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A Policy Proposal for the Functional Enhancement of Internal Audit of Japan¹

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1. Background of the policy proposal

- (1) There are two functions in the mission of internal audit: contribution to the value protection of an organization and contribution to the value creation². In the first function internal audit takes a role as governance for defense conducting compliance related audits. In the second function internal audit takes another role as governance for offense conducting audits focusing on the business effectiveness and efficiency, and the risks relating to the business model or business strategy.
- (2) As the business environment rapidly and disruptively changes management needs to implement successfully their firm's business model and strategy for the value creation and achieve the sustainable growth. Considering this factor as well as the limitation of internal audit function of protecting the firm against non-compliance events, internal audit should enhance its function to contribute to the value creation of the firm and play more role in governance for offense. The benefit of this functional enhancement of internal audit has already been realized in major firms in the west. Internal audit of Japanese firms should follow their experience to enhance the internal audit function and this argument is supported by Japanese Financial Services Agency (FSA) at least for financial institutions when FSA publicly issued a document "Present conditions and future issues for enhancement of internal audit functions in Japanese financial institutions" in June, 2019.
- (3) A research backing this policy proposal shows that among the 49 Japanese firms that have 20 and more internal auditors and that have issued integrated reports

¹ This policy proposal is based on Hiroshi Naka, "Functional Enhancement of Internal Audit in Japan - How Should Internal Audit Help Management Respond to Risks in Disruptively Changing Business Environment?", Journal of the Institute of Internal Auditors-Japan, December, 2019.

² See "Mission of Internal Audit" included in "International Professional Practices Framework (IPPF)" of Institute of Internal Auditors (IIA).

some have already established a function relating to the value creation while the majority remain at a stage where its main function relates to the value protection.

- (4) It is easy to assume that internal audit departments with less than 20 internal auditors remain at the stage due to its scale limitation. Therefore, the cause analysis of the functional gap of the 49 firms surely tells what policy proposal is needed for the functional enhancement of internal audit in Japanese firms as a whole.
- (5) Two factors are analyzed to explain about the functional gap: the difference of the awareness level of risk management of the subject firms and the difference of the level of trust in the internal audit departments of the subject firms. Due to the difficulty to observe the level of trust directly, the difference of interactions of internal audit departments with the supreme governance organizations (CEO, Directors of the Board including unaffiliated directors, Audit Committee, Audit and Supervisory Committee, and Kansayaku (Audit and Supervisory Board=a Japanese unique system to supervise the Directors of the Board)) is analyzed instead. The analyses have found that the two factors respectively have a moderate correlation with the functional gap.

2. Policy Proposal

- (1) Japanese firms should enhance internal audit functions toward the following direction :
 - A) Be responsible for governance for defense (audit for value protection) as well as governance for offense (audit for value creation).
 - B) Shift the focus of audit to the risk that arises when the business model and processes do not meet their objectives.
 - C) Step forward to become a trusted advisor.
- (2) In order to achieve the enhancement of internal audit functions specified in (1), we propose the measures below³. The measures are tagged to two routes that

³ The proposed measures are based on the analysis of 49 Japanese companies that have relatively large size internal audit department (20 staff members or more) and considered for them to enhance internal audit functions. The measures, however, are also applicable to other companies with smaller internal audit department because the two routes are just standard ones to strengthen the internal audit functions from the following logics:

- ✓ Management/The Board wishes to use internal audit more for better risk management

are identified as two causes in the analysis of the functional gap: ① measures to raise awareness of risk management and ② measures to gain more trust in internal audit function.

① Measures to raise awareness of risk management (A-D)

A) Encourage management to write up the integrated report based on the integrated thinking defined by IIRC Integrated Reporting Framework⁴⁵

- ◆ What were found in the analysis of 49 firms :
 - The material issues and the risks and opportunities are not considered in an integral manner. It is a strategic issue.
 - The attitude toward daily risk management and strategic risk management should be strengthened and communicated in the integrated report as a

when they get more aware of risk management.

- ✓ Management/The Board wishes to use internal audit more when they trust in internal audit department.

Of course, it is much more difficult for small internal audit department to enhance the functions but they should do it step by step taking their own time.

⁴ http://integratedreporting.org/wp-content/uploads/2015/03/International_IR_Framework_JP.pdf

⁵ One of the cores of “integrated thinking” is risk management on how the material issues and strategic risks relating to the sustainability of the business model for value creation should be managed. The following is the essence of it abstracted from the Integrated Reporting Framework, IIRC:

- ✓ “Integrated thinking is the active consideration by an organization of the relationships between its various operating and functional units and the capitals that the organization uses or affects.”
- ✓ One of the subjects to consider: “How the organization tailors its business model and strategy to respond to its external environment and the risks and opportunities it faces.”
- ✓ Development of a strategy including risk mitigation and management: “Continuous monitoring and analysis of the external environment in the context of the organization’s mission and vision identifies risks and opportunities relevant to the organization, its strategy and its business model.” “The organization’s strategy identifies how it intends to mitigate or manage risks and maximize opportunities. It sets out strategic objectives and strategies to achieve them.”
- ✓ Identification of ‘Materiality’: “Considering the Guiding Principle, Materiality, the organization’s approach to any real risks (whether they be in the short, medium or long term) that are fundamental to the ongoing ability of the organization to create value and that could have extreme consequences is ordinarily included in an integrated report, even when the probability of their occurrence might be considered quite small.

tone at a top.

- Some internal audit organizations remain focused mainly on value protection aspect such as compliance issue.

◆ Measures :

- Encourage management to write up the integrated report based on the integrated thinking defined by IIRC.
- Externally evaluate the integrated reports every year from a risk angle to give firms a pressure to raise awareness of risk management.⁶

B) Grant internal audit function a role in the process of preparing an integrated report (e.g., assurance of the integrity of the report⁷).

◆ What were found in the analysis of 49 firms :

- None included the statement on it.

◆ Measures :

- Grant internal audit function a role in the process of preparing an integrated report while implementing the measure to facilitate “integrated thinking. This measure will directly enhance the functions of internal audit.
- Examples of the role of internal audit in the integrated reporting:
 - ✓ Report an assurance given by internal audit when it audits the risk management of a value creation activity.
 - ✓ Report an assurance given by internal audit when it audits how effectively management achieve a KPI relating to a business model.
- IIA should discuss what role internal audit function should be granted in terms of integrated reporting. Each company should consider to grant such a role to internal audit.

C) Raise awareness of Japanese companies of the fundamental risk management framework.

◆ What were found in the analysis of 49 firms:

⁶ It is ideal to require Japanese firms to follow the Integrated Reporting Framework, IIRC by a soft law such as Corporate Governance Code but it will take time to get consensus on it. So it should be considered as a long-term task and the proposed external evaluation can be better solution in the short-run.

⁷ IIRC Framework: “An integrated report should include a statement from those charged with governance that includes: An acknowledgement of their responsibility to ensure the integrity of the integrated report.”

- Only a few integrated reports of 49 firms included statements on the fundamental risk management frameworks such as the Three Lines of Defense (TLoD) model, Risk Appetite Framework, Enterprise Risk Management, Chief Risk Officer.

◆ Measures :

- Disseminate the fundamental risk management frameworks and encourage firms to adopt them.
- Particularly encourage firms to intentionally adopt the TLoD model.
 - ✓ The model emphasizes the importance of internal audit as the third line of defense.
 - ✓ The intentional adoption of the model will lead to the functional enhancement of internal audit.
 - ✓ The challenge by the second line to the excessive risk taking practice by the first line is essential.
 - ✓ The third line, internal audit, can reallocate its resources to other priorities when the first and second line function well.
- The review of the TLoD model by IIA is under way to include the offensive governance element in the model. Take advantage of this opportunity and outreach beyond the internal audit industry boundary to significantly improve the awareness of the (new) model.

D) Internal audit department should make an extra effort to raise awareness of risk management inside the company.

◆ Measures :

- In addition to the measures above, the extra effort by internal audit department is essential to improve further the management's awareness of risk management.
- There are many that internal audit department can do to contribute to 'add value to the organization (a mission of internal audit function)'. Here are some examples:
 - ✓ Disseminate the fundamental risk management frameworks inside the company.
 - ✓ Communicate the concern of internal auditors over emerging risks to management.

② Measures to gain more trust in internal audit function (A-E)

A) Enrich the interactions of internal audit department with the supreme governance organizations (CEO, Directors of the Board including unaffiliated directors, Audit Committee, Audit and Supervisory Committee, and Kansayaku⁸).

◆ What were found in the analysis of 49 firms :

➤ While there is a certain good interactions especially with the Kansayaku, the analysis could not make it clear that the interactions are really rich.

◆ Measures :

➤ In order to heighten the expectation to and the trust in internal auditors, enrich the interactions between internal audit department and the supreme governance organization with deeper discussion.

➤ Here are some examples of good practice :

✓ Internal auditors should not only report the results of audits but also discuss how the root causes behind the findings can be addressed. If necessary, they should tell the issue of corporate culture or employee behaviors.

✓ Internal auditors should share their concern over the risks that are unaware by management or that are emerging rapidly.

✓ Internal auditors should listen to what risks members of the supreme governance organizations are concerned of and consider what internal auditors can do.

➤ The change in expectation to and trust in internal auditors should be continuously monitored in the quality assurance.

B) Increase the interactions of internal audit department with the Board, particularly with the unaffiliated directors.

◆ What were found in the analysis of 49 firms:

➤ There are more room to improve in the relations between internal audit department and the Directors of the Board, particularly unaffiliated directors than the relations between internal audit department and Kansayaku, Audit Committee, and Audit and Supervisory Committee.

◆ Measures :

⁸ Kansayaku: A Japanese unique system to supervise the Directors of the Board (Audit and Supervisory Board in English)

- Increase the interactions of internal audit department with the Board, particularly with unaffiliated directors, and make it really beneficial to both.
- Internal audit function is expected to play not only a role in governance for defense but also a role in governance for offense. As the reform of governance for offense progresses in Japan, the strengthening of the interactions and collaboration between internal audit department and the Board should be on the agenda of the reform.
- Many companies report the review results of the Board activities in the integrated report as a governance improvement. They should add a review of the interactions between internal audit and the Board to the Board activities review.

C) Develop the dual reporting line.

◆ What were found in the analysis of 49 firms :

- Only 14 firms seem to have the dual reporting line.

◆ Measures :

- Change the reporting line of the internal audit department to the supreme bodies. As IIA standards require, the internal audit charter should make clear that CAE functionally reports to the Board of Directors, the Audit Committee, or the Audit and Supervisory Committee and administratively reports to CEO.
 - ✓ The dual reporting line helps CAE gain stronger support than CAE with a single reporting line can.
 - ✓ The dual reporting line with a proper power balance has a significance for internal audit function to keep independence and objectiveness.
 - ✓ A reporting line to Kansayaku instead of the Board of Directors, etc. is not ideal because the role of Kansayaku in governance for offense is limited in reality.
- IIA Japan's survey conducted every three year does not include a specific question on the dual reporting line. It should include the question and the industry as a whole should follow up the improvement in the reporting line.

D) Provide more consulting services to management.

◆ What were found in the analysis of 49 firms :

- None but an important issue to raise.

◆ Measures :

- Encourage management to ask for more consulting services.
 - ✓ A consulting service can provide more forward looking, future focused advice than an assurance.
 - ✓ It may be a good opportunity for internal auditors to add value to a business model, business strategy or key initiative from governance, risk management and control viewpoints.
 - ✓ In the west there is a tendency that consulting services are regarded as a key service in the enhancement of internal audit functions.
- IIA Japan's surveys (a comprehensive one conducted every three years and a survey of audit themes conducted every year) do not include any specific questions on consulting services. They should include such questions and the industry should follow up the development of consulting services.

E) Make internal audit experience as a career step to senior management.

◆ What were found in the analysis of 49 firms :

- None but an important issue to raise.

◆ Measures :

- Make internal audit experience as a career step to senior management.
 - ✓ An experience in internal audit department is very valuable to understand the businesses and operations of the company.
 - ✓ For internal audit department this measure has a benefit to gain a significant support from senior management in the long-run.
 - ✓ Although this measure takes time to realize the benefit, it is worth to implement while paying due attention to the independence of internal audit function.