Material 3

Provisional translation

Reference Materials for the 25th Meeting of Council

(Ensuring the reliability of audits/ internal control and risk management)

March 9, 2021

Japan Financial Services Agency

(1) General remarks

(1) Description of internal control and risk management in the Corporate Governance Code

Excerpt from the Corporate Governance Code

[General Principle 4]
Given its fiduciary responsibility and accountability to shareholders, in order to promote sustainable corporate growth and the increase of corporate value over the mid- to long-term and enhance earnings power and capital efficiency, the board should appropriately fulfill its roles and responsibilities, including:
(1) Setting the broad direction of corporate strategy;
(2) Establishing an environment where appropriate risk-taking by the senior management is supported; and
(3) **Carrying out effective oversight of directors and the management (including *shikkoyaku* and so-called *shikkoyakuin*) from an independent and objective standpoint**.

Principle 4.3 Roles and Responsibilities of the Board (3)
The board should view the effective oversight of the management and directors from an independent and objective standpoint as a major aspect of its roles and responsibilities. It should appropriately evaluate company performance and reflect the evaluation in its assessment of the senior management. In addition, the board should engage in oversight activities in order to ensure timely and accurate information disclosure, **and should establish appropriate internal control and risk management systems.**

Supplementary Principle
4.3.4 The establishment of effective internal control and proactive risk management systems for compliance and financial reporting has the potential of supporting sound risk-taking. The board should place priority on the appropriate establishment of such systems and the oversight of whether they effectively operate, and should not limit itself to the examination of compliance with respect to specific business operations.

[Principle 4.4 Roles and Responsibilities of *Kansayaku* and the *Kansayaku* Board]
***Kansayaku* and the *kansayaku* board should bear in mind their fiduciary responsibilities to shareholders and make decisions from an independent and objective standpoint when executing their roles and responsibilities including the audit of the performance of directors' duties, appointment and dismissal of external auditors and the determination of auditor remuneration.**
Although so-called "defensive functions," such as business and accounting audits, are part of the roles and responsibilities expected of *kansayaku* and the *kansayaku* board, in order to fully perform their duties, it would not be appropriate for *kansayaku* and the *kansayaku* board to interpret the scope of their function too narrowly, and they should positively and proactively exercise their rights and express their views at board meetings and to the management.

Supplementary Principle
4-4.1 Given that not less than half of the *kansayaku* board must be composed of outside *kansayaku* and that at least one full-time *kansayaku* must be appointed in accordance with the Companies Act, the *kansayaku* board should, from the perspective of fully executing its roles and responsibilities, increase its effectiveness through an organizational combination of the independence of the former and the information gathering power of the latter. In addition, ***kansayaku* or the *kansayaku* board should secure cooperation with outside directors so that such directors can strengthen their capacity to collect information without having their independence jeopardized.**

(1) Description of cooperation with the internal audit department in the Corporate Governance Code

Excerpt from the Corporate Governance Code

[Principle 4.13 Information Gathering and Support Structure]
In order to fulfill their roles and responsibilities, directors and *kansayaku* should proactively collect information, and as necessary, request the company to provide them with additional information.
Also, **companies should establish a support structure for directors and kansayaku, including providing sufficient staff.**
The board and the *kansayaku* board should verify whether information requested by directors and *kansayaku* is provided smoothly.

Supplementary Principle
4.13.3 **Companies should ensure coordination between the internal audit department, directors and kansayaku.** In addition, companies should take measures to adequately provide necessary information to outside directors and outside *kansayaku*. One example would be the appointment of an individual who is responsible for communicating and handling requests within the company such that the requests for information about the company by outside directors and outside *kansayaku* are appropriately processed.

[Principle 3.2 External Auditors]
External auditors and companies should recognize the responsibility that external auditors owe toward shareholders and investors, and take appropriate steps to secure the proper execution of audits.

Supplementary Principle
3.2.2 The board and the *kansayaku* board should, at minimum, ensure the following:

i) Give adequate time to ensure high quality audits;

ii) Ensure that external auditors have access, such as via interviews, to the senior management including the CEO and the CFO;

iii) **Ensure adequate coordination between external auditors and each of the *kansayaku* (including attendance at the *kansayaku* board meetings), the internal audit department and outside directors; and**

iv) Ensure that the company is constituted in the way that it can adequately respond to any misconduct, inadequacies or concerns identified by the external auditors.

(1) Rules for the development of systems related to internal control systems under the Companies Act

- Under the Companies Act, **corporate groups** are also included in the **development of systems related to** a so-called **internal control system**, which is required to be decided by the Board.

Companies Act
(Authority of Board of Directors)
Article 362 Board of directors is composed of all directors.
2 to 3 (Omitted)
(4) Board of directors may not delegate the decision on the execution of important operations such as the following matters to directors:
(i) to (v) (Omitted)
(vi) the development of **systems necessary to ensure that the execution of duties by directors complies with laws and regulations and the articles of incorporation**, and other systems prescribed by Ministry of Justice Order as systems necessary to **ensure the properness of operations of a Stock Company and operations of group** of enterprises consisting of the Stock Company and its Subsidiary Companies

(vii) (Omitted)

2014 amendment to provide for this at the legal level

Ordinance for Enforcement of the Companies Act
(Systems for Ensuring the Propriety of Business Activities)
Article 100 (1) The systems prescribed by Order of the Ministry of Justice as establisheded in Article 362, paragraph (4), item (vi) of the Act are the following systems of the stock company:
(i) systems regarding retention and management of information in relation to the execution of the duties of a director of the stock company;
(ii) rules and other systems related to management of the risk of loss of the stock company;
(iii) systems to ensure that the execution of the duties of a director of the stock company is performed efficiently;
(iv) systems to ensure that the execution of the duties of an employee of the stock company complies with laws and regulations and the articles of incorporation;
(v) the following systems and other systems to ensure the properness of business activities in a business group comprised of the stock company and any Parent Company or Subsidiary Companies thereof:

(a) systems related to reporting of particulars regarding the execution of the duties of a director, executive officer, member who executes the business, person who is to perform the duties of Article 598, paragraph (1) of the Act, and other persons equivalent thereto (referred to as a "director, etc." in (c) and (d)) of a Subsidiary Company of the stock company;

(b) rules and other systems related to management of the risk of loss of a Subsidiary Company of the stock company;
(c) systems to ensure that the execution of the duties of a director, etc. of a Subsidiary Company of the stock company is performed efficiently;
(d) systems to ensure that the execution of the duties of the duties of a director, etc. or an employee of a Subsidiary Company of the stock company complies with laws and regulations and the articles of incorporation.
2 to 3 (Omitted)

(1) Outline of the Group Guidelines of the Ministry of Economy, Trade and Industry

- The following is a summary of the **Practical Guidelines for Corporate Governance Systems (Group Guidelines)** released on June 28, 2019 by the CGS Study Group of the Ministry of Economy, Trade and Industry (Chairperson: Professor Hideki Kanda of Gakushuin University; Secretariat: Industrial Organization Division, Economic and Industrial Policy Bureau).

Group design	➢ A rational approach should be considered in order to achieve medium to long-term corporate value enhancement and sustainable growth for the group.
Business portfolio Management	➢ It is important to identify the core businesses for the company and strategically make concentrated investments of management resources in the core businesses through M&A and consolidate non-core businesses in order to strengthen them.
Internal control system	➢ **The board of the parent company** is **responsible for appropriately monitoring and supervising the establishment and operation of the internal control system of the entire group**. ➢ The **introduction, maintenance of and appropriate operation of** so-called **"three-line defense"** should be considered. Other contingency plans are also mentioned.
Nomination and compensation of the subsidiary management team	➢ The board, nomination committee and remuneration committee of the parent company should consider, for example, including top management of major wholly-owned subsidiaries in their deliberations.
Governance of listed subsidiaries	➢ The parent company should deliberate at its board meetings on the rational reasons for maintaining listing as a subsidiary and ensuring the effectiveness of its governance system, and fulfill its accountability to investors through information disclosure. ➢ Listed subsidiaries should basically aim to increase the ratio of independent directors (such as 1/3 or more or a majority) (see Note). Note: Even in cases which this is not immediately possible consideration should be given to introducing a system whereby material conflict of interest transactions are deliberated and reviewed by a committee led by an independent director (or independent *kansayaku* (Audit & Supervisory Board member))

(1) Audit, internal control, and risk management rules in the UK code

- The UK Corporate Governance Code has a separate chapter on auditing, internal control and risk management, and refers to the **role, etc. of the board and audit committee** on these matters.

Structure of the code

Section 1 Board Leadership and Company Purpose
Section 2 Division of Responsibilities
Section 3 Composition, Succession and Evaluation
Section 4: **Audit, Risk and Internal Control**
Section 5 Remuneration

Principles and Provisions Concerning Internal Control, Risk Management, etc.

○ The board should establish formal and transparent policies and procedures to ensure the independence and effectiveness of internal and external audit functions and satisfy itself on the integrity of financial and narrative statements. (Principle M)

○ The board should establish procedures to manage risk, oversee the internal control framework, and determine the nature and extent of the principal risks the company is willing to take in order to achieve its long-term strategic objectives. (Principle O)

● The board should establish an audit committee of independent non-executive directors, with a minimum membership of three, or in the case of smaller companies, two. The chair of the board should not be a member. The board should satisfy itself that at least one member has recent and relevant financial experience. The committee as a whole shall have competence relevant to the sector in which the company operates. (Provision 24)

● **The main roles and responsibilities of the audit committee** should include: (Provision 25)
・reviewing the company's internal financial controls and internal control and risk management systems (excerpt)
•monitoring and reviewing the effectiveness of the company's internal audit function or, where there is not one, considering annually whether there is a need for one and making a recommendation to the board(excerpt)

● The board should carry out a robust assessment of the company's emerging and principal risks. The board should confirm in the annual report that it has completed this assessment, including a description of its principal risks, what procedures are in place to identify emerging risks, and an explanation of how these are being managed or mitigated. (Provision 28)

● The board **should monitor the company's risk management and internal control systems and, at least annually, carry out a review of their effectiveness and report on that review in the annual report.** The monitoring and review should cover all material controls, including financial, operational and compliance controls. (Provision 29)

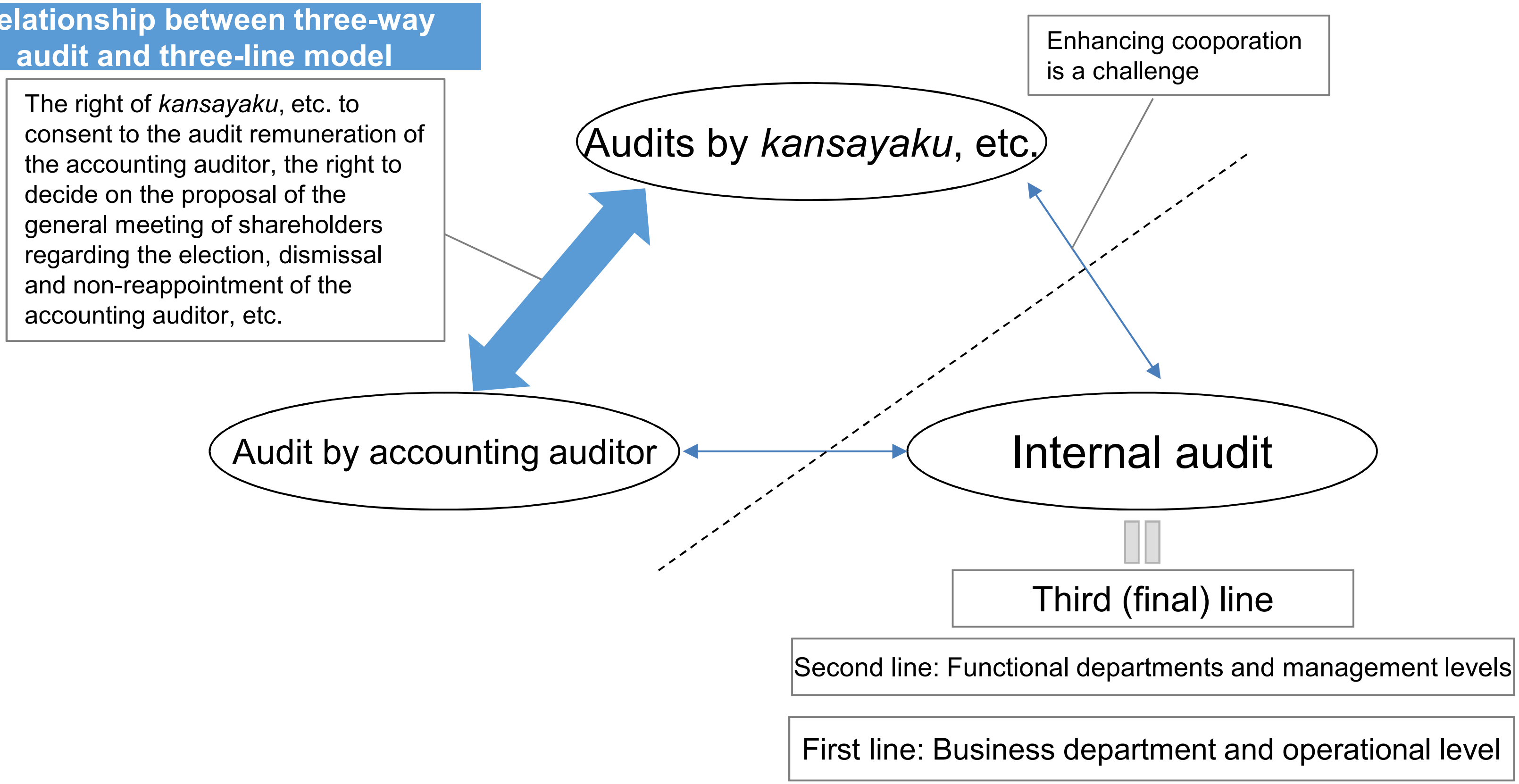
Note: In addition to the Code, the UK has published guidance on best practice in relation to internal and other controls, risk management and audit committees ("Guidance on Audit Committees" (2016), "Guidance on Risk Management, Internal Control and Related Financial and Business Reporting" (2014)).

(2) Cooperation between audits by *kansayaku*, etc. and internal audits

(2) Three-way audit and three-line model

- In internal control, **the first line (operation departments), the second line (management departments), and the third line (internal audit departments) must function independently and effectively**.
- It has been pointed out that cooperation between *kansayaku*, etc. and the internal audit department is not necessarily legally ensured, and **that this cooperation is becoming more and more important** from the perspective that the *kansayaku* board, etc. effectively fulfills its responsibilities and contributes to the enhancement of corporate value.

Relationship between three-way audit and three-line model



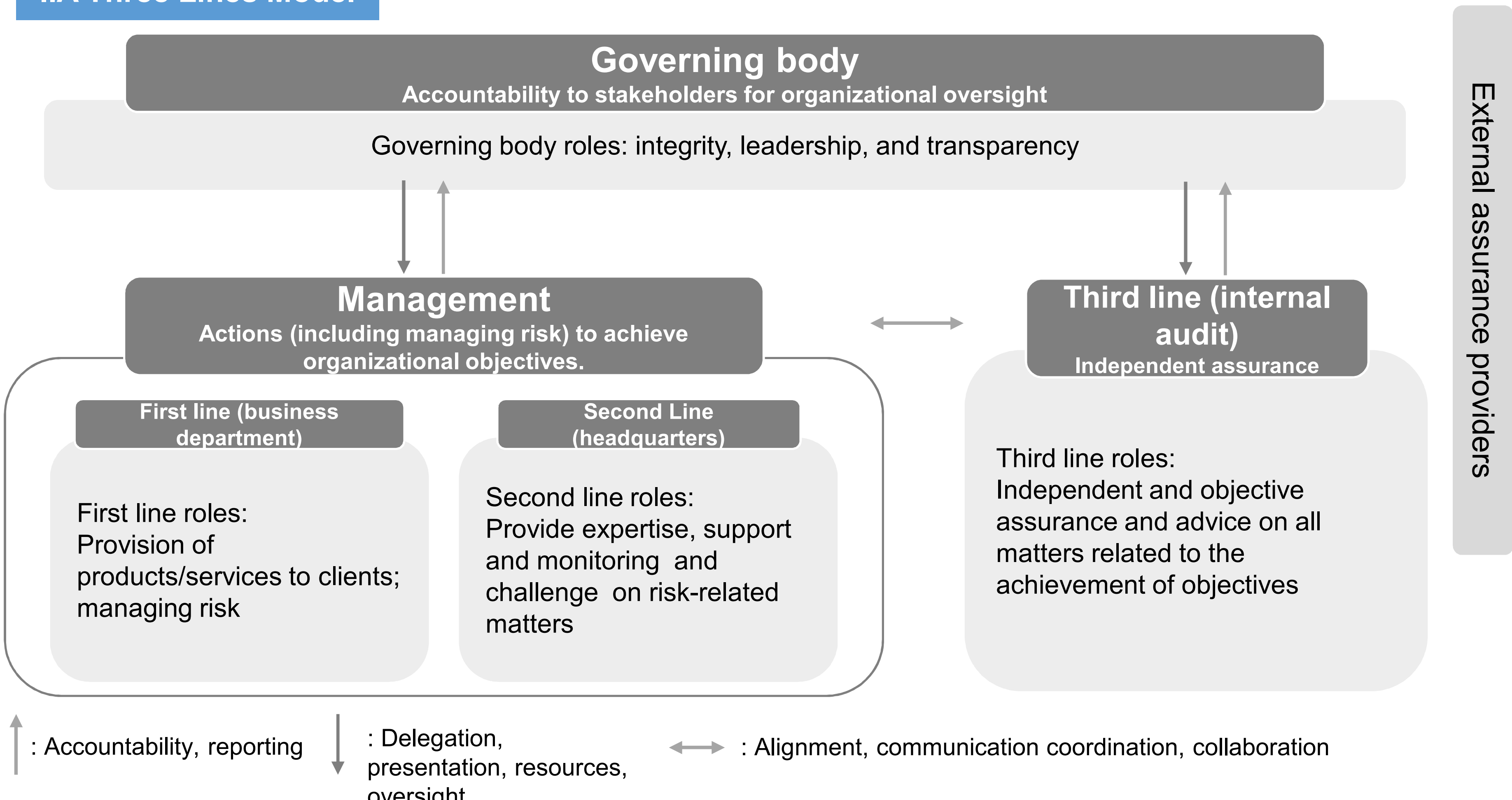
Note: Three-way audit: Audit by *kansayaku*, etc., audit by accounting auditor, and audit by the internal audit department.

Source: Prepared by the FSA with reference to "Cooperation between *Kansayaku*, etc. and Internal Audit Departments" (January 13, 2017), Audit and Regulation Committee, Japan Audit & Supervisory Board Members Association

(2) Outline of the three-line model

- .The Institute of Internal Auditors (IIA) published " IIA **Three Lines Model** - **The Revision of Three Lines of Defense**" in July 2020 .
- The said revision focuses on the fact that risk management is **not only a matter of defense and preservation of value, but also something that contributes to the achievement of goals and the creation of value**.

IIA Three Lines Model



Source: Prepared by the FSA based on "IIA Three Lines Model - The Revision of Three Lines of Defense"

(2) Structure of the Internal Audit Department

- In all institutional designs, the internal audit department **reports directly to the president** in the largest percentage of cases, and **to the board of directors, the *kansayaku*, board, or audit committee** in3.1% to 17.1% of cases.

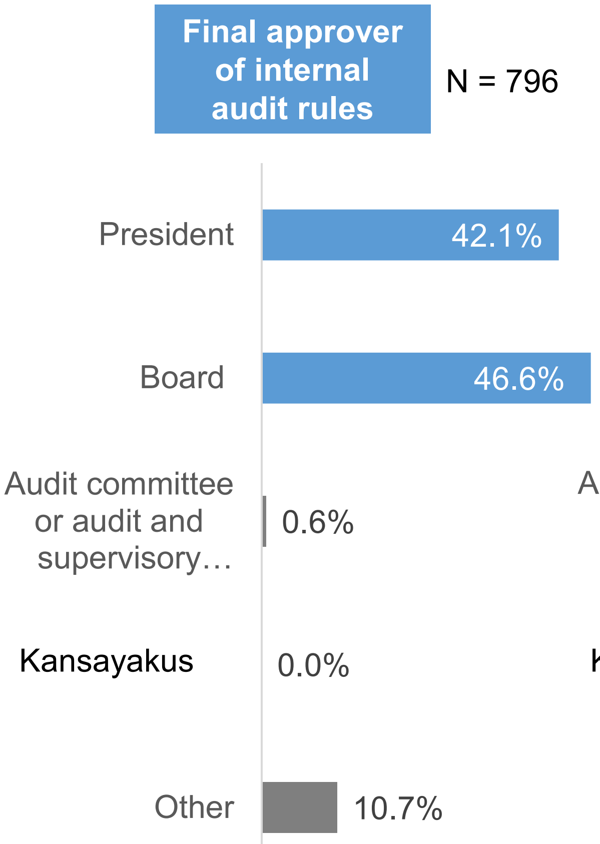
Position of the internal audit department in the organization

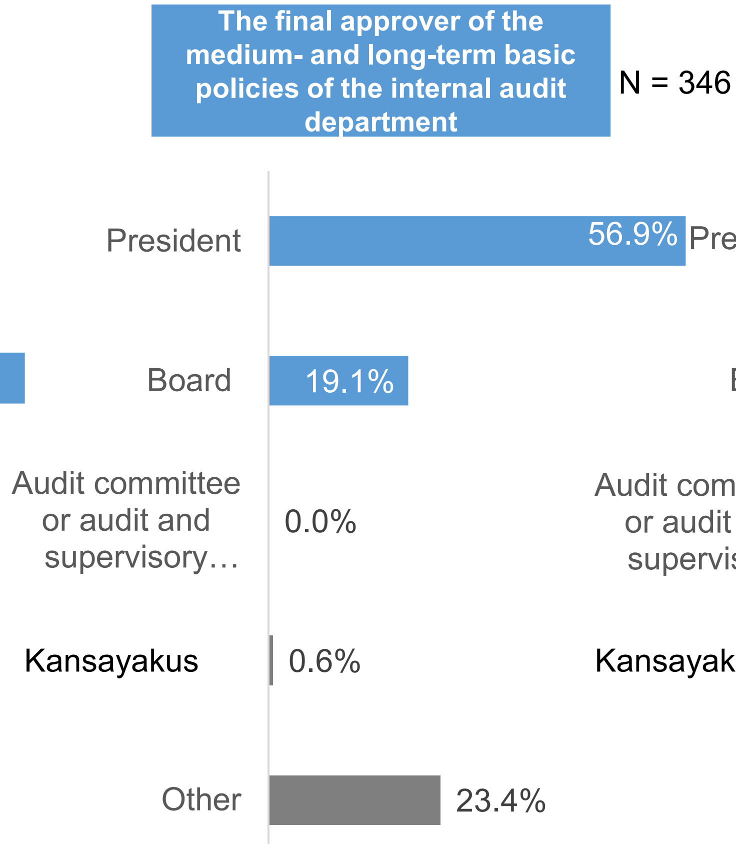
Upper row: Number of companies Lower row: %.	Company with *kansayaku* board	Company with audit and supervisory committee	Company with three committees (nomination, audit and remuneration)
Reports directly to the president	1,097 **83.2%**	383 **81.1%**	22 **62.9%**
Reports directly to other executive directors/ reports directly to other executives	108 8.2%	20 4.2%	5 14.3%
Reports directly to executive managing officers (includes cases where executive directors have the authority to give orders as executive managing officers)	57 4.3%	14 3.0%	—
Reports directly to the board	32 **2.4%**	33 **7.0%**	0 **0.0%**
Reports directly to *kansayaku*, etc. or *kansayaku* board(Note 1)	0 **0.0%**	0 **0.0%**	4 **11.4%**
Reports directly to both executives and *kansayaku*, etc. or *kansayaku* board	9 **0.7%**	14 **3.0%**	2 **5.7%**
Other	15 1.1%	8 1.7%	2 5.7%
Number of responding companies	1,318	472	35

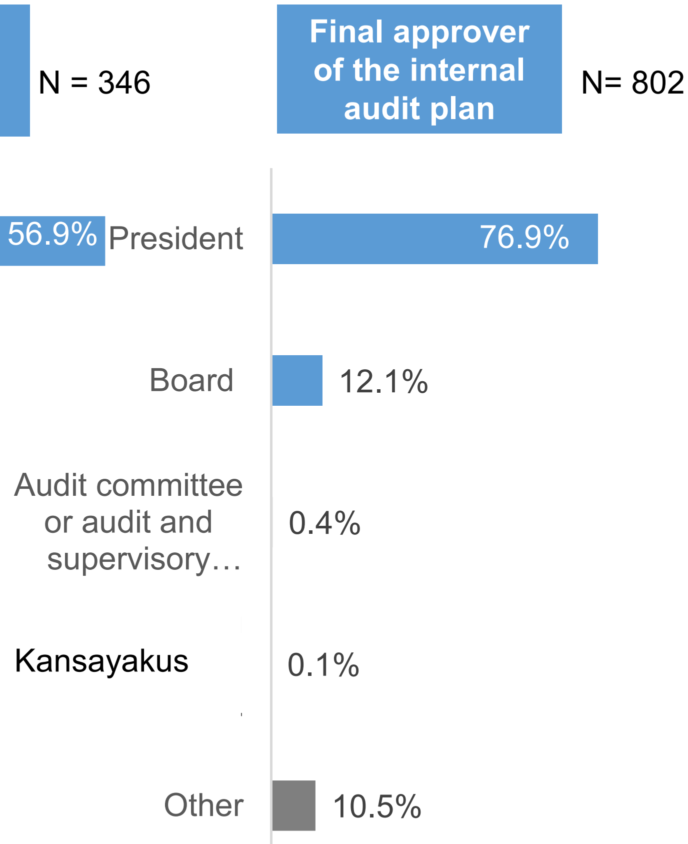
Note 1: Includes audit and supervisory committee, audit committee, etc. The same shall apply hereinafter in this page.
Note 2: Japan Audit & Supervisory Board Members Association conducted an online survey of its members between January 15 and February 4, 2020. The table shows aggregated data for listed companies.
Source: Prepared by the FSA based on "Results of the 20th Internet Questionnaire on Changes in the Composition of Officers, etc." (May 18, 2020), Japan Audit & Supervisory Board Members Association

(2) Final approver of internal audit rules, etc.

- As for the **final approvers of the internal audit rules**, 42.1% and 46.6% of the total respondents selected **"president"** and **"board**", respectively.
- As for the **final approver of the medium- to long-term basic policy of the internal audit department** and the **final approver of the internal audit plan**, 56.9% and 76.9% of the total respondents respectively chose **"president** ".



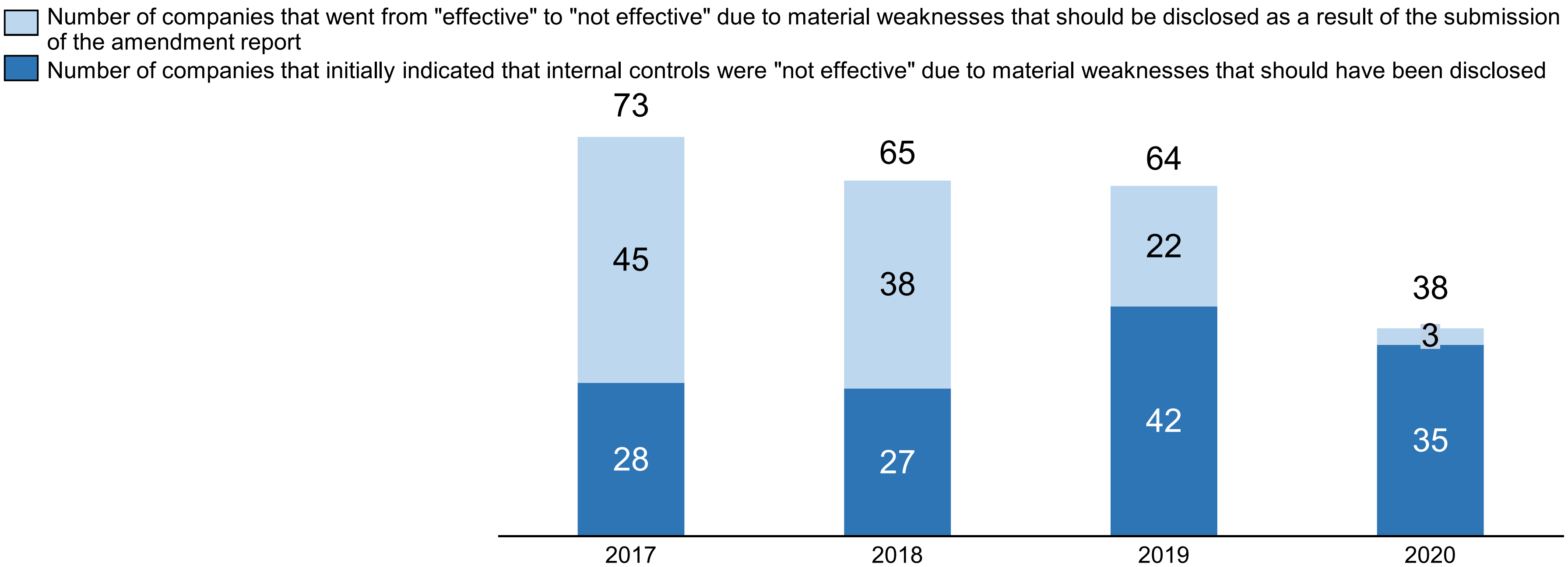




Note: The population is the number of companies that responded about the final approver of internal audit rules, medium- and long-term basic policies, and internal audit plans among companies that their internal audit department reports directly to the president.
Source: Prepared by the FSA from data compiled by the Institute of Internal Auditors based on the "19th Comprehensive Audit Survey (2017 Audit White Paper)" by the Japan Institute of Internal Auditors.
(2) Analysis of the status of the submission of corrected internal control reports

(2) Analysis of the status of the submission of the amended internal control report

- With regard to the internal control reporting system under the Financial Instruments and Exchange Act, while **more than 98% of those who submit internal control reports** assess their **internal control over financial reporting as "effective**," there are a considerable number of cases where the internal control was **assessed as "effective** " at the time of the initial report, but was **later revised to "not effective" upon the submission of an amended securities report, etc.**



	2017	2018	2019	2020
Number of companies submitting internal control reports ((1)+ (2) + (3))	3,658	3,710	3,750	3,785
(1) Number of companies that answered that internal control is "effective" (%)	3,629 (99.2%)	3,681 (99.2%)	3,708 (98.9%)	3,750 (99.1%)
(2) Number of companies that initially indicated that internal controls were "not effective" due to material weaknesses that should have been disclosed from the beginning	28	27	42	35
(3) Number of companies that stated the results of the internal control evaluation could not be expressed	1	2	0	0
Number of companies that went from "effective" to "not effective" due to material weaknesses that should be disclosed as a result of the submission of the amendment report	45	38	22	3

Source: Compiled by the FSA based on reports, etc. submitted to EDINET from January 2017 to December 2020

(3) Internal control and risk management

(3) Discussions on risk management, etc. up until now

Background and factors behind the emergence of contemporary risk management discussions

Fumitoshi Sugino, "A Study on the Historical Development of Corporate Risk Management" (2009)

- In the midst of **intensifying global competition** due to changes in the business environment, such as the shift to IT, globalization, and business restructuring, **corporate management has shifted significantly toward value creation**.
- A series of corporate scandals that occurred around the world made it **necessary to improve corporate governance**. For example, the UK's Turnbull Guidance identified the importance of risk management in relation to corporate governance

Kazuyoshi Ueda, " Risk Management Conducive To Corporate Value Creation [3rd Edition]" (2006)

- The emergence of overseas competition due to the progress of internationalization since the 1970s and the increase in liability accidents due to the increase in corporate social responsibility in the 1980s have made **companies even more wary of speculative risks.** For example, this has led to the refusal of insurance companies to accept product liability insurance, which covers product liability, and made clear **the limits of corporate risk management by insurance management type.**
- Risks such as fraud and concealment by companies are one of the characteristics of modern risks, which are uninsurable and non-financial risks. At the same time, modern risks are characterized by leading to a significant decline in the value of intangible assets. **The occurrence of** such **risks, which are not insurable and which can cause a significant reduction in corporate value**, is driving the need for a **new modern form of risk management**.
- Regarding the change in the concept of risk management, it can be pointed out that the scope of risks to be handled is changing from **pure risks or insurable risks** such as fire, traffic accidents, product liability accidents, etc., **which cause only losses**, to include **financial risks** such as foreign exchange risks, price fluctuation risks, credit risks, etc., **and risks related to other intangible assets** (risks related to brand value, reputation, intellectual property, unique business processes, etc.) in business risks. These **changes in the risk environment** are driving the need for **many changes in traditional risk management**

Background and factors behind the focus on risk management under the UK's Turnbull Guidance

"Conditions for Corporate Value Enhancement - Turnbull Guidance" (2002), translated by Shinji Hatta

- Although the spirit of the **Cadbury Committee** was correct, the way it was embodied was also problematic. By taking the easy option of reporting on **internal financial controls**, companies have **created an annual review process that is detached from actual business management**.
- The Combined Code and the Turnbull Guidance are based on the recognition that this has not been positive for individual organizations, nor has it had the full effect originally envisaged of strengthening governance. While the **opportunity to improve business performance through better risk management** has always existed, the link between running a business and managing risk was first identified by the Turnbull Guidance, **which was developed with this objective in mind**

(3) Discussions on risk management, etc. up until now

"Framework for Internal Control Systems in Banking Organizations" (1998), Basel Committee on Banking Supervision

- A framework was formulated for assessing internal control systems, as effective internal control is an essential element of bank management and the foundation for safe and sound operations of a bank organization.
- An effective internal control system requires that significant risks that could adversely affect the achievement of the bank's objectives are recognized and continuously assessed, and that this assessment should cover all risks faced by the bank and the bank group as a whole.

"Enhancing Corporate Governance for Banking Organisations" (1999), Basel Committee on Banking Supervision *Revised in 2006

- In light of developments including the publication of the Principles of Corporate Governance by the OECD, the Committee has developed this paper to draw attention to corporate governance-related issues that have been addressed in the Committee's previously published papers. It presents ideas on a wide range of corporate governance-related issues, not limited to internal control.
- The revised version of 2006 presents **methods to enhance the effectiveness of the internal audit function in identifying problems related to risk management and internal control systems.** It makes suggestions such as the board and senior management promoting the independence of internal auditors by allowing them to report to the board or the audit committee.

"Principles for Enhancing Corporate Governance" (2010), Basel Committee on Banking Supervision *Revised in 2015

- Under the circumstances where corporate governance problems (for example, inappropriate risk management) surfaced during the financial crisis that began in mid-2007, "Enhancing Corporate Governance for Banking Organisations"(1999 and 2006) were reviewed.
- The focus is on the following points for risk management and internal control.
    - Should have a risk management function, compliance function and internal audit function with sufficient authority, position, voice, management resources and access to the board
    - **Risks** should be **identified, assessed, and monitored on an ongoing basis at both a company-wide and individual entity levels**.
    - The foundations of risk management, compliance and internal control should be upgraded in line with changes in the risk profile of the bank (including the bank's growth) and the external risk environment, etc.
- The board should approve and monitor not only the internal control system, but also the **overall risk strategy** including **risk tolerance and risk appetite**, **and policies related to risk management, etc.**

“Thematic Review of Risk Governance” (2013), Financial Stability Board (FSB)

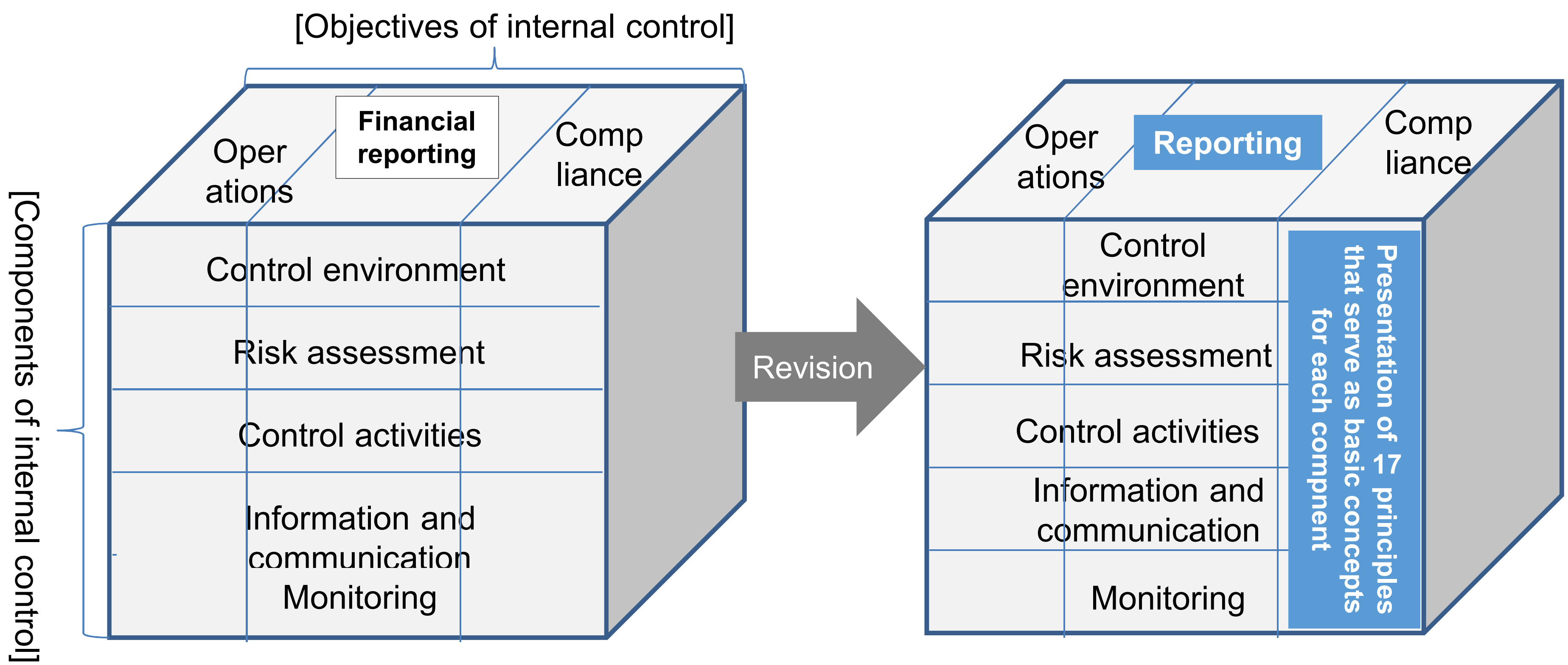
- Focusing on the risk governance of financial institutions, the report assesses the improvement measures taken by financial institutions and supervisors in each country since 2010. Although governance systems have improved, the risk management function, etc. needs to be further strengthened.

Note: The above "Principles for Enhancing Corporate Governance" was revised in response to the review. In the revised version, key components of risk governance were emphasized, including risk culture, risk appetite, and their relationship to risk capacity.

(3) Outline of COSO Framework for Internal Control

- The US COSO, which develops international frameworks for internal control, revised its **framework for internal control** in 2013.
- In the revised framework ("Internal Control — Integrated Framework"), one of the objectives of internal control, “financial reporting”, was changed to “reporting” and **expanded to include not only financial reporting but also non-financial reporting**. In addition, 17 principles, which are basic concepts related to each component of internal control, were presented.

Objectives and components of internal control



(3) Outline of the COSO Enterprise Risk Management - Integrated Framework

- ☐ In 2017, the US COSO revised its **framework for enterprise risk management (ERM)**.
- ☐ This framework clarifies that risk and corporate strategy are interrelated.

Definition of risk management

Culture, capacity, and practices, integrated with strategy development and performance, that the organization relies on to manage risk in the process of creating, maintaining, and delivering value

Components of risk management

1) Governance & Culture
(2) Strategy & Objective-setting
3) Performance
4) Review & Revision
5) Information, Communication, & Reporting

Note: Twenty principles have been formulated for each component.

Relationship with internal control

- ➤ Internal control and enterprise-wide risk management are distinct concepts, but complement each other
- ➤ Risk management is a more developed version of internal control and covers a broader area

(3) Examples of the use of enterprise-wide risk management frameworks

- In June 2018, the US COSO released ERM Compendium of Examples, which provides **specific examples in various industries to apply the principles of the Framework for Enterprise-wide Risk Management in practice** (revised in 2017).
- An example of strategy and objective setting in an energy company is as follows.

Example of setting goals, objectives, and tolerances from a company-wide perspective

Note: Company A is a nationwide oil and gas downstream supply company. Assume that the company is in the process of deciding whether to move from traditional gas meters to smart meters

Mission: Company A will acquire and distribute oil and natural gas safely and reliably in a sustainable and cost effective manner.

Vision: To be the largest and most trusted distributor of oil and gas in the region.

Core values: We always work with the interests and expectations of our customers, employees, investors and local communities fully in mind.

Strategy: Manage gas demand through the development of smart meters and billing practices in a cost-effective manner, providing transparency and incentives for customers to manage their own demand.

Risk appetite: Company A will pursue innovations that lead to improved customer service and operational efficiency as long as they do not raise safety concerns or cause significant disruption to business operations. Innovations that raise significant concerns about current financial performance will only be considered if the safety risk to customers is unacceptably high.

Business objectives (company-wide level): Identify suitable suppliers for the introduction of smart meters

Goal: Identify five suitable suppliers

Tolerance: 3 to 8 companies

Risk: Possibility of a limited number of suppliers with appropriate experience and capabilities.

Risk: Possibility of foreign-made meters not meeting regulatory requirements

Business objectives (departmental level): Develop eligibility requirements to determine the number of potential suppliers

Business objectives (departmental level): Provide a list of requirements and required times for interested suppliers

Business objectives (departmental level): Provide meter specifications and regulatory standards to potential investors

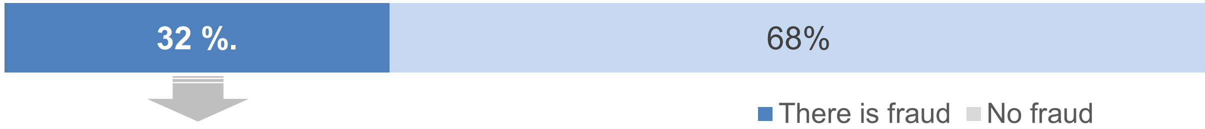
Source: Prepared by the FSA based on "COSO Enterprise Risk Management—Integrating with Strategy and Performance - ERM Compendium of Examples" (2018), translated by Shinji Hatta et al.

(4) Individual issues

(4) Occurrence of misconduct in companies

□ **32%** of companies responded that **fraud had occurred within their corporate group** in the past three years. Companies responded that **"business operations reliant on individual skills"** and **"insufficient or inadequate establishment of ethical standards such as the code of conduct"**,etc. were root causes of the frauds that occurred.

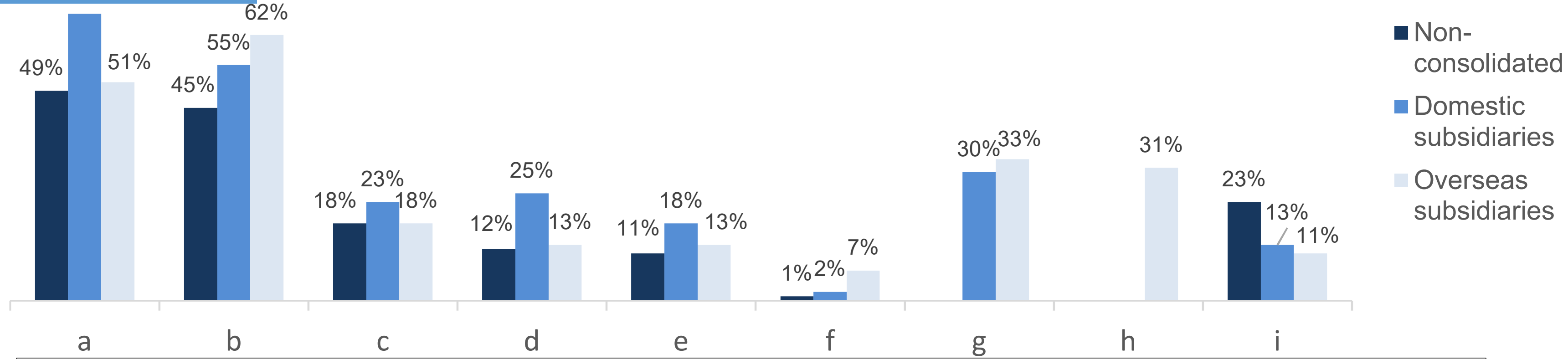
Has fraud occurred in any part of the corporate group (non-consolidated, domestic, or overseas subsidiaries) in the past three years?



■ Of the companies that responded that "fraud occurred", **about 45%** answered that **no fraud occurred on a non-consolidated basis, but fraud occurred in domestic or overseas subsidiaries**.

Root cause of the fraud that occurred

Multiple answers possible



a. Business operations reliant on individual skills

b. Insufficient or inadequate establishment of ethical standards such as the code of conduct

c. Organizational culture that makes it difficult to express opinions to superiors, colleagues, etc.

d. Decline in loyalty to the company

e. Performance-centric

f. Employee compensation system that is largely linked to individual performance

g. Lack of control by the parent company (note 1)

h. Special circumstances unique to the country concerned (note 2)

i. Other

Note 1: Only companies with domestic and overseas subsidiaries responded.
(Note 2) Only companies with overseas subsidiaries responded.

Note: Of the 3,699 listed companies (excluding REITs, foreign companies, and the Bank of Japan) as of the end of June 2018 , 429 companies (11.6% response rate) responded to the survey.
Source: Prepared by the FSA based on "Survey on Fraud in Japanese Companies" (March 2019) by KPMG FAS

(4) Remarks in reports of third-party committees on cases of misconduct

- In the reports of third-party committees released in response to the occurrence of cases of misconduct, it has been pointed out that there were **cases in which supervision and checks and balances from supervisors over the persons (departments) in charge were not functioning properly** and that checks and balances over the management team, including the president and CEO, were not working.
- It has been pointed out that **there have been instances where** the third-party committee has not been **sufficiently independent, such as when the members are selected by management**.

[Cases in which supervision and checks and balances from higher-ups over the persons (departments) in charge were not functioning properly]

○ **Insufficient information sharing due to lack of independence of the audit department, etc.**

- The internal audit department directly under the president, or full-time internal *kansayaku*s or audit committee members delay or fail to report to the board or the *kansayaku* board about accounting irregularities or serious misconduct due to factors such as lack of independence of the personnel of the audit department or psychological pressure
- The contents of the internal audit investigation were not shared with the *kansayaku*s and directors
  *In particular, there were cases where information was not shared with outside directors and outside *kansayaku*s

○ **Formal audits by *kansayaku*s and internal audit departments**

- Follow-up audits were not conducted despite potential violations of the law being identified
- Didn't understand the true risks of the business
- Limited staff with expertise and no checks and balances in place

○ **Important facts related to the misconduct were not understood or recognized by anyone other than the person (or department) in charge**

- Whistle-blowing system was not used even though it was in place / reporting was neglected

[Cases in which checks and balances on the management teams including the president and CEO, are not working]

○ **An environment that makes it difficult for the board to fulfill its role**

- A system was established in which management had control over personnel affairs and there were no checks and balances
- They detected the fraud early on, but covered it up

(4) Amendment of the Whistleblower Protection Act

- The **Whistleblower Protection Act**, which was amended in 2020, obliges businesses to **establish the necessary systems to respond appropriately to whistleblowing, and** requires those engaged in internal investigations, etc. to keep confidential information that identifies the whistleblower. Note 1: SMEs (with 300 or fewer employees) are obligated to make efforts Note 2: Effective from the date specified by a Cabinet Order within a period not exceeding two years from the date of promulgation

In recent years, there has been no end to cases of misconduct involving businesses that have become social problems
→ **Need to prevent damage** through **early correction**

(1) Make it easier for businesses to correct injustices themselves and to make reports with a sense of reassurance

○ Require the business to **establish the system necessary** for responding appropriately to whistleblowing (setting up a contact point, investigation, corrective action, etc.). Formulate guidelines for specific content [Article 11]

*SMEs (with 300 or fewer employees) are obligated to make efforts

○ **Administrative measures** (advice and guidance, recommendations, and public announcements in cases where recommendations are not followed) have been introduced to ensure effectiveness [Article 15 and Article 16].

○ Obligation of confidentiality of informationidentifying the whistleblower to persons engaged in internal investigations, etc. (introduction of criminal penalties for violation of this obligation) [Articles 12 and 21].

(2) Make it easier to report to administrative bodies

○ Conditions for reporting to competent administrative bodies [Article 3, Item 2]

(Current)		(Amended)
Reporting when there are reasonable grounds for belief	〉	Addition of reporting in case of **submission of documents stating names, etc.**

○ Conditions for reporting to the press, etc. [Article 3, Item 3]

(Current)		(Amended)
Harm to life and limb	〉	Addition of **damage to property** (difficult to recover or serious)
(No)	〉	Addition of **cases where there is a high likelihood that information identifying the whistleblower will be leaked**

○ Establishment of systems necessary for appropriate response to whistleblowing in authorized administrative bodies, etc. [Article 13, Item 2]

Effectiveness of internal and external whistleblowing

(3) Better protection for whistleblowers

○ Persons to be protected [Article 2, Item 1, etc.]

(Current)		(Amended)
Employees	〉	Addition of **retirees** (within one year of retirement) and **officers** (in principle, previous engagement of investigative corrective actions)

○ Whistleblowing to be protected [Article 2, Item 3]

(Current)		(Amended)
Subject to criminal penalty	〉	Addition of **administrative penalties**

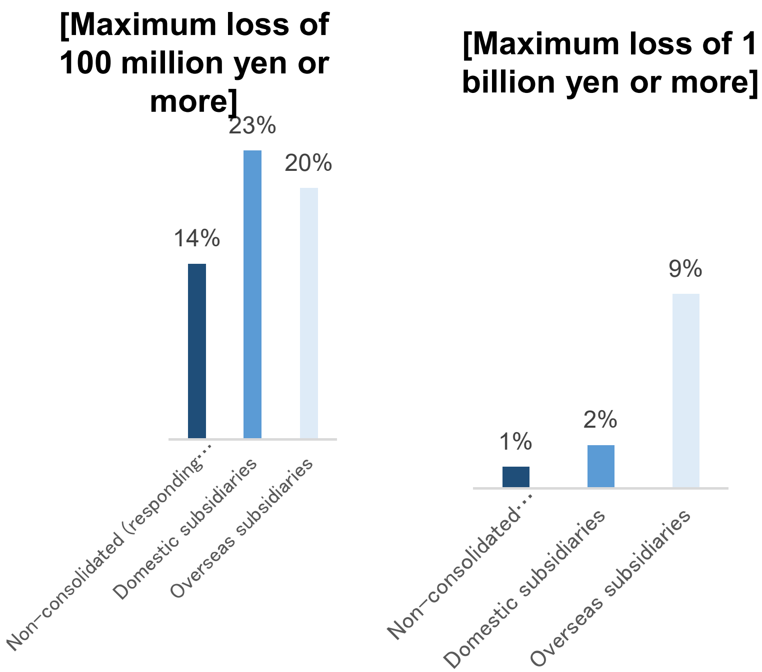
○ Contents of protection [Article 7]

(Current)		(Amended)
(No)	〉	Addition of **exemption from liability for damages** resulting from whistleblowing

(4) Occurrence of misconduct at group companies

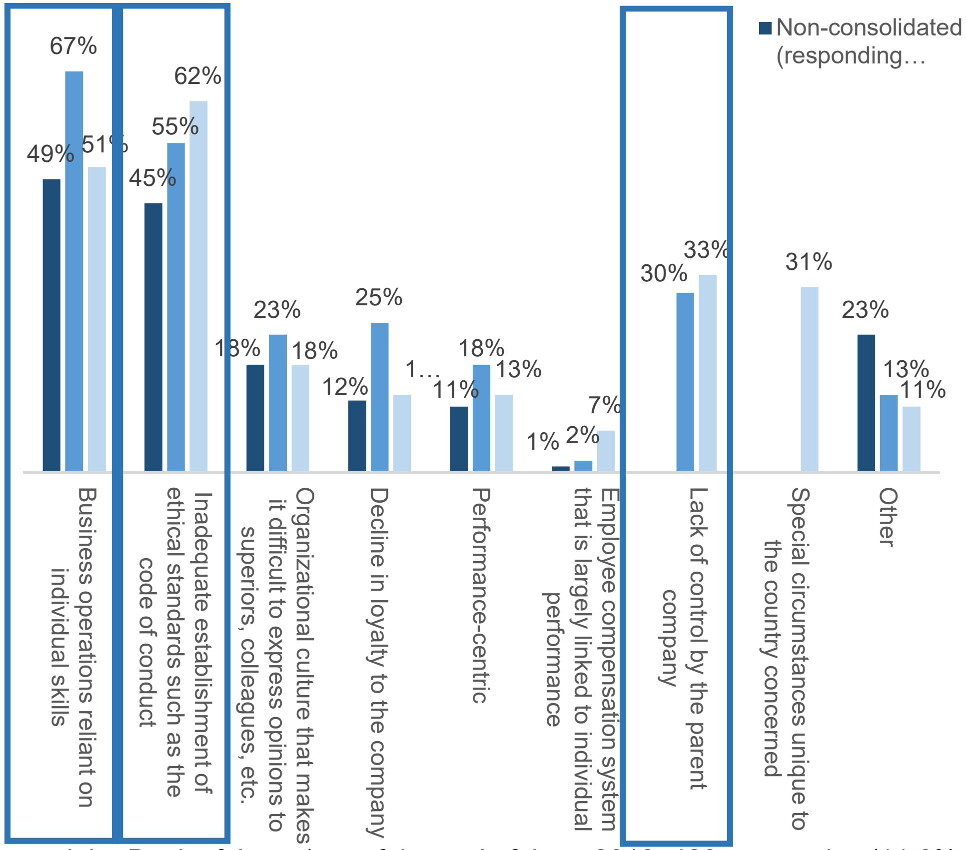
- According to the Survey on Fraud in Japanese Companies, t**he amount of damage tends to be larger when the scandal occurs at a subsidiary,** regardless of whether the subsidiary is located in Japan or overseas.
- The most frequently cited root causes of misconduct were **“business operations reliant on individual skills” at domestic subsidiaries** and **“inadequate establishment of ethical standards such as the code of conduct” at overseas subsidiaries**, according to the data. More than 30% of both domestic and overseas subsidiaries cited **"lack of control by the parent company"** as the cause of misconduct at subsidiaries.

Amount of damages due to fraud



Root cause of the fraud

Multiple choice



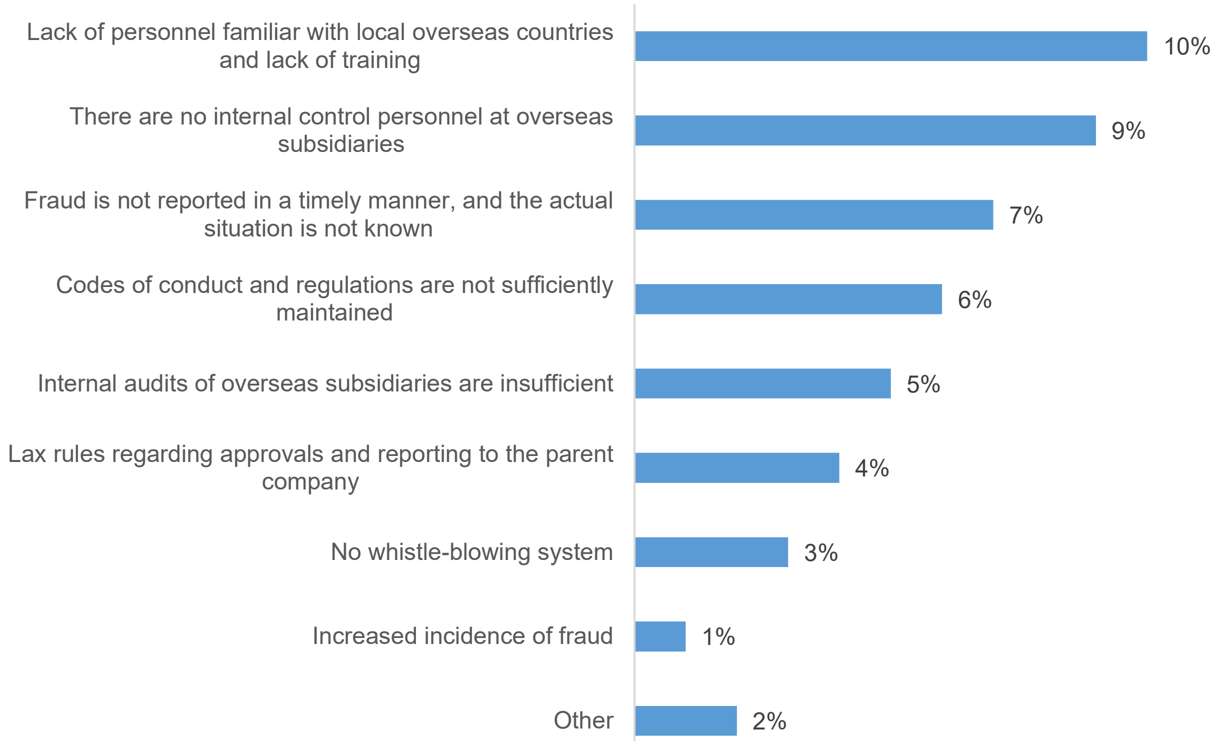
Note: Of the 3,699 listed companies (excluding REITs, foreign companies, and the Bank of Japan) as of the end of June 2018, 429 companies (11.6% response rate) responded to the survey.
Source: Prepared by the FSA based on “Survey on Fraud in Japanese Companies" (March 2019) by KPMG FAS

(4) Management of overseas subsidiaries

- According to the Survey on Fraud in Japanese Companies, the following issues have been pointed out **in the management of overseas subsidiaries**: **lack of human resources who are familiar with overseas local countries**,**inability to understand the actual situation because fraud is not reported in a timely manner, and insufficient development of codes of conduct**.
- According to the same survey, **5% of the companies responded that they discovered fraud within three years after implementation of of an M&A with a foreign company**

(4) Issues in managing overseas subsidiaries

(Number of respondents: 45 companies)



Fraud discovery within three years after implementation of overseas M&A

Fraud was discovered (within three years after the implementation of overseas M&A)

5%

Note: Of the 3,699 listed companies (excluding REITs, foreign companies, and the Bank of Japan) as of the end of June 2018, 429 companies (11.6% response rate) responded to the survey.

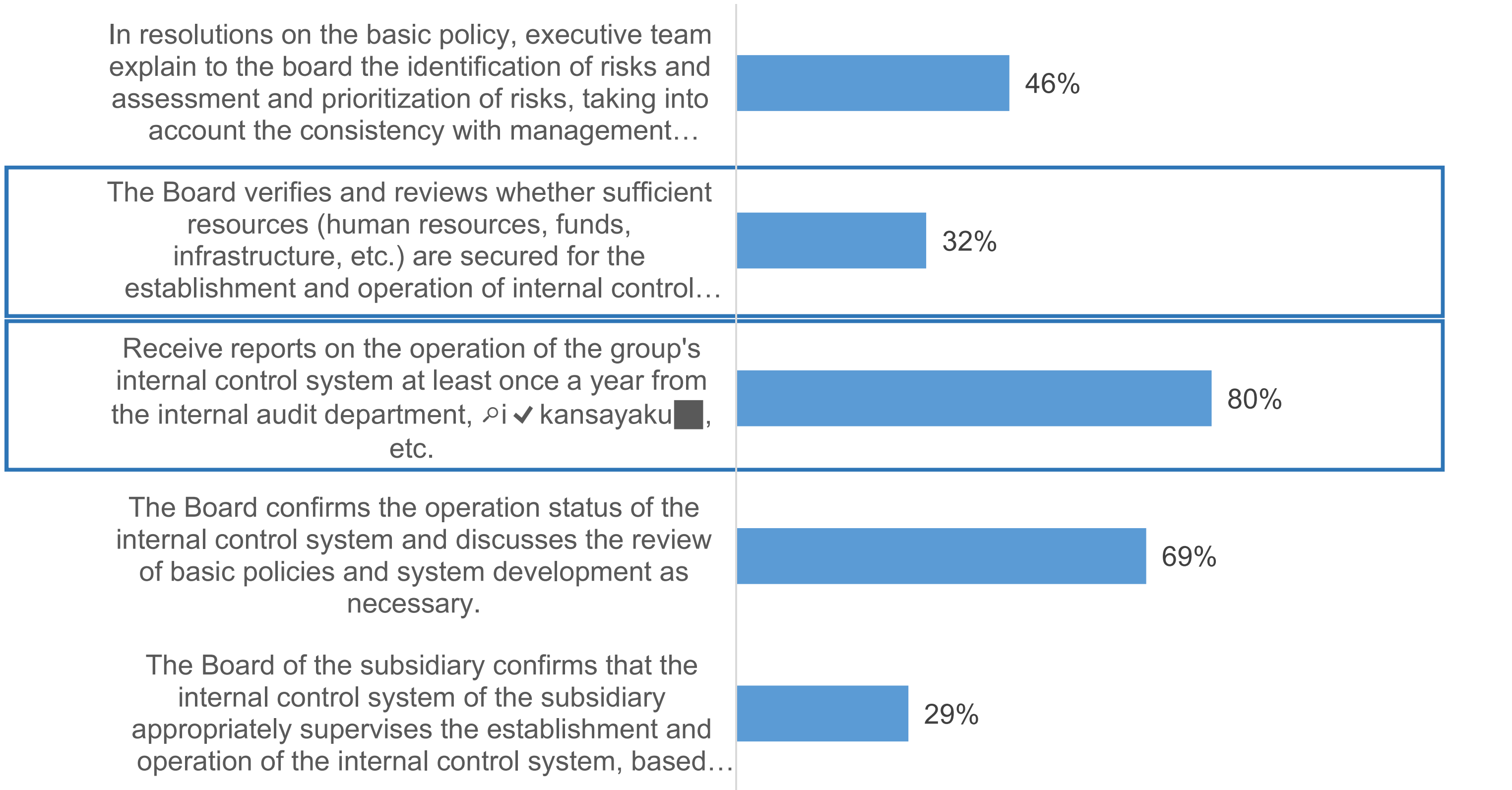
Source: Prepared by the FSA based on "Survey on Fraud in Japanese Companies" (March 2019) by KPMG FAS

(4) Establishment and operation of internal control systems at group companies

- For 80% of companies, the parent company's board **receives reports at least once a year from the internal audit department, *kansayaku*s, etc. on the status of the establishment and operation of the group's internal control system.** On the other hand, 32% of companies, including subsidiaries, responded that they are **verifying and reviewing whether they have sufficient resources to establish and operate internal control systems**.

Status of supervision by the board of the parent company regarding the establishment and operation of the group's internal control system

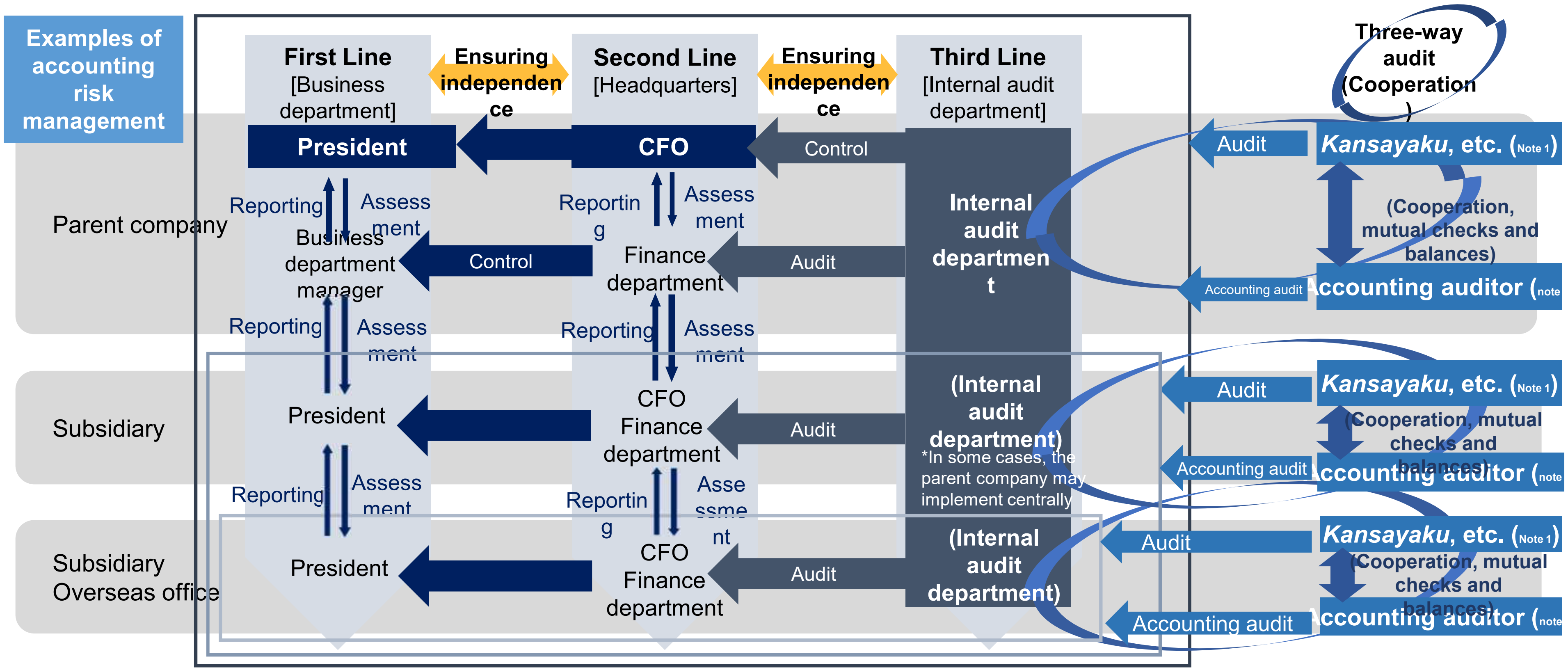
（N = 754）



Source: Prepared by the FSA based on the FY2018 Industrial Economics Research Contracted Projects (Research Project Expenses Related to Economic and Industrial Policy and the Fourth Industrial Revolution) (Research on Corporate Governance in Group Management) Research Report (March 31, 2019, Deloitte Tohmatsu Consulting G.K.)

(4) Example of the three-line model in operation at Group companies (image)

- The internal control system is **not limited to compliance and fraud prevention, but is also part of risk management** and a “mechanism for ensuring the execution of business strategies”.
- As an organizational model for this purpose, it has been pointed out that in order to effectively operate the three lines, **it is important that the second and third lines are integrated between the parent and the child regarding authority over personnel, performance evaluation, budget allocation, etc., and that checks and balances are exercised on the first line**.



Note 1: Includes members of audit and supervisory committee, audit committee, etc.
(Note 2): Required for a company with an audit and supervisory committee, a company with three committees, or a large company. (Article 327, Paragraph 5 and Article 328, Paragraphs 1 and 2 of the Companies Act)

Source: Prepared by the FSA based on the "Practical Guidelines for Group Governance Systems (Group Guidelines)" (formulated on June 28, 2019) by the Ministry of Economy, Trade and Industry

(4) Results of survey on method of determining candidates and individual remuneration for *kansayaku*

- Under the Companies Act, **the *kansayaku* board has the right to consent** when submitting a proposal for **the election of a *kansayaku*** to a general meeting of shareholders, and **the *kansayaku* board has the right to propose** the election of a *kansayaku* to a general meeting of shareholders.
- Under the Companies Act, if there are two or more *kansayaku*rs and there is no provision in the Articles of Incorporation or resolution of the general meeting of shareholders regarding the amount of individual remuneration for each *kansayaku*, the **allocation of remuneration** shall be **determined by discussion of the *kansayaku* board**.
- In practice, **in the majority of cases, the candidates for *kansayaku*s and the amount of individual remuneration are proposed by executive team**.

Method of determining candidates for *kansayakus*

	First section listing	Second section listing	Emerging market listing
A *kansayaku* or the *kansayaku* board proposes a candidate for a *kansayaku*.	4.2%	4.6%	6.5%
An executive team proposes a candidate for a *kansayaku*.	92.6%	88.1%	88.2%
Other	3.3%	7.3%	5.2%

Method of determining the amount of individual remuneration for *kansayaku*

	First section listing	Second section listing	Emerging market listing
Decisions are made through discussions among the *kansayaku*s without the involvement of executive team.	11.7%	7.6%	11.4%
Individual remuneration proposals are presented in advance by executive team, and decisions are made based on the proposals after consultation with executive team.	23.7%	21.2%	26.2%
The *kansayaku* board decides on the amount of individual remuneration presented by the executive team.	58.0%	64.4%	52.8%
Other	6.6%	6.8%	9.6%

Note: Of the 5,851 member company with *kansayaku*s or a *kansayaku* board , from May 27 to June 7, 2019, 2,447 companies responded (response rate: 41 .8%).

Source: Prepared by the FSA based on "The Process for Determining the Appointment and Remuneration of *Kansayaku*" (2019), Japan Audit & Supervisory Board Members Association

(4) Promoting dialogue between outside directors and investors

- In the re-revision of the Stewardship Code, reference is made to the **usefulness of dialogue between officers who are not involved in the execution of business (independent directors, *kansayakus*, etc.) and investors**.

Statements in the Stewardship Code (re-revised on March 24, 2020)

Principle 4. Institutional investors should seek to arrive at an understanding in common with investee companies and work to solve problems through constructive engagement with investee companies

Guidance

4-1 Institutional investors should endeavor to arrive at an understanding in common[17] with investee companies through constructive dialogue with the aim of enhancing the companies' medium to long-term value and capital efficiency, and promoting their sustainable growth. In case a risk of possible loss in corporate value is identified through the monitoring of and dialogue with companies, institutional investors should endeavor to arrive at a more in-depth common understanding by requesting further explanation from the companies and to solve the problem .

Note 17: In order to arrive at a common understanding with an investee company on priority issues of the management including governance structure situation (use of independent officers, etc.) and review of business portfolio, **it is considered beneficial that institutional investors have dialogue with non-executive officers (independent directors and kansayaku etc.) .**

(4) Participation in dialogue by *kansayaku*s and audit committee members, etc.

- **6.2%** of *kansayakus* and audit committee members, etc. responded that they **have participated in dialogue** with investors.
- With regard to *kansayaku* and audit committee members, etc. being the counterparty in engagement with investors, . 9.9% of respondents answered that they "should actively participate in dialogue", and **77.0**% of *kansayaku*s and audit committee members, etc. answered that they "may participate in **dialogue if requested to do so by investors or executive team**".

Experience in participating in dialogue with investors

N = 434
(%)

	Overall	Institutional design		Listing classification					Capital			
		Company with an audit and supervisory committee	Company with three committees	First section of TSE	Second section of TSE	Emerging market listing	Other listing	Unlisted	Up to 1 billion yen	1 to up to 3 billion yen	3 to up to 10 billion yen	10 billion yen or more
Yes	27 6.2	22 5.4	5 20.8	20 7.5	2 3.5	3 4.5	- -	2 6.5	7 6.0	2 1.9	10 8.8	8 7.9
No	407 93.8	388 94.6	19 79.2	247 92.5	55 96.5	64 92.5	12 100.0	29 93.5	109 94.0	102 98.1	103 91.2	93 92.1
Overall	434 100.0	410 100.0	24 100.0	267 100.0	57 100.0	67 100.0	12 100.0	31 100.0	116 100.0	104 100.0	113 100.0	101 100.0

View on being the counterparty in a dialogue with investors

N = 434
(%)

	Overall	Institutional design		Listing classification					Capital			
		Company with an audit and supervisory committee	Company with three committees	First section of TSE	Second section of TSE	Emerging market listing	Other listing	Unlisted	Up to 1 billion yen	1 to up to 3 billion yen	3 to up to 10 billion yen	10 billion yen or more
Kansayaku, etc. should also actively participate in dialogue	43 9.9	37 9.0	6 25.0	27 10.1	6 10.5	3 4.5	1 8.3	6 19.4	13 11.2	7 6.7	12 10.6	11 10.9
May participate in dialogue if requested to do so by investors or executive team	334 77.0	317 77.3	17 70.8	212 79.4	39 68.4	54 80.6	7 58.3	22 71.0	88 75.9	87 83.7	81 71.7	78 77.2
Kansayaku, etc. do not need to participate in the dialogue	48 11.1	48 11.7	- -	23 8.6	12 21.1	9 13.4	3 25.0	1 3.2	14 12.1	9 8.7	17 15.0	8 7.9
Other	9 2.1	8 2.0	1 4.2	5 1.9	- -	1 1.5	1 8.3	2 6.5	1 0.9	1 1.0	3 2.7	4 4.0
Overall	434 100.0	410 100.0	24 100.0	267 100.0	57 100.0	67 100.0	12 100.0	31 100.0	116 100.0	104 100.0	113 100.0	101 100.0

Source: Prepared by the FSA based on "How Audit and Supervisory Committees Should Be Involved in Sound Risk-Taking by Companies" (December 16, 2020), Audit Committee Practice Study Group, Japan Audit & Supervisory Board Members Association

(4) Disclosure regarding the activities of the audit committee

- In the UK, there are some **cases** where the **chairperson of the audit committee takes the lead** in **disclosing details of the activities of the audit committee** in the annual report.

Describe the activities of the committee and the committee's evaluation in the name of the audit committee chairperson

List the areas of focus for the year, and describe the issues considered and the results of the review in those areas.

AUDIT

Introduction

I am pleased to present the 2019 report of the Audit Committee which describes how the Committee has carried out its responsibilities during the year. This will be my last report as the Chair of the Audit Committee and I know I will be leaving the Committee in Nick Luff's good hands. I would like to thank the members of the Committee, the executive management team and the external auditors for the open discussions that take place at our meetings and the importance they all attach to its work.

We have had a number of key issues to consider in 2019, most significantly:

- key judgements and estimates in accounting for the Trent 1000 in-service issues and provisions made in respect of customer loss making contracts and restructuring costs;
- assessment of the recognition of UK deferred tax assets;
- the balance sheet position of the Group and enhanced cash disclosures;
- presentation of the impact of the pension buy-out in the UK;
- judgements in respect of various M&A activity in the year;
- the carrying value of investments, tangible and intangible assets; and
- the adoption of the new leasing standard, IFRS 16.

The Audit Committee also participated in a number of deep dives focused on long-term contract accounting judgements and finance transformation.

Membership and operation of the Committee

In addition to myself, members of the Committee are George Culmer, Beverly Goulet, Lee Hsien Yang and Nick Luff. Irene Dorner served as a member of the Committee during the year, stepping down in December 2019. George Culmer joined the Committee on 1 January 2020. All members of the Committee are independent Non-Executive Directors. For the purposes of the Code and DTR 7.1, George Culmer, Beverly Goulot, Nick Luff and I have recent and relevant financial experience. The Board has confirmed that it believes the Committee as a whole has competence relevant to the Company's sector. Our biographies are on pages 62 to 64 and our meeting attendance is shown on page 66.

The Committee's responsibilities are outlined in its terms of reference which can be found at www.rolls-royce.com. We review these annually and refer them to the Board for approval. No changes have been made in 2019. This follows a detailed review in 2018 to ensure alignment with the principles of the Code.

Other attendees

In addition to the members of the Committee, the Chairman, Chief Executive, Chief Financial Officer and any of the Non-Executive Directors may attend one or more meetings at the Committee Chairman's invitation. The Committee is supported by the General Counsel, the corporate governance director, the group controller, the head of group reporting, the director of risk and internal audit and the external auditors.

Committee evaluation review

Belinda Hudson Limited (BHL) was appointed to undertake a light touch review of the Board and committees for a second year, following a full review in 2018. The effectiveness review process of the Board and its committees is discussed in greater detail on page 74 together with the overall findings.

Principal responsibilities

Financial reporting

- Financial announcements, focusing on: accounting policies, judgements and estimates; inclusion of appropriate disclosures; compliance with relevant regulations; and whether the Annual Report is fair, balanced and understandable.

Risk and control environment

- Monitor the effectiveness of the risk management and internal control systems.
- Review concerns of financial fraud.

Principal risks

- Business continuity, market and financial shock and IT vulnerability.

Internal audit

- Scope, resources, results and effectiveness.

External audit

- Relationship with, and effectiveness of, the external auditor.
- Approve the external auditor's terms of engagement and fees.

Areas for focus in 2020

- continuing oversight of the risk management and internal control environment
- through our Data Security Committee, reviewing our principal risk: cyber threat
- supporting risk owners to assess the effectiveness of mitigating controls
- assessing the impact of changing regulation on our risk management plans
- keeping appraised of any developments with the audit reforms in the UK

DIRECTORS' REPORT

Risk and control environment	Improvements in the approach to risk management and internal control systems, including in relation to financial reporting controls. The processes for identifying and managing risks. The effectiveness of the Group's risk management and internal control systems. The progress against the commitments under the DPAs as they relate to financial reporting. The process and assumptions underlying the going concern and viability statements.	Recognised improvements in the analysis of risk appetite, risks at remote sites and increased focus on emerging risks, and identified areas for future improvements, including in relation to financial reporting controls. Satisfied ourselves that the processes for identifying and managing risks are appropriate and that all principal risks and mitigating actions had been subject to a detailed review by the Board or a Board committee during the year. Reported to the Board that an appropriate process is in place to make the going concern and viability statements. Particular attention was given to the going concern status of the Group's material subsidiaries.
2019 Principal risks	Management's assessment of the risk of, and activities to manage, a business continuity event. The activities in place or required to prevent, detect and recover from any breaches due to cyber threats. The Group's policies, procedures and controls for identifying, managing and mitigating a market or financial shock.	Processes and plans are in place to manage the risks associated with business continuity, cyber and market or financial shock.
Internal audit	The effectiveness of the internal audit function, matters and themes arising as a result of the audit work and resolution of any associated actions.	The scope, extent and effectiveness of internal audit are appropriate and there is a plan to sustain this.

Source: Annual report of UK company A

(4) Disclosure of information on risks of business and other - (1)

- Some companies have **evaluated major risks in terms of likelihood of occurrence and impact** and explained them graphically in their annual securities reports.

[Business risks] *partial excerpt

(2) Major risks

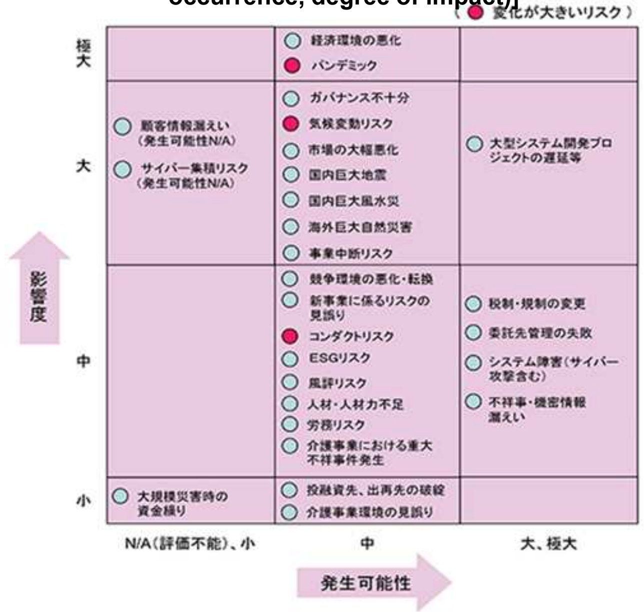
(1) Assessment of major risks and their likelihood of occurrence and impact

Major risks, as defined by the group, are those that management recognizes as having the potential to have a significant impact on the group's operating results. An assessment of major risks and the likelihood of their occurrence and impact are as follows.

[List of major risks]

Classification		No.	Major risks
a. Management strategy risk			
	External environment	1	Deterioration and transformation of the competitive environment
		2	Deterioration of economic environment
		3	Pandemics
		4	Tax and regulatory changes
	Business strategy	5	Insufficient governance
		6	Misjudgment of risks associated with new business
		7	Delays in large system development projects, etc.
		8	Climate change risk
		9	ESG risk
		10	Reputational risk
	Human resources and personnel	11	Lack of human resources and human resource capacity
b. Financial and operational risk			
	Market risk	12	Significant deterioration in the market
	Credit concentration risk	13	Bankruptcy of investee, borrower, and reinsurance companies
	Liquidity risk	14	Funding in the event of a major disaster
c. Operational risk and compliance risk			
	Administrative risk	15	Failure to manage contractors
	System risk	16	System failure (including cyber attacks)
	Compliance risk, etc.	17	Labor risk
		18	Leak of customer information
		19	Misconduct and leakage of confidential information
		20	Conduct risk
d. Business-specific risk			
Underwriting risk			
	Natural disaster	21	Massive earthquake in Japan
		22	Massive storm and flood disaster in Japan
		23	Massive natural disaster overseas
	Other	24	Cyber-congestion risk
Nursing care service risk			
	Nursing care service risk	25	Misjudging the nursing care business environment
		26	Serious misconduct in nursing care services
e. Other risk			
	—	27	Business interruption risk

[Heat map of major risks (possibility of occurrence, degree of impact)]



	Likelihood of occurrence	Degree of impact		
		Economic loss	Business continuity	Damage to reputation
Maximum	One or more times a year	500 billion yen or more	Revocation of business license	Very significant loss of confidence
Large	1 or more times in ten years	50 billion yen or more	Suspension of major operations	Significant loss of confidence (Will take 5 or more years to restore confidence)
Medium	One or more times in 100 years	5 billion yen or more	Partial suspension of operations	Loss of confidence (Will take 2 to 3 years to restore confidence)
Low	Less than one time in 100 years	Less than 5 billion yen	—	Low chance of a loss of confidence

Source: Annual Securities Report of Japanese company B

(4) Disclosure of information on risks of business and other - (2)

- In some companies' annual securities reports, they describe in detail the **nature of each business risk and their response to it, as well as which management strategy it may affect and its relevance**.

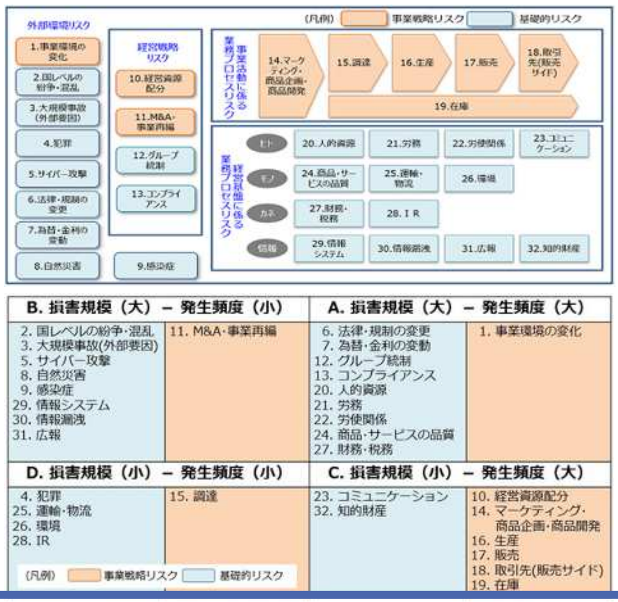
[Business, etc. risks] *partial excerpt

Among the matters described in the annual securities report, the major risks that management believes may have a material impact on the consolidated operating results and countermeasures against those risks, and the relationship between the four key strategies set forth in the medium-term management plan and the strategies by business segment are as follows.

In addition, the Group is working to develop and improve system and framework to promote risk management in order to improve its ability to respond to risks and to practice sound and highly transparent management. The Company has established the Risk Management Committee as an advisory body to the Representative Executive Officer and President, which deliberates on risk management-related topics from a company-wide perspective and reports to the Representative Executive Officer and President. The BCP/Disaster Countermeasures Subcommittee, Financial Management Subcommittee, Compliance Subcommittee, Export Inspection Subcommittee, and Information Security Subcommittee have been established as subordinate organizations of the Committee to formulate action policies and implement monitoring on important themes across the Company.

The Risk Management Committee classifies various identified business-related risks into four major categories: external environment risks, management strategy risks, business process risks related to business activities, and business process risks related to management infrastructure. The company assesses the importance of risks according to the scale of assumed loss and assumed occurrence frequency. The Company evaluates the level of control for each risk, identifies important risks that should be addressed on a priority basis, designates departments in charge, and works to raise the level of control by implementing risk reduction activities.

Forward-looking statements in this document are based on the judgment of the Group as of the end of the current consolidated fiscal year.



(Omitted)

Risk category	Risk iter	Risk description	Risk measures	Impact on strategy: The four focus strategies	Impact on strategy: Business-specific strategies
Business process risk related to business activities	Business partners/sales side	We face intense competition in each of the areas in which we operate. In the sales channels for consumer products in the musical instruments and acoustics business, the market presence of e-commerce and wide-area mass retailers is growing, and business with the Group is growing year by year. Sales channels rooted in the local community are shrinking, including the successor problem. In addition, the development of the e-commerce market has led to greater price transparency and intense price competition, which could affect the Group's current competitive edge. The semiconductors, automotive interior components, and other products manufactured and sold by the Group are affected by the performance of the manufacturers to which they are supplied. In addition, if the relationship of trust with manufacturers to whom we supply our products is damaged in terms of factors such as delivery times or quality, it may have an adverse effect on subsequent orders. Moreover, we may be required to pay compensation from the manufacturers to whom we supply our products due to factors such as quality defects.	By expanding and diversifying geographic areas and customer contact points (physical stores and e-commerce), we are reducing the impact of the risk of excessive dependence on specific business partners by connecting with customers widely, deeply, and over the long term. In addition, we are promoting measures to optimize wholesale prices that appropriately reflect product value, based on careful consideration of the market environment, competitive relationships, and product characteristics. In addition to revising the prices of existing products, we add value when introducing new products or by adding new services, and price them appropriately. In the components and equipment business, which handles semiconductors and automotive interior components, we will continue to work to maintain good relationships with the manufacturers to which we supply our products, and we are working to diversify our risks in the areas of in-vehicle modules and automotive interior components by entering new markets and expanding our product lineup.	(1)	(1)(2)(3)

(Note) Each of the four key strategies and business-specific strategies are as follows. For details, please refer to "1. Management Policy, Management Environment, and Issues to be Addressed."

(Four key strategies)

(1) Connect more with customers (2) Create new value (3) Improve productivity (4) Contribute to society through business

(Business-specific strategies)

(1) Musical instruments business (2) Audio equipment business (3) Other businesses

Source: Annual securities report of Japanese company C