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J-SOX FLASH REPORT

The Japanese Institute of Certified Public Accountants Released an Exposure Draft of Guideline for Audit concerning Internal Control over Financial Reporting

July 18, 2007

On July 18, 2007, the Japanese Institute of Certified Public Accountants (JICPA) released an exposure draft of Guideline for Audit concerning Internal Control over Financial Reporting (JICPA Guideline). This document contains audit procedures, consideration points, suggested wording for the auditor's report, and other information and is designed to assist auditors in performing an audit of internal control over financial reporting in accordance with the “Standards and Practice Standards for Management Assessment and Audit concerning Internal Control over Financial Reporting” issued by Financial Service Agency on February 15, 2007 (FSA Standards). This Flash Report summarizes Questions raised, JICPA’s guidance, and Protiviti’s recommendations for management on the following five topics covered in JICPA Guideline:

1. Relationship between the internal control audit and the financial statement audit
2. Evaluation of the appropriateness of the scope of management’s assessment
3. Evaluation of the assessment of company-level controls
4. Evaluation of the assessment of process-level controls
5. Use of the work of internal auditors and others

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

Question
During the performance of a financial statement audit, how should the external auditor approach the internal controls not included in management’s assessment?

JICPA Guidance
Once J-SOX becomes effective, auditors are to assess the adequacy of management’s assessment of the internal control design and operating effectiveness. Therefore, during the financial statement audit, the external auditor is expected to rely on the results of the internal control audit. For areas where internal controls are not evaluated by management, the auditor should continue to evaluate the design and operating effectiveness of internal controls as in the past.

Protiviti’s Recommendation
Management has the responsibility to design and effectively operate internal controls for all areas of the business whether required by J-SOX or not. In a financial statement audit, the external auditor prepares an audit plan based on their understanding of the design and operating effectiveness of the internal controls and a review of internal controls of selected areas. Therefore, management must be prepared to support the external auditors to perform an audit of internal controls of areas not required by J-SOX.

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2. Evaluation of the Appropriateness of Scope of Assessment

(1) Scoping of Company-Level Controls

Question
The FSA Standards requires management to assess company-level controls for all locations and business units from a company-wide perspective except for locations and business units that do not have a material effect on financial reporting. How should the external auditor determine "material effect" in this case?

JICPA Guidance
The external auditor should use both qualitative and quantitative factors when determining materiality. For quantitative factors, ratio of consolidated sales, consolidated total assets, and consolidated income before taxes are included as examples. The external auditor should consider not only the degree of influence of an individual entity to the consolidated entity but also the degree of influence of all excluded entities to the consolidated entity.

Protiviti's Recommendation
JICPA guideline does not include any example for qualitative factors. Factors Protiviti believes auditors may use include: (1) whether additional business processes were added to the scope at the subject entity, and (2) whether external auditor identified deficiencies in internal controls as a part of the financial statement audit in the recent past.

(2) Scope of Process-Level Controls

Accounts that are closely associated with the company's business

Question
The FSA standards list sales, accounts receivable, and inventory as accounts that are closely associated with the company's business for a generic company. How should the external auditors determine which other accounts are closely associated with the company's business?

JICPA Guidance
The guidance defines "Accounts closely associated with the company's business" as accounts closely reviewed by investors and other stakeholders when evaluating the operating results and financial condition of the primary business of the company.

Protiviti's Recommendation
If there are other accounts that investors and other stakeholders often review or utilize to analyze the company or the industry, Protiviti recommends management evaluate whether such accounts should be considered as accounts closely associated with the company's business.

Significant business processes individually added to scope

Question
What should the external auditors consider when evaluating significant business processes individually added to scope at an important business location and another business location, in relation to financial

statement audit?

JICPA Guidance
Business processes relating to accounts that contain risks which require special considerations should generally be included in scope for evaluation of internal control by management.

Protiviti's Recommendation
Significant financial reporting risks that require special audit consideration are treated as significant audit items during a financial statement audit. If you observe the following symptoms, there is a high possibility that the external auditors will consider these related accounts as significant audit items:

- Significant effort spent during the financial statement audit
- Regularly treated as audit issues
- Consistently results in audit differences, or raised as issues at an audit closing meeting
- Frequently commented by the external auditors during their visit to facilities and subsidiaries

If there are such accounts, Protiviti recommends management evaluate a possible inclusion of related business processes to the scope and obtain external auditor's advice.

3. Evaluation of the Assessment of Company-Level Controls

Question
Evaluations of company-level controls are often performed before the year-end. How should the external auditor evaluate the effectiveness as of the year-end?

JICPA Guidance
When management operates a monitoring system that detects changes to internal controls in a timely and appropriate manner, external auditors should evaluate the effectiveness of the monitoring system. If an effective monitoring system has not been established, auditors should ask management to perform roll forward procedures in order to evaluate the effectiveness of internal controls after the date of initial evaluation. Then the external auditor should evaluate the results of these roll forward procedures.

Protiviti's Recommendation
If the external auditor performs the audit of roll forward procedures at the year-end, it significantly increases the effort of both auditors and management. In order to avoid this, Protiviti recommends management establish and operate monitoring procedures of company-level controls.

4. Evaluation of the Assessment of Process-Level Controls

Question
Management is required to perform additional procedures when the evaluation of operating effectiveness is performed before the year-end and when there is an important change to internal controls by the year-end. What should external auditors do when the audit of operating effectiveness is performed before the year-end?

JICPA Guidance

When the audit of operating effectiveness is performed before the year-end, the external auditor should evaluate whether the evaluation results is still valid at the year-end. The external auditor must consider the needs for additional procedures based on the length of time between time the audit procedure is performed and year-end, the nature of the audit evidence, and whether there is any change to internal controls before the year-end.

Protiviti's Recommendation

The external auditor is expected to perform an updated test in a similar manner management performs an updated test. In order to reduce the amount of updated tests required and to reserve adequate time to perform procedures possible only at the year-end, Protiviti suggests management discuss the following points with the external auditor in advance:

- Timing of interim test
- Specifics of audit evidence obtained from the interim test
- Procedures to determine the changes to internal controls

5. Use of Work of Internal Auditors and Others

Question

The external auditor may use the work performed by an internal auditor and others as audit evidence for the management's assessment provided they have evaluated the quality and effectiveness of the work. In what cases, should an external auditor use the work of internal auditors and others as the audit evidence of management's assessment?

JICPA Guidance

First, an external auditor should evaluate the company's internal audit function in accordance with Audit Standards Committee Statement No. 15 "Understanding the Functions and Activities of Internal Auditing; Using Internal Auditing for the Purposes of the External Audit". In high risk areas, the use of the work of an internal auditor must be evaluated carefully. In an audit of lower risk areas such as routine transactions that occur daily, an auditor may utilize samples selected by internal auditors.

Protiviti's Recommendation

The focus of internal audit is generally an operational audit, and the work that can be utilized for financial statement audit is limited. At some companies, the external auditor and internal auditor may jointly perform audit procedures such as account reconciliation and branch audit. Protiviti recommends that management first obtain an understanding of the nature of internal audit and the external auditor's use of internal audits results for financial statement audit. If an external auditor is not using the results of internal audit even if the result appears usable, management should confirm the reason with the external auditor. Based on such review, management should review the nature of the internal audit, and it may become necessary to change the nature of the internal audit to allow the external auditors to more effectively utilize the results of internal audit. After such review and preparation, management should discuss the potential use of the results of internal audits for the internal control audit.