



Navigating Risk in Japan

Insights on risk and internal audit
for multinationals operating in Japan

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Introduction

With a highly educated workforce, world-class infrastructure and third largest economy in the world, Japan is a strategic business location for global and multinational corporations.

Such corporations understand that operating overseas creates a range of risk management issues, from maintaining compliance with new domestic legislation to adapting to unique features of local business culture. This challenge has increased in recent years due to a growing web of supranational legislation and rapidly evolving technology platforms.

Doing business in Japan is no exception and, in this context, there is increased pressure both on management to address international risks and on internal audit to robustly assess their approach.

In this thought leadership we provide insights for Internal Audit into three risk areas through the lenses of Regulation, Culture and Technology. We highlight how internal audit can effectively determine if these risks are being addressed, and how KPMG's international Risk Consulting team can support internal audit in their role.



Regulatory Compliance

Multinationals must hold two perspectives to comply with regulatory requirements – domestic and global.

The regulatory environment in Japan is becoming increasingly onerous. According to the World Bank's latest annual ratings (2019), the country now ranks 39th among countries for "Ease of Doing Business", continuing a gradual decline from a peak of 11th in 2007. Recent changes or areas of increased scrutiny include:

- Quality management in manufacturing due to high-profile test falsification scandals
- Heightened data privacy and cyber security concerns following a series of high profile corporate attacks.
- Pressure by regulators to transform internal audit in the financial sector
- A more rigorous Corporate Governance Code to raise governance standards
- Labor management directives strengthening obligations over working hours and overtime

Without clear responsibilities to monitor these changes, overseas headquarters will not have complete awareness of such laws or their implications. The detail of new legislation is commonly only available in Japanese and,

even once translated, may be open to interpretation. Often local company policies to support compliance are insufficiently detailed, vague or out-of-date. Conflicts between local and group policies go unresolved, meaning it is not clear for either management or auditors on what is expected. Through our work, we have experience of how industry and regulators have approached new laws and can help bring clarity to these grey areas.

Companies with a global footprint also need to take into account a patchwork of supranational legislation such as the UK Bribery Act, US Foreign and Corrupt Practices Act, EU General Data Protection Regulation and UK Modern Slavery Act. Several or all of these may apply depending on the profile of the organization as a whole, even if not directly related to the Japan operations. Again, their applicability may be missed if not carefully monitored.

In the context of a broad range of regulatory concerns, a strong Governance, Risk Management and Compliance (GRC) approach coupled with local legal guidance is essential to promote compliance. Without this, both HQ and local management risk gaps in awareness and understanding of their obligations.

Areas to consider

- Determine if clear responsibilities are defined for identifying all obligations and maintaining ongoing compliance, including local language and legal expertise and communication flows with HQ.
- Assess the approach to collating, capturing and monitoring compliance with all relevant Japanese and global obligations, including addressing gaps, identifying regulatory changes, and resolving any conflicts between local and global requirements.
- Focus on the completeness and quality of local supporting policies, with recommendations supported by a clear explanation of the value of defining accountabilities and setting clear minimum standards.
- Plan internal audit activity to complement, not duplicate, work of any other Compliance teams as part of coordinated assurance approach, but without compromising the duty to provide independent challenge of other lines of defense.



Culture

Fostering a corporate culture that supports strategic objectives without compromising company values is a key success factor, albeit a challenging one to achieve. An embedded set of values act as a strong 'soft control', incentivizing employees to follow defined process and act with integrity where judgment is needed.

When operating in a new location, Management face the difficult task of embedding the essential elements of their corporate culture while taking into consideration the nuances of Japanese business culture. Newcomers to Japan will traditionally find a very different business culture based around:

- 'Consensus building' decision-making
- Heavy reliance on trust between parties
- Valuing stability more greatly than change.

The significant language barrier only serves to further complicate these issues. These and other unique local business practices can lead to different control interpretations or availability of evidence, with local employees believing they are acting appropriately. Common examples include far higher cash usage than

peer countries, expense receipts with non-verifiable detail, and verbal approvals instead of a physical record.

In this context, the focus should always be on the underlying risks which target controls are looking to manage. If alternative local practices meet minimum requirements in a different way, is there value in raising a finding? Is it clear which controls are so significant to the Group that no alternatives can be permitted?

Many employees from Japanese operations may also lack exposure to a mature, risk-based internal audit; instead more accustomed to a light touch, checklist approach which covers a wide area in a consistent manner but delivers limited value to the business. Auditors may be hesitant to challenge management and accept statements at face value. Explaining the benefits of a robust approach and how it can potentially help management is key to overcoming traditionally slow-to-change teams and practices.

It is also important to consider the impact on controls in an environment where two potentially opposing cultures must be balanced. Suggested improvements must be value-adding and practical, rather than simply aggravating existing tensions.

Areas to consider

- Increase focus on assessing the quality of operational procedures and control frameworks in place which can reduce the impact of a weak or imbalanced corporate culture by establishing a minimum governance and control standards.
- Strive to plan the audit timetable well in advance, with comprehensive documents requests and clear agendas circulated in time for interviewees to prepare.
- Maintain flexibility in the audit approach and control interpretations so technical exceptions arising from cultural differences can be accommodated where the underlying risks are still addressed.
- Consider the appropriateness and frequency of activities undertaken to embed the corporate culture locally including communication, training, alignment to objectives, and overall support from HQ.



Technology

The business environment is changing rapidly as new systems and ways of working are introduced. Every company should be concerned about how its lines of defense and, in particular, internal audit can develop the skills and tools to act as a business advisor on emerging technology risks.

To free-up the capacity needed for the demands of this role, leading internal audit functions drive more efficient and higher quality assurance by deploying technology to:

- Reduce effort on low value-add activities
- Optimize and automate high value-add tasks
- Build and deploy specific advanced solutions

While there is an evolving range of tools available – including data analytics, process automation, collaboration and visualization areas – this modern approach is not yet widespread in Japan. When evaluating new technology for use locally, particular consideration should be given to the interaction of new technology with local legacy systems, and whether group systems are sufficiently tailored to local operations and language. We find local management prefer clear peer examples and case studies before deciding to adopt particular tool.

Alongside emerging technology risk, cybersecurity remains a growing threat, with companies worldwide facing more sophisticated threats to their data, intellectual property and operations. Again Japanese companies have historically lagged behind international peers when developing cyber defenses, but investment has risen following greater government and corporate attention. Internal audit must play a role challenging the governance and implementation of these investment programmes to gain comfort that high risk areas are identified and appropriately prioritised.

Internal audit should also consider whether Business Continuity and Disaster Recovery plans are sufficiently rigorous for the level of risk faced by businesses in Japan. While there is an established domestic culture of emergency preparedness due to the prevalence of natural disasters, the existing approach used by multinationals based in lower risk locations may require adapting to be fit for purpose for their Japan operations. While the expected continuity controls and practices are largely the same, regular scenario testing to generate feedback to keep plans up-to-date is of greater importance.

Areas to consider

- Periodically review the skill mix of the internal audit team to determine if there is adequate capability to tackle emerging technology risks, with any gaps addressed through recruitment or use of a co-source partner.
- Work with subject matter experts to review the local cyber security approach, including sufficiency of resource allocation, alignment to the organization's strategic priorities, adequacy of policies, procedures and controls to protect internal data, risk prioritization, and incident response preparedness.
- Assess the maturity of the site's disaster recovery and business continuity approach, including their crisis preparedness frameworks, range of planned scenarios and periodic testing.
- Consider procuring a data analytics "health check" to understand the spread and maturity of technology use across the local internal audit function and organization in general.



How KPMG can help

KPMG's Risk Consulting practice in Japan has a dedicated team to service international clients. They are experienced internal audit professionals with deep technical and industry knowledge from working with multinationals both in Japan and across our global member firms. The team includes both bilingual and native English speakers working together to deliver projects, overcoming the language barrier which is the principal challenge for overseas internal audit teams.

KPMG's internal audit risk and compliance services are designed to enhance and support internal audit functions,

enterprise risk management, governance and regulatory compliance. Our holistic approach draws on a range of technological tools, including data analytics, process automation and digitization, to maximize the value, effectiveness and efficiency you receive.

Beyond internal audit, KPMG Advisory's specialists work with you to navigate today's rapidly changing marketplace. We leverage the knowledge and skills across our global network of KPMG member firms to develop practical recommendations designed to help you work smarter, grow faster and compete stronger.

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KPMG member firms can be found in 154 countries and territories. Collectively they employ 200,000 people across a range of disciplines.

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