

J-SOX FLASH REPORT

Internal Control Reporting: 56 out of 2,672 Japanese Companies Reported Material Weaknesses

July 28, 2009

Compliance with Japanese reporting requirements relating to Internal Control over Financial Reporting (ICFR) became effective for fiscal years beginning on or after April 1 2008. As of June 30, 2009, a total of 2,672 companies filed Internal Control Reports for their first compliance year. Of these companies, only 56 (or 2.1 percent) reported one or more material weaknesses. Another nine companies were unable to formulate a conclusion on the effectiveness of ICFR in their respective Internal Control Reports. Altogether, a total of 65 companies (or 2.4 percent) had issues with their internal controls.

In this Flash Report, we have analyzed the 56 companies reporting material weaknesses from several angles and discussed how companies should address these issues in the future. Based on our analysis, the main root causes of the material weaknesses cited by these companies are reported in Table 1. Also, we have summarized the major sources of accounting adjustments in Table 2. We summarized cases and issues identified in the “Description and Explanation of Material Weaknesses” and “Policy Towards Remediation of Material Weakness” sections of those Internal Control Reports listing material weaknesses. The total number of causes and issues exceeds 56 due to some companies listing multiple material weaknesses, which is not unusual.

Table 1

Causes of Material Weaknesses	Cases
Material adjustments to financial statements	32
Deficiencies in financial close process	28
Human resources	27
Monitoring of subsidiaries and affiliate companies	23
Design and operation of business processes	14
Fraud	13

Table 2

Accounting Adjustments	Cases
Adjustments of financial statements and disclosures	13
Inventory / Cost of sales	8
Revenue recognition	7
Impairments	7
Tax liabilities / Deferred taxes	6

In Table 1, the item, “Monitoring of subsidiaries and affiliate companies” indicates that there were fraud issues or material adjustments in financial statements among subsidiaries and affiliate companies. In Table 2, while most accounting adjustments were associated with revenue recognition, accounts receivable and inventory – which were expected to be selected as significant accounts in the initial stages of the evaluation process – we also noted adjustments occurred related to accounts requiring estimates and judgments such as impairments and tax liabilities/deferred taxes.

Table 3 represents a breakdown of the companies reporting material weaknesses, by revenue size.

Table 3

	Total
> \$10 billion	2
> \$1 billion	7
> \$500million	7
> \$300million	4
> \$100million	14
< \$100million	22
Total	56

There were nine cases of companies with total revenue of more than one billion dollars, only sixteen percent of the total number of companies reporting material weaknesses. More than 50 percent of the reporting companies was found among companies with less than 300 million dollars in revenue. Many of the smaller companies did not have enough people resources with the requisite financial reporting expertise (human recourses).

How Companies Should Address These Issues in the Future

We discuss below how companies should address these issues in the future. Although the case information was from only 2 percent of the total companies, these issues can arise for other companies in their second year compliance efforts.

For material adjustments to financial statements and deficiencies in the financial close process, many companies need to improve their financial close and reporting processes (FCRP). Adequate controls are necessary to prevent accounting treatment errors or detect them timely in order to avoid material adjustments from the audit process. In particular, companies need to focus on those accounts that require estimates which could most easily cause errors. The accounting manual for the accounts subject to the estimation process should be prepared based on a comprehensive review of the provisions of accounting standards, and should be utilized by all accounting personnel involved in the estimation process.

Noted earlier, human resources are a root cause in common with many material weaknesses. Accounting firms will cite an issue being due to the lack of financial accounting and reporting expertise. Since application of international financial reporting standards (IFRS) is getting closer in Japan, the education of employees responsible for financial accounting and reporting, such as strengthening the skills and competence of accounting personnel in applying IFRS,

should be included as short and mid-term goals of every public company's career development program.

Likewise, monitoring of subsidiaries and affiliate companies are closely related with other causes. According to a subsidiary's or affiliate company's importance, location and issues in the past, it may be necessary to establish improved control processes and monitor the execution of that process. The reporting parent company needs to have transparency into how well the subsidiary or affiliate company is executing on its improvement mandate. Thus, there will be instances when it is important to establish appropriate monitoring systems and prevent and remediate issues in the early stages of the processes where they arise.

For the design and operation of business processes, the revenue recognition process is especially important. Fifty percent of the fourteen cases are related to revenue recognition. It should be noted that the accounting standard for reporting revenue under construction contracts shall be effective for fiscal years ended March 31, 2010, so the effected companies should take steps to align their processes with the new standard. In summary, if there are reporting units that have identified control deficiencies in the revenue process, it is necessary to take evaluate those deficiencies to ascertain the process improvements that are necessary. External auditors will always be mindful of the importance of this risk.

Last, companies should focus on fraud prevention. Once fraud occurs and is identified, it becomes difficult to rate the resulting financial misstatements as immaterial. If companies find any material misstatement due to fraud, its risk becomes even higher. In order for companies to manage fraud risk, they should evaluate whether common fraud scenarios exist. It is important to identify possible fraud scenarios which could have a significant impact on the financial statements using actual case examples from the industry in which companies operate. When companies identify specific fraud risk scenarios, they should use them as a context for evaluating the effectiveness of existing internal controls. For example, companies may assess whether or not fraud risk is adequately identified and whether the design and operation of controls to prevent the identified fraud scenarios are effective by adding control objectives related to the prevention of the selected scenarios. These objectives should include assertions for the prevention of fraud that can be addressed by entity level controls and/or process level controls. The company's fraud risk management should cover all of its group companies, including headquarters, subsidiaries and affiliates. It also should incorporate integrated initiatives to prevent, detect and respond to fraud associated not only with the financial statements but also with business operations. According to this year's internal control reports, there were seven cases of fraud carried out by directors and senior management. These cases are regarded as deficiencies in the control environment and could be directly linked to one or more material weaknesses. Thus, increasing management's understanding of internal controls is a continuing and significant future issue.

Even if the company has not reported material weaknesses this year, J-SOX compliance has only just started. Many organizations may not yet have fully adequate controls. Some companies may still have to remediate last year's deficiencies in a coming year. Unremediated deficiencies can evolve into material weaknesses, if left unattended. If the company did not identify any material weaknesses and seeks to avoid such weaknesses in the future, it will need to continue identifying new risks and ensure that well-designed controls are operating effectively

in the future. Maintaining effective ICFR can also lead to opportunities for improving cost efficiency.

In closing, we have attached two appendices. The first compares US SOX and J-SOX compliance results in terms of the internal control issues the two compliance exercises identified, with emphasis on the prevalence of the issues giving rise to material weakness determinations. The second offers another comparison of US SOX and J-SOX compliance results in terms of the areas of failure the two compliance exercises identified in the application of generally accepted accounting principles (GAAP), again with emphasis on the prevalence of the issues giving rise to material weakness.

APPENDIX

1. US SOX versus J-SOX: Comparison of Issue Prevalence and Category – Internal Control Issues

			Internal Control Issues					
	Audit Opinions Filed	Material Weaknesses (MW)	Personnel Issues	Segregation of Duties	Restatement of Financials	Material YE Adjustments	Internal Audit Issues	IT Processing, Access Issues
US SOX								
Year 4	4012	280	175	34	57	194	6	70
% of Category		7.0%	62.5%	12.1%	20.4%	69.3%	2.1%	25.0%
Year 3	4216	382	179	50	126	260	14	74
% of Category		9.1%	46.9%	13.1%	33.0%	68.1%	3.7%	19.4%
Year 2	3791	390	207	57	177	250	4	79
% of Category		10.3%	53.1%	14.6%	45.4%	64.1%	1.0%	20.3%
Year 1	3700	624	304	149	324	335	17	135
% of Category		16.9%	48.7%	23.9%	51.9%	53.7%	2.7%	21.6%
J-SOX								
Year 1	2672	56	27	4	5	32	0	1
% of Category		2.1%	48.2%	7.1%	8.9%	57.1%	0%	1.8%

In addition to the above, the following deficiencies were reported by Japanese companies; financial reporting process issues (28cases, 50 percent), monitoring of subsidiaries and affiliate companies (23 cases, 41 percent), business process design/operating effectiveness issues (14 cases, 25 percent), fraud (13 cases, 23 percent), inadequate monitoring (12 cases, 21 percent), control environment (9 cases, 16 percent), and risk assessment and responses (5 cases, 9 percent).

US data is extracted from “*Audit Analytics 404 Dashboard Year 4 Update, Advanced AICPA Conference Copy.*”

2. US SOX versus J-SOX: Comparison of Issue Prevalence and Category – Areas of Failure

		Areas of Failure in Application of GAAP									
	Audit Opinions Filed	Material Weaknesses (MW)	Cash Flow Statement Error	Debt, Warrants & Equity Security Issues	Depreciation and Amortization	Inventory/ Cost of Sales	Leases or Contingencies	Fixed/ Intangible Assets	Revenue Recognition	Tax Accruals Deferrals etc.	Consolidation Issues
US SOX											
Year 4	4012	280	9	11	14	58	24	42	64	84	28
% of Category		7.0%	3.2%	3.9%	5.0%	21%	8.6%	15%	23%	30%	10%
Year 3	4216	382	16	22	25	72	30	79	106	124	31
% of Category		9.1%	4.2%	5.8%	6.5%	19%	7.9%	21%	28%	33%	8.1%
Year 2	3791	390	28	19	26	102	45	70	119	133	37
% of Category		10.3%	7.2%	4.9%	6.7%	26%	11.5%	18%	31%	34%	9.5%
Year 1	3700	624	198	198	172	58	44	45	106	78	120
% of Category		16.9%	32%	32%	28%	9.3%	7.1%	7.2%	17%	13%	19%
J-SOX											
Year 1	2672	56	2	0	0	8	1	8(*)	7	6	0
% of Category		2.1%	3.6%	0%	0%	14.3%	1.8%	14.3%	12.5%	10.7%	0%

(*) Includes seven cases of Impairment

In addition to the above, the following deficiencies are reported by Japanese companies; preparation of financial statements, disclosure adjustments (13 cases, 23 percent), and reserves (5 cases, 9 percent).

US data is extracted from “*Audit Analytics 404 Dashboard Year 4 Update, Advanced AICPA Conference Copy.*”