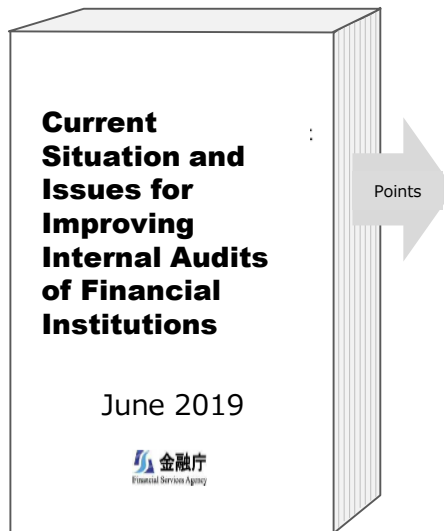


Introduction (“Current Situation and Issues for Improving Internal Audits of Financial Institutions”)

- In June 2019, the Financial Services Agency (FSA) announced the “Current Situation and Issues for Improving Internal Audits of Financial Institutions” (hereinafter referred to as “Current Situation and Issues”)
- “Current Situation and Issues” organizes and summarizes the current situation and issues for improving internal audits, based on the results of monitoring of financial institutions*1 and the knowledge obtained from external experts*2 in July 2018-June 2019 .



Points

- It shows that the level of internal audits can be evaluated in four phases.

Large financial institutions

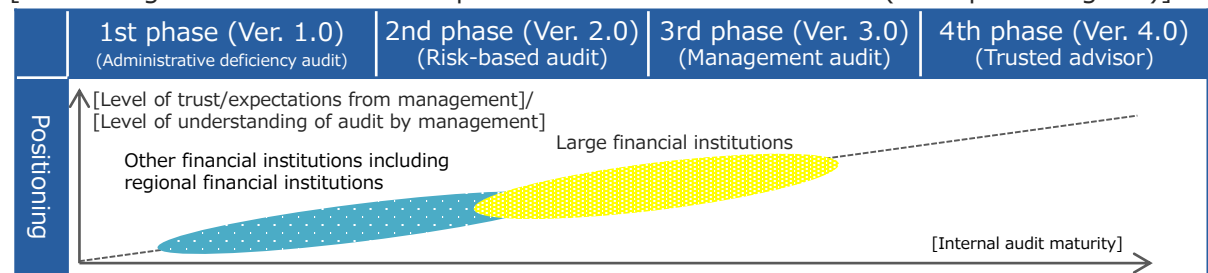
- Level of internal audits: **2nd to 3rd phase**
- Requesting to develop the 3rd phase level system, and then to further improve by referring to advanced initiatives such as overseas G-SIFIs.

Other financial institutions including regional financial institutions

- Level of internal audits: **1st to 2nd phase**
- Requesting for raising standards and improvement according to scale, characteristics, etc.

*Mainly in regional financial institutions, there are large differences in the level of internal audit depending on the degree of involvement by management.

[Positioning of an internal audit department in financial institutions (conceptual diagram)]

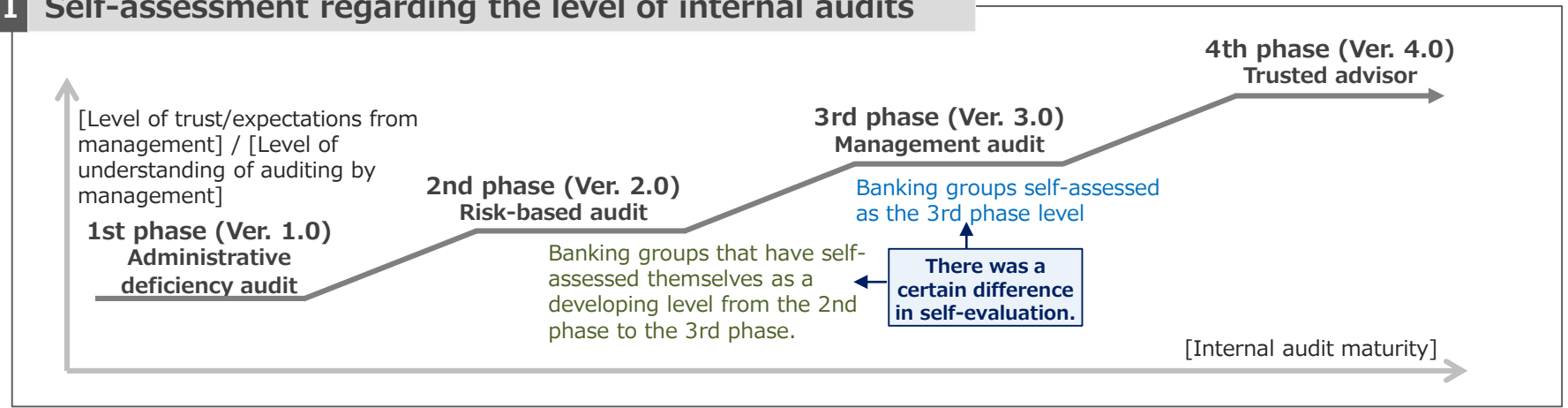


*1: Other financial institutions including large banking groups, large life insurance companies, large nonlife insurance companies, large securities companies, and regional financial institutions.

*2: Consulting company, audit corporation

- Overall, large banking groups are actively working to improve their internal audit even after the publication of the “Current Situation and Issues”.
- However, there were certain differences in self-assessment regarding the level of internal audit among large banking groups (see I).
- Based on the dialogue, clarify the three perspectives necessary for financial institutions to ensure operational appropriateness and financial soundness and improve corporate value through effective internal audits (see II).

I Self-assessment regarding the level of internal audits

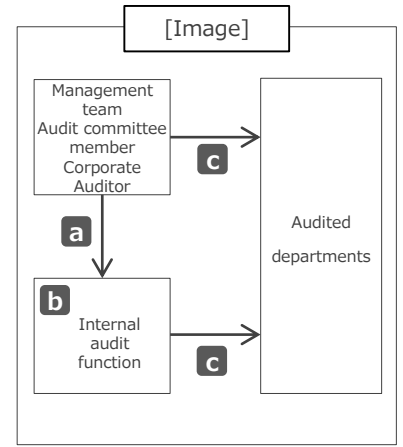


II Three perspectives necessary to ensure operational appropriateness and financial soundness and improve corporate value

Three perspectives



- a Support for the internal audit function by management teams, audit committee members, and corporate auditors**
 - Strongly recognize the importance and usefulness of internal audit and actively support it.
- b Initiatives for improvement in the internal audit function**
 - Improve the audit system and strengthen the audit infrastructure in response to changes in the environment.
- c Initiatives for audited departments**
 - To promote understanding of internal audits and risk ownership among audited departments.



- When monitoring **large banking groups**, the FSA confirmed examples of initiatives where **management teams, audit committee members, and corporate auditors were thought to understand the importance and usefulness of internal audits, and that they** expected the internal audit function to become more improved.
- In addition, the FSA confirmed that **the internal audit function was working to improve internal audit, promote understanding of internal audit among audited departments, and aim to foster risk ownership**. On the other hand, **the issues related to the audit system, audit infrastructure, etc.** were also confirmed.

Status of initiatives after publication of “Current Situation and Issues”

Issues recognized by large banking groups, etc.

Banking groups that assessed themselves as 3rd phase level

Banking groups that assessed themselves as being on the way from the 2nd phase to the 3rd phase

a Support for the internal audit function by management teams, audit committee members, and corporate auditors

- Growing awareness of the importance and usefulness of internal audit.
- Discuss the role of internal audit, including the management team, increase the number of officers and staff and the budget
- Opinions have been requested more often by the chairs of various conference bodies, etc.

[Expectations from management teams, audit committee members, and corporate auditors]

- **Flexible audit**
- Audit targeting **management strategy, etc.***
- **Recommendations from the perspective of strategic execution issues and operational efficiency, etc.**

*Status of development, implementation, and penetration of management strategies, sufficiency, and appropriateness of management resource allocation, etc.

[Expectations from management teams, audit committee members, and corporate auditors]

- Even if it is difficult to say, **speak freely** from a third party's perspective **based on the facts**.
- **Fulfillment of an assurance function for the internal control system**
- **Audit from a management perspective, etc.**
(Expectations from outside directors)

b Initiatives for improvement of the internal audit function

- **Audit from the management perspective, flexible response to risk changes, and improvement of audit quality**
- **Develop systems on a group/global basis, etc.**

- **Audits that consider the perspectives of all stakeholders**
- **Identifying the root cause of management issues**
- **Establishing a virtuous cycle of human resources** between the 1st, 2nd and 3rd lines
- **Initiatives for transition to the 4th phase, etc.**

- **Transition from compliance audits to audits that verify the maintenance and operational status on business processes**
- **Pursuing the root cause of issues** using frameworks for analysis
- **Building a system to comprehensively understand and accurately evaluating risks across the entire group.**
- **Securing and developing human resources responsible for management audits, etc.**

c Initiatives for audited departments

- **Understanding of internal audit for the audited department**
- **Foster risk ownership in audited departments**

[Expectations from outside directors to management teams]

- **Explanation and penetration of the significance of “audits that contribute to management” from management and internal audit function to audited departments**

[Management team's self-identified issues]

- **Fostering a culture in which audited departments actively accept and cooperate with internal audits**
- [Issues recognized by the internal audit department]
- **Understanding of the role of internal audits for audited departments**

[Management team's self-identified issues]

- **Fostering a culture in which audited departments actively accept and cooperate with internal audits**

[Issues recognized by the internal audit function]

- **Understanding by the audited departments that internal audit function is colleagues in achieving a common goal, etc.**

- **Clarify main issues for future monitoring from three perspectives.** From now on, the FSA will encourage not only large banking groups, but also regional banks, securities companies, insurance companies, and other financial industries to **improve their internal audits through in-depth monitoring based on the main issues.**
- **To improve the efficiency of financial administration, the target scope and depth of monitoring will be determined according to the internal audit level of each financial institution.**
- Based on international trends regarding monitoring and internal audits of financial institutions, **the FSA will consider the need to update the “Current Situation and Issues”,** including the perspective of promoting further improvement of internal audits on a group/global basis.

3 perspectives

Main issues for future monitoring

a Support for the internal audit function by management teams, audit committee members, and corporate auditors

Issue 1 Support for the internal audit function by management teams, audit committee members, and corporate auditors

Main actors : Management teams, audit committee members, and corporate auditors

- ① **Examining the ideal state** of internal audits, ② **Supporting the improvement** of internal audits, ③ Status of initiatives regarding **the utilization** of internal audit functions

b Initiatives for improvement of the internal audit function

Issue 2 Improving the system and strengthening the infrastructure of the internal audit function

Main actors : Internal audit function

Sophistication of an auditing system

- ① **Exchange of opinions and information** with management teams, audit committee members, and corporate auditors, ② **Ensuring independence**, ③ **Identifying risks and narrowing down the scope of audit**, ④ **Flexible response** to risk changes, ⑤ **Audit depth** (including root cause analysis), ⑥ **Utilization of IT/data analysis**, ⑦ **Continuous improvement of audit quality**, ⑧ Status of Initiatives of **group/global system development**

Strengthening of an audit infrastructure

- ① Status of initiatives to **secure and develop human resources**, ② Status of **implementation of the audit system**

Co-sourcing

- ① **Utilization policy**, ② **Responsibility for final evaluation**, ③ Status of initiatives to **absorb knowledge and know-how**

c Initiatives for audited departments

Issue 3 Understanding of internal audits for audited departments and fostering risk ownership

Main actors: Management teams, audit committee members, corporate auditors, and internal audit functions

- ① **Understanding** of internal audits for audited departments, ② Status of initiatives regarding **evaluation and fostering of risk ownership** in audited departments, **and communication with audited departments**