

J - S O X F L A S H R E P O R T

Subcommittee on Internal Control of Business Accounting Council Releases an Exposure Draft of Implementation Standards

Information as of November 21, 2006

On November 21, 2006, the Financial Services Agency (FSA) released a 93-page draft of “Implementation Standards for Evaluation and Audit of Internal Control over Financial Reporting” [Exposure Draft]. This document is intended to supplement the “Standards for Evaluation and Audit of Internal Control over Financial Reporting” [Draft Standard], which was issued on December 8, 2005, after closing its exposure period. (See Appendix 1 for an outline of topics addressed in this document.) An overview of the Draft Standard is discussed in *J-SOX Insights*, produced by Protiviti Japan.

The Exposure Draft consists of the following three sections:

- Internal Control Basic Framework
- Evaluation and Reporting of Internal Control over Financial Reporting
- Audit of Internal Control over Financial Reporting

Each of these sections is discussed further below.

The Exposure Draft is expected to be finalized in early 2007, after comments received from the public through December 20, 2006 are evaluated.

Internal Control Basic Framework

The structure of this section consists of the following:

- (1) Definition (objectives) of internal control
- (2) Basic elements of internal control
- (3) Limitations of internal control
- (4) Roles and responsibilities of individuals supporting internal control
- (5) Establishment of internal control over financial reporting (ICFR)

Parts (1) through (4) of the Exposure Draft are the same as the items included in the Draft Standard, which was issued on December 8, 2005. The Exposure Draft provides additional explanation for the four parts included in the Draft Standard. Part (5) of the Exposure Draft is a new item.

“Establishment of internal control over financial reporting” consists of (1) key considerations for establishing internal control over financial reporting, and (2) the process to establish internal control over financial reporting. The “key considerations” section lists key points of focus to consider when establishing internal control over financial reporting based on the internal control basic framework. The “process” section lists examples of standard steps required to prepare for an evaluation of internal control and to report the results of that evaluation. These steps consist of [1] a determination of an overall plan and approach, [2] an assessment of the current state of internal control design, and [3] a response to and remediation of identified deficiencies.

IT matters are an important part of the internal control framework. “Response to IT” was included as the sixth component of internal control in the Draft Standard, effectively expanding the components of the COSO framework from five to six. The “Response to IT” component includes the following:

- “Response to IT environment” lists attributes of the IT environment that are common to many organizations, and describes the need to understand and respond to them appropriately.
- “Use and Control of IT” includes “use of IT” and “IT controls,” and provides a detailed explanation of each. The “use of IT” section explains how organizations can deploy IT to enhance the effectiveness and efficiency of business processes when establishing internal control for the other five components of the internal control framework, and provides specific examples to support this assertion. The “IT controls” section lists examples of IT control objectives relating to effectiveness, efficiency, compliance, reliability, availability, and confidentiality. In order to achieve the IT control objectives related to the reliability of financial reporting, it is required to establish both IT general controls and IT application controls. IT general controls are defined as control activities that assure an environment within which IT application controls function effectively. IT application controls are defined as those control activities built into business processes that ensure all authorized business activities are processed and recorded accurately.

Evaluation and Reporting of Internal Control over Financial Reporting (ICFR)

The Draft Standard includes a section on management’s report on ICFR. However, the Exposure Draft does not include such a section. The following points require special attention with respect to the evaluation of and reporting on ICFR:

(1) **The scope of “financial reporting”** – The Draft Standard defines financial reporting as “external reporting that relates to both the financial statements and the disclosures that have significant impact on the reliability of financial statements.” The Exposure Draft further clarifies this definition. Financial statements include the consolidated financial statements, as well as company-only financial statements and their footnotes. “Disclosure that has significant impact on the reliability of financial statements” is defined as disclosure information included in the company’s Securities Reports other than the financial statements and related footnotes. This information refers to the financial and other information that has a significant impact on the judgments made in preparing the financial statements. As a result, the disclosure information other than information included in the section of “Financial Conditions” within the Securities Report is an integral part of financial reporting.

(2) **Determination of a material weakness** – In order to determine whether a control deficiency is a material weakness, both quantitative and qualitative elements must be considered. The Exposure Draft states that quantitative materiality is judged, for example, by using ratios to consolidated total assets, consolidated revenue and consolidated pre-tax profit. As to consolidated pre-tax profit, the acceptable threshold is established at approximately five percent; however, the Exposure Draft also states that judgments with respect to materiality must be made carefully and in conjunction with the materiality threshold set for purposes of the financial statement audit.

(3) **Entities subject to evaluation** – The Exposure Draft states the following:

- The consolidated subsidiaries (including foreign subsidiaries) must be considered when the company selects significant entities subject to evaluation.
- Affiliates subject to equity method accounting shall be included when selecting significant entities.
- To determine the scope for evaluation, the significance of each affiliate in relation to the financial statements must be considered.

- Because applying the same evaluation method to affiliates as subsidiaries may be difficult sometimes, the Exposure Draft suggests utilizing a questionnaire for company-level controls, as well as interviews and a review of internal control reports prepared by the affiliates.

(4) Determination of evaluation scope – The Exposure Draft states that, in principle, company-level controls and the period-end financial reporting process (except for certain sub-processes) are subject to evaluation with a companywide view of all business units. However, for the business units that have a negligible impact on financial reporting, their company-level controls and period-end financial reporting processes can be excluded from the evaluation scope.

For business processes other than the period-end financial reporting process, the following steps are followed to determine the scope of the evaluation:

(a) Selection of business units to evaluate – The Exposure Draft provides the following example: If company-level controls are evaluated and a conclusion is reached that they are effective, then the evaluation scope can be determined by selecting significant business units using a measure such as revenue. Based on that measure, a selection is made to include the largest business units in the order of size until the coverage reaches approximately two-thirds of consolidated revenue. While total revenue may be used to determine the scope of business units, alternative or additional measures may be used depending on the nature of the business environment.

(b) Identification of business processes to evaluate – For the significant business units included in the scope, all of the core business processes that affect the accounts that have a direct relationship with the business objectives of the company should be evaluated. For most companies, these processes are the ones affecting sales, accounts receivable, and inventory. However, business processes that do not have a direct relationship with the business or the operation of significant business units and that have a negligible impact on financial reporting do not have to be evaluated. Note that the Exposure Draft has dropped the discussion of the steps to select significant accounts.

For significant business units, as well as other business units, business processes that have a significant impact on financial reporting should be added to the scope for evaluation. For example, management should include in the scope:

- Business processes related to the business units or operations that have high-risk transactions
- Business processes that affect significant accounts that are subject to estimate or forecast by management
- Business processes that involve non-routine or irregular transactions that have a higher likelihood of misstatement and thus require special attention

(c) Considering the effect of company-level internal controls – Based on the results of the evaluation of company-level controls, the scope and method of evaluation for process-level internal controls is adjusted.

- If the company-level internal controls are not effective, the scope of evaluation of the process-level controls is expanded and/or evaluation procedures are added.
- If the company-level internal controls are highly effective, it is possible to select less stringent evaluation methods with reduced testing scopes. For example, less significant processes may be evaluated at multi-year intervals.

(5) Evaluation of company-level internal control – An evaluation of company-level controls is vital to a top-down approach. The Exposure Draft provides guidance with respect to both “evaluation points” and evaluation methods. It provides 42 evaluation points for company-level controls over financial reporting. Many of the evaluation points are similar to the points outlined in the “Principles Evaluation Matrix,” which is included in

Volume III of COSO's Internal Control over Financial Reporting – Guidance for Smaller Public Companies, released in July 2006.

With respect to evaluation methods pertaining to company-level controls, the Exposure Draft states that, after understanding and analyzing the overall internal control environment, the appropriate procedures to validate them include interviews and reviews of documents.

(6) Evaluation of process-level internal control – Based on the results of the evaluation of company-level controls, management must analyze the business processes selected for evaluation, identify the controls that have a significant impact on the reliability of financial reporting, and evaluate whether the key controls adequately reduce the risks of material misstatements. More specifically, management should take the following steps:

(a) Understand and analyze the business processes to evaluate. This step results in documentation of the processes. The Exposure Draft includes business flowcharts and narratives as examples.

(b) Identify the risks of material misstatements and the controls to mitigate such risks for each selected business process. To illustrate this, for each selected business process, management would identify the risks of misstatements by focusing on both material fraud and material errors or omissions. Once these risks are understood, management would identify the controls to mitigate the risk of misstatements. The Exposure Draft includes a risk control matrix as an example.

(c) Evaluate design effectiveness of process-level internal controls. During this step, management evaluates the design effectiveness of internal control by reviewing appropriate documentation, directing relevant questions to employees, and observing the process and the underlying control techniques in action.

(d) Evaluate the operational effectiveness of internal control. In taking this step, management evaluates the operational effectiveness of internal control by reviewing appropriate documentation, interviewing appropriate employees, inspecting operational evidence of internal control, and reviewing the results of self-assessment by process owners on control operational effectiveness. The Exposure Draft points out that, in principle, sufficient and appropriate evidence should be obtained through sample-based testing to evaluate operational effectiveness. However, if company-level controls are highly effective, the testing scope may be reduced at the process level.

(7) Determining the effectiveness of internal control – The Exposure Draft provides guidance on determining whether a material weakness exists based on the results of the evaluation of controls design effectiveness and controls operating effectiveness. With respect to determining the effectiveness of company-level internal control, the Exposure Draft lists the following examples of material weaknesses in such controls:

- Management is not evaluating risks related to the reliability of financial reporting or not responding to the risks identified.
- The board of directors, and corporate statutory auditors or audit committee, are not providing oversight, monitoring or evaluation of the design and operation of ICFR.
- The responsibility of division/department management to evaluate ICFR is not defined clearly.
- Identified deficiencies in IT access controls are left unattended and no remedial action is taken in a timely manner.
- The board of directors, and corporate statutory auditors or audit committee, cannot provide oversight, monitoring or evaluation on the effectiveness of ICFR due to lack of documentation pertaining to the design of internal control. For example, the following documentation is not available: transaction flows of business processes, identification of significant misstatement risks, and documentation related to control activities for identified risks.

- Company-level internal control deficiencies reported to management, the board of directors, and the corporate statutory auditors or audit committee are not being remedied within a reasonable period of time.

With respect to determining the effectiveness of process-level internal controls, the Exposure Draft states that in order to determine whether an identified control deficiency is a material weakness, the amount of potential misstatements of the related accounts must be estimated. The likelihood of the misstatement occurring also must be evaluated.

(8) Evaluating IT controls – The Exposure Draft provides the following guidance with respect to evaluating IT controls:

- (a) Obtain an understanding of the relationship between business processes and application systems using such information as data flows and a list of application systems.
- (b) Obtain an understanding of the IT infrastructure underlying the identified application systems.
- (c) Based on the understanding of the IT infrastructure, identify the evaluation unit for IT general controls.

Examples of IT infrastructure provided by the Exposure Draft include: the organizational structure related to IT functions, IT-specific policies and procedures, hardware, key software, networks and use of service organizations.

For each identified evaluation unit, the related IT general controls must be evaluated. These controls include IT development and maintenance processes, system operations management, system security management (such as access controls for internal and external parties), and contract management related to service organizations. IT general control deficiencies do not become material weaknesses automatically. Instead, they must be evaluated to determine their impact on IT application controls.

IT application controls are embedded in business processes. These application controls must be evaluated to determine whether they are designed and operating effectively, considering such relevant assertions as completeness, accuracy and validity of input data, adjustment of error data and reprocessing, master data accuracy, and access control. The evaluation of the effectiveness of IT application controls is conducted in a similar manner as process-level internal controls. However, for automated IT application controls, if there are no changes in such controls, and no failures incurred during the year with respect to such controls and the underlying general IT controls have been effective, the Exposure Draft allows the results of the evaluation from the prior year to be carried over to the current year.

Audit of Internal Control over Financial Reporting

The Draft Standard includes a section titled “Report by the External Auditors,” which describes the expression of an opinion, including the particulars to include in the internal control audit report. The Exposure Draft covers:

(1) Audit of internal control over financial reporting – This section of the Exposure Draft emphasizes the integration of the financial statement audit and the audit of ICFR, as discussed further below. As the internal control audit, in principle, is performed by the same external auditor who audits the financial statements, planning for the audit of ICFR should be integrated with the planning of the financial statement audit. Furthermore, even though the external auditor is required to understand the company’s ICFR, or obtain evidence of the effective design or operation of the controls, the external auditor’s knowledge or evidence obtained through the financial statement audit could be utilized in conjunction with the internal control audit.

(2) **Scope of internal control audit** – The external auditor should consider the following matters in conjunction with an audit of management’s evaluation of ICFR:

(a) Determine the appropriateness of the evaluation scope. The external auditor must evaluate the selection of the significant business units and identify the priority business processes to evaluate. In evaluating the selection of the priority business processes, the external auditor should consider whether the following processes are included in management’s scope: (1) those processes directly related to the achievement of the key business objectives at the significant business units, and (2) other processes that have a significant impact on financial reporting. The external auditor also must evaluate whether the scope of management’s evaluation, and the method of evaluation, are adjusted properly to reflect the evaluation results of company-level internal controls.

(b) Determine the appropriateness of management’s company-level internal control evaluation. The external auditor’s focus is on the adequacy of management’s evaluation process. For example, the external auditor should consider, among other things, whether (1) management’s evaluation points for company-level internal controls, and the related evaluation results, are appropriate, (2) the oversight function of the board of directors and the corporate statutory auditor (or audit committee) is effective, and (3) management’s consideration of deficiencies of company-level internal controls, including the identification of deficiencies, is appropriate.

(c) Determine the appropriateness of the process-level internal control evaluation. The external auditor must consider several things with respect to this determination. First, the external auditor must consider management’s approach to evaluating the design effectiveness of process-level internal controls. To accomplish this objective, the external auditor must:

- Understand the accounting process and the transaction flows within the priority business processes requiring evaluation.
- Assess whether personnel have sufficient capability and appropriate authority to monitor and perform the internal control procedures for which they are responsible.
- Determine how management identified the risks of material misstatements.
- Determine how management identified the internal controls in place to mitigate those risks.
- Assess management’s evaluation process for concluding that the internal control design is sufficient to mitigate the identified risks.

Second, the external auditor must evaluate management’s approach to testing the operating effectiveness of process-level internal controls. In addressing this objective, the external auditor must:

- Understand management’s approach to validating the operating effectiveness of the internal controls in the business processes selected for evaluation. Such validation includes tests of operation of internal controls in place, as well as reliance on self-assessment.
- Determine how management is satisfied that company personnel have sufficient capability and appropriate authority to perform the important internal controls.
- Understand management’s process for performing appropriate additional procedures in circumstances when there is a change in internal controls.

Third, the external auditor must ascertain that IT controls were considered appropriately during management’s evaluation. For example, the external auditor should (1) understand the IT controls in place, (2) assess whether management’s evaluation scope for IT general controls and IT application controls is appropriate, (3) determine the appropriateness of management’s evaluation of IT general controls, and (4) determine the appropriateness of management’s evaluation of IT application controls.

Finally, the external auditor must understand management’s process for evaluating the effectiveness of internal controls performed by service organizations.

(3) Evaluation of the deficiencies of process-level internal control – External auditors are expected to perform this evaluation by applying several steps. First, the external auditor must determine the account balance(s) and/or disclosure item(s) and the related business processes and units that could be impacted by an unremediated control deficiency. Second, the external auditor must assess the likelihood of an occurrence of a control deficiency. Finally, the external auditor must evaluate both quantitative and qualitative materiality by determining the potential exposure, after considering both the amount of the potential misstatements and likelihood of occurrence.

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Appendix 1

Evaluation and Auditing Draft Standards for Internal Control Reported in Financial Reports

(Draft Standards issued on December 8, 2005)

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