtained in the process of the Internal Control Audit may be used as audit evidence for the Financial Statement Audit, and vice versa.

Notes:In this context, "the same external auditor" means not only the same audit firm but also the same engagement partner that conducts the audit.

Generally, when internal control over financial reporting is ineffective due to material weaknesses, for the purpose of the Financial Statement Audit, the external auditor cannot apply sampling testing where he/she relies on Internal Control in accordance with the Audit Standards.

In performing the Internal Control Audit, external auditors must comply with not only the standards in this guideline, but also with general standards under the "Audit Standards" and "Quality Control Standards for audit."

[Integration of Internal Control Audit with Financial Statement Audit]

The integration of the internal control audit with the financial statement audit may achieve effective and efficient audit execution, by using the same audit evidence in both audits. Therefore, in principle, it shall be performed by the same external auditor who performed the company's financial statement audit (not only the same audit firm, but also the same engagement partner).

Consequently, the external auditor should sufficiently understand the situation of the management's design, operation and assessment of internal controls corresponding to each company's environment, and effectively and efficiently integrate execution of the internal control audit with the financial statement audit, while considering the audit materiality.

Also, when attesting the management's assessment of internal controls, the external auditor may usually obtain certain audit evidence in the financial statement audit execution procedure. In this case, keep in mind that this audit evidence can also be used in the internal control audit.

For example, if the external auditor uses internal or external IT experts, etc. in the Financial Statement Audit, keep in mind that audit documentation prepared by those experts can be used as audit evidence for the Internal Control Audit.

[Restriction concerning the Simultaneous Provision of Internal Control Audit Service and Non-audit Certification Services]

It should be noted that external auditors who conduct the internal control audit service must not have any positional or financial interests that are prohibited under relevant laws, and that simultaneous provision of certain non-audit certification services shall be restricted.

However, in the course of the internal control audit, external auditors should report identified control deficiencies (including material weaknesses) to the management and request remediation. In the course of establishing the internal control system, they are not prohibited from exchanging opinions with the management or other parties as needed, or from providing appropriate suggestions towards the establishment of an effective internal control system, if the company or the management, not external auditors, implements relevant tasks and makes necessary decisions.

3. Audit Planning and the Scope of Assessment

(1) Audit Planning

External auditors must establish the audit plan based on the audit materiality, considering the company's environment, business characteristics and others and fully understanding the status of the management's design, operation and assessment of internal controls.

External auditors must update the audit planning on a timely basis, by performing procedures including the assessment of the improvement of internal controls, when there have been changes in the events or circumstances based upon which the plan was developed or when control deficiencies (including material weaknesses) have been identified in the audit process.

In order to perform the Internal Control Audit effectively and efficiently, external auditors must establish the audit plan, based on the audit materiality, by considering the company's environment, business characteristics and others and fully understanding the status of the management's design, operation and assessment of internal controls.

The Internal Control Audit and the Financial Statement Audit are, in principle, performed by the same external auditors. External auditors shall therefore be required to establish an internal control audit plan as a part of the financial statement audit plan.

[1]. Understanding the company's environment, business characteristics and others

External auditors should understand the company's environment, business characteristics and others, including:

- market, business partners, shareholders, parent company, regional characteristics, restrictions inherent to the industry and other conditions existing outside the company; and
- history, size, line of business, employee makeup and other conditions existing inside the company.

However, external auditors are usually considered to have gained an understanding of such information in the course of the Financial Statement Audit. In that case, they are not required to perform special procedures.

[2]. Understanding of the status of the design and operation of internal controls

External auditors should, by reviewing records, querying the management and appropriate managers or responsible personnel, or through other procedures, understand the status of the design and operation of the company's internal controls, including, for example, the following.

- Knowledge of the company's internal control over financial reporting
- Whether or not there have been any changes recently to the company's business or internal control over financial reporting
- The status of locations or business units within the company group, in regard to records and retention of the information on internal control over financial reporting and implementation of monitoring activities

[3]. Understanding the management's assessment of internal controls

External auditors should, by reviewing records, querying the management and appropriate managers or responsible personnel, or through other procedures, understand procedures and plans for the management's assessment of internal control over financial reporting effectiveness, including, for example, the following.

- Contents and timing of significant procedures such as the determination of the scope of assessment
- The status of the establishment of criteria for judging whether the magnitude of control deficiencies constitute material weaknesses or not
- Whether or not there are any control deficiencies or material weaknesses already reported to the management, corporate auditors or audit committee or board of directors, and if any, their details
- Results of the procedures performed through internal audits, etc.

Paragraphs [2] and [3] above do not preclude external auditors from using certain information they have obtained in the course of the Financial Statement Audit.

[4]. Audit planning

For the purpose of effective and efficient audit, external auditors should develop the audit planning by considering the information specified in Paragraphs [1] – [3] above and the audit results of the previous year and focusing on the risk of misstatements in significant components of financial reporting.

External auditors should update the audit planning accordingly when there have been changes to the events or circumstances based on which the plan was developed or when any significant factors have been newly identified in the audit process.

(2) Evaluation of the Appropriateness of the Scope of Assessment

External auditors must evaluate the reasonability of the methods and grounds used by the management, in order to verify the adequacy of the scope of assessment determined by the management.

In the case when the management has prepared an Internal Control Report that excludes a certain scope of internal controls for which sufficient assessment procedures could not be performed due to unavoidable circumstances, it is particularly important that external auditors fully evaluate whether the reasons for the management's exclusion of the scope are justified and the impact of the exclusion on the financial statements.

[1]. Selection of significant locations or business units

External auditors should understand the process of the management's determination of significant locations or business units to be included in the scope of assessment, and review whether the management has adequately selected significant locations or business units based on Chapter II, "Assessment and Report on Internal Control Over Financial Reporting."

The following are examples of the procedures that external auditors should perform for the aforementioned purposes.

- Obtain a full list of all locations and business units of the company on a consolidated basis, including subsidiaries, affiliates, etc.
- Locations and business units may be classified into headquarters, subsidiaries, local offices, branches, business units, etc. according to the company's situation. In such cases, external auditors should confirm the adequacy of the methods and results of such classification
- Basic criteria for the selection of significant locations or business units may be the amount of sales and other factors. External auditors should evaluate whether the criteria adopted by the management are appropriate by referring to Chapter II, "Assessment and Report on Internal Control Over Financial Reporting."
- Confirm whether significant locations or business units have been appropriately selected according to the criteria adopted by the management;
- When judging that the process or the result of the management's selection of significant locations or business units is inappropriate, report to the management, and require the management to perform additional procedures corresponding to the degree of impact on financial reporting, such as re-selection of the significant locations or business units.

[2]. Identification of business processes to be assessed

A. Business processes of significant locations or business units that relate to the company's business objectives

External auditors should confirm, for significant locations or business units, whether their business processes related to significant accounts that have material impact on the company's business objectives (sales, accounts receivable, inventory and other accounts) are appropriately included in the scope of assessment, in accordance with Chapter II, "Assessment and Report on Internal Control Over Financial Reporting."

If there are any business processes excluded from the scope of assessment as a result of the management's conclusion that they only have remote association with significant locations or business units and therefore have immaterial impacts on the financial reporting, external auditors should confirm whether the management's conclusion is appropriate or not.

External auditors should evaluate the appropriateness of the management's selection of the business processes to be included in the scope of assessment by reviewing the internal control records described in Section 3(7)[1], C to F, of Chapter II, "Assessment and Report on Internal Control Over Financial Reporting" and querying the management and appropriate managers or responsible personnel, or through other procedures.

If external auditors judge that the management's selection of the business processes to be included in the scope of assessment is not appropriate, they should report to the management, and require the management to perform additional procedures corresponding to the degree of impact on financial reporting, such as re-selection of such business processes.

B. Business processes that have a significant impact on financial reporting

When business processes in significant locations or business units have a significant impact on financial reporting, external auditors should confirm whether such business processes are appropriately included in the additional scope of assessment, in accordance with Chapter II, "Assessment and Report on Internal Control Over Financial Reporting."

In the confirmation, external auditors may perform procedures including reviewing the internal control records described in Section 3(7)[1], C to F, of Chapter II, "Assessment and Report on Internal Control Over Financial Reporting," querying the management and appropriate managers or responsible personnel, or other procedures. However, they should note that if they have already examined the existence of business processes that have a significant impact on the financial reporting while in the process of the Financial Statement Audit, the result of such an examination may be used.

If external auditors judge that the management's selection of the business processes to be included in the scope of assessment is not appropriate (e.g. inadequate identification of high-risk businesses or business operations), they should report to the management, and require the management to perform additional procedures corresponding to the degree of impact on financial reporting, such as re-selection of business processes to be assessed.

C. Adjustment of the scope, method, etc. of assessment, based on the assessment results of company-level controls

In the case where the management has adjusted the scope, method, etc. of the assessment of business processes based on the assessment results of company-level controls (refer to Section 3(2)[3] of Chapter II, “Assessment and Report on Internal Control Over Financial Reporting”), external auditors should evaluate the appropriateness of such adjustment by reviewing the internal control records described in Section 3(7)[1], C to F, of Chapter II, “Assessment and Report on Internal Control Over Financial Reporting,” querying the management and appropriate managers or responsible personnel, or through other procedures.

If external auditors judge that the management’s adjustment is not appropriate, they should report to the management, and require the management to perform additional procedures corresponding to the degree of impact on financial reporting, so that the scope of assessment, method, etc. would be adequately readjusted.

[3]. Communication with the management

When the scope of assessment determined by the management is judged as inappropriate as a result of the evaluation performed by external auditors, the management shall be required to perform reassessment procedures over the new scope of assessment. However, the reassessment procedures may be difficult due to the limited timeframe. Therefore, after the management has determined the scope of assessment, external auditors, if necessary, should communicate with the management regarding the methods, grounds, etc. based on which he or she has determined such scope.

4. Performance of the Internal Control Audit

(1) Evaluation of the Assessment of Company-Level Controls

> External auditors must evaluate the appropriateness of the management's assessment of company-level controls.
> In the evaluation, external auditors must fully consider the status of the design and operation of internal controls at the management level, including the board of directors, corporate auditors or audit committee, internal auditors, etc.

External auditors should obtain a general understanding of company-level controls and evaluate the appropriateness of the management's assessment, taking into consideration, for example, the assessment items listed in Exhibit 1, "Examples of Assessment Items for Company-Level Controls over Financial Reporting" of Chapter II, "Assessment and Report on Internal Control Over Financial Reporting."

[1]. Evaluation of the status of the design and operation of company-level controls

In evaluating the design status of company-level controls, external auditors should review the appropriateness of the assessment items adopted by the management by referring, for example, to the assessment items shown in Exhibit 1 above ("Examples of Assessment Items for Company-Level Controls over Financial Reporting"). In the process, external auditors should evaluate the appropriateness of the assessment results of the management, by confirming the result for each assessment item and the grounds based on which the results were obtained, by reviewing the internal control records described in Section 3(7), A and B, of Chapter II, "Assessment and Report on Internal Control Over Financial Reporting," querying the management and other personnel, etc., or through other procedures.

Regarding some items under the "control environment" category, however, it is sometimes the case that the information on the operation of internal controls is not recorded. In such cases, external auditors should assess the operation of internal controls through inquiries to relevant persons or observations.

[2]. Evaluation of monitoring functions performed by the board of directors and corporate auditors or audit committee

The management has the ultimate responsibility for the preparation and release of the Annual Securities Report and other financial reporting documents. However, the board of directors and corporate auditors or audit committee plays an important role in the appropriate disclosure of information by performing monitoring functions in the process from the preparation to the release of such documents. When evaluating the status of the design and operation of company-level controls, it is therefore important that external auditors assess the monitoring functions performed by the board of directors and corporate auditors or audit committee regarding, for example, the following points.

A. Are there any rules in place that set out the responsibilities of the board of directors, corporate auditors or audit committee?
B. Are there any records or minutes of the meetings of the board of directors, corporate auditors or audit committee?
C. Do the members of the board of directors, corporate auditors or audit committee understand and properly fulfill their responsibilities to adequately supervise and monitor the management, in order to perform the monitoring functions over the design and operation of internal controls?
D. Do corporate auditors or the audit committee maintain an appropriate level of cooperation with internal and external auditors?

External auditors should note that if they, as is generally expected, have obtained certain audit evidence in the process of the Financial Statement Audit, they may use such audit evidence for [1] and [2] above.

[3]. Evaluation of deficiencies in company-level controls

External auditors, when identifying deficiencies in company-level controls, should carefully consider their likelihood of causing a significant impact on the financial reporting, including their impact on process-level controls, and verify the appropriateness of the management's assessment.

When determining whether deficiencies in company-level controls constitute material weaknesses, descriptions in Section 3(4)[1] "Judgment of the effectiveness of company-level controls" of Chapter II, "Assessment and Report on Internal Control Over Financial Reporting" should be taken into account.

(2) Evaluation of the Assessment of Process-Level Controls

External auditors must evaluate the appropriateness of the management's assessment of process-level controls. In the evaluation, external auditors must evaluate whether the management has appropriately selected key controls, considering the status of the management's assessment of company-level controls and with a full understanding of the company's business processes. In order to judge whether basic components of internal controls are properly functioning in regards to each key control assessed by the management, external auditors must obtain audit

evidence for key audit objectives such as existence or occurrence, completeness, rights and obligations, valuation, allocation and presentation and disclosure.

In evaluating the effectiveness of basic components of process-level controls, external auditors must also fully evaluate the status of the design and operation of internal controls (including response to IT).

[1]. Evaluation of the assessment of process-level controls

External auditors should understand the status of the design and operation of process-level controls which have been included in the scope of assessment, and evaluate the appropriateness of the management's assessment.

A. Evaluation of the status of the design of process-level controls

External auditors should understand the status of the design of process-level controls that have been included in the scope of assessment. For that purpose, external auditors should obtain the records described in Section 3(7)[1], C to F of Chapter II, "Assessment and Report on Internal Control Over Financial Reporting" and perform, for example, the following procedures regarding business processes that have been included in the scope of assessment.

a. Understand the flow of transactions in the business processes that have been included in the scope of assessment (including how transactions are initiated, authorized, recorded, processed and reported), by reviewing the obtained records regarding the status of the design of internal controls, querying the management and appropriate managers or responsible personnel or through other procedures. External auditors should also understand the accounting process from the origination of transactions such as computing, journalizing, etc. When it is difficult to understand the status of the design of internal controls by the review of records, inquiries, etc., external auditors should conduct on-site observations at the location of the business processes, in order to determine the appropriateness of the procedures performed in such business processes.

b. External auditors should note that, for the purpose of ensuring an accurate understanding of the status of internal control design, it is useful for them to select one or more typical transactions of each business process included in the scope of assessment, and trace the business flow from their origination to their recording in financial statements, according to the records on internal controls described in Section 3(7)[1], C to F of Chapter II, "Assessment and Report on Internal Control Over Financial Reporting," etc.

External auditors should also consider whether the appropriate manager or responsible personnel for internal controls has the authority or competencies necessary for the design of internal controls.

c. Understand how the management identified the risk of misstatements in the significant components of financial reporting, by reviewing the obtained records concerning the status of the design of internal controls, querying the management and appropriate manager or responsible personnel, or through other procedures.

d. Understand how the management identified key controls that perform a pivotal role in mitigating the risk of misstatements, by reviewing the obtained records on the status of the design of internal controls, querying the management and appropriate manager or responsible personnel, or through other procedures.

e. Evaluate whether the key controls described under d. above are designed to mitigate the risk of misstatements in significant components of financial reporting sufficiently if they are operated in accordance with prescribed policies. This should be evaluated based on the judgment of whether they provide reasonable assurance for securing requirements for the creation of appropriate financial information, such as existence or occurrence, completeness, rights and obligations, valuation, allocation and presentation and disclosure. Based on this judgment, external auditors should evaluate the appropriateness of the management's assessment of the effectiveness of the internal control design.

External auditors should note that if they, as is usually expected, have obtained certain audit evidence in the process of the Financial Statement Audit, they may use such audit evidence for the evaluation of the status of the internal control design stated above.

Also, the external auditors should keep in mind what is stipulated in 3.(7)[1] of II. Assessment and Report on Internal Control Over Financial Reporting: “Especially for smaller and less-complex organizations, etc., there could be various formats and methods of records. Keep in mind that it is sufficient to suitably use and supplement records as needed. For example: internal notices from the company’s management; questionnaires that the company’s management prepared for people within and outside the organization, documents in which predecessors describe to successors the content of operations; documents prepared when salespeople receive orders; software manuals; original documents such as vouchers and receipts; and shipping instructions output from a sales management system after orders are input, etc.” (Same hereinafter in Practice Standards “III. Audit on Internal Control Over Financial Reporting”)

B. Evaluation of the status of the operation of process-level controls

Concerning business processes which have been included in the scope of assessment, external auditors should evaluate the management’s assessment of the effectiveness of the operation of internal controls, judging whether they are appropriately operated as designed and whether the manager or responsible personnel performing internal controls has the authority and competencies necessary for fulfilling the task.

a. Details and methods of the evaluation of the operation

External auditors must understand the status of the operation of process-level controls included in the scope of assessment. For that purpose, external auditors should obtain the records on the management's operation of internal controls described in Section 3(7)[1] of Chapter II, "Assessment and Report on Internal Control Over Financial Reporting" and evaluate the operation of internal controls (including the status of self-assessment), by reviewing relevant records, querying appropriate managers or responsible personnel, or through other procedures.

When it is difficult to evaluate by the review of records, inquiries, etc., external auditors should observe business operations or have appropriate managers or responsible personnel re-perform the procedures, if necessary.

The procedures above are, basically, performed by obtaining appropriate evidence through the conduct of tests using samples selected by external auditors themselves (for example, in the case of repetitive daily-routine transactions, at least 25 samples for each key control in the scope of assessment would be necessary, in order to achieve a reliability rate of 90% based on the binominal statistical distribution).

In the process, if, for example, the management has randomly selected samples from repetitive routine transactions, it would not be efficient for external auditors to select other samples through the same approach. In such cases, external auditors may reuse the samples selected by the management as part or all of the samples they themselves have selected for each internal control selected as a key control, after evaluating their adequacy and verifying a portion of the results of the tests conducted by the management. For those samples, the management's assessment can also be used as audit evidence, after verifying the adequacy of the management's assessment methods, and verifying part of the management's work results.

In assessing the operation of process-level controls which were indicated as effective by the results of the previous fiscal year's assessment of internal controls, if there are no items which should be additionally verified, e.g. no significant changes in the design of those process-level controls, then consider performing efficient procedures, such as using the management's assessment results and the sample selected in the management's assessment.

Also keep in mind that for a smaller and less-complex organization, etc., there are situations in which efficient investigation of operations is possible. For example, to verify the implementation situation of internal controls, use the results of daily direct monitoring by the management, and results of internal controls verification by the external auditor (e.g. reports which summarize results of visiting audits such as onsite inspections of inventory).

b. Timing of the evaluation of the operation

External auditors should evaluate the status of the operation of internal controls at an appropriate time in order to assess whether internal controls are effectively operating as of the fiscal year end date. When to evaluate the status of the operation of internal controls may vary depending on the nature of the internal controls to be evaluated and the frequency at which the internal controls is performed.

When significant changes are made to internal controls during the period from the management's assessment date to the fiscal year end date, external auditors should confirm whether the management has performed the additional procedures necessary to understand and assess the design and operation of internal controls after the change according to Chapter II, "Assessment and Report on Internal Control Over Financial Reporting."

Regarding the internal controls over the period-end financial reporting processes, external auditors should note that it is efficient and effective to evaluate its operation status at an early date, based on the previous year's operation, on the premise that appropriate additional procedures would be performed when there are significant changes to the internal controls before the fiscal-year end date. This is because (1) identified deficiencies, if there are any, should be corrected at an early date, so that appropriate period-end financial reporting processes would be secured before the fiscal year end date; and (2) it is considered that the evaluation of the operation of internal controls over the period-end financial reporting processes is largely overlapped with the evaluation process for internal controls in the Financial Statement Audit.

External auditors should note that if they, as is generally expected, have obtained certain audit evidence in the process of the Financial Statement Audit, they may use such audit evidence for a. and b. above.

c. Points to be noted when determining the method of evaluating the operation

External auditors should obtain sufficient and appropriate evidence to evaluate the appropriateness of the management's assessment of process-level controls that have been included in the scope of assessment. The following points should be considered when determining the procedures to perform.

[Nature of the internal controls]

When determining the evaluation method, external auditors should consider (1) the significance and complexity of the internal controls; (2) the significance of judgments made in the course of the operation of the internal controls; (3) the competencies of the person who implements the internal controls; (4) the frequency at which the internal controls are implemented and (5) evaluation results of the previous year and changes made afterward.

[Period-end financial reporting processes]

Internal controls over the period-end financial reporting processes are significant business processes for the achievement of the reliability of financial reporting, and external auditors may be able to evaluate the fewer cases of internal controls over the period-end financial reporting processes, since internal controls over the processes are less frequently implemented. Therefore, the operation of internal controls over the period-end financial reporting processes must be evaluated more carefully than in the case of other internal controls. (Internal controls over period-end financial reporting processes may be assessed either as company-level controls or as specific process-level controls. For details, refer to Sections 2(2) and 3(3)[4]Db of Chapter II, "Assessment and Report on Internal Control Over Financial Reporting.")

[2]. Evaluation of the assessment of IT-based controls

A. Understanding of IT-based controls

External auditors should understand the overview of IT-based controls by obtaining the records on internal controls described in Section 3(7) of Chapter II, "Assessment and Report on Internal Control Over Financial Reporting," at the same time evaluating whether IT general controls and IT application controls included in the management's scope of assessment are appropriate.

When evaluating the effectiveness of the management's assessment of business processes undertaken in companies using IT, external auditors should perform the "[1].Evaluation of the assessment of process-level controls" stated above for the manually performed controls, and evaluation of the assessment of IT general controls and IT application controls stated hereinafter for the IT-based controls.

B. Evaluation of the assessment of IT general controls

External auditors should understand IT general controls and evaluate the appropriateness of the management's assessment. In the process, external auditors should consider, for example, the following items.

a. System development, modification and maintenance

When the company develops, procures or modifies the system or software associated with the financial reporting, external auditors should check whether the proper approval has been obtained and pre-implementation tests have been adequately carried out.

In the process, external auditors should note, for example, the following points.

- Prescribed approval has been obtained in advance from the management or appropriate managers, for the development, procurement or modification of the system or software.

- Development methods suitable for the development objectives are applied in the development, procurement or modification of the system or software.
- When implementing the new system or software, sufficient tests have been conducted and their results have been approved by appropriate managers of the user department and IT department.
- The process of developing, procuring or modifying the new system or software should be appropriately recorded and retained. In the case of modification, records on the status of internal control design over the old system or software must be updated.
- Before data is stored in or transferred to the new system or software, measures to prevent errors, fraud, etc. must be taken.
- Before the introduction of the new system or software, employees who use the system or software must have received education and training based on the appropriate planning.

b. System operation and administration

External auditors should verify the effectiveness of the operation and administration of the system relating to the financial reporting. In the process, external auditors should consider, for example, the following points.

- To deal with data loss or other problems due to malfunctions, failures, etc., critical data or software constituting the system should be backed up, and measures for the prompt recovery should be taken.
- In the case of malfunctions, failures, etc. of the system or software, adequate responses should be taken for such matters as the identification, analysis, and solution, etc. of such problems.

c. System security

External auditors should verify whether the company has established appropriate access control and other policies, in order to prevent unauthorized use, falsification, destruction, etc. of data, the system, software and others relating to the financial reporting.

d. Outsourcing contract management

When the company outsources its IT-based processes related to the financial reporting to a third party, external auditors should evaluate whether the company is appropriately managing the outsourcing contracts.

External auditors should note that if they, as is generally expected, have obtained certain audit evidence in the process of the Financial Statement Audit, they may use such audit evidence for a to d above. It should also be noted that companies using relatively simple systems such as uncustomized packaged software should place larger importance on IT general controls.

C. Evaluation of the assessment of IT application controls

External auditors should evaluate the assessment of the design and operation of IT application controls, according to, for example, the following procedures.

a. External auditors should review system specifications or other records to confirm that the system has been properly developed to perform the accounting procedures that the company had intended.

b. In the process, external auditors should take into consideration, for example, the following assessment items, which are described in Section 3(3) of Chapter II, “Assessment and Report on Internal Control Over Financial Reporting”.

- Are measures taken to ensure the completeness, accuracy, validity, etc. of entry information?
- Are erroneous data appropriately corrected and reprocessed?
- Are master data on suppliers, customers and others appropriately maintained and managed?
- Are there appropriate access control measures, including user authentication and limitation of the operation range?

c. External auditors should review the operation of application controls.

External auditors should evaluate the status of the operation of application controls and self-assessment by reviewing the obtained records, etc. described under A. above, querying the appropriate managers or responsible personnel or through other procedures.

In the process, external auditors should: (1) choose some transactions (sampling) for each of the key application controls included in the scope of assessment; (2) compare the input data and output data of such transactions; and (3) check whether the output data is as expected by, for example, recalculating based on the input data.

In such cases, external auditors may utilize the samples selected by the management as part or all of the samples they themselves have selected for each internal control selected as a key control, after evaluating their adequacy and verifying a portion of the results of the tests conducted by the management. For those samples, the management's assessment can also be used as audit evidence, after verifying the adequacy of assessment methods results of the management's assessment, and verifying part of the management's work.

For example, when assessing the operation of IT application controls which were indicated as effective by the results of the previous fiscal year's assessment of internal controls, if there are no items which should be additionally verified, e.g. no significant changes in the design of those application controls, then consider performing efficient procedures, such as using management's assessment results and the sample selected in management's assessment.

Since IT-based controls repeat and continue consistent processing, when their design is evaluated to be effective, their operation can generally be evaluated through simpler evaluation procedures compared to manual controls (i.e., reduction of the number of samples, shortening of the sampling period), on the premise that IT general controls are functioning effectively. External auditors can continuously use the assessment results of the previous years for IT-based automated internal controls, provided that they have confirmed and recorded that (1) no changes have been made to the controls after the last assessment; (2) no failures or errors are occurring and (3) related general controls have been judged to be effectively functioning, as a result of the assessment of their design and operation.

External auditors should note that if they, as is generally expected, have obtained certain audit evidence in the process of the Financial Statement Audit, they may use such audit evidence for the evaluation stated above.

D. Use of IT experts

When planning and conducting an Internal Control Audit, external auditors should determine whether an expert's work should be used or not, considering the degree of IT utilization in the company and the significance of the impact of IT on the assessment of internal control over financial reporting effectiveness. If an expert's work is used, external auditors should consider the professional competence of the expert (i.e. whether he or she possesses not only IT knowledge but also the knowledge necessary to assess the risk of any significant impact on the financial reporting related to the information system), as well as whether the work of the expert possesses adequate objectivity.

[3]. Evaluation of the assessment of outsourced processes

If the processes contracted out by the management to external service organizations constitute a part of a business process included in the scope of assessment, external auditors should examine the effectiveness of internal controls regarding the outsourced processes, by following, for example, the procedures described below.

A. Obtain an understanding of internal controls over outsourced business processes implemented by service organizations, as well as those implemented by the company.
B. In the case when the company implements internal controls over business processes operated by the service organization, review the status of the management's assessment of such internal controls.
C. When the company has obtained reports, etc. on the evaluation performed by the service organization regarding the design and operation of internal controls over outsourced processes, consider whether the reports, etc. provide sufficient evidence.

[4]. Evaluation of deficiencies in process-level controls

When control deficiencies are identified, external auditors should determine whether the deficiencies constitute, either individually or in combination with other deficiencies, material weaknesses, by following, for example, the procedures described below.

A. Determine which account, etc. and to what extent the deficiencies identified in business processes may have impacts on.

When external auditors determine the significance of deficiencies identified in business processes, they should consider which accounts, etc. and to what extent the deficiencies may have impacts on.

For example, when a deficiency is identified in a business process relating to the sales of a certain item, the total sales of the location or business unit would be affected, if such a sales process is pervasively adopted in the location or business unit (for example, when a deficiency is identified in a shipment process of a location or business unit where all shipments are made according to formulated sales procedures). On the other hand, if the problematic business process were peculiar to the sales process of a specified item, the deficiency would only affect the sales of that item.

A deficiency would affect the total sales of all other locations and business units, if the same procedure as the problematic business process is applied pervasively across other locations and business units (for example, in the case when other locations and business units adopt the same sales procedures based on the same narratives, etc. with the location or business unit where the deficiency is identified). However, the ultimate significance of control deficiencies is to be determined by considering the actual occurrence rate of problems in other locations and business units, as is shown in B below.

B. Evaluation of the likelihood of having an actual impact

External auditors should evaluate the likelihood of having an actual impact considered in A. above. The likelihood may be deduced statistically from sampling results. If the deduction is regarded to be difficult, however, external auditors may qualitatively comprehend the significance of risks (e.g. levels of likelihood-high, medium, low) and apply a predetermined ratio respectively, taking into account the points described below.

In such cases, if the likelihood of having an actual impact is judged to be extremely small, it may be excluded from the evaluation.

- Significance and frequency of detected exceptions

  For example, it is judged that the more significant the errors identified in the evaluation through sampling tests, and the more frequently errors are detected, the greater the likelihood of them having an actual impact is.
- Cause of detected exceptions

  For example, an error may occur due to carelessness at a location or business unit where rules related to internal controls are complied with, while an error may occur at a location or business unit where rules related to internal controls are not complied with at all; the likelihood of having an actual impact may be judged lower in the former case than the latter.
- Complementary controls

  For example, if complementary controls are identified, certain control deficiencies may be compensated for by other controls. In such cases, the likelihood of having an actual impact may be reduced.

C. Determination of qualitative and quantitative significance of control deficiencies

External auditors should evaluate the potential quantitative impact of control deficiencies on financial reporting, based on the amounts and likelihood evaluated according to A. and B. above, and then judge their qualitative and quantitative significance in accordance with 1 [2] “Guidelines for determining material weaknesses” of Chapter II, “Assessment and Report on Internal Control Over Financial Reporting.” If deficiencies in business processes have a significant qualitative or quantitative impact, they should be judged as material weaknesses.

When there are multiple deficiencies, whether or not they constitute material weaknesses should be judged by aggregating their quantitative impact (without duplicating amounts).

D. Treatment of deficiencies in IT general controls over IT-based controls

IT general controls over IT-based controls are control activities to ensure an environment that supports the effective operation of IT application controls. If deficiencies exist in general controls, they may prevent continuous and effective operation of application controls, even if they have been designed to function effectively. Therefore, deficiencies identified in general controls must be improved immediately.

However, deficiencies in IT general controls are not necessarily directly related to the risk of misstatements in significant components of the financial reporting. Accordingly, it should be noted that if application controls have been verified to be functioning effectively, deficiencies in general controls should not immediately be judged as material weaknesses.

(3) Reporting and Remediation of Material Weaknesses in Internal Controls

When identifying material weaknesses in internal controls in the course of the Internal Control Audit, external auditors must report such material weaknesses to the management, request remediation, and assess the remediation status on a timely basis. External auditors must also report the details of such material weaknesses and the remediation results to the board of directors, corporate auditors or audit committee.

External auditors must report to appropriate personnel when identifying deficiencies in internal controls.

External auditors must report the results of the Internal Control Audit to the management, board of directors, corporate auditors or audit committee.

Note: External auditors may be required to report the material weaknesses in internal controls identified in the course of the Internal Control Audit to the management, board of directors, corporate auditors or audit committee by the final date of the Companies Act Audit.

[1]. Report of material weaknesses and others

[Report of material weaknesses and others identified in the course of an Internal Control Audit]

If external auditors identify material weaknesses in the course of an audit, they should report the details of the material weaknesses to the management and request for their remediation. They should also report to the board of directors and corporate auditors or audit committee that they have reported the details of the material weaknesses to the management.

When external auditors identify deficiencies other than material weaknesses over financial reporting in the process of the audit, even though they are not required to do so proactively, they should also report such deficiencies to appropriate managers on a timely basis.

In the reporting, external auditors must clarify whether the deficiencies are classified as control deficiencies or material weaknesses. However, if they find it necessary, they may immediately report the deficiencies without clear classification and report such classification at a later time.

[2]. Evaluation of the remedial status of material weaknesses

[Examination of the remedial status of material weaknesses identified during the fiscal year]

When identifying material weaknesses in internal controls in the course of the audit, external auditors must report them to the management, request for their remediation, and assess the remedial status on a timely basis.

Even if the management or external auditors identify material weaknesses in the course of an audit, internal controls can be judged effective, if such material weaknesses, including those identified in the previous year or earlier, have been remediated by the assessment date (the fiscal year end date) specified in the Internal Control Report.

External auditors must also report the results of the remediation of material weaknesses to the board of directors and corporate auditors or audit committee.

If remedial actions have been taken before the assessment date (the fiscal year end date), external auditors should evaluate the appropriateness of the management's assessment of such remedial actions.

[3]. Remedial actions taken after the fiscal year end date

A. Evaluation of remedial actions taken after the fiscal-year end

If the supplementary information on remedial actions taken after the fiscal year end date is added to the Internal Control Report, external auditors should perform, for example, the following procedures to evaluate the appropriateness of such information.

a. Obtain and examine internal approval documents, etc. on such remedial actions.
b. Query officers, etc. in charge of finance, accounting and other relevant departments about the details of the remedial actions.
c. If remedial actions have been taken in consolidated subsidiaries, etc., which are audited by other external auditors, ask such auditors their views on such remedial actions.

B. Additional information on remedial actions taken after the fiscal year end date

If external auditors conclude that the supplementary information on remedial actions taken after the fiscal year end date that the management added to the Internal Control Report is appropriate, they should add it as additional information to the Internal Control Audit Report.

If external auditors conclude that the information on the remedial actions is not appropriate, they should express a qualified opinion with exceptive items, or express an adverse opinion that the statement in the Internal Control Report is inappropriate with relevant reasons.

If it has been confirmed that internal controls have been effectively designed and operated before the issue date of the Internal Control Report, the management shall state in the Report the details of the remedial actions and that such actions have been completed. In such cases, external auditors should evaluate the appropriateness of such information stated by the management.

However, external auditors should note that if they have already obtained certain audit evidence for the management's information stated above in the course of the Financial Statement Audit, they may use such audit evidence accordingly.

(4) Reporting of Fraud and Others

When identifying frauds or significant illegal facts in the course of an Internal Control Audit, external auditors must report it to the management, the board of directors and corporate auditors or the audit committee and request the appropriate remediation, at the same time evaluating their impact on the effectiveness of internal controls.

When identifying fraud or an illegal fact in the course of an Internal Control Audit, external auditors must report it to the management, board of directors and corporate auditors or audit committee on a timely basis, and request for the appropriate remediation. External auditors should evaluate their impact on the effectiveness of internal controls and, if judging the fraud or illegal fact to constitute control deficiencies or material weaknesses, should take the measures described under (3) above.

(5) Coordination with Corporate Auditors or Audit Committee

External auditors should determine the scope and degree of coordination with the corporate auditors or audit committee, in order to perform effective and efficient audits.

External auditors are required to determine the scope and degree of coordination with the corporate auditors or audit committee, in order to perform effective and efficient audits. The method and timing of the coordination and the information and opinions to be exchanged should be determined based on the agreement with corporate auditors and other parties, in accordance with the condition of the audit company, etc.

(6) Use of Other Auditors, etc.

When using the results of the Internal Control Audit performed by other auditors, external auditors must assess the appropriateness of such results and accordingly determine the degree and method of using them, considering their significance and the reliability of other auditors.

External auditors must evaluate the status of the internal audit performed by the company, which is a part of its monitoring activities that comprise the basic components of internal controls, and decide the scope and degree of its use.

[1]. Use of other auditors

The appropriateness of the use of other auditors should be determined based on the generally accepted financial statement audit standards.

External auditors may use the audit results of overseas subsidiaries performed by other auditors under non-Japanese internal control audit standards, when they are judged to be substantively equivalent to those performed under Japanese internal control audit standard.

[2]. Use of the work of experts

The appropriateness of the use of work of experts in an audit on internal control over financial reporting should also be determined based on the generally accepted financial statement audit standards.

[3]. Use of the work of internal auditors, etc.

A. Evaluation of the work of internal auditors, etc.

When internal auditors, etc. have performed the assessment of the effectiveness of internal controls, external auditors cannot use their work as a substitute for their own assessment, but may use such work as audit evidence for the management's assessment, provided that they have evaluated the quality and effectiveness of the work of internal auditors.

B. Procedures to be performed in evaluating the work of internal auditors, etc.

When evaluating the quality and effectiveness of the assessment work of internal auditors, etc., external auditors should perform, for example, the following procedures.

a. Evaluation of the competence and objectivity of the person who performed the assessment work

External auditors should assess whether the person who performed the assessment work has adequate technical competence and maintains objectivity with respect to the business operations assessed.

b. Evaluation of a portion of the assessment work

External auditors should evaluate a portion of the assessment work performed in internal audits, etc., in order to determine their quality and effectiveness.

5. Auditor's Report

(1) Exceptions to Opinions

[1] When external auditors identify inappropriate parts in the Internal Control Report regarding the scope, procedures and results of the assessment determined by the management, and judge that the impacts are significant to the extent that the external auditors may not be able to express an unqualified opinion, but not significant to the extent that the Internal Control Report is misstated as a whole, they should express a qualified opinion with exceptive items. In such cases, a separate section must be established, and the inappropriate parts that have been excluded and their impact on the Financial Statement Audit must be described in the external auditors' opinion on the Internal Control Report.

[2] When external auditors identify remarkably inappropriate parts in the Internal Control Report regarding the scope, procedures and results of the assessment determined by the management, and judge that the impacts are significant that the Report is misstated as a whole, they must express an opinion that the Internal Control Report is not fairly stated. In such cases, a separate section should be established, and the fact that the Report is not fairly stated, relevant reasons and its impact on the Financial Statement Audit should also be described.

[Expression of a qualified opinion]

When external auditors identify inappropriate parts regarding the scope, procedures or assessment results determined by the management, and judge that their impacts are significant to the extent that the external auditors may not be able to express an unqualified opinion, but not significant to the extent that the Internal Control Report is misstated as a whole, they should express a qualified opinion.

For example, it applies to the case when external auditors conclude that the management's assessment that there are material weaknesses in internal control over financial reporting is appropriate, but at the same time conclude that the management's statement in the Internal Control Report regarding the remedial actions taken after the fiscal year end date is not appropriate.

(2) Limitation of the Scope of Assessment

[1] When external auditors cannot express an unqualified opinion because they were unable to perform some of the important audit procedures, etc., they must express a qualified opinion with exceptive items, unless they judge that the impact is significant to the extent that they cannot express any opinion on the Internal Control Report as a whole. In such cases, external auditors must establish a separate section, and state the audit procedures that could not be performed in the summary of the audit performed, and its impact on the audit procedures, etc. and Financial Statement Audit in their opinion on the Internal Control Report.

[2] External auditors must not express any opinions on the Internal Control Report as a whole when they have not been able to obtain a reasonable basis for expressing opinions as a result of not being able to perform some of the important audit procedures, etc. In such cases, external auditors should establish a separate section, and state the fact that they do not express their opinion on the Internal Control Report and relevant reasons.

[External auditors' treatment of limitation of the scope of assessment]

If, due to “unavoidable circumstances,” sufficient assessment procedures could not be performed for a certain part of the internal controls, external auditors should carefully examine whether the reasons are justified. If external auditors conclude that the management’s assessment of internal control over financial reporting is fairly stated in all material respects in accordance with generally accepted assessment standards for internal control, except for the scope for which sufficient assessment procedures could not be performed due to unavoidable circumstances, they should express an unqualified opinion in the Internal Control Audit Report. In such cases, external auditors should add in the Internal Control Audit Report the scope that the management excluded from the scope of assessment due to unavoidable circumstances and relevant reasons.

If external auditors conclude that the reasons for the management not performing a part of the assessment procedures are justified and express an unqualified opinion, they should consider the following points.

A. The management’s assessment of internal control over financial reporting effectiveness is fairly stated in all material respects, except for certain controls for which the assessment procedures could not be performed due to unavoidable circumstances

B. The impact of not performing sufficient assessment procedures due to unavoidable circumstances is not so significant as to constitute material weaknesses in the reliability of financial reporting.

(3) Additional Information

External auditors should create an Emphasis and Matter paragraph in the Internal Control Audit Report that includes the following matters which they judge appropriate for emphasis:

[1]. The fact that there are material weaknesses and their impact on the Financial Statement Audit, if the management has written in the Internal Control Report a description of material weaknesses in internal controls over financial reporting and the reasons why they have not been remediated
[2]. Subsequent events that would have a material impact on the assessment of internal control over financial reporting effectiveness;
[3]. Remedial and other actions taken after the fiscal year end date;
[4]. The scope for which sufficient assessment procedures could not be performed and relevant reasons, when external auditors judge that the management could not perform a certain part of the assessment procedures due to unavoidable circumstances and therefore express an unqualified opinion.

[Subsequent Events to be described in the Internal Control Report]

External auditors should examine whether there have been any subsequent events that may have a significant impact on the effectiveness of the assessment of internal control over financial reporting; and if there are any subsequent events that need to be described in the

Internal Control Report, external auditors should examine whether they are appropriately described.

The following are examples of procedures to examine whether there are any significant subsequent events.

A. Query financial and accounting officers about whether any events that should be recognized as significant subsequent events have occurred.

B. Review minutes of important meetings of the shareholders and board of directors, corporate auditors and managing directors, etc. held after the year-end closing date. If such minutes are not available, make inquiries about the matters discussed in the meetings.

External auditors should note that if they, as is generally expected, have already identified significant subsequent events in the process of the Financial Statement Audit, they may accordingly use such audit evidence obtained in the Financial Statement Audit with respect to the significant subsequent events.

(Reference Drawing 1)

Process of Establishing Internal Control Over Financial Reporting

1. Determination of Basic Planning and Policies

The management should determine basic planning and policies for the implementation of company-level controls and process-level controls over financial reporting, according to the determination made by the board of directors regarding basic policies for internal controls.

※The management should determine, for example, the following basic planning and policies.

[1]. Policies, principles, the scope and level of internal controls to be established

[2]. Responsible personnel and company-level management system for the establishment of internal controls

[3]. Procedures and schedule for the establishment of internal controls

[4]. Personnel to be involved in the establishment of internal controls and the method of their organization, education and training; and others.

⇩

2. Understanding of the Design Status of Internal Controls

Understand, record and retain the design status of internal controls.

[1]. Understand, record and retain the design status of company-level controls in the light of rules and practices of existing internal controls and their compliance status.

*Documentation of tacit rules within the company, if there are any

[2]. Identify, record and retain the design status of important process-level controls.

*Organize and understand the flow of transactions and accounting procedures of important business processes.

*Identify the risks of misstatements regarding business processes that have been organized and understood. Examine the relationship between the risks and the financial reporting or accounts; and whether the risks are sufficiently mitigated by the internal controls incorporated into operations.

⇩

3. Response and Remediation for Identified Deficiencies

Identified deficiencies should be appropriately remediated.

(Reference drawing 2)

Flow of the Assessment and Report on Internal Control Over Financial Reporting

Assessment of company-level controls
(In principle, the management should assess all business locations from a company-wide perspective.)

Assessment of process-level controls over financial closing and reporting
(Financial closing and reporting process appropriate to be assessed from a company-wide perspective should be assessed in a manner similar to company-level controls.)

Assessment of process-level controls other than those over the financial and reporting process.

1. Selection of significant business locations/units

Significant business locations/units are selected in the descending order of sales (or other factors) until their combined amounts reach a certain ratio (for example, approximately two-thirds) of the total amounts.

※Business locations include headquarters, subsidiaries, local offices, branches, business units, etc.

※Different or additional criteria may be used depending on the company's business environment or characteristics.

⇩

2. Identification of business processes to be assessed

[1]. All business processes of significant business locations/units which impact the accounts (in principle, in the case of general companies, sales, accounts receivable and inventory) that are closely associated with the company's objectives should be in the scope.

※Business processes can be excluded from the scope of assessment when they are only remotely associated with businesses or operations performed in significant business locations/units and do not have a material impact on the financial statements.

[2].Business processes of significant and other business locations/units that have a significant impact on the financial reporting should be added to the scope of assessment individually.

(Examples) *Business processes that relate to businesses or operations dealing with high-risk transactions
*Business processes relating to significant accounts involving estimates and management's judgment
*High-risk business processes that require special attention which include non-routine or irregular transactions

[3]. Adjustment of the scope of and approaches to the assessment of process-level controls based on the assessment results of company-level controls

※When company-level controls have been assessed as ineffective, measures such as the expansion of the scope of assessment or addition of assessment procedures may be necessary.

※When company-level controls have been assessed as effective, the assessment procedures may be simplified by, for example, reducing the scope of sampling, or reducing the frequency of a certain scope of assessment, according to the materiality of the scope, to every two or more accounting periods.

⇩

Discuss the scope of assessment with external auditors as appropriate.

⇩

3. Assessment of business processes included in the scope of assessment

[1]. Identify and organize the overview of business processes included in the scope of assessment.

[2]. Identify the risk of misstatements in business processes and controls that would mitigate such risk.

[3]. Assess the design status of internal controls by reviewing related documents, making inquiries, conducting observations and through other procedures.

[4]. Assess the operation status of internal controls by reviewing related documents, making inquiries, conducting observations, verifying records on the performance of internal controls, examining the status of self assessment, etc.

※The scope of sampling may be reduced when the company-level controls are assessed to be operating effectively and in other circumstances.

⇩

4. Report of internal controls

[1]. Remediate identified control deficiencies, if any, by the business year end date.

[2]. Disclose material weaknesses existing as of the business year end date, if there are any.

Evaluation of Deficiencies in Process-level Controls

Evaluation of the Effectiveness of the Assessment of Process-level Controls

Evaluate through sampling tests (at least 25 samples per each key control would be necessary to attain a reliability rate of 90%)

※In the case of repetitive daily-routine transactions, etc., the number of samples may be reduced.

⇩

Identify Deficiencies in Process-level Controls

⇩

[1]. Evaluation of the extent of the impact of deficiencies

Determine which accounts, etc. and to what extent the deficiencies identified in process-level controls may have impacts on.

*When a deficiency is identified in the sales process of a certain product in a certain business location, the total sales of the business location would be affected if the sales process were adopted throughout across the business location.

*When the problematic sales process is peculiar to a certain product, it will only affect the sales of such a product.

*When a similar sales process is adopted in other business locations, the deficiency stated above would also affect the sales of such other business locations.

⇩

[2]. Evaluation of the likelihood of the impact

Determine the likelihood of the actual impact stated in [1] above.

* Deduce the likelihood by using the results of sampling tests.

* If the deduction is difficult, categorize risks by their qualitative significance (e.g. levels of likelihood –high, medium, low), and apply a ratio predetermined respectively.

※If the likelihood of the impact is extremely remote, it may be excluded from the evaluation.

⇩

[3]. Determination of qualitative and quantitative significance of control deficiencies

Considering the extent and likelihood stated in [1] and [2] above, determine the qualitative and quantitative significance of the control deficiencies (for example, approximately 5% of the consolidated income before tax).

※When there are multiple deficiencies, the significance should be judged by the aggregate impact (excluding duplicating amounts).

⇩

If the deficiencies have a qualitative and quantitative significance, they should be judged to be material weaknesses.