

MFA Perspective *On* J-SOX

Approaching J-SOX: A 4-Phase compliance strategy for Japan's new Financial Instruments and Exchange Law



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JAPAN'S FINANCIAL SERVICES AGENCY TAKES ACTION

In response to the massive financial scandals in Japan (e.g., Seibu Railway, Kanebo, Livedoor and Murakami Fund) Japan's Parliament enacted the Financial Instruments and Exchange Law in June of 2006. This law empowered the Financial Services Agency ("FSA"), Japan's equivalent of the SEC, to create requirements and guidelines for the preparation and submission of financial and internal control reports by management.

To the casual observer, the Japanese Standards, or J-SOX as some have come to call them, are similar to the US's Sarbanes-Oxley Act of 2002. But that is somewhat of a misconception: unlike in the United States, the implementation of J-SOX is not driven by wavering investor confidence. Instead, the FSA efforts are designed to crack down on interests and criminal groups who have been actively manipulating stocks and perpetrating frauds. Understanding this key difference in background is an important piece of getting started on the right track to compliance.

Another substantial difference between J-SOX and SOX is that materiality is statutorily defined as anything that would change the reporting entities' pre-tax income by 5%, as well as other more definable guidelines than those presently existing under SOX.

Time is short to react to the mandate: the Japanese Standards require all Japanese exchange registrant companies to submit internal control reports on a consolidated basis for fiscal years beginning on or after April 1, 2008. The internal control reports must be audited by an external auditor, including efforts by United States auditors in support of their Japanese counterparts. These guidelines were officially handed down on February 15, 2007, when the Business Accounting Council of the FSA finalized its requirements and standards for internal controls over financial reporting as put forward in *Standards and Implementation Standards*

for Evaluation and Auditing of Internal Control over Financial Reporting report.

MFA PERSPECTIVE

A variety of proposed approaches to achieving compliance with the J-SOX law have come to light for Japanese-owned, US-based subsidiaries. Regardless of the stage at which a company may currently find itself, there are two main take-aways for decision makers: the first is that the J-SOX deadline is set, and the second is that all public issuers will need to comply. What remains to be determined is the shape and expense of the final compliance effort.

Clearly, compliance will not be an easy undertaking. Finding, dedicating and judiciously employing company resources to achieve compliance goals are daunting challenges for management, especially given the newness of the law and indecision that may come out of corporate headquarters in Japan. Costs could be significant, as the effort is complex and time consuming, and what truly needs to be accomplished can be difficult to discern.

Placing all uncertainties aside, the fundamental issue at hand is how to attain compliance. As it stands today, Japanese public issuers will have to be compliant or state otherwise by the first fiscal year end filing after April 1, 2008, on a consolidated basis.

To achieve compliance, MFA strongly advises that organizations leverage existing SOX readiness approaches to the extent relevant to J-SOX. They should start the process early and plan the effort thoroughly: the better the organization plans and marshals its resources, the greater the potential for cost savings and the easier it will be to dictate the pace and scope of the effort. This begins with a realistic assessment of an organization's internal capacity for project execution, which will enable the organization to acquire the long term resources necessary to achieve its goals. The judicious scoping of the effort and the alignment of dedicated resources should equate to an efficient and streamlined compliance

effort, all of which should lead to substantial cost savings.

A sound approach to J-SOX compliance encompasses the following:

- Phase One is the thorough planning and scoping of a company's J-SOX effort, understanding the differences from US SOX and leveraging the similarities;
- Phase Two is the assessment of the corporate governance environment of the subsidiary, in effect a look at the "macro environment." This includes a review of policies, the tone at the top of the organization, and the extent to which the company is covering its risks;
- Phase Three is the documentation and assessment of the company's processes and embedded internal controls: a closer look at the day-to-day or "micro environment." This includes documenting the current environment and control activities (i.e., accounts payable);
- Phase Four is the testing of the company's internal controls (the micro environment) and assisting management in coming to a conclusion.

FINAL THOUGHTS

In articulating these perspectives, MFA acknowledges that there is no one way to achieve compliance or to institute effective internal controls. In fact, we strongly discourage a cookie cutter approach to the new guidelines. Typically, the circumstances facing each organization will require a thoughtful assessment of what is logical to the organization and what truly needs to be accomplished in order to achieve compliance with the Japanese law.

Regardless of what a company's end goal and rationales are, compliance options should be identified now so that organ-

izations can stand ready to react to mission critical goals. Whether that is reacting to the next round of FSA and corporate decisions or the strategic strengthening of the organization, through the judicious application of such an undertaking management will gain a thorough understanding of their options and will be prepared to deal with the evolving marketplace.

FOR MORE INFORMATION, PLEASE CONTACT

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