

## **Exposure Draft for Standards of Management Assessments and Reports on Internal Control Over Financial Reporting and Audits Thereon**

On July 13, 2005, the Business Accounting Council (BAC) issued an exposure draft proposing a set of new standards to report on the effectiveness of internal control over financial reporting; comments on the draft were solicited by August 31.

This set of draft standards was deliberated and prepared, from the viewpoint that it is necessary to further enhance the internal controls of issuer companies as a measure to improve the reliability of disclosures, based on recently uncovered inappropriate disclosure cases.

This set of draft standards consists of the following components.

### **I. Basic framework of internal control**

The basic framework of internal control constitutes to the basis for the standards of management assessments and reports of internal control over financial reporting and audits thereon. Under this framework, internal control is defined as a process that should be effected by all people in an entity to achieve objectives in four categories ((i) effective and efficient operations, (ii) reliable financial reporting, (iii) compliance with applicable laws and regulations, (iv) safeguards of assets), and consists of six basic components ((i) control environments, (ii) risk assessments and responses, (iii) control activities, (iv) information and communication, (v) monitoring, (vi) utilization of IT). This framework also defines managements' roles and responsibilities to include designing and implementing internal control.

### **II. Assessments and reports on internal control over financial reports**

Managements are required to reasonably determine the scope of assessments, and assess company-level and process-level internal control as at the year's end. In addition, when deficiencies and/or material weaknesses are identified, managements are required to take remedial actions appropriately. Managements are also required to prepare reports that state the effectiveness of internal control over financial reporting, based on their assessments.

### **III. Audits of internal control over financial reporting**

Auditors are required to report their opinions on managements' assessments of the effectiveness of internal control over financial reporting. Auditors need to plan audit engagements, considering the surrounding environments of entities, etc. Then, they need to evaluate the appropriateness of the scope of managements' assessments, and managements' assessments of company-level and process-level internal control. When deficiencies and/or material weaknesses are identified in the internal control, auditors need to communicate these findings to the relevant persons. Auditors are required to form their opinions based on the procedures performed, and express such opinions in their audit reports.