

Monitoring Report for Improving Internal Audits of Financial Institutions (2024)

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I. Introduction

Since the Financial Services Agency (FSA) has published the “Current Situation and Issues for Improving Internal Audit of Financial Institutions” (hereinafter referred to as “Current Situation and Issues”) in June 2019, it has been encouraging financial institutions to improve their internal audits through monitoring. As part of this effort, in October last year, the FSA summarized the status of initiatives and recognition of issues of internal audit in large banking groups and has published them as a progress report (hereinafter referred to as “Interim Report 2023”).

The environment surrounding financial institutions is constantly changing, and in recent years, in addition to changes in the global financial and economic situation, interest rates are rising in Japan, the situation has reached a major turning point. In these circumstances, it is urgent for financial institutions to understand the risks they face in a timely manner, analyze the risks from a forward-looking perspective, and establish a system to promote business while appropriately controlling risks. It goes without saying again that the establishment of such a system requires effecting of the internal audit functions, and the importance of internal audits and the need to improve them are increasing, such as providing objective assurance on the internal control, risk management system, and business operations of financial institutions and proposing improvements as necessary.

In addition, the FSA, in its inspections and monitoring, aims to identify vulnerabilities in risk management systems of financial institutions and prevent them from becoming apparent, and to encourage the establishment of appropriate internal management systems, which is same direction with the purpose of internal audits in this respect. For this reason, the FSA intends to further advance collaboration with the internal audit functions of financial institutions.

From this perspective, even after the publication of the “Interim Report 2023”, the FSA has continued to monitor large banking groups, regional financial institutions, large securities companies, and large insurance companies, focusing on the “Three Issues for Improvement of Internal Audits” (hereinafter referred to as “Three Issues”) presented in the report, and has also exchanged opinions with external experts (consulting companies and auditing firms). In the process, the FSA received many requests to provide specific examples of the evaluation of each phase of the level of internal audits [Chart 1] and an image of the 4th phase (trusted advisor).

Against this background, the FSA has compiled the recognition of issues and expectation level by the FSA in this document, along with the above monitoring results. The FSA hopes that each financial institution will use this document, together with the “Interim Report 2023”, to help promote initiatives to improve internal audits according to their own size and characteristics.

From the perspective of encouraging financial institutions to further improve their internal audits, in light of monitoring results and international trends, the FSA intends to continue to consider the need to update the “Current Status and Issues” (including necessity of reconsideration of each phase),

[Chart 1] Maturity Level of Internal Audits (From the “Interim Report 2023”)

	1st phase (Ver. 1.0) (Administrative deficiency audit)	2nd phase (Ver. 2.0) (Risk-based audit)	3rd phase (Ver. 3.0) (Management audit)	4th phase (Ver. 4.0) (Trusted advisor)
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.	In addition to providing assurances and resolving issues associated with them, providing advice that contributes to management strategies to management teams and other executives and employees within the organization.

II. Monitoring Results

1. Overall Evaluation (Progress)

The FSA has been monitoring based on the three issues presented in the “Interim Report 2023”. As a result, it was confirmed that each financial institution is, in general, continuously working on improvement of its internal audits according to their size and characteristics. On the other hand, there is a significant difference in the progress between advanced financial institutions that are making progress in their initiatives to improve their internal audits (hereinafter referred to as “advanced financial institutions”) and financial institutions that are still developing their initiatives (hereinafter referred to as “developing financial institutions”), and it was confirmed that initiatives to improve internal audits are more influenced by the difference in management team’s awareness than by the size of the institution.

Of course, such differences are problems related to the overall management of financial institutions, such as securing resources including human resources, and are difficult to resolve by the internal audit function alone, and are greatly influenced by “Understanding and Support Attitude of Management Teams, Audit Committee Members, and Corporate Auditors (Issue 1)”. In this regard, in advanced financial institutions, the awareness of the importance and usefulness of internal audits has come to be recognized and expanded among Management Teams, and Audit Committee Members, and Corporate Auditors¹ (hereinafter, those may be referred to as “management teams, etc.”) through close communication with the internal audit function, whereas in developing financial institutions, communication between management teams, etc. and the internal audit functions is insufficient, the purpose and role of internal audits are not shared, and it was confirmed that sufficient support is difficult to realize, especially when the awareness of management teams, etc. is low [Chart 3].

Regarding “Improving the System and Strengthening the Infrastructure of the Internal Audit Function (Issue 2)”, proactive initiatives were observed not only in large financial institutions but also in small financial institutions. On the other hand, the difference in progress between advanced financial institutions and developing financial institutions is that advanced financial institutions are trying to refine risk assessments to improve the audit process and off-site monitoring systems to grasp risk changes in a timely manner and respond flexibly, while some developing financial institutions have not

¹ In addition to audit committee members, and corporate auditors, this includes audit and supervisory committee members, auditors, etc. The same shall apply hereinafter.

even established such a system in the first place. Furthermore, there were also differences in the approach to the use of IT solutions and co-sourcing [Chart 4].

In this context, large banking groups with international operations has evaluated themselves as being at the level of 3rd phase and the FSA confirmed that they were working on introduction of “the use of IT and data analysis” and “audit methods for corporate culture”, etc.², which were presented as “major initiatives to realize 4th phase internal audits” in the “Current Status and Issues” and were aiming for further improvement. In this regard, there are cases where some regional financial institutions have also been working on initiatives for improvement [Chart 5].

Similarly, with regard to “Understanding of Internal Audits for Audited Departments and Fostering Risk Ownership (Issue 3)”, while there were proactive initiatives regardless of size, there were differences in the progress of initiatives such as understanding of internal audits for audited departments [Chart 6].

The FSA will continue to encourage further ingenuity by management teams and internal audit functions.

² In the “Current Status and Issues”, the main initiatives to achieve the 4th phase (trusted advisor) internal audit are “flexible audit methods”, “utilizing of IT, data analysis, etc.”, audit methods for corporate culture” and “forecasts in response to changes in the business environment and advice based on them”.

2. Status of Initiatives of Financial Institutions Regarding Three Issues

The FSA presents three issues and main points in the “Interim Report 2023”. [Chart 2]

[Chart 2] Three issues and main points presented in the “Interim Report 2023”

Three Perspectives		Issues for Monitoring	
a	Support for the internal audit function by management teams, audit committee members, and corporate auditors	Issue 1	Support for the internal audit function by management teams, audit committee members, and corporate auditors
			Main actors: Management teams, audit committee members and corporate auditors - (1) Examining the ideal state of internal audits; (2) Supporting the improvement of internal audits; (3) Status of initiatives regarding the utilization of internal audit functions
b	Initiatives for improvement of the internal audit function	Issue 2	Improving the system and strengthening the infrastructure of the internal audit function
			Main actors: Internal audit function Sophistication of an auditing system - (1) Exchange of opinions and information with management teams, audit committee members, and corporate auditors; (2) Ensuring independence; (3) Identifying risks and narrowing down the scope of audit; (4) Flexible response to risk changes; (5) Audit depth (including root cause analysis); (6) Utilization of IT/data analysis; (7) Continuous improvement of audit quality; (8) Status of initiatives of group/global system development
			Strengthening of an audit infrastructure - (1) Status of initiatives to secure and develop human resources; (2) Status of implementation of the audit system,
			Co-sourcing - (1) Utilization policy; (2) Responsibility for final evaluation; (3) Status of initiatives to absorb knowledge and know-how
c	Initiatives for audited departments	Issue 3	Understanding of internal audits for audited departments and fostering risk ownership
			Main actors: Management teams, audit committee members, corporate auditors, and internal audit function - (1) Understanding of internal audits for audited departments; (2) Status of initiatives regarding evaluation and fostering risk ownership in audited departments, and communication with audited departments

Below, the FSA will describe examples of initiatives, etc. based on these “Three Issues” that have been identified through monitoring of financial institutions³ and exchanging opinions with external experts since the publication.

(1) Support for the Internal Audit Function by Management Teams, Audit Committee Members, and Corporate Auditors

Regarding support for the internal audit function by management teams, and audit committee members and corporate auditors, in addition to good practices and issues listed below, initiatives and

³ The monitoring results of financial institutions (number of clients) used as the basis for compiling this document are as follows:

- Major banks, including large banking groups (hereinafter referred to as “major banks, etc.”): 9 banks
- Small- and medium-sized regional financial institutions, such as regional banks, second-tier regional banks, shinkin banks (hereafter referred to as “regional financial institutions”): 63 institutions
- Large securities companies and large insurance companies (hereinafter referred to as “securities/insurance companies”): 7 companies

Below, examples of initiatives by each financial institution are introduced in accordance with this business category.

issues such as those shown in [Chart 3] are observed, and the FSA confirmed that there are financial institutions where management teams, etc. have a widespread and penetrating recognition of the importance and usefulness of internal audits.

[Good practices]

i) Regarding the importance and usefulness of internal audits, the top management officer sends out a message describing the role and expectations of internal audits, and the management team actively gets involved in making improvements based on the audit findings, thereby promoting internal audits throughout the company. (major bank, etc.)

ii) The internal audit function sets out “ideal internal audits” and “visions” based on the future business model and the needs and expectations of the management team, etc. and holds multiple discussions with the president, vice president, and audit and supervisory committee members regarding their sufficiency and measures to improve them.

⇒ As a result, the necessary budget for measures to improve them was allocated. (regional financial institutions)

iii) The audit results are reported at monthly audit report meetings attended by the bank president, full-time directors, chief of headquarters, and sales area managers, as well as at board of directors, and after discussions there, the bank president, etc. issues for improvement to the relevant departments.

⇒ As a result, the recognition that management is proceeding with an emphasis on audit results has penetrated throughout the organization (regional financial institutions)

iv) The reporting line has been changed to a direct one to the audit committee.⁴

⇒ As a result, the frequency of communication with external audit committee members has increased, understanding of internal audits deepened, and audit committee members increasingly expressed their support for internal audit. (securities/insurance companies)

[Issues]

- A characteristic of developing financial institutions is that there is insufficient communication between management teams, etc. and the internal audit function regarding risk awareness and issues related to management strategies and business operations, and policies for dealing with them, and the financial institutions are not able to share its goals to be achieved through effecting function of internal audits.

⇒ Discussions on how to improve internal audits, such as how to improve the system for conducting risk-based audits at headquarters as well as administrative deficiency audit at sales bases⁵, and clarifying the roles and responsibilities of the 2nd and 3rd lines, have not been sufficiently in-depth.

⁴ Since before, some clients, mainly major banks, etc., have had a reporting system in place that reports to the audit committee and the board of corporate auditors in addition to the management teams.

⁵ Refers to the so-called business site of a financial institution. Depending on the financial institution, it is called a “business office” or “business base”.

[Chart 3] Characteristic good practices and issues at monitored targets

Overview of Characteristic Good practices	
<p>Support by management teams, audit committee members, and corporate auditors</p>	<p><Major Banks, etc.></p> <ul style="list-style-type: none"> ● Once a year, the management team and the audit committee evaluate the internal audit system and report back to the internal audit function recognition of issues or requests for improvement (similar initiatives in securities/insurance companies). <p><Regional Financial Institutions></p> <ul style="list-style-type: none"> ● The following initiatives led by the management team were observed. <ul style="list-style-type: none"> ➢ Assigning a person with experience in the corporate planning or secretarial department with a management perspective to the position of the chief of internal audit function ➢ In order to increase opportunities for communication with management teams, auditors participate in morning meetings with management teams ➢ Reviewing the treatment of contract employees to pass on audit skills and motivate them ➢ Organizing the roles of the 2nd and 3rd lines, and transferring the administrative deficiency verifying function to the 2nd line ● Thematic audits related to governance and management issues are conducted in collaboration with the audit and supervisory committee. ● Once a year, as part of the quality evaluation (periodic self-assessment), questionnaires and interviews are conducted with management teams, etc., and recommendations are made to the internal audit function to improve internal audits. ● In order to raise the status of internal audits, the top management officer attends audit review meetings with audited offices held after individual audits. <p><Securities/Insurance Companies></p> <ul style="list-style-type: none"> ● The audit committee shares the awareness of each audit committee member regarding audit methods and communication with the audited departments that they have grasped by accompanying the internal audit function on its audits with the internal audit function. ● Under the leadership of the management team, mid-career and young employees with overseas experience and expertise in risk management, compliance, and systems are assigned to the internal audit function (trial of personnel rotation).

Main Issues	
<p>Support by management teams, audit committee members, and corporate auditors</p>	<p><Regional Financial Institutions></p> <ul style="list-style-type: none"> ● The management teams, etc. have not yet established a relationship in which they can frankly discuss with the internal audit function. ● The management teams, etc. have not discussed the internal audit system, and there is a divergence between the level of internal audits that the management teams recognize and the actual level. ● The board of directors receives annual audit plans and audit results from the internal audit function, but has not yet discussed based on validity of the plan or internal audit results.

(2) Initiatives for Improvement in the Internal Audit Function

As initiatives to improve in the internal audit function, there are initiatives regarding the audit system to improve the audit perspective and audit methods, etc., and regarding the audit infrastructure to secure and develop audit personnel, etc.

Not only large financial institutions but also small financial institutions have been actively working

on each item, and in general, the FSA confirmed that financial institutions are continuously working to improve their internal audits according to their size and characteristics. Good practices and issues [Chart 4] are shown below.

However, there are remarkable differences between advanced financial institutions and developing financial institutions, and it was confirmed that the understanding and support attitude of management teams, etc. makes a big difference. In this regard, securing resources, including human resources, is a problem related to the overall management, and it appears that it is difficult to resolve by the internal audit function alone.

[Good practices]

- i) Regarding the exchange of opinions and information with management teams, audit committee members and corporate auditors,
 - i. the internal audit function had opportunities to hold discussions with management teams, etc. on a half-yearly basis, and each time, it set a theme and discussed to improve internal audit
⇒ As a result, management teams, etc. got deeper understanding of internal audits and began to support them. (regional financial institutions)
 - ii. the internal audit function conducted audits of sales bases regarding the actual operation of high target value set by the sales promotion department, and reported to the board of directors as audit findings that there were adverse effects such as “administrative errors, existence of customer problems, and staff fatigue” in the business operations of the headquarters.
⇒ As a result, the board of directors lowered the target value. (regional financial institutions)
- ii) Regarding off-site monitoring, repeated discussions were held with the departments subject to monitoring.
⇒ As a result, the understanding of the operations and status of risk control inherent in business was deepened, and the verification points in individual audits were clarified. (securities/insurance companies)
- iii) Regarding risk assessment,
 - i. in order to maintain and improve the comprehensiveness and timeliness of risk recognition, evaluation items are diversified and subdivided, and initiatives have been made to ensure the objectivity of assessment, not only by conducting assessment getting on the same page with management teams, etc. but also by documenting the basis of assessment and developing assessment guidelines. (major banks, etc.)
 - ii. in order to conduct audits as a whole financial holding group, a common risk assessment report is used for the constituent banks, and the results of off-site monitoring of each subsidiary bank are brought together every month to review the evaluation, which is used to review the audit perspective, priorities, and audit plans. (regional financial institutions)

iv) Regarding root cause analysis,

i. the root causes underlying each audit issue are summarized and reported in regular quarterly reports.

⇒ As a result, the understanding of management teams, etc. against issues has penetrated (major banks, etc.)

ii. the issues in internal control common to the problems found in multiple individual audits and the reasons why the controls did not work were analyzed, and the problems in each department in charge and the problems related to the attitude of the management teams were delved into in accordance with the concept of 3rd line management. (securities/insurance companies)

v) Regarding the audit quality evaluation, in addition to conducting reviews concurrently with the implementation of audits to improve the skills of young auditors, companies conduct cross-sectional assessment of specific processes to identify issues common to the group, synchronize the cycle of medium-term management plans and external evaluation, and conduct external evaluation on a group/global uniform basis, thereby working to improve both internal and external evaluations. (major banks, securities/insurance companies)

[Issues]

- Some developing financial institutions are expected to strengthen their audit systems and audit infrastructure to raise the level of internal audits, but the management teams are not taking steps to strengthen the audit infrastructure, such as increasing personnel, due to the size of the organization.

⇒ Insufficient staffing in the internal audit function makes it difficult to start audit other than administrative deficiency audit at sales bases. In addition, personnel newly assigned to the internal audit function are urged to work as immediate assets, leading to a situation where they have no choice but to be trained on-the-job basis.

[Chart 4] Characteristic good practices and issues at monitored targets

Items	Overview of Characteristic Good practices
Audit System	
<p>Exchange opinions and information with management teams, audit committee members, and corporate auditors</p>	<p><Major Banks, etc.></p> <ul style="list-style-type: none"> ● The president, bank president, and business department managers regularly share risk awareness and exchange opinions on how to deal with issues. In order to have two-way discussions during interviews, the internal audit function explains its views and then asks for their opinions. <p><Regional Financial Institutions></p> <ul style="list-style-type: none"> ● Discussing individual audit results monthly with management teams, etc. and each department managers. Discussions have become lively, with opinions from managers of department which is not subject to audits. The auditors in charge also participate in these discussions, which also contributes to motivating the auditors.

Items	Overview of Characteristic Good practices
Audit System	
<p>Exchange opinions and information with management teams, audit committee members, and corporate auditors</p>	<p><Securities/Insurance Companies></p> <ul style="list-style-type: none"> ● The director in charge of internal audits regularly holds one-on-one meetings with each audit committee member. The meeting themes are centered on risk awareness and issues related to the specialty of each audit committee member, and opinions are exchanged with chairperson of the audit committee on the improvement and efficiency of internal audits.
<p>Off-site monitoring</p>	<p><Major Banks, etc.></p> <ul style="list-style-type: none"> ● A special team is formed to monitor areas of management concern (strategies and projects) identified during monitoring and individual audits. ● Key perspectives in monitoring (example) <ul style="list-style-type: none"> ➢ Grasping facts ➢ Impact and risk awareness (including possible future risks) ➢ Nature of change (temporary, structural) ➢ Impact of change ➢ Status of recognition and response by executive departments <p><Regional Financial Institutions></p> <ul style="list-style-type: none"> ● Assigning an area of responsibility to each person in charge or team in the internal audit function and monitoring changes in risk in a timely manner. The division of roles is by business, department, and risk category, as well as by sales base for audit on sales bases, etc., depending on the financial institution. ● For in-depth audits, the same auditor is in charge of monitoring and individual audits and conducts hypothesis verification. ● Monitoring meetings are held regularly (weekly, monthly, etc.) within the internal audit function. Each person in charge of monitoring provides an overview, based on that, and considers whether risk assessments need to be revised, the need for flexible audits, and points to be verified in individual audits. ● In addition to grasping the business situation and risks changes, monitoring also focuses on deepening auditors' understanding of the business and training them. <p><Securities/Insurance Companies></p> <ul style="list-style-type: none"> ● In order to conduct in-depth audits, reviewing the contents to be verified in individual audits as required, based on risk changes identified in monitoring. ● Reporting important findings discovered during monitoring to management teams and related departments, and, responding flexibly, such as switching to a special audit if the risk is deemed high.
<p>Risk assessment</p>	<p><Major Banks, etc.></p> <ul style="list-style-type: none"> ● For the purpose of “visualization of the verification items”, there is a movement in several financial institutions to change the evaluation unit from “business unit” to “audit unit”. ● Regarding the axis of risk categories, in addition to including strategic risks and conduct risks as evaluation targets, common risk categories are set for the entire organization for the purpose of discussion on the same evaluation axis as the audited department (similar initiatives are being made in securities/insurance companies). ● The control status is evaluated based on the perspective of past internal audit results and improvement status, occurrence situation of accident and administrative error, new risk occurrence and response status, control environment, etc.

Items	Overview of Characteristic Good practices
Audit System	
Risk assessment	<p><Regional Financial Institutions></p> <ul style="list-style-type: none"> ● Aiming to conduct audits from a management perspective, exchanging opinions with management teams, etc., understanding issues and risk recognition (macro approach), integrating the internal audit function's risk recognition (micro approach) and selecting important items for verification (audit themes), and reflecting them in the annual audit plan ● Conducting risk assessment and reviewing annual audit plans during the period; the frequency of the reviews varied depending on financial institutions: quarterly, or semi-annually ● Trying sharing risk assessment results throughout the company with the aim of maintaining and improving the comprehensiveness and timeliness of risk recognition and increasing risk sensitivity of the 1st and 2nd lines ● Analyzing the correlation between the prior risk assessment results and individual audit scores each fiscal year to verify the appropriateness of risk assessment
Audit plan	<p><Major Banks, etc.></p> <ul style="list-style-type: none"> ● When formulating the annual audit plan, clarifying the time allocated to individual audit services, off-site monitoring work, human resource development, etc. from the total annual man-hours, and considering both the execution of audit services and the maintenance/improvement of expertise by managing based on the plan during the term. <p><Regional Financial Institutions></p> <ul style="list-style-type: none"> ● Formulating a medium-term audit plan (3 years) in line with the medium-term management plan. The medium-term audit plan reflects measures of initiatives to improve the audit system in the medium-term, personnel plans, human resource development plans, areas to be watched over the medium- to long-term, and priority verification items, etc. ● The annual audit plan has a high position within the organization, and is disseminated within the organization along with the annual management plan.
Individual audit	<p><Major Banks, etc.></p> <p>[Thematic audit]</p> <ul style="list-style-type: none"> ● In the advance preparation stage, preparing a flow chart to visualize the risk controls of the processes covered by the audit, and considering the risk controls to be verified. ● Regarding follow-up responses, in order to prevent recurrence of high-risk audit findings, confirming the response of the audited departments in writing, and verifying the implementation/establishment status by on-site audits. <p>[Sales base audit]</p> <ul style="list-style-type: none"> ● Conducting comprehensive audits that verify all areas of sales bases from a risk-based perspective, as well as partial audits that are limited to high-risk areas. ● Conducting cross-sectional verification of sales bases for the purpose of identifying common issues at sales bases and verifying the effectiveness of internal controls. <p>[Audit aimed at improving operational efficiency]</p> <ul style="list-style-type: none"> ● After confirming the purpose and effect of operations and the risk control status, verifying the location of excessive procedures and duplicated operations in internal controls from an objective standpoint. Since audits of operational efficiency are highly challenging, experienced auditors of audits are assigned as dedicated personnel. <p><Regional Financial Institutions></p> <p>[Thematic audit]</p> <ul style="list-style-type: none"> ● Before starting the individual audit, interviews are conducted to understand the risk awareness of the director in charge of the audited department and the director in charge of corporate planning, and obtaining CSA (Control Self-Assessment) from the audited department to analyze the issues in internal control.

Items	Overview of Characteristic Good practices
Audit System	
Individual audit	<p><Regional Financial Institutions> [Thematic audit]</p> <ul style="list-style-type: none"> ● Based on the monitoring results and the information obtained through advance preparations, formulating RCM (Risk Control Matrix) and business flow diagrams, and creating an audit program (procedure manual) after analyzing the location of risks and the control status. ● In the audit report, recording excellent initiatives and reflecting in the evaluation. In order to gain the satisfaction of the management teams and the audited departments, the descriptions in the audit report are subdivided (“findings”, “risks”, “causes of occurrence”, “improvement proposals”) and fostering motivation for improvement responses. <p>[Sales base audits]</p> <ul style="list-style-type: none"> ● At the beginning of the fiscal year, conducting self-evaluation questionnaires on the internal control system for all sales bases, and are using results to consider the focus of the audit. ● In order to understand the situation of the sales bases in the advance preparation stage, interviews are conducted with the sales management department, loan planning department, and administrative department, as well as with the sales base managers and executives. ● Accumulating good practices confirmed in the sales base audit within the internal audit function and using to provide advice during various interviews and during considering improvement proposals. <p><Securities/Insurance Companies> [Thematic audit]</p> <ul style="list-style-type: none"> ● Directly reporting the audit results, excellent initiatives, and process of discussion content to the directors in charge of the audited department to foster a sense of satisfaction. <p>[Sales base audits]</p> <ul style="list-style-type: none"> ● Verification is carried out using an audit program (procedure manual) based on the risk characteristics of the sales base, rather than a unified audit program (procedure manual) for all sales bases. <p>[Collaboration between headquarters/theme audits and sales base audits]</p> <ul style="list-style-type: none"> ● Regularly exchanging opinions and information between the headquarters audit and the sales base audit teams to conduct audits that are conscious of the series of process from headquarters to sales bases.
Root cause analysis	<p><Major Banks, etc.></p> <ul style="list-style-type: none"> ● Analyzing the root cause of issues found in individual audits from the perspective of whether there are any problems related to procedures, reporting systems, 2nd line monitoring/guidance, strategy formulation processes, plans/goal setting, management team’s attitude, and governance. <p><Regional Financial Institutions></p> <ul style="list-style-type: none"> ● Summarizing the results of the sales base audits at the end of the fiscal year, and reporting to the board of directors on initiatives and risk assessments of findings regarding the internal control systems of the sales bases, and trends in causes. ● Analyzing trends in events observed at multiple sales bases, and discussing causes and measures with the relevant departments at headquarters. <p><Securities/Insurance Companies></p> <ul style="list-style-type: none"> ● When conducting root cause analysis, the focus is on the authority /division of responsibilities of the responsible departments, decision-making structure, governance structure, etc., as well as comprehensively analyzing based on the corporate culture through data analysis, interviews, and questionnaires.

Items	Overview of Characteristic Good practices
Audit System	
<p>Quality assurance</p>	<p><Major Banks, etc.> [Internal evaluation: continuous monitoring] (Concurrent audit reviews)</p> <ul style="list-style-type: none"> ● The person in charge of quality evaluation conducts concurrent review at each stage of creating plans of the individual audit, conducting audit, and creating audit report to improve quality, facilitate smooth audit services, and develop human resources. <ul style="list-style-type: none"> ➢ The targets of the concurrent audit review are determined according to the importance of the audit and the years of experience of the audit manager. ➢ When creating an individual audit plan: confirming contents of the audit plan and audit program (procedure manual). ➢ When conducting an audit: confirming findings, the hypothesis of the root cause at that time, and the future verification policy. In addition, the person in charge of quality evaluation attends interviews with the audited department to confirm the communication skills of the audit team. ➢ When creating an audit report: confirming findings and the depth of the root cause analysis. <p>(Cross-sectional assessment of specific processes)</p> <ul style="list-style-type: none"> ● In order to understand issues common to group companies and propose measures to improve quality, conducting a cross-sectional assessment of specific processes of the audit services (e.g. risk assessment, root cause analysis, etc.) by the person in charge of quality evaluation. <p>(Ex post facto questionnaire)</p> <ul style="list-style-type: none"> ● In order to improve the quality of internal audits, conducting an ex post facto questionnaire for the audited departments at the end of the audit. Grasping the status of understanding of audited operations and risk control, the effectiveness of improvement proposals, satisfaction with audit results and findings, communication, sense of burden in audit response, and realization of the difference from “inspection”. <p>[External evaluation]</p> <ul style="list-style-type: none"> ● Conducting external evaluation on a group/global uniform basis (similar initiatives for securities/insurance companies). <p><Regional Financial Institutions> [Internal evaluation: Continuous monitoring]</p> <ul style="list-style-type: none"> ● Considering the Internal evaluation as part of human resource development, and reflecting the soft skills of auditors (interview skills, logical thinking skills, presentation skills) in the evaluation. <p>[Internal evaluation: Periodic self-assessment]</p> <ul style="list-style-type: none"> ● Once a year, conducting an evaluation by a CIA (Certified Internal Auditor) holder based on the “International Standards for the Professional Practice of Internal Auditing”, and extracting issues using regulations and guidelines as evaluation standards to extract new improvement opportunities. <p>[External evaluation]</p> <ul style="list-style-type: none"> ● In addition to evaluation based on the “International Standards for the Professional Practice of Internal Auditing”, obtaining an evaluation of whether or not there are any areas in which the internal audit structure is excessive in light of the actual situation (from the perspective of efficiency).

Items	Overview of Characteristic Good practices
Audit System	
<p>Quality assurance</p>	<p><Securities/Insurance Companies> [Collaboration with human resource development programs]</p> <ul style="list-style-type: none"> ● By having one team within the internal audit function take charge of the quality evaluation function, audit methodology development function, and education function, the results of the quality evaluation are used to review audit methods and human resource development programs. In addition, the person responsible for the team frequently exchanges information and opinions with other financial institutions, and uses them for reviewing audit methods and training. <p>< Reference: Foreign Financial Institutions></p> <ul style="list-style-type: none"> ● The following initiatives are conducted to prevent variations in audit quality among auditors. <ul style="list-style-type: none"> ➢ In individual audits, clearly stating when, where, who, what is being done, and why the auditor judged it to be appropriate or inappropriate in the deliverables (audit records and audit reports) as evaluation items for the development status of internal control in the individual audits. ➢ Verifying deliverables that auditors who have little experience creates by independent auditors who are not involved in the individual audits. ➢ Verifying individual audits ex-post by the quality evaluation team.
<p>Group/global audit</p>	<p><Major Banks, etc.></p> <ul style="list-style-type: none"> ● Grouping the internal audit function of domestic group companies into four groups: i) companies with an autonomous audit system, ii) companies that conduct risk-based audits, iii) companies that focus on compliance audits, iv) companies that do not have an internal audit function), and organizing the role of each internal audit function by each grouping. ● In addition to providing support for overseas bases to improve their internal audit function according to the level of their local internal audit systems, the internal audit function of the holding company and parent company provide support and advice to overseas group companies by providing audit tools and audit personnel. <p><Regional Financial Institutions></p> <ul style="list-style-type: none"> ● Regarding group internal audit systems, some financial institutions have integrated and aggregated their internal audit function into the holding company, while others have established internal audit function in each group company. The characteristics of each are as follows. <ul style="list-style-type: none"> ➢ Financial institutions that have integrated and aggregated their internal audit function into the holding company communize the sales base audit methods for subsidiary banks, share the findings in audits of each subsidiary bank's sales base within the holding company's internal audit function, and verify whether other subsidiary banks have similar vulnerabilities in internal control that have been found, thereby implementing horizontal deployment among group banks. ➢ In financial institutions that have established internal audit function in each group company, the internal audit function of the holding company grasps and manages the implementation status of internal audits of each group company, and cooperates with and provides guidance and advice to the internal audit function of each group company. <p><Securities/Insurance Companies></p> <ul style="list-style-type: none"> ● Group/global audits are managed in a matrix system based on two axes by region and by audit area. By region, the focus is mainly on reporting to the regional audit committee and regional resource management, while by audit area, the focus is on audit programs (procedure manual) for each audit, audit quality such audit results and project management. Cooperation between roles is achieved through regular meetings attended by the director in charge of internal audit, the person in charge of internal audit of each region, and the person in charge of each audit area, where information is shared and discussions are carried out. ● Unifying audit methods and templates required for conducting internal audits on a group/global basis.

Items	Overview of Characteristic Good practices
Audit Infrastructure	
Securing human resources	<p><Major Banks, etc.></p> <ul style="list-style-type: none"> ● Based on the results of risk assessment, comparing the human resources portfolio required for the next fiscal year’s audit and monitoring with the current human resources portfolio, and after confirming the excess or deficiency by specialist area, requesting the human resources department to address the deficiency, as well as utilizing human resources development and co-sourcing within the department (similar initiatives for securities/insurance companies). <p><Regional Financial Institutions></p> <ul style="list-style-type: none"> ● Conducting external and internal recruitment. In the internal recruitment, several applicants have applied because they can learn internal control that is useful for management. ● Hiring people who have CIA (Certified Internal Auditor) certification from large financial institutions and auditing firms. ● Some new employees are motivated by the fact that young employees who could be future management candidates are assigned to the internal audit function, and wish to be assigned to the internal audit function. ● In order to accumulate know-how within the internal audit function and elevate the position of the internal audit function, establishing an audit expert system instead of personnel rotation. ● Establishing a system to extend the tenure of those with professional qualifications (Certified Internal Auditors, etc.) in the internal audit function. <p><Securities/Insurance Companies></p> <ul style="list-style-type: none"> ● External recruitment in Japan is carried out by the internal audit function of the holding company all at once, and auditors are seconded from the holding company to each domestic group company, aiming to standardize the auditors.
Human resource development	<p><Regional Financial Institutions></p> <ul style="list-style-type: none"> ● In order to improve audit skills, regularly holding “individual audit review training sessions” within the internal audit function. ● Formulating skill checklists and training curricula by specialty field, visualizing individual skills, and developing specialized human resources. <p><Securities/Insurance Companies></p> <ul style="list-style-type: none"> ● By providing mentors to auditors in their first and second years after transferring, aiming to improve their skills through guidance on audit skills and communication skills. ● Recognizing that in order to sustainably conduct audits that contribute to management, it is necessary to integrate audit specialists with personnel from the business and management departments, and implementing personnel rotations between the 1st, 2nd, and 3rd lines from a medium- to long-term perspective.

Items	Main Issues
Audit System	
Off-site monitoring	<p><Major Banks, etc.></p> <ul style="list-style-type: none"> ● Comprehensive understanding of risks from a forward-looking perspective is insufficient. <p><Regional Financial Institutions></p> <ul style="list-style-type: none"> ● Most audit resources are allocated to individual audits on a priority basis, so monitoring is limited to mere information gathering, and timely response systems for changes in risks have not been established or are insufficient. ● In new audit areas, such as DX, verification is limited to compliance audits, and still exploring what measures are necessary for forward-looking audits.

Items	Main Issues
Audit System	
Risk assessment	<p><Regional Financial Institutions></p> <ul style="list-style-type: none"> ● Due to a lack of audit resources, risk assessments were not reviewed during the period. ● Risk assessments become personalized, and the basis for risk assessment decisions is unclear. ● Results of risk assessment of the sales base are reflected in audit frequency and cycle, but are not reflected in the depth of audits (the depth of audits is currently the same for high-risk and low-risk stores, and the results of risk assessment are not reflected in audit procedures) <p><Securities/Insurance Companies></p> <ul style="list-style-type: none"> ● Recognizing that annual risk assessments require a lot of human and time effort, and considering the development of a more automated risk assessment method to improve efficiency.
Individual audits	<p><Major Banks, etc.></p> <ul style="list-style-type: none"> ● Regarding the formulation of audit programs (procedures), there are differences in the comprehensiveness of risk controls and the depth of audits depending on the level of auditors. <p><Regional Financial Institutions></p> <ul style="list-style-type: none"> ● The audited department’s operations were not fully understood in advance preparation, and on-site audits were conducted without a clear understanding of the location of risks and the status of risks and controls to be verified (incomplete audits). ● The audit program (procedures) for sales bases was not reviewed, resulting in an increase in the number of items to be checked, which reduced the time available for interviews with sales staff and root cause analysis. <p><Securities/Insurance Companies></p> <ul style="list-style-type: none"> ● In advance preparation, the establishment and hypothesis of “ideal controls (decision criteria for verification)” relies on the knowledge of experienced auditors, so it is necessary to improve the level of each auditor (through internal study sessions and on-the-job training).
Root cause analysis	<p><Major Banks, etc.></p> <ul style="list-style-type: none"> ● The analytical and advisory functions to link problems discovered in individual audits to the root causes common to the entire company and to solutions to company-wide issues are undeveloped (regional financial institutions also have similar issues) <p><Regional Financial Institutions></p> <ul style="list-style-type: none"> ● Part of the cause analysis is limited to human factors such as “carelessness” and “lack of understanding”, and the root cause analysis is undeveloped. <p><Securities/Insurance Companies></p> <ul style="list-style-type: none"> ● Digging deeper the root causes through trend analysis of past problems is undeveloped.
Audit Infrastructure	
Securing human resources	<p><Major Banks, etc.></p> <ul style="list-style-type: none"> ● Due to the aging of chief auditors, it is difficult to secure future chief auditors. (regional financial institutions also have similar issues) <p><Regional Financial Institutions></p> <ul style="list-style-type: none"> ● It is difficult to secure people with experience in the corporate planning department and people with expertise in systems and markets.
Human resource development	<p><Regional Financial Institutions></p> <ul style="list-style-type: none"> ● Skill management and training curricula for auditors in their specialized fields are undeveloped. <p><Securities/Insurance Companies></p> <ul style="list-style-type: none"> ● Immature communication skills for in-depth dialogue with the management team and audited organizations

Furthermore, the FSA was able to confirm that advanced financial institutions were taking steps to further raise the level of internal audits. The Characteristic initiatives are as follows and shown in Figure 5.

[Audit System]

- (i) Agile audits were introduced as a flexible audit method, but the burden of frequent meetings with the audited department was greater than expected, so the company reverted to a traditional audit method⁶.

On the other hand, meetings were held with the audited department approximately every two weeks during the audit period, and the progress and findings of the audit were shared in a timely manner to share the verification content and lead to early consideration of responses.

⇒ As a result, it became easier to share awareness by communicating with the audited department, and it became possible to conduct audits that were more efficient than before and that satisfied the audited department. (securities/insurance companies)

- (ii) Regarding the use of IT and data analysis,

- i. Using transcription tools, RPA, and ChatGPT to reduce the workload associated with audits (all business types).

- ii. Presenting the results of analysis based on objective facts using data analysis to the audited department leads to satisfying recommendations, and shifting from sample verification to verification of all data leads to improved assurance accuracy. (major banks, etc., securities/insurance companies)

- iii. Utilizing AI to assign score levels from a vast amount of data, auditors focus on examining high scores to identify deficiencies in internal control systems and strengthen them. (securities/insurance companies)

- iv. In addition to setting target values for the utilization of data analysis in individual audits, optical character recognition (OCR) and natural language programming (NLP) are being used to change the checking of all contracts (thousands of contracts) from the partial checking.

⇒ As a result, the number of cases utilizing data analysis has increased, and data analysis has been used to compare and analyze the set standards with thousands of customer information, identifying those that do not meet the standards, and raising important issues from the identified exceptions. (securities/insurance companies)

- (iii) Regarding the audit method for corporate culture, in order to evaluate the impact of corporate culture on risk control, a thematic audit was conducted in which questions were created to verify the behavioral patterns of sales base managers in situations where there was concern about behavior contrary to customer-oriented business operations at the time of sales of high-risk products, and interviews were conducted.

⇒ From the results of the interviews, the existence of behavioral patterns that go against expected

⁶ "Agile audits" is one of the methods to realize flexible audits, but it is not the only method, and each financial institution is expected to use its own creativity and ingenuity according to its size and characteristics.

behavior and the underlying causes were identified. (major banks, etc.)

- (iv) Working to establish a system that allows us to conduct audits that respond to environmental changes that occur during the progress of long-term large-scale projects (all business types)

[Audit Infrastructure]

- (i) Some financial institutions position the internal audit function as one of the important career paths for future management personnel, and they are working to develop future auditors by temporarily assigning them to audit services through the trainee system from the audited department. (all business types)
- (ii) Some of the financial institutions with trainee systems are engaged in continuous communication to develop future auditors, for example, by providing follow-up services to trainee participants. (major banks, etc.).
- (iii) Proactive using of co-sourcing for audits in highly specialized areas to create a sense of satisfaction within the organization (all business types)

[Chart 5] Initiatives toward 4th Phase and Other Characteristic Good practices

Items	Overview of Characteristic Good practices
Initiatives toward 4th Phase	
Flexible audit	<p><Securities/Insurance Companies></p> <ul style="list-style-type: none"> ● Developing a guide for agile audits, with the assumption that they will be applied to project audits and audits conducted at the urgent request from the management team.
Utilization of IT, data analysis	<p><Major Banks, etc.></p> <ul style="list-style-type: none"> ● Analyzing data on the characteristics of sales bases where problems occur based on the results of audits conducted over several years, and selecting sales bases to be audited and key verification items based on the results of the analysis. <p><Regional Financial Institutions></p> <ul style="list-style-type: none"> ● Utilizing RPA (Robotic Process Automation) to acquire data for sales bases risk assessments and extract data for verification of unusual transactions ● In order to verify the penetration and retention state of the corporate culture, questionnaires targeting all employees was conducted via a web system. Text mining was used for open-ended questionnaires, and the factors impeding the penetration and retention of the corporate culture were analyzed based on response trends and word correlations, etc. <p><Securities/Insurance Companies></p> <ul style="list-style-type: none"> ● Establishing a team dedicated to data analysis to promote the digitalization of the internal audit department <p>< Reference: Foreign Financial Institutions></p> <ul style="list-style-type: none"> ● A dedicated data analysis team composed of people having a background in science has been established in the internal audit function. In addition to data analysis, this team develops and provides training programs. ● Data analysis can improve the accuracy of assurance, increase the efficiency of audits, and provide persuasive recommendations based on objective facts, so the team focuses on improving the data analysis skills of auditors in charge of individual audits. ● Auditors are trained according to the internal audit department’s own training program, with individual data analytics skill levels divided into five categories.

Items	Overview of Characteristic Good practices
Initiatives toward 4th Phase	
Utilization of IT, data analysis	<p>< Reference: Foreign Financial Institutions ></p> <ul style="list-style-type: none"> ● In order to manage the use of data analysis in individual audits, a dashboard is created to display the type of data analysis and cases that directly contributed to the findings. ● Examples of utilization of IT and data analysis <ul style="list-style-type: none"> ➢ Using a program that extracts relevant character strings from PDF files and transcribes them into a spreadsheet, verifying whether the amounts in the PDF files match the amounts in the system. ➢ Using a program that extracts data entered into a spreadsheet attached to an email from the middle department's mailbox regarding the transaction process with a large customer, verifying that it matches the data calculated by the front department and performing recalculations. ➢ Visualizing the discussion structure from meeting minutes using natural language processing technology.
Audit methods for corporate culture	<p><Major Banks, etc.></p> <ul style="list-style-type: none"> ● Setting an issue (hypothesis) that a positive corporate culture is a negative factor and conducting verification <ul style="list-style-type: none"> ➢ Setting an issue (hypothesis) and conducting verification that cost is being ignored (negative) in response to the challenge (positive). ➢ Setting an issue (hypothesis) and conducting verification that it may be personalized (negative) as opposed to specialty oriented (positive). <p><Regional Financial Institutions ></p> <ul style="list-style-type: none"> ● In order to evaluate the penetration status of appropriate behavioral patterns for achieving business goals, conducting questionnaires, etc., and verifying the level of awareness and practice status in each department and base. ● After grasping the situation of the sales base based on the qualitative and quantitative information collected in advance, verifying whether a sound corporate culture has been fostered on both offensive and defensive sides based on the evaluation axis considering the management philosophy. In addition, based on the perception and behavior of individual measures, verifying the content of the measures and the management system of the headquarters, and making improvement recommendations to the headquarters. <p><Securities/Insurance Companies ></p> <ul style="list-style-type: none"> ● Conducting an audit of the risk culture by determining the elements to be evaluated, such as attitudes and behaviors regarding risk awareness, management, and risk control, as well as the perspective and goals to be achieved for the maturity evaluation of each element.
Forecasts in response to changes in the business environment and advice based on them	<p><All Business Types ></p> <ul style="list-style-type: none"> ● Audits for projects are conducted and divided into several accompanying audits to respond flexibly. ● New audit format for large-scale projects to be run side-by-side over a long period of time
Other Characteristic Initiatives	
Career path	<p><Regional Financial Institutions ></p> <ul style="list-style-type: none"> ● In order to cultivate a management perspective in young employees who are candidates for the position of sales base manager, they are assigned to the internal audit function. <p><Securities/Insurance Companies ></p> <ul style="list-style-type: none"> ● In order to ensure a balance between aggressive and defensive management of sales base, one of the requirements for sales base managers is set to have multiple years of experience in sales base audits.

Items	Overview of Characteristic Good practices
Other Characteristic Initiatives	
Trainee system	<p><Major Banks, etc.></p> <ul style="list-style-type: none"> ● Accepting trainees for the purpose of providing future management candidates with opportunities to systematically acquire knowledge and skills related to governance, internal control, and internal audits, which are necessary for management. ● Aiming to develop human resources for global integrated audits by sending them to overseas regions for short periods to acquire the knowledge of auditors. <p><Regional Financial Institutions></p> <ul style="list-style-type: none"> ● Through the trainee system, accepting a dozen employees a year and select those with experience in the trainee system as candidates for auditors.
Co-sourcing	<p><All Business Types></p> <ul style="list-style-type: none"> ● Co-sourcing is used for the purpose of utilizing external expertise and supplementing audit resources. Knowledge and know-how gained from co-sourcing is absorbed and used in the next and subsequent audits. ● Co-sourcing is managed as part of outsourcing management, and the rules clarify that the final responsibility for deliverables lies with the internal audit function that is the outsourcer. <p><Regional Financial Institutions></p> <ul style="list-style-type: none"> ● To absorb know-how in communication skills such as interviewing skills is set as one of the objectives of co-sourcing. ● In order to gain a sense of satisfaction for co-sourcing within the organization, not only the internal audit function but also each department participates in the selection of co-sourcing partners.

(3) Understanding of Internal Audits for Audited Departments and Fostering Risk Ownership

Looking at the status of initiatives in audited departments, it could be confirmed that both advanced and developing financial institutions continued to work on i) understanding of internal audits in audited departments and ii) fostering risk ownership in audited departments, depending on their own circumstances.

In building a relationship with audited departments, given the position and status within the company of the internal audit function, there is no rapid progress in mutual understanding between the internal audit function and audited departments in a short period of time. For example, in the case of audits related to corporate culture, it can be seen that there are difficulties in sharing awareness of the results with audited departments. However, without stopping this approach, the internal audit function should continue its initiatives to foster risk ownership in audited departments while seeking support from the management team, etc. It should be reaffirmed that these initiatives will ultimately strengthen the internal controls of a financial institution and lead to an increase in corporate value.

The following are good practices and issues and other characteristic initiatives [Figure 6].

[Good practices]

i) Understanding of internal audits in audited departments

- The purpose, significance, and role, etc. of internal audits were communicated in the

company newsletter (major banks, etc., regional financial institutions)

- Introduced the activities of the internal audit function through an internal SNS (major banks, etc.)

ii) Fostering risk ownership in sales base managers, etc.

- Divided the risk assessment results of sales base audits into “items that can be controlled by the sales base” and “items that cannot be controlled by the sales base”, and regularly returned to the sales base, utilizing motivation to take autonomous improvement measures (regional financial institutions)
- Regularly communicated with sales base managers to evaluate whether they were promoting and managing sales based on appropriate risk awareness, and provided advice as necessary (securities/insurance companies)

iii) Communication with audited departments, etc.

- In addition to shifting the audit method from the directive to interactive approach, introduced good communication methods with audited departments and increased opportunities for communication, such as removing audit results from the performance evaluation items.

⇒ As a result, psychological safety of audited departments was secured, and frank communication was realized. Furthermore, the situation has progressed to the point where the audited departments have requested audit departments to provide advice on the internal control system (regional financial institutions).

[Issues]

(i) Because measures to foster risk ownership in the audited departments are not fully functioning, some of the departments in charge of the 1st line do not correctly understand the information on risk awareness and risk control, etc. transmitted by the internal audit department, etc.

⇒ Some audited departments promoted sales based on incorrect understanding, resulting in occurrence of multiple problematic sales practices in terms of compliance.

(ii) Some of the departments of the 1st line are giving priority to fulfilling their sales promotion responsibilities.

⇒ As a result, risk awareness was being naive and the implementation of procedures has become a mere formality, leading to inappropriate sales promotion from the viewpoint of customer-oriented business operations.

(iii) In audits of promotion measures to “improve the current situation”, it is difficult to make effective improvement proposals because there are many issues for which there is not only one answer, such as goals, processes and time axes.

⇒ This does not lead to a sense of satisfaction from the audited department.

[Chart 6] Characteristic good practices and issues at monitored targets

Overview of Characteristic Good practices	
Understanding of internal audits for audited departments	<p><Major Banks, etc.></p> <ul style="list-style-type: none"> ● Various initiatives were seen to introduce the role and work contents of the internal audit function. <ul style="list-style-type: none"> ➢ An interview with the head of the internal audit function on the importance and attractiveness of internal audits was published in the company newsletter. ➢ Self-produced PR video (drama-style) for audited departments to watch prior to the start of audits ➢ Original character from the internal audit function to introduce the work contents
Fostering risk ownership in audited departments, etc.	<p><Regional Financial Institutions></p> <ul style="list-style-type: none"> ● The internal audit function sends out the company newsletter to the bank, which introduces good practices and deficiencies in sales base audits related to sales base operations and management, as well as examples and key points of root cause analysis. In addition, for sales base managers, the management reports to the internal audit function on the status of the use of the company newsletter. ● The internal audit function's risk assessments are shared throughout the company to foster risk ownership on the 1st line and raise risk awareness on the 2nd line. ● The sales base manager presents the status of improvement initiatives in response to findings from the sales base audits at the audit review meeting attended by audit committee members and each department manager of headquarters, followed by discussions among participants, thereby contributing to fostering risk ownership and improvement of internal control systems. <p><Securities/Insurance Companies></p> <ul style="list-style-type: none"> ● In addition to the overall evaluation in the audit report, the awareness of the person in charge of the audited department regarding the control environment is evaluated on a three-grade evaluation (proactive, reactive, passive), which (i) raise the awareness of the person in charge regarding the risk management system, and (ii) create a system to continuously grasp the improvement or deterioration of the control environment over time. *The evaluation is determined based on the attitude of the person in charge (Tone at the top) and the degree to which RCSA (Risk Control Self-Assessment) has been established.
Communication with audited departments, etc.	<p>[Communication with audited departments]</p> <p><Major Banks, etc.></p> <ul style="list-style-type: none"> ● In the process of moving from the 3rd phase to the 4th phase, promoting the creation and establishment of a personnel cycle in which employees with audit experience can make utilization of their experience in departments involved in management. <p><Regional Financial Institutions></p> <ul style="list-style-type: none"> ● In order to gain the audited department's satisfaction of the findings and contribute to better business operations of the audited department, setting up opportunities to explain the background of the findings and to hear opinions from the audited department. <p><Securities/Insurance Companies></p> <ul style="list-style-type: none"> ● Communicating to the audited department the exemplary initiatives and innovative ideas and other excellent initiatives of the audited department identified through internal audits, and proactively reporting them to management team, etc. ● Since the frequency of communication with the departments monitored varied depending on the person in charge, the audit planning person manages the communication status.

Overview of Characteristic Good practices	
Communication with audited departments, etc.	<p>[Collaboration with the management department (2nd line)]</p> <p><Major Banks, etc.></p> <ul style="list-style-type: none"> ● In order to identify signs of risk, monthly information sharing meetings are held with the risk management department, compliance department, etc. regarding signs and risk awareness. ● In order to share risk awareness with the 2nd line, sharing the results of risk assessment conducted by the internal audit function with the risk management department. <p><Regional Financial Institutions></p> <ul style="list-style-type: none"> ● In order to identify signs of risk, monthly meetings are held between the heads of the audit function, risk management department, compliance department, etc. to exchange information on risk awareness, etc. <p>< Reference: Foreign Financial Institutions></p> <ul style="list-style-type: none"> ● In addition to collaboration with the management department (2nd line) through regular or ad-hoc meetings, quarterly verification of the management system of the management department (2nd line) is conducted separately from regular audits to enhance the functions of the management department (2nd line). If, based on the results of the verification, the internal audit function determines that it can rely on the monitoring function of the management department (2nd line), it doesnot conduct direct audits of the 1st line, thereby promoting the enhancement of the functions of the management department (2nd line) and the efficiency of audits.

Main Issues	
Understanding of internal audits for audited departments	<p><Regional Financial Institutions></p> <ul style="list-style-type: none"> ● The audited department perceives internal audits as mere inspections because the management team, etc. and the internal audit function do not make initiatives to understand the purpose and role of internal audits. ● The audited department does not understand the purpose and role of internal audits, and perceives internal audits as being in a conflicting position (there is no culture that actively accepts them).

3. The Importance of Communication between the Financial Services Agency and the Internal Audit Function

The FSA recognizes that good communication with the financial institution's internal audit function is important in order to carry out more efficient and in-depth monitoring.

In its inspections and monitoring, the FSA engages in in-depth dialogue with the internal audit function regarding identified vulnerabilities in the risk management systems of financial institutions and the measures to mitigate and improve them. At the same time, it checks whether the management team responds in a timely and appropriate manner to vulnerabilities in the risk management systems discovered by the internal audit function. It can be said that the FSA's monitoring and financial institutions' internal audits have the same way of doing, in that they aim to discover vulnerabilities in risk management systems and prevent them from becoming apparent.

The management resources of the FSA's Monitoring Department are limited, and the FSA recognizes that by receiving information from the internal audit function and proactively utilizing the results of their verifications, etc., the FSA can also improve the efficiency of its administration by narrowing down the items to be verified and the scope of verification in monitoring to the main issues.

For this reason, the FSA would like to further promote collaboration with the internal audit functions of financial institutions.

The FSA is taking the following actions in its monitoring of large banking groups.

- About once every half-year period, the FSA requests financial institutions to submit audit reports compiled by the internal audit functions of financial institutions, and exchanges opinions with them after sharing the status of internal audits. Through this, the FSA confirms the financial institutions' own risk awareness and communicates the FSA's risk awareness, thereby contributing to risk assessment in the internal audit functions.
- Providing financial institutions with information on individual complaints, etc. which the FSA received, and requesting them to investigate the facts and share the results of such investigations, thereby fostering recognition of issues within the internal audit functions of financial institutions and encouraging financial institutions to conduct self-cleansing and to take autonomous improvement measures.
- Promoting financial institutions to strengthen their own project management and take necessary improvement measures by requesting reports on the audit results of projects for such as integration of overseas bases and systems, and checking the progress of important projects.
- Regarding problematic incidents that have occurred at group companies, while the group companies are investigating the facts and taking improvement measures based on the findings, the FSA receives information from the group internal audit function of the holding company that manages the group companies, which makes it easier for the FSA to confirm the status of initiatives at the group company or other group companies. Furthermore, by having a dialogue with each company based on that information, efficient and effective monitoring is achieved.

III. Recognition of Issues and Expectation Level by the Financial Service Agency

1. Recognition of Issues by the Financial Service Agency

Based on the monitoring results to date, the FSA has confirmed that advanced financial institutions have made steady progress in developing the system from the 2nd phase to 3rd phase and from the 3rd phase to 4th phase. In order to continue to respond to changes in the business environment and to their own business models and management issues that are becoming more diverse and complex, it is desirable for them to continue to improve their internal audit functions, including securing and assigning personnel, with reference to the Institute of Internal Auditors (IIA) "Global Internal Audit Standards," etc. which are scheduled to be applied from January 2025⁷.

Some of these financial institutions are also clarifying the roles and responsibilities of the 1st, 2nd, and 3rd lines, and some are working to improve their internal audits with a view to business sustainability from a medium- to long-term perspective.

On the other hand, for developing financial institutions, the FSA found that there were large differences in the progress of initiatives even within the same business type, depending on the degree of understanding and support for internal audits by management teams, etc (proactive or passive). It can be seen that each financial institution has different management issues, and in addressing these issues, difficult decisions must be made on how to allocate limited management resources.

However, effective internal audits are an essential element of corporate governance, which is essential for ensuring financial soundness and the appropriateness of operations, and provide extremely important assurance to stakeholders, including management teams, etc. and the FSA. Management teams, etc. should be more aware of the importance and usefulness of internal audits, and also referring to the "Interim Report 2023" and the examples of initiatives introduced in this document, should discuss what kind of internal audits they should aim for based on the size and characteristics of their own financial institutions, and constantly work for sophistication. In doing so, the FSA hopes that the management teams, etc. will take lead in facilitating the implementation of such initiatives by the internal audit function and other related departments, also referring to the FSA's expectation level shown below. And the FSA would like to reaffirm that this will ultimately lead to the medium- to long-term business sustainability.

⁷ The Institute of Internal Auditors (IIA) "Announcement of the Publication of 'Global Internal Auditing StandardsTM' (Japanese version)" (IIA website (URL: https://www.iiajapan.com/leg/iaa/info/2024/20240705_global_ia_std.html))

The Standards include revisions to the roles and responsibilities of the board of directors and clarification of the roles and responsibilities of the chief executive officer with respect to governance of the internal audit function. The Standards are principles to enable high quality and effective internal audits in all organizations, and it is expected that financial institutions, especially those that are becoming increasingly globalized, will utilize the Standards as quality assessment criteria for periodic internal and external assessments, and will work to improve the internal audit function and the governance.

In this regard, some advanced financial institutions are conducting gap analysis with their current internal audit systems, formulating response policies, and making preparations with the support of external experts in anticipation of the start of application of the Global Internal Audit Standards in January 2025. In addition, some of the good practices introduced in this document incorporate requirements that have already been defined in the Standards (i.e., "shall be" in the Standards).

2. Expectation level by the Financial Service Agency

Based on the above recognition of the issues and the monitoring results, the FSA would like to present the expectation level of the FSA with respect to the issues presented in the “Interim Report 2023” as follows.

(Role of internal audits in maintaining and improving governance and risk management)

Financial institutions have made initiatives to establish and improve appropriate internal control systems, including internal audit functions. However, misconduct incidents that have a significant impact on the management of financial institutions and significantly damage their credibility continue to occur. Many of these misconduct incidents appear to be caused by problems related to the attitude of management teams, business models, management strategies, corporate culture, etc.

Based on the above, strengthening governance is an important issue, and the role and function effecting of internal audits will contribute greatly to solving it. Management teams, etc. should reaffirm that improving internal audits is a means of maintaining and improving governance and risk management throughout the organization.

As an example of characteristic initiatives, there was a case in which the concept of the “Three Lines Model⁸” is being promoted as beneficial to the establishment of strong governance and an optimal risk management system for financial institutions.

(Off-site Monitoring)

It is necessary to grasp the risks arising from accelerating changes in the environment in a timely manner, and when an increase in risk is recognized, it is necessary to make timely recommendations to the responsible department to promote prompt improvement if any concerns are identified, such as considering whether or not a review of risk assessment is necessary, the need for flexible audits, and the points to be verified in individual audits. To this end, it is important for the internal audit function to immediately identify changes in risk from a forward-looking perspective (dynamic risk assessment).

As characteristic initiatives, for example, there was a case in which the internal audit function not only identified risks that became apparent through off-site monitoring, but also examined possible future risks and their impact based on that.

(Risk Assessment)

While the environment surrounding financial institutions changes and the areas to be audited expand, it is important to ensure the comprehensiveness of risk assessment. In addition, in order to utilize limited audit resources effectively and efficiently, it is necessary to allocate audit resources efficiently, such as concentrating audit resources on areas with high residual risk. To this end, it is important to improve the

⁸ The Institute of Internal Auditors (IIA) “IIA’s Three Lines Model: Revision of the Three Lines of Defense” (July 2020)
(IIA website: URL : https://www.iiajapan.com/leg/pdf/data/iaa/2020.07_1_Three-Lines-Model-Updated-Japanese.pdf), etc.

accuracy of risk assessment for the business operations of the entire organization (group as a whole). Furthermore, if the risk categories and risk assessments used by the 2nd line departments for risk management are effective, the results can be used as risk assessments for the internal audit function.

As characteristic initiatives, for example, since the audit units used in risk assessment may change in accordance with corporate activities, there were cases where a mechanism was established to ensure the comprehensiveness of audit units by capturing such changes in a timely manner. In addition, there were cases where IT and data analysis were used to collect and analyze data required for risk assessment, thereby improving efficiency.

(Root Cause Analysis)

Root cause analysis is conducted on findings and observations in individual audits according to their importance. Root cause analysis is an important method for clarifying the location of issues and risks in organizational management, and should be considered a prerequisite for audits required by management, regardless of the level of internal audits.

As characteristic initiatives, for example, there were cases where the results of individual audits for a certain period of time were aggregated, after seeing the big picture, and analyzed to lead to improvements (improvement of management systems). In addition, there were cases where the location and magnitude of risks were objectively evaluated through analysis of a large volume of data using IT, and high-risk items were intensively audited to lead important management issues.

In addition, some financial institutions considered that issues to identify the root causes of individual findings, but not to identify the root causes of issues common to the entire organization and to make recommendations to management.

(Ideal Way of Group/Global Audit System)

Large banking groups, large securities companies, and large insurance companies are becoming increasingly globalized. At the same time, large banking groups have become financial groups that include not only banks but also companies engaged in non-banking businesses, such as securities companies, leasing companies, credit card companies, etc. Similarly, many securities companies and insurance companies other than large banking groups are financial groups that have other types of businesses under their umbrella. In addition, some regional banks are also shifting to holding company structures, and some of them have companies engage in non-banking businesses under their umbrella, such as securities companies and advanced banking service companies.

Given these circumstances, it is important for financial institutions to evaluate the effectiveness of various organizational activities by conducting effective internal audits from a group/global perspective.

Within a financial group, there are various types of financial and non-financial companies, and it is important to promote commonality and sophistication not only efficiency of audit methods and introduction of audit support systems but also viewpoint of quality control, while taking into account

the size and characteristics of the group.

As characteristic initiatives, for example, there were cases where each financial institution established and operated audit systems from a group/global perspective. In cases where there is no internal audit function within the group, or where there is an internal audit function but only a company with a small number of people, there were cases where the holding company provided necessary support, such as by conducting internal audit services for the company⁹. In addition, financial institutions with overseas bases need to respond to the laws and regulations and systems related to internal audits, which differ by country and region, as well as the policies of overseas authorities, and there were cases where they were considering raising the level of their audit systems from a group/global perspective by referring to advanced approach established by responding to these issues.

(Use of co-sourcing)

In conducting internal audits, the use of external specialized organizations has been observed through co-sourcing and other means. The environment surrounding financial institutions has been changing dramatically in recent years, in addition to the expansion of financial institutions' business areas, such as the provision of new financial services in the digital field in collaboration with FinTech companies, with the sophistication and complexity of financial institutions' responses to social issues such as sustainability, as a result, the areas have emerged in which it is difficult to conduct audits using only in-house resources. In order to verify these issues in a timely and appropriate manner, it appears that the use of external expertise is essential. The FSA considers the use of external specialized agencies to be one useful means of improving the efficiency and effectiveness of audits. However, external specialized agencies should be used under the responsibility of the internal audit functions of financial institutions, and the internal audit function should be responsible for the results.

Therefore, the audit quality of co-sourcing must be evaluated and managed based on the understanding of internal audit function. It is also important for the internal audit function to manage the deliverables by external specialized agencies under its own responsibility, and to accumulate and use skills and expertise within the internal audit function based on those deliverables.

⁹ Responses to the public comments in the "Results of Public Comments on the 'Cabinet Order for Partial Revision of the Banking Act, etc. (Draft)'" published on the FSA's website on March 14, 2017 (<https://www.fsa.go.jp/news/28/ginkou/20170324-1.html>) indicated the view that a bank holding company may conduct internal audits of companies belonging to the bank holding company group as an operation incidental to business management.

IV. Conclusion

Even after the publication of the “Interim Report 2023”, the FSA has continued to monitor not only large banking groups but also regional financial institutions, large securities companies, and large insurance companies, and has now summarized the results based on “three issues”.

It was confirmed that financial institutions are generally making initiatives to improve their internal audits. On the other hand, it was also confirmed that the current level of internal audits remains low at some financial institutions, and there are differences in the driving force to move one step further from the current level. In particular, some regional financial institutions have not made much progress from the level when publishing the “Current Situation and Issues”, while others have self-evaluated themselves as having reached the third stage, suggesting that the divergence is widening.

Although the widening of this divergence is primarily due to the initiatives of each financial institution’s internal audit function itself, there are limits only by such initiatives. The FSA believes that the initiatives of management teams, etc. have a significant impact. In particular, the management team must take initiatives in allocating management resources in order to achieve results, and it is essential to change of the management team’s way of thinking and attitude for initiatives.

The FSA will continue to promote the improvement of internal audits by proceeding with in-depth monitoring of financial institutions based on the “three issues” presented in the “Interim Report 2023”, and will encourage the improvement of internal audits through such monitoring¹⁰.

In doing so, the FSA emphasizes again that the issues and focus items presented in this document and the “Interim Report 2023”, etc. are not used as formal checklists.

In addition, when monitoring financial institutions, the FSA will continue to strive for good communication with the internal audit functions of financial institutions, determine the areas and depth of monitoring depending on the level of internal audits, appropriately identify and analyze issues inherent in financial institutions and their response status, and encourage initiatives for the establishment and improvement of financial institutions’ risk management systems. The FSA hopes that the internal audit functions of financial institutions actively engage in dialogue, etc., with the FSA based on the recognition that they are in a cooperative relationship with the FSA to discover and improve vulnerabilities in the risk management systems of financial institutions.

At the same time, the FSA will continue to consider the necessity of updating the “Current Situation and Issues” (including necessity of reconsideration of each phase evaluation) based on the monitoring results and international trends from the viewpoint of promoting financial institutions to further improve their internal audits.

¹⁰ As for small financial institutions, FinTech companies, and other new business types not introduced in this report, the FSA will also take advantage of monitoring and other opportunities to understand the internal audit systems and status of initiative of internal audits, and promote the improvement of internal audits in accordance with their sizes and characteristics.