

J - S O X F L A S H R E P O R T

Japanese Guidelines for Internal Control Reporting Finalized – Differences in Requirements Between the U.S. Sarbanes-Oxley Act and J-SOX

On February 15, 2007, the Business Accounting Council of the Financial Services Agency finalized its report on the establishment of Standards and Implementation Standards for Evaluation and Auditing of Internal Control over Financial Reporting (the Standards). They are to become the practical standards and guidelines for requirements around the preparation and submission of internal control reports by management, as stipulated in the Financial Instruments and Exchange Law (enacted in June 2006). An overview of the Standards is discussed in a separate J-SOX Flash Report, titled “Subcommittee on Internal Control of Business Accounting Council Releases an Exposure Draft of Implementation Standards” (November 21, 2006). The Standards do not differ significantly from the Exposure Draft.

The Standards require all listed companies in Japan to prepare and submit internal control reports on a consolidated basis starting from the fiscal year commencing on or after April 1, 2008. Similar to requirements under Section 404 of the U.S. Sarbanes-Oxley Act of 2002, management will evaluate the internal control over financial reporting (ICFR) of its own company, prepare reports of its conclusions, and be subject to audit by its external auditors. In the internal control reporting system in Japan, to avoid the confusion and excessive burden caused in response to the Sarbanes-Oxley Act, the Implementation Standards include the following examples of specific guidance or judgment:

- For the evaluation of process-level controls, business units that comprise two-thirds of consolidated revenue are included in scope.
- For the scope of the evaluation of process-level controls, companies should focus on processes related to book-closing and financial reporting, as well as significant processes related to the business objectives of the company. (For a typical company, this includes processes affecting sales, accounts receivable, and inventory.)
- Deficiencies detected during the internal control evaluation process should be classified as “material weaknesses” if the effect of a misstatement is greater than 5 percent of consolidated pre-tax income.

The Implementation Standards, however, also require a broader initiative than the Sarbanes-Oxley Act, as illustrated below:

- “Financial reporting” subject to evaluation shall include not only the financial statements and their footnotes, but also items that should be disclosed in other areas of Securities Reports by summarizing, excerpting, breaking down, or utilizing the amounts, quantities, and footnotes disclosed in the financial statements.
- Evaluation of certain controls at affiliates accounted for in accordance with the equity method of accounting.
- Evaluation of entity-level internal controls including book-closing and financial reporting processes at all business units.

In the future, further guidance on the Financial Instruments and Exchange Law and consideration of questions and answers for the Implementation Standards are expected.

Based on the experiences with the Sarbanes-Oxley Act during the past few years, guidance is currently being considered for the management of U.S. companies and their external auditors. This Flash Report summarizes a comparison of Sarbanes-Oxley Act and J-SOX requirements. Japanese companies have raised concerns regarding the short preparation time (preparation of internal control reports on a consolidated basis and audit by external auditors starting from the fiscal year commencing in or after April 2008) and lack of qualified resources with knowledge and experience in internal control evaluations. For Japanese companies and their main subsidiaries to build the system of internal control over financial reporting on a consolidated basis for the first time, it will be necessary to understand the intent of the Implementation Standards issued by the Business Accounting Council and respond efficiently, while learning from practices and experiences with the Sarbanes-Oxley Act (US-SOX).

Comparison of US-SOX and J-SOX (2/20/2007)

A. Structure of requirements		
	US-SOX	J-SOX
1. Governing Laws	Sarbanes-Oxley Act of 2002 (Signed by President, July 2002)	Financial Institution and Exchange Laws (Passed by Diet, June 2006)
2. Auditor Oversight	Public Company Accounting Oversight Board (PCAOB) - Oversight - Issue Audit Standards	Financial Services Agency (FSA) - Design supervisory framework for CPAs CPA & Auditing Oversight Board (CPAAOB) - Oversight of JICPA - Conduct investigation and deliberation of disciplinary actions, etc. against CPAs and audit firms FSA Business Accounting Council - Issue Audit Standards
3. Reporting Requirements under the Law	- Section 302/906 certification on periodic reports - Section 404 on internal controls - Auditor report on management's evaluation and internal controls (Proposed Revision) - Auditor report on internal controls	- Management report on accuracy of disclosures - Management report on internal controls - Auditor report on management's evaluation of internal controls
4. Guidance to Management in Effect, Proposed or Expected	Sarbanes-Oxley Act and SEC Rules (Proposed Revision) SEC Proposed Interpretive Guidance (Draft issued December 2006)	Standards for Evaluation and Auditing of Internal Control over Financial Reporting and Implementation Standards for Evaluation and Audit of Internal Control over Financial Reporting (Issued by FSA, February 2007)

A. Structure of requirements		
	US-SOX	J-SOX
5. Guidance to Auditors in Effect, Proposed or Expected	Auditing Standard No.2 (Issued by PCAOB, March 2004) (Proposed Revision) Proposed Auditing Standard No. 5 (Draft issued by PCAOB in December 2006)	Standards for Evaluation and Auditing of Internal Control over Financial Reporting and Implementation Standards for Evaluation and Audit of Internal Control over Financial Reporting (Issued by FSA, February 2007)
6. Related Regulations and Guidelines	Listing requirements issued by stock exchanges (NYSE, NASDAQ, and others)	Government and ministerial ordinances (not available at present)
7. Timing of Implementation	Phased in approach based on the company size (Management Report) FYE 11/15/2004 for Market Cap > \$75M The 7/15/2006 date for foreign filers is for those with a Market Cap > \$75M For the other companies, it is FYE 12/15/2007.	For the year beginning 4/1/2008

B. Organizations and information subject to regulations		
	US-SOX	J-SOX
1. Organizations Subjected to Rules	All public companies listed on a U.S. stock exchange	All public companies listed on a stock exchange in Japan and other companies requested by ministerial ordinance
2. Foreign Issuers	Must comply on a delayed basis	Must comply
3. Smaller Companies	Delayed compliance and reporting dates	No special provision for smaller companies
4. Type of Controls Subjected to the Rules	Disclosure Controls and Procedures (Section 302) Internal Control over Financial Reporting (Section 404)	Disclosure Controls and Procedures (Section 24-4-2) Internal Control over Financial Reporting (Section 24-4-4)

B. Organizations and information subject to regulations		
	US-SOX	J-SOX
5. Type of Information Subjected to the Rules	(Section 302) Significant Disclosures in quarterly and annual reports (Section 404) Financial statements and footnotes included in 10K, 10KSB, 20F, and 40F	(Section 24-4-2) Disclosures included in the Securities Report (Section 24-4-4) - (Consolidated) financial statements and their footnotes in the financial section of the Securities Report - Disclosures that have a significant impact on the reliability of financial statements in other sections of the Securities Report
6. Definition of Financial Statement	Consolidated statements only	Consolidated and parent company-only statements

C. Design of internal control		
	US-SOX	J-SOX
1. Internal Control Framework	- No specific framework mandated. - SEC rule views COSO as one of the recognized frameworks. - COSO framework generally adopted for U.S.-based corporations. - Equivalent foreign framework generally adopted for foreign corporations.	- An original framework ("J-SOX framework") is suggested. - J-SOX framework was developed based on COSO framework. - J-SOX framework includes an objective of "safeguarding of assets" in addition to three COSO objectives. - J-SOX framework includes an element of "Response to IT" in addition to five COSO elements.

D. Management evaluation of internal control		
	US-SOX	J-SOX
1. Suggested Overall Approach	Top-down, risk-based approach heavily influenced by Auditing Standard No. 2 (Proposed Revision) Top-down, risk-based approach	Top-down, risk-based approach

D. Management evaluation of internal control		
	US-SOX	J-SOX
2. Suggested Evaluation Steps	<p>Protiviti's Suggested Approach</p> <ol style="list-style-type: none"> 1. Select entities and business processes subject to evaluation 2. Evaluate entity-level internal control 3. Evaluate process-level internal control <ol style="list-style-type: none"> (a) Understand selected business processes (b) Identify risks and controls related to financial reporting for each process chosen (c) Evaluate effectiveness of control design (d) Evaluate effectiveness of control operation 4. Report on overall results of management's evaluation <p>(Proposed Revision)</p> <ol style="list-style-type: none"> 1. Identification of risks to reliable financial reporting and the related controls that management has implemented to address those risks 2. Evaluation of the design effectiveness of controls 3. Evaluation of the operating effectiveness of controls 4. Reporting the overall results of management's evaluation 5. Documentation at a reasonable level 	<p>Approach based on the Standards</p> <ul style="list-style-type: none"> - Determine the evaluation scope reasonably considering materiality of quantitative and qualitative impacts to the financial reporting. <p>Approach based on the Implementation Standards</p> <ol style="list-style-type: none"> 1. Evaluation of company-level internal control 2. Evaluation of process-level internal control over closing and financial reporting 3. Evaluation of process-level internal control other than closing and financial reporting processes <ol style="list-style-type: none"> (a) Select significant entities subject to evaluation (b) Identify business processes subject to evaluation (c) Evaluate the business processes subject to evaluation <ol style="list-style-type: none"> i) Understand selected business processes ii) Identify risks and controls related to financial reporting for each process chosen iii) Evaluate effectiveness of control design iv) Evaluate effectiveness of control operation (d) Report on overall results of management's evaluation

D. Management evaluation of internal control		
	US-SOX	J-SOX
3. Entity-Level Controls	<p>Use a framework</p> <p>(Proposed Revision) Entity-level controls would include:</p> <ol style="list-style-type: none"> 1. Controls related to the control environment 2. Controls over management override 3. Company's risk assessment process 4. Centralized processing and controls 5. Controls to monitor results of operations 6. Controls to monitor other controls 7. Controls over period-end financial reporting process 8. Policies that address significant business control and risk management practices 	<p>Use the framework as described in the Standard, which includes the following six elements:</p> <ol style="list-style-type: none"> 1. Control environment 2. Risk assessment 3. Control activities 4. Information and communication 5. Monitoring 6. Response to IT <p>List of 42 questions is included as an example.</p> <p>The list of questions is similar to the matrix in COSO – Guidance for Smaller Companies.</p>
4. Evaluation of Process-Level Internal Control Over Closing and Financial Reporting	For selected entities only	<p>Controls are divided into 1) company-level controls and 2) process-level controls.</p> <p>In principle, the company-level controls should be evaluated at all business units.</p>
5. Evaluation of Process-Level Internal Control Other Than Closing and Financial Reporting Processes (a) Selection of Financial Reporting Elements	<p>Quantitative approach based upon materiality, with qualitative factors considered to include additional accounts</p> <p>(Proposed Revision) Risk-based approach focused on reasonable possibility of a material misstatement</p>	<p>Standards</p> <ul style="list-style-type: none"> - Accounts are determined based on both quantitative and qualitative factors. <p>Implementation Standards</p> <ul style="list-style-type: none"> - Accounts that have a significant relationship with the primary objectives of the business. - In principle, sales, accounts receivable and inventories are listed as examples of such accounts for typical companies.

D. Management evaluation of internal control		
	US-SOX	J-SOX
5(b) Selection of Entities	<p>Provide for substantial coverage of the organization.</p> <p>Generally 65% to 80% of operations and financial position.</p> <p>(Proposed Revision) Selection based upon risk</p>	<p>2/3 coverage based on revenue is suggested as an example.</p>
5(c) Non-Consolidated Entities	<p>Evaluation of internal controls for the proper reporting of the equity method of accounting at the company.</p> <p>Evaluation ordinarily would not extend to controls at the equity method affiliate.</p>	<p>Certain affiliates subject to equity method should be included.</p>
5(d) Selection of Business Processes	<p>All processes that impact financial reporting elements in scope</p> <p>(Proposed Revision) Risk-based identification of controls that address the risk of a material misstatement</p>	<p>Approach based on the Implementation Standards</p> <ol style="list-style-type: none"> 1) Identify process that affects accounts that have a significant relationship with the primary objectives of the business on significant entities subject to evaluation 2) Add significant business processes to evaluate 3) Consider result of evaluation of company-level internal control <p>In the case of typical companies, in principle, all processes that affect sales, accounts receivable, and inventory accounts should be selected for evaluation. Other higher risk business processes and processes that affect significant accounts that involve management estimates and judgment must be evaluated.</p>
5(e) Outsourced Processes	<p>Certain outsource providers included</p>	<p>Same</p>

D. Management evaluation of internal control		
	US-SOX	J-SOX
5(f) Evaluation of IT Controls	No specific guidance (Proposed Revision) Relevant application and general IT controls based upon risk-based approach	The following controls should be evaluated: (1) IT general controls (2) IT application controls
5(g) IT General Controls	No specific guidance (Proposed Revision) Consider: (1) Program development (2) Program change (3) Computer operations (4) Access to programs and data	Consider: (1) Management of development and maintenance of system (2) System operation and management (3) System security management, such as access controls (4) Contract management related to service organizations
6. Consideration for Smaller Companies	None (Proposed Revision) Less formal internal control and testing process is acceptable for smaller companies under certain circumstances	Not specifically mentioned; however, the Report states considerations should be given to special circumstances, including compensating controls to segregation of duties and use of specialists.
7. Use of Prior Period Results	Not relied upon (Proposed Revision) Can be relied upon depending on risk	May use the result of the prior period for automated controls in certain cases, provided that they operated effectively since the point of testing and have not been changed since, etc.

E. Management reporting of internal control		
	US-SOX	J-SOX
1. Contents of Report	Management conclusion on design and operating effectiveness of ICFR	Same (For details, information will be determined based on a government and ministerial ordinance. Currently, it is not available.)
2. Frequency	Annually	Same
3. Definition of Deficiencies	Three types of deficiencies primarily based on quantitative factors: (1) Deficiency (2) Significant Deficiency (3) Material Weakness (Proposed Revision) Three types of deficiencies based on	Two types based on quantitative and qualitative factors: (1) Deficiency (2) Material Weakness 5% of consolidated pre-tax income is provided as an example of a materiality threshold; however, consideration

	quantitative and qualitative factors. Materiality is the same as that of the financial statement audit.	should be given to the materiality for the financial statement audit.
4. Certification Timing	As of the last day of FYE (point in time certification)	Same

F. Auditing of internal control		
	US-SOX	J-SOX
1. Subject of Audit	Audit of the effectiveness of management's assessment of ICFR Audit of ICFR (Proposed Revision) Audit of ICFR	Audit of the effectiveness of management's assessment of ICFR
2. Selection of Auditing Party	Integrated audit	Same
3. Timing	Concurrently with the financial audit	Same
4. Use of the Audit Results Based on Foreign Standards	When the auditor of a foreign subsidiary audits ICFR using a foreign standard, the parent auditor may utilize the product of the foreign auditor, provided that the parent auditor concludes the use of either standard would lead to basically the same conclusion.	Same
5. Use of the Work of Internal Auditors and Others	Auditor may use the product of the internal auditors to support its audit, after validating their quality and effectiveness. (Proposed Revision) Work of others, as well as internal auditors, may be used.	Auditor may use the product of internal auditors and others to support its audit, after validating their quality and effectiveness.

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