Report

Internal Audit Contributing to Value Creation

~Evolution and Recommendations for Internal Auditing to Contribute to Strategy~.

"English Translation"

※This document is a provisional translation of the original report written in Japanese. In case of any discrepancies between this translation and the original Japanese text, the original Japanese version shall prevail.)

July 2024

Japan Internal Audit Research Foundation
Study Group on The Future of Internal Auditing

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Greetings from the Chairperson

Today, rapid changes in the internal and external environment are forcing companies to rethink and transform their business models. In response to this change, there is an increasing need to redefine the roles and responsibilities of internal auditing within the organization. Japan Internal Audit Research Foundation's "Study Group on the Future of Internal Auditing" has been deepening discussions on the role and significance of internal auditing from the perspective of contributing to the creation of corporate value through internal auditing, analyzing current issues, and exploring directions for the future, intending to contribute to the spread and development of internal auditing.

With the cooperation of 10 representative companies from various industries, the study group conducted a questionnaire survey and follow-up interviews from June 2023 through the end of the year to gather information on issues and initiatives in the internal audit function. Subsequently, the study group members deepened discussions and examined the role of internal auditing from the value creation perspective. We would like to express our deepest gratitude to the management and internal audit staff of the companies that cooperated with us in this study.

Chapter I of this report explores changes in the business environment and their impact and identifies changing expectations for internal auditing. Chapter II analyzes the challenges of internal auditing as a management function and explores the gap between expectations and the current state. Chapter III focuses on value creation as management and the involvement of internal auditing and examines how internal auditing can contribute to the value creation process. Chapter IV identifies how internal auditing can contribute to business strategy and discusses adapting to global guidance and promoting sustainability. Chapter V proposes a step-by-step approach to internal auditing transformation and provides direction for the evolution of internal auditing. The final chapter provides recommendations and an action plan for the board of directors and management to utilize internal auditing in light of the important role it plays in business strategy. Please note that this report summarizes the concept of internal auditing as a management function that contributes to value creation and does not seek to make any changes to the IIA's Global Internal Audit Standards™ or other relevant standards related to internal auditing.

In a rapidly changing business environment, the impact of internal auditing on organizational governance and risk management is becoming increasingly important. Through this study, we hope to provide an opportunity for a wide range of stakeholders—including those involved in internal auditing such as internal audit function, board of directors and management, audit & supervisory board members, and audit committee members, as well as auditing firm and external auditing professionals, those involved in corporate governances, and participants in sustainability discussions—to reflect on and discuss new roles and approaches for internal auditing.

We would like to thank the experts who provided valuable advice during the planning stages of this study group, the Japan Internal Audit Research Foundation for their cooperation in the operation of the study group, and the members of Protiviti LLC for their great support in the preparation of the report (details are included in the attached document).

We sincerely hope that the results of this study will help Japanese companies' internal auditing move to a new stage where they can contribute to value creation.

July 2024

Japan Internal Audit Research Foundation
"Study Group on the Future of Internal Auditing"
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Executive Summary

Expectations and Gaps in Internal Audit in a Changing Business Environment

The business environment has changed dramatically, and companies need to engage in new value creation and risk management. The two paradigm shifts of "proactive governance" and "contribution to the public interest" require companies to improve management transparency through information disclosure, build governance systems that emphasize social responsibility, and shift risk management from traditional risk avoidance to a balance between active risk-taking and proactive risk management. Against this backdrop, the importance of internal audit as a management function is being reaffirmed, and internal audit needs to be reformed to meet management expectations.

While expectations for internal audit have thus increased, there are cases where internal controls are not fully effective due to malfunctions. We also see problems where companies miss the boat on rapid environmental changes and fail to properly comply with internal audit standards, rather than creating new value. In addition, the role of internal audit is often biased with traditional compliance audit, lacking insight that could contribute to management and responses related to sustainability.

Value Creation and Internal Audit

Companies need to focus on sustainability and demonstrate a narrative story that creates value for the company. In response, internal audit is expected to contribute to the value-creation process. The value creation process consists of values (purpose), a long-term strategy based on those values, an execution strategy to implement it, and performance evaluation through KPIs. For internal audit to actively contribute to value creation, it may be difficult to become directly involved in the values and long-term strategy from the outset. However, incorporating internal audit into the execution strategy phase can be considered as an entry point.

While many internal audit currently focuses primarily on compliance with rules and procedures, they need to evolve to a more risk-focused audit, and even move to a stage where they contribute to strategy. The new Global Internal Audit Standards issued by the Institute of Internal Auditors, as well as various other guidance on internal audit, provide a framework to help companies ensure proper governance, manage risk and create sustainable value.

Internal Audit Transformation

The role of internal audit is not simply to target risks and controls but also to provide assistance and insight to management in formulating and executing its strategy. Internal audit is expected to contribute to the strategy by providing assurance, advice, and insight and foresight.

For internal audit to move up from compliance audits (Stage 1) to risk-based audits (Stage 2), including ERM (enterprise risk management) and organizational culture, internal audit must not only verify that risks are managed through internal controls based on laws, regulations, and internal policies, but also understand and assess risks related to business strategy. To that end, the followings are recommended for internal audit.

① Foster a mindset of corporate value enhancement.
② Utilize a risk lens to incorporate a risk perspective into the control evaluation.
③ Understand ERM and support effective risk management.
④ Root cause analysis and provide insight.
⑤ Reinforce the skills required for internal audit.

To move up from risk-based auditing (Stage 2) to auditing that further contributes to strategy (Stage 3), internal audit must go one step beyond contributing to risk management and play a role in helping the company achieve its strategic objectives. The key is for the internal auditor to maintain a strategy-based perspective. To this end, the followings are recommended for internal audit.

① Utilize horizontal and thematic audits to contribute to management decision-making.
② Provide insight and present root causes and recommendations.
③ Introduce sustainability auditing and focus on new areas such as ESG.
④ Maintain high-quality output and constructive communication to build trust from the Board of Directors and management.

Recommendations for the Use of Internal Audit by the Board of Directors and Management

The Board of Directors and management are faced with the need to enhance the value of the company as it responds to rapid changes in the business environment. To do so, they need to continually review their business models and strengthen risk management systems and governance throughout the organization and should consider the use of internal auditing as a means to achieve this. The Corporate Governance Code of Japan and international sustainability reporting and assurance requirements also envision the use of the internal audit function. Therefore, the followings are recommended for the Board of Directors and management:

① Foster risk sensitivity throughout the organization, set risk appetites, and share them with all employees.

② Understand the new role of internal audit and help the internal audit team participate in projects and initiatives within the organization that are relevant to the strategy.

③ Strengthen the governance of the organization by designing dual reporting lines (chain of command) with appropriate reporting by the internal audit function to the board of directors and management.

④ Promote integrated review and collaboration among First Line (business/ operational function), Second Line (risk management function), and Third Line (internal audit function).

Main body of the report

1. Changes in the Business Environment and Expectations for Internal Auditing

Japan's business environment has changed dramatically, requiring companies to engage in new value creation and risk management. The government, industry associations, and major corporations have responded to these changes with strategic initiatives and governance reforms to promote economic growth. In particular, driven by two paradigm shifts—“proactive governance” and “contribution to the public interest”—companies are building governance structures emphasizing transparency, information disclosure, and social responsibility. They are also transitioning their risk management approach from traditional risk avoidance to a balanced strategy incorporating proactive risk-taking. Against this backdrop, expectations for internal auditing are also changing, and internal auditing is expected to play an important role in assurance and advisory functions from a management perspective.

1.1. Changing Business Environment and Paradigm Shift

Over the past decade, Japan's business environment has been transformed by a number of factors. These include increased global competition, an aging population and workforce shortage, the advancement of digital transformation (DX), growing interest in sustainability, and the impact of the pandemic. These wide-ranging and complex changes are forcing companies to shape and present new value-creation stories.

The government, industry associations, and many companies have responded by revamping not only their strategies but also their governance. For example, by promoting economic growth through Abenomics policies, companies have pursued new business opportunities and corporate governance reforms. In addition, the "Grand Design and Action Plan for New Capitalism" proposed by Prime Minister Kishida states that "It is difficult for the government alone to take the initiative in solving many social issues. For society as a whole to promote solutions, it is necessary to review market rules and the legal system to ensure that contributions to problem-solving are rewarded, thereby inducing a flow of funds and people to companies that make significant contributions, and aim for a society in which the private sector can proactively engage in problem-solving. (text omitted) From this perspective, it is necessary to measure "impact" in addition to the traditional "risk" and "return," and to make "problem-solving" another evaluation measure in capitalism. “

In addition, while working to strengthen international competitiveness, economic organizations are also working with the government to respond to economic policies, for example, the Japan Business Federation (Keidanren) issued a report titled "Promoting Purpose-Driven Dialogue through the Use of Impact Indicators: Implementing Sustainable Capitalism by Businesses and Investors," which encourages the sharing of information and the dissemination of best practices. Many companies are emphasizing investment in innovation, developing new products and services, promoting digitalization, and stepping up efforts to address ESG (environmental, social, and governance) and sustainability issues.

As Japanese companies experience these major changes in the business environment, two major paradigm shifts are occurring: a paradigm shift to proactive governance and a paradigm shift to the public interest.

1.2. Paradigm Shift to Proactive Governance and Risk Taking

Japanese companies are transforming their risk management with proactive governance that emphasizes maximizing corporate value through transparency and communication. In the past, governance focused primarily on the "defensive" aspects of compliance and internal controls, but with the Abenomics growth strategy, "proactive governance" has become more important, and this approach emphasizes more transparent disclosure and communication with investors in order for the board of directors and management to maximize corporate value.

While the traditional view of risk focused on risk avoidance and risk minimization, with the goal of preventing losses, the new view of risk is aggressive, with companies responding more flexibly in a changing environment and proactively taking risks and linking them to profitable opportunities in order to achieve sustainable growth. There is now an increased emphasis on developing new business opportunities and increasing competitiveness.

In the new risk approach to business operations and risk management, the following points are now emphasized

- Risk Management Optimization: Recognizing that it is difficult to avoid risk altogether, it is instead important to manage risk appropriately and find the optimal balance between risk-taking and profit opportunities.

- Active management of risk: Aiming to actively manage risk and achieve an optimal risk profile (overall risk picture and characteristics). This will increase the potential to exploit new revenue opportunities, such as market changes and competitive advantages.

- Creative use of risk: Work to develop innovations and new business models to link risk with profit opportunities. This will turn risk-taking into a positive profit-generating force.

- Ongoing Monitoring and Adjustment: Risks are changing and appropriate actions should be taken in response to market and company conditions. Maintain a balance between risk and profit opportunities through continuous monitoring and adjustment.

1.3. Paradigm Shift to Public Interest

Contribution to the public interest means that a company considers the public interest in its activities and decisions and fulfills its responsibility to society. Companies are now expected to be highly aware of their social responsibility and to emphasize environmental considerations, contribution to society, and transparency in governance (each element of ESG).

Due to the following factors, the public interest perspective has become an important theme in the fulfillment of social responsibility as it affects corporate management.

- Consideration for stakeholders: Companies increasingly need to meet the expectations not only of investors but also of their diverse stakeholders, including customers, employees, and local communities, and to strengthen dialogue with them.

- Sustainability Initiatives: It is becoming increasingly important for companies to transform themselves into sustainable business practices, aiming to minimize their impact on the environment and maximize their positive impact on society.

- Enhancing Transparency and Accountability: Companies need to be transparent and extensively accountable for their activities. Conducting external audits and disclosing non-financial information can help build trust with stakeholders.

- Impact on investment decisions: Investors are beginning to base their investment decisions on public interest-based valuation axes such as sustainability, resulting in an increase in conscious investment behavior.
- Changing Regulatory Environment and Adaptation: Regulations regarding the disclosure of non-financial information, such as sustainability information, are becoming stricter, and companies (especially listed companies) must respond to these regulations.

Legal and regulatory requirements are also strongly encouraging the disclosure of non-financial information, and companies are required to report and disclose their environmental and social impact and corporate governance practices. Whether or not a company is fulfilling its social responsibilities is also becoming an important factor in consumer purchasing trends and recruitment of human resources.

1.4. Expectations for Internal Auditing

As mentioned above, as companies are required to adapt to rapid changes in their internal and external environments, and the need to review their business models has arisen, there is a growing expectation for change in internal auditing.

Against the backdrop of rapid changes in the business environment, regulatory trends that are spreading globally, and changes in businesses and companies in response to these changes, corporate management expects new methods in addition to traditional assurance with regard to the use of internal audit. Internal audit needs to respond to these expectations by shifting from traditional assurance from a business perspective to assurance from a management perspective, and by performing an advisory function to support management. Internal audit is expected to play an important role in business risk management by reassessing the risk profile (the overall picture and characteristics of risk) through a review of the company's business model and by digging deeper into new risk factors.

With the increasing international emphasis on integrated reporting and value creation stories, companies need to disclose not only financials but also information from an ESG (environmental, social, and governance) perspective, as well as the feasibility and transparency of their strategies for sustainable growth. The value creation story should be explained in more detail in the integrated report, explaining the company's activities and achievements, and the integrated report should disclose the ESG efforts and sustainability strategy behind it. Internal audit is expected to contribute to areas that are difficult to reach by external audit, such as its role in assessing risks and opportunities simultaneously through sustainability initiatives and contributing to the enhancement of corporate value. Internal audit needs to meet management's expectations by supporting management's implementation of sustainability initiatives and strategies.

2. Challenges of Internal Auditing as a Management Function

Despite the above increased expectations for internal audits, current internal audits are facing challenges. First, internal audits may not be fully effective due to dysfunctional internal controls. In addition, we see problems such as missing the boat on rapid environmental changes and failing to properly comply with standards, rather than creating new values. In addition, it is sometimes pointed out that the role of internal audit is biased toward traditional compliance and critically lacking in insight and sustainability responses that contribute to management.

2.1. Internal Control Dysfunction and Internal Auditing

In recent years, when fraud and scandals have occurred, the causes are often attributed to dysfunctional internal controls and internal audits.

Although internal audit is responsible for the monitoring function of internal control, in reality, if problems exist in internal control itself, such as unclear division of responsibilities, inadequate processes, inaccurate information, and poor communication, internal audit may not be able to properly assess risks, making early detection of fraud and problems more difficult. In order for internal audit to function well and to further enhance its function, it is first essential to strengthen internal controls, and companies need to improve the design and operation of internal controls and enhance their risk assessment and monitoring capabilities.

2.2. Internal Audit’s delay in responding to changes

In response to the rapid pace of economic and social change, internal auditing must evolve at an appropriate pace. If a company operates in a limited scope and fails to adapt to new values, it is at risk. Considering both economic and social values ensures sustainable growth, corporate credibility, and flexibility to respond to changes in the environment. Internal audit protects economic value by evaluating the accuracy of financial reporting and the health of the organization. From a social value perspective, internal audits assess a company's compliance and ethical practices and support efforts to build public trust.

If there is concern that the scope of internal audit is limited and that it is not doing enough to keep up with new values and standards, then internal audit need to be equipped with both economic and social value perspectives and quick to respond to change.

2.3. Necessity of Reevaluating the Role of Internal Auditing and Enhancing Value Delivery

Some are concerned that current internal audit focuses on internal controls and compliance and lacks involvement in proactive governance. There are also concerns that internal audit is not contributing enough as management takes the helm in sustainability management due to a lack of expertise in sustainability.

The role of internal auditing is not limited to identifying issues and managing risks; it is also expected to provide the board of directors, audit bodies (such as the Audit & Supervisory Board, Audit Committee, and Audit & Supervisory Committee, hereinafter collectively referred to as "Audit Bodies"), and management with insight that contributes to management. For internal audit to fulfill its role from a management perspective without being biased toward internal control and compliance, it is necessary to reevaluate its role.

In this connection, there has been an international debate on the value proposition of internal audit as the business environment changes and risks become more complex. Institute of Internal Auditors (IIA) has removed "defense" from the "Three Lines of Defense" and has moved toward the Three Lines Model approach. The reason behind this change is the belief that internal audit should contribute not only to the preservation of corporate value, but also to value creation. To this end, in addition to traditional assurance, assurance and advisory functions with a management perspective are required, based on the premise that risk is integral to profit opportunities.

3. Value Creation as Management and Involvement of Internal Auditing

This section examines the process by which management creates value, the elements of that process, and the contribution of internal audit to that process. It will examine how internal audit can create value in relation to the value creation process, as well as the direction for staging internal audit to be positioned more closely to the value creation process.

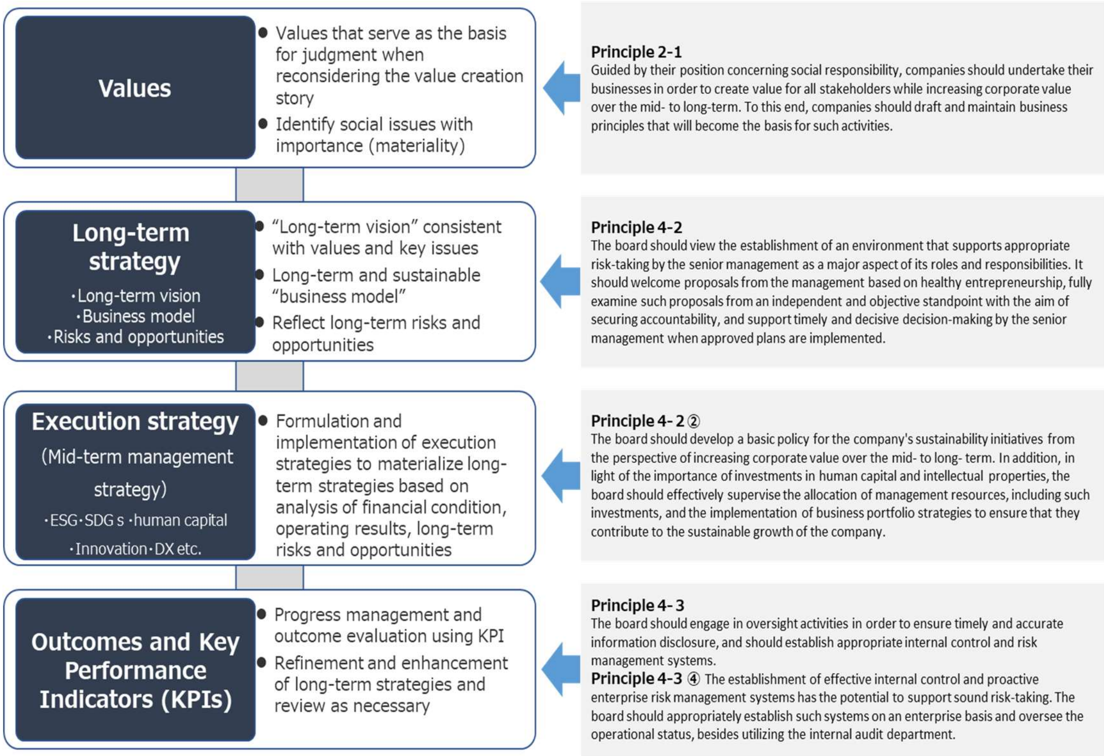
3.1. What is Value Creation as management?

Value creation as management refers to the creation of economic value by a company for its investors and other stakeholders through its activities, based on a social sustainability perspective. It is now imperative for companies to tell this value creation story and pursue its realization.

To understand the relevance to internal auditing, we have created a simplified version of the "Value Creation Process as Management" based on the overall framework of the Ministry of Economy, Trade and Industry's Value Co-creation Guidance 2.0
(https://www.meti.go.jp/policy/economy/keiei_innovation/kigyoukaikei/ESGguidance.html). (See Figure 1)

Figure 1: A simplified version of the "Value Creation Process as Management" developed by our study group, referencing the Ministry of Economy, Trade and Industry's Value Co-creation Guidance 2.0 framework, and its related principles of the Corporate Governance Code.

Value Creation Story



The process of value creation as management consists of the following components

- Values (Purpose): We define a clear set of values as the foundation for value creation and link them to contributions to the public interest. It also identifies social issues, assesses their importance, and integrates them into a set of values to solve those issues.

- Long-term Strategy: Establish a long-term vision and ensure alignment of that vision with values and key issues. Develop a sustainable business model and recognize long-term risks and revenue opportunities, which will be reflected in its vision and business model.

- Execution Strategy: Recognize the importance of ESG (Environmental, Social, and Governance), SDGs (Sustainable Development Goals), and human capital, and incorporate them into the execution strategy. We will consider innovation, digital transformation (DX), and other initiatives, and formulate concrete action plans to realize our long-term strategy. Furthermore, we will formulate a medium-term business strategy and concretize the execution strategy based on our financial position and operating results.

- Outcomes and Key Performance Indicators (KPIs): KPIs are established to manage the progress of the strategy and evaluate results. We also conduct the necessary reviews to refine and upgrade our long-term strategy and business model to improve the adaptability of our strategy.

3.2. Factors to be considered in the Pursuit of Value Creation

Factors that a company should consider as it builds and pursues its value creation story include those related to governance and risk, as well as those related to the public interest. These elements should not be overlooked as internal audit contributes to the value creation process.

＜Elements Related to Governance and Risk＞

- Rapid changes in the external environment : The business environment is changing rapidly, with accelerating technological innovation, DX, and market globalization. These changes are changing the competitive environment and creating new markets, which are constantly creating new challenges and revenue opportunities for companies.

- Business Model Change : Traditional business models are becoming increasingly difficult to achieve sustainable results, and companies need to work to transform their business models. Creating new business models or overhauling existing models is essential to remain competitive and achieve growth.

- Risk Management and Profit Opportunity Recognition : In a rapidly changing business environment, risks and profit opportunities exist simultaneously. Companies need not only the ability to manage risk reduction and avoidance, but also the ability to identify and take advantage of new revenue opportunities. Value creation stories are an important element in balancing risk management and new revenue opportunities.

<Factors relevant to the public interest>

- Changing Stakeholder Expectations: Stakeholders, especially customers, investors, employees, local communities, government agencies, and NGOs, have increasing expectations of companies to fulfill their social responsibilities as appropriate. Sustainability compliance and ethical management are gaining attention as contributions to the public interest, and companies need to meet these expectations.

- Capital Market Perspectives: Capital markets have become increasingly sensitive to corporate sustainability and value creation. Sustainable business models and environmental considerations are considered factors in increasing investment value, and companies need to meet capital market expectations.

- Building Strategies to Achieve Contributions to the Social Environment: Corporate values (Purpose) are the reason for a company's existence and social responsibility, and increasingly focus on a sustainable society, not just the pursuit of profit. The emphasis is on companies creating value by building strategies that not only pursue profit but also contribute to the social environment.

3.3. Contribution of Internal Auditing to the Value Creation Process

Internal audit is considered to contribute to the creation of corporate value through

- Ensuring Compliance: Ensuring compliance with legal requirements and regulations reduces risk and protects a company's reputation. Internal

Audit audits compliance with these regulations and addresses any signs of problems as soon as they are detected.

- Improving Organizational Culture: Internal audits emphasize transparency, integrity, and responsibility, and contribute to improving organizational culture. A good organizational culture increases employee satisfaction and contributes to the long-term success of the company.
- Process Improvement: Internal audit evaluates processes and procedures within an organization, makes recommendations for improvement, and establishes efficient and effective processes to improve management productivity and enhance competitiveness.
- Cost Reduction and Efficiency Improvement: Internal audits assess the efficiency of processes, operations, and resources to identify opportunities for cost reduction. Reducing waste and properly allocating resources improves the company's profitability.
- Improved Risk Management: Internal audits assess risks within a company and enhance risk management processes. This contributes to minimizing risks and maximizing opportunities, thereby supporting business stability and sustainable growth.
- Providing Insight: Management gains insight by providing insight through root cause investigations. Internal audits provide valuable information about a company's first and second line operational challenges, organizational culture, and external stakeholders to help modify and improve strategy.
- Decision Support: Internal Audit provides fact-based information to the Board of Directors and management to strengthen the basis for decision making. Providing insight into strategic direction and resource optimization helps the board and management make accurate decisions.
- Adaptation to Change: In light of changes in the market and business environment, Internal Audit provides the Board of Directors and management with insight into how to adapt to change, remain competitive and promote growth.

Based on the discussion thus far, the management value creation process and the corresponding contribution of internal audit can be summarized roughly as follows.

Management Value Creation Process	Possible Internal Audit Contributions

Values (Purpose): • Clarify the values underlying the value creation story and incorporate their contribution to the public interest. • Identify social issues, assess their importance (materiality), and integrate them into values.	• Improving organizational culture: helping values become integrated into the organizational culture, integrating forces for growth throughout the organization, and improving risk sensitivity and ethical values. • Adaptation to change: assess whether values are responsive to and maintained through change, and help companies adapt quickly.
Long-Term Strategy: • Establish a long-term vision and ensure alignment of values with key issues. • Develop sustainable business models to support the realization of our long-term vision. • Recognize long-term risks and opportunities and reflect them in our vision and business model.	• Improved risk management: assess risks in long-term strategy and provide advice to strengthen the effectiveness of execution strategies. • Provide Insight: Provide insight on projects and initiatives that support the long-term strategies and provide direction to the Board of Directors and management for future strategic adjustments and improvements. • Decision support: Provide the data and analysis necessary for decision-making to support long-term strategies and assist in the decision-making process regarding strategy implementation.
Execution Strategy: • Recognize the importance of ESG (Environmental, Social and Governance), SDGs (Sustainable Development Goals) and human capital and	• Ensure Compliance: Ensure that corporate actions are consistent with laws and regulations to ensure compliance. • Operational Improvement and Cost Reduction: Help reduce waste, improve operational efficiency, and reduce costs

incorporate them into execution strategies. • Examine innovation, digital transformation (DX), and other initiatives, and develop an action plan to realize the long-term strategy. • Develop a medium-term management plan and other plans, and concretize execution strategies based on financial position and operating results.	in the implementation of management strategies. • Improved Risk Management: Identify and assess risks associated with the implementation of execution strategies, recommend improvements to risk management processes and governance through an assessment of the effectiveness of risk management measures, and help companies manage risk effectively. • Decision Support: In evaluating execution strategies, internal audit provides the board of directors and management with information and insight to support decision making. • Provide Insight: Provide data and analysis on execution strategies to provide insight to decision makers and help them refine and revise their strategies. • Adaptation to change: Assess risks and revenue opportunities in the implementation of execution strategies in response to changes in the business environment, and assist in adapting to change. Provide advice on how to respond flexibly and effectively to change by suggesting revisions to processes and strategies related to change.
Outcomes and Key Performance Indicators (KPIs): • Set KPIs, manage the progress of the	• Process Improvement: Through identifying process improvement opportunities and helping to establish effective and efficient processes, management strategy implementation

strategy, and evaluate results. • Conduct the necessary reviews to refine and upgrade long-term strategies and business models to improve the adaptability of strategies.	will proceed smoothly and KPI achievement will improve. • Improving the Reliability of Information: Improve the reliability of information through the assessment of internal controls to ensure the accuracy of financial and non-financial processes and reporting. • Provide Insight: Provide insight on outcomes and KPIs to provide insight on trends and drivers of performance and identify opportunities for improvement by providing information to the Board of Directors, Audit Bodies, and management to assess the health and effectiveness of the business. • Decision Support: Provide information to help the Board of Directors and management make effective execution strategy decisions through the evaluation of KPIs.

In theory, these contributions of internal audit could be applied to the entire value creation process. However, based on the information obtained from interviews with internal audit leaders from several companies, we unfortunately did not find any cases where internal audit was directly involved in the value creation process of the purpose and materiality or long-term strategies. However, we did identify a number of instances where internal audit does contribute during the execution strategy phase.

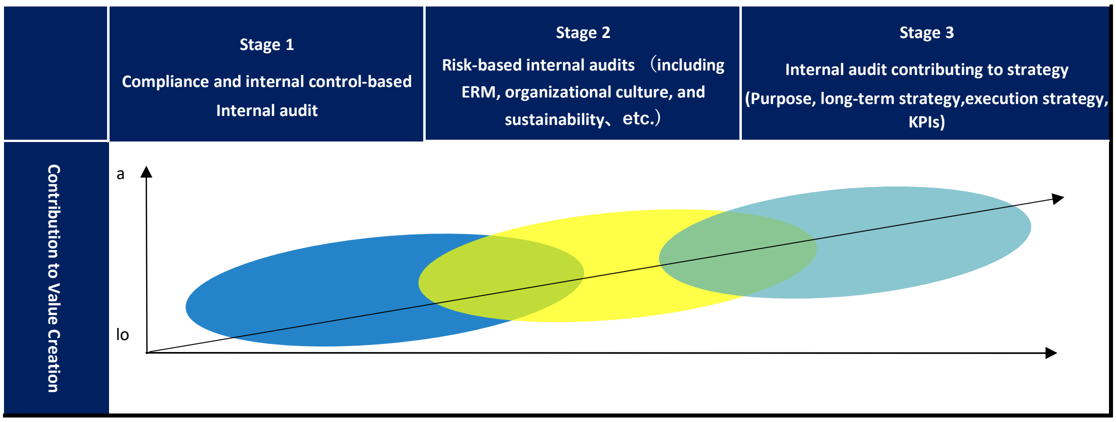
Given this reality, **a practical way to further stage internal audit toward value creation is to actively integrate the internal audit function into the execution strategy phase**. This allows internal audit to play an important role in the strategy execution process, identifying and assessing risks and revenue opportunities in line with the company's vision and purpose. This step would also be an entry point for internal audit to become actively involved in the value creation purpose and materiality and long-term strategy as well.

3.4. Elevating Internal Auditing towards Value Creation

Although most internal audits today focus on compliance, we must admit that a significant gap exists in terms of internal audits contributing to the strategy of executing the value creation process. Traditionally, internal audit has focused primarily on compliance and internal controls. However, in order to keep pace with the complexity and rapid changes in today's business environment, its role needs to be reassessed and evolved to a new stage.

The stage of internal audit should evolve from compliance-centered internal audit to broader risk-based internal audit, and then to internal audit contributing to strategy. Figure 2, "Stages of Internal Audit's Contribution to Value Creation," illustrates the relationship between the scope of internal audit and its contribution to value creation, as well as an image of its stage advancement.

Figure 2: Stages of Internal Audit's Contribution to Value Creation



In compliance- and internal control-centric internal audits, companies are expected to comply with laws and regulations, and internal audits help ensure this, but this alone is not enough. Internal audit has evolved to a risk-based approach, which contributes to improving and strengthening risk management processes, and more sophisticated internal audits have increased the ability to address risks related to strategy. Today, internal audit is expected to further evolve and operate closer to the value creation process. Internal audit should step up to a function that establishes values consistent with the company's vision and mission, assesses strategy-related risks, and supports the decision-making process.

In line with Figure 2, "Stages of Internal Audit's Contribution to Value Creation," the following summarizes the **focus of internal audit evolution and** recommendations **for stepping up the stage from the current**

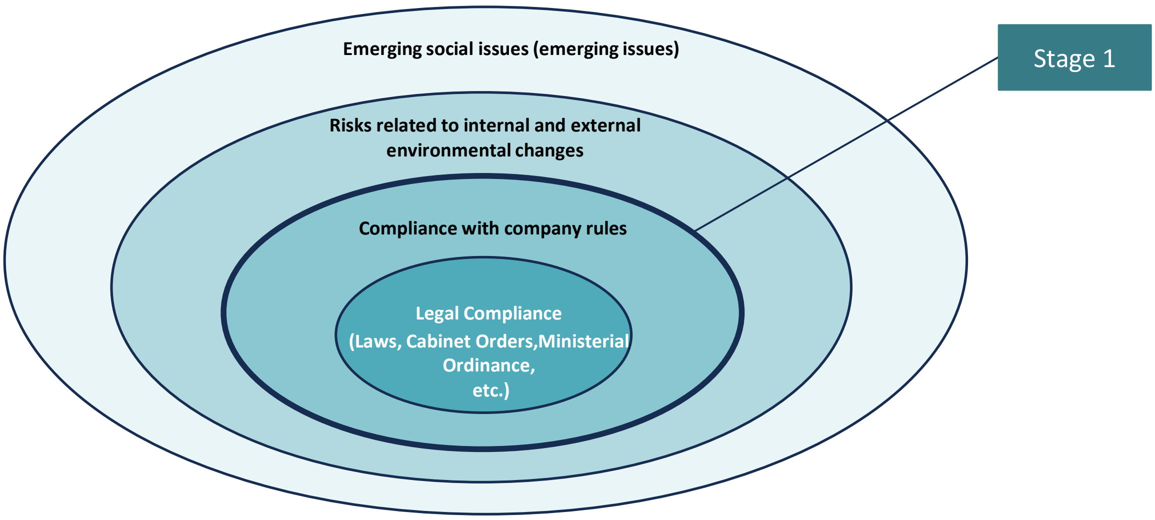
compliance-centric internal audit to a broader risk-based internal audit, and then to an internal audit that contributes to strategy.

Stage 1: Internal audit focusing on compliance and internal controls

Internal audits have focused primarily on compliance, checking internal controls and verifying compliance with laws, regulations, and internal rules. In this stage, a control-based approach is adopted and audits are conducted primarily over traditional internal controls, with priority given to ensuring compliance.

Step-up recommendation: Internal auditing should expand its focus beyond compliance to include risk management and strategy, exploring ways to contribute to value creation across the entire organization. Furthermore, the concept of "compliance" targeted by internal auditing should not be limited to the narrow scope of "legal compliance" or adherence to "internal rules" (compliance at Stage 1). As illustrated in Figure 3, "Expansion of the Concept of Compliance," compliance should be understood in a broader sense, encompassing risks related to changes in internal and external environments and, further, addressing "emerging societal issues." This broader perspective is essential for a more comprehensive approach to compliance.

Figure 3: Expansion of the concept of compliance



Stage 2: Risk-based internal audit (including ERM, organizational culture, sustainability, etc.)

During this phase, internal audit moves to a risk-based approach. It will have a "risk lens" that explores the root causes of risk through a root cause analysis. It will also have an integrated view of risk and revenue opportunities and will seek an integrated approach to evaluate not only controls, but also governance and risk management processes.

Step-up recommendation: internal audit should develop a comprehensive view of risks and revenue opportunities and the ability to adapt to rapid change.

Stage 3: Internal Audit Contributing to Strategy (Purpose, Long Term Strategy, Execution Strategy, KPIs)

During this phase, internal audit evolves into a role that actively contributes to strategy. It facilitates active involvement in the governance process and engages with the strategy in real time. In addition, they step up from execution strategy to long-term strategy, engaging in strategies to achieve the company's goals.

Step Up Recommendation: It is important that internal audit be involved in the company's strategy, strengthen governance and risk management processes, and actively contribute to value creation.

The next section of the discussion will focus on how internal audit can contribute to value creation by "internal audit contributing to strategy." By becoming more closely involved in a company's strategy, internal audit will evolve from its traditional role and strengthen governance processes and further develop risk management. This evolution confirms that internal audit can play an active role beyond compliance and risk management, involving itself in a company's strategy to achieve its long-term goals and create value.

4. Internal Auditing that Contribute to Strategy

This section first provides an overview of how global internal audit guidance and requirements are evolving with respect to their relationship to strategy. It then considers how internal audit contributes to strategy and what role it can play. In addition, with the increasing importance of sustainability management, we will discuss how sustainability audits can serve as a gateway to contributing to strategy, and how internal audit can contribute to the realization of strategy through sustainability audits and examples of how this can be done. Through these, we will discuss the role and importance that internal audit plays in a company's strategy.

4.1. Adaptation to Global Guidance

Internal audit guidance and requirements are evolving as the external environment changes and responsibilities to stakeholders are recognized. Internal audit guidance and requirements provide a framework to help companies ensure proper governance, manage risk, and create sustainable value. This section addresses the FSA's guidance on internal audit, the revised Three Lines Model, and the new Global Internal Audit Standards.

FSA Guidance on Internal Auditing

The FSA provides internal audit guidance for banks, securities firms, and other financial institutions. In June 2019, the Agency published a discussion paper, "Current Status and Challenges in Advancing Internal Auditing of Financial Institutions," which aims to help financial institutions ensure market stability and credibility through appropriate risk management and compliance with laws and regulations. The paper organizes the stages of internal audit development, and presents the changes in audit approaches and characteristics at each stage, as follows

- Ver. 1.0: Internal audits are conducted mainly for the purpose of detecting clerical defects and violations of regulations and managing sales branches, and are part of the administrative risk management from a second line perspective.

- Ver. 2.0: Taking into account changes in the internal and external environment, audits will be based on risk assessment, and audits will be added to high-risk areas and headquarters, as well as thematic audits.

- Ver. 3.0: Internal audit as a third line is emphasized as an assurance function independent of the first and second line, with emphasis on auditing on a group and global basis, proactive prevention, root cause investigation, and implications for management.

- Ver. 4.0: Positioned as an audit that moves forward with management. Introduced as an advanced case study, it looks toward the further advancement of internal audits.

Ver. 4.0 of this developmental stage of internal audit requires the internal audit department to serve as a trusted advisor. Stage 3, "Internal Audit Contributing to Strategy" (see Figure 2), shown in this research report, is positioned as similar to Ver. 4.0 in the FSA's Discussion Paper.

Revised Three Lines Model

The Three Lines of Defense Model is a framework that defines responsibilities for risk management and internal control within an organization across three lines. This model, proposed by the IIA, has been popularized as a framework for ensuring that risk management and internal control functions within an organization are appropriately divided and that an independent internal audit function functions effectively.

In 2020, the Three Lines of Defense Model was changed to the Three Lines Model, with the concept of Defense removed. This change is intended to promote a more forward-looking approach to risk management and internal controls within the organization, emphasizing that risk management is not only a defense, but also an element that supports the achievement of strategic objectives and sustainable growth. Accordingly, internal audits are now also expected to take an offensive perspective that brings value to the company, not just a defensive one.

Excerpt from Principles of the Three Lines Model of IIA

Management and first and second-line roles

Management's responsibility to achieve organizational objectives comprises both first and second-line roles. **First-line roles** are most directly aligned with the delivery of products and/or services to clients of the organization, including support functions. **Second-line roles** provide assistance with managing risk. First and second-line roles may be blended or separated. Some second-line roles may be assigned to specialists to provide complementary expertise, support, monitoring, and challenge to those with first-line roles. Second-line roles can focus on specific objectives of risk management, such as: compliance with laws, regulations, and acceptable ethical behavior; internal control; information and technology security; sustainability; and quality assurance. Alternatively, second-line roles may span a broader responsibility for risk management, such as enterprise risk management (ERM). However, responsibility for managing risk remains a part of first-line roles and within the scope of management.

Third line roles

Internal audit provides independent and objective assurance and advice on the adequacy and effectiveness of governance and risk management. It achieves this through the competent application of systematic and disciplined processes, expertise, and insight. It reports its findings to management and the governing body to promote and facilitate continuous improvement. In doing so, it may consider assurance from other internal and external providers.

Third Line Independence

Internal audit's independence from the responsibilities of management is critical to its objectivity, authority, and credibility. It is established through: accountability to the governing body; unfettered access to people, resources, and data needed to complete its work; and freedom from bias or interference in the planning and delivery of audit services.

Creating and protecting value

All roles working together collectively contribute to the creation and protection of value when they are aligned with each other and with the prioritized interests of stakeholders. Alignment of activities is achieved through communication, cooperation, and collaboration. This ensures the reliability, coherence, and transparency of information needed for risk-based decision making.

(Omitted.)

Between management (both first and second-line roles) and internal audit

Internal audit's independence from management ensures it is free from hindrance and bias in its planning and in the carrying out of its work, enjoying unfettered access to the people, resources, and information it requires. It is accountable to the governing body. However, independence does not imply isolation. There must be regular interaction between internal audit and management to ensure the work of internal audit is relevant and aligned with the strategic and operational needs of the organization. Through all of its activities, internal audit builds its knowledge and understanding of the organization, which contributes to the assurance and advice it delivers as a trusted advisor and strategic partner. There is a need for collaboration and communication across both the first and second line roles of management and internal audit to ensure there is no unnecessary duplication, overlap, or gaps.

New Global Internal Audit Standards

The Global Internal Audit Standards, published by the IIA in January 2024, define the purpose of internal audit as follows

"Internal audit enhances the ability of the organization[1] to create, preserve, and maintain value by providing independent, risk-based, and objective assurance, advice, insight, and foresight to the board of directors and management."

The internal audit is also supposed to strengthen the following matters and functions of the organizational entity

- Successful achievement of goals
- Governance, risk management and control processes
- Decision-making and supervision
- Reputation and credibility among stakeholders
- Ability to serve the public interest

The Global Internal Audit Standards provide the following linkages between internal audit and the strategies and goals of an organizational entity. They emphasize how important internal audit is not only to risk management, but also to the effective achievement of strategic goals by the organizational entity. For example, the following perspectives are presented

- As it states, "Internal audit (omitted) enhances the ability of the organization to create, preserve, and maintain value," it emphasizes the point that internal audit is essential to achieving the strategic goals of the organization, ensuring the creation and preservation of value through objective assurance.

- Reinforcing the Successful Achievement of Goals" emphasizes that internal audit plays a critical role in helping an organizational entity achieve its strategic goals by evaluating processes and controls.

- "The internal audit strategy should be adjusted whenever there is a change in the strategic objectives of the organizational entity or stakeholder expectations." and that changes in the strategic goals of the organizational entity should be reflected in the internal audit strategy.

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[1] The term "organizational entity" is used here as a concept that includes not only corporations, but also non-profit organizations, government agencies, schools, and local governments.

In addition, the Global Internal Audit Standards provide the following linkage between internal audit and the public interest.

Internal audit plays an important role in enhancing an organization's ability to serve the public interest. While the primary function of internal audit is to strengthen governance, risk management, and control processes, the benefits of internal audit extend beyond the organizational entity."

Internal audits contribute to the stability and sustainability of the organization as a whole, which in turn fosters public trust and confidence not only in the organization itself, but also in the broader system to which it belongs. The concept is reflected in the following statement.

4.2. How Internal Audit "Contributes to Strategy": The Roles It Can Play

The role of internal audit is not simply to target risks and controls, but also to provide assistance and insight to management in formulating and executing strategy. This section discusses the role that internal audit can play in contributing to strategy. There are three aspects of internal audit's "contribution to strategy"

- Providing Assurance
- Providing Advisory
- Providing Insight and Foresight

Under "Providing Assurance," internal audit assesses whether the strategic objectives of an organizational entity are being achieved and audits whether the entity is taking appropriate actions to achieve those objectives. In particular, Internal Audit considers factors that may hinder the achievement of strategic objectives as risks, and audits and provides assurance from the perspective of the design and operational effectiveness regarding whether management has identified and evaluated such risks and taken appropriate actions to control them within the scope of its risk appetite and risk tolerance.

Under "Providing Advisory," Internal Audit contributes to management's formulation and review of strategy by providing insight and expertise, as well as advice on the relevance and appropriateness of the strategy. Internal Audit contributes to the smooth execution of the strategy by providing suggestions for managing and controlling risk factors that may impede the achievement of strategic objectives during the strategy development phase.

“Providing Insight and Foresight" requires more speed and precision than ever before to respond to rapid change, and in doing so, objective insight and foresight are crucial, both in providing assurance and in providing advisory services. Evaluating and improving strategy, which is difficult to do from an external perspective alone, can be accomplished through internal audits, which have the advantage of an insider's access to information and processes within a company. Leveraging the information and knowledge gained from their insider perspective, internal audits can serve as an in-house advisor to the organization by providing the management with valuable insights based on accurate data and analysis from an objective standpoint distinct from the second line of defense. In doing so, internal auditing can play a crucial role in helping the organization adapt to changes and support decision-making aligned with its strategic direction.

In order to fulfill these roles, it is important that Internal Audit maintain its independence and work with other departments to ensure transparency. Cooperation between internal audit and other first and second line departments is essential in order to move toward common goals.

4.3. Involvement in Sustainability: Auditing Sustainability as a Gateway to Contribution to the Strategy

Sustainability has become an important issue in corporate management. Many Japanese companies have begun to actively address this issue. Because of the importance of sustainability, not only in developed countries but also in Japan, listed companies are now required to disclose sustainability information. In Europe, companies are required to obtain assurance from an external evaluator to ensure the reliability of disclosed information, and this is now being considered in Japan as well.

The International Auditing and Assurance Standards Board (IAASB) has released a proposed revision to the International Sustainability Assurance Standard (ISSA) 5000 as a standard for external assurance, which is expected to be adopted as an international framework. The proposed revision allows external assessors to use the results of audits performed by internal auditors.

By conducting audits of operational areas related to sustainability, internal audit can help identify corporate sustainability risks and opportunities and contribute to recommendations for improvement. So they can support the board of directors and management's strategy to address sustainability issues. Sustainability audits by the internal audit department can also serve the public interest in ensuring investors and other stakeholders' confidence in disclosed information.

Sustainability is closely related to strategy, as we will see in more detail in 5.2, From Risk-Based Internal Audit (Stage 2) to Internal Audit Contributing to Strategy (Stage 3). For internal audit departments struggling to contribute to strategy, sustainability audits can be a gateway to contributing to strategy. Sustainability-related disclosures are also non-financial information, and sustainability audits are significant because they allow the internal audit department to play a greater role in auditing non-financial information.

5. Transformation of Internal Auditing (How can we change?)

5.1. From Compliance and Internal Control-Focused Internal Auditing (Stage 1) to Risk-Based Internal Auditing (Stage 2)

For internal audits to advance from compliance and internal control-focused audits (Stage 1) to risk-based internal audits (Stage 2) that encompass ERM (Enterprise Risk Management) and organizational culture, it is essential for internal audits not only to verify whether risks are managed through internal controls based on laws, regulations, and internal policies but also to understand and assess risks related to business strategy.

Below are recommendations for transforming internal audits into risk-based internal audits (Stage 2):

① Have a mindset to improve corporate value

For internal audits to fulfill their role, they need to go one step beyond traditional compliance checks (formal compliance checks to regulations) and develop a mindset of proactive corporate value enhancement.

It is essential that internal audits identify problems and risks within the organization at an early stage and provide management with suggestions for improvement, so that management can take steps to improve the efficiency and effectiveness of the enterprise. It is necessary to ensure the accuracy of data collected from the field and to strengthen internal controls based on this data. Insight (deep insight) that contributes to management through both value creation and risk management perspectives is important. The contribution to corporate management comes from an internal audit mindset that focuses on value creation.

② Focus on risk in control evaluation (risk lens)

While traditional internal audits have been limited to assessing the adequacy of processes and controls related to specific operations, it is necessary to delve deeper into how those controls address risk and reduce or minimize risk. It is important to understand the close relationship between risk and controls by assessing not just how well controls are in place, but how they address risk and support business objectives. In other words, have a risk lens.

A risk lens is a perspective for identifying, assessing, and managing potential risks. By using a risk lens, events are not viewed merely as superficial, but risks that lie within them can be found. Internal audits need to ensure that governance, ERM (enterprise-wide risk management), and internal control processes are working in an integrated manner to address risks. It is important not merely to check whether risks are controlled by internal controls alone, but also to evaluate the governance and risk management processes that are integrated with them.

As shown in the examples below, the internal audits of several companies confirmed that they are focused on risk.

Company A: Risk assessment is based on nine categories, with a focus on "business and strategic" risks, which contributes to improved risk management. The medium-term business strategy is monitored by the Corporate Strategy Department and committees, while internal audit confirms the adequacy of the business plan and strategy and the systems in place. As part of the strategic audit, the business strategy, objectives, risk appetite and risk tolerance are assessed, and elements related to the strategy are evaluated from the annual audit planning stage.

Company B: Conducts audits across the entire organization, helping to clarify risks and responsibilities. It adopts a risk-based approach and focuses on reporting and providing awareness to top management.

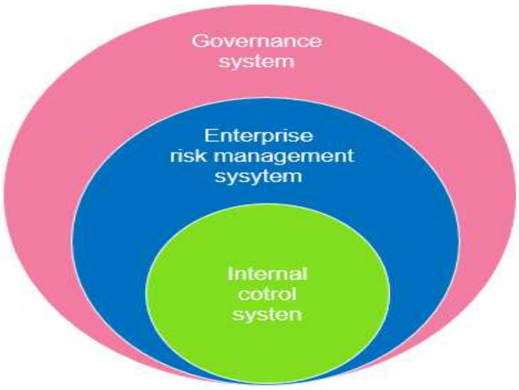
Company C: Conducts business process audits on a risk-based basis and contributes to the organization's risk management. Through risk-based reporting, the company is expanding communication with management and providing them with valuable information. Repeated semi-annual risk assessments contribute to dialogue with management and improvement of risk assessments.

③ Understanding Enterprise Risk Management (ERM)

Understanding enterprise-wide risk management (ERM) is important to assist companies and internal audit in systematic and effective risk management. erm is the process by which companies identify, assess, and manage risks and minimize or optimize them to achieve their goals. It helps companies formulate strategies based on proactive risk-taking and effectively manage risk.

When internal control deficiencies are identified and their causes are investigated, they may be traced to deficiencies in company-wide management processes, in other words, ERM deficiencies. Further investigation into the causes of ERM deficiencies may lead to the identification of governance deficiencies, such as lack of management leadership or organizational culture issues. Conversely, if governance is functioning properly, it will have a positive impact on ERM, and better ERM operations will have a positive impact on internal control. Thus, internal control, ERM, and governance are very closely interrelated and mutually influential.

COSO's internal control framework positions "internal control as part of ERM and ERM as part of the governance process," as shown in the figure below. Thus, it is important to have a big picture perspective in the evaluation of internal control based on its relationship with ERM and governance.



Understanding and incorporating ERM concepts and approaches into the internal audit process will help internal audit move from a traditional controls-based approach to a risk-based approach. In addition, by reviewing the definition of risk from the perspective of factors that may hinder the execution of strategies and introducing a risk lens, companies can more clearly identify the risks associated with their strategies and take appropriate action. Internal audit should focus its audit planning and execution on these strategy-related risks. At the same time, it is important to understand the entity's risk appetite and risk tolerance and to establish internal controls within those limits. Internal audit can then assess whether the entity's risk management is functioning properly within its scope, taking into account risk appetite and risk tolerance.

④ Pursue root causes (Root Cause Analysis)

Internal audits need to go beyond addressing the surface of problems and provide insight by going to the root causes of problems. By identifying the root causes behind problems, rather than simply addressing symptoms or phenomena, internal audit can help companies avoid similar problems in the future and find tangible directions for improving processes and strategies. Root cause analysis is critical for internal audit to provide value to the company and to fulfill its role of providing useful information and insight to the board of directors, audit bodies, and management.

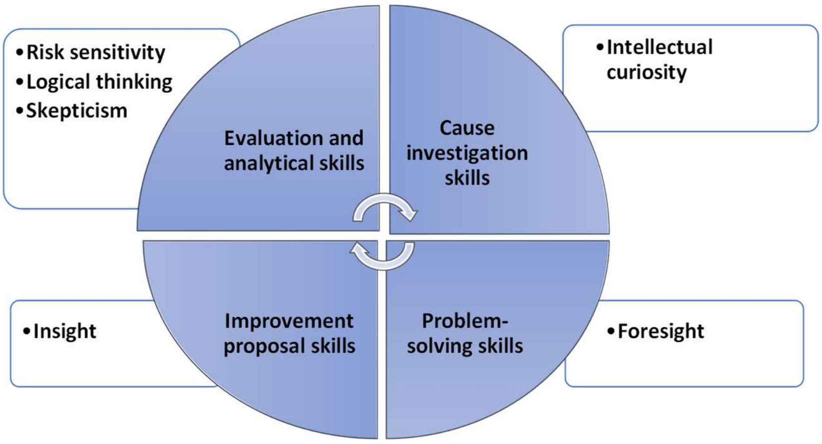
Traditionally, internal audits have evaluated internal controls from the perspective of whether they are being implemented as designed (so-called compliance audits). However, by looking for the root causes of non-implementation, it is possible to identify governance issues (e.g., management may not fully understand the severity of the risks involved, the corporate culture may be too risk tolerant, the second line may not be raising appropriate issues with the first line, etc.). The second line may not raise the appropriate issues with the first line). Repeated efforts to identify root causes will help cultivate a risk lens and facilitate the transition from Stage 1 to Stage 2 and then to Stage 3.

Company B: Exploring the root causes of risk management issues. When we get to the bottom of the "why-why," we find that it becomes a matter of resource allocation and culture. Issues such as resource allocation are discussed in the audit committee.

⑤ Reinforce the skills required for internal audits

For internal audit to proactively contribute to risk management and management, four skills are required: evaluation and analysis, root cause investigation, problem solving, and improvement proposals (Figure 4). By honing these skills, internal audit can provide useful information and recommendations to the board of directors, audit bodies, and management, leading to internal audit contributing to sustainable growth and value creation. To hone these skills, the internal audit team needs to improve itself through training and practical experience.

Figure 4: Skills required to stage internal auditors



Evaluation and analytical skills	Risk Sensitivity: The ability to accurately identify risks and accurately assess their significance and impact. Logical Thinking: The ability to analyze issues logically and objectively based on evidence and information and to make appropriate decisions. Skepticism: an attitude of questioning superficial information and explanations and exploring the depths.
Cause investigation skills	Intellectual curiosity: the willingness and ability to proactively gather and analyze information to determine the root causes of phenomena and problems.
problem-solving skills	Foresight: The ability to propose appropriate remedial and preventive measures for current issues and future risks.
Improvement proposal skills	Insight: The ability to see the essence of a problem, understand a situation comprehensively, and find an appropriate solution.

In addition to the above skills, "communication skills" and "business acumen" (Business Acumen[2]) are fundamental skills that are important for internal auditors to contribute toward the overall success of the organization.

Internal auditors must be able to organize information and data and communicate it as a story in a clear and understandable manner. Communication skills are demonstrated in the aspect of communicating audit results to various stakeholders (e.g., board of directors, audit bodies, and management, employees, investors, etc.) in an easy-to-understand manner. Communication skills are also essential for effective communication to build and strengthen trust between the internal audit department and other departments. Not only does it create a cooperative atmosphere for joint problem solving, but it also contributes to the internal audit team being perceived as a trusted entity by the organization as a whole.

Business acumen enables internal auditors to accurately understand their business model and industry trends, as well as the organization's overall goals and strategies and how they align with risk management. Business acumen also translates into the internal auditor's ability to properly assess risk at the organization-wide and individual project level, make appropriate remediation recommendations, and provide useful insight and advice to management's decision-making.

5.2. From Risk-Based Internal Auditing (Stage 2) to Internal Auditing contributing to Strategy (Stage 3)

In the phase from risk-based internal audit (Stage 2) to internal audit contributing to strategy (Stage 3), internal audit goes one step beyond contributing to risk management and plays a role in helping the company achieve its strategic goals. While this may seem like a high hurdle for many internal audit departments, it is not. The key is to keep a strategy-based perspective.

[2] In general, Business Acumen refers to the understanding and insight into business and the skills needed to run a business and make decisions. People with Business Acumen are considered to have an accurate understanding of business conditions and are able to make strategic decisions. Business Acumen is the ability to understand the business situation and make strategic decisions.

The following are recommendations for transforming **internal audit into an internal** audit **that contributes to the** Stage 3 **strategy**.

- **Cultivate the** perspective and viewpoints necessary for internal audit to contribute to strategy: understand the risk management and governance frameworks used to assess the functioning of the enterprise and cultivate the perspective and viewpoints necessary for internal audit to contribute to strategy.

- **Utilize thematic audits with a strategic perspective:** We contribute to management decision-making **through thematic audits that include** not only specific issues and business processes, but also **strategic perspectives** extracted from a company-wide, long-term perspective.

- **Provide insight**: We do not simply confirm facts or point out problems, but provide insight that includes underlying causes, future impacts, and suggestions for improvement.

- **Conduct sustainability audits:** ESG and other non-financial information also have a significant impact on corporate value assessment. We will conduct sustainability audits that incorporate a strategic perspective so that internal audit can play a role in this new area.

- **Gain the trust of the Board of Directors, Audit Bodies and management: It is** essential to be positioned as a trusted member of the Board of Directors, Board of Corporate Auditors, and management. This is achieved not only through consistent and high quality output, but also by maintaining a fair and independent position and by practicing constructive communication.

In the following, we will further examine these issues that need to be addressed in order for internal audit to transform into **an internal** audit **that contributes to the** Stage 3 **strategy**.

A) Cultivate the internal audit perspective and viewpoints necessary to contribute to the strategy

The perspective and viewpoints necessary for internal audit to contribute to strategy are developed through

① Understand the different levels of strategies and their objectives and associated risks

② Understand the underlying perspective (risk lens) from which to view strategy
③ Understand the governance that supports strategy development

These perspectives provide the foundation for internal audits to contribute to value creation.

① Understand the different levels of strategies and their objectives and associated risks

For internal audit to contribute to the value creation of a company, it is necessary to understand the different levels of strategy. The strategy levels can be organized as follows

- Values (Purpose): Defines the goals and principles that the entire organization shares and should pursue.
- Long-Term Strategy: A long-term vision for the organization as a whole and the path toward achieving it.
- Execution Strategy: Develop and implement specific work plans and project promotion policies.
- Outcomes and Key Performance Indicators (KPIs): measure specific outputs or performance resulting from strategy execution.

The first step in Internal Audit's contribution to the value creation process is involvement in the "Execution Strategy" and "Outcomes and Key Performance Indicators (KPIs)". This may lead to future involvement in the strategic level of the "long-term strategy" based on purpose.

As shown in the case studies below, internal audits of several companies were found to contribute to the strategic phase of the implementation of the value creation process.

Company A: The medium-term business strategy is monitored by the Corporate Strategy Department and committees, while internal audit checks the adequacy of the business plan and strategy and the system. As part of the strategic audit, the business strategy, objectives, and risk appetite are evaluated, and elements related to the strategy are assessed from the annual audit planning stage.

Company D: Based on the defined vision and values, the auditor checks whether the strategy of the auditee is consistent with these principles. The focus is not on the appropriateness of the auditee's

strategy, but on its consistency with the parent company's mid-term business strategy.

Company B: The company conducts audits and monitoring of key strategies in its medium-term management plan and evaluates its business strategies. The audit department continuously reviews and approves business strategies and conducts audits to check the development and operation of internal controls.

When first undertaking an audit on strategy, the first step is to focus on the "execution strategy" and the "outcomes and key performance indicators (KPIs)". At this stage, internal audit becomes deeply involved in the process of how a company embodies its strategy and achieves its KPIs. In this way, internal audit gains a deep understanding of the organization's overall functions and workflow, and contributes to improving the efficiency and effectiveness of the organization as a whole by identifying potential risks and issues and proposing improvements at an early stage. Through the accumulation of such activities, the internal auditor gradually acquires a higher level of strategic understanding and auditing skills.

② Utilize a foundational perspective (risk lens) when looking at strategies

Internal Audit should utilize a "risk lens" when evaluating against strategy. The risk lens is the foundational perspective from which to engage with the strategy. An important perspective is that the assurance that internal audit should provide is not about whether the strategy will succeed, but whether the risks that could prevent the achievement of the established strategic goals and objectives are being adequately managed. Without this perspective, involvement in the strategy process may itself be perceived as difficult.

Risks" are viewed as elements that may hinder the achievement of the objectives or goals set by a particular strategy. The internal auditor focuses on identifying risk elements that may hinder the company's strategic goals or direction and whether they are being adequately managed.

Through this risk lens, we identify risks that may impede the achievement of goals. We then verify that the methods used to address these identified risks are integrated through governance, enterprise risk management (ERM), and internal control processes. We evaluate the effectiveness from both perspectives, considering not only the design of the measures but also the status of their implementation.

Through a "risk lens," the internal auditor is responsible for taking a comprehensive look at the company's overall strategy and providing the necessary assurance information along with clear insights.

The following are examples of key points for utilizing a risk lens.

Perspectives in Internal Audit that Contribute to Strategy:

1. What is the "objective" or "goal" (goal) of the strategy?
2. Is the strategy being targeted consistent with higher-level strategies?
3. Where is the risk that the "objectives" or "goals" of the strategy will not be achieved?
4. Are all of the risks recognized by the board of directors and management? Are there any risks that have gone unrecognized?
5. Are the board and management in agreement on the extent to which they are willing to accept each risk (risk appetite and risk tolerance)?
6. To keep risk within an acceptable amount of risk,
   ① Governance (the Three Lines Model, risk committee, etc.)
   ② Risk management (e.g., monitoring risks, implementing risk mitigation measures, and verifying the effectiveness of risk management mechanisms)
   ③ How are internal controls (e.g., rules to control risks) supposed to be integrated through each process (design)? And is that design considered effective?
7. Is the designed risk management process actually implemented and effective? Is there a process in place to review whether it is working effectively under the second line?
8. If not functioning effectively, is there a mechanism to correct this? And, are these corrective actions actually being taken?
9. What are the root causes of the issues discovered up to the above?
10. Are the objectives and goals of the strategy continuously reviewed to determine whether they are appropriate at this point in time? If not, is there a mechanism to correct them?

③ Understand the governance that supports strategy development

The board of directors is responsible for the effective application of corporate governance, which establishes corporate direction and facilitates strategy formulation and implementation. This is a matter that Internal Audit should assist with to the best of its ability.

Governance emphasizes corporate values and leadership, which in turn influence the direction of the overall corporate strategy. These elements arise from the governance process itself, and understanding them is critical.

The strategy itself is also developed based on corporate governance, supported by ERM, which identifies, assesses, and manages the associated risks and thus the achievement of strategic objectives. These strategic decisions are also considered in the governance process. This process takes into account information provided by ERM, so internal auditors need to understand "how the strategy aims to increase revenues" and "how it faces the risk that it may not be feasible.

Examples of key points for understanding governance with respect to strategy:

1. Do the board of directors and management clearly set strategic objectives and goals?
2. Do the board of directors and management confirm and evaluate whether the strategy is consistent with the corporate purpose and mission?
3. Do the board and management confirm and discuss whether both risk and opportunity factors are considered in the strategy development process?
4. Do the board and management adequately discuss the likelihood of occurrence and impact of the risk that the objectives and goals of the strategy will not be achieved?
5. Do the board of directors and management adequately discuss their risk appetite and risk tolerance?
6. Do the board of directors and management make appropriate decisions regarding measures to reduce risk to the level of risk appetite and risk tolerance (e.g., internal controls in the first

line, risk management in the second line, and enterprise-wide risk management (ERM))?

7. Are the board of directors and management accurately informed in 1. through 6. above?

8. Are the board of directors and management briefed and discussed in a timely manner on the status of strategy implementation and risk management, and do they review strategies and provide guidance when necessary?

9. Do the board of directors and management provide direction for necessary risk-taking to execute the strategy?

B) Utilize theme audits that include a strategic perspective.

The use of thematic audits is an important means of incorporating a strategic perspective. Cross-departmental audits often include thematic audits that focus on themes related to corporate strategy. For example, an organization-wide, in-depth look at specific topics such as supply chain efficiency, strategies for entering new markets, or even environmental sustainability. These thematic audits often include elements that span the entire organization or multiple departments.

Through this approach, thematic audits serve as a method by which internal audit gains perspective on specific strategies. In this way, it is possible to understand and assess how each theme relates to the organization's overall strategy, and in the process, risks and opportunities are also assessed. As a result, this type of thematic audit reinforces the role of internal audit as a provider of insight and information that companies need to make decisions about their strategy. While it may be difficult to audit the strategy itself, internal audit's view of the strategy is possible by gaining this perspective on the strategy in the audit.

Company B: Internal audit, as the third line, strives to identify issues by considering the perspectives of both internal and external stakeholders and presents these issues through communication with management.

When proceeding with an audit of a topic related to strategy, it is often considered a hurdle for internal audit to make recommendations on strategy. Instead, internal audit can take the approach of presenting issues without making recommendations, tracing them back to their root causes, presenting the essence of the problem to management, and asking management to devise a solution. By taking this approach, internal audit can provide management with insights and issues that are useful to management and contribute to the company's strategic decision making. By first asking management to come up with an action plan to address the issues, the audited department is more likely to accept the plan, which can also be expected to strengthen the ownership of the audited department.

Company E: Internal Audit objectively evaluates long-term strategies and performs an advisory function to advise management rather than purely auditing. They may consult with management and provide advice as a Trusted Advisor. Proposals are decided by management based on risk appetite, and internal audit evaluates the decision in subsequent audits.

C) Provide insights (deep insights)

Internal Audit provides fact-based, cross-functional, objective insight to companies, contributing to the success of their decisions and strategies. The role of internal audit is to support the evolution and improvement of the company through information and data-driven insights. The prerequisites for gaining insight are "performing assurance work" and "ensuring independence.

Insights are gained through internal audit assurance engagements. Assurance engagements provide objective evaluation and assurance of a company's processes and information. In the process, Internal Audit analyzes data and information to gain insight into a company's operations and risk management. Specifically, through assurance engagements, Internal Audit evaluates the effectiveness of the entity's internal controls and the adequacy of risk management, and identifies issues and opportunities for improvement. Assurance engagements consisting of such assessments and assurance provide internal audit with a valuable opportunity to gain valuable insight into the overall functionality of the organization and directions for improvement.

Internal audits provide insight by evaluating a company's operations and risk management from an objective perspective while maintaining independence. This objectivity is essential for companies to move away from self-assessment and gain insight based on honest improvement and decision-making. What differentiates internal audit from the second line is its objectivity.

Ethical conduct and independence are fundamental principles of internal audit, and they are critical to ensuring the credibility and transparency of the entity. Ethical behavior means that the internal auditor complies with laws and regulations and acts fairly and morally, which leads to building trust internally and with stakeholders.

Independence is also the foundation for the internal auditor to provide objective and fair assessments, uninfluenced by pressures or biases within the organization. Internal auditors evaluate the activities of the entire organization in a fair and objective manner and report problems fairly. This not only prevents concealment and fraud, but also identifies opportunities for improvement. However, excessive emphasis on independence may lead to a curtailment of internal audit activities, so care must be taken.

Below are some examples of the types of insights that internal audits can provide.

① Provide *fact-based* insights

Internal audits are important to provide data and fact-based insight. This allows companies to make decisions based on objective information. Internal audit serves to provide solid fact-based *insight, not subjective opinion.*

Company F: The audited department is convinced through evidence-based reporting of audit results, which contributes to the recognition and resolution of problems.

Company E: The accuracy and validity of KPIs and KRIs are checked and audited to ensure that management is using accurate information. The implementation of internal controls is also subject to confirmation.

Company B: Utilizing data analysis skills, the results are deployed to the first and second lines for information sharing.

② Provide insight gained from a cross-organizational perspective

Internal Audit has the opportunity to audit across different departments and processes, and this lateral audit approach can identify linkages and challenges within the organization and provide insight into the organization as a whole. It *connects* disparate information and data to provide new perspectives and insights. Internal audit provides a holistic understanding of information across the organization and uses hypothesis-setting capabilities to support strategic decision making. By going beyond simply collecting data and identifying issues, internal audit can provide more operational insight and value to the organization through the use of hypothesis-setting capabilities.

Insights *gained from a* cross-sectional perspective can be more valuable than when looking at only a single department or process.

Company F: Publicizing results through analysis of good practices and initiatives and providing reference information to other departments. The audit scope has been shifted to value-added improvement.

③ Provide insight through root cause investigation (root cause analysis)

Internal audits provide insight by going after the root causes of problems, rather than merely addressing them superficially. Internal audits identify specific problems or risks, which are often superficial events that may themselves be signs of a larger problem. By focusing on understanding and resolving the root causes of problems, internal audits provide insight that informs management, allowing companies to work toward sustainable solutions to problems.

Company B: Exploring the root causes of risk management issues. When you get down to the "why-why", it becomes a question of resource allocation and culture.

④ Provide a foresight (forward looking) perspective

Internal audits provide not only historical data analysis, but also a forward-looking perspective - the so-called "forward looking" perspective. This informs companies with information that is critical for forecasting risks and identifying and identifying new opportunities. Companies must of course correct past problems, but they must also consider measures for future growth and sustainability.

The ability to set hypotheses (imagination) is essential to this forward looking perspective. This ability requires the ability to anticipate future risks and challenges and effectively prepare for them.

The role of internal audit is to understand not only the events that exist today, but also the risks that may occur in the future, and then to provide the company with the tools to strategically address them.

In addition, the ability to set hypotheses enables us to predict corporate challenges and potential opportunities. It also enables them to propose appropriate countermeasures and actions. In short, the ability to formulate hypotheses is essential for internal auditors to proactively provide positive and useful advice to management for the organization as a whole.

D) Conduct a sustainability audit

As described in Section 4.3, "Sustainability Involvement: Auditing Sustainability as a Gateway to Contribution to Strategy," internal audit's involvement in sustainability plays an important role in itself in providing value to strategy. At the same time, it is an opportunity to open the door to new approaches for internal audit departments that are experiencing difficulties in engaging with strategy.

Sustainability audits conducted by internal audit can play a pivotal role in supporting and encouraging proactive sustainability initiatives within the board of directors, audit bodies, and management. At the same time, as the demand for assurance on sustainability information continues to grow, challenges such as a shortage of external assurance providers and potentially high associated costs are becoming apparent. In this context, it is critical to advocate for the use of internal audit results by external evaluators within the IAASB's international framework, thereby paving the way for internal audit departments to engage more deeply in sustainability efforts. Establishing such involvement is an urgent priority. To utilize internal audit results in external evaluations, external assurance providers must assess various aspects of the internal audit function, including its organizational positioning to ensure objectivity, the adequacy of its policies and procedures, and its capabilities. This also presents a valuable opportunity to strengthen the internal audit department's framework, such as by aligning with the new "Global Internal Audit Standards" issued by the IIA.

So how should the internal audit department approach the audit of sustainability efforts and sustainability information? In a sustainability audit, what should be audited depends on the information disclosed about the company's sustainability efforts.

Information to be disclosed is,

① What are the goals of the activity being disclosed and how well the goals are being achieved (KPIs and their performance)
② How will you achieve your goals (strategy)?
③ Why the activity or goal was selected as important (materiality)

The three phases are usually the same. For each of these dimensions, the audit target will be different.

According to the approach of "traditional ESG investing," which focuses on minimizing the negative environmental and social impact of the activities being disclosed, and "evolved ESG investing," which aims to maximize the positive impact (this perspective has begun to be emphasized in the European CSRD), The level of strategy to be audited (see 5.2 "From risk-based internal audit (stage 2) to internal audit contributing to strategy (stage 3)") varies. In the former case, the main focus is on the strategy to achieve the KPIs, while in the latter, the focus is on the long-term strategy and execution strategy (i.e., the value creation story). This reflects the difference that in the former, the main response is to improve operations, while in the latter, the main response is to develop the core business.

It is important to note that no matter what the nature or type of disclosure, the "strategy" in (2) above, "how to achieve the goals," is the subject of the audit.

With the trend toward the demand for assurance of sustainability information, it is expected that strategy audits will become an important element of such assurance. Considering the clear advantage of internal auditors as insiders who have access to information and processes within a company compared to external assessors in auditing strategy, sustainability audits by the internal audit department can contribute greatly to a company's sustainability activities. In addition, since the consistency with the internal decision-making process, governance system, and purpose regarding sustainability initiatives is an important point for the "materiality identification process and reasons for identifying materiality" in (3) above, "Why were the activities and goals selected as important? This is an area of audit where internal auditors have an advantage.

Furthermore, in the "KPI and its performance" section (1) above, "What are the goals of the activities subject to disclosure and how are the goals being achieved?", data management (governance and control of the entire process of collecting, processing, and analyzing data, etc.), which is the basis for the accuracy of performance data, and KPI's The validity of KPIs (e.g., whether the KPIs appropriately reflect the goals) is an area of audit coverage in which internal auditors have a certain advantage.

The table below summarizes these various points, and you can see that the internal audit department has a wide range of areas to audit.

Disclosure information on sustainability initiatives and primary audit objectives (examples)

Nature and type of sustainability information	What are the goals of the activity subject to disclosure and how well are the goals being met? (KPIs and their performance)	How to achieve your goals? (Strategy)	Why did you select that activity or goal as important? (Materiality)
Corporate efforts to minimize negative environmental and social impacts (traditional ESG investment approach: primarily operational improvements)	【KPIs and their performance (e.g., CO2 emissions and annual reduction results)】 -Accuracy and completeness of KPIs and their performance data itself -Data management (e.g., governance and controles for the entire process of collecting, processing, and analyzing data) -Relevance of KPIs (do the KPIs appropriately reflect the goals, is the linkage between outputs and outcomes reasonable, etc.) -Compliance with disclosure regulations and other laws and regulations	【Strategies on how to achieve the KPIs】 -Are the factors (risks) that may hinder the achievement of the strategy adequately managed (design effectiveness), and are they adequately managed in practice (implementation effectiveness)? (Perspectives from a risk lens)	【Proess of identifing materiality and reasons for it】 -Adequacy of the process for setting specific criteria (e.g., alignment with the purpose) -Adequacy of governance for specific processes
Corporate efforts to maximize positive environmental and social impact (evolved ESG investment approach: developed primarily through core business)	【KPIs and their performance (e.g., manufacture, sale, and provision of health promotion equipment and services)】 -The audit scope is the same as above. -KPIs indicate the performance of the core business, such as productionvolume (output) or the environmental and social impact (outcome). When shown in terms of outcomes, the rational link to outputs is more strongly questioned.	【Long-term strategy and execution strategy to achieve the targeted business = value creation story】 -The difference is that factors (risks) that may hinder the achievement of the long-term strategy or implementation strategy are targeted but the same perspective (risk lens perspective) is applied as above.	【Process of identifying materiality and reasons for it】 The audit scope is the same as above.
Comparative Advantage of Internal Audit Function over External Evaluators	Advantages in data management, Relevance of KPIs, etc.	Advantageous	Advantageous

Interviews with heads of corporate internal audit departments have already identified examples of internal audit's contribution with respect to sustainability, so below we present the focus and examples of internal audit's involvement in sustainability.

Internal Audit in the area of Sustainability: Internal Audit focuses on sustainability and conducts audits of operational areas related to sustainability, identifying risks and opportunities related to corporate sustainability and making recommendations for improvement.

Company G: "Sustainable Procurement Audit" was conducted. The audit topic was taken up because of the high risk of the sustainable procurement management system. Company A: The company is auditing public commitments related to ESG and focusing on the execution of strategies related to sustainability promotion. The company also has a governance structure in place to audit ESG-related activities and compliance with public commitments. Company F: Conducted an audit on sustainability strategy. Thematic audits include confirmation of human capital and SDGs, and recommendations are being made. The audit also checks for issues, risks, and gaps related to the development of the system and the implementation of the strategy.

Ensuring Accurate Data: Accurate data is essential for sustainability assessment. Internal audits play a role in ensuring data collection methods and data accuracy to provide reliable information to support accurate assessments and strategic decisions.

Company E: Internal Audit uses two approaches, Core Assurance and Specialized Assurance, to verify the accuracy and validity of KPIs and KRIs and to audit whether management is using the correct information.

Internal Controls over Sustainability Information Disclosure: Since sustainability information is disclosed externally and affects the credibility and reputation of a company, it is important to have appropriate disclosure controls and internal controls over data management to ensure the reliability and accuracy of the information. Internal audit assists in designing and establishing internal controls to ensure the reliability and accuracy of information.

Company B: The company has ESG as a major verification theme and conducts ongoing audits and monitoring, with climate change response as a particularly important issue. The focus is on governance aspects, and the company is auditing whether it is leading to accurate numbers and disclosures on ESG.

Involvement in anticipation of external assurance **in international standards:** External assurance of sustainability information is expected to be conducted in accordance with international standards. Internal audit can be actively involved in this, verifying the reliability and accuracy of sustainability information, providing external stakeholders with reliable information, and contributing to international recognition and credibility.

Company H: We are also working on assurance for non-financial information, and internal audit is involved in the non-financial information task force to study the issue.

E) Gain the confidence of the Board of Directors, Audit Bodies, etc. and management (become a Trusted Advisor)

It is important for the internal audit department to earn the trust of the Board of Directors, a**udit bodies**, and management by building a track record of performance that meets their expectations. This requires a high level of expertise, independence, and effective communication skills. The Board of Directors, a**udit bodies**,, and management have a wide range of expectations, but the main ones are to understand the overall organization, strengthen risk management, and ensure compliance. In order to meet these expectations, the internal audit department must build a relationship of trust by providing excellent audit performance, assurance, advice and insight, and future-oriented foresight. As a result, the internal audit department can become a trusted partner. The internal audit function should use its position to provide ongoing value to the board of directors, a**udit bodies**, and management and contribute to the success of the organization as a whole.

The role of trusted advisor means that internal audit provides management with advice that helps to achieve strategic and corporate goals. **Positioning as a trusted advisor does not start at the beginning; it is important to be recognized by management as a trusted position through the following**

- Internal Audit has expertise in improving corporate governance, risk management, and control processes, and provides information and opinions that assist the Board of Directors and management in strategy formulation and decision-making.
- Internal Audit is in a position of independence and objectivity within the company, and the Board of Directors, A**udit bodies**, and

management have a high degree of confidence and trust in the results of Internal Audit.

- Reliability stems from the fact that internal audits provide fact-based assessments and opinions and objective evaluations of the entity's risks and performance.
- Internal Audit is independent of management and can objectively evaluate corporate processes and activities, and the Board of Directors, Audit bodies, and management accept advice and suggestions from Internal Audit from a neutral and objective perspective.
- Internal audit identifies corporate problems and risks at an early stage and makes recommendations for improvement to management, which can then take steps to improve the efficiency and effectiveness of the company.

Placing experienced personnel in the internal audit department and leveraging experts with deep insight into business strategy is one effective way to strengthen the internal audit function. Experienced audit advisors have often been previously involved in strategy development and execution in management positions. Their expertise and experience can be leveraged in their ability to understand and effectively evaluate complex strategies and initiatives from a management perspective. Advisors with experience in strategy planning and execution can provide useful insights for improving decision-making and risk management, and may guide improvement recommendations to better align them with long-term strategic objectives. Experienced advisors can also act as a bridge between the audit team and management, helping to ensure that audit findings are effectively communicated and understood in the broader context of corporate objectives. Their use in the internal audit function can also provide an opportunity for other team members to learn how to conduct audits from the perspective of achieving strategic objectives.

Company I:
Audit Advisor Audits: The internal audit department assigns experienced audit advisors to conduct audits from a management perspective. They conduct high quality audits and make recommendations from a strategic perspective.
Problem-solving audits: The internal audit department identifies organizational issues and brings new ideas, especially from younger employees, to help develop management leaders and solve problems.

Company J: The internal audit department responded to management changes and global business expansion by establishing several audit groups and specialized teams. The company is improving the quality of internal audits while sharing knowledge.

Company F: The focus of the audit is not on the legitimacy of the strategy, but on the adequacy of the process, communication, existence of gaps, and adequacy of the time line. Audit results are divided into findings and recommendations, and recommendations are tracked without requiring a response.

Company C:
Risk-based Reporting and Communication: Through risk-based reporting, we are expanding communication with management and providing them with valuable information.
Repeated and improved risk assessments: Semi-annual risk assessments are repeated, contributing to dialogue with management and improved risk assessments.
Improving the value of reporting: Efforts are being made to communicate audit results in an easy-to-understand manner so that management perceives the reports as valuable.

Company G: The adequacy and effectiveness of governance, risk management, and internal controls are verified through exchanges of opinions with each headquarters section and audits by basic function.

Company A: Expectations and advice to top management: In response to instructions from top management, the internal audit department provides advice and works on risk management upgrading programs, etc.

6. Recommendations for the use of Internal Auditing by the Board of Directors, Audit bodies, and Management

6.1. Why should the Board of Directors, Audit Bodies, and Management consider Internal Auditing important?

The board of directors, **audit bodies**, and management need to review the business model and strengthen the risk management system of the entire organization to enhance the value of the company in the rapidly changing business environment. In doing so, they need to recognize the importance of internal auditing. In addition, the Corporate Governance Code, disclosure requirements in securities reports, application of the Global Internal Audit Standards, and international sustainability reporting requirements position internal audit as an important tool that contributes to improving corporate value, and requires the board of directors, audit bodies, and management to utilize and be transparent about internal audit from various aspects.

A) Requests to increase corporate value based on corporate purposes

The board of directors, audit bodies, and other members of management recognize the importance of a value creation story based on corporate purpose and the need to create a sustainable business model to support this story. In this business model, risk appetite is set to maintain a balance between revenue opportunities and risks. It also entails the responsibility to monitor and strengthen the effectiveness of the three-line structure under an effective governance structure to ensure the sustainability of the business model. The board of directors, audit bodies, and management must fully understand the role of internal audit in contributing to and preventing damage to corporate value, and recognize that it is also their important responsibility to work to establish an effective internal audit system.

In light of the rapidly changing internal and external environment, including digitization and transformations to ensure sustainability, the board of directors and management need to review the business model and strategy. Failure to do so could lead to a loss of sustainability in the business model or even risk corporate bankruptcy. In addition, since the review of the business model affects the risk profile of the company, the corresponding risk management system (second line) should also be reviewed at the same time. While risks that manifest themselves in financial terms (e.g., investment management gains and losses, liquidity, etc.) are of course important, it is also important to focus on non-financial risks and risks related to strategy.

However, the board of directors, audit bodies, and management may have a lower level of interest in non-financial risks, and there may not always be a strong understanding of the importance of using internal auditing to assess the effectiveness of a new risk management system. In a rapidly changing business environment, it is important for the board of Directors, audit Bodies, and management to improve and strengthen the second-line risk management system and the third-line internal audit system in an integrated manner at the same time as they review the business model. The market environment and customer needs are constantly changing, and business models must be regularly reviewed in light of these changes to ensure adaptability. Risk management systems must also evolve in response to changes in the business environment. Identifying new risks and developing countermeasures to address them will help sustain and grow the business. Internal audit systems should also be reevaluated and redesigned in response to changes in the business environment and risk profile. This will help to ensure that all business activities are conducted properly and efficiently.

B) Requirements of the Revised Corporate Governance Code

The Revised Corporate Governance Code, published by the Tokyo Stock Exchange in June 2021, presents the following new requirements for corporate boards of directors and emphasizes the role of each company's board of directors in establishing an internal company-wide risk management system and monitoring its operation. Of particular importance is the recommendation to "utilize an internal audit department. The internal audit department is required to have a reporting line (dual reporting line) that provides information not only to management but also to external independent bodies such as the board of directors and independent committees. Internal audit is positioned as a proactive tool to support and strengthen corporate governance and is expected to be operational and effective in its use.

- The board of directors should supervise the timely and accurate disclosure of information, as well as the appropriate internal control and risk management systems. (Principle 4-3. Roles and Responsibilities of the Board of Directors)

- The development of internal controls and proactive corporate-wide risk management systems can ensure appropriate compliance and support risk-taking, and the board of directors should appropriately establish these systems, including for the entire group, and supervise their operation while utilizing the internal audit department. (Supplementary Principle 4-3 ④)

- Listed companies should ensure cooperation between the internal audit division and directors and audit & supervisory board members by, for example, establishing a system whereby the internal audit division can report directly to the board of directors and audit & supervisory board in an appropriate manner in order for the board of directors and audit & supervisory board to fulfill their functions. In addition, listed companies should devise ways to provide outside directors and outside audit & supervisory board members with the necessary information in an appropriate manner, for example, by appointing a person to liaise and coordinate with the company so that the company's information can be appropriately provided under the direction of outside directors and outside audit & supervisory board members. (Supplementary Principle 4-13 ③)

C) Request for disclosure of "Status of Internal Audit" in Annual Securities Report and proactive disclosure on website and Integrated Report

As mentioned above, the "Revised Corporate Governance Code" requires that a company's board of directors establish a company-wide risk management system and supervise its operation using the internal audit department. In addition, a new reporting requirement has been added beginning with securities reports for the fiscal year ending March 31, 2023, and "dual reporting lines" (internal audit has a chain of command of both the board of directors and management) have been specified in the disclosure guidance regarding internal audit reporting lines. In the "Status of Auditing" section of the "Status of Corporate Governance" section, disclosure is now required regarding efforts to ensure the effectiveness of internal audits (including the existence of dual reporting lines that report directly to the board of directors and the audit & supervisory board as well as the Representative Director).

In the "Good Practices for Disclosure of Narrative Information" published by the Financial Services Agency, investors and analysts recognize the "state of auditing" as an important item from the perspective of corporate risk management. They point out that disclosures on the establishment and operation of a "dual reporting line" are useful for understanding how companies address risks.

Investors and analysts have recognized that "dual reporting lines" are one way to strengthen corporate governance, and companies are increasingly proactively disclosing information on the status of internal audits not only in securities reports but also on their websites and in integrated reports.

Here are examples that provide detailed disclosures on the use of internal audits, such as those conducted by the board of directors and audit bodies, as well as the state of internal audits that involve collaboration with management and the second line.

Example of Disclosure by SoftBank Corp.

[Excerpt from the Annual Securities Report for the Fiscal Year Ended March 2023]

(omitted)

D) New "Global Internal Audit Standards" requested by the IIA (Institute of Internal Auditors)

In January 2024, the Institute of Internal Auditors (IIA) published the Global Internal Audit Standards as a comprehensive guide for internal audit engagements worldwide. The Global Internal Audit Standards consist of five domains and 15 principles.

Domain III of the Global Internal Audit Standards addresses "Governance of the Internal Audit Function" and includes the principles of "Board Approval," "Independent Status," and "Board Oversight," detailing the governance elements for effectively positioning and operating the internal audit function within an organization.

The board of directors, audit bodies, and executive management of companies aiming for global standards in management and governance are expected to understand and implement the following points requested by the new Global Internal Audit Standards under Domain III, directed at boards of directors and chief executives.

- Purpose and Responsibilities of the Internal Audit Department: In order for the internal audit department to function effectively, it is important to understand and recognize its purpose and responsibilities. Understand how internal audit works to strengthen a company's governance, risk management, and control processes.

- Internal Audit Independence: The internal audit department needs to remain objective in the eyes of the company as a whole. To ensure that Internal Audit is able to provide assurance and advice in a fair and objective manner, the Head of Internal Audit should have a direct reporting channel to the Board of Directors.
- Role of the board of directors and management: The board of directors and management should be involved in approving budgets, evaluating performance, and appointing the head of the internal audit function, which directly affect the success of the internal audit function.
- Mutual Collaboration: To implement a consistent risk management strategy across the organization and to prevent duplication and gaps, the Internal Audit Director should collaborate and cooperate with other internal and external assurance service providers.

E) Design and operational expectations of the organizational structure of the Three Lines Model (integrated design of first, second, and third lines)

The design and operation of the Three Lines Model organizational structure are critical elements in corporate governance and risk management. This model is recognized globally as a best practice that strengthens risk management and governance within organizations and supports the long-term success and sustainability of companies. The role of each of these factors when considering the design of the Three lines Model organizational structure is reiterated below. An explanation of the relationship between the second and third lines is also provided below.

Excerpt from Principles of the Three Lines Model (cited again)

Management and first and second-line roles

Management's responsibility to achieve organizational objectives comprises both first and second-line roles. **First-line roles** are most directly aligned with the delivery of products and/or services to clients of the organization, including support functions. **Second-line roles** provide assistance with managing risk.

First and second-line roles may be blended or separated. Some second-line roles may be assigned to specialists to provide complementary expertise, support, monitoring, and challenge to those with first-line roles. Second-line roles can focus on specific objectives of risk management, such as: compliance with laws, regulations, and acceptable ethical behavior; internal control; information and technology security; sustainability; and quality assurance. Alternatively, second-line roles may span a broader responsibility for risk management, such as enterprise risk management (ERM). However, responsibility for managing risk remains a part of first-line roles and within the scope of management.

Third line roles

Internal audit provides independent and objective assurance and advice on the adequacy and effectiveness of governance and risk management. It achieves this through the competent application of systematic and disciplined processes, expertise, and insight. It reports its findings to management and the governing body to promote and facilitate continuous improvement. In doing so, it may consider assurance from other internal and external providers.

(Omitted.)

Relationship between the second and third lines

Second-line roles may include monitoring, advice, guidance, testing, analyzing, and reporting on matters related to the management of risk. Insofar as these provide support and challenge to those with first-line roles and are integral to management decisions and actions, second-line roles are part of management's responsibilities and are never fully independent from management, regardless of reporting lines and accountabilities. A defining characteristic of third-line roles is independence from management. The Principles of the Three Lines Model describe the importance and nature of internal audit independence, setting internal audit apart from other functions and enabling the distinctive value of its assurance and advice. Internal audit's independence is safeguarded by not making decisions or taking actions that are part of management's responsibilities (including risk management) and by declining to provide assurance on activities for which internal audit has current, or has had recent, responsibility.

In order to properly design a three lines model organizational structure, the first, second, and third lines must be considered in an integrated manner. These three lines work together to ensure risk management and governance of the entire enterprise and support sustainable business operations. Therefore, for effective enterprise-wide risk management, it is essential that these first, second, and third lines work closely together and complement each other.

F) International Sustainability Reporting Requirements

In June 2023, the International Sustainability Standards Board (ISSB) published standards for IFRS S1, General Requirements for Sustainability-Related Financial Disclosures, and S2, Climate-Related Disclosures, to be effective in January 2024. In March 2024, the Sustainability Standards Board of Japan (SSBJ) also released a draft climate-related disclosure standard for Japanese companies, with a target date of the end of March 2025 for the release of the finalized standard. In that case, it is assumed that the standards can be applied early, starting in the fiscal year ending March 31, 2025. In sustainability, ESG "G" governance is of particular importance. Stronger governance assists in the detection and management of risks within a company, and potential problems are identified in advance. This builds trust with investor shareholders and is expected to increase the long-term value of the company.

Furthermore, as seen in 4.3 "Involvement in Sustainability: Auditing Sustainability as a Gateway to Contribution to the Strategy" and 5.2 "From

Risk-Based Internal Auditing (Stage 2) to Internal Auditing Contributing to Strategy (Stage 3)," it is becoming essential to disclose contributions to the environment (E) and society (S) as part of sustainability information, obtain assurance on this information, and gain trust in the disclosures. To ensure the credibility of such information disclosure, it is very effective to utilize the audit results of internal audits. The use of internal audits is an option that can provide significant short-term benefits to a company, considering the difficulty of securing external evaluators and the costs involved. It can also contribute to sustainability initiatives and pave the way for internal audits to contribute to strategy, thereby increasing corporate value over the long term.

6.2. Actions to be taken by the Board of Directors, Audit Bodies, and Management to enable Internal Auditing work

To enable internal audit to step up and contribute strategically, we propose the following recommendations for the Board of Directors, Audit Bodies, and Executive Management: cultivating and sharing risk awareness, enhancing understanding and support for internal audit, designing organizational structures and roles, and promoting the integrated review and collaboration of the first, second, and third lines. These efforts aim to heighten risk consciousness, embed the role of internal audit into organizational strategy, ensure effective governance, and drive risk management and growth across the organization. The Board of Directors, Audit Bodies, and Executive Management must approach the design and operation of internal audit not as someone else's responsibility but as their own. Active engagement and leadership are essential to advancing internal audit’s evolution towards contributing to the long-term success of the organization.

A) Fostering Risk Sensitivity and Sharing Risk Appetite

The Board of Directors and management need to foster risk awareness throughout the organization, establish clear and consistent risk appetites, and share these with all employees. The Board of Directors and management must promote a risk culture through leadership and demonstrate a willingness to accept and appropriately manage risk.

Risks are constantly changing. **Increasing risk sensitivity** will help the board of directors, audit bodies, and management improve their sensitivity to corporate risk and develop a proactive attitude toward risk, which will help them avoid overlooking new business opportunities and enhance competitiveness. It is also important to understand that risk does not only arise from non-compliance with laws, regulations, and internal policies, but also from the business itself. Profit-earning opportunities arise from risk-taking, and profit-earning opportunities and risk-taking are two sides of the same coin. Therefore, a balance must be struck between risk-taking and risk management, taking into account the company's circumstances, posture, capabilities, etc. In this **connection, risk appetite** is important as a concept that indicates the **degree and** extent of **risk an organization is willing to accept**.

Specifically, risk appetites are generally set by the board of directors and management and are aligned with the company's strategy and vision. The risk appetite quantitatively or qualitatively expresses how much risk a company will take and how much risk it will avoid, and serves as a guide for risk management and decision-making. **Sharing the level of risk appetite among the board of directors, audit bodies, and management** is essential for managing risk and maximizing returns. A shared understanding of risk among the board of directors, **audit bodies**, and management ensures consistent decision-making within the organization. **Attention** should be **paid not only to visible risks, but also to invisible risks and events before they become risks**.

Internal audit can assess corporate risks from an objective and independent perspective and provide the board of directors, **audit bodies**, and management with warnings of unseen risks.

B) Provide understanding and support for internal audits

As the role of internal audit is transforming within the organization, the understanding and support of the board of directors, audit bodies, and management is essential. The board of directors, audit bodies, and management need to fully understand the new role of internal audit and its role in strategy execution, understand how internal audit contributes to the achievement of strategic objectives, and properly evaluate its role. This includes educating internal audit about its changing roles and responsibilities.

In addition, for internal audit to be closely involved in strategy, the board of directors, audit bodies, and management need to support internal audit leadership and assist the internal audit team to participate in projects and initiatives within the organization related to strategy. This includes ensuring that the head of internal audit participates in the decision-making process related to the strategy and creating an environment in which internal audit insights are leveraged in the implementation of the strategy.

Company I: The transition to a company with a nominating committee triggered instructions from management to enhance proper risk management, decision-making, and internal auditing on the executive side, which has the authority to execute operations. This led to an increase in the number and quality of personnel in the internal audit department. There is a strong need to enhance the sophistication of internal auditing.

Company C: In order to broaden the internal audit department's communication with management, reports such as business losses and risks of legal violations are being taken seriously. By specializing in a risk-based approach, the internal audit department has become closer to management.

The board of directors, audit bodies, and management should consider actively using internal audit as a career path. Internal audit provides an opportunity to gain a comprehensive understanding of an organization as a whole and to develop a basic knowledge of business processes and risk management. In addition, through experience in different departments and projects, you will gain knowledge and insight into a wide range of operational areas. Internal audits are also a good opportunity to develop problem-solving and strategic thinking skills in the process of assessing risks and proposing improvements, which can be used to enhance your credibility and expertise within the organization and prepare you to advance to management or leadership positions in other departments in the future. By promoting internal audit as a career path in developing talent within the organization and identifying future executive candidates, it is expected to contribute to the sustainable growth and development of the organization.

Company A: Comment from an executive: "Internal audit is highly regarded within the company. We are creating a rotation that brings in the best people and leads to them as a path to higher positions." Company A: Comment from an executive: "The Risk Management Upgrading Program is lacking in establishing and spreading a risk culture, so I expect more cooperation from internal audit, which has a good understanding of the workplace."

C) Design appropriate organizational structure and roles/reporting lines (chain of command)

It is important for the Board of Directors and management to strengthen the governance of the organization by designing the internal audit department to ensure dual reporting lines of command to the Board of Directors and management. Clear reporting lines ensure the independence and objectivity of internal audit while providing appropriate information to the board of directors and management, thereby improving risk management and internal controls throughout the organization.

Effective governance will be ensured by strengthening cooperation between the audit bodies (audit & supervisory board, audit committee, audit & supervisory committee) and the internal audit division, and by clearly allocating their respective roles and responsibilities. Appropriate collaboration between the Board of Corporate Auditors, etc. and the internal audit division is required to exchange opinions and share information regarding audit activities, to build cooperative relationships, and to enhance the effectiveness of audit activities.

Company A: The audit implementation plan and budget are approved by the audit committee. The reporting parties are the audit committee and the Internal Control Committee.

Company H: The audit committee and the internal audit function work together to improve audit quality throughout the organization. The members of the audit committee conduct high-level management audits and monitor the entire organization from a bird's eye view while maintaining audit quality.

Company A: · Collaboration with the audit committee: The internal audit function works closely with the audit committee and contributes to strategic audit activities and risk assessment throughout the organization.

D) Promote Integrated Review and Collaboration of the First, Second, and Third Lines

The Board of Directors and Executive Management must undertake an integrated and simultaneous review of the first line and the business model to adapt to rapid changes in the operating environment, the resulting shifts in the risk profile and second line, and subsequently the third line. This comprehensive review and collaboration will enable the concurrent advancement of strategic execution and risk management, leading to sustainable outcomes that adapt to change.

In reviewing the first line and the business model, it is essential to respond sensitively to changes in the external environment and reassess the business model. Organizations must adapt to customer needs and market trends to maintain and enhance competitiveness. For the second line, the review should focus on assessing changes in the risk profile and revisiting the risk management strategy. Identifying new risks, analyzing their impact, and implementing appropriate measures ensure the organization's capacity to respond effectively to evolving risks. For the third line, the role of internal audit must be reassessed, and audit processes should be designed and executed to align with the changing business environment. By strengthening risk assessment and internal controls, the overall reliability of the organization can be ensured.

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