

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

Financial Service Agency Issues Internal Control Report System Q & A

October 2, 2007

On October 2, 2007, the Financial Service Agency issued the “Internal Control Report System Q & A,” in which answers to frequently asked questions regarding the Internal Control Reporting System were addressed to set good precedents in practice. Following are some of these questions and answers with commentary provided by Protiviti, accompanied by references, as necessary, to the *Guideline for Audit Concerning Internal Control over Financial Reporting* issued by JICPA (hereinafter referred to as the “JICPA Guideline”).

1. Criteria to Determine Materiality (Q1)

In order to develop an evaluation plan for internal control over financial reporting, management may establish the materiality by using the prior year’s financial result or the current year’s forecast. In such instances, as the fiscal year approaches year-end, when there is a significant difference between the projection and the actual financial results, it is necessary to reassess the materiality.

Protiviti Commentary: Criteria of materiality are finally determined using the actual financial results for the current year. In order to develop an evaluation plan, however, management may determine the criteria by using the prior year’s financial results or the current year’s forecast. This is expected in practice. Therefore, when there is a significant difference between the projection and the actual, it is necessary to reassess the materiality and to revise the evaluation plan, as necessary.

2. Criteria to Establish the Materiality of a Significant Deficiency

When the use of consolidated EBIT (Earning before Income Tax) is not appropriate for setting materiality criteria, management may use another measurement in combination with EBIT, or may make sole use of that alternative measurement. When the consolidated EBIT eventually becomes so insignificant or small, management may revise the rate or adjust EBIT by removing unusual transactions.

Protiviti Commentary: It would not be appropriate for a company generating operating margins that are significantly lower than normal to use EBIT for purposes of setting materiality criteria. When the materiality threshold becomes so small due to the use of lower than normal margins, the additional work required to evaluate internal controls would not be appropriate. In these situations, the company may use another measurement that is appropriate to fit the circumstances. The Auditing Standard Committee Report No. 5, *Materiality in Audit*, provides useful information regarding the measurement that auditors may use to determine materiality in conjunction with a financial statement audit. Section 6 of the Report requires auditors to take into consideration when determining criteria of materiality, such measures as sales, ordinary income, net income, total assets and the magnitude of the impact to shareholders’ equity. The JICPA Guideline also provides insights regarding what to do in instances where EBIT becomes insignificant and small. For example, the guidelines allow the use of average EBIT over recent fiscal years. Unusual transactions may be removed from EBIT to exclude those extraordinary items and prior period adjustments. We recommend that complicated and intricate calculations be avoided to identify abnormalities, as it is often difficult to justify these calculations in practice.

3. Criteria to Determine Business Units Excluded from the Scope of Assessing Company-Level Internal Control (Q3)

In assessing company-level internal control, it is necessary to assess criteria for determining business units immaterial to financial reporting. It is generally accepted to use a method of excluding a business unit if the business units to be included in scope in aggregation already comprise 95 percent coverage of the consolidated sales. In addition, it should be noted that the period-end financial reporting process to be assessed from a companywide perspective should be assessed in a manner similar to company-level control.

Protiviti Commentary: It should be noted that the JICPA Guideline provides that management should take into consideration not only the impact that each of the individual business units has on financial reporting, but also the impact that those business units that are excluded from the scope have in the aggregate to the consolidated financial statements. It also provides that whether or not the impact to the financial statements is immaterial should be determined through the consideration of both quantitative and qualitative considerations. Therefore, it is necessary that the company should first identify those business units that are sufficient to constitute 95 percent of consolidated sales on a quantitative basis. Second, the company should assess the excluded business units through the consideration of qualitative factors, including whether material fraud has occurred and whether a material misstatement (from a consolidated financial reporting standpoint) has occurred or could occur in the financial statements through the excluded units.

4. Threshold of Significant Account Balance (Q6)

The FSA Practice Standards state that it does not use the method in which, when the company selects significant business units, if the aggregated amount in each significant account does not reach a certain threshold (two-thirds of the consolidated account balance, for example), then the company must add more business processes in other business units to the scope until the aggregate amount reaches the threshold to ensure a minimum coverage is achieved for the significant accounts.

Protiviti Commentary: This guidance is important because it suggests that it is not necessary to keep adding business processes until the aggregate balance reaches the minimum threshold of coverage. As is described in the JICPA Guideline, if there is a business process that contains a high risk of material misstatement in a business unit that is not a significant business unit, then it should be added to scope as “a business process specifically added to the scope of assessment.” In the United States, auditors often insisted that it was necessary to ensure sufficient coverage for significant accounts. Accordingly, some are concerned that the concept of account coverage also might be required as a practice in Japan, without consideration of risk. Recently, however, the risk-based approach under the new guidance and standards in the United States has brought about a level of flexibility that did not exist previously in practice. Now, a risk-based approach exists in the United States for multilocation coverage. Therefore, the FSA specifically indicates that it does not employ the method to ensure certain coverage in the Practice Standard in view of the new guidance and standards in the United States.

5. Selection of Business Locations for Inclusion in Scope When a Business Unit Has Several Business Locations (Q10)

The FSA Practice Standards accept a method of assessing effectiveness of internal control through selecting business locations based on the level of risk, instead of performing an assessment for all business locations within a significant business unit. In selecting business locations to include in the assessment scope, it is acceptable to employ a sampling method that (1) excludes business locations from the population if they have an insignificant impact to the financial statements and then focuses attention on ensuring the similarity of items within the population, as well as (2) employs random sampling covering all locations at least once within a certain period of time.

Protiviti Commentary: In the JICPA Guideline, there is a reference to a sampling method that separates business locations into different groups according to the underlying characteristics of the various locations. This approach results in the selection of homogeneous groups of business locations for testing purposes. Management’s evaluation team then can apply tests of operating effectiveness to samples with emphasis on tests addressing the common characteristics of each location group. The guidance does not include the notion of selecting business units after excluding insignificant locations. Therefore, when removing insignificant locations from further consideration, it is necessary to provide the auditor with an appropriate explanation for the excluded business locations, and to obtain agreement from the auditor that the excluded locations are immaterial from a quantitative standpoint and that no fraud has occurred at these locations. This approach is acceptable when company-level internal control is assessed as effective. If company-level controls are not effective, issues may arise in the discussions with the auditor.

6. When IT General Controls (ITGC) Deficiencies Exist (Q14)

The Practice Standard states that, because ITGC is not directly linked to the risk of a material misstatement, a deficiency in ITGC is not necessarily assessed as a material weakness. For example, although there is a deficiency in program change management controls, such as lack of control to obtain appropriate approval, it may be verified through alternative means that there is no change in the actual program related to business process controls. In that case, it is less likely that the information process system will impact the business process controls. Thus, management can conclude that the system’s internal control is operating effectively.

Protiviti Commentary: The JICPA Guideline states that “as a deficiency in ITGC is not directly linked to the risk of a material misstatement in the financial statements, if it may be verified that business process controls are operating effectively, it is not necessarily assessed as a material weakness.” It appears that the FSA Practice Standard, as described above, indicates the same point. The Practice Standard also states, as an example, that it is important for the company to eventually verify there was no change in the actual IT program affecting the business process controls under consideration. In such instances, management could conclude that the system’s internal control is operating effectively. This point suggests that in order to conclude that the business process controls are operating effectively during the period in scope, it is necessary to check the change log to ensure that there is no change in the application program. If it is very difficult to check the change log, it is also acceptable to increase the sample size for purposes of assessing the operating effectiveness of the underlying business process controls.

7. Internal Control Audit (Q18)

The question arises as to whether the external auditor can express an opinion on management’s internal control assessment without examining the details underlying the evaluation procedures. The Practice Standard requires auditors to evaluate management of the scope, the key controls and the design and operating effectiveness of internal controls. Therefore, the external auditor’s evaluation of the identification of key controls is considered to be an evaluation procedure. The Practice Standard does not require the auditor to examine the basis for management’s assessment of design and operating effectiveness of internal controls (e.g., testing the details supporting management’s conclusion on operating effectiveness), unless the auditor decides to use the management assessment results in lieu of performing their own evaluation. Thus, the auditors are only required to audit management’s assessment results and not the underlying details supporting those results.

Protiviti Commentary: When reviewing this Q & A, it helps to keep in mind that the external auditors can perform their own evaluation or use management’s assessment in lieu of performing their own evaluation. The approach the auditor decides upon impacts the nature and extent of the auditor’s procedures applied to the details supporting management’s assessment results. Therefore, the point that needs special attention here is the statement of “unless the auditor decides to use the management assessment results.” If management’s assessment process is determined to be inappropriate, the external auditors will not use the evidence gathered in support of management’s assessment results and, accordingly, will perform the evaluation of operating effectiveness themselves, obtain the necessary audit evidence and, based on that evidence, evaluate the adequacy of management’s conclusion regarding the effectiveness of internal controls. Notwithstanding the adequacy of management’s assessment process, for processes that the external auditor considers to be significant and high risk, the auditor may decide not to use management’s assessment and perform independent testing and other procedures as appropriate.

8. Internal Auditors, etc. (Q19)

The term “Internal Auditors, etc.” is considered to include not only internal auditors, but also employees who perform monitoring activities at different departments, as well as outsourced specialists who perform the internal control assessment on behalf of management.

Protiviti Commentary: The Practice Standard uses the term “Internal Auditors, etc.” The Internal Control Report System Q & A states the type of personnel included within the scope of this term. The JICPA Guideline states that the internal control evaluation project team and accounting personnel are examples of personnel in other departments who may perform internal audit-related activities directed to evaluate internal controls to support management. “Personnel who belong to other departments and perform monitoring activities” is considered to include the general group administration and management department, and the compliance department. Additionally, cross-evaluation or peer-to-peer reviews, in which one department performs an evaluation of another department, may be conducted with sufficient objectivity and competence.

9. Alternate Internal Controls for Segregation of Duties (Q20)

As alternate controls for segregation of duties in a smaller and less complex company, the “Internal Control Report System Q & A” provides examples to mitigate risks, such as monitoring by management and employees from other departments, and outsourcing the monitoring functions to specialists.

Protiviti Commentary: Monitoring by management and employees from other departments must be performed appropriately with sufficient objectivity and competence.

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