Auditing and Assurance Practice Committee Statement No.82

Practical Guidance for Audits of Internal Control over Financial Reporting

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The Japanese Institute of Certified Public Accountants

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The original text of the Practical Guidance is prepared in the Japanese language, and this translation is to be used solely as reference material to aid in the understanding of the Practical Guidance. For all purposes of interpreting and applying the Practical Guidance, users should consult the original Japanese texts available on the following website: http://www.hp.jicpa.or.jp/specialized_field/82.html
1. Introduction

In response to a series of corporate disclosure irregularities that first began to come to light in the fall of 2004, in order to ensure the reliability of the corporate disclosure system, the Financial System Council of the Financial Services Agency, requested the Business Accounting Council to establish standards for management’s assessment of internal controls over financial reporting and standards for audits thereof by certified public accountants.

The Business Accounting Council resolved to establish an Internal Control Committee at a general meeting in January 2005 and initiated discussions on this topic which included consideration of the level of assurance to be given by certified public accountants. Since internal control audits are to give assurance on the management’s assessment of the internal control over financial reporting, which supports the effective audits of the financial statements, the Council concluded that such audits require an assurance of reliability of the same level as financial statement audits.

In June 2006, the Financial Instruments and Exchange Law was passed by the Upper House in a plenary session. Consequently, it was announced that an internal control reporting system which requires the management of listed companies to assess internal control over financial reporting, and the external auditors of financial statements to audit such assessments, would be introduced from the fiscal year beginning April 1, 2008. In February 2007, the Business Accounting Council approved and announced at a general meeting a statement entitled “On the Setting of the Standards and Practice Standards for Management Assessment and Audit concerning Internal Control Over Financial Reporting (Council Opinions)”, (hereinafter “Council Opinions”).

In light of the introduction of the Internal Control Reporting System, this statement, based on the Council Opinions, summarizes the audit procedures, key notes and sample internal control audit reports. This is followed by practical guidance for external auditors on performing internal control audits.

External auditors, when performing internal control audits, should take into full account the Council Opinions and this statement, and exercise appropriate practical responses, in order to perform effective and efficient audits.

2. Terms

The terminology in this statement is used in accordance with the following:

- Internal Control Cabinet Office Ordinance: Cabinet Office Ordinance concerning the System to Ensure the Fairness of Financial Statements and Other Information (August 10, 2007, Cabinet Office Ordinance No. 62)
- Internal Control Government Guidelines: Points to consider in the handling of the Cabinet Office Ordinance concerning the System to Ensure the Fairness of Financial Statements and Other Information
- Auditing Standards: Standards established by the Business Accounting Council as the norms with which certified public accountants must comply when performing audits of financial statements (October 28, 2005, final revision). In this statement, the simple use of the term “Auditing Standards” shall denote the auditing standards for financial statements.
Standards for Management Assessment and Audit concerning Internal Control Over Financial Reporting, and Practice Standards for Management Assessment and Audit concerning Internal Control Over Financial Reporting: The standards and practice standards set by the Business Accounting Council (announced February 15, 2007) consist of the following three sections, respectively:

- Basic Framework of Internal Control: The definition and conceptual framework of the internal control of which management has roles and responsibilities for design and operation are indicated. In this statement, the basic framework of internal control will be referred to as the “Standards for Internal Control Frameworks” and “Practice Standards for the Internal Control Framework”; together these shall be referred to as the “Internal Control Framework Standards”.

- Assessment and Report on Internal Control Over Financial Reporting: the management’s thinking behind the assessment standards concerning the effectiveness of the internal control over financial reporting is indicated. In this statement, this will be referred to as the “Standards for Internal Control Assessments” and the “Practice Standards for Internal Control Assessments”; together these will be referred to as the “Internal Control Assessment Standards”.

- Audit on Internal Control Over Financial Reporting: the thinking behind the standards for audits by certified public accountants on the effectiveness of internal control over financial reporting is indicated. In this statement, this will be referred to as the “Standards for Internal Control Audits” and “Practice Standards for Internal Control Audits”; together these will be referred to as the “Internal Control Audit Standards”.

- Internal Control Standards: collective term referring to the “Standards for Internal Control Frameworks”, the “Standards for Internal Control Assessments” and the “Standards for Internal Control Audits”.

- Internal Control Practice Standards: collective term referring to the “Practice Standards for Internal Control Frameworks”, the “Practice Standards for Internal Control Assessments”, and the “Practice Standards for Internal Control Audits”.

- Combined audit: audits performed in a manner combining financial statement audits and internal control audits based on the Internal Control Audit Standards.

3. The intention of internal control audits

(1) The objectives of internal control audits

According to the introductory section of the Council Opinions published by the Business Accounting Council, in order to ensure the reliability of corporate disclosures, it is necessary to seriously consider a measure to enhance the internal controls of listed companies.

Examinations of the internal controls by external auditors is performed to examine managerial assessments on the effectiveness of said controls, which is a prerequisite for the preparation of reliable financial statements, and also supports the effective and efficient conducting of financial statement audits. This examination process is combined with the audit of financial statements and supports the in-depth and efficient conducting of said audits. If such examinations were to not require the same level of assurance as a financial statement audit and external auditors were to
perform different procedures and gather different evidences for the respective audits, it would be unsuitable. It would make the procedures of both audits more cumbersome and complicated if external auditors were to evaluate audit evidence and derive different conclusions in each audit based on the differences in the levels of assurance required. Therefore, the introductory section of the Council Opinions, levels of assurance to the assessment on the effectiveness of internal control are concluded to be determined by way of “audits.”

An audit conducted by external auditors on management’s assessment of effectiveness of internal controls over financial reporting ("Internal Control Audits") is to give assurance, by certified public accountants, of assessments at listed companies, thereby ensuring the reliability of management’s corporate disclosures.

(2) The characteristics of the audit approach

According to the Internal Control Audit Standards, the object of the internal control audit is the Internal Control Report prepared by management, and external auditors should express their opinions, based on audit evidence they themselves obtain, as to whether management’s Internal Control Report fairly states the results of the assessment of the effectiveness of internal control, in all material respects, in accordance with generally accepted assessment standards for internal control. Unqualified opinions expressed by external auditors include judgment that they have obtained reasonable assurance that the Internal Control Report does not include any material misstatements. This “reasonable assurance” denotes the fact that the external auditors have obtained sufficient competent evidence to express such opinions.

Meanwhile, the introductory section of the Council Opinions states that in order to avoid the burden of excessive cost in the assessment of internal control and the audit thereof, the Committee conducted research of the current operations of internal control reporting system in the United States, which preceded Japan in implementation, and decided to adopt a number of measures to keep the cost reasonable. One of the measures mentioned is abandonment of “direct reporting”. Direct reporting refers to the process whereby external auditors express their opinions directly on the effectiveness of the internal control over financial reporting of listed companies.

It should be noted, however, that in conducting internal control audits, despite the abandonment of direct reporting as stated in the Council Opinions, external auditors are required to “express their opinions, based on audit evidence obtained by themselves, as to whether the management’s Internal Control Report fairly states the results of the assessment, in all material respects”. In other words, external auditors should basically obtain appropriate audit evidence by conducting tests using samples they select. However, it is also permissible for external auditors to utilize a portion of the samples selected by management in their assessment, considering the validity of the samples and by examining some of the results derived using the management’s test.

(3) The subject of internal control audits

The subject of internal control audits will not be limited to the “financial information” section of the Annual Report, and will include other sections. As stated in the Internal Control Practice Standards, internal control audits should be conducted on the appropriateness of management’s
assessment of not only the “financial information” section, but also of other sections such as the “company overview”, “business results”, “production, orders received, and sales”, which are outside of the scope of financial statement audits. Thus, the differences in the scope of financial statement audits and the scope of internal control audits should be noted.

In the Practice Standards for Internal Control Assessments, “financial reporting” is defined as “external reporting of both financial statements, and disclosure information and others that could have a material effect on the reliability of financial statements”. The expression, “financial statements, disclosure information and other matters that could have a material effect on the reliability of financial reporting” refers to (1) disclosure information to be provided as a summary, excerpt, or breakdown, or by use of the amounts and values presented in, or notes to, the financial statements (hereinafter “information derived from data presented in financial statements”) and (2) matters that are closely related to the decision of whether an entity is an affiliate, decision on the scope of consolidation or the necessity to apply the equity method of accounting, determination of whether a party is a related party and other decisions involved in preparing the financial statements.

“Information derived from data presented in the financial statements”

For example, certain items of the “production, orders received, and sales” section constitute “information derived from data presented in financial statements”, and are to be included in the scope of financial reporting. Information on orders received is not normally included in the scope of financial reporting since such information usually does not fall under the above definition of “information derived from data presented in the financial statements”. Moreover, production information prepared based on the company’s own management statistics other than its cost accounting system is also excluded from the scope of financial reporting.

Furthermore, since management’s assessment of controls on the “information derived from data presented in financial statements” is, in effect, assessment of the design and operation of the system which provides summaries, excerpts, or breakdowns or utilization of information presented in the financial statements, the consistency with process-level controls related to financial statements subject to the assessment should also be considered when evaluating the appropriateness of the assessment.

Information derived from process-level controls that are not part of the scope of assessment could be included in the “information derived from data presented in financial statements”. For example, the “R & D activities” in the “overview of business” portion contain research and development expenses. The business process of recording research and development expenses may not be included in the scope of the assessment if such a process has very little risk of misstatement. Thus, it should be noted that the “information derived from data presented in financial statements” would not necessarily be included in the scope of the assessment of internal control if such information is derived from the business processes that are outside of the scope of the assessment and the item is not deemed to have a high risk of misstatement.

“Matters that are closely related to the decision of whether an entity is an affiliate, decision on the scope of consolidation or the necessity to apply the equity method of accounting,
determination of whether a party is a related party, and other decisions involved in preparing the financial statements”.

Examples of the above include “overview of business” and “affiliated companies” under the “corporate information” section, and affiliates, related parties, and big shareholders in “big shareholders” under the “(filing) company information” section of the Annual Report. It should be noted that management’s assessment takes into account the materiality of the impact of these disclosures on significant judgments in preparing the financial statements, and that the scope of the assessment does not necessarily include all of the information described above. The contents of the disclosures relating only to the portions that are closely related to decisions involved in preparing the financial statements should be included in the scope of the financial reporting. Examples of such decisions are whether an entity is an affiliate, the scope of consolidation, the necessity to apply the equity method of accounting, and whether a party is a related party.

Thus, not all of the information contained in the “big shareholders” section will be subject to management assessment, only the information on majority shareholders and on the ones that are required to be taken into consideration in determining related parties.

Moreover, in order to conduct efficient internal control audits, adequate communications with management should take place on the scoping of the financial reporting.

In auditing financial statements, external auditors have been examining internal controls of audited entities in order to understand the design of internal controls and to determine the nature, timing and extent of substantive audit procedures. Consequently, once the Internal Control Report System is implemented and internal controls are audited, the requirement for the current examinations of internal controls for the financial statement audits becomes a point of discussion.

On this point, the introductory section of the Council Opinions states “the effective and efficient practice of audits may be ensured, since the audit evidence obtained through the internal control audits and that obtained through audits of financial statements can be reciprocally utilized in the respective audits”, thereby suggesting that the examination of internal controls will remain a requirement for financial statement audits, as has been the case in the past.

From the discussion above, it should be noted that external auditors should consider two audit plans (carefully considering the procedures for financial statement audits and for internal control audit purposes).

4. The relationship between the Financial Statement Audit and the Internal Control Audit

(1) The combination of Financial Statement Audits with Internal Control Audits

Engagement teams are composed under the direction and supervision of the same engagement partners of financial statement audits, and internal controls are audited integrally. That is, financial statements and internal controls are audited integrally at every stage of the audit processes, i.e., from audit planning, evaluation by the external auditor of the adequacy and appropriateness of the audit evidence, performance of audit procedures to obtain audit evidence, through expression of the auditor’s opinion.

Following the introduction of internal control audits, the timing and extent of matters from audit
planning through risk assessment and the risk response procedures of traditional financial statement audits are expected to be seriously affected.

In financial statement audits, the timing and extent of risk assessment and of risk response procedures are determined in detailed plans of audits at an early stage of audits, in consideration of the results of audits in previous fiscal years.

Audit procedures responsive to the assessed risks (hereinafter “risk response procedures”) consist of tests of controls and substantive procedures. External auditors should develop appropriate audit approaches to designs and perform risk response procedures based on the risk assessment of material misstatements at the financial statement account level. During this process, an external auditor may decide that tests of controls alone effectively respond to the assessed risk of material misstatements relating to a particular management’s assertions, or that it is necessary to perform only substantive procedures to respond to a particular management’s assertions and not take into account the effect of internal controls in the process of risk assessment if unable to identify any relevant internal controls on the management’s assertions by performing risk assessment procedures or if unable to obtain satisfactory results from tests of controls. It should be noted that in order to conclude that only performing substantive procedures to prove management’s assertions appropriately reduces the risk of material misstatement to an acceptable level, sufficient investigation is required. An integrated approach, of tests of controls and performing substantive procedures, is, in general, an effective approach. Irrespective of the approach selected, external auditors are required to devise and perform substantive procedures for each material class of transaction, account balance, and disclosure.

In financial statement audits, external auditors evaluate the effectiveness of the internal controls of an entity mainly for the purpose of planning substantive procedures, and decide the timing of the tests of controls after communicating with management, from the perspective of conducting an efficient audit.

In internal control audits, management assess the effectiveness of internal controls after deciding upon the scope of the assessment taking into consideration the degree of quantitative and qualitative impact on financial reporting. The external auditor is requested to express an opinion on the results of the management’s assessment.

Consequently, in performing a financial statement audit and an internal control audit in a combined manner, the business processes which will be the subjects of the internal control audit by an external auditor are determined using the management’s determination of the scope of the assessment for the effectiveness of internal control. External auditors should pay sufficient attention to the timing and others of the evaluation of internal controls when planning an audit, considering the design of the substantive procedures in the financial statement audit, in order to perform the combined audit efficiently and effectively. As mentioned in the Practice Standards for the Internal Control Audit, when external auditors evaluate the scope of the assessments that management determined and judge the scope to be inappropriate, management should perform the assessment procedures again in accordance with the new scope for the assessment, although this may sometimes be difficult due to limited timeframes. Therefore, to avoid such situations, the Practice
Standards for Internal Control Audits recommend that management communicate with external auditors as appropriate and carry out preliminary discussions about the methods, grounds, etc., the scope of the assessments soon after the scope is determined.

Therefore, an external auditor is recommended to communicate with management regarding the determination of the scope of management’s assessment of internal controls prior to establishing an audit plan. Subsequently, the external auditor should establish a combined audit plan for the financial statement audit and the internal control audit. Practically, the timing for communication with the management may be before or soon after the start of the fiscal year subject to audit.

In internal control audits, management’s assessment of company-level controls and the period-end financial reporting process shall also be subject to audit. In the financial statement audit, although an external auditor is required to understand the design of the company-level controls, examination of the operation of the controls is not required. In terms of the period-end financial reporting process, an external auditor normally grasped the outline of such a process, but rarely performed audit procedures to evaluate the design and the operation of the process in the financial statement audit. Particularly, for the company’s procedures for consolidated closing and preparation of disclosure materials, external auditors usually performed substantive procedures and obtained or reviewed materials that served as the basis of consolidation journal entries and drafts for disclosure materials, rather than adopt approaches that rely on internal control after evaluating the design and operating effectiveness of the internal controls included in the related process. Therefore, the external auditor should consider the nature and timing of the audit procedures relevant to the period-end financial reporting process in the planning stage in order to perform the financial statement audit and the internal control audit in a combined manner.

The timing of performing procedures by an external auditor is based on the results of management’s assessment of effectiveness of the internal controls. As the results of the assessment of the company-level controls impact on the scope of the evaluation of the business processes as well as on the assessment procedures to be performed by management itself, communication with the management at an early stage of the fiscal year under assessment seems to be required for the external auditor to be able to perform the relevant procedures. Moreover, for the evaluation and the assessment of the operation of internal controls over the period-end financial reporting process, deficiencies, if identified, would, due to their very nature, constitute material weaknesses. Therefore, it would be effective and efficient for external auditors to communicate with the management, based on the operation of internal controls in the previous year, related to the preparation of quarterly reports, etc., in order to evaluate the period-end financial reporting process at an early stage in the fiscal year.

(2) Issues on using results of internal control audits in financial statement audits

The external auditor may, upon communication with the management, reach a preliminary decision on the appropriateness of the scope of the assessment of the internal controls determined by management. In such case, the external auditor should perform tests of controls on the business processes which were out of the scope of the assessment (e.g., business processes related to fixed
assets and wages/personnel) as part of the process of the financial statement audit, separately from internal control audits, when assuming that the related internal controls operate effectively or when concluding that sufficient competent audit evidence cannot be obtained for the related item on the financial statements by performing substantive procedures alone.

Similarly, internal controls within the scope of the assessment by management and sufficient preliminary discussions about the timing and types of procedures seem to be required for the management’s assessment of effectiveness of internal controls and audits of the internal control. External auditors should also carefully note the possibility that the results of internal control audits impact on the auditor’s opinion on the financial statement audits. For example, external auditors should consider the possibility that management’s assessment of internal controls does not progress as planned. In such case, external auditors need to prepare to conduct risk assessments and risk response procedures to the extent necessary to express an opinion on the financial statement audits in regard to the internal controls as determined to be within the scope of the management’s assessment.

(3) Understanding management’s assessment of internal controls and audit planning

Even in financial statement audits, it is accepted practice to treat the management’s attitude towards the design, implementation and maintenance of internal controls as a crucial point in evaluating the basic policy of an audit (Appendix to JICPA Auditing Standards Committee Statement No. 27). However, practical procedures to evaluate the management’s attitude toward the design, implementation and maintenance of internal controls, however, have not been clarified. With the introduction of the Internal Control Report System, management perform the assessments of effectiveness of internal controls, and then external auditors are required, in devising audit plans, to obtain enough understanding as to whether the management’s attitude toward control deficiencies and material weaknesses in internal control, decision policy for the scope of the assessment, the method of assessment of internal controls and the development of the system for the assessment is appropriate in light of generally accepted assessment standards for internal control. As a result, since the external auditor is now able to evaluate the management’s attitude toward the design, implementation and maintenance of internal controls objectively in the process of obtaining said understanding, is the external auditor is able to devise the risk assessment and risk response procedures to evaluate material misstatements as required in JICPA Auditing Standards Committee Statement No. 29, “Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement” (hereinafter “Auditing Standards Committee Statement No. 29”), taking into consideration of the result of such evaluation.

(4) Procedures for evaluating assessment of the design/operation of internal controls

In internal control audits, external auditors should obtain records of management’s assessment of the design and operation of the internal control (Section 3(7) of the Practice Standards for Internal Control Assessments), and then examine the design and operation of the internal control as well as the status of self-assessment through reviews of relevant records or inquiries to appropriate managers or the relevant personnel. If the external auditor cannot achieve this goal through a review
of the records and inquiries, the external auditor should observe business operations or have appropriate managers or the relevant personnel re-perform the procedures, if necessary.

In financial statement audits, tests of controls should be conducted through a combination of inquiries and other audit procedures. Generally, the assurance level obtained is higher if inquiries are combined with inspections of documents or re-performance of the procedures than if inquiries are combined solely with observation. Aside from the scope and the depth of the audit, the procedures to be conducted in internal control audits are basically the same as those performed in traditional financial statement audits in terms of the auditing perspective.

(5) Evaluation of the assessment of company-level controls and the period-end financial reporting process

In financial statement audits, an external auditor should obtain an understanding of the company-level controls, but is not explicitly required to evaluate their design or operation. On the other hand, for internal control audits, it is necessary to formulate and implement appropriate procedures to evaluate the design and operation of company-level controls and to obtain sufficient audit evidence of the controls. Certain procedures to evaluate the design and operation of company-level controls may be conducted through inquiries or observations alone since it is often difficult to inspect documents.

Furthermore, since the period-end financial reporting process is not generally included in the scope of the assessment of internal controls in financial statement audits, an external auditor is required to devise and implement appropriate audit procedures to evaluate the design and operation of the process, and obtain sufficient audit evidence thereof in internal control audits.

(6) The relationship between audit procedures for internal control audits and those for internal controls in financial statement audits

Audit procedures for internal controls in financial statement audits and those for internal control audits for company-level controls, the period-end financial reporting process, and process-level controls may be summarized as follows.

Although multiple business processes may be assumed to exist for each financial statement account, here, in accordance with the Practice Standards for Internal Control Assessments, business processes are classified into two types: business processes which impact the accounts that are closely associated with the company’s business objectives and those which do not.

- Company-level controls
  A. Internal control audits

An external auditor, as a general rule, should understand the overall status of company-level controls at all locations or business units (excluding those with limited materiality or those which pose a low risk of misstatements; the same applies below), and consider the appropriateness of the management’s assessment of the design and operation of company-level controls, paying attention to the assessment items stated in (Exhibit 1) “Examples of Assessment Items for Company-level Control over Financial Reporting” of the Practice Standards for Internal Control Assessments.
B. Financial statement audits

(a) Prior to the introduction of internal control audits

An external auditor should perform risk assessment procedures in order to understand the company, including its internal controls, and the environment surrounding the company. Understanding the company’s internal controls includes an evaluation of their design.

The management’s assessment of the effectiveness of internal controls over financial reporting is not utilized in current financial statement audits, nor are the records and retention of the internal control as stated in Section 3(7) of the Practice Standards for Internal Control Assessments. When conducting financial statement audits, external auditors use their own discretion in determining the nature and extent of the audit procedures in order to understand the company’s internal controls.

(b) After the introduction of internal control audits

After the introduction of internal control audits, it is assumed that audit procedures for financial statement audits utilize the results of internal control audits.

C. Status after the introduction of internal control audits

As the audits will be conducted based on the results of the management’s assessments of company-level controls, an evaluation of the assessment of the operation of the controls will be added to the scope. Improvements in the recording and retention of information on internal controls and further depth in the audit procedures for internal controls are anticipated.

- Period-end financial reporting process

A. Internal control audits

For the period-end financial reporting process which has been deemed appropriate for assessment from a company-wide perspective, the external auditor should, as a general rule, evaluate, in the same way as for the company-level controls, the appropriateness of the management’s assessment of the design and operation at all locations and business units.

B. Financial statement audits

(a) Prior to the introduction of internal control audits

Paragraph B(a) above applies.

(b) After the introduction of internal control audits

After the introduction of internal control audits, audit procedures for financial statement audits are assumed to utilize the results of internal control audits.

C. Status after the introduction of internal control audits

As the audit is conducted on the results of the management’s assessments of the period-end financial reporting process, the evaluation of the assessment of its operation will be added to the scope. Improvements in the recording and retention of information on internal controls and further depth in the audit procedures for internal controls are anticipated.
Business processes which impact the accounts that are closely associated with the company’s business objectives (e.g. sales process, etc.)

A. Internal control audits

When an entity has more than one location or business unit, an external auditor considers the appropriateness of the management’s assessment of the design and operation of the business processes which impact the accounts that are closely associated with the company’s business objectives at significant locations or business units based on the degree of materiality of their sales or other.

B. Financial statement audits

(a) Prior to the introduction of internal control audits

An external auditor should perform risk assessment procedures to understand the company, including its internal controls, and the environment surrounding the company. Understanding the company’s internal controls includes an evaluation of their design. External auditors should also perform tests of controls in order to determine the timing and extent of substantive procedures according to the risk of material misstatement (risk response procedures).

The management’s assessment of the effectiveness of internal controls over financial reporting, however, is not utilized in current financial statement audits, nor are the recording and retention of internal controls as stated in Section 3(7) of the Practice Standards for Internal Control Assessments. When conducting financial statement audits, external auditors use their own discretion in determining the nature and extent of the audit procedures in order to understand the company’s internal controls and the evaluation of their operation.

(b) After the introduction of internal control audits

Audit procedures for financial statement audits of significant business locations or business units are assumed to utilize the audit results of internal control audits.

For other business locations or business units which are not significant, Paragraph B(a) should apply unless they are determined to be business processes with material risks of misstatements, considering their impact on financial reporting.

C. Status after the introduction of internal control audits

As internal control audits will be conducted on the results of the management’s assessments of financial reporting for significant locations and business units, improvements in the recording and retention of information on internal controls and further depth in the audit procedures for internal controls are anticipated. For other locations or business units which are not significant, the design and operation of their internal controls will be evaluated based on the framework of the financial statement audit unless they are determined to be significant business processes, considering their impact on financial reporting.
Other business processes (e.g. business processes relating to the business or operations involving financial or derivatives transactions)

A. Internal control audits

For other business processes identified as imposing material risks of misstatements, considering their impact on financial reporting, the external auditor should evaluate the appropriateness of the management’s assessment of the design and operation of such processes.

The Practice Standards for Internal Control Assessments identifies business processes to be individually added to the scope of the assessment, which have a high risk of misstatements and require special attention, considering their impact on financial reporting; examples are business processes that relate to businesses or operations dealing with high-risk transactions, business processes relating to significant accounts involving estimates and management’s judgment and high-risk business processes requiring special attention which include non-routine or irregular transactions.

B. Financial statement audits

(a) Prior to the introduction of internal control audits

Paragraph □ B(a) above applies.

(b) After the introduction of internal control audits

If the processes are identified as significant business processes, considering the impact on financial reporting, the results of internal control audits should be used. If the processes are not identified as significant business processes, even when their impact on financial reporting is taken into account, Paragraph □ B(a) should apply.

C. Status after the introduction of internal control audits

If the processes are identified as business processes with a high risk of material misstatements, considering the impact on financial reporting, the results of internal control audits should be used. As the audits will be conducted on the results of the management’s assessments on internal controls over financial reporting, improvements in the recording and retention of information on internal controls and further depth in the audit procedures for internal controls are anticipated.

If the processes are not identified as business processes with a high risk of material misstatements, considering their impact on financial reporting, procedures for the evaluation of their design should generally be performed, based on the framework of financial statement audits.

(7) Impact of results of internal control audits on financial statement audits

In internal control audits, when external auditors identify inappropriate statements in the Internal Control Report regarding the scope, procedures or the results of the assessment by the management and are unable to express an unqualified opinion in the Internal Control Audit Report and conclude that the impact is not so significant that the Internal Control Report is misstated as a whole, they should express a qualified opinion with exceptive items. In such cases, inappropriate parts that have been excluded and their impact on the financial statement audits should be described in the Internal Control Audit Report. Moreover, when external auditors identify remarkably inappropriate statements in the Internal Control Report regarding the scope, procedures or the results of the
assessment by the management and conclude that the Internal Control Report is misstated as a whole, they should describe the fact that the Internal Control Report is not fairly stated, the relevant reasons, and the impact on the financial statement audit in the Internal Control Audit Report.

The results of the internal control audits are likely to affect financial statement audits relating to the following:

- The scope of the assessment determined by the management
  For example, the expansion of the scope of the assessment of process-level controls corresponds to the assessment results of company-level controls, following communication with the management in the early stage of the audit.

- Management’s assessment procedure
  For example, inappropriate identification of key controls by management, which has a material impact on the reliability of financial reporting. It should be noted that the “identification” in this case means the practical issue of identifying key controls appropriately, no matter whether such controls have been recorded in a prescribed form. Moreover, it should be noted that not all assessment procedures undertaken by the management need to be evaluated; for example, verification of the specific contents of a test undertaken by management on operations is not required.

In regard to the above, the external auditor should conduct financial statement audits, revising the audit plan on a timely basis depending on the nature and degree of the matter. There are two approaches for the revision of the audit plan, depending on the external auditor’s judgment: one is to reconsider the nature, timing and extent of the substantive procedures after implementing tests of controls as part of the financial statement audit; the other is to reconsider the nature, timing and extent of the substantive procedures without performing tests of controls. An unqualified opinion could be expressed for the financial statement audit if the external auditor obtains a reasonable basis for expressing the opinion that material misstatements do not exist in the financial statements, based on audit procedures under the revised audit plan.

Moreover, a qualified opinion with exceptive items should be expressed when the external auditor is unable to express an unqualified opinion because of the inability to perform important audit procedures even under the revised audit plan and when its impact on the financial statement as a whole was not judged to be so significant as not to express an opinion. Furthermore, the external auditor should not express any opinions when unable to obtain a reasonable basis for expressing an opinion because of an inability to perform important audit procedures even under the revised audit plan.

(8) The impact of the results of financial statement audits on internal control audits

Unqualified opinions should generally be expressed in the internal control audit, when the management has revised the financial statements for the detected misstatements by the financial statement audits during the fiscal year (generally through performing substantive procedures) and when the misstatements are identified as caused by control deficiencies which have been remedied by the end of the fiscal year and the external auditor recognizes the operating effectiveness of the
related controls.

When the management has revised the financial statements for the detected misstatements by the financial statement audits during the fiscal year (generally through performing substantive procedures) and when the misstatements are identified to be caused by control deficiencies which have not been remedied by the end of the fiscal year, the external auditor should formulate opinions of the internal control audit, considering how the management is addressing the deficiencies in the Internal Control Report.

When the management has revised the financial statements for the detected misstatements by the financial statement audits after the end of the fiscal year (generally through performing substantive procedures) and when the misstatements are identified as caused by control deficiencies, the external auditor should formulate opinions of the internal control audit, considering how the management is addressing the deficiencies in the Internal Control Report.

(9) Company Law audits and internal control audits

The Practice Standards for Internal Control Audits state that the external auditor may be required to report material weaknesses in internal controls which have been identified in the course of the internal control audit, to the management, the board of directors, corporate auditors or the audit committee by the final date of the Company Law audit.

Certain procedures for the internal control audit (e.g., evaluation of the assessment of the period-end financial reporting process related to the preparation of the Annual Report) are not usually completed by the final date of the Company Law audit, although most of the other procedures will have been completed by then. Therefore, it should be noted that the content to be reported to the management or the other parties could be changed or added as a result of procedures conducted during the period up to the date of the Internal Control Audit Report. Furthermore, as the reporting dates of the Company Law audit and the audit under the Financial Instruments and Exchange Law differ, the periods for evaluating subsequent events will also differ; consequently, material weaknesses in internal control that were not recognized by the reporting date of the Company Law audit may be identified. When reporting to the management, the board of directors, corporate auditors or the audit committee, external auditors should first obtain the draft of the Internal Control Report from the management and, after confirming its contents, report verbally or in writing. It should be noted that the external auditors’ report as of the final date of the Company Law audit is merely a progress report on the internal control audit.

5. Independence of external auditors

While external auditors are expected to make appropriate suggestions to the audited entity to enable the entity to design an assessment system that will withstand internal control audits, they are required, at the same time, to ensure their independence as external auditors. When providing advisory and consulting assistance, external auditors should take care not to render services that would compromise their independence, including acts that would violate the prohibition on simultaneously providing auditing and non-auditing services as prescribed in Article 24-2 of the Certified Public Accountant Law.
The Interpretive Guidance (No. 4) for Independence (in response to the revision of the CPA Law — the Interim Report) “Restriction of Services to Large Corporations / Non-audit Certification Services (2)” (The Japanese Institute of Certified Public Accountants, March 17, 2004) prohibits services that may be deemed to constitute auditing or attesting with regard to financial documents that have been prepared by oneself or deemed as involving oneself in the business decision of the client requesting the audit.

The audited entity should be the main operator of the design and operation of internal controls over financial reporting, both substantively and in appearance. Certified public accountants — the external auditors — may offer advice and counsel in regard to work done with the management accepting responsibility, but should not engage in actions such as the establishment or operation/monitoring of internal controls.

Furthermore, Q7 of the Ethics Standards Committee Statement No. 1, “Interpretive Guidance for Professional Ethics” (The Japanese Institute of Certified Public Accountants, March 17, 2006) lists the following examples as specifically prohibited activities:

1. To become an operational manager or a member of the audited entity’s project or to engage in operational management of the audited entity’s project.
2. To perform an assessment of the effectiveness of company-level controls or process-level controls on behalf of the management.
3. To decide the scope of management’s assessment of internal control on behalf of the management.
4. To undertake the preparation of reports on internal control.
5. To decide whether deficiencies detected in internal control in the preparation of the management’s report on internal control are material weaknesses.
6. To undertake testing to confirm the operation of internal controls.

Note that certified public accountants are permitted to provide services beyond the framework of advice and counseling to companies other than audited entities, as the issue of maintaining independence in the context of audits is not relevant to such cases. However, the design and operation of internal controls are based first and foremost on the premise that management takes the initiative in and responsibility for such design and operation, and therefore it should be noted that certified public accountants should not perform operations that contravene the premise.

Additionally, the following summarizes whether providing non-audit services simultaneously with audit services is possible according to the procedures for establishing internal controls over financial reporting as outlined in Section 5(2) of the Practice Standards for Internal Control Frameworks, “Process for Establishing Internal Control Over Financial Reporting”:  

- 15 -
<table>
<thead>
<tr>
<th>Process for establishing internal control over financial reporting</th>
<th>Simultaneous provision of internal control audit service and non-audit certification services</th>
</tr>
</thead>
<tbody>
<tr>
<td>Determining basic plans and policies</td>
<td></td>
</tr>
<tr>
<td>· Policies, principles, scope, and level of the internal control to be established for proper financial reporting.</td>
<td>Not possible, since this would mean taking over a function of management. However if the person in charge of establishing the company’s internal control is substantially making the decisions, it is permissible to comment on the statements prepared by the company.</td>
</tr>
<tr>
<td>· Relevant persons at management or lower level for establishing internal control and the entity-wide control structure.</td>
<td>As above</td>
</tr>
<tr>
<td>· Procedures and schedule necessary for establishing the internal control.</td>
<td>As above.</td>
</tr>
<tr>
<td>· Personnel who will be involved in the individual procedures necessary for the establishment of internal control; organization of the personnel; methods of preliminary education and training for the personnel.</td>
<td>As above. It would be possible to conduct education and training.</td>
</tr>
<tr>
<td>Understanding the design of the internal controls.</td>
<td></td>
</tr>
<tr>
<td>· Understand, record and maintain the design of company-level internal control over financial reporting based on the rules and practices on the existing internal control, as well as compliance with such rules and practices.</td>
<td>Possible. It would also be possible to point out any inadequacies based on the comparison between the basic framework of internal controls and the current situation. However, the external auditor should take care that his/her actions are not construed as establishing the system of internal controls</td>
</tr>
<tr>
<td>· Sort out and understand the organization’s key business processes for the flow of transactions and accounting processes, using charts and diagrams as necessary.</td>
<td>Possible, to understand the current state of the company’s internal controls and the recording thereof. However, the recording should strictly relate to the current situation, and care should be taken that the establishment of internal controls is not construed.</td>
</tr>
<tr>
<td>· Identify the risk of misstatement for the relevant business processes, and examine the financial reporting and accounts to which the risk relates and whether the internal control</td>
<td>Possible, since design deficiencies have always been pointed out by external auditors in the course of financial statement audits. However, care should be taken so as not to be construed as making suggestions on the specific</td>
</tr>
</tbody>
</table>
incorporated into the processes is effective enough to reduce the identified risk, using charts and diagrams as necessary.

- Addressing and remedying identified deficiencies.
  - Design procedures, incorporating new internal controls.
    Not possible, since this would result in auditing one’s own work.
  - Support the introduction of remedial actions.
    Possible to exchange opinions with management on the direction of remediation. However, care should be taken so as not to be construed as establishing internal controls.

- Offer comments on audit procedures so that the internal audit procedures will correspond to the “Assessment and Report on Internal Control Over Financial Reporting”.
  Possible.

- Determine the scope of management’s assessment.
  Direct support is not possible. It would be possible to offer comments on the scope of the assessment determined by management.

- Support the management’s assessment of the effectiveness of the internal controls.
  Not possible to undertake an assessment of effectiveness, but possible to offer advice on the concept behind such assessment of effectiveness.

### 6. Audit planning

The internal control audit and the financial statement audit are, in principle, performed by the same external auditor in order to achieve both objectives. Thus, external auditors should plan the internal control audit in a manner combined with the financial statement audit. External auditors should therefore be required to plan the internal control audit in addition to the financial statement audit, considering the following items.

1. Items added to the audit plan
   - Understanding the management assessment plan (e.g., the nature and timing of procedures)

     The objective of an Internal Control Audit is for external auditors to express their opinions, based on the audit evidence they obtain, as to whether the internal control report prepared by management fairly presents the results of the assessment in all material respects, in accordance with generally accepted assessment standards for internal control. It is, therefore, necessary to first understand the nature of management’s assessment procedures.

     Since external auditors are to evaluate the appropriateness of the management’s assessment of internal controls, by considering the management’s assessment of design of internal controls, they should understand the timing of the management’s assessment in order to plan their audit.
Communications with management on the scope of the assessment of internal controls

When the scope of the assessment determined by management is judged as inappropriate by external auditors, management shall be required to re-perform the assessment procedures based on a new scope. The re-performance of procedures, however, may be difficult due to timeframe limitations. Therefore, after the management has determined the scope of the assessment, external auditors, if necessary, should communicate with the management concerning the methods and the grounds used for determining the relevant scope of the assessment with the management at an early stage of the audit.

Whether or not any control deficiencies and/or material weaknesses have already been reported to the management, the board of directors, corporate auditors or the audit committee, and if so, the details thereof.

If any control deficiencies have already been detected, the auditing responses for such deficiencies should be considered as items with high risks of misstatement. Moreover, if control deficiencies are not remediated within a reasonable period of time, it is highly possible that the external auditors will conclude that a material weakness exists in the control environment, in which the management recognizes the importance of reliable financial reporting.

(2) Reconsideration of the scope of assessing internal controls in the financial statement audit

In the existing financial statement audit, external auditors are not required to completely evaluate all internal controls, such as the operating effectiveness, related to all the accounts. In cases where external auditors determine that audit risks are kept to a reasonably low level by substantive procedures alone, they might perform only substantive procedures without a test of controls, which would be necessary if they intend to rely on such controls. However, in cases in which these financial statement items correspond to the period-end financial reporting process, business processes which impact accounts that are closely associated with the company’s business objectives, or business processes that have a significant impact on financial reporting, they should be subject to the internal control audit.

Conversely, in cases in which an audited entity has included in the scope of the assessment the three items, i.e., sales, accounts receivable and inventory, as “business processes which impact accounts that are closely associated with the company’s business objectives” and has not recognized any other items to be added to the scope of the assessment, there is a possibility that the evaluation of internal controls required for the financial statement audit will not take place in the Internal Control Audit. In such cases, external auditors should, if necessary, proactively conduct risk assessment and risk response procedures (and should at least evaluate the effectiveness of the design) regarding the internal controls that have not been included in the scope of the assessment by the management.

(3) Internal Control Audit procedures for subsidiaries and the equity method for affiliated companies

Listed consolidated subsidiaries

Consolidated subsidiaries and other entities (including partnerships) shall be subject to the process of determining the scope of the assessment. When a subsidiary, etc., is a listed company
and has prepared its internal control report based on the Practice Standards for Internal Control Assessments, and when the report has been audited by an external auditor, the parent company may use the relevant subsidiary’s internal control report (including the report received from the subsidiary in the course of preparation) in assessing the effectiveness of the relevant subsidiary’s internal control over financial reporting.

The external auditor should, in addition to examining the internal control report prepared by the relevant subsidiary, be fully involved as the principal auditor in order to obtain adequate and appropriate audit evidence, in the same manner as auditing the relevant subsidiary alone. In cases where the subsidiary is audited by another auditor, the necessary procedures should be performed to comply with JICPA Auditing Standards Committee Statement No. 8, “Using the Work of Other Auditors” (hereinafter “Auditing Standards Committee Statement No. 8”).

Unlisted consolidated subsidiaries

Unlisted consolidated subsidiaries are also included in the scope of Internal Control Audits when they have been selected as a significant location or business unit. In such cases the following points should be noted.

A. Company-level controls

Company-level controls are internal controls that have a significant impact on consolidated financial reporting in their entirety throughout the company group. In principle, the management shall assess company-level controls for all locations and business units from a company-wide perspective, based on the internal control determined by the parent company.

If it is deemed appropriate to perform a separate assessment of the internal controls at a specific subsidiary or business unit because of its unique history, practice, or organizational structure, company-level controls applicable only to a specific subsidiary or business unit may be assessed. The scope of the expression “if it is deemed appropriate” shall include cases of assessment of subsidiaries newly acquired through mergers and acquisitions. It should also be noted that the assessment of company-level controls includes assessment of the design and operating effectiveness of the controls in all such subsidiaries.

B. Period-end financial reporting process

Certain period-end financial reporting processes, which are deemed appropriate to be assessed from a company-wide perspective, should, in principle, be assessed in a similar manner as company-level controls, as described in Paragraph A above. It should also be noted that operating effectiveness should be evaluated at each location or business unit.

C. Business processes which impact accounts that are closely associated with the company’s business objectives

In general, in the locations or business units selected based on materiality of their sales and other factors, all business processes which impact accounts (e.g., in the case of companies in general, accounts that would fall within the scope relate, in principle, to sales, accounts receivable and inventory) that are closely associated with the company’s business objectives should be included in the scope of the assessment.
External auditors should perform procedures to evaluate the design and operating effectiveness of such business processes at the selected subsidiaries, etc.

D. Business processes that have been added which are viewed to be significant considering their effect on financial reporting

Business processes at selected locations or business units which have significant effects on the financial reporting shall be added individually to the scope of the assessment.

External auditors should perform procedures to evaluate the design and operating effectiveness of the additional business processes that have been selected. Even when some addition business processes are included in the scope after considering the materiality thereof on the financial reporting, it may be sufficient to address only certain transactions or events (or certain key business processes) rather than the entirety of the business or operation.

Equity-method affiliated companies

Equity-method affiliated companies shall also be subject to the process of determining the scope of the assessment based on materiality. However, it may be difficult in practice to treat equity-method affiliated companies in the same manner as subsidiaries, for reasons such as the existence of other controlling shareholders. Therefore, in such cases, the design effectiveness should be confirmed through questionnaires, focusing mainly on company-level controls. It should also be noted, however, that in cases in which an equity-method affiliated company has been selected as a significant location or business unit, or in cases in which a situation is deemed to pose a high risk of misstatement, an assessment of the business processes should also be considered.

Significant changes in internal controls over financial reporting in consolidated subsidiaries after the end of the fiscal year

“If the consolidated financial statements of a company submitting internal control reports are prepared based on the financial statements for the fiscal year of consolidated subsidiaries with final closing dates different from the consolidated closing dates of the company submitting the internal control reports (hereinafter “consolidated closing date”), with the exception of cases in which significant changes occurred in the internal controls over financial reporting of the consolidated subsidiary after the end of the fiscal year of the consolidated subsidiary but before the consolidated closing date of the consolidated financial statements, the assessment of the internal controls over financial reporting of the consolidated subsidiary performed in the course of preparing the internal control report of the company submitting the report may be performed based on the assessment of the internal controls over financial reporting for the consolidated subsidiary as of the end of the fiscal year of the consolidated subsidiary.” [Article 5-3 of the Internal Control Cabinet Office Ordinance]

If a significant change in the internal controls over financial reporting after the end of the fiscal year of the consolidated subsidiary has taken place, external auditors should evaluate whether the result of management’s assessment of the design and operating effectiveness of the internal controls after the change are appropriate. In such case, when it is sufficient to merely add the
change into the scope of the evaluation of the assessment of the internal control over financial reporting, only the change should be subject to evaluation.

External auditors, generally, should monitor whether significant changes have taken place after the end of the fiscal year of consolidated subsidiaries based on the reports obtained by the company from the consolidated subsidiaries.

If the management is unable to assess the significant changes in the internal control over financial reporting because of a limited timeframe, etc., external auditors should consider the existence of “unavoidable circumstances”.

7. Evaluation of the appropriateness of the scope of the assessment

(1) Evaluation of the scope of the assessment

External auditors should evaluate the reasonability of the methods and grounds used by the management, in order to verify the adequacy of the scope of the assessment of the internal controls determined by the management. External auditors should obtain documents as to how the management determined the scope of the assessment, and through communication with the management, obtain an understanding of the management’s policy for determining the scope of the assessment.

It is appropriate for external auditors to discuss with the management the scope of the assessment at an early phase in the fiscal year subject to audit. External auditors should take into consideration information obtained through previous financial statement audit experiences and risk assessment procedures performed in the course of audit planning (JICPA Auditing Standards Committee Statement No. 29) to decide whether the management has appropriately determined the scope of the assessment of the internal controls in accordance with the Internal Control Assessment Standards. When the management’s policy of determining the scope of the assessment and/or its application is judged as inappropriate, external auditors should encourage the management to revise the scope of the assessment and request additional procedures. In the event that the management ultimately does not comply with the request to add to the scope of the assessment or a portion of the management’s assessment is left uncompleted because of a limited timeframe, or in the event that a portion of the assessment of the internal controls is not completed due to unavoidable circumstances, external auditors should consider whether to treat those matters as limitations of the scope (see 16(5) of Internal control audit report).

When the evaluation of the scope of the assessment, if performed at an early stage of the fiscal year subject to audit, is based on the financial figures and business conditions of the previous fiscal year, it should be noted that it is necessary to re-examine the appropriateness of the scope of the assessment close to the end of the fiscal year, taking into consideration subsequent changes to the business, the organization and other matters.

(2) Evaluation of the scope of the assessment of company-level controls and period-end financial reporting processes appropriate to be assessed from a company-wide perspective

Company-level controls and period-end financial reporting processes appropriate to be assessed from a company-wide perspective (hereinafter “company-level period-end financial reporting processes”) should, in principle, be assessed at all locations or business units, including
equity-method affiliated companies. However, locations or business units that do not have a material effect on financial reporting may be excluded from the scope of assessment (Section 2(2) of the Practice Standards for Internal Control Assessments).

When locations or business units have been excluded from the scope of the assessment by management, external auditors should understand the reason for this and consider the validity of the reason. The materiality of the impact on the financial reporting should be considered from the perspectives of both quantitative and qualitative materiality. When the management has determined to exclude certain locations or business units based on a certain set of financial criteria (e.g., percentage of consolidated sales, consolidated total assets, consolidated income before income taxes and retained earnings in the case of equity-method affiliated companies), external auditors should take into account not only the individual impact from each excluded location or business unit, but also the aggregate impact on financial reporting on a consolidated basis.

In general, the scope of the assessment of company-level controls and the company-level period-end financial reporting processes are thought to coincide. If this is not the case, external auditors should consider the reasons thereof.

(3) Evaluation of the scope of the assessment of process-level controls

(1) Selecting significant locations or business units

When a company has multiple locations and business units, the selection of locations or business units to be assessed should be based on the degree of materiality of their sales or other factors (Section 2(2)[1] of the Practice Standards for the Internal Control Assessment). Since this seems to assume that business locations with a high volume of business activity among the company group are to be assessed, external auditors should consider the following points when evaluating how the management has selected significant locations or business units.

A. Concept of locations or business units

Although locations or business units are often considered to consist of legal entities included in the company group, they are not necessarily limited to geographic concepts or legal form. External auditors need to evaluate whether the management is identifying the locations or business units according to the management structure of the company group (including the delegation of authority, similarities in business risks, processes and management methods). For example, when a company group consists of multiple business divisions, each of which is engaged in a unique business and managed using a unique style, it may be more appropriate to consider each division, including the subsidiaries within the division, as a location or business unit. Also, when sales companies have been established for each prefecture or region, it may be more appropriate to treat all such companies as one business unit.

B. Selection criteria for locations or business units

External auditors should evaluate the appropriateness of the criteria adopted by the management in selecting significant locations or business units, including whether such criteria represent the size of the business activity of each location or business unit in the company group. As indicated in Section 2(2)[1] of the Practice Standards for Internal Control Assessments,
Assessments, the ratio of the sales of each location or business unit, after excluding inter-company sales, to the consolidated sales is thought to be appropriate as a criterion. When it is difficult to accurately calculate the sales of each location or business unit after excluding inter-company sales, the ratio of the sales before the exclusion of inter-company sales to the combined sales may be used. Table (1) shows an example in which parent company and sales subsidiaries are selected on the basis of consolidated sales (after exclusion of inter-company sales).

Also, when significant locations and business units are selected on the basis of the sales of each company before the exclusion of inter-company sales, there is a possibility that those locations or business units with substantial inter-company sales may be ranked at the top, while companies selling to customers outside the consolidated group are not selected. In such cases, external auditors should ensure that the management considered whether the sales process of the company should be individually added to the scope of the assessment as business processes that have a significant impact on the financial reporting.

Moreover, in addition to, or as an alternative to, the amount of sales, other financial criteria such as the consolidated total asset amount may also be used as selection criteria. Therefore, it is necessary to exercise judgement using the appropriate criteria according to the business activities of the company group.

Table (1)

<table>
<thead>
<tr>
<th>Accounts that are closely associated with the company’s business objectives</th>
<th>Location A (Parent company)</th>
<th>Location B (Sales subsidiary with largest sales)</th>
<th>Location C (Sales subsidiary with 2nd largest sales)</th>
<th>Location D (Sales subsidiary with 3rd largest sales)</th>
<th>Total of significant locations (A,B)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Sales</td>
<td>55%</td>
<td>20%</td>
<td>7%</td>
<td>5%</td>
<td>75%</td>
</tr>
<tr>
<td>Accounts receivable</td>
<td>60%</td>
<td>18%</td>
<td>5%</td>
<td>7%</td>
<td>78%</td>
</tr>
<tr>
<td>Inventories</td>
<td>20%</td>
<td>13%</td>
<td>10%</td>
<td>9%</td>
<td>33%</td>
</tr>
</tbody>
</table>

Note 1: This example assumes a company group consisting of the parent company and sales subsidiaries.

Note 2: The criteria for selecting significant locations or business units are the consolidated sales amounts (after exclusion of inter-company sales). Consequently, locations A and B, which account for more than two-thirds of the consolidated sales, were selected.

Note 3: For the ratio of accounts that are closely associated with the company’s business objectives, such as inventories, to the outstanding balance of accounts in the consolidated financial statements (coverage) and business processes to be individually added to the scope of the assessment because of the high risk of material misstatement, refer to Paragraphs _DIV_B

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C. A certain ratio

The Practice Standards for Internal Control Assessments state that locations or business units including the head office are to be selected for inclusion in the scope of the assessment based on the sales amount, in descending order, until the accumulated sales amount reaches a certain ratio of the consolidated sales. There can be no “certain ratio” uniformly applicable to all organizations because individual organizations differ in business and operational characteristics. If, however, the assessment of the company-level controls is determined to be effective, then this “certain ratio” may generally be approximately two-thirds of the consolidated sales and other factors. If different criteria are used in addition to, or as an alternative to, consolidated sales, “appropriately two-thirds” would also be referred to.

In order to judge company-level controls to be “effective”, it is important that the company-level controls satisfy the following conditions in order to mitigate the risk of causing false statements and disclosures in the financial reporting (Section 3(4)(1)B of the Practice Standards for Internal Control Assessments).

- The company-level controls have been designed and operated in accordance with the generally accepted framework of internal control.
- The company-level controls support the effective design and operation of process-level controls, and adequately compose the overall structure of the company’s internal controls.

In cases in which the management has determined that company-level controls are “ineffective”, measures such as raising the “certain ratio” may be considered. The degree by which the ratio is raised is based on the extent and degree by which the deficient company-level controls impact on the likelihood of material misstatements. In such cases, in addition to uniformly raising the certain ratio, other methods, such as adding business processes at the locations and business units at which deficiencies in company-level controls have been reported, may be considered. External auditors should evaluate the appropriateness of the method, taking into account the management structure of the company group (centralized management or decentralized management).

Identifying business processes at significant locations or business units

External auditors should evaluate whether the management has appropriately selected accounts and business processes that are closely associated with the company’s business objectives at significant locations or business units (excluding equity-method affiliated companies) in line with above.

A. Selection of accounts that are closely associated with the company’s business objectives

The Practice Standards for Internal Control Assessments cite sales, accounts receivable and inventories as examples of the accounts that are closely associated with the business objectives of companies in general. “Accounts that are closely associated with a company’s business objectives” are thought to be accounts that are important for general investors and other stakeholders using the financial statements in interpreting the results of operations and financial
condition of the main business of the company. It should also be noted that these accounts have been used in the past in various fraudulent financial reporting cases.

In terms of companies in general such as manufacturing and merchandizing companies, the three accounts indicated should suffice as the “accounts that are closely associated with the company’s business objectives” at significant locations or business units.

Companies, other than companies in general, are required to carefully consider which accounts qualify as “accounts that are closely associated with the company’s business objectives” according to the characteristics of the business. Since accounts corresponding to sales and accounts receivable are integrally related to the profit-earning activities of a company, such accounts are thought to be “accounts closely associated with the company’s business objectives” in any type of business. However, in the case of businesses without accounts corresponding to inventories or businesses for which inventory accounts scarcely have importance whether the accounts, other than those corresponding to sales and accounts receivable, are closely associated with the company’s business objectives should be determined based on the characteristics of the relevant industry. In such cases, matters to be considered are not limited to the content and scale of the element indispensable to the main business activities of the company, but the degree of fraud risk in those accounts should also be considered. For example, companies disclosing gross profit on sales in their consolidated financial statements, accounts that impact on gross profit on sales may be considered as “accounts that are closely associated with the company’s business objectives”. In industries that do not disclose gross profit on sales, the management, upon considering the risk of misstatements, may consider personnel expenses in the service industry where personnel expenses account for large portions of operating expenses or property, plant and equipment in industries where facilities account for large portions of business assets as “accounts that are closely associated with the company’s business objectives.” Moreover, in a business enterprise with multiple business segments, “accounts that are closely associated with the company’s business objectives” may differ by segment. In cases in which a business enterprise is comprised of significant locations involved in differing industries, it is deemed appropriate for management to carefully consider “accounts that are closely associated with the company’s business objectives” based on the characteristics of the industry to which each significant location or business unit belongs.

B. The ratio of the balance of accounts that are closely associated with the company’s business objectives at significant locations or business units to the balance of the accounts in the consolidated financial statements (coverage)

All business processes which impact the accounts that are closely associated with the company’s business objectives at significant locations or business units, in principle, should be included in the scope of the assessment. However, business processes that are only remotely associated with the significant businesses or operations performed at each significant location or business unit and have little impact the financial reporting may be excluded from the scope of the assessment. External auditors need to evaluate the appropriateness of the exclusion of certain business processes from the scope of the assessment, based on the fact that they are only
remotely associated with significant businesses or operations performed in a significant location or business unit and have little impact on the financial reporting, and the reasons for the exclusion.

As significant locations and business units have been selected, in principle, on the basis of consolidated sales, as stated above, the outstanding balance of an account that is closely associated with the company’s business objectives at a significant location or business unit could be extremely small. In such instances, business processes relating to accounts with minimal balance may be excluded from the scope of the assessment as having little impact on financial statements.

There are also cases where the total outstanding balance of the accounts determined to be closely associated with the company’s business objectives do not reach the certain ratio (two-thirds) of the outstanding balance of the corresponding account in the consolidated financial statements. For example, due to monthly sales fluctuations or collection terms and conditions, the total outstanding balance of accounts receivable may not reach two-thirds of the total accounts receivable in the consolidated financial statements. However, as long as the significant locations or business units and the accounts that are closely associated with the company’s business objectives have been properly selected, the ratio of those accounts subject to assessment need not reach the certain ratio used to determine the significant locations or business units (see Paragraph 𘕉, Table (1). above). Moreover, in cases in which business processes with a high risk of material misstatement exist at locations or business units other than those selected through this process, such processes should be added to the scope of the assessment according to Paragraph 𘕜 “Business processes to be individually added to the scope of the assessment”, below.

C. Business processes which impact the accounts that are closely associated with the company’s business objectives

Business processes may be excluded from the scope of the assessment as having only a remote association with significant businesses or operations performed in a significant location or business unit and having no material impact on the financial statements in the following cases.

There is a possibility that sales recorded at a significant location or business unit may be composed of multiple classes of transactions processed through different processes. For example, sales may be divided into wholesale and store sales (see the example of business process classification of Section 5(2)[2] of the Practice Standards for Internal Control Frameworks). In cases in which the main business activity is wholesale, while store sales are considered an auxiliary type of business performed in order to monitor market trends, generating minimal sales, it would suffice to include only wholesale as the business process relevant to the recording of sales/accounts receivable.

In such cases, the impact on financial reporting, with respect to the class of transactions excluded from the scope of the assessment, in principle, is determined based on whether there is a high risk of quantitative or qualitative material misstatement. The judgment as to whether
the impact on financial reporting is minimal or not may be practically regarded as reasonable for the audit purpose, if the management makes such decisions in a consistent manner in every period based on the one of the following methods or a combination of them.

- The degree of impact of the outstanding balance of accounts associated with the class of transactions at each significant location or business unit, which have been excluded from the scope of the assessment and which are closely associated with company’s business objectives, on the outstanding balance of the accounts closely associated with the company’s business objectives at each significant location or business unit.

- The degree of impact of the total outstanding balance of accounts associated with the class of transactions that have been excluded from the scope of the assessment, which are closely associated with company’s business objectives, on the consolidated financial statement balance of the accounts closely associated with the company’s business objectives.

Moreover, even in cases in which multiple classes of transactions are included in one of the business processes leading to the accounts subject to assessment (e.g., sales) which are closely associated with the company’s business objectives, the management is not necessarily required to assess all classes of transactions uniformly. In such cases, external auditors should keep in mind that management may select, as appropriate, procedures such as inquiries or inspections of records, according to the impact of the class of transactions on financial reporting.

Business processes to be individually added to the scope of the assessment

Business processes to be individually added to the scope of the assessment are those at the selected or other locations or business units that, in view of their impact on the financial reporting, involve a high risk of material misstatements. Consequently, external auditors should evaluate whether the management has appropriately added to the scope of the assessment the following business processes involving high risks of material misstatements at all locations or business units, including equity-method affiliated companies.

A. Business processes relating to a business or operation dealing with high-risk transactions.

Examples include business locations or business operations that have a high-risk business likely to result in a misstatement in significant components of the financial statements (for example, businesses that have financial and/or derivatives transactions, or those that have inventory with volatile pricing) or those engaged in transactions that require complex accounting treatment, such as real estate and liquidation and securitization of financial assets.

B. Business processes relating to a significant account involving estimates and management’s judgment

A business process that relates to a significant account involving estimates and management’s judgment (for example, allowances, loss on impairment of fixed assets, and deferred tax assets or liabilities) is believed to ultimately have a significant effect on the financial reporting. In terms of various allowances, the status of the item for which the allowance is provided (for example, total account receivables in the case of an allowance for doubtful accounts) should also be considered. The recording of accounts that involve estimates
and management’s judgment, such as allowances, loss on impairment of fixed assets, and deferred tax assets or liabilities, is generally related to the period-end financial reporting process.

C. Business processes requiring special attention because of the involvement in non-routine or irregular transactions that have a high risk of misstatement

For example, when a business process involves non-routine or irregular transactions (for example, transactions under unusual business conditions and terms, transactions concentrated around the period-end, transactions with significant increase in number compared to the previous year, etc.) are likely to result in a high risk of misstatements, because the same level of internal controls applicable to recurring and usual sales, purchases or payments transactions may not be applied to such transactions.

D. When a business process is included in the scope for a reason such as that noted above, after considering the materiality to the financial reporting it may be sufficient to address only certain transactions or events (or certain key business processes), rather than the entirety of the business or operation.

The above assumes that business processes with high risks of material misstatement at a specific location or business unit are selected individually. Thus, even when the same business processes exist at other locations or business units, such processes need not be included in the scope of the assessment if the volume of transactions is limited and the impact of the business process on financial reporting is minimal. In judging the impact on financial reporting, the management is not required to uniformly include in the scope of the assessment business processes of locations or business units with account balances or volume of transactions exceeding a certain qualitative materiality. External auditors, however, should evaluate whether the management has appropriately selected the business processes that involve high risks of material misstatement.

External auditors should verify whether the accounts identified involve significant risk which requires special evaluation based on experience from past financial statement audits and the implementation of risk assessment procedures relate to business processes which impact accounts that are closely associated with the company’s business objectives, or that are to be individually added to the scope of the assessment. Business processes related to accounts identified as involving significant risk which requires special evaluation should generally be included in the scope of management’s assessment of internal controls. Consequently, in cases in which management has not included these processes in the scope of the assessment, external auditors should carefully consider whether there is a reasonable explanation for the exclusion. [For risks which require special evaluation, refer to Paragraphs 102–108 of the Auditing Standards Committee Statement No. 29.]

Treatment of equity-method affiliated companies

The Practice Standards for the Internal Control Assessment state that assessments of internal control should be performed on a consolidated basis, meaning that the entities included in a set of
consolidated financial statements (i.e., the company issuing the annual report and its subsidiaries and affiliates) should be subject to the process for determining the scope of the assessments. Accordingly, equity-method affiliated companies should be included in determining the scope of the assessment. An equity-method affiliated company impacts on the consolidated financial statements in the “equity in net earnings (losses) of affiliates” (consolidated statement of income) and the “investments in affiliates” (consolidated balance sheet). Consequently, external auditors should, considering the impact of these on the financial reporting, examine whether the management has considered adding individual business processes with risks of material misstatements, if any, to the scope of the assessment.

External auditors evaluate whether the management has performed an appropriate assessment of the selected affiliated companies based on the following methods.

- In cases in which the affiliated company has prepared its internal control report based on the Internal Control Assessment Standards, and the report has been audited by an external auditor and has been recognized to be useful in evaluating the internal controls of the affiliated company, the internal control report prepared by the affiliated company and the Internal Control Audit Report thereof may be used.

- When the affiliated company cannot be assessed in the same manner as that of a subsidiary due to factors such as the existence of other controlling shareholders, the status of investment interest and the equity method profit or loss in the affiliated company, or dispatched or interlinked officers (directors, corporate auditors and similar), external auditors should evaluate whether the management performed, focusing on company-level controls, appropriate procedures such as sending out questionnaires, making inquiries, or reviewing reports prepared by the affiliated company.

8 Evaluation of the assessment of company-level controls

(1) Positioning of the evaluation of company-level controls

Company-level controls are referred to as internal controls that have a pervasive impact on the company and cover the entire company group (Section 3(1) of the Standards for Internal Control Assessments). The management and external auditors are required to assess and evaluate internal controls based on a top-down/risk-based approach. Management and external auditors should first assess and evaluate company-level controls, and then, considering the result of these assessments and evaluations, assess and evaluate the process-level controls to the extent necessary, focusing on material misstatements that could not be prevented or detected by the company-level controls.

This means, the external auditors are required to evaluate the management’s assessment of company-level controls (specifically an evaluation on the assessment of design) at an early stage of their audit process, usually conducted as part of audit planning. In auditing financial statements, external auditors evaluate the internal control, which is equivalent to company-level control, during the course of evaluating a risk of material misstatement at the overall financial statement level and/or certain financial statement account level. The decisions on the scope of the internal control to be included in company-level controls and the selection of business locations subject to evaluation...
were, however, at the discretion of the external auditors. Hereafter, when conducting a combined audit, the external auditors should first obtain the result of the management’s assessment of company-level controls based on the Internal Control Assessment Standards, evaluate the appropriateness of the assessment, and then reflect the results in the evaluation of the risk of material misstatements both at financial statement level and financial statement account level. It is necessary to note that in a traditional financial statement audit, when evaluating the internal control equivalent to company-level controls, the evaluation is required to be performed on the design only, and not on the operation, if the internal control does not directly affect the mitigation of the risk of material misstatements in the non-consolidated financial statement accounts (e.g., the control environment).

In the meanwhile, company-level control includes company-level IT general controls. For IT company-level controls, the development and knowledge sharing of the basic policies, structure and procedures as well as risk assessment and risk response procedures to risks related to IT are evaluated.

(2) Evaluation of the assessment of company-level controls

When evaluating company-level controls, the external auditors should first obtain the records of the management’s assessment of the company-level controls as described in Section 3(7)[1] A and B of the Practice Standards for Internal Control Assessments, and evaluate the controls in accordance with the following procedures. It is usually possible to examine the design of the company-level controls at the parent company. As to the operation of the controls, assessments are evaluated at the parent company's head office based on the assumption that the internal audit of the uniform application of the internal control is proper monitoring and effective operating. It will be necessary to consider whether to visit a business location for examination when there are high risks of material misstatements.

In judging whether there are high risks of material misstatements, business locations where material weaknesses were identified in the past, for example, will be considered.

Audit procedures for business locations which are determined necessary to be visited for examination usually include an inquiry, inspection of related documents, observation and other actions. The external auditors should select audit procedures effective for the specific risks identified at relevant locations.

In addition, note that if evaluation of the company-level controls is conducted together with an evaluation of the internal control over the period-end financial reporting processes and of process-level controls, audits could be performed more effectively and efficiently.

Evaluation on the scope of the assessment regarding company-level controls conducted by the management is described in “7. Evaluation of the appropriateness of the scope of assessment”.

Evaluate the assessment of the design

A. Evaluate whether the assessment items are appropriately selected by the management in line with the assessment items of company-level controls over financial reporting as described in the Practice Standards for Internal Control Assessments (Exhibit 1) with consideration to the company's actual condition. At the same time, evaluate whether the management has set
assessment units for company-level controls in an appropriate manner from the viewpoints of the history, practice or organizational structure of a subsidiary and/or business units within the company group. For example, in the case that the company group is operated based on a decentralized organizational structure, it would be possible that policies or procedures applicable to the entire company group (including overseas subsidiaries) do not exist. In such a case, it may be necessary to assess the design for each of the assessment units operated based on a common principle or procedures for almost all the items described in the Practice Standards for Internal Control Assessments (Exhibit 1). Likewise, in the case that the company group operates based on a centralized structure and globally standardized policies or procedures are applied by the entire company group (including overseas subsidiaries) by assessing the design of such policies or procedures at the parent company, assessment at a subsidiary or business unit could be unnecessary. Whether assessment units and assessment items have been appropriately established in line with each company group's actual condition should be evaluated.

B. Evaluate the appropriateness of the results of the assessment by the management, through inspection of the internal control documentations prepared by the management and inquiry of the management and other people, by verifying the results of the assessment for each assessment item made by the management and the basis for arriving at such results.

Evaluation of the assessment of the design includes an evaluation of the internal control structure and judgment as to whether it is applied in the business operations. The procedures for obtaining audit evidence for judging whether the internal control is appropriately designed and applied in the business operations are the same as those for the risk assessment procedures for financial statement audits; the procedures include inquiry of the persons in charge at the company, observation of the operating effectiveness of specific internal controls, and inspection of the documents and reports describing the operation of the internal controls. When evaluating the design of company-level controls, the external auditors should perform the aforementioned procedures by combining some or all of them, as appropriate.

C. Company-level controls include controls that directly prevent or detect the risks of material misstatements in relation to individual accounts and controls that do not. For example, the control environment can have a significant effect on the risks of fraud or material misstatement at the financial statement level, but it does not prevent, detect or correct material misstatements in the management's assertions concerning individual transactions, account balances and disclosure, etc. On the other hand, control activities and daily monitoring are usually developed and operated in a way that such activities can directly prevent, detect or correct the risks of material misstatement in relation to individual account balances. Usually, such controls are evaluated in detail as process-level controls. The purpose of evaluating the assessment of company-level controls at an early stage of a combined audit is to determine the scope of the assessment of the process-level controls, the procedures for the test of controls to be applied, and the timing and extent of performing the procedures for process-level controls.

When examining the effectiveness of the internal control, a judgment on “whether the
assessment of company-level controls is effective” should be basically made for the entire company group, but could be made at each subsidiary or business unit separately, if appropriate.

Evaluation of the assessment of the operation

A. Select an internal control subject for the test of controls among all of the internal controls that are effectively designed for each basic component and actually used in the business operations. It is not necessary to evaluate the assessment of the operating effectiveness for all identified company-level controls.

B. The procedures for the test of controls are the same as the risk response procedures for financial statement audits and include inquiry of persons in charge, inspection of the related documents, observation and re-performance. Among such procedures, re-performance is considered to provide the strongest audit evidence. The re-performance of company-level controls by external auditors, however, is extremely difficult from a practical point of view. Moreover, as for some items concerning the control environment, there are cases in which no records of internal control operation are prepared or, if there are any, such records are just for form. In such cases, the external auditors should verify the operating effectiveness by making inquiry of the persons in charge or by observation.

C. Since evaluation of the assessment of company-level controls is, in principle, undertaken at an early stage of the audit, both the management and the external auditors should verify that the design and operation of the internal controls has been continuously effective until the end of the fiscal year. In the case that the management has developed and undertaken monitoring procedures that can apply to modifications to the internal controls in a timely and appropriate manner, the external auditors should evaluate the effectiveness of such procedures. For example, in the case where all of the business locations report to the parent company any modifications to company-level controls in a timely manner, the external auditors should inspect such reports sometime close to the end of the fiscal year to examine whether the reported modifications actually occurred, by performing procedures such as inquiry, inspection of related documents, and observation. In the case that the company does not have any effective monitoring procedures, the external auditors should first request the management to perform procedures to ascertain the effectiveness of the design and operation of the internal controls for the period from the day upon which the management performs such procedures to the end of the fiscal year (hereinafter referred to as “roll-forward procedures”), and then evaluate the nature and results of the procedures.

(3) Evaluation of the assessment of deficiencies in company-level controls

In cases where deficiencies are identified in company-level controls which do not directly prevent or detect misstatements in a specific financial statement account, it is not possible to determine the extent of the misstatements resulting from such deficiencies. Such deficiencies, however, could influence the likelihood of material misstatements in the overall financial statement and in individual accounts. Therefore, the evaluation of the assessment of the deficiencies in the
company-level controls should be based on the probability of material misstatements in the financial statements caused by the identified deficiencies. Specifically, an evaluation of the assessment should be conducted via the following procedures.

- Whether the identified deficiencies fall into the following categories described as a material weakness in internal control in Section 3(4)[1]C of the Practice Standards for Internal Control Assessments.
  
  A. The management does not perform risk assessment associated with the reliability of financial reporting, nor does it respond to such risks.
  
  B. The board of directors, corporate auditors or audit committee does not supervise, monitor or examine the design and operating effectiveness of internal controls for securing the reliability of financial reporting.
  
  C. The department that shall be responsible for the assessment of internal control over financial reporting effectiveness is not clear.
  
  D. Deficiencies existing in internal controls over IT relating to financial reporting are left unimproved.
  
  E. The board of directors, corporate auditors or audit committee cannot supervise, monitor or examine internal control over financial reporting effectiveness due to the lack of records on the design of internal controls, such as records on the process flow, identification of misstatement risks or internal controls over risks.
  
  F. Deficiencies in company-level controls reported to the management, board of directors or corporate auditors or audit committee are not remediated within a reasonable period of time.

- Based on a list of the deficiencies in company-level controls which have been summarized for each basic component at all business locations, the external auditors should evaluate the effect of the deficiencies on the likelihood of material misstatements in the consolidated financial statements, by examining the following items:
  
  A. The scope of the influence of the deficiency on the effectiveness of other internal controls.
  
  B. The relative importance of the internal control affected by the deficiency in basic components (control environment, risk assessment and response, etc.).
  
  C. Whether the deficiency increases the risk of errors, judging from experience of misstatements.
  
  D. Whether the deficiency increases the risk of fraud (including increase in the ignorance of internal control by the management).
  
  E. Whether the deficiency is causing exceptions identified by other internal controls in the operating effectiveness or is affecting the frequency of exceptions.
  
  F. What could be the consequences of the deficiency?

Based on the above evaluations, company-level controls can be judged as being effective to mitigate the risk of misstatements in the consolidated financial statements if they satisfy both of the following conditions (Section 3(4)[1]B of the Practice Standards for Internal Control Assessments).
They have been designed and are operating in accordance with the generally accepted framework of internal control.

They support the effective design and operation of process-level controls, and adequately compose the overall structure of the company’s internal controls.

Effective company-level controls mean that they are free of material weakness. Even if certain deficiencies exist in the company-level controls, the controls can be judged to be effective so long as such deficiencies do not pose a high possibility of causing material misstatements in the financial reporting. When all of the six basic components of internal controls are judged as “effective”, it is relatively easy to judge the company-level controls as being effective; when certain deficiencies are detected, careful examination is required. The Practice Standards for Internal Control Assessments indicate that, even if deficiencies exist in company-level controls, it is sometimes the case that process-level controls function effectively on an independent basis. On the other hand, the Practice Standards for Internal Control Assessments also indicate that deficiencies in company-level controls mean deficiencies in the design of basic internal controls, and therefore internal controls as a whole would be less likely to function effectively. In such a case, careful consideration is required.

(4) The effect of the results of the assessment of company-level controls (top-down/risk-based approach)

External auditors should evaluate whether the management has appropriately determined the scope, method, etc., for the assessment of process-level controls, reflecting the results of the assessment of company-level controls. In doing so, the external auditors should note the following items:

- Influences on the scope of the assessment of internal control

  When company-level controls are judged as effective, the management is allowed to use approximately two-thirds as the certain ratio of a criterion, such as sales, for selecting significant locations or business units. On the other hand, when company-level controls are judged as not effective, the certain ratio should be raised (see “7. Evaluation of the appropriateness of the scope of the assessment”). In addition, the status of some of the internal controls included in the company-level controls has a significant influence on the selection of the business processes individually added to the scope of the assessment. For example, in a case where no group accounting policies or manuals have been developed for the entire company group, and each subsidiary has its own accounting policies and application methods, it means that there are as many business processes subject to assessment as there are subsidiaries. Moreover, in a case where each group company has its own policy for providing allowance for doubtful accounts, it is necessary to individually determine at each company the scope of the assessment for the business process of providing allowance for doubtful accounts, also taking quantitative materiality into consideration. On the other hand, in a case where there is a common rule for the entire company group, it is possible to judge that, in principle, only one business process exists in the company group for providing allowance for doubtful accounts.
Influences on procedures for evaluating the operating effectiveness of the internal control.

Company-level controls and process-level controls influence and compensate each other. Therefore, the external auditors should evaluate whether the management appropriately assesses, considering the balance of both controls, the operating effectiveness of the process-level controls, taking the following items into consideration:

A. In cases where the management judges that the company-level controls are not effective, the external auditors should evaluate whether the management responds appropriately, in assessing the operating effectiveness of the process-level controls which are influenced by the company-level controls, by performing additional procedures which provide stronger competent evidence, expanding the scope of the assessment, or conducting the assessment closer to the end of the fiscal year.

B. In case that the management assesses that the company-level controls are effective, simpler assessment procedures, such as reducing the scope of sampling or the frequency of a certain scope of assessment to once every few accounting periods, (for example, every three accounting periods), according to the materiality of the scope, in evaluating the process-level control, can be performed. The Practice Standards for Internal Control Audits indicate that in the case of repetitive daily-routine transactions, at least 25 samples for each key control in the scope of assessment would necessary. However, this number of samples is decided by a statistical sampling method when there is no expected deviation (cases of incompliance with internal control) in the population, which means that the number is determined assuming that the company-level controls are assessed as effective. Therefore, in case that there is any deficiency in the company-level controls and that incompliance with internal control is expected to some extent in process-level controls, the external auditors should evaluate whether it is necessary to correct the expected deviation rate and to expand the number of samples for evaluation procedures on the operating effectiveness, including the management response thereof.

C. When a company has multiple business locations and outlets, its company-level controls are assessed to be operating effectively if (1) the business is performed based on common rules, (2) information and communication are sufficient to make decisions during the course of business, and (3) an internal audit is conducted to monitor the integrity of the internal controls. In such a case, instead of conducting assessment for all business locations every accounting period, it is sufficient to select some business locations, on a test basis, and to assess operating effectiveness once in every few accounting periods. When business locations subject to the assessment of the operating effectiveness are selected on a test basis, management can categorize locations and business units by characteristics, choose samples from each group, and assess the operating effectiveness of the samples, and then uses the results of those assessments to estimate and assess the operation of internal controls for the entire group. The external auditors are to evaluate whether the management is appropriately deciding the assessment procedures for process-level controls, based on the assessment results for company-level controls.

The following table shows examples of designing assessment procedures for process-level
controls, according to the assessment results of company-level controls. In a case where assessment of company-level controls is conducted only for each subsidiary or business unit, because of its characteristics and importance, the assessment results should be reflected in the assessment of process-level controls at such subsidiary or business unit.

<table>
<thead>
<tr>
<th>Assessment results of company-level controls</th>
<th>Examples of test of controls of process-level controls</th>
</tr>
</thead>
<tbody>
<tr>
<td>Number of samples</td>
<td>Type of procedures</td>
</tr>
<tr>
<td>Selection of business locations to be visited, in case of multiple outlets or branches</td>
<td></td>
</tr>
<tr>
<td>Effective</td>
<td>Small</td>
</tr>
<tr>
<td>Mainly consist of inquiry and inspection of related documents. Observation and re-performance for important internal controls.</td>
<td></td>
</tr>
<tr>
<td>1. Select locations subject to a test of controls, all of which are to be included in the scope within a few accounting periods.</td>
<td></td>
</tr>
<tr>
<td>2. Categorize locations by the nature of business and size, and then select locations on a test basis.</td>
<td></td>
</tr>
<tr>
<td>Not effective</td>
<td>Enlarged</td>
</tr>
<tr>
<td>In addition to inquiry and inspection of related documents, enlarged observation and re-performance in order to obtain stronger evidence.</td>
<td></td>
</tr>
<tr>
<td>1. Carefully consider whether to select locations subject to a test of controls, all of which are to be included in the scope within a few accounting periods.</td>
<td></td>
</tr>
<tr>
<td>2. Carefully consider whether to select locations on a test basis.</td>
<td></td>
</tr>
</tbody>
</table>

(5) Relationship between basic components of internal control

It is noted in Practice Standards 2. that “to achieve internal control objectives in an organization, it is important that all of the six basic components be properly designed and operated”. As for the assessment of the internal control over financial reporting, the scope of assessment of business processes is determined after the assessment of company-level controls and reflecting the results thereof. The relationship among company-level controls, process-level controls, and the six basic components is as follows.

Company-level controls are internal controls that have a pervasive impact on the entire company and address the entire company, which basically means the entire company group. Specifically, internal controls, which have a pervasive impact, directly and indirectly, on the entire company, over the reliability of financial reporting, are assessed in terms of the six basic components.
On the other hand, process-level controls are internal controls which are built into business processes and prevent or detect expected risks. In relation to the basic components, the process-level controls mainly relate to control activities, information and communication, monitoring, and response to IT.

Among six basic components, the control environment determines the tone of an organization, influences the awareness of the staff toward control, and lays the foundation for all of the other five components. It should be noted that the control environment is the most important basic component for internal control over reliable financial reporting.

9. Method of evaluating assessment of process-level controls

When external auditors understand the design and operation of process-level controls subject to assessment and evaluate the appropriateness of the assessment procedures conducted by the management, specific audit procedures and points to be noted are described below.

(1) Evaluation of the assessment of the design of process-level controls

When evaluating the assessment of the design of process-level controls, the external auditors should first communicate with the management to understand the flow of the transactions in all business processes subject to the management’s assessment, including initiation, authorization, recording, processing and reporting of transactions, and to understand the accounting procedures from the origination of transactions to computing and journalizing transactions, etc. The external auditors should understand how the management identified risks of material misstatements in these business processes. The external auditors should also determine whether the risks have been appropriately identified by the management, whether the management has appropriately identified the key controls to such risks, and whether such key controls, if operated effectively, would prevent or promptly detect the risks of misstatement. In evaluating the assessment of the design of the internal controls, the completeness of the IT application controls subject to assessment should be noted to include automated IT application controls built into computer systems.

(2) Types of audit procedures for evaluating the assessment of the design

Audit procedures conducted to evaluate the effectiveness of the design of process-level controls and the appropriateness of the assessment by the management include inquiry, observation, inspection of related records and documents, such as flow charts, and walk-through (a procedure that tracks the flow of a transaction from initiation to recording in financial statements based on records of internal control as described in Section 3(7) C, D, E, and F of the Practice Standards for Internal Control Assessments), etc. The external auditors should understand, by inquiry and inspection of related records and documents, how the management has identified the risks of material misstatements in financial reporting and internal controls (key controls) that play a primary role in mitigating such risks. In cases when it is difficult to understand the design of internal control only by inspection of records and/or inquiry, the external auditors should visit the locations and observe business processes, as necessary. A walk-through is a useful measure for the
external auditor to assure understanding of the design of internal controls. When the external auditors conduct a walk-through, in order to understand the design of internal control, it would be appropriate to base the walk-through on the records of the assessment by the management.

In addition, the external auditors should note that is sometimes possible to obtain evidence of the effectiveness of the design of process-level controls in the course of understanding the internal control for the financial statement audit.

Points to be noted when evaluating the assessment of the design

The external auditors should consider whether the appropriate manager or responsible personnel for the internal controls possesses the required authority and competencies and have ever received any instruction ignoring internal controls. Judging from audit evidence obtained by conducting the above-mentioned procedure and audit evidence obtained from the process of the financial statement audit, external auditors may determine that the key control selected by the management is inappropriate or come to different conclusions from the results of the assessment by the management on the effectiveness of the design of the process-level controls. Such judgment should be made with due care, considering such factors as other internal controls that compensate for deficiencies (compensating controls). In such a case, external auditors should report to appropriate managers in a timely manner concerning the deficiencies in the design of the relevant internal controls. The external auditors should perform the procedures for evaluating the assessment of the operating effectiveness of process-level controls for which the design is determined to be effective.

(2) Evaluation of the assessment of the operating effectiveness of process-level controls

Evaluation of the assessment of the operating effectiveness

The external auditors should understand the operating effectiveness of the process-level controls subject to the assessment, verify whether the internal control is appropriately operated, and evaluate the appropriateness of the assessment by the management on the operating effectiveness of the internal controls. Evaluating the operating effectiveness means understanding whether the internal control is appropriately operated as designed and whether the person in charge of the internal control possesses the authority and competencies required to conduct the relevant internal control effectively.

Types of audit procedures for evaluating the assessment of the operating effectiveness

The external auditor should evaluate the appropriateness of the assessment by the management of the operating effectiveness of process-level controls. Audit procedures conducted by the external auditors include inquiry, inspection of related documents, observation of business processes, reproduction of the business processes by persons in charge at the company, re-performance by the external auditors, and combinations of these.

Usually, inquiry alone is not sufficient to obtain appropriate evidence to substantiate the effectiveness of the operating effectiveness of internal controls. Therefore, external auditors need to conduct procedures other than inquiry in order to verify the responses obtained by inquiry. The
external auditors should determine the relevant procedures considering the importance and complexity of the internal controls, the importance of the judgments made in the operation of the internal controls, the competence of the person in charge of the internal controls, the frequency at which internal controls are conducted, the results of the evaluation of internal controls for the previous fiscal year, and the changes made to internal controls since the previous fiscal year.

Characteristics of internal controls may impact on the types of audit procedures to be conducted for the evaluation of the assessment of the operating effectiveness. For example, as for internal control with records existing in the form of documents, etc., it is possible to vouch the relevant records. However, in the case of internal controls built into automated computer systems, records to substantiate the operating effectiveness of the controls may not exist in a visible documented form. In such cases, it is necessary to combine multiple procedures, such as inquiry and observation, or computer-assisted auditing techniques, etc.

Sampling method

The procedures for evaluating the assessment of the operating effectiveness of process-level controls are usually conducted by external auditors on a test basis using a sampling method selected by them to obtain appropriate evidence (as for the use of samples selected by the management, see 3(2)). However, specific item sampling cannot be used, because the total population needs to be estimated. As for the sampling method, both statistical and non-statistical sampling methods can be used, as long as they are able to eliminate arbitrariness in sampling. The external auditors should choose a method that enables them to obtain sufficient competent audit evidence in the most effective and efficient manner, depending on each situation.

The number of samples used to evaluate the assessment of the operating effectiveness of the internal control should be decided based on the following: the extent to which the external auditors intend to rely on internal controls, the deviation rate (tolerable error rate) from the given internal control that the external auditors view tolerable, the deviation rate (expected error rate) from the given internal control that the external auditors expect in the population, the confidence level of sampling that the external auditors feel to be necessary, and the number of items that make up the population (see JICPA Auditing Standards Committee Statement No. 9, “Sampling”). Since an internal control audit aims to evaluate the assessment of the effectiveness of the internal control itself, the number of samples should be decided based on the tolerable error rate, the expected error rate, the confidence level of sampling that the external auditors feel to be necessary, and the number of items that make up the population.

In statistical sampling, attribute sampling is used as a sampling method that leads to conclusions on the error rate of the population, which means the method is not used to calculate an amount, but rather to judge whether a certain attribute exists or not. Therefore, the conclusion is given as a percentage.

In statistical sampling when any deviation in internal controls is discovered or the necessity of improving reliability is noted, as a result of testing, the number of samples should be increased (see Appendix 2).
As for transactions other than those entered into on a recurring basis, the number of samples should be based upon frequency (daily, weekly, monthly, quarterly or annually).

In the case that the management is using a method of selecting samples that allows the elimination of arbitrariness, such as the random sampling method, the external auditors can use the samples chosen by the management in their assessment as a part of their own samples, after evaluating the adequacy of the samples chosen by the management and some of the results obtained by the management.

The timing of evaluating the assessment of the operating effectiveness

The external auditors should evaluate the assessment of the operating effectiveness of the internal control in a timely manner in order to judge whether the internal control is effectively operated as of the end of the fiscal year. In the case that there have been important changes to the internal control during the period from the date of the assessment by the management up to the end of the fiscal year, the external auditors should verify whether the management has taken the additional measures necessary for understanding and assessing the design and operation of the internal control concerning the changes, according to the Internal Control Assessment Standards. In the case that the external auditors have conducted procedures for evaluating the assessment of the operating effectiveness up to the end of the fiscal year, it is also necessary to verify that there has been no change in the results of the evaluation up to the end of the fiscal year. After conducting the procedures for evaluating the assessment of the operating effectiveness, the external auditors should evaluate the need for additional procedures, such as a roll-forward procedure, by considering the length of the period up to the end of the fiscal year, the characteristics of the audit evidence obtained in the processes of conducting procedures to evaluate the assessment of the operating effectiveness, and whether there has been any change in the internal control up to the end of the fiscal year, while also verifying whether the company has conducted monitoring procedures.

Evaluation of the assessment of the operating effectiveness of IT application control

When evaluating the assessment of the operating effectiveness of IT application controls, it is assumed that the related IT general controls are assessed. Therefore, it should be noted that, in principle, it is not possible to come to a conclusion on the effectiveness of internal control only by assessing IT application control. As for the evaluation of the assessment of IT general controls, see “10. Evaluation of the assessment of IT general controls”.

Among IT application controls, automated controls, if once appropriately built in, will continue functioning by their nature unless a change is intentionally made. Therefore, it is possible to evaluate the assessment of the operating effectiveness by a minimum number of samples, on the condition that IT general controls are assessed as effective.

As for IT application controls, in the case that an evaluation of the assessment of the operating effectiveness of the automated control was conducted up to the end of the fiscal year, the external auditors should determine the necessity of additional procedures considering whether there have been any program changes after conducting the procedures for evaluating the assessment of the
operating effectiveness, the occurrence of failure, and the effectiveness of related IT general controls.

(3) The period-end financial reporting processes

The period-end financial reporting processes are a series of processes mainly performed by the accounting department to produce annual reports for public announcement, including preparation of monthly compound trial balances, non-consolidated financial statements and consolidated financial statements.

The period-end financial reporting processes are among the most important business processes concerning the reliability of financial reporting, since they relate to accounting estimates and judgment, such as allowances, deferred tax assets or liabilities, and loss on impairment of fixed assets. The frequency of internal control related to the period-end financial reporting processes is lower than that related to the process-level controls around daily transactions; therefore, the number of samples to be assessed will be small. It is necessary to conduct the audit procedures in a prudent manner when evaluating the design and operation of the controls for the period-end financial process.

The Practice Standards for Internal Control Assessments classify the business processes concerning period-end financial reporting into two categories: those to be assessed from a company-wide perspective and those to be individually added to the scope of assessment, considering their impact on financial reporting. Such distinction is inferred from the Practice Standards for Internal Control Assessments which suggests there are two categories of period-end financial reporting processes: those characteristically close to company-level controls (in other words, the management's policies or ways of thinking), such as decisions regarding consolidation accounting policies, accounting forecasts and estimates; and those characteristically close to process-level controls, such as procedures regarding closing adjustment in connection with preparation of non-consolidated financial statements.

The Practice Standards for Internal Control Assessments give the following examples of procedures for the period-end financial reporting processes to be assessed from a company-wide perspective that should be assessed in a similar manner as company-level controls.

- Preparing financial statements from the general ledger
- Entry to prepare consolidated financial statements (consolidation adjustments, aggregation, reclassification and others) and recording the contents
- Stating disclosure items relevant to financial statements

As for the decision to differentiate period-end financial reporting processes that should be assessed from a company-wide perspective in a similar manner as company-level controls, and those that should be individually added to the scope of assessment considering their impact on financial reporting, there is no universal rule to follow; it is considered appropriate to classify and sort them based on each company's business conditions.
Period-end financial reporting processes to be assessed from a company-wide perspective, in a similar manner as company-level controls

As for audit procedures applicable to business processes appropriate to be assessed from a company-wide perspective among period-end financial reporting processes, when the company has an accounting policy for the entire group and has clearly established accounting procedures, the company’s internal control is not so complex; therefore, the external auditors can perform the procedures from a company-wide perspective, in a similar manner as company-level controls, by obtaining a questionnaire or other documents prepared by the management.

The following are examples of internal control to be assessed from a company-wide perspective.

A. Preparing, distributing and explaining an accounting procedure manual, which describes the accounting policies for the current period and points to consider, to all business locations, to ensure everyone is well informed.
B. Completing a form of consolidated package to collect necessary financial data and others from subsidiaries and other business organizations for consolidation.
C. Delivering information and explanations on the above-mentioned consolidation package, such as deadlines for submission to the parent company, to subsidiaries and other business organizations.
D. Having a person in charge at the parent company review the consolidation packages (comparison with the budget, figures of the previous year, etc.) submitted by the business locations, investigate the reasons for, and, if necessary, report, any abnormal fluctuations to the management.
E. Undertaking a review by the management when filing the annual report, and taking appropriate measures when an abnormal fluctuation is found.
F. Considering, at an early stage, new disclosure items as a result of amendments to the applicable laws and regulations, and, when necessary, discussing with legal specialists, external auditors, etc.

Period-end financial reporting processes that should be individually added to the scope of the assessment in consideration of the impact on financial reporting

Period-end financial reporting processes that should be individually added to the scope of the assessment in consideration of the impact on the financial statements include, for example, closing procedures at business locations. A business process that relates to a significant account involving estimates and management’s judgment, such as allowances, loss on impairment of fixed assets, and deferred tax assets or liabilities, which could have a significant impact on financial reporting have to be assessed to decide whether to add any to the scope of the assessment by the management. When such business processes are individually added to the scope of assessment, it is necessary to evaluate whether the assessment conducted by the management on the design and operation of the relevant of internal controls is appropriate by obtaining flow charts and other records, and conducting, in principle, the same audit procedures as those conducted for the other
process-level controls.

As for evaluation of the assessment of the operating effectiveness of the internal controls over period-end financial reporting processes, if a deficiency is identified, the deficiency will likely be classified as a material weakness due to the nature of this process, considering the impact it would have on the financial reporting and because of the lack of time to undertake remedial actions up to the end of the fiscal year. The Practice Standards for Internal Control Audits set flexible timing for the internal control audit, noting that the audit is not necessarily required to be conducted after the end of the fiscal year and that it can be conducted at an appropriate time, on the premise that, if any significant change was made to the internal controls up to the end of the fiscal year, appropriate additional measures would be performed. Therefore, it is considered to be effective and efficient to evaluate the period-end financial reporting processes during the fiscal year by referring to the previous year's operating effectiveness and through the quarterly closing process.

In case that spreadsheets are used

In the period-end financial reporting processes, spreadsheet software (referred to as “spreadsheet(s)” hereinafter) is widely used for calculating, aggregating, analyzing and processing numeric data for the closing and consolidation process. In such cases, it will become important to assess the risk from the perspective of end-user computing (“EUC” hereinafter), where system users themselves establish the application system and participate in the operation of the system. Accordingly, it could be especially important to conduct audit procedures that allow evaluation of the assessment of the effectiveness of internal control related to EUC.

Concerning EUC, it is necessary to evaluate the following points.
A. In cases of using a spreadsheet to prepare supporting documents for financial reporting, that macros, calculation formulas, etc., are verified.
B. In cases where evaluations of the macros, calculation formulas, etc., are not properly verified, alternative or compensating procedures such as manual calculations are performed.
C. Access control, change management, and backup of the spreadsheet are evaluated.

(4) Evaluation of the assessment of internal controls over outsourced processes

Some companies outsource business processes such as authorization, execution, calculation, aggregation and recording of transactions, which form the basis for the preparation of financial statements or disclosure information preparation, to a professional company outside the group. The outsourced processes can be seen as a part of the company's significant internal control over financial reporting process. In order to evaluate the assessment by the management concerning the effectiveness of the relevant internal control, external auditors should conduct various procedures, for example:

- Obtain an understanding of the internal controls over outsourced business processes implemented by service organizations, as well as those implemented by the company (outsourcer).
- In the case when the company (outsourcer) itself assesses the business processes operated by the service organization via a sampling method, verify the status of the management’s assessment.
When the company has obtained reports, etc., on the evaluation performed by the service organization regarding the design and operation of internal controls over outsourced processes, consider whether the reports, etc., provide sufficient evidence.

When evaluating the assessment of the outsourced processes, for example, in case of a sales process where the receiving and shipping of goods are outsourced to a warehouse belonging to a warehouse owner outside the company group and that key controls in the scope of the assessment are conducted by the warehouse owner, the external auditors could consider visiting the relevant warehouse to perform an audit based on the assessment by the management.

In the case that reports are obtained from the service organization, the external auditors should evaluate the following items in order to verify that the reports provide sufficient evidence of the design and operation of the internal controls.

- The relationship between the date of conducting the procedures for evaluating the operating effectiveness of the internal controls within the scope and the date (the end of the fiscal year) of the assessment conducted by the management.
- The results of the procedures for evaluating the operating effectiveness of the internal control and the service organization's view on the operating effectiveness.

As for the reports submitted by the service organization, the reports could be prepared within the service organization itself. Other examples of such reports from service organizations include “Report on the design and operation of the internal control” stipulated in JICPA Auditing Standards Committee Statement No. 18, “Assessing Control Risk for Entities Using Service Organizations” published by the Japanese Institute of Certified Public Accountants (“Auditing Standards Committee Statement No. 18” hereinafter) and reports used in other countries, such as Statement on Auditing Standards No. 70 (SAS70, AICPA Professional Standards Vol.1, AU sec 324, as revised) stipulated by the American Institute of Certified Public Accountants (AICPA)).

10. Evaluation of the assessment of IT general control

(1) Positioning of IT general control

Application control includes internal control for manual processes and IT application control.

Among IT application controls, automated controls, if once appropriately built into, will continue functioning by their nature unless a change is made, intentionally or by error.

For IT application control to function continuously, it is necessary to appropriately manage the application system, into which the IT application control is built, and the IT infrastructure, such as the hardware, network, and operating system, used to support the application system. IT general controls means the control activities to ensure these.

Therefore, IT general controls are implemented, identifying the assessment units based on an overview of the IT infrastructure corresponding to the IT application control within the scope of the assessment. IT general control could affect the reliability of the IT application control over the application system which corresponds to the IT infrastructure in the scope.

Accordingly, the external auditor should understand the IT general control and evaluate the appropriateness of management’s assessment of the IT general control, before evaluating the
assessment of the IT application control

(2) Evaluation of the assessment of the IT general control
   When evaluating the management’s assessment of the IT general control, the external auditor
should obtain documents on the IT environment written by the management and evaluate the control
according to the following procedures.

□ Evaluation of the appropriateness of the scope of the assessment of the IT general control
   A. Understand the IT environment of the entire company group based on the documents written
      by the management on the overview of the IT environment.
   B. Confirm whether the IT infrastructure corresponding to the IT application control is subject to
      the assessment of the IT general control.

□ Evaluation of the assessment of the design
   A. Confirm whether the assessment items selected by the management are appropriate in
      accordance with Section 3(3)[5] of the Practice Standards for Internal Control Assessments
      “Assessing IT-based controls”.
   B. Evaluate the appropriateness of the management’s assessment over the design and operation of
      the IT general control by inspecting documents and records prepared by the management and
      inquiring as a result of the management’s assessment.

□ Evaluation of the assessment of the operation
   A. Select the IT general controls that are subject to the evaluation of the assessment of the
      operating effectiveness among those assessed as “effectively designed” by the management.
   B. Conduct procedures to evaluate the management’s assessment of the selected IT general
      controls. The procedures for evaluating the assessment of the operating effectiveness are the
      same as those for examining the IT general control in the financial statement audit. When
      evaluating the assessment of the operational effectiveness, the external auditors should select
      their own samples, if necessary.

(3) Evaluation of deficiencies in IT general control
   It should be noted that, if any deficiency exists in the IT general control, all of the related IT
application controls can be affected.

   IT general control indirectly supports the continuous operation of the IT application controls. Any
deficiency in the IT general control can result in the ineffective functioning of the IT application
controls and increase the risk of misstatement.

   It should be noted that since deficiencies in IT general control do not directly relate to the risk of
material misstatement in financial reporting, the deficiency should not be immediately determined
as a material weakness as long as application controls are evaluated to be functioning effectively.

11. Material weakness in internal controls
(1) Deficiencies in internal controls
   Control deficiencies are classified into design deficiencies and operating effectiveness
deficiencies. Deficiencies in design arise when a control is missing or an existing control is not
properly designed and the control objective is not always met; deficiencies in operating
effectiveness arise when a properly designed control does not operate as designed, when there are
many errors in operation or when the person performing the control does not properly understand
the nature and objectives of the control.

(2) Guidelines for determining material weakness

Material weakness is deficiency that has a reasonable possibility of having a material effect on
financial reporting. Guidelines for determining material weakness cannot be presented uniformly
because material weakness varies based on the environment or the nature of the business of a
company. Basically, material weakness should be determined based on the likelihood and impact of
misstatements relating to financial reporting. Whether a certain deficiency constitutes material
weakness depends on the extent of the likelihood of the risk (possibility) of the inability to prevent
or detect material misstatements in a timely manner, rather than on whether misstatements have
actually occurred.

Material weaknesses in internal control are weaknesses that are possible to cause material
misstatements exceeding certain quantitative materiality or involving qualitative materiality; when
evaluating materiality, both quantitative and qualitative materiality should be considered, in
principle, on a consolidated basis. The guidelines for determining the materiality of deficiencies in
internal control are eventually related to the reliability of financial statements, and, therefore, are
considered to be the same as those for financial statement audits.

Regarding quantitative materiality, the Practice Standards for Internal Control Assessments have
set, for example, approximately 5% of consolidated income before income taxes and minority
interests. The materiality threshold should, however, be applied depending on the company's actual
condition, including the sector of business, size, characteristics of the company, and the like. It
should be noted that in some cases in which the company records consolidated losses before income
taxes and minority interests or only a very small consolidated income before income taxes and
minority interests, it is not appropriate to automatically apply the threshold of 5% of consolidated
income before income taxes and minority interests as a rule to determine quantitative materiality. In
addition, in cases in which consolidated income before income taxes and minority interests
potentially fluctuates significantly every fiscal year due to business characteristics or other reasons,
it is necessary to consider modifying the criteria for judging quantitative materiality such as
changing the threshold or using average figures for the few most recent fiscal years.

As for qualitative materiality, evaluation should be based on the significance of the effect that
delisting criteria and restrictive financial covenants could have on investment decisions, and on the
significance of the effect that transactions with related parties and the state of big shareholders could
have on the reliability of financial reporting.

Delisting criteria

Delisting criteria set by the Financial Instrument Exchanges involve certain items. For example,
Tokyo Stock Exchange Group, Inc. sets rules regarding the number of listed shares, distribution of
shares, market capitalization, excess liabilities, misstatements in Annual Reports, “adverse
opinion” or “disclaimer of opinion” by external auditors, trading volume, and the like.

Evaluating as to whether a particular deficiency constitutes material weakness should be based on the magnitude of such items on significant judgment in preparation of financial statements. Therefore, a misstatement in the financial statements which violates the delisting criteria, such as a misstatement aiming to avoid reporting excess liabilities, is determined as qualitatively material.

Restrictive financial covenants

When financial institutions make a loan to a borrower, if the borrower's financial condition and business results run afoul of specific requirements, the borrower will lose the benefit of the term and will be obliged to repay the lump sum immediately. Restrictive financial covenants include, for example, covenants related to the maintenance of net assets, profits, and cash equivalents.

A misstatement in the financial statements which is intended to elude restrictive financial covenants will be determined as having qualitative materiality.

Transactions with related parties

If there is any deficiency in internal control regarding the identification of the existence of related parties that are subject to disclosure, identification of transactions with them, and assessment of the completeness of disclosure, this will be determined as having qualitative materiality.

State of big shareholders

This section is, in part, a duplication of the above “Transactions with related parties”. Regarding internal control to assess the existence of related parties, deficiencies in internal control regarding the assessment of the parent company of the company submitting the financial statements, other related companies, or big shareholders, such as dummy shares, block share reports, etc., will be evaluated as having qualitative materiality.

In the “State of big shareholders”, the names of some ten shareholders are listed according to the number of owned shares in descending order. It should be noted that when assessing internal control over financial reporting it is not necessarily required that all the descriptions concerning these big shareholders be correct.

Deficiencies in company-level controls have wide-ranging influences, both directly and indirectly, not only on process-level controls, but also, ultimately, on the contents of financial reporting.

When assessing whether a deficiency in internal controls is a material weakness, it is necessary to examine, in addition to the materiality of the above-mentioned points, the likelihood of causing a misstatement in the financial statement accounts or other disclosure items.

As for process-level controls, the results of sampling could be used to statistically calculate the likelihood of occurrence. If this is difficult, a predetermined ratio could be used as the likelihood of occurrence according to the result of qualitative evaluation of risk (for example, ranking the likelihood of occurrence as high, medium, or low), which is determined taking into account such factors as the size and frequency of detected exceptions, the causes of the occurrence of such exceptions and complementary controls.
(3) Control deficiencies for which examination is necessary to determine whether they constitute material weakness

Section 3(4)[1]C of the Practice Standards for Internal Control Assessments lists deficiencies in company-level controls that can constitute material weakness in internal control over financial reporting. The following are examples of control deficiencies for which examination is necessary in order to determine whether they constitute material weakness.

- In the case that significant modifications were made to the financial statements of the previous fiscal years.
- In the case that the external auditor detects material misstatements in the financial statements undetected by the company's internal control.
- In the case that fraud by certain senior management is identified.

In addition, in the case that any control deficiencies are detected in the following areas, there could be significant influence on the reliability of financial reporting. Therefore, it is necessary to deliberately examine whether they constitute material weakness.

- Internal control concerning the selection and application of accounting policies.
- The system related to preventing and detecting fraud.
- Internal control concerning business transactions or operations with high risks.
- Internal control concerning significant financial statement accounts involving estimates and forecasts by the management.
- Internal control concerning non-routine or irregular transactions.

(4) In the case that there are multiple control deficiencies.

It is necessary to assess whether control deficiencies constitute material weakness either individually or in combination with other deficiencies. In other words, all the deficiencies concerning the same account should be aggregated before determining whether the influences of the relevant deficiencies have the possibility to constitute material misstatements in financial reporting. It should also be noted that, in the case of a deficiency in IT application controls, based on the nature of such controls, the deficiency has the likelihood of giving rise to the same errors repeatedly.

On this occasion, it is not reasonable to aggregate deficiencies with inconsequential effect. Therefore, it is appropriate to set a threshold to apply in identifying deficiencies to be aggregated (deficiencies with tolerable impact), based on the criteria of judging quantitative materiality.

It should be noted that occasionally the aggregate impact of deficiencies on a single account may not constitute material misstatements at the financial statement level, but may on multiple accounts.

(5) Response in case management has identified a material weakness

The following is stipulated in the Practice Standards for Internal Control Assessments: When identifying control deficiencies and material weaknesses in the assessment of internal control over financial reporting, the person should report them to the appropriate personnel, such as his or her supervisor, together with their details, quantitative impact on the entire financial statements, countermeasures to be taken and other information considered useful, and request remedial actions. At the same time, the person identifying them should report the material weaknesses and control deficiencies when deemed to be necessary (together, material weaknesses and control deficiencies
shall be referred to as “material weakness and the like” hereinafter) to the management, the board of
directors, corporate auditors or the audit committee and external auditors. If material weaknesses
remain as of the end of the fiscal year, their details and the reasons why they have not been remedied
should be stated in the internal control report.

The external auditor should consider the risk of material misstatements in financial reporting,
taking the material weakness and the like identified by the management into consideration.

In evaluating the assessment of company-level controls, the external auditor should verify, based
on the material weakness and the like identified by the management, whether the management’s
assessment is appropriate, considering the results of management’s assessment and basis thereof and
examining the possibility of significant influence on financial reporting, including an effect on
process-level controls.

In evaluating the assessment of process-level controls, the external auditor should verify whether
the management’s assessment is appropriate, considering the material weakness and the like
identified by the management from the viewpoints of both qualitative and quantitative materiality,
the accounts affected and the extent of the affect, the likelihood of occurrence of the effect, based on
their likelihood of occurrence and significance.

In the case that the management has acted to remedy a material weakness up to the assessment
date (the end of the fiscal year), the external auditor should confirm whether the management’s
assessment of its own remedial actions is appropriate. On this occasion, the external auditor should
note whether the assessment of the remedial actions was appropriately conducted, that is whether
the management spent sufficient time from the day of the identification of a material weakness to the
date of the final evaluation (the end of the fiscal year).

In case that the management has not taken any remedial action against a material weakness up to
the date of the assessment (the end of the fiscal year), the external auditor should evaluate the
adequacy of the description of the results of management’s assessment in the internal control report
(the existence of a material weakness, the statement that the internal control over financial reporting
is not effective, a description of the material weakness and the reason why it was not remedied up to
the end of the fiscal year) and determine whether the description is appropriate. In addition to this
description, in the case that management describes policies to remedy the relevant material
weakness and has devised plans to execute such policies based on Cabinet Office Ordinance
Guideline 4-5, the external auditor should evaluate the existence of such policies and plans.

In case that the management has taken remedial actions against material weakness after the end of
the fiscal year, the external auditor should evaluate the adequacy of supplementary information on
the relevant remedial actions and other descriptions in the internal control report, and then determine
whether the relevant descriptions are adequate.

(6) Reporting and remediation of material weakness

When identifying material weaknesses in internal controls in the course of an internal control
audit, the external auditor should report to the management and request remediation, and confirm, in
a timely manner, that remedial actions are being taken against the relevant material weakness. The
external auditor should also report the content of the relevant material weakness and the results of
the remediation to the board of directors and to the corporate auditors or the audit committee. When
detecting control deficiencies, the external auditor should report to the appropriate person in charge.

An internal control audit is not intended to detect all deficiencies in internal control; rather it is
intended to request remediation of material weaknesses detected by an internal control audit. Except
for material weaknesses, the external auditor is not required to detect deficiencies in internal control
in a proactive manner. However, it should be noted that, when control deficiencies are detected
during the process of auditing, the external auditor should report such to the appropriate person in
charge in a timely manner.

(7) Influences on the financial statement audit

In the case that there is material weakness in internal control over financial reporting and that
therefore, internal control is not effective, the external auditor cannot apply sampling testing relying
on internal control in accordance with the audit standards in the financial statement audit. Therefore,
it is very likely that the audit plan for the financial statement audit needs to be revised.

Even when a material weakness is detected, if it is remedied up to the assessment date (the end of
the fiscal year) in the internal control report, it can be acknowledged that internal control over
financial reporting is effective. However, in this case, it is possible that of the period subject to audit,
the period up to the material weakness was remedied, so only limited reliance can be placed on the
internal control. It is necessary to confirm, in a timely manner, whether the material weakness was
remedied and to evaluate the extent to which internal control can be relied upon. In the case that a
material weakness was remedied just before the assessment date (the end of the fiscal year), it is
possible that substantial additional procedures are necessary for the financial statement audit.
Therefore, material weakness should be remedied as soon as possible.

12. Response to fraud

When identifying fraud or significant illegal acts (hereinafter, “fraud”) in the course of an Internal
Control Audit, external auditors should report them to the management, the board of directors and to
the corporate auditors or the audit committee and request appropriate remediation, and, at the same
time, evaluate their impact on the effectiveness of the internal controls.

JICPA Auditing Standards Committee Statement No. 35, “The Auditor's Responsibility to Consider
Fraud in an Audit of Financial Statements” prescribes that “fraud refers to an intentional misstatement
in financial statements with an intentional act by one or more individuals among the management,
corporate auditors, the audit committee, employees or third parties, involving the use of deception to
obtain an unjust or illegal advantage”.

There are two types of fraud relevant to financial reporting: misstatement in financial reporting
(fraudulent financial reporting, etc.) and misappropriation of assets. Fraud is categorized into
management fraud and employee fraud. In either case, there may be collusion with third parties outside
of the entity, falsification of records, or false explanation in order to conceal such fraud.

In an Internal Control Audit, the external auditor is responsible for expressing an opinion as to
whether there are no material misstatements in the internal control report. Accordingly, management is
primarily responsible for assessing the impact of an identified fraud on the effectiveness of the internal controls.

Even though the Internal Control Audit is not primarily intended to detect fraud, if the external auditors detect any fraud, they should report the matter to the management and evaluate the impact on the assessment of the effectiveness of the internal controls over financial reporting, as the fraud may indicate problems in the effectiveness of internal controls.

13. Use of the management’s assessment
(1) Use of the work of the internal auditors and other people

Auditing standards are not necessarily based on the premise of external auditors using the work of internal audits. The standards prescribe, “External auditors should evaluate whether the purposes and the procedures of the internal audit of the company are adequate for the audit objective, and whether the method used for, and the results of, the internal audit are reliable. Then, if the external auditors decide to use the results of the internal audit, they should determine the extent of such use, considering the impact on financial reporting accounts and disclosures” (Auditing Standards Part 3 Practice Standard Section 4 “Use of Other Auditors” Article 3).

On the other hand, the Practice Standards for Internal Control Audits are based on the premises of using the work of internal audits. These standards prescribe, “External auditors must evaluate the status of the internal audit performed by the company, which is a part of its monitoring activities that comprises the basic components of internal controls, and decide the scope and degree of its use”.

The discrepancy can be attributed to the fact that the extent of the internal audit regarding internal control over financial reporting used to differ company by company. Hereafter, as Council Opinions clearly prescribe that the internal audit be conducted as a separate assessment (part of the monitoring activities that comprises the basic components of the internal controls), the internal audit is expected to be performed to a certain degree, and external auditors may be able to use the results.

When using the work of the internal audit, external auditors are required to evaluate the status of the internal audit performed by the company, considering the factors prescribed in JICPA Auditing Standards Committee Statements No. 15, “Understanding the Functions and Activities of Internal Auditing; Using Internal Auditing for the Purpose of the External Audit” (“Auditing Standards Committee Statements No. 15” hereinafter).

The Auditing Standards Committee Statements, No. 15 states that, even when the external auditor decides to use the results of the internal audit, it is necessary to take note of the following points.
- External auditors have sole responsibility for the audit opinion expressed, and that responsibility is not reduced by use of internal auditing.
- Audit evidence obtained indirectly from an internal audit could be less probative than audit evidence obtained directly by external auditors conducting similar audit procedures.
- External auditors may likely be required to obtain audit evidence directly by performing audit procedures themselves for areas such as financial statement items with quantitative materiality, specific key audit objectives with higher risk of material misstatements (inherent or control risk), and audit procedures in which a higher degree of professional judgment or estimate (for example,
audit procedures relating to the evaluation of allowance) by external auditors are required in evaluating audit evidence.

In the Internal Control Audit, the management's scope of assessment includes company-level controls, period-end financial reporting processes, business processes at significant locations or business units which impact accounts that are closely associated with the company’s business objectives, and significant business processes in significant and other locations or business units which are relevant to a high risk of material misstatements. Therefore, in using the work of the internal audit, external auditors should carefully consider the extent of such usage.

External auditors should consider carefully whether to use the work of the internal audit in evaluating assessment items on the control environment of company-level control, because the control environment serves as the foundation of all other components of internal control and also because the result of the internal audit regarding control environment may be affected by the subjective judgment of those in charge of the internal audit.

The term “other people” in “internal auditors and other people” may include certain persons, other than internal auditors, who assess the internal control in place of the management, such as the people who perform monitoring in a section separate from the sections to be assessed, or external specialists. And the term “sections” may include, for example, an internal control assessment project team or the accounting department. When using the work of such sections other than for internal audits, external auditors need to evaluate whether the person who performed the assessment is independent from the business operations assessed.

(2) Extent of use of the work of internal auditors and other people

External auditors are required to obtain sufficient competent audit evidence to form the basis for expressing their opinions for the Internal Control Audit. Therefore, external auditors cannot use the work of internal auditors as a substitute for their own evaluation. However, for example, when evaluating the operation of controls relevant to repetitive routine transactions with low inherent/control risk, external auditors may use the samples selected by the internal auditors as a part of the samples they themselves have selected.

(3) Points to be noted when using the work of internal auditors and other people

The following points should be noted when using the work of internal auditors and other people.

- The appropriateness of the scope of the work to meet the objectives.
- The appropriateness of the assessment process.
- The professional skills of the person who perform the work.
- The independence of the person who performed the work from the operation subject to the assessment.
- The work performed is adequately documented in a verifiable manner.
- The conclusions are appropriate in the circumstances.
14. Use of other auditors and experts

(1) Definition of other auditors and experts

In Internal Control Audits, “other auditors” means an external auditor, other than the principal auditor defined in Auditing Standards Committee Statement No. 8 means a professional person or firm whose work the external auditor needs to use where special knowledge or skill is required for judgment, in conformity with JICPA Auditing Standards Committee Statements No. 14, “Using the Work of an Expert” (“Auditing Standards Committee Statements No. 14” hereinafter.)

(2) Auditing standards when using the work of other auditors or experts in Internal Control Audits

When using the work of other auditors or experts in the Internal Control Audit, Auditing Standards and Auditing Standards Committee Statement No. 8 should apply as the generally accepted financial statement audit standard, and the following factors should be considered:

- The qualitative or quantitative significance of the item subject to audit.
- The complexity, particularity, or highly specialized nature of the item subject to audit.
- The independence and objectivity of the other auditors or experts from the item subject to audit.
- The competence, experience, and reputation of the other auditors or experts.
- Documentation to determine the extent of using the work of other auditors or experts in the audit plan and working paper.

(3) Using audit results of overseas subsidiaries performed by other auditors

External auditors may use the audit results of overseas subsidiaries performed by other auditors under non-Japanese internal control audit standards, when they are judged to be substantively equivalent to those performed under the Japanese Internal Control Audit Standards.

- When an auditor of overseas subsidiaries performs the Internal Control Audit based on a non-Japanese internal control framework, the principal auditor should assess whether the framework that the other auditor used satisfies the requirements of the Japanese Internal Control Framework Standards by obtaining, for example, answers to written inquiries.
- When the principal auditor determines that the internal control audit standards that the auditor of the overseas subsidiaries follows are not practically equivalent to the Japanese Internal Control Audit Standards, or that there is no internal control reporting system, the primary auditor, in principle, should instruct the other auditor to perform an Internal Control Audit in conformity with the Japanese Internal Control Audit Standards and obtain the results thereof.

(4) Principal auditor’s responsibility when using the work of other auditors

Even when using the work of other auditors, the principal auditor has a responsibility to express an opinion without making reference in the Internal Control Audit Report to the work of the other auditors.

(5) Auditing standards when using the work of experts in the Internal Control Audit

When using the work of experts, Auditing Standards and Auditing Standards Committee Statement No. 14 should be applied as generally accepted financial statement audit standards in the Internal Control Audit.

In addition, when using the work of IT experts, JICPA Information Technology Committee
Statement No. 3, Section 8 *Use of IT Experts*, should apply.

When using IT experts in evaluating management's assessment of IT general controls and IT application controls, adequate communication in the engagement team is required.

15. Audit documentation

JICPA Auditing Standards Committee Statement No. 36, “Audit Documentation” (“Auditing Standards Committee Statement No. 36” hereinafter) prescribes various matters of audit documentation, from the standpoint of financial statement audits, including the definition, objective, nature, form, contents, scope, assembly of the ultimate filings and changes to audit documentation in exceptional circumstances after the date of the audit report. The internal control audit and the financial statement audit are performed integrally, so external auditors should prepare audit documentation for internal control audits in accordance with the practical guidelines provided in Auditing Standard Committee Statement No. 36. When committee statements, etc., released by the Japanese Institute of Certified Public Accountants other than this statement and Auditing Standards Committee Statement No. 36 provide guidelines for audit documentation relating to internal control audits, such committee statements also apply.

As a general rule, one set of audit files should be prepared for each audit report (see Paragraph 79 of JICPA Quality Control Standards Committee Statement No. 1, “Quality Control for Firms That Perform Audits”). However, it is not necessary to create separate sets of files for the financial statement audit and the internal control audit: one set of audit files could be sufficient because the work of these audits relates to each other.

See Appendix 1 for matters to be included in audit documentation for internal control audits.

16. Internal control audit report

(1) Internal control audit report and financial statement audit report

External auditors should express an opinion in the internal control audit report regarding whether the internal control report prepared by management accords with generally accepted assessment standards for internal control over financial reporting and presents fairly, in all material respects, the results of the assessment of internal control over financial reporting. The internal control audit report should, in principle, be combined with the financial statement audit report (Section 4(2) of the Standards for Internal Control Audits). Therefore, in principle, the internal control audit report and the financial statement audit report are to be prepared as a combined report.

However, the aforementioned rule does not apply if unavoidable circumstances exist (Article 7 of the Internal Control Cabinet Office Ordinance). In such cases, note that the following points and necessary explanations should be included in the respective audit reports so as to provide the users of the reports with the same information as in the form of one combined report.

- The internal control audit report and the consolidated financial statement audit report (or the financial statement audit report, if no consolidated financial statements are prepared) should be signed by the same person(s).
- Both the internal control audit report and the consolidated financial statement audit report should include a statement that both audits were performed concurrently. The external auditor’s opinion
should be expressed in the other report.

For matters that are not stipulated in the Internal Control Cabinet Office Ordinance, the Internal Control Audit Standards or this statement, the internal control audit report is to be prepared based on JICPA Auditing and Assurance Practice Committee Statement No. 75, “Practical Guidelines for Preparation of the Audit Report.”

(2) Items to be included in the internal control audit report

The internal control audit report is, in principal, divided into the following three sections: internal control audit objectives, overview of the internal control audit performed, and the external auditor’s opinion on the internal control report.

- Internal Control Audit objectives:
  a. Scope of the internal control report audited (Company ABC’s internal control report as of (Date)).
  b. A statement denoting that management is responsible for the design and operation of the internal control over financial reporting and the preparation of the internal control report.
  c. A statement denoting that the responsibility of the external auditors for Internal Control Audits is to express an independent opinion on the internal control report.
  d. A statement denoting that internal control over financial reporting may not completely prevent or detect misstatements in financial reporting.

- Overview of the performed Internal Control Audit:
  a. A statement denoting that the external auditor performed the Internal Control Audit in accordance with generally accepted audit standards for internal control over financial reporting.
  b. A statement denoting that the auditing standards for internal control over financial reporting require that external auditors obtain reasonable assurance about whether the internal control report is free of material misstatements.
  c. An outline of the audit procedures performed in the Internal Control Audit (a statement denoting that the internal control audit is performed on a test basis and includes evaluating the appropriateness of the scope, procedures and result of the assessment determined and presented by management, and evaluating the overall internal control report presentation.
  d. Obtaining a reasonable basis to express an opinion as a result of the Internal Control Audit.

- External auditor's opinion on the internal control report:
  a. An identification of management’s conclusion in the internal Control Report subject to Internal Control Audit.
  b. An opinion denoting whether the management’s assessment of internal control over financial reporting in the internal control report is fairly stated, in all material respects, in accordance with the generally accepted assessment standards for internal control over financial reporting.

(3) Implication of the statement denoting that the internal control report is free of material misstatements

The external auditor is required to express an opinion as to whether the internal control report
subject to internal control audit presents fairly, in all material respects, the status of internal control at the end of the fiscal year in conformity with generally accepted assessment standards for internal control over financial reporting. The term “the internal control report is presented fairly” means that the report is free of material misstatement (including omissions). Specifically, it means that the report properly presents the matters stated below in accordance with generally accepted assessment standards for internal control over financial reporting. In the event that the internal control report does not properly present information on any of the following items, the external auditor cannot express an unqualified opinion.

- The scope of the assessment of the internal control over financial reporting
- The procedures for the assessment of the internal control over financial reporting
- The results of the assessment of the internal control over financial reporting
- The contents of supplementary information, etc.

(4) Additional information

When an external auditor concludes that the internal control report is fairly stated but needs to include additional explanations to this conclusion as information in the Internal control audit report, these explanations should be clearly segregated from the expression of opinion (Section 4(2) of the Standards for Internal Control Audit). Such information is provided by the external auditor to the users of the internal control report that the external auditor concludes to be fairly presented. However, because the preparation of the internal control report is the responsibility of the management, the external auditor is not expected to provide information that is not included in the internal control report on behalf of management, which is the same situation as in the financial statement audits. Therefore, additional information, in principle, is limited to matters included in the internal control report.

The Standards for Internal Control Audits show the following examples of information that should be included as additional information.

- Material weaknesses in internal control over financial reporting, and the reasons why they have not been remedied, which are stated in the Internal Control Report by the management, and their impact on the Financial Statement Audit, when external auditors judge the statements to be appropriate and therefore express an unqualified opinion.
- Subsequent events that would have a material impact on the assessment of internal control over financial reporting effectiveness.
- Remedial actions and others taken after the end of the fiscal year.
- The scope for which sufficient assessment procedures could not be performed and relevant reasons, when external auditors judge that the management could not perform a certain part of the assessment procedures due to unavoidable circumstances, and therefore express an unqualified opinion.
(5) Points to be noted when there is limitation of the scope of assessment

- When management did not assess certain internal controls that the external auditor considers to be included in the scope of assessment

When management did not assess certain internal controls that the external auditor considers to be included in the scope of assessment in accordance with the Internal Control Assessment Standards, the external auditor is unable to perform the necessary audit procedures due to the lack of objects subject to the internal control audit in the area in question. In such cases, the external auditor should consider either expressing a qualified opinion with exceptive items associated with the limitation of the scope of the audit or a disclaiming opinion, depending on the influence of the scope not included in management’s assessment. In other words, it should be noted that judgment about the appropriateness of the scope of management’s assessment should be treated as a problem related to the limitation of the scope of audit.

- When the external auditor identifies a material misstatement outside of the scope of management’s assessment of internal control

When a material error in financial statements is identified by the external auditor in the process of the financial statement audit at fiscal year end and the error arose in a business process outside of the scope of management’s assessment of the internal control, or when the external auditor, for the purpose of the financial statement audit, evaluates a business process outside of the scope of management’s assessment of the internal control and identifies a deficiency that is deemed to constitute a material weakness of the internal control, the external auditor needs to evaluate whether the business process in which the material error or material weakness arose should have been included in the scope of the assessment of the internal control as a “business process which has a material impact on financial reporting”. When the external auditor concludes that the process should have been included as a “business process which has a material impact on financial reporting” but the management are unable to make an assessment due to time constraints, such a case should be eventually treated as a limitation of the scope of the assessment of the internal control audit.

In such exceptional cases, the external auditor’s evaluation of the internal control in the area in question may eventually precede management’s assessment. However, if management, after being notified by the external auditor, performs an assessment of the effectiveness of the relevant internal control based on its own policy, such assessment is not considered to be dependent on the external auditor’s evaluation. Thus, this would not be considered as a violation of the external auditor’s independence.

- Unavoidable circumstances

When the management has prepared the internal control report excluding a certain part of the internal control because they were unable to perform sufficient assessment procedures due to unavoidable circumstances, the external auditor should sufficiently evaluate whether the reason for the exclusion is reasonable and how the exclusion influences the financial statement audit. The situation of “unavoidable circumstances” occurs in very limited cases in which it is considered
difficult for management to perform assessment procedures within a specified period in accordance with the Standards for Internal Control Assessments. Examples are given below.

- The company acquired or merged with another company immediately before the end of the fiscal year. Given the scale of the acquired or merged company and/or the complexity of operations, a considerable time is needed for the assessment of internal control, and thus it is reasonable to consider that assessment will not be completed by the time the board of directors approved the financial results for the fiscal year.
- Large-scale system changes
- Large earthquakes, wind and flood damage, and other disasters
- When a coup or other form of political instability impedes the company’s activities

Accordingly, it should be noted that reasons attributable to the company’s responsibility for being unable to perform internal control assessment are not considered to be “unavoidable circumstances”. Such reasons include sudden changes or retirement of officers or other personnel responsible for internal control assessment and the careless loss of important documents that constitute the bases for internal control assessment. Meanwhile, depending on the nature of the “unavoidable circumstances”, the formulation of an opinion on the financial statement audit and the internal control audit could be affected in different ways. For instance, when the company acquired or merged with another company immediately before the end of the fiscal year, the scope of the audit is normally not limited for the financial statement audit, while the extent of the limitation of the scope of the audit is to be examined for the internal control audit. When a major disaster occurs, it is highly possible that the scope of both audits will be limited, unless accounting records can be reconstructed. Even in such cases, however, the extent of the limitation of the scope of the audit should be examined in light of the objectives of each audit.

When the external auditor expresses an unqualified opinion, recognizing that the management was unable to perform certain assessment procedures due to unavoidable circumstances, the external auditor should describe the scope of the assessment for which the management could not perform sufficient assessment procedures and the reasons as additional information in the audit report.

However, if the external auditor determines that the scope of the internal control for which management could not perform the assessment due to “unavoidable circumstances” could have a material impact to the extent that the external auditor would not be able to express an opinion on the internal control report, the external auditor should not express any opinion, even if the unavoidable circumstance is based on reasonable grounds.

(6) Audit opinion in the internal control audit report

- Unqualified opinion

A statement denoting that the internal control report is subject to the Internal Control Audit presents fairly the status of the assessment of the internal control over financial reporting in all material aspects in accordance with generally accepted assessment standards for internal control.
Examples

a. The management concludes in the internal control report that internal control over financial reporting is effective, and the scope, procedures and results of the assessment performed by the management are fairly presented by the management (see Appendix 3(1), Example 1).

b. The management describes in the internal control report that the internal control over financial reporting is not effective due to a material weakness in the internal control over financial reporting and the reason why they are unable to remedy this, and they present the scope, procedures and results of their assessment fairly. In such cases, the effect of the material weakness on the financial statement audit should be included as additional information in the internal control audit report (see Appendix 3(2), Example 2).

c. The management was unable to perform sufficient assessment procedures for certain internal controls due to unavoidable circumstances, but they conclude in the internal control report that the internal control over financial reporting is effective, and that the scope, procedures and the results are fairly presented. In such cases, the scope of internal control for which management was unable to perform sufficient assessment procedures and relevant reason should be included as additional information in the internal control audit report (see Appendix 3(3), Example 3).

Qualified opinion with exceptive items concerning opinion

When the external auditors cannot express an unqualified opinion because they identify inappropriate parts in the internal control report regarding the scope, procedures and results of the assessment performed by the management, but they judge that their impact is not so significant that the internal control report is not misstated as a whole, they should express a qualified opinion with exceptive items. In such cases, they should express an opinion that the internal control report presents fairly in all material respects, excluding an exceptive item, in accordance with generally accepted assessment standards for internal control over financial reporting, and inappropriate parts that have been excluded and their impact on the financial statement audit should be described in their opinion on the internal control audit report.

When the management did not assess certain internal control that the external auditor considers to be included in the scope of the management’s assessment, such a case is to be treated as a limitation of the scope of the audit, and, therefore, should not be included in the case that “they identify inappropriate parts in the internal control report regarding the scope”.

Adverse opinion

When external auditors identify remarkably inappropriate parts in the internal control report regarding the scope, procedures and results of the assessment performed by the management, and judge that the report is misstated as a whole, they should express an opinion that the internal control report is not fairly stated. In such cases, the fact that the report is not fairly stated, the relevant reasons and the impact on the financial statement audit should also be described in the external auditor’s opinion on the internal control audit report.

Examples
a. When the management did not identify a material weakness that the external auditor has identified, and, consequently, the related information is not included in the internal control report. This is also applicable to cases in which the management has identified material weaknesses and reached the conclusion that the internal control over financial reporting was not effective, but the external auditor requested the management to include additional information concerning a material weakness identified by the external auditor other than those identified by the management in the internal control report, which the management did not agree to include in the report (see Appendix 3(4), Example 4).

b. When the internal control report is significantly misstated to include remarkably inappropriate statements which contradict the facts regarding the scope, procedures and the results of the assessment performed by the management.

Disclaimer of opinion

External auditors should not express any opinions on the internal control report when they have not been able to obtain a reasonable basis for expressing opinions as a result of not being able to perform some of the important audit procedures. In such cases, external auditors should state the fact that they do not express their opinion on the internal control report and the reasons for this. In such cases, with regard to the description of the principle of dual responsibility, only the management responsibility for preparing the internal control report is to be described, because no audit opinion is expressed, and no statement about whether or not the internal control report is prepared in accordance with generally accepted assessment standards for internal control over financial reporting is included in the external auditor’s opinion on the internal control report.

Example

When a limitation arose on the scope of the management’s assessment due to a large disaster or other incidents (see Appendix 3(5), Example 5).

Qualified opinion with exceptive items regarding the limitation of the scope of the audit

When the scope of the audit was limited because some important audit procedures could not be performed, but the external auditor judges that the effect is not significant to the extent that the external auditor cannot express an opinion about the internal control report, an exceptive item regarding the limitation of the scope of the audit is to be added. In such cases, unperformed audit procedures are to be described in the overview of the performed Internal Control Audit, and the effect of the exceptive item on the financial statement audit is to be included in the external auditor’s opinion on the internal control report.

Examples

When, although the scope of management’s assessment of internal control is not sufficient in some areas, the results of the assessment themselves are appropriate. When the scope of the assessment is limited in some areas and the results of the management’s assessment are considered inappropriate, the external auditor should express an adverse opinion. In such cases, the reason for the judgment and the status of the limitation of the scope should be described in the internal control audit report (see Appendix 3(6), Example 6).
(7) Treatment of the internal control audit report based on Japanese standards for a company subject to an internal control audit in accordance with U.S. standards

When a U.S. SEC-registered company that discloses its consolidated financial statements in the U.S. in accordance with accounting principles generally accepted in the U.S. discloses its consolidated financial statements in Japan in accordance with accounting principles generally accepted in Japan, external auditors should prepare the company’s internal control audit report in accordance with Japanese standards as well, because internal control reports disclosed in Japan should be in accordance with Japanese standards. In such cases, there is a possibility that an internal control audit has been performed in accordance with U.S. standards. It would be reasonable to consider that the results of such an internal control audit, for the most part, could be used for an internal control audit based on Japanese standards. Thus, the external auditor would be able to deal with this matter by adding procedures that are deemed necessary to prepare an internal control audit report based on Japanese standards.

The “procedures that are deemed necessary” in the preceding paragraph would normally be those to evaluate an assessment of equity-method affiliates and disclosure information and others that could have a material effect on the reliability of financial statements.

17. Management representation letter to be obtained for the Internal Control Audit

In principle, a management representation letter is to be obtained on the date of each audit report delivered by the external auditor. However, the Internal Control Audit is performed concurrently with the financial statement audit by the engagement team for the financial statement audit, and audit evidence obtained in the process of the Internal Control Audit may be used as audit evidence for the financial statement audit, and vice versa. Accordingly, matters requiring management confirmation for both audits may overlap. Furthermore, since reports on both audits are issued on the same date, it would be practical to prepare a management representation letter intended combinedly for both audits.

When performing an Internal Control Audit and a Financial Statement Audit integrally, the external auditor should require management to additionally include at least the following information in the management representation letter which has been previously obtained in the Financial Statement Audit. Appendix 4 shows a sample management representation letter.

(1) Matters pertaining to the internal control report subject to the Internal Control Audit

Management realizes that it is responsible for assessing internal control over financial reporting in accordance with generally accepted assessment standards for internal control over financial reporting and preparing the internal control report.

The internal control report fairly presents the status of the internal control as of the end of the fiscal year in accordance with generally accepted assessment standards for internal control over financial reporting.

The scope of the assessment and the assessment procedures for the internal control over financial reporting were determined properly in accordance with generally accepted assessment standards for the internal control over financial reporting, the effectiveness of the internal control was assessed with sufficient evidence on the basis of the assessment procedures performed, and the records of the assessment are retained.
(2) Matters pertaining to the limitation of the audit procedures

☒ All data necessary for the Internal Control Audit have been made available to the external auditor.

☒ Of deficiencies relating to the design and the operation of the internal control over financial reporting identified in the process of the assessment of internal controls, all of the material weaknesses (and internal control deficiencies, if any) specified in Section 3(4)[4] of the Practice Standards for Internal Control Assessments, along with the details of the remedial actions taken if such deficiencies were remedied during the fiscal year, have been disclosed to the external auditor. Such deficiencies as are considered material weaknesses have been disclosed to the external auditor.

(3) Matters having a significant impact on the internal control report

☒ There is no notice, guidance or any other communication from administrative agencies that could have a material impact on the effectiveness of the internal control over financial reporting.

☒ No subsequent events that could have significant impact on the status of the internal control as of the end of the fiscal year have occurred after the end of the fiscal year to the date of the audit report, other than those described in the internal control report. (If any such event has occurred, state “no event has occurred, other than those described in the internal control report”.)

☒ [When there is any material weakness that management states has been remediated by remedial actions completed by the date of the internal control report.] The material weakness in internal control that existed as of the end of the fiscal year has been remedied by remedial actions taken after the end of the fiscal year as described in the internal control report and that the internal control is now operating effectively, which the management have confirmed by spending a sufficient assessment period.

☒ [When, in the internal control report, the management states that the remedial actions are in progress (including cases when assessment are in progress) as of the date of the internal control report.] The remedial actions described in the internal control report and instituted after the end of the fiscal year will be completed by (month) (year), and the management believe that the material weakness that existed as of the end of the fiscal year will be remediated upon completion of such actions.

(4) Matters pertaining to the effectiveness of internal control over financial reporting

No deficiency relating to the internal control over financial reporting identified as a material weakness, either individually or in combination with other deficiencies, exists and the design and the operation of the internal control over financial reporting is effective as of (the end of the fiscal year). [If any material weaknesses have been disclosed, confirm that “all deficiencies relating to internal control over financial reporting that have been identified to constitute material weaknesses, either individually or in combination with other deficiencies, are properly presented in the internal control report without exception”.)

If the management refuses to confirm some or all of the matters that the external auditor required them to describe in the management representation letter, which represents a limitation of the scope of audit, the external auditor should consider whether to express a qualified opinion or disclaim an
When determining how to treat this matter in the internal control audit report, the external auditor should consider the importance of the effect of the matters in question and the effect of management’s refusal to confirm matters on the reliability of other responses by the management for inquiries from the external auditors in the process of the audit. In the case that the management has refused to confirm matters which relate to the basis of the Internal Control Audit (for example, representation of the management responsibility for the design and operation of the internal control and the assessment thereof), the external auditor should not express any opinion.

18. Application

This statement will apply to Internal Control Audits for fiscal years beginning on or after April 1, 2008.
Appendix 1 Examples of Matters to Be Described in Audit Documentation for the Internal Control Audit

(1) Audit planning
   The matters to be considered in documenting an audit plan are as follows:
   □ Understanding of the procedures planned for management to assess the effectiveness of the internal control over financial reporting including the nature and timing of the relevant procedures.
      Record what was understood about the procedures for management’s assessment of the effectiveness of the internal control over financial reporting and the planned timing of the assessment.
   □ Whether or not any control deficiencies and/or material weaknesses have been reported to the management, the board of directors and the corporate auditors or the audit committee, and, if any, the details thereof.
      Record matters understood about internal control deficiencies and/or material weaknesses that have been reported to the management, the board of directors, corporate auditors or to the audit committee, and record the results of the evaluation regarding the response to such deficiencies/weaknesses by the external auditor.
   □ Internal Control Audit procedures for subsidiaries and equity method affiliated companies.
      In the case that consolidated subsidiaries and equity method affiliated companies have been determined to be locations or business units subject to assessment, record plans for the internal control audits and the relevant procedures for these entities. Instructions to other auditors may be included.

Evaluation of the appropriateness of the scope of assessment
   □ Communication with management on the scope of the assessment of the internal controls.
      Record the results of communications with management concerning the method and the grounds for determining the scope of management’s assessment of the internal controls.
   □ Evaluation of the scope of the assessment of company-level controls and the company-level period-end financial reporting process.
      a. Matters understood about the determination of the scope of assessment.
      b. Results of the evaluation of the locations or business units excluded from the scope of the assessment or the difference in locations or business units between those subject to the assessment of company-level controls and those subject to the assessment of the company-level period-end financial reporting process, if any.
      c. In the case that the external auditor determined that the scope of the assessment was not appropriate, the results of the communications with management.
   □ Evaluation of the scope of the assessment of process-level controls.
      a. Selecting significant locations or business units.
         In evaluating the selection of significant locations or business units, the following matters
may be recorded in the audit documentation.
(a) Matters understood about the determination of the scope of assessment.
(b) The results of examining the appropriateness of the concept of significant locations or
business units, and of the criteria for selection.
(c) The proportion of selected locations or business units determined by the criteria, and the
results of the evaluation of the appropriateness of the selected significant locations or
business units.
b. Identifying business processes subject to assessment.
   The following matters with respect to the business processes which impact the accounts that
are closely associated with the company’s business objectives and business processes to be
individually added to the scope of the assessment considering their impact on financial
reporting may be recorded in the audit documentation.
(a) Matters understood concerning the business processes which were determined to be
included in the scope by the management.
(b) Matters understood concerning whether the business processes subject to the assessment
include outsourced operations.
(c) Matters understood concerning whether the outsourced operations in the preceding item
constitute significant business processes.
(d) When the external auditor judged that the scope of the assessment was inappropriate, the
results of the communications with management.

(2) Results of audit procedures performed

Evaluation of the assessment of company-level controls

Ⅲ Evaluation of the assessment of the design of company-level controls.
   The following matters may be recorded in the audit documentation with respect to the
appropriateness of the assessment of the design of company-level controls.
a. Matters understood about the list of assessment items for the company-level controls adopted
by the management, and the results of evaluating the appropriateness thereof.
b. Matters understood about the procedures for the assessment of the designs of company-level
controls performed by the management, and the results of the assessment.
c. Results of inspections, inquiries, and other audit procedures performed by the external auditor,
and the audit evidence obtained.
d. If the external auditor detected any deficiencies in the design of the company-level controls, the
results of comparison with those identified by management.
e. Results of evaluating the appropriateness of the results of the management’s assessment of the
design of the company-level controls.
Ⅳ Evaluation of the assessment of the operation of company-level controls.
   The following matters may be recorded in the audit documentation with respect to the
appropriateness of the assessment of the operation of the company-level controls.
a. Matters understood about the procedures for the assessment of the operation of the
company-level controls performed by the management, and the results of the assessment thereof.
b. Results of inquiries, inspections of relevant documents, observations and other audit procedures performed by the external auditor, and the audit evidence obtained.
c. If the external auditor detected any deficiencies in the operation of the company-level controls, the results of comparison with those identified by the management.
d. Results of the evaluation of the appropriateness of the results of the management’s assessment of the operation of the company-level controls.

Evaluation of the assessment of the company-level period-end financial reporting process.

- Evaluation of the assessment of the company-level period-end financial reporting process.
  a. Evaluation of the assessment of the design of the company-level period-end financial reporting process shall apply correspondingly provisions in “Evaluation of the assessment of the company-level controls”.
  b. Evaluation of the assessment of the operation of the company-level period-end financial reporting process shall apply correspondingly provisions in “Evaluation of the assessment of company-level controls”.

Evaluation of process-level controls

- Evaluation of the assessment of the design of process-level controls.
  The following matters may be recorded in the audit documentation with respect to the appropriateness of the assessment of the design of process-level controls.
  a. Matters understood about the procedures for the assessment of the design of the process-level controls performed by the management and the results of the assessment thereof.
  b. Results of inquiries, observations, inspections, walkthroughs and other audit procedures performed by the external auditor, and the audit evidence obtained.
  c. Results of the external auditor’s evaluation regarding whether key controls identified by the management provide reasonable assurance to satisfy the requirements for preparing appropriate financial information.
  d. If the external auditor detected any deficiencies in the design of the process-level controls, the results of comparison with those identified by the management.
  e. Results of the evaluation of the appropriateness of the results of the management’s assessment of the design of the process-level controls.

- Evaluation of the assessment of the operation of process-level controls.
  The following matters may be recorded in the audit documentation with respect to the appropriateness of the assessment of the operation of the process-level controls.
  a. Matters understood about the procedures for the assessment of the operation of the process-level controls performed by the management, and the results of the assessment thereof.
  b. Results of inquiries, inspections of relevant documents and observations by the external auditor,
reproduction of work by the company’s personnel and other people, re-performance by the
external auditor of the work performed by the company’s personnel and other people, and other
audit procedures, and the audit evidence obtained.
c. In the case that the external auditor decides to utilize as samples a portion of the samples
selected by the management in their assessment, the grounds for such decision, the procedures
for evaluating the validity of the samples selected by the management, and the results thereof.
d. If the external auditor detected any deficiency in the operation of the process-level controls, the
results of comparison with those identified by the management.
e. Results of the evaluation of the appropriateness of the results of the management’s assessment
of the operation of the process-level controls.

(3) Aggregation of deficiencies

a. Matters understood about the list of control deficiencies prepared by the management.
b. Results of the evaluation of the accounts related to each deficiency, the scope of the effect
thereof, etc.
c. Results of the evaluation concerning the possibility that control deficiencies actually cause
misstatements (including an evaluation of the possibility of compensating controls to substitute
certain internal control with other internal controls).
d. Results of the evaluation of whether a control deficiency, if any, is deemed to constitute a
material weakness. If multiple deficiencies exist, the significance should be judged by the
aggregate impact.
e. The results of the evaluation of the effect of identified internal control deficiencies, etc., on the
financial statement audit.

In the case that the management has taken remedial actions on the material weakness, the
external auditor shall record the following matters in the audit documentation.
a. Matters understood about the remedial actions taken by the management.
b. The results of the evaluation of the appropriateness of the management’s assessment of the
remedial actions.
c. Status of the reporting of the results of the remedial actions to the board of directors and the
corporate auditors or the audit committee.
Appendix 2 Example of the number of statistical samples

The number of samples with a tolerable error rate of 9%, sampling risk of 10% (or confidence level of 90%) and an expected error rate of 0% is shown in the cells of the table below.

<table>
<thead>
<tr>
<th>Expected population deviation rate</th>
<th>2%</th>
<th>3%</th>
<th>4%</th>
<th>5%</th>
<th>6%</th>
<th>7%</th>
<th>8%</th>
<th>9%</th>
<th>10%</th>
<th>15%</th>
<th>20%</th>
</tr>
</thead>
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<td>0.00%</td>
<td>114</td>
<td>76</td>
<td>57</td>
<td>45</td>
<td>38</td>
<td>32</td>
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<td>11</td>
</tr>
<tr>
<td>0.25%</td>
<td>194</td>
<td>129</td>
<td>96</td>
<td>77</td>
<td>64</td>
<td>55</td>
<td>48</td>
<td>42</td>
<td>38</td>
<td>25</td>
<td>18</td>
</tr>
<tr>
<td>0.50%</td>
<td>194</td>
<td>129</td>
<td>96</td>
<td>77</td>
<td>64</td>
<td>55</td>
<td>48</td>
<td>42</td>
<td>38</td>
<td>25</td>
<td>18</td>
</tr>
<tr>
<td>0.75%</td>
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<td>129</td>
<td>96</td>
<td>77</td>
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<td>96</td>
<td>77</td>
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<td>18</td>
</tr>
<tr>
<td>1.25%</td>
<td>*</td>
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<td>132</td>
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<td>64</td>
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<td>42</td>
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<td>25</td>
<td>18</td>
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<tr>
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<td>*</td>
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<td>105</td>
<td>88</td>
<td>55</td>
<td>48</td>
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<td>18</td>
</tr>
<tr>
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<td>*</td>
<td>*</td>
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<td>18</td>
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<td>*</td>
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<td>*</td>
<td>*</td>
<td>*</td>
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<td>*</td>
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<td>113</td>
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<td>25</td>
<td>18</td>
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<td>*</td>
<td>*</td>
<td>*</td>
<td>*</td>
<td>*</td>
<td>131</td>
<td>98</td>
<td>73</td>
<td>52</td>
<td>25</td>
<td>18</td>
</tr>
<tr>
<td>4.00%</td>
<td>*</td>
<td>*</td>
<td>*</td>
<td>*</td>
<td>*</td>
<td>149 (6)</td>
<td>98 (4)</td>
<td>73 (3)</td>
<td>65 (3)</td>
<td>25 (1)</td>
<td>18 (1)</td>
</tr>
<tr>
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<td>-------</td>
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<td>-------</td>
</tr>
<tr>
<td>5.00%</td>
<td>*</td>
<td>*</td>
<td>*</td>
<td>*</td>
<td>*</td>
<td>160 (8)</td>
<td>115 (6)</td>
<td>78 (4)</td>
<td>34 (2)</td>
<td>18 (1)</td>
<td></td>
</tr>
<tr>
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<td>*</td>
<td>*</td>
<td>*</td>
<td>*</td>
<td>*</td>
<td>182 (11)</td>
<td>116 (7)</td>
<td>43 (3)</td>
<td>25 (2)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>7.00%</td>
<td>*</td>
<td>*</td>
<td>*</td>
<td>*</td>
<td>*</td>
<td>*</td>
<td>199 (14)</td>
<td>52 (4)</td>
<td>25 (2)</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

* The data in this table assumes a large population.
* The figures in parentheses are the number of expected errors.
* Asterisks are indicated where the sample size is too large to be cost effective.

[Audit and Accounting Guide – AUDIT SAMPLING, p.107 Table 2 Statistical sample sizes for compliance testing ten-percent risk of over reliance (with the number of expected errors in parentheses), American Institute of Certified Public Accountants, 1983, as partially modified]

Appendix 3 Examples of Combined Auditor’s Reports on the Financial Statement Audit and the Internal Control over Financial Reporting

(1) Example 1 Combined Auditor’s Report on the Financial Statement Audit (unqualified opinion) and the Internal Control over Financial Reporting Audit (unqualified opinion)

Independent Auditor’s Report on Financial Statement Audit
and
Internal Control Over Financial Reporting

(Date)

To the Board of Directors of ABC Company

XYZ Audit Corporation
Designated Partner Certified Public Accountant XXXX Seal
Engagement Partner
Designated Partner Certified Public Accountant XXXX Seal
Engagement Partner

(Note 1)

Financial statement audit

We (Note 2) have audited the accompanying consolidated financial statements of ABC Company and its consolidated subsidiaries, provided in the “Financial Information” section in the Company’s Annual Report, which comprise the consolidated balance sheet as of (Date) and the related, consolidated statements of income, changes in shareholders’ equity, cash flows for the year then ended, and supplementary schedules, in accordance with Article 193-2-(1) of the Financial Instruments and Exchange Law. These consolidated financial statements are the responsibility of the Company’s management; our (Note 2) responsibility is to independently
express an opinion on these consolidated financial statements based on our audit.

We (Note 2) conducted our audit in accordance with auditing standards generally accepted in Japan. These standards require that we plan and perform the audit to obtain reasonable assurance about whether the consolidated financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, and evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

In our (Note 2) opinion, the consolidated financial statements referred to above present fairly, in all material respects, the consolidated financial position of ABC Company and subsidiaries as of (Date), and the consolidated results of their operations and their cash flows for the year then ended in accordance with accounting principles generally accepted in Japan.

Internal control audit

We (Note 2) also have audited the accompanying Internal Control Report of ABC Company as of (Date), in accordance with Article 193-2(2) of the Financial Instruments and Exchange Law. The design and operation of the internal control over financial reporting and the preparation of the Internal Control Report are the responsibility of the Company’s management; our responsibility is to independently express an opinion on the Internal Control Report based on our audit. The internal control over financial reporting may not completely prevent or detect financial statement misstatements.

We conducted our internal control audit in accordance with auditing standards for internal control over financial reporting generally accepted in Japan. These standards require that we plan and perform the audit to obtain reasonable assurance about whether the Internal Control Report is free of material misstatement. An internal control audit is performed on a test basis and includes evaluating the appropriateness of the scope, procedures and result of the assessment determined and presented by management, and evaluating the overall Internal Control Report presentation. We believe that our internal control audit provides a reasonable basis for our opinion.

In our opinion, the Internal Control Report, in which ABC Company states that the internal control over financial reporting was effective as of (Date), presents fairly, in all material respects, the assessment of the internal control over financial reporting in accordance with the assessment standards for internal control over financial reporting generally accepted in Japan.

Our firm and engagement partners (Note 2) have no interest in the Company which should be disclosed pursuant to the provisions of the Certified Public Accountants Law of Japan.

Note 1 When the external auditor is an audit corporation and the audit is not a designated audit engagement, the auditor should be presented as follows:
Note 2 When the external auditor is a Certified Public Accountant or Certified Public Accountants, use “I,” “my,” and “we,” “our,” as appropriate.

Note 3 Notes 1 and 2 also apply to the examples hereafter.

(2) Example 2 Combined Auditor’s Report on the Financial Statement Audit (unqualified opinion) and the Internal Control over Financial Reporting Audit (unqualified opinion with an additional information paragraph concerning material weakness)

---

**Independent Auditor’s Report on Financial Statement Audit**

**and**

**Internal Control Over Financial Reporting**

(Date)

To the Board of Directors of ABC Company

XYZ Audit Corporation  
Designated Partner  
Certified Public Accountant XXXX Seal  
Engagement Partner  
Certified Public Accountant XXXX Seal

Designated Partner  
Certified Public Accountant XXXX Seal  
Engagement Partner  
Certified Public Accountant XXXX Seal  
(Date)

Financial statement audit  
(Report on the financial statement audit omitted)

Internal control audit

We (Note 2) have also audited the accompanying Internal Control Report of ABC Company as of (Date), in accordance with Article 193-2(2) of the Financial Instruments and Exchange Law. The design and operation of the internal control over financial reporting and the preparation of the Internal Control Report are the responsibility of the Company’s management; our (Note 2) responsibility is to independently express an opinion on the Internal Control Report based on our audit. The internal control over financial reporting may not completely prevent or detect financial statement misstatements.

We conducted our internal control audit in accordance with auditing standards for internal
control over financial reporting generally accepted in Japan. These standards require that we plan and perform the audit to obtain reasonable assurance about whether the Internal Control Report is free of material misstatement. An internal control audit is performed on a test basis and includes evaluating the appropriateness of the scope, procedures and result of the assessment determined and presented by management, and evaluating the overall Internal Control Report presentation. We believe that our internal control audit provides a reasonable basis for our opinion.

In our opinion, the Internal Control Report, in which ABC Company states that the internal control over financial reporting was not effective as of (Date) because of the existence of a material weakness, presents fairly, in all material respects, the assessment of the internal control over financial reporting in accordance with the assessment standards for internal control over financial reporting generally accepted in Japan.

Additional Information

Without qualifying our opinion we draw attention to the matter described in the Internal Control Report With regard to transactions handled through the XX process, which had a material weakness as described in the Internal Control Report, the Company rechecked the corresponding arrangements for all transactions processed through the XX process. All necessary adjusting entries identified as a result of the recheck have been reflected in the consolidated financial statements; accordingly, the material weakness did not affect the financial statement audit.

Our firm and engagement partners (Note 2) have no interest in the Company which should be disclosed pursuant to the provisions of the Certified Public Accountants Law of Japan.

(3) Example 3 Combined Auditor’s Report on the Financial Statement Audit (unqualified opinion) and the Internal Control over Financial Reporting Audit (unqualified opinion with an additional information paragraph concerning the limitation on the scope due to unavoidable circumstances)
Financial statement audit  
(Report on the financial statement audit omitted)

Internal control audit  

We (Note 2) also have audited the accompanying Internal Control Report of ABC Company as of (Date), in accordance with Article 193-2(2) of the Financial Instruments and Exchange Law. The design and operation of the internal control over financial reporting and the preparation of the Internal Control Report are the responsibility of the Company’s management; our (Note 2) responsibility is to independently express an opinion on the Internal Control Report based on our audit. The internal control over financial reporting may not completely prevent or detect financial statement misstatements.

We conducted our internal control audit in accordance with auditing standards for internal control over financial reporting generally accepted in Japan. These standards require that we plan and perform the audit to obtain reasonable assurance about whether the Internal Control Report is free of material misstatement. An internal control audit is performed on a test basis and includes evaluating the appropriateness of the scope, procedures and result of the assessment determined and presented by management, and evaluating the overall Internal Control Report presentation. We believe that our internal control audit provides a reasonable basis for our opinion.

In our opinion, the Internal Control Report, in which ABC Company states that the internal control over financial reporting was effective as of (Date), presents fairly, in all material respects, the assessment of the internal control over financial reporting in accordance with the assessment standards for internal control over financial reporting generally accepted in Japan.

Additional Information  

Without qualifying our opinion we draw attention to the matter described in the Internal Control Report. As described in the Internal Control Report, DEF Company, which became a consolidated subsidiary as a result of a share acquisition on (Date), is excluded from the assessment of the internal control over financial reporting as of the end of the fiscal year because the Company was unable to perform sufficient assessment due to unavoidable circumstances. Given the scale, diversity, and complexity of the acquired operations, considerable time is required to assess the internal control of the acquired Company. Therefore it was difficult for management to complete the assessment by the time the board of directors approved the financial results for the fiscal year.

Our firm and engagement partners (Note 2) have no interest in the Company which should be disclosed pursuant to the provisions of the Certified Public Accountants Law of Japan.
Independent Auditor’s Report on Financial Statement Audit and Internal Control Over Financial Reporting

(Date)

To the Board of Directors of ABC Company

XYZ Audit Corporation
Designated Partner
Engagement Partner
Certified Public Accountant XXXX Seal

Designated Partner
Engagement Partner
Certified Public Accountant XXXX Seal

(Note 1)

Financial statement audit
(Report on the financial statement audit omitted)

Internal control audit

We (Note 2) also have audited the accompanying Internal Control Report of ABC Company as of (Date), in accordance with Article 193-2(2) of the Financial Instruments and Exchange Law. The design and operation of the internal control over financial reporting and the preparation of the Internal Control Report are the responsibility of the Company’s management; our (Note 2) responsibility is to independently express an opinion on the Internal Control Report based on our audit. The internal control over financial reporting may not completely prevent or detect financial statement misstatements.

We conducted our internal control audit in accordance with auditing standards for internal control over financial reporting generally accepted in Japan. These standards require that we plan and perform the audit to obtain reasonable assurance about whether the Internal Control Report is free of material misstatement. An internal control audit is performed on a test basis and includes evaluating the appropriateness of the scope, procedures and result of the assessment determined and presented by management, and evaluating the overall Internal Control Report presentation. We believe that our internal control audit provides a reasonable basis for our opinion.

The Company, through its XXX Division, entered into composite arrangements for goods and services with customers individually. In this connection, the Company made significant adjusting entries for sales and deferred revenue for the current fiscal year due to the insufficiency in examination of arrangements and approval procedures required for appropriate revenue recognition. For this reason, we concluded that this internal control deficiency is a material weakness, because it is highly likely that this deficiency causes material misstatements in the Company’s consolidated financial statements according to the
assessment standards for internal control over financial reporting generally accepted in Japan. However, the Company did not disclose this deficiency in the Internal Control Report, on the basis that the deficiency does not constitute a material weakness.

In our opinion, because of the effect of the material weakness described above, the Internal Control Report, in which ABC Company states that the internal control over financial reporting was effective as of (Date), does not fairly present the assessment of the internal control over financial reporting in accordance with the assessment standards for internal control over financial reporting generally accepted in Japan. However, the aforementioned material weakness did not affect the financial statement audit, because the Company rechecked all arrangements associated with the weakness and made the necessary adjusting entries.

Our firm and engagement partners (Note 2) have no interest in the Company which should be disclosed pursuant to the provisions of the Certified Public Accountants Law of Japan.

(5) Example 5 Combined Auditor’s Report on the Financial Statement Audit (unqualified opinion) and the Internal Control over Financial Reporting Audit (disclaimer of opinion)

<table>
<thead>
<tr>
<th>Independent Auditor’s Report on Financial Statement Audit</th>
<th>and</th>
<th>Internal Control Over Financial Reporting</th>
</tr>
</thead>
<tbody>
<tr>
<td>(Date)</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

To the Board of Directors of ABC Company

XYZ Audit Corporation

Designated Partner

Engagement Partner

Certified Public Accountant XXXX Seal

Designated Partner

Engagement Partner

Certified Public Accountant XXXX Seal

(Note 1)

Financial statement audit

(Report on the financial statement audit omitted)

Internal control audit

We (Note 2) also have audited the accompanying Internal Control Report of ABC Company as of (Date), in accordance with Article 193-2(2) of the Financial Instruments and Exchange Law. The design and operation of the internal control over financial reporting and the preparation of the Internal Control Report are the responsibility of the Company’s management. The internal control over financial reporting may not completely prevent or detect financial statement misstatements.
We conducted our (Note 2) internal control audit, excluding the matter described below, in accordance with auditing standards for internal control over financial reporting generally accepted in Japan. These standards require that we plan and perform the audit to obtain reasonable assurance about whether the Internal Control Report is free of material misstatement. An internal control audit is performed on a test basis and includes evaluating the appropriateness of the scope, procedures and result of the assessment determined and presented by management, and evaluating the overall Internal Control Report presentation.

As described in the Internal Control Report, important records for assessment procedures for the internal control over financial reporting were destroyed on (Date) by a fire at the head office of DEF Company’, a significant consolidated subsidiary of the Company. The Company considers the influence of the resulting limitation on the scope of assessment was limited. Since ABC Company’s sales account for X% of consolidated sales and its total assets for X% of consolidated total assets, we were unable to obtain a reasonable basis for expressing an opinion on the Internal Control Report of ABC Company’s internal control over financial reporting as of (Date).

because of the effect on financial reporting of the influence of the limitation on the scope of assessment of internal controls disclosed in the Internal Control Report, we do not express our opinion on whether the Internal Control Report, in which ABC Company states that the internal control over financial reporting was effective as of (Date), presents fairly the assessment of the internal control over financial reporting.

Our firm and engagement partners (Note 2) have no interest in the Company which should be disclosed pursuant to the provisions of the Certified Public Accountants Law of Japan.
Independent Auditor’s Report on Financial Statement Audit

and

Internal Control Over Financial Reporting

(Date)

To the Board of Directors of ABC Company

XYZ Audit Corporation

Designated Partner

Engagement Partner

Certified Public Accountant XXXX Seal

Designated Partner

Engagement Partner

Certified Public Accountant XXXX Seal

(Note 1)

Financial statement audit

(Report on the financial statement audit omitted)

Internal control audit

We (Note 2) also have audited the accompanying Internal Control Report of ABC Company as of (Date), in accordance with Article 193-2(2) of the Financial Instruments and Exchange Law. The design and operation of the internal control over financial reporting and the preparation of the Internal Control Report are the responsibility of the Company’s management; our (Note 2) responsibility is to independently express an opinion on the Internal Control Report based on our audit. The internal control over financial reporting may not completely prevent or detect financial statement misstatements.

We conducted our internal control audit, excluding the matter described below, in accordance with auditing standards for internal control over financial reporting generally accepted in Japan. These standards require that we plan and perform the audit to obtain reasonable assurance about whether the Internal Control Report is free of material misstatement. An internal control audit is performed on a test basis and includes evaluating the appropriateness of the scope, procedures and result of the assessment determined and presented by management, and evaluating the overall Internal Control Report presentation. We believe that our internal control audit provides a reasonable basis for our opinion.

As described in the Internal Control Report, DEF Company, which became a consolidated subsidiary as a result of share acquisition made on (Date), is excluded from the scope of the assessment of the internal control over financial reporting as of the end of the fiscal year. Given the fact that considerable time has passed since the acquisition date, we do not
consider this exclusion to be regarded as an unavoidable circumstance.

In our opinion, the Internal Control Report, in which ABC Company states that the internal control over financial reporting was effective as of (Date), presents fairly, in all material respects, the assessment of the internal control over financial reporting in accordance with assessment standards for internal control over financial reporting generally accepted in Japan, excluding the aforementioned matter, which was excluded from the scope of the assessment in the Internal Control Report. The aforementioned exclusion of the consolidated subsidiary from the scope of assessment in the Internal Control Report did not affect the financial statement audit, because the financial statements of the subsidiary have been reflected in the consolidated financial statements.

Our firm and engagement partners (Note 2) have no interest in the Company which should be disclosed pursuant to the provisions of the Certified Public Accountants Law of Japan.

Appendix 4 Example of a Management Representation Letter (for combined audit of financial statements and internal control)

(Date)

To Audit Corporation[name of Audit Corporation]
[Name of Partner], Certified Public Accountant
Designated Partner (Note 1)

[Name of client]
Representative director (signature) ( or name and seal )

Director in charge of
Finance and Accounting (signature) ( or name and seal )

We are providing this letter in connection with your audits of the financial statements and the consolidated financial statements (hereinafter “[consolidated] financial statements”) for the [ ] fiscal year from [the beginning of fiscal year] to [the end of the fiscal year] and the Internal Control Report as of [date], which are included in the annual report. We confirm, to the best of our knowledge and belief, the following representations made to you during your audits. We confirm that we are responsible for the preparation of the [consolidated] financial statements and the Internal Control Report.

1. The [consolidated] financial statements referred to above fairly present the financial position, results of operations, and cash flows in accordance with accounting principles generally
accepted in Japan.

2. The Internal Control Report referred to above fairly presents the status of the internal control as of the end of the fiscal year in accordance with assessment standards for internal control over financial reporting generally accepted in Japan.

3. There are no material transactions that have not been properly recorded in the accounting records underlying the [consolidated] financial statements.

4. We confirm that we are responsible for establishing and maintaining effective internal control over financial reporting in the Company group in order to prevent and detect any fraud, and properly provide financial reporting.

5. We have no knowledge of any fraud (or suspected fraud) or illegal act (if there are such cases, we have disclosed to you all acts of fraud or suspected fraud or illegal acts) involving:
   (1) management,
   (2) employees who have significant roles in the internal control over financial reporting within the Company group, or
   (3) acts of fraud (including suspected fraud) by other people which could have a material effect on the [consolidated] financial statements.

6. We have disclosed to you the management’s assessment of the possibility of material misstatements caused by fraud in our financial statements and in the consolidated subsidiaries’ financial statements.

7. We have no knowledge of any allegations of fraud or suspected fraud affecting the [consolidated] financial statements from consolidated subsidiaries’ employees, former employees, investors, regulators or other people.

8. We have made available to you, all:
   (1) financial records and related data,
   (2) records concerning our assessment of the internal control over financial reporting, and
   (3) other information necessary for performing your audits.

9. We have made available to you all:
   (1) minutes of the meetings of shareholders and directors held to date, and
   (2) significant documents circulated for approvals and arrangements.

10. We have disclosed to you deficiencies relating to the design and operation of the internal control over financial reporting identified in the process of the assessment of the internal controls, all of the material weaknesses (and internal control deficiencies, as necessary) specified in Section 3(4)[4] of the Practice Standards for Internal Control Assessments, along with the details of remedial actions taken if such deficiencies were remedied during the fiscal year. If such deficiencies are considered material weakness, we have also disclosed the fact to
11. We have properly determined the scope of the assessment and the assessment procedures in accordance with assessment standards for internal control over financial reporting generally accepted in Japan in performing our assessment of the internal control over financial reporting. Also, we have assessed the internal control based on sufficient evidence obtained from the assessment procedures we performed as management, and we have retained the records thereof.

12. We have received no notice, guidance or any other communication from administrative agencies that could have a material impact on our [consolidated] financial statements and the effectiveness of the internal control over financial reporting.

13. We have no plans nor intentions that may materially affect the carrying value or presentation of the assets and liabilities in the [consolidated] financial statements.

14. We and our consolidated subsidiaries have complied with all aspects of contractual agreements that would have a material effect on the [consolidated] financial statements in the event of noncompliance.

15. We have no significant assets whose ownership is restricted, except as disclosed in the [consolidated] financial statements.

16. We have no knowledge of significant contingencies or subsequent events, except as disclosed in the [consolidated] financial statements or the Internal Control Report.

17. [In the case there is any material weakness that management states has been remediated by remedial actions that have been completed by the date of the Internal Control Report.] We have confirmed, over a sufficient period of evaluation, that the material weakness in the internal control that existed as of the end of the fiscal year has been remedied by remedial actions taken after the end of the fiscal year as described in the Internal Control Report and that the internal control is now operating effectively.

18. [In connection with (17) above, if the management states in the Internal Control Report that the remedial actions are in progress (including cases when assessment is in progress) as of the date of the Internal Control Report.] The remedial actions described in the Internal Control Report and instituted after the end of the fiscal year will be completed by (month) (year), and we believe that the material weakness that existed as of the end of the fiscal year will be remediated upon completion of such actions.

19. We have properly disclosed the following, if material, in the [consolidated] financial statements: related party transactions and amounts of receivables from or payable to related parties, and derivatives transactions.
20. We believe that the effects of the uncorrected misstatements in the [consolidated] financial statements summarized in the accompanying schedule are immaterial, both individually and in the aggregate, to the [consolidated] financial statements taken as a whole.

21. We believe that there are no deficiencies relating to the internal control over financial reporting that have been identified as material weaknesses, either individually or in the aggregate, and that the design and operation of the internal control over financial reporting is effective as of (date).

22.  

Note 1 When the auditor is a certified public accountant, the address of the recipient should be written as shown below. In addition, “your audit corporation” in the letter should be changed to “you”.

To XXXX  Certified Public Accountancy Office
           Certified Public Accountant  XXXX