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J-SOX: Standards and Practice Standards for Management Assessment and Audit of Internal Control over Financial Reporting - An Overview

This article discusses Standards and Practice Standards for Management Assessment and Audit of Internal Control over Financial Reporting, commonly termed “J-SOX”. The standards were introduced by the Business Accounting Council of the Japanese Financial Services Agency on 7 June 2006. The regulation (J-SOX) named after the U.S. Sarbanes - Oxley Act, is applicable to companies that are publicly registered on Japanese Stock Exchanges and is effective for fiscal years beginning on or after 1 April 2008.

Since the symbolic collapse of global players such as the telecommunications giant, WorldCom Inc. and the energy trader, Enron Corp. there has been a significant change towards stronger corporate governance reform for all public corporations. Paul Sarbanes and Michael Oxley led the enacting of the Sarbanes - Oxley Act (“SOX” or “SarbOx”) in 2002 which requires all US listed companies to evaluate their Internal Controls over Financial Reporting.

The implementation of SOX established a new agency called the Public Company Accounting Oversight Board (PCAOB). The PCAOB is responsible for overseeing, regulating, inspecting and disciplining accounting firms in their roles as auditors of public companies. The Act establishes enhanced standards for all US public company boards, management and public auditors. It discusses corporate board responsibilities to criminal penalties, and requires the US Securities and Exchange Commission to implement all rulings on SOX compliance requirements. SOX also covers matters on auditor independence, corporate governance, internal control assessment and enhancing financial disclosures.

As in the US, Japan has also experienced corporate scandals in recent years including, for example, Kanebo Cosmetics Inc. and Livedoor Co., Ltd. Such events triggered Japan’s own standard setters to initiate their governance requirement in Japan similar to the requirements of SOX.



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The J-SOX Act is Japan's version of SOX (US). The Internal Control Committee under the Business Accounting Council of the Japanese Financial Service Agency (FSA) provided the final Implementation Guidance for Management Assessment and Audit of Internal Controls over Financial Reporting as required, under the Financial Instruments and Exchange Law. This law will be effective in April 2008 and will apply to all Japanese listed companies and will also affect the subsidiaries of the listed companies, regardless of whether they operate in other parts of the world.

Limited or "KK" companies in Japan, some with multi-billion dollar revenues are not subject to J-SOX.

The introduction of J-SOX will have a number of far reaching implications in Japan in contrast to the US.

- i. Japan has less than 10% of the number of qualified accountants than in the US;
- ii. Japanese corporations can and will rely on the influence and recommendations of their audit firms;
- iii. Audit automation is key; increasing process efficiency and software that can support the processes;
- iv. Support of IT governance i.e. IT controls.

Japanese corporations that have a significant presence in the US will be able to use their US SOX documentation for J-SOX compliance.

J-SOX will impact up to 4,000 Japanese public listed companies and any companies designated by the Government of Japan. Such companies are required to conduct ongoing management assessment and reporting of internal controls over financial reporting (ICFR). To comply with J-SOX, corporations have commenced the time consuming and difficult task of implementing a control framework, documenting controls and establishing a top down, risk based approach to ICFR.



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The implementation guidance published by the FSA details for Japanese corporations how to implement a management assessment of ICFR as required by J-SOX. The FSA is suggesting a risk based, top down approach to J-SOX implementation. A risk based approach focuses on financial statement accounts and related processes that are significant to the financial statements. The top down methodology means that the parent company will begin by evaluating entity level controls and will work down to specific processes and financial statement accounts.

Under J-SOX management will need to assess the design and operating effectiveness of ICFR and report the result in the filings. The independent auditor will provide an attestation of the effectiveness of management's assessment.

The Implementation Guidance provides details to Japanese corporations on how to implement a Management Assessment of ICFR. The guidance consists of three sections with related sub-topics.

Section 1: Basic Framework for Internal Control (establishing a control framework to include the following)

- Control Environment
- Risk Assessment
- Control Activities
- Information and Communication and Monitoring

Section 2: Management Assessment and Reporting ICFR

- Definition of Financial Reporting
- Scoping of Management Assessment
- Structure for Internal Control Assessment Method and Use of Specialist
- Evaluation of Company Level Controls
- Process Level Controls - Assessment of Operating Effectiveness
- Recording and Retention of Assessment Procedures



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Section 3: Audit of ICFR

- The Meaning of Auditor's "Indirect Reporting"
- Sample Size for Testing Operating Effectiveness
- Use of the Work of Internal Audit and/or Others
- Reporting on Material Weaknesses and Other Reportable Conditions

In summary, J-SOX (and SOX) are not just compliance programs that a corporation needs to adopt and follow but J-SOX and SOX are compliance programs that will help corporations to avoid losses and may, more importantly, restore investors' and shareholders' confidence.