Issues on J-SOX:
A Comparative Study

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Sadakazu Osaki
Head of Research, Center for Knowledge Exchange and Creation, Nomura Research Institute
Visiting Professor, University of Tokyo Law School
An Overview

- 2006 amendments of the SEL (now FIEL) included following provisions.
  - Listed companies shall submit reports evaluating their internal control over financial reporting (Art. 24-4-4 FIEL).
  - The reports shall be audited by independent auditors or auditing firms (Art. 193-2 FIEL).
  - Listed companies shall certify appropriateness of their annual reports (Art. 24-4-2 FIEL).

- The provisions became effective on September 30, 2007.
  - The first internal control report will appear in June 2009, evaluating its effectiveness as of the end of March 2009.
J-SOX?

- These provisions are commonly referred to as J-SOX.
- However, the amendments did not simply follow SOX model.
  - The discussion led to the amendments started in 2005, after SEIBU Railway Co. had been delisted from TSE.
- The discussion took criticism against US SOX into account, and tried to simplify the system.
  - Importance of top down, risk-based approach is emphasized.
  - Criteria for evaluation of effectiveness are simplified (effective, with a deficiency, material weakness).
  - Detailed guidelines (Standard for Implementation) were adopted before the law took effect.
Problems in Implementation

- Some accounting firms and consulting firms urged listed companies to prepare “set of three documents” (business manual, business flow chart, risk control matrix) for every business process.

- Even small or medium sized listed companies believe they must set up an independent body such as “Internal Audit Department” within their organization.

- Large costs associated with a preparation for internal control reporting let some private companies postpone their IPOs.
## Stalled IPO Market

### Number of IPOs in Venture oriented Markets

<table>
<thead>
<tr>
<th>Year</th>
<th>TSE Mothers</th>
<th>Jasdaq</th>
<th>Hercules</th>
<th>Others</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>1999</td>
<td>2</td>
<td>73</td>
<td>-</td>
<td>0</td>
<td>75</td>
</tr>
<tr>
<td>2000</td>
<td>27</td>
<td>97</td>
<td>40</td>
<td>0</td>
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<td>2001</td>
<td>7</td>
<td>98</td>
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<td>2</td>
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<td>8</td>
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<tr>
<td>2003</td>
<td>31</td>
<td>63</td>
<td>11</td>
<td>1</td>
<td>106</td>
</tr>
<tr>
<td>2004</td>
<td>56</td>
<td>71</td>
<td>18</td>
<td>7</td>
<td>152</td>
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<td>2006</td>
<td>41</td>
<td>59</td>
<td>38</td>
<td>21</td>
<td>159</td>
</tr>
<tr>
<td>2007</td>
<td>23</td>
<td>54</td>
<td>28</td>
<td>9</td>
<td>114</td>
</tr>
<tr>
<td>2008 (~June)</td>
<td>8</td>
<td>9</td>
<td>3</td>
<td>2</td>
<td>22</td>
</tr>
<tr>
<td>1999 ~ 2007</td>
<td>239</td>
<td>662</td>
<td>227</td>
<td>58</td>
<td>1,186</td>
</tr>
<tr>
<td>Listed Co. as the end of 2007</td>
<td>198</td>
<td>979</td>
<td>172</td>
<td>54</td>
<td>1,403</td>
</tr>
</tbody>
</table>

*Note: Others means Centrex in Nagoya, Ambitious in Sapporo, and Q-Board in Fukuoka*
Efforts by the FSA

In March 2008 the FSA published “11 Misunderstandings on Internal Control Reporting System”.

The document emphasizes the difference between US and Japanese system, importance of flexibility in implementation, etc.

The FSA urge accountants not to be too defensive when they are consulted by the listed companies.
Remaining Issues

- How would Japanese investors react when a listed company reports “material weakness” in its internal control?
  - TSE made clear that material weakness would not directly lead to the delisting of the company.

- Is internal control reporting system really effective for preventing accounting frauds?
  - Number of accounting fraud cases is increasing, especially among smaller listed companies.
  - Some investors may argue that strict system is needed for Mothers companies rather than for Toyota Motors.

- Is principles behind the regulation understood, although the rule itself is followed rigidly?