



*Summary of Developments in
Japan's SOX Act and Internal Control Systems*

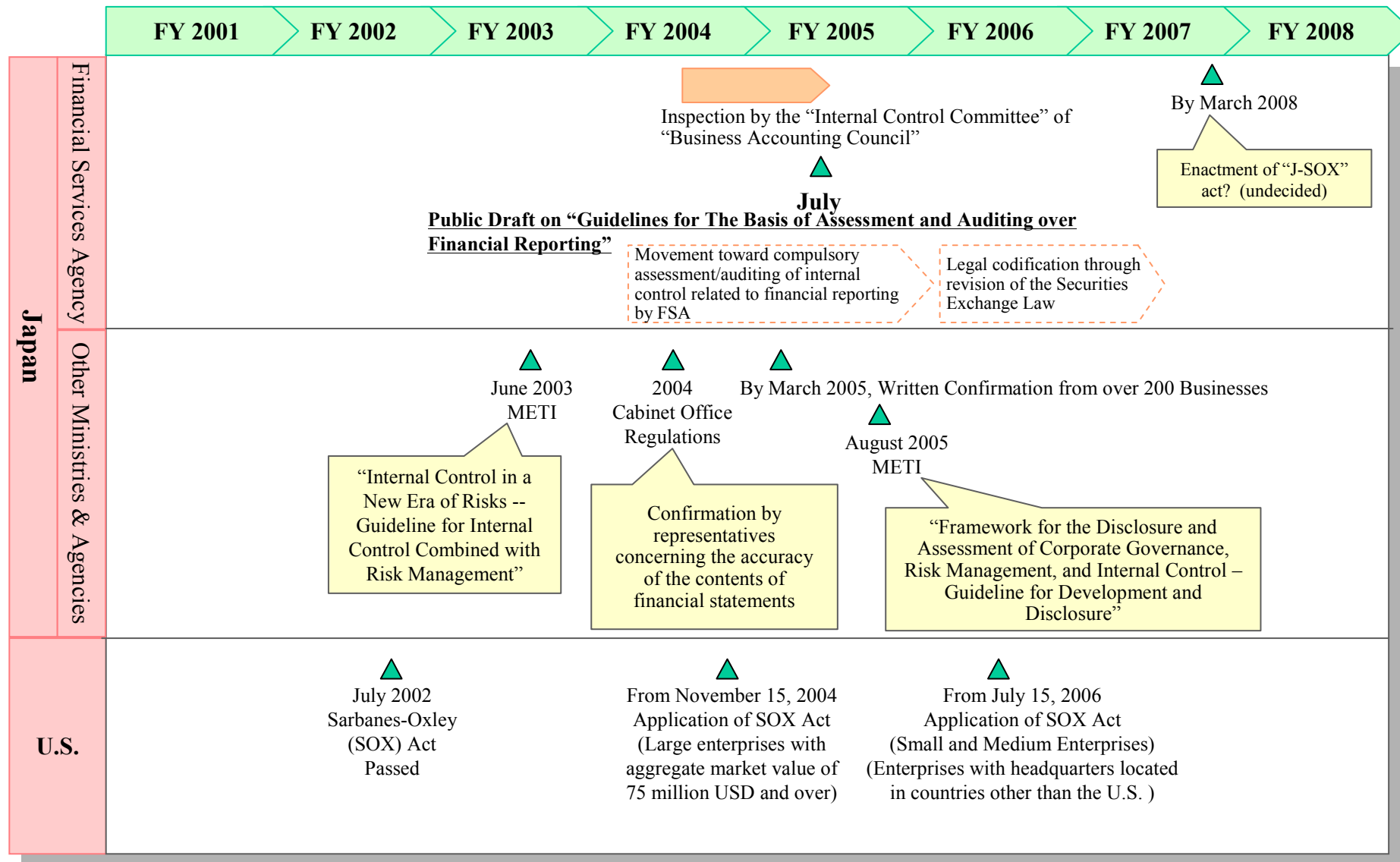
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Fujitsu Research Institute

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THE POSSIBLE THE SOX TRUTH

1. Movements in Internal Control



2. FSA's Attitude toward Internal Control in Japan

Background

- Enron and other incidents in the U.S.
 - >SOX Act Enacted (July 2002)
- Kokudo, Kanebo, and other incidents of improper disclosure in Japan

Importance of strengthening internal control in Japan as well increases

Regulation

- Voluntary System (Cabinet Office Regulations)
Submission of written confirmation of contents of financial statements by a company representative, etc

- - - -
- Public draft of the Business Accounting Council Internal Control Committee announced (July 2005)
“Guidelines for The Basis of Assessment and Auditing over Financial Reporting (Public Draft)”

- Inspection by Business Accounting Council Internal Control Committee

- Period of Inspection: February-July, 2005

- Purpose: Raise diligence regarding compliance with Japan's system of corporate law, improve accountability on an international level, establish effective standards in keeping with current conditions in Japan

- Expectant Role:

- (1) Contribute to system of written confirmation of financial statements
- (2) Form basis of discussion for the possibility of compulsory assessment by managers and compulsory inspection by chartered accountants

Details of the Guideline

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2. Scope of Assessment of Internal Control over Financial Reporting
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1. Purpose of Internal Control Auditing by an Auditor of Financial Statements
2. Relation between Internal Control Auditing and Financial Statements Auditing
3. Implementation of Internal Control Auditing
4. Reporting by Auditor

3. FSA’s “Guidelines for The Basis of Assessment and Auditing over Financial Reporting (Public Draft)”

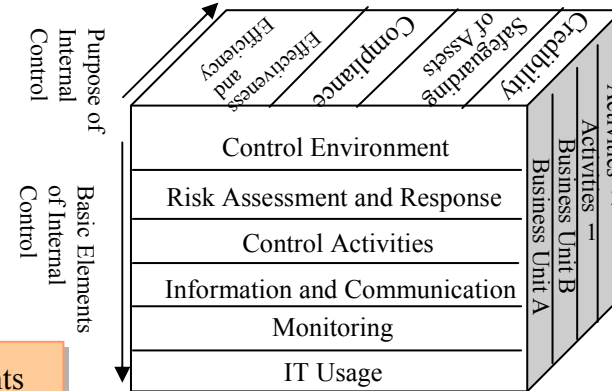
I. Basic Framework of Internal Control

1. Definition of Internal Control

- In essence, internal control is a process incorporated within a business that is to be carried out by all members of an organization for the purpose of achieving the goals set forth in (1) below.
- It consists of the basic elements described in (2).

(1) Purpose

- * Effectiveness and Efficiency of Operations
Increase the effectiveness and efficiency of operations in order to achieve business activity goals
- * Credibility of Financial Reporting
Safeguard the credibility of both financial statements and information that can be greatly influenced by financial statements
- * Compliance with Laws and Regulations Regarding Business Activities
Promote compliance with laws related to business activities and other regulations
- * Safeguarding of Assets
Safeguard assets by conducting the acquisition, use, and disposal of assets through proper procedures and approval



(2) Basic Elements

- * Control Environment
Decides organization’s ethos, extends awareness of control to all members, and forms foundation for other basic elements
- * Risk Assessment and Response
Identification, analysis, and assessment of all risks that influence the achievement of an organization’s goals
- * Control Activities
Policies and procedures to ensure that managers’ orders and instructions are observed appropriately
- * Information and Communication
Ensures that important information is adequately transferred between organizations and relevant parties
- * Monitoring
Ongoing process for supervising / evaluating effectiveness of internal control
- * IT Usage
Application of a range of IT to ensure that the other basic elements function effectively and efficiently

4. *Considerations and Discussions on FSA's "Guidelines for The Basis of Assessment and Auditing over Financial Reporting (Public Draft)"*

I. Cost Burden Considerations

In order to prevent an excessive cost burden, the following considerations are being explored, with the operational conditions of the U.S. SOX Act in mind.

- Implementation of a top-down risk approach
- Classification of faults of internal control
(2 types: inadequate, defective)
- Rejection of direct reporting
- Integration of internal control auditing with financial statement auditing
- Integration of internal control auditing reports with financial statement auditing reports
- Coordination between auditor and auditing officer/internal auditor
- Include "IT usage" as a basic element of internal control

II. unconfirmed and pending issues

-Period of Implementation

In accordance with the public draft announced on July 13, 2005, invited opinions concerning the timeframe for preparation.

-Guidelines for Implementation

Detailed provisions within managers' assessments

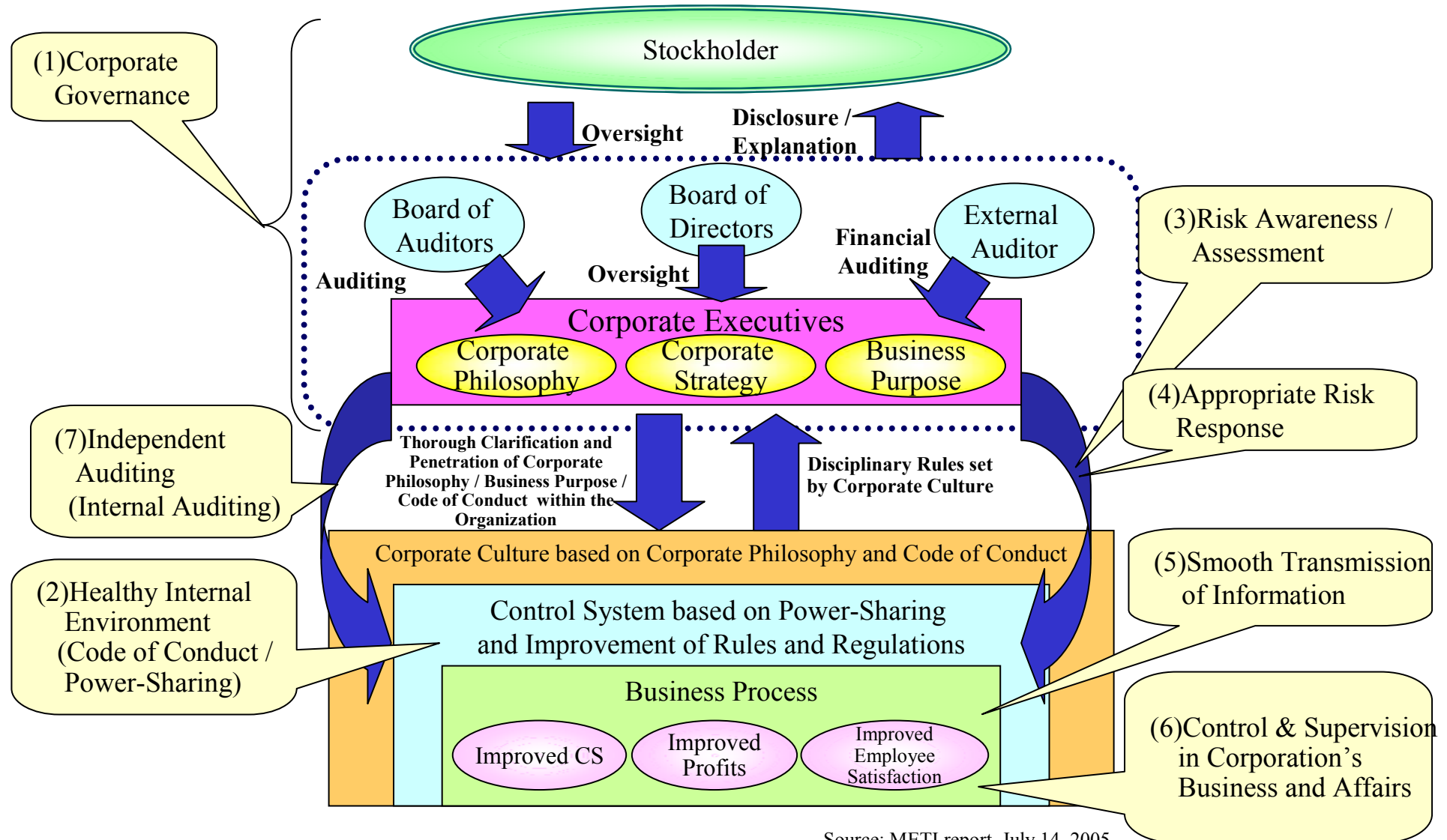
- >In U.S. business reform law: auditing standards are published from PCAOB; each company provides written documentation of internal controls and conducts assessments and in compliance with auditing standards concerning auditors
- >In Japan, concrete auditing standards have yet to be seen

-Details of the "Top-down Approach"

Public draft suggests only the "consideration of the significance of monetary and qualitative influence on financial reporting;"

- >concrete significance, scope of assessments, etc. is left unspecified.

5. METI's Overarching Structure and Research Committee Guidelines concerning Corporate Governance and Risk Management/Internal Control



Source: METI report, July 14, 2005

6. Movements in Internal Control in Japan by Individual Businesses

Responses to the U.S. SOX Act

- Some companies listed or scheduled to be listed on the U.S.'s NYSE are already in compliance with the U.S. SOX Act (hereafter, they will be responsible for maintaining compliance operations)

Forerunners: Toyota, Showa Shell, Takeda Chemical Industries, Orix, etc.

- Many other companies paying notice to developments in Japan's Corporate Reform Law (Japan's version of the SOX Act: J-SOX)

Strengthening of Internal Control

- Stems from the response to scandals by NHK and West Japan Railways and actions taken by companies involved in the recent asbestos problems.
- Many companies thought to be pursuing the creation of mechanisms for internal control throughout corporate activities.
- Some companies try to enhance the internal control to improve their competitiveness as well as to comply with regulations.

7. Relationship of Internal Control and IT

--IT and Internal Control as seen from the FSA's Guidelines of Internal Control --

Internal Control Over Financial Reporting
and the Role of IT

Acknowledgement that the drafting and
transmission of today's financial reports are
heavily dependent upon large computer systems

IT is present in all elements of financial
reporting, and performs assistance and
support functions

Emphasis on IT Control

Various Risks surrounding Financial ISs

- Willful dangers stemming from malicious intent
- e.g. illicit access by insiders
- Dangers in IT environment compared with environment of manual procedures
- Potential for batch processing of large volumes of data
- > Potential for fraud in a very short time
- Account processing through the coordination of various kinds of systems
- >Difficult to discover fraud in front systems
- Implementation of processing based on incorrect information resulting from fault or negligence
- >Small-scale overpayments, faulty claims, etc. can accumulate into large sums
- New dangers to security
- Viruses, illicit intrusion, etc.

- The IT usage is also situated as a basic element of the standards of internal control
- “General control” and “application control” are proposed

*General Control using IT

Indirect control to maintain an environment for the effective functioning of application control including:

- Operations / maintenance control over hardware and networks,
- Development, modification, operation, and maintenance of software,
- Access security,
- Acquisition, development, and maintenance of applications software.

*Application Control using IT

Computer program-incorporated control that ensures proper processing and recording of all transactions approved in individual applications and systems. The coverage is not limited to accounting applications, but also includes other application systems including information systems for marketing, internal operation, procurement and manufacturing.

*General Control and Application Control

Continually assists application control functions

8. Conclusions

- Japan is on track to implement its own version of the SOX Act (i.e. internal control audit).
 - >*Timeframe is still undecided*
- Japan's SOX Law treats IT usage independently as a basic element of internal control, thereby emphasizing its importance.
- Currently, high probability that documentation and assessment of system controls will be demanded even for IT that is operating stably.
- In companies with loose IT governance, number of divisions subject to assessment will increase
 - >High possibility that the costs for documentation and assessment of general control in IT will rise
- In Japan, a SOX law combining the skillful use of IT with high cost effectiveness is necessary.

Source: KPMG et al, "Concerning the Control of IT in Internal Control Over Financial Reporting"; compiled by FRI

- IT investment of Japanese corporations to comply with J-SOX and other internal control regulations is estimated by IDC about 700 billion yen (about 7% of total IT investment) in 2009. Japanese IT vendors including total IS providers such as Fujitsu and NEC regard this trend as business opportunities, and they are preparing for solutions including consultation, e-documentation, work flow programs and storage services. But they are still behind of U.S. vendors.
- There is an anxiety among Japanese managers that J-SOX may become a hard burden for Japanese companies. The IT solution is necessary in Japanese market which is not a copy from U.S. and fits to the Japanese corporate governance system. Such services should enable customers to improve their productivity and competitiveness as well as to comply regulations.