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JAPANESE SOX - AN EMERGING OPPORTUNITY

Introduction

Internal Controls and Corporate Governance is the buzz word today. Post Enron and world com in America, regulators are trying their best to sustain investor's confidence in the corporate world. **Sarbanes Oxley's Act** is also one of the results of such thinking process. All over the world, such steps are taken to regulate public companies to take care of interest of stakeholders. In London, combined code is working in the same direction and in India, **clause 49** is steering the boat.

In Japan also the problematic disclosure of false information in financial statement reports was a major concern in the past. Like the scandals of **Enron** and **WorldCom**, the former executives of **Livedoor** which is a Japanese major internet portal service provider like Yahoo Japan were arrested on charge of fraud. Regulators in Japan, though culturally different from Western and European countries, were equally concerned about taking care of such confidence and interest. By the end of 2004, stimulated distrust toward Japan's securities market forced the wholesale review of Japan's disclosure system. Consequently, in December 2004, the **Financial System Council of the Financial Services Agency (FSA)** recommended that assessment and verification of internal controls related to financial reporting be made **compulsory** in order to guarantee the credibility of the disclosure system.

After that, the **Internal Control Committee of the Business Accounting Council**, following the rules for establishing standards for internal controls, announced the fundamental principles for upgraded standards the first year, and put together a written proposal containing practice standards the second year.

The same law as US-SOX was established by Japanese government in Jun, 2006. The law is so-called **J-SOX (Japanese SOX; Financial Products Dealings Act of 2006)**. It will be in force for all the fiscal years starting after **April 1, 2008**. In order to protect general investors, it is aimed at preventing from accounting fraud by public companies. The regulation, which will apply to all listed companies in Japan, calls for the establishment of internal control rules to ensure proper disclosures and reporting on internal accounting procedures. It will also require company management to verify that these rules are being complied with, and for auditing firms to conduct the relevant audits.

Milestones

Following dates are important milestones

- a) **December 22, 2005**

Schedule Report of the First Subcommittee of the Financial System Council titled as “Legislation for ‘the Investment Services Law (provisional title)’”

b) March 10, 2006

Cabinet decision on the following two bills for legislating the “Financial Instruments and Exchange Law”

- i) bill for amending the Securities and Exchange Law and other financial laws
- ii) bill for abolishing and amending the related laws to implement the above bill for amending the Securities and Exchange Law and other financial laws

c) March 13, 2006

Submission of the bills to the Diet (Japanese Legislature)

d) June 7, 2006

Passage of the bills in the Diet

e) June 14, 2006

Promulgation of the legislations

f) April, 2008

J-SOX Mandatory requirement for Listed Companies

Compliance Requirements

The U.S. Public Company Accounting Reform and Investor Protection Act of 2002 (“SOX Act”) consist of 11 titles containing a total of 69 sections. The stipulations in **Section 404 of Title IV-US SOX** are similar in content to the provisions and stipulations contained in both **Article 24, Section 4, Paragraph 4 of Japan’s Financial Instruments and Exchange Law** and **Article 193, Section 2, Paragraph 2 of Japan’s Securities and Exchange Law**. These legal provisions are sometimes referred to as the Japanese version of the SOX Act.

Besides other important issues, as per section 24-4-4 of the Financial Service Act, 2006 of Japan, all the listed corporate will have to present a report on Internal Controls as part of Annual Financial Reports for the fiscal years starting after April 1, 2008.

The difference in adoption of US-SOX & J-SOX

SOX act is the same and both US Sox and J Sox have focus on documentation and putting responsibility on the management, yet there are some key differences in the Countries and the way it has to be adopted in both places.

- a) The biggest difference between the two countries lies in the methodology employed by outside auditors. In the United States, the main method used is direct reporting, whereby accountants go to company's offices to audit where the risks lie and verify whether the checking function is working or not. In Japan, on the other hand, auditors mainly conduct indirect inspections.
- b) Japan will not adopt the type of direct reporting approach used in the United States, because it can be assumed that this is already being implemented during inspections conducted by in-house auditors which are installed in corporate structure in Japan.
- c) The major burden for SOX compliance is documentation of all of the activities in a company. It makes additional cost of more than 3-5 million dollars. If J-SOX follows US-SOX as it is, it must arouse devaluation of all Japanese public companies and elevate the hurdle of IPO. Therefore, not only executives of Japanese public companies but also some of the Committee members insist that it should be much simpler than US-SOX.
- d) Liquidation of employees in Japanese economy is less than that of the US. Business process and business rules are handed down from person to person. They are not clearly documented in detail. There are very few manuals / SOP's in Japan unlike in US where the Focus on Documentation is much higher.

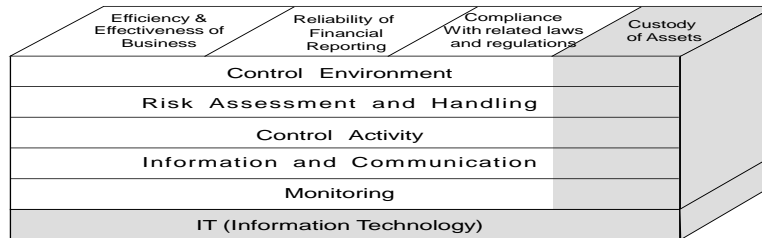
Framework

Implementing Standards on the assessment and audit of internal controls over Financial Reporting" is composed of three parts;

- 1) Internal Control Framework
- 2) Assessment of Internal Control over Financial Reporting and
- 3) Auditing Internal Control over Financial Reporting.

Though it would follow the Internal Control Framework of COSO, 1 additional item is included for each objective and composing elements. In short, the 4th objective, "Custody of Assets" and the 6th composing elements "IT (Information Technology)" was added.

Japanese COSO Framework



Some specific Parameter's to be observed while working for J-SOX

For a Chartered Accountant, it is important to know some protocols to enter Japanese market

1. It takes long time to built confidence among Japanese clients. Communication and pre planning is critical. A Japanese company would like to know beforehand the timelines. Once committed, it is very difficult to convince them about the delay.
2. Sharing case studies is very effective. So the best way is the get your acceptance in one and then that Business case gets you more Business.
3. You have to start with Zero base. The most popular solution in the US / India is not necessarily corresponded to the most popular one in Japanese market. It means that you have a chance to make big success even if you are not listed on top Ranks' in US/Indian market.
4. You should cooperate with influential system consultants, integrators and strong distributors. When you speak with Japanese candidates as partner, do not hurry to make a contract. They start business without it.

Planning Ahead

Companies listed in Japan and operating in India as subsidiary companies, will need to Report the J-SOX Compliance to the main Companies in Japan.

To implement the guidelines and preparing documentation, attention is to be given on

- (i) Defining Process
- (ii) Documentation of Process Maps
- (ii) Defining the risks and controls in the process
- (iii) After identifying the risk at each step, implementation of controls document the steps taken to mitigate the such risks and implementation of Controls to counter the Risk
- (iv) Testing of the Process regularly
- (v) Reporting to Management the results of the tests and the controls in place.

A Chartered Accountant is the best person to help in the compliance of J-SOX. To prepare for J-SOX compliance, documentation is must. A workflow tool is very helpful to draw business flow and document business activities. Tools like MS-Visio or MS-Excel/MS-word help in a big way in documentation. Following is an example of defining process, mapping and identifying risks and controls.

