J-SOX Insights

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Independent Risk Consulting

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Frequently Asked Questions About J-SOX

Q1: What is J-SOX? Is it the same as the U.S. Sarbanes-Oxley Act?

"J-SOX" is an unofficial term that refers to the Japanese requirements similar to Sarbanes-Oxley Act Section 302 (management certification) and Section 404 (management evaluation and report on internal controls) in the United States. The so-called J-SOX requirements are incorporated in the legislative draft titled "Financial Instruments and Exchange Law," which covers new enactments of, and amendments to, various laws related to financial instruments and Securities and Exchange Laws.[1]

While this legislation in Japan is different from the contents of the U.S. Sarbanes-Oxley Act, the specific requirements unofficially referred to as "J-SOX" are similar in substance to the Sarbanes-Oxley Act Sections 302 and 404.

Q2: Has the J-SOX legislation already been passed? Under the legislation, when would the J-SOX requirements be effective?

The J-SOX legislation was passed as part of the "Financial Instruments and Exchange Law" on June 7, 2006. Compliance with J-SOX requirements is effective for fiscal years beginning on or after April 1, 2008. As most Japanese companies have a March 31 fiscal year-end, their first filing of a management evaluation report on internal control would be for the fiscal year ending March 31, 2009.

Q3: Which companies are subject to J-SOX requirements?

Approximately 3,800 listed Japanese companies, including their significant subsidiaries and affiliates, fall under the J-SOX mandate. "Significant subsidiaries and affiliates" is defined in the exposure draft of implementation standards. (See Q4 below.)

Q4: What does J-SOX require companies to do? Are the requirements the same as those under the U.S. Sarbanes-Oxley Act?

The Subcommittee on Internal Controls of the Business Accounting Council deliberated on the standards for the evaluation of the effectiveness of internal control over financial reporting by management and external auditors. The Subcommittee's report titled "Evaluation and Auditing Standards for Internal Control for Financial Reports" was issued on December 8, 2005, after its exposure period was closed.

Separately, on November 21, 2006, the Subcommittee issued an exposure draft with detailed practical guidelines ("Implementation Standards"), to clarify the requirements under the "Evaluation and Auditing Standards" report. Details of the "Implementation Standards Exposure Draft" are discussed further in the November 21, 2006 J-SOX Flash Report, produced by Protiviti Japan.

Both the "Evaluation and Auditing Standards for Internal Control for Financial Reports" (Draft Standards) and the "Implementation Standards Exposure Draft" are expected to be finalized in early 2007.

The "Evaluation and Auditing Standards" report describes the management's evaluation and audit of internal control over financial reporting as follows:

> **Evaluation of and Reporting on Internal Control for Financial Reports –** Management assumes the role and the responsibility to develop and operate internal controls, and is required to evaluate the effectiveness of internal control for financial reports, and report the results in the form of an internal control report to the public. In order to evaluate the effectiveness of internal controls, management must *first evaluate internal controls that have a significant and pervasive impact on the financial reports as a whole (companywide internal control)*. Management must then *evaluate the internal controls relating to specific processes*. The scope of the review of specific processes would be based on the results of the evaluation of the companywide controls.

[1] The Securities and Exchange Law is a Japanese law equivalent to the Securities Act of 1933 and Securities Exchange Act of 1934 in the United States.

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Audit of Internal Control for Financial Reports – The external auditor responsible for auditing the company's financial statements also must conduct an *audit of management's evaluation of the effectiveness of internal control for financial reports*. The objective of the audit is to determine the appropriateness of management's evaluation. The external auditor compiles the audit results in the form of an internal control audit report, and submits it to management.

The flow of management's evaluation of internal control over financial reporting and the work of the external auditor was depicted in the July 2005 exposure draft of "Evaluation and Auditing Standards for Internal Control Reported in Financial Reports."

The "Evaluation and Auditing Standards" report does not refer to terms like "documentation" or "testing;" therefore, it does not articulate specifically what needs to be done in practice. However, the evaluation framework is similar to that of the U.S. Sarbanes-Oxley Act in several respects:

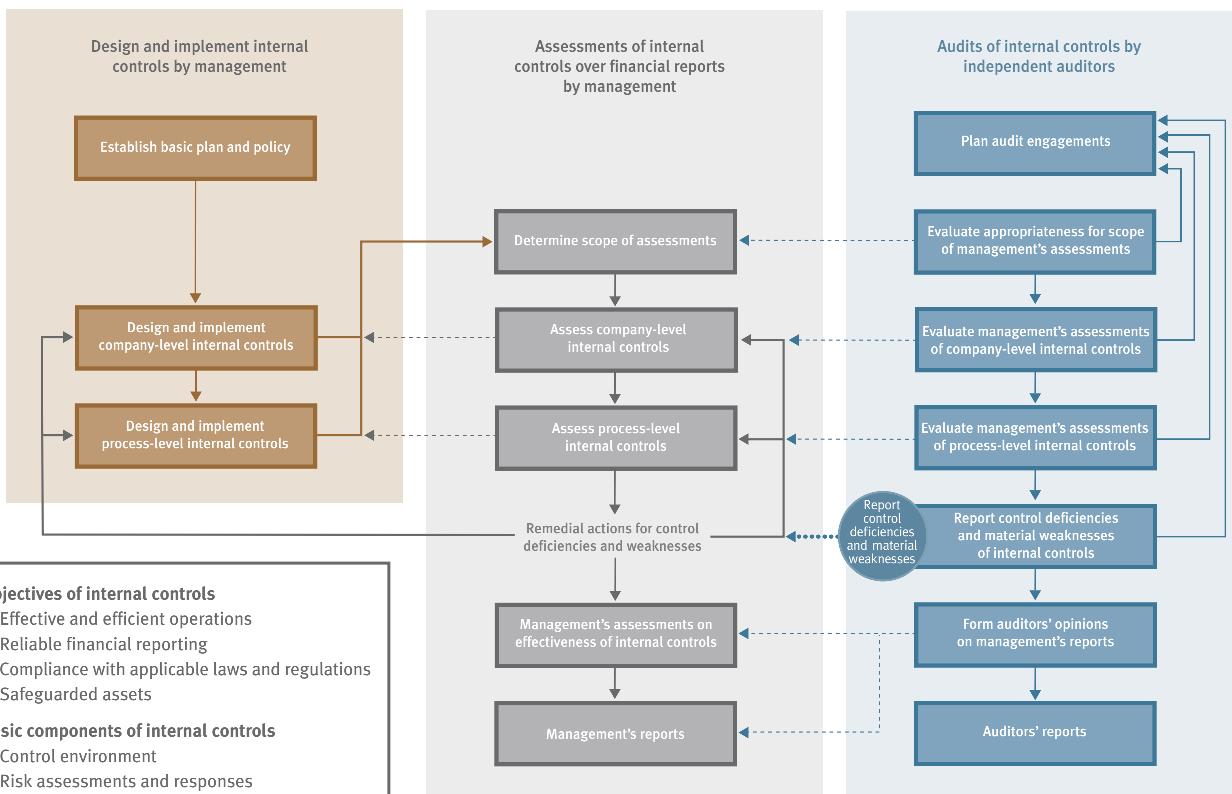
- It includes an evaluation by management based on an internal control framework.
- It includes an external audit requirement, in addition to management's evaluation.
- It is based on an approach that begins with an evaluation of companywide internal controls, followed by an assessment of process-level controls.

However, unlike Section 404 of the U.S. Sarbanes-Oxley Act, the external auditor is not required to issue an opinion on the effectiveness of internal control over financial reporting. The external auditor is required only to issue *an opinion on management's evaluation of the effectiveness of internal controls*. Therefore, while the activities around the "documentation" and "testing" by management for purposes of completing its evaluation are expected to be similar, the extent and scope of such activities is not clear at this time.

Q5: Is the scope of J-SOX limited to "internal control over financial reporting"?

Yes. The "Evaluation and Auditing Standard" report states that "internal controls aimed at ensuring the reliability of financial reports are defined as *"internal control for financial reports,"* and *"are subject to the evaluation and audit based on the draft standards."*

Management's Assessments of Internal Control Over Financial Reports and Auditors' Evaluations of Those Assessments



Objectives of internal controls
- Effective and efficient operations
- Reliable financial reporting
- Compliance with applicable laws and regulations
- Safeguarded assets

Basic components of internal controls
- Control environment
- Risk assessments and responses
- Control activities
- Information and communication
- Monitoring
- Response to IT

However, the definition of "Financial Reports" for J-SOX is expected to be larger than the scope of the Sarbanes-Oxley Act. "Financial Reports" include financial statements and footnotes, which are the focus of "internal control over financial reporting" in the United States, and certain other financial-related disclosures in public reports, such as financial highlights, status of stock issued and shareholders.

Q6: Is the J-SOX internal control framework different from the COSO framework used in the United States?

The draft standards presented in the "Evaluation and Auditing Standards for Internal Control for Financial Reports," issued on December 8, 2005, consist of three parts:

(1) Part I is the "Basic Framework of Internal Control" that describes the definition and the conceptual framework of internal control over financial reporting, which management has the role and responsibility to design and operate;

(2) Part II is the "Evaluation and Reporting of Internal Control for Financial Reports," which articulates management's approach to evaluating the effectiveness of internal control for financial reports; and

(3) Part III is the "Auditing of Internal Control for Financial Reports," which explains the approach to the standards for audits conducted by the independent accounting firm.

The "Basic Framework of Internal Control" (Part I) is discussed in the report as follows:

> "Internal control is basically a process that is carried out by all members of the company, in order to fulfill *four corporate objectives*: (1) effectiveness and efficiency of operations; (2) reliability of financial reports; (3) compliance with laws and regulations relating to business activities; and (4) *preservation of assets*.
>
> It is comprised of *six basic elements*: (1) control environment; (2) risk assessments and responses; (3) control activities; (4) information and communication; (5) monitoring; and (6) response to IT. Internal controls aimed at ensuring the reliability of financial reports are defined as *"internal control for financial reports,"* and *"are subject to the evaluation and audit based on the draft standards."*

While the Basic Framework of Internal Control under J-SOX is similar to the COSO framework in its objectives and elements, "preservation of assets" also is added as an objective (which is similar to the addition by COSO of "safeguarding of assets" in its addendum to its internal control framework), and "IT support" is added as an internal control element to reflect the importance of the IT environment to effective internal control.

Q7: When should Japanese companies start preparing for J-SOX compliance?

The first filing date of management's report on internal control is proposed for fiscal years beginning on or after April 1, 2008; this requirement means the fiscal year ending March 31, 2009 for most Japanese March year-end companies. While the report filing date for these companies is a little over two and a half years from now, many large, March year-end Japanese companies are already in the process of initiating their compliance projects.

The publicity around the cost and time for U.S. companies and Japanese SEC-registered companies to implement the U.S. Sarbanes-Oxley Act requirements has gained the attention of many Japanese companies. External auditors and consultants are recommending that Japanese companies start their projects early. While the United States had the COSO framework, as well as the common practice over previous decades by external auditors of relying on selected internal controls in conjunction with the financial statement audit, these concepts are rather new to Japanese management and external auditors. Due to the language barrier and their corporate governance style, many Japanese companies have decentralized operations and allow their business units and subsidiaries to have their own operating practices and IT systems. There is also less history of internal auditing in comparison to companies in the United States. Evaluating internal controls on a consolidated basis, including overseas subsidiaries, is expected be a very new and challenging experience for many Japanese companies.

Report by the Subcommittee on Internal Controls, Business Accounting Council: "Evaluation and Auditing Standards for Internal Control Reported in Financial Reports"[1]

Recent incidents of improper disclosure are claimed to have been caused partly by the failure of internal controls to function effectively and ensure the reliability of disclosure. In the United States, the Sarbanes-Oxley Act has enforced mandatory evaluation by management and mandatory audits by certified public accountants (CPAs) with respect to internal controls for financial reports since 2004. In response to such a trend, the Subcommittee on Internal Controls of the Business Accounting Council headed by Shinji Hatta (Professor at the Graduate School of Aoyama Gakuin University) has deliberated on the standards for evaluation by the management and audits by CPAs, etc.

[1] Translated summary of the reports issued by the Subcommittee on Internal Controls, from the *FSA Newsletter*, February 2006 (http://www.fsa.go.jp/en/newsletter/2006/02a.html)

with respect to the effectiveness of internal controls for financial reports, and compiled its report titled "Evaluation and Auditing Standards for Internal Control Reported in Financial Reports," dated December 8, 2005.

The draft standards presented in the report consist of three parts: (1) "Basic Framework of Internal Control" that describes the definition and the conceptual framework of internal control itself, which management has the role and responsibility to develop and operate; (2) "Evaluation and Reporting of Internal Control for Financial Reports," which shows the approach to evaluation by management with respect to the effectiveness of internal controls for financial reports; and (3) "Auditing of Internal Controls for Financial Reports," which explains the approach to the standards of audits conducted by CPAs, etc.

1. **Basic Framework of Internal Control**
   Internal control is basically a process that is carried out by all members of the company in order to fulfill four corporate objectives: (1) effectiveness and efficiency of operations; (2) reliability of financial reports; (3) compliance with laws and regulations relating to business activities; and (4) preservation of assets. It is comprised of six basic elements: (1) control environment; (2) response to risks and evaluation; (3) control activities; (4) information and communication; (5) monitoring; and (6) IT support. Among them, internal controls aimed at ensuring the reliability of financial reports are defined as "internal controls for financial reports," and are subject to the evaluation and audit based on the draft standards.

2. **Evaluation and Report of Internal Control for Financial Reports**
   Management assumes the role and the responsibility to develop and operate internal controls, and is required to directly evaluate the effectiveness of internal controls for financial reports, and report the results to the public in the form of an internal control report. When evaluating the effectiveness of internal controls, management first must evaluate internal controls that have a material impact on the financial reports as a whole (companywide internal control), and evaluate the internal controls relating to operations based on the results.

3. **Audit of Internal Controls for Financial Reports**
   The external auditor in charge of auditing the financial statements of the company audits the evaluation of the effectiveness of internal controls for financial reports performed by the management, to determine the appropriateness of the evaluation results. The external auditor compiles the audit results in the form of an internal control audit report, and submits it to management.

The report by the Subcommittee on Internal Controls describes the modality of internationally accountable and effective standards that are consistent with the company laws of Japan. It verifies the implementation status, etc., in the United States, where the system was introduced before Japan, and incorporates measures to prevent costs, etc., from becoming excessive. This is in consideration of debates over whether or not mandatory evaluation by management and mandatory audits by external auditors, with respect to internal controls for financial reports, would be an excessive burden. Furthermore, for the draft standards presented in the said report, there have been many requests for the development of detailed practical guidelines (implementation standards) that would be applicable at the working level. Accordingly, the Subcommittee decided to conduct further studies on implementation standards, and established a working group headed by Nao Hashimoto (Professor at the Graduate School of Aoyama Gakuin University) under the Subcommittee in December 2005.

The report submitted by the First Subcommittee of the Financial System Council on December 22, 2005 recommends that evaluation by management and audits by CPAs be made mandatory, based on the report by the Subcommittee on Internal Controls, in order to ensure the appropriateness of financial reports of listed companies. It also recommends the introduction of a system that requires management to confirm the appropriateness of statements in securities reports at the same time.

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