

# **Current Situation and Issues for Improving Internal Audit of Financial Institutions**

**June 2019**



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## **1. Introduction**

The environment surrounding finance is significantly changing, including a shrinking domestic market due to population decline and aging, and the persistence of a low interest rate environment worldwide. In addition, global business expansion and operational complexity are progressing with a focus on large financial institutions.

Under these circumstances, it is important for financial institutions that governance functions effectively to ensure the appropriateness of operations and the financial soundness and to contribute to the stability of the financial system by building sustainable business models.

To this end, the internal audit function must appropriately fulfill its mission<sup>1</sup> of enhancing and preserving the value of the organizational entity by providing objective and independent assurance<sup>2</sup>, advice, and insight into the effectiveness of organizational activities from a risk-based and forward-looking perspective, and must improve internal audits in response to rapid changes in the environment.

Based on this recognition, and taking into account the results of monitoring and findings from external experts from July 2018 to June 2019, this document organized and summarizes the current situation and issues for improving internal audits of financial institutions as of June 2019. In addition, the definitions of terms used in this document are taken from the IIA's list of terms and other sources at the time of publication of this document (Japanese version).

This document is published with the expectation that it will assist financial institutions in considering the way of their internal audit systems in light of their respective business models and management strategies. Merely introducing or practicing the initiatives described in this document does not mean to be evaluated as having an internal audit system in place. When using this document, it should be noted that each financial institution needs to conduct independent consideration based on its own size, characteristics, etc.

In addition, the Financial Services Agency (FSA) does not formally apply the individual points at issue in this document or use them as a checklist in its monitoring. In dialogue using this document, the FSA will continuously discuss based on the size, characteristics, etc. of each financial institution.

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<sup>1</sup> The Institute of Internal Auditors (IIA) states that the "mission of internal audits" is to "to enhance and protect organizational value by providing risk-based and objective assurance, advice, and insight."

<sup>2</sup> The IIA defines "Assurance Services" as "An objective examination of evidence for the purpose of providing an independent assessment on governance, risk management, and control processes for the organization."

**2. Perspective of Monitoring**

The FSA evaluates the overall level of internal audits through dialogue with each financial institution, and conducts monitoring based on the following points from the perspective of increasing the effectiveness of internal audits through coordination and utilization with internal audits.

**(1) Evaluation of Internal Audits**

The FSA is verifying the effectiveness of internal audits from the perspective of whether the internal audit functions of each financial institution are conducting audits that correspond to the risk profile based on each company’s business model, management strategy, and organizational structure.

Specifically, through dialogue with the internal audit functions of each financial institution, the FSA will evaluate the overall level of internal audits at each company, and identify issues for raising standards and improvement of each company's internal audits.

In particular, the evaluation is focused on whether internal audits can be converted from audits centering on ex post facto checks to forward-looking audits (from the past to the future), from compliance audits to management audits (from the form to the substance), and from partial audits to full audits (from element by element to holistic), and whether the internal audit system is developed to support these efforts and the three types of audits (internal audit, audit by corporate auditors<sup>3</sup>, external audit) are well coordinated.

The level of internal audits can be evaluated according to the following phases (Chart 1).

Chart 1: Level of Internal Audits (Conceptual Diagram)

	1st phase (Ver. 1.0) (Administrative deficiency audit)	2nd phase (Ver. 2.0) (Risk-based audit)	3rd phase (Ver. 3.0) (Management audit)
Role Mission	Exercising a check function on each business office by discovering administrative deficiencies, violation of rules, etc.	Raising issues for business processes in high-risk areas based on risk assessment	Providing assurances that contribute to management in response to internal and external environmental changes, etc.
	Past/Form/Element by element		Future/Substance/Holistic

(Source) Financial Services Agency

**i) 1st Phase (Ver. 1.0): Administrative Deficiency Audit**

- The level of trust and expectations from the management team for the internal audit department and the level of understanding of audits by the management team are low, and the internal audit function is at a phase where its role is limited to superficial ex post facto checks of compliance with regulations, etc. The internal audit department is required to play the role of exercising a check function on business offices by discovering administrative deficiencies and violations of

<sup>3</sup> Corporate auditors, board of corporate auditors, audit and supervisory committee, or audit committee (the same shall apply hereinafter)

regulations.

- Audit methods are not risk-based, but rely on the experience and intuition of the audit department staff and focus on indication through physical inspections of business offices.
- Regarding human resources, there is no medium-to long-term policy for the internal audit function, and personnel are assigned through normal personnel rotation. In addition, the PDCA cycle has not been established, such that quality evaluation of internal audits has not been conducted, or even if it is conducted, it is only a formality.

### **ii) 2nd Phase (Ver. 2.0): Risk-based Audit**

- The level of trust and expectations from the management team for the internal audit function and the level of understanding of audits by the management team are gradually increased, and in addition to the role of the 1st phase, the role of raising issues for business processes in high-risk areas is required based on risk assessment.
- Specifically, risk assessments based on the internal and external environments are conducted, the maintenance and operational status of business processes in high-risk areas are verified, audits not only of business offices but also of headquarters are conducted, and cross-departmental thematic audits are conducted.
- The portfolio of audit personnel is managed from a medium-to long-term perspective, and personnel will be allocated with an awareness of their expertise in the business. Additionally, from the perspective of improving management skills at business offices, etc., there are moves to partially utilize internal audit functions, such as accepting short-term trainees from executive departments. Furthermore, initiatives are beginning to be seen to implement quality evaluations based on international standards for internal audits (IIA standards).

### **iii) 3rd Phase (Ver. 3.0): Management Audit**

- The level of trust and expectations from the management team for the internal audit department and the level of understanding of audits by the management team are further increased, and the internal audit is viewed as a useful department that can provide useful suggestions to the management team. In addition to the role of the 2nd phase, the internal audit role<sup>4</sup> is required to assess the effectiveness and adequacy of the organization's governance, risk management, and control processes and proactively provide useful suggestions for improvement in these

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<sup>4</sup> The Standard 2100 - Nature of Work in the International Framework for Professional Practice (IPPF) states that "The internal audit activity must evaluate and contribute to the improvement of the organization's governance, risk management, and control processes using a systematic, disciplined, and risk-based approach".

areas. The internal audit function has a management perspective and, from a more forward-looking perspective, provides assurance that contributes to management in response to changes in the internal and external environment, etc.

- Specifically, audits that focus on whether substantial high-quality financial services are being provided, audits that focus on changes in the business environment and the balance of profits, risks, and equity capital, and audits on the status of execution of management strategies are also conducted. This requires more forward-looking risk identification. In addition, the root causes of problems related to business models and governance are investigated. Furthermore, financial institutions that operate on a group/global basis establish internal audit systems on a group/global basis, such as reviewing the system for coordination and reporting with domestic and overseas internal audit bases and standardizing audit methods.
- For management audit, personnel who understand the business and management strategy of the entire organization is strategically assigned. In addition, from the perspective of improving the status of the internal audit function and career development in the organization, there are career paths, after assigning young staff, department head candidates, or management candidates to the internal audit function to gain experience, and then returning them to the executive department in a managerial position. In addition to the IIA standards, some initiatives are made to conduct quality assessments based on relevant regulations and guidelines<sup>5</sup> in regions where international business is conducted.
- The internal audit function's independence is strongly recognized for the management audit, and initiatives are being made to ensure direct instructions and reporting routes<sup>6</sup> on duties to the board of directors, as well as instructions and reporting routes<sup>7</sup> for departmental operations to the CEO to facilitate the day-to-

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<sup>5</sup> Examples include the following:

Basel Committee on Banking Supervision, "The internal audit function in banks"

Federal Reserve Board, "Supplemental Policy Statement on the Internal Audit Function and Its Outsourcing"

Chartered Institute of Internal Auditors, "Effective Internal Audit in the Financial Services Sector"

<sup>6</sup> The Standard 1100 - Independence and Objectivity in the IPPF states that "To achieve the degree of independence necessary to effectively carry out the responsibilities of the internal audit activity, the chief audit executive has direct and unrestricted access to senior management and the board. This can be achieved through a dual-reporting relationship." In addition, the Standard 1110 – Organizational Independence provides, as examples of the board's operational instructions and reports, approval of the internal audit charter, approval of the risk based internal audit plan, and approval of decisions regarding the appointment and removal of the chief audit executive.

<sup>7</sup> The IIA recommends that the chief of the internal audit department have an operational direction and reporting path to the CEO. On the other hand, the IPPF's 1110 - Organizational Independence states that "the chief audit executive must report to a level within the organization that allows the internal audit activity to fulfill its responsibilities.", and the preferred form of affiliation of the internal audit function depends on the size and characteristics of each financial institution. The preferred form of affiliation of the internal audit department varies depending on the size and characteristics of each financial institution. Also, the purpose of this provision is that the chief of the internal audit department, by having a channel of instruction and reporting in the operation of the department to one of the top managers, can acquire sufficient position in the organization and sufficient authority to fulfill his/her responsibilities without interference and tackle difficult issues together

day operations of the internal audit function.

- The management team recognizes the importance of the three lines of defense<sup>8</sup>, with the internal audit department (3rd line) providing assurance in a position independent from the business department (1st line) and the management department (2nd line).

## **(2) Coordination and Utilization with Internal Audits**

From the perspective of enhancing the effectiveness of internal audits of financial institutions, the FSA intends to coordinate with the internal audit functions of each financial institution and, when the level of internal audits of financial institutions is at the 3rd phase and autonomous functioning is recognized, to utilize the internal audit function in monitoring from the perspective of enhancing the efficiency of the monitoring.

Specifically, during the dialogue with the internal audit function, the two parties should share recognition of issues regarding the FSA's awareness of the issues of concern (I. risks and issues related to individual financial institutions; II. risks and issues common to the business category to which the subject financial institutions belong; and III. risks and issues common to financial institutions in general). Furthermore, in cases where matters in line with these issues are not covered by the risk assessment or internal audit, the FSA encourages them to be reflected in the risk assessment or audit plan.

In addition, the FSA will aim to request that internal audits be conducted on themes that are common to financial institutions in general or cross-sectoral themes as necessary, and based on the results, and to increase or decrease the scope and depth of the monitoring.

## **3. Monitoring Results**

In this year's monitoring, the FSA conducted multiple dialogues mainly with large financial institutions<sup>9</sup>.

Furthermore, other financial institutions, including regional financial institutions, were newly added to the scope of monitoring, dialogue was held, and the internal audit systems of each financial institution were verified.

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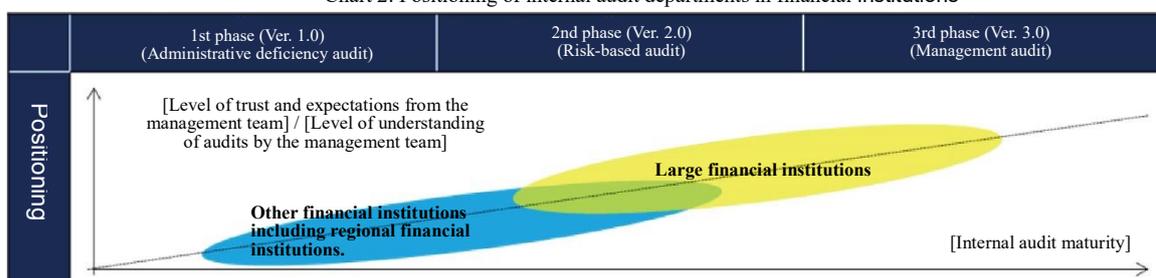
with other top managers.

<sup>8</sup> It is not the purpose in itself to introduce the concept of the three lines of defense in a formulaic and formal manner, clearly divide the roles of each line of defense, and develop a system. It is important for each financial institution to consider its own system based on the actual situation of its organization.

<sup>9</sup> The three megabank groups (Mizuho Financial Group Inc., Mitsubishi UFJ Financial Group Inc., and Sumitomo Mitsui Financial Group Inc.), other large banking groups (Resona Holdings Inc., Sumitomo Mitsui Trust Holdings, Inc., The Norinchukin Bank, and Japan Post Bank Co.,Ltd.), large life insurance companies (Nippon Life Insurance Co., Dai-ichi Life Insurance Inc., Meiji Yasuda Life Insurance Co., and Sumitomo Life Insurance Co.), large non-life insurance companies (Tokio Marine Group, MS&AD Insurance Group Holdings, Inc., and Sampo Japan Nipponkoa Insurance Group), and large securities companies (Nomura Securities Co. Ltd. and Daiwa Securities Co. Ltd.)

The overall evaluation of other financial institutions, including large financial institutions and regional financial institutions, is as follows (Chart 2).

Chart 2: Positioning of internal audit departments in financial institutions



(Source) Financial Services Agency

### (1) Large Financial Institutions

Large financial institutions are conscious of moving away from compliance audits, and are now oriented toward audits from a predictive perspective that captures changes in the business environment, etc. The level of internal audits is considered to be in the 2nd to 3rd phases, taking into account the status of initiatives (Chart 3) as described below.

For example, in order to improve the status of internal audit functions and ensure their expertise, initiatives are being made to clarify medium-to long-term career paths, systematically develop and deploy specialized human resources, and enhance internal audit systems. In addition, in some large financial institutions where overseas operations and group-wide coordinated operations are progressing, initiatives are also being made to establish a dedicated team within the holding company’s internal audit function to conduct group-wide audits in high-risk areas such as Anti-Money Laundering/Combating the Financing of Terrorism and cybersecurity.

On the other hand, it has been recognized that the internal audit function has not sufficiently delved into the background and causes of the events discovered, and that this has not sufficiently led to improvements in management strategies and business operations.

Chart 3: Issues and distinctive initiatives identified through monitoring of large financial institutions (examples)

Audit method	<Issues identified through monitoring>
	<ul style="list-style-type: none"> <li>✓ Due to lack of depth in cause analysis for individual findings, it is insufficient to pursue root causes that are common to multiple events.</li> <li>✓ Issues in risk assessment, audit planning, audit quality control, and human resource management on a group and global basis.</li> <li>✓ Issues in effective use of data analysis in headquarters and thematic audits.</li> <li>✓ Some large financial institutions have issues with comprehensive risk identification, timely risk recognition, and documentation of risk assessment results.</li> </ul>
	<Distinctive Initiatives>
	<ul style="list-style-type: none"> <li>✓ In addition to periodic (once a year) risk assessments based on a macro-</li> </ul>

	<p>micro approach, information collection as a daily and continuous monitoring, and review of risk assessments and audit plans during the period based on this information (reflecting risks with significant management impact (top risks), matters of concern to the authorities, etc.) have developed.</p> <ul style="list-style-type: none"> <li>✓ Evaluating the effectiveness of internal controls and practicing<sup>10</sup> audits from a predictive perspective that captures changes in the business environment, etc.</li> <li>✓ Unification of auditing methods across the group and globally has progressed. For domestic group audits, the holding company's internal audit function has established a team dedicated to high-risk areas to conduct group-wide audits. Global audits are conducted under the supervision of a global supervisor in specialized areas such as money laundering.</li> </ul>
<p>Audit system</p>	<p>&lt;Issues identified through monitoring&gt;</p> <ul style="list-style-type: none"> <li>✓ With the progress of globalization, the issue is hiring or training the head of the audit department as an internal audit expert who can effectively supervise the audit function members of the entire group, including overseas offices.</li> <li>✓ Some large financial institutions are facing issues with systems such as optimizing the human resource portfolio based on age, years of audit experience, field of expertise, etc., clarifying and managing career paths, and securing specialized human resources<sup>11</sup>.</li> </ul> <p>&lt;Distinctive Initiatives&gt;</p> <ul style="list-style-type: none"> <li>✓ Assigning a person as the head of the audit function who has a bird's-eye view of the business and management strategy of the entire organization and is skilled in understanding the organization's business processes and internal controls.</li> <li>✓ Progress has been made in initiatives to enhance the internal audit system by clarifying medium- and long-term career paths and systematically developing and assigning specialized personnel to improve the status and expertise of the internal audit function.</li> <li>✓ The Audit Committee receives reports from the internal audit function independently from the executive department and has the authority to direct the executive department to block information in the event of misconduct in which the management team may be involved.</li> <li>✓ The Audit Committee conducts a personnel evaluation of the head of the internal audit department and submits the results to the Nominating and Compensation Committee.</li> <li>✓ The administrative deficiency audit function of business offices, etc. has been transferred to the business department and administration department, and the internal audit function has changed its structure so that it can focus on management audits.</li> <li>✓ For the improvement of the internal audit system, the management team have discussed the medium-to long-term target level based on the current level, the final state of the company, etc.</li> <li>✓ Conducting awareness-raising activities, such as clearly stating recommendations to the management team in the materials for the board of directors related to audit reports, regarding the fact that internal auditing is</li> </ul>

<sup>10</sup> For example, establishing a working group to identify warning signs, deploying IT and other specialized personnel, and centrally managing and analyzing organizational information, etc.

<sup>11</sup> For example, personnel related to IT systems, cyber security, Anti-Money Laundering/Combating the Financing of Terrorism, ERM (Enterprise Risk Management), etc.

	an activity aimed at improving corporate value and operational quality.
Quality assurance	<p>&lt;Issues identified through monitoring&gt;</p> <ul style="list-style-type: none"> <li>✓ Although some large financial institutions regularly conduct monitoring at their parent companies to improve the quality of internal audits of group companies and evaluate the results of internal audits of subsidiaries as dependable, there are cases where initiatives are found to be insufficient (development of audit systems, decision processes of audit policy, and risk assessments).</li> </ul>
	<p>&lt;Distinctive Initiatives&gt;</p> <ul style="list-style-type: none"> <li>✓ Dedicated quality evaluation specialists are assigned within the internal audit function.</li> <li>✓ To continuously evaluate audit quality, there are cases where evaluations are conducted not only at the time of planning, but also at the time of audit implementation in an accompanying manner. In this case, the evaluator also goes together during the on-site visit and interviews the person in charge of the audited department at the same time from the perspective of quality evaluation.</li> <li>✓ A specialized team is assigned to check whether the improvement measures taken by the audited department have taken root in the business and are functioning effectively.</li> <li>✓ When conducting quality evaluations, in addition to IIA standards, initiatives are also progressing to verify and evaluate compliance with relevant regulatory guidelines, etc. in regions where business is conducted internationally, and gaps with the advanced initiatives of overseas G-SIFIs.</li> </ul>
Coordination of three-way audits	<p>&lt;Issues identified through monitoring&gt;</p> <ul style="list-style-type: none"> <li>✓ Although some large financial institutions have been exchanging opinions multiple times a year, there are some institutions that have remained one-way information dissemination, such as simply sharing information and deliverables.</li> </ul>
	<p>&lt;Distinctive Initiatives&gt;</p> <ul style="list-style-type: none"> <li>✓ In addition to sharing risk information and audit plans, etc. examined by each audit entity, opinions were exchanged on timely issues, such as misconduct cases at other companies.</li> <li>✓ External auditors attend every Audit Committee meeting as observers and share information.</li> <li>✓ Audit committee members accompany external auditors on visits to overseas branches.</li> </ul>

## (2) Other Financial Institutions Including Regional Financial Institutions

While other financial institutions, including regional financial institutions, advocate a shift to risk-based audits and management audits, many still emphasize traditional audit functions (fraud and misconduct prevention and compliance audits), and based on the following initiatives (Chart 4), the level of internal audits can be considered to be in the 1st to 2nd phases.

However, in the current environment of population decline and low profits, there is a need for increased revenue, efficient management, and speedy business execution. As company-wide personnel reductions are progressing, the autonomous control functions of business divisions and the monitoring functions of management departments are insufficient, and the internal audit department is supplementing these functions. Furthermore, the fact that there are circumstances in which it is not possible to allocate additional personnel solely to the internal audit function is considered to be one of the factors inhibiting improvement.

Under these circumstances, mainly at regional financial institutions, where management is more aware of the importance and usefulness of internal audits and is actively involved, initiatives are being made to move from the 2nd to the 3rd phase, such as strategically allocating management resources including specialized personnel, and discussing the appropriateness and comprehensiveness of priority audit items based on risk assessment results at board of directors' meetings to realize management audits. On the other hand, institutions with a low degree of involvement by the management team remain at the 1st phase, and there are large differences in the level of internal audits depending on the degree of involvement by the management team.

Chart 4: Issues identified through monitoring of other financial institutions including regional financial institutions and characteristic initiatives (examples)

<p>Audit method</p>	<p>&lt;Issues identified through monitoring&gt;</p> <ul style="list-style-type: none"> <li>✓ Some institutions effectively and efficiently use departmental and theme-based audits depending on the risk, but there is a lack of depth in headquarters audits (risk assessment results are only used to determine the audit cycle, and are not reflected in specific audit procedures and processes. Also, risk assessment results are not reported to the management team, and audit plans are centered on the annual audit schedule.)</li> <li>✓ While there are a certain number of institutions that carry out daily and continuous monitoring such as attending meetings of risk management committees and reading minutes, there are issues in implementing in-depth monitoring such as data analysis.</li> </ul>
	<p>&lt;Distinctive Initiatives&gt;</p> <ul style="list-style-type: none"> <li>✓ In addition to understanding the auditing needs of the management team including outside directors, through interviews, developing an audit plan based on effective risk assessments considering external factors such as misconduct cases at other companies and risks associated with large measures in the mid-term management plan.</li> <li>✓ Verifying the status of penetration of the management strategy by conducting interviews to assess the level of understanding of the medium-term management plan.</li> <li>✓ Conducting flexible checks on matters detected through routine and continuous monitoring, such as by conducting interviews through telephone confirmation and on-site visit, and considering bringing forward the timing</li> </ul>

	of on-site visit when necessary.
Audit system	<p>&lt;Issues identified through monitoring&gt;</p> <ul style="list-style-type: none"> <li>✓ Many institutions are facing issues with systems such as optimizing their human resource portfolios, clarifying, and managing career paths, and securing specialized human resources.</li> <li>✓ In addition to the IT and market fields, there is a shortage of experienced headquarter staff in planning and other areas, as well as a difficulty to break away from a situation where internal audit department is used as waiting posts for older employees' secondment.</li> <li>✓ The holding company is facing issues in the operation of the group audit system (audit resource management, company-wide risk assessment).</li> <li>✓ Although the approval of the audit plan and budget is decided by the board of directors, there are some institutions where the coordination is limited to reporting individual audit results to the audit committee members.</li> </ul>
	<p>&lt;Distinctive Initiatives&gt;</p> <ul style="list-style-type: none"> <li>✓ Creating a skill map for audit department members and using it in discussions with the management team (auditors, etc.) about securing the necessary human resources and training policies, reviewing the treatment of part-time employee, and using it to maintain motivation and pass on audit skills.</li> <li>✓ Audit committee secures prior consent for audit plans, budgets, and personnel.</li> <li>✓ The internal audit departments of subsidiary banks and subsidiaries conduct compliance audits, and the internal audit department of the holding company is reorganized to specialize in management audits.</li> <li>✓ A liaison meeting where the management department, internal audit department, and auditors come together is held on a regular basis to discuss the causes of deficiencies and measures to prevent recurrence, and each department within the management department has assigned an audit department member in charge to work together daily.</li> </ul>
Quality assurance	<p>&lt;Issues identified through monitoring&gt;</p> <ul style="list-style-type: none"> <li>✓ Regular quality assessment (internal and external assessment) are not conducted.</li> <li>✓ Internal assessment is a task to complete a checklist, and the PDCA cycle is not functioning, external assessment is only a formality without understanding the purpose of the recommendations, and no substantive improvements have been made.</li> </ul>
	<p>&lt;Distinctive Initiatives&gt;</p> <ul style="list-style-type: none"> <li>✓ There are institutions that strategically use quality assessment results, institutions that conduct internal quality assessment by an independent department within the internal audit function, and some institutions that, at the time of the external assessment, request assessment from the perspective of whether there are any areas where procedures and systems are excessive in light of their actual situation, in addition to the conformity with IIA standards.</li> </ul>

Coordination of three-way audits	<Issues identified through monitoring> ✓ It remains a mere forum for providing information from the internal audit function or external auditors, and is not utilized in the activities of each audit entity based on shared risk recognition.
	<Distinctive Initiatives> ✓ All auditing entities regularly meet together and exchange opinions on risk factors based on the internal and external environment surrounding the financial institution. A common feature is that the corporate auditors recognize the importance of three-way audits and take the initiative to strengthen coordination.

#### **4. Fourth Phase (Ver. 4.0): Trusted Advisor / For Further Improvements of Internal Audits**

During this fiscal year, the FSA exchanged opinions with the internal audit departments of foreign financial institution groups, as well as internal audits of consulting companies and auditing corporations. In light of the advanced internal audit initiatives identified, we suppose that a more advanced phase of internal audits beyond the 3rd phase exists.

The reason why their internal auditing is becoming more sophisticated is that the business environment is changing rapidly and innovatively due to the progress of digitalization, and the demands of internal and external stakeholders are also becoming more diverse and improved than ever (e.g., responding to SDGs<sup>12</sup>).

The progress of digitalization has brought, for example, the expansion of FinTech, the expansion of services provided by the introduction of new technology, the intensification of cost competition due to the entry of firms from different industries, and the promotion of outsourcing to cloud service providers. Furthermore, the scope of data governance, which is considered to be important in financial institutions, is expanding beyond traditional data protection to include how data is managed and utilized.

On the other hand, as the demands of stakeholders become more diverse and sophisticated, there is a situation in which conduct risk<sup>13</sup> by employees and others arising from their inability to accurately grasp these changes is increasing.

These movements are bringing not only diverse risks but also profit opportunities to financial institutions, requiring the management team to respond quickly and flexibly.

Under these circumstances, the internal audit functions of financial institutions that have reached the 4th phase are expected to go beyond providing assurance and solving related issues, and to provide advice that contributes to management strategy, as trusted advisors to

<sup>12</sup> Sustainable Development Goals

<sup>13</sup> See Financial Services Agency, “JFSA’s Approaches to Compliance Risk Management”, III. Management Framework at Financial Institutions, 2. Development of a risk-based approach, (2) Identification and understanding of a wide range of risks, <BOX>.

the management team and other officers and employees within the organization<sup>14</sup>.

The following are the main initiatives to achieve the 4th phase of internal audits.

### **(1) Flexible Audit Method**

To respond to accelerating environmental changes, etc., it is necessary to immediately identify changes in risk, promptly conduct necessary audits when an increase in risk is recognized and have a system in place to quickly and flexibly change audit content in response to changing circumstances.

In some overseas G-SIFIs, there are cases in which KRIs<sup>15</sup> are identified during continuous monitoring and analyzing data to automatically confirm changes in risk each time (dynamic risk assessment), and cases in which flexible audit methods are adopted based on shared recognition of issues through communication with audited departments and others at an early stage of the audit (Agile Audit<sup>16</sup>).

### **(2) Utilization of IT, Data Analysis, etc.**

To realize the above-mentioned flexible auditing, etc., it is necessary to improve audit methods utilizing IT, including development of the IT infrastructure and data analysis.

In some overseas G-SIFIs, the utilizing area of data analysis is not limited to detecting fraudulent acts and their signs, it has been expanded the entire internal audit work cycle<sup>17</sup>, including cases enabling more flexible risk assessment in the use in continuous monitoring as described in (1).

### **(3) Audit Method for Corporate Culture**

Because it is difficult to reduce conduct risk solely through the development of traditional policies, institutions, and systems, the management team needs to ensure that the corporate culture that influences the behavior of employees and others meets the demands of stakeholders. Along with this, the importance of audits of corporate culture is increasing, and initiatives are being made in overseas G-SIFIs<sup>18</sup>.

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<sup>14</sup> However, even in the case of providing forecasts that contribute to decision-making and advice based on such forecasts, from the perspective of ensuring the independence of the internal audit department, it is assumed that the internal audit department is not involved in the decision-making process by the management team itself.

<sup>15</sup> Key Risk Indicators

<sup>16</sup> Although there is no fixed definition, a common example is to subdivide the audit area and implementation period, and conducting the audit while flexibly changing the plan based on the implementation status of small-scale audits.

<sup>17</sup> Planning, implementation, communication of results and monitoring of progress.

<sup>18</sup> As an audit method for corporate culture;

- Evaluate the perception of control by department managers, etc. of the audited department by verifying their perception of risk and how they are responding to risk.

Up until now, large Japanese financial institutions have mainly been limited to verifying matters pointed out in individual audits<sup>19</sup>, but some financial institutions are beginning to conduct thematic audits related to corporate culture and incorporate corporate culture elements<sup>20</sup> into the scope of verification in individual audits.

#### **(4) Forecasts in Response to Changes in the Business Environment and Advice Based on Them**

For the internal audit department to provide advice that goes beyond assurance and contributes to management strategy, it is expected to make proactive predictions in response to changes in the internal and external environment and business model reforms, etc., as well as to take initiatives to monitor the internal audit department concurrently and flexibly from the drafting of management strategy.

In some foreign G-SIFIs, internal audit functions are making efforts to predict the impact of the entry of FinTech companies through analyzing the introduction of new technologies and changes in customer behavior, regulations, or market competition.

A major issue to implement this improvement is securing specialized human resources for the internal audit function.

To carry out highly flexible audits that can respond to accelerating environmental changes, it is essential for internal audit departments to facilitate communication with audited departments and external experts. However, increasing complexity of the work to be audited requires personnel who are familiar with both the organization and business as well as the audit methodology, and who can translate complex and sophisticated matters into easy-to-understand terms.

Additionally, as audit methods that utilize IT, including data analysis, become more important in internal audits, the need for audit personnel who can handle this will be expected to increase. Some overseas financial institutions are already requiring all audit department members to acquire a certain level of data analysis skills.

Furthermore, in financial institutions, including overseas G-SIFIs, which are implementing

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• Evaluate the penetration of the corporate culture through questionnaires and interviews with managements and employees regarding the code of conduct on a company-wide or segment-by-segment basis (by department, industry, risk category, etc.), and if there is a problem with penetration, identify the cause and make improvements.

• As a part of the dynamic risk assessment described in (1), there are cases of continuous monitoring being carried out by setting KRIs related to corporate culture.

<sup>19</sup> Examining corporate culture in the root cause analysis of issues pointed out in individual audits is positioned as part of the 3rd stage (p. 4).

<sup>20</sup> For example, a method to examine how performance evaluation affects the behavior of organizational members, or a method to conduct a questionnaire survey consisting of questions on how organizational members would behave in a hypothetical situation where risks are hidden.

the above-mentioned advanced initiatives, the internal audit functions, which are equipped with highly specialized human resources, have a very high position within the organization.

## **5. The Authorities' Awareness of the Issues and the Direction of Future Monitoring**

### **(1) Awareness of Issues Regarding Large Financial Institutions**

Considering the size and influence of large financial institutions, it is desirable that they develop systems at the 3rd phase level. Based on this, in order to respond to accelerating environmental changes and the diversifying demands of stakeholders, it is appropriate that to refer to advanced initiatives and aim for further improvement according to the management issues and business models faced by each institution.

### **(2) Awareness of Issues Regarding Other Financial Institutions Including Regional Financial Institutions**

For other financial institutions, including regional financial institutions, there are large differences in the level of internal audits depending on the degree of involvement by the management team.

Therefore, it is essential for management teams to be more aware of the importance and usefulness of internal audits, to strategically assign management resources such as personnel who understand the business and management strategies of the entire organization to the internal audit function, and to actively involve management in discussions at board meetings regarding the appropriateness and comprehensiveness of priority audit items based on risk assessment results, etc. It is appropriate to raise the level and improve the internal audit system according to its size and characteristics.

### **(3) Future Direction of Monitoring**

#### **i) Collecting, Accumulating, and Utilizing Case Studies of Initiatives to Improve Internal Audits**

The FSA will continue to collect and accumulate advanced cases identified through dialogue with external experts, as well as good practices appropriate to the size and characteristics of financial institutions through monitoring of each type of business.

In addition, we will capture trends<sup>21</sup> in various guidelines that affect internal audits in

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<sup>21</sup> At the time of publication of this document (Japanese version), IIA is collecting opinions on the proposed revisions to the

a timely manner, analyze their impact on monitoring, and then use them as focus points for dialogue with the internal audit function, etc., as necessary.

**ii) Implementation of Continuous Monitoring and Encouragement of Further Improvement of Internal Audits, etc.**

Through dialogue with the internal audit functions of each financial institution, the FSA will not only understand the audit system, but also continuously monitor the status of responses based on individual issues.

During the dialogue, the FSA will share its understanding of the issues and problems identified through monitoring, and encourage responses and further improvement, such as introducing case studies that are appropriate for the level, scale, and characteristics of each financial institution's internal audits from the case studies accumulated in i) above.

Furthermore, depending on the importance of issues and problems identified through monitoring, the FSA will discuss on initiatives to improve internal audits during dialogue with management teams, outside directors, corporate auditors, audit committee members, etc.

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three defense lines. In addition, in the written opinion of “The Council of Experts Concerning the Follow-up of Japan’s Stewardship Code and Japan’s Corporate Governance Code” (4), dated April 24, 2019, it was stated that “For the initiatives to ensure the reliability of audits that ensure the effectiveness of defensive governance, including internal audit issues, we will proceed examination, taking into account the characteristics of companies’ institutional designs”.