

2020 Monitoring Report

Key Points

July 2020

Certified public Accountants and
Auditing Oversight Board



About the 2019 Monitoring Report

Purpose of publication

- This report is aimed not only at audit and accounting specialists, but also market participants as well as ordinary readers such as students and working people. We have published it for the purpose of promoting understanding within society of the importance of audits by providing easy-to-understand and relevant information that is centered on the circumstances and results of the CPAAOB's monitoring activities but also encompasses the current state and changes in the environment surrounding the audit sector.

Structure

- The Report comprises the following four sections (I-IV). In "I. Overview of the Audit Sector," we have added information about the CPA exam and presented new information about the nature of audits of financial institutions and support with IPOs. In "III. Operation of Audit Firms," we have expanded descriptions of organizational structures for supporting audit engagements. In "IV. Responses to Changes in the Global Environment Surrounding Audits," we have provided information about the latest trends shaping audit, such as the use of IT in audits and responses to the spread of the new coronavirus. (main revisions for the 2020 edition)

I. Overview of the Audit Sector

Describes the situation with regard to CPAs, audit firms, audited companies, etc., and provides an overview of the audit sector as a whole

- Example content (1) Concentration of audit engagements at large-sized audit firms (market share by type of audit firm [FY2018])

II. CPAAOB's Monitoring

Describes the activities of the CPAAOB (overview of system and situation with examinations, collection of reports, and inspections)

- Example content (2) Situation with overall ratings

III. Operation of Audit Firms

Describes the operation of audit firms as gleaned through monitoring conducted by the CPAAOB

- Example content (3) Initiatives based on The Audit Firm Governance Code
- Example content (4) Changes of Accounting Auditors

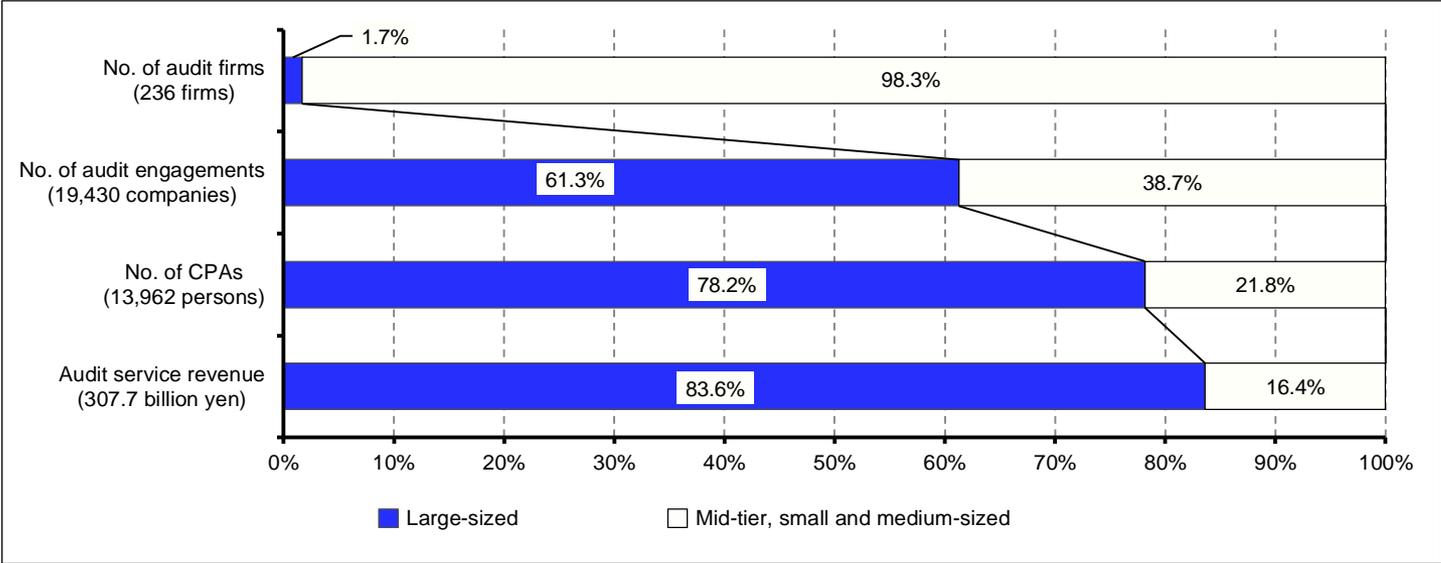
IV. Responses to Changes in the Global Environment Surrounding Audits

Describes recent key trends with audit firms

Example content (1) Concentration of audit engagements at large-sized audit firms

- Approximately 84% of audit service revenue is marked by large-sized audit firms (four firms).
- The same oligopolistic tendency is also seen in the United States and the UK.

Market share by type of audit firm (FY2018)



(Note) Compiled based on FY2018 JICPA member data and operational reports submitted by audit firms.

Big Four global networks' share of audit engagements for major listed companies (based on number of companies)

	Japan	United States	UK
Big Four global networks' share	96%	99%	97%

(Note) Shares were calculated based on the numbers of companies included in the following stock indexes:
 Japan: Nikkei 225
 United States: S&P 500
 UK: FTSE 350

Example content (2) Situation with overall ratings

- Based on inspection results, the operation of services of an audit firm is given one of five grades. This grade constitutes their overall rating, and the firm is notified of it. When this notification is made, the firm is required to disclose it to the audit and supervisory board members of the audited companies (from PY2016).
 - No audit firms qualified as “Generally satisfactory,” the highest rating in the overall rating scheme, so the operation of services at all audit firms was rated as “Satisfactory with minor deficiencies” or lower.
 - Small and medium-sized audit firms, partnerships, and solo practitioners tended to have lower overall ratings than large-sized audit firms and second-tier audit firms. This is because the CPAAOB selects audit firms to be inspected on a risk basis.

Overall ratings (Covers inspections completed in PY2016-19)

Overall rating description	Details	Large-sized audit firms, mid-tier audit firms	Small and medium-sized audit firms
Generally satisfactory	Given when operation of services is deemed to be satisfactory	-	-
Satisfactory with minor deficiencies	Given when there are issues needing to be fixed, but operation of services is deemed to be satisfactory on the whole	9	3
Unsatisfactory	Given when operation of services is deemed to be unsatisfactory	5	4
Unsatisfactory and in need of immediate remediation	Given when operation of services is deemed to be unsatisfactory and in need of immediate remediation	-	3
Extremely unsatisfactory	Material deficiencies with the quality control environment and audit engagements were identified and voluntary remediation cannot be expected to be implemented by the audit firm (recommendation is made to the FSA Commissioner)	-	4

(Note) Firms are notified of their overall ratings following regular inspections. Regular inspections take place once every two years in the case of large-sized audit firms, once every three years in the case of second-tier audit firms, and as necessary in the case of small and medium-sized audit firms, partnerships, and solo practitioners.

Example content (3) Initiatives based on the Audit Firm Governance Code

Action required of audit firms

- The Audit Firm Governance Code must not be adopted in a perfunctory way. Each audit firm must implement it independently in light of their characteristics. They must consider how to implement it to achieve effective organizational administration.

Examples of action by audit firms (Principle 3, Principle 5)

- Large-sized audit firms are moving to strengthen oversight/assessment bodies by appointing independent third persons to these bodies. Furthermore, some of them are enhancing the effectiveness of oversight/assessment bodies and “nomination,” “compensation,” and “audit” subcommittees by increasing the proportion of independent third persons of these bodies (relates to Principle 3).
- Moreover, some large-sized audit firms have established, separately from oversight/assessment bodies, independent bodies comprising independent third persons, and given them the authority to provide information to independent third persons (relates to Principle 3).
- With the aim of improving audit quality, audit firms are creating opportunities for dialogue not only with the audit and supervisory boards of audited companies, but also with a broad range of market participants, including institutional investors and analysts. They are also exchanging information internally and organizing joint forums involving multiple audit firms (relates to Principle 5).

The Audit Firm Governance Code

Principle 1: Role to be accomplished by an audit firm
Principle 2: Organizational structure (management functions)
Principle 3: Organizational structure (oversight/assessment functions)
Principle 4: Operation
Principle 5: Ensuring transparency

Experience/expertise of independent third persons (number of persons)

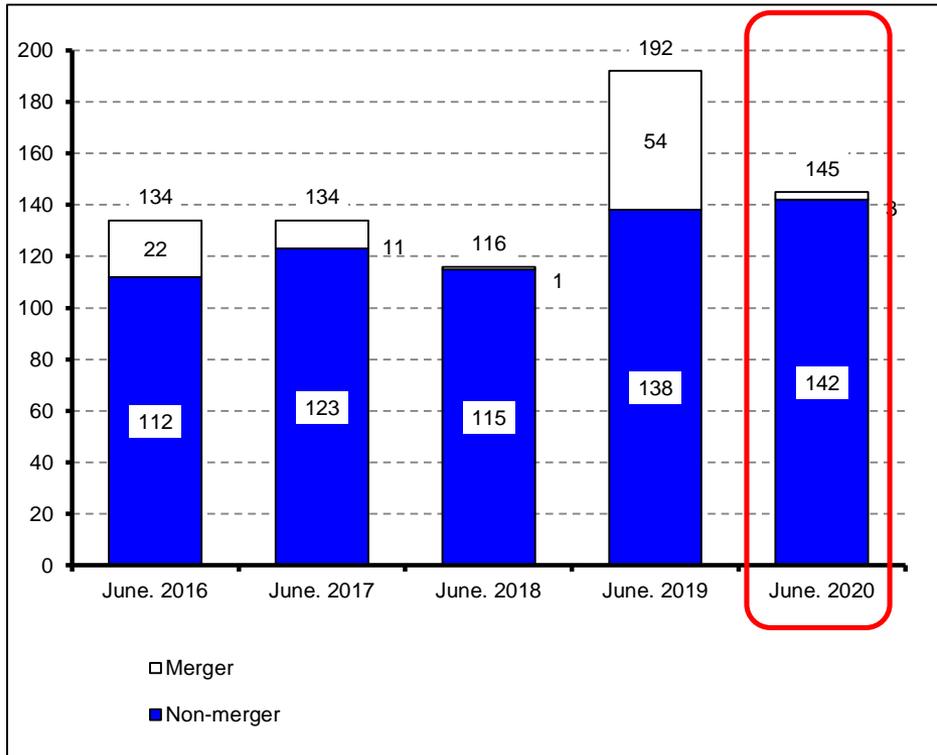
	Former senior management	Academic expert	Attorney and legal experts	Former ministry/ agency officials	Other
Large	10	1	1	1	—
Mid-tier	4	1	1	2	2
Small/ medium	—	3	1	—	—

(Note) Prepared by the CPAAOB based on PY2018 inspections and data released by audit firms

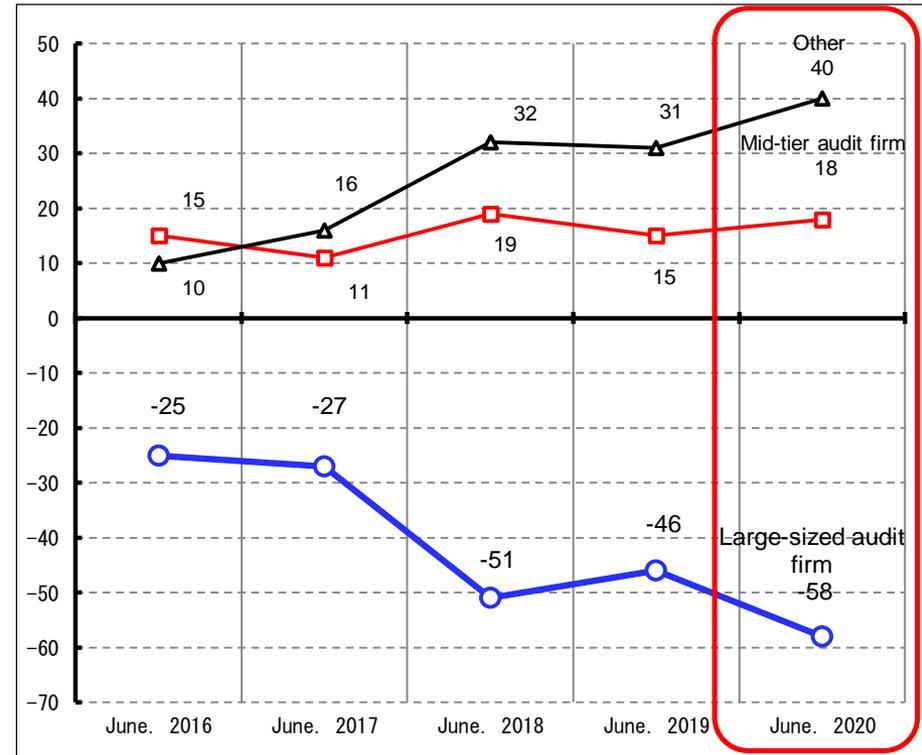
Example content (4) Changes of accounting auditors (1/2)

- Even if changes due to merger are excluded, the number of changes of accounting auditors is at its highest level in five years.
- Breaking things down by size of audit firm reveals an ongoing shift from large-sized audit firms to second-tier or smaller audit firms.

Number of listed domestic companies that changed audit firms (unit: companies)



Changes by size of audit firm (unit: companies)



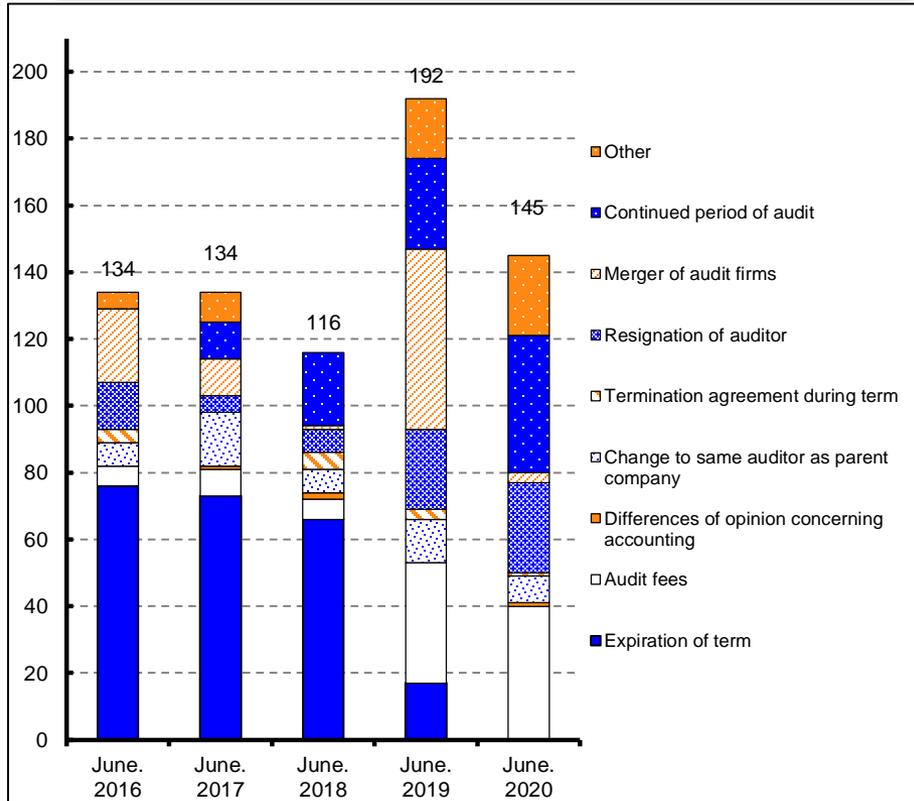
(Note) The figures above show the number of companies that had decided on an incoming auditor by the end of June of each period, based on timely disclosures of listed domestic companies

(Note 1) Net increases/decreases in the number of changes

Example content (4) Changes of accounting auditors (2/2)

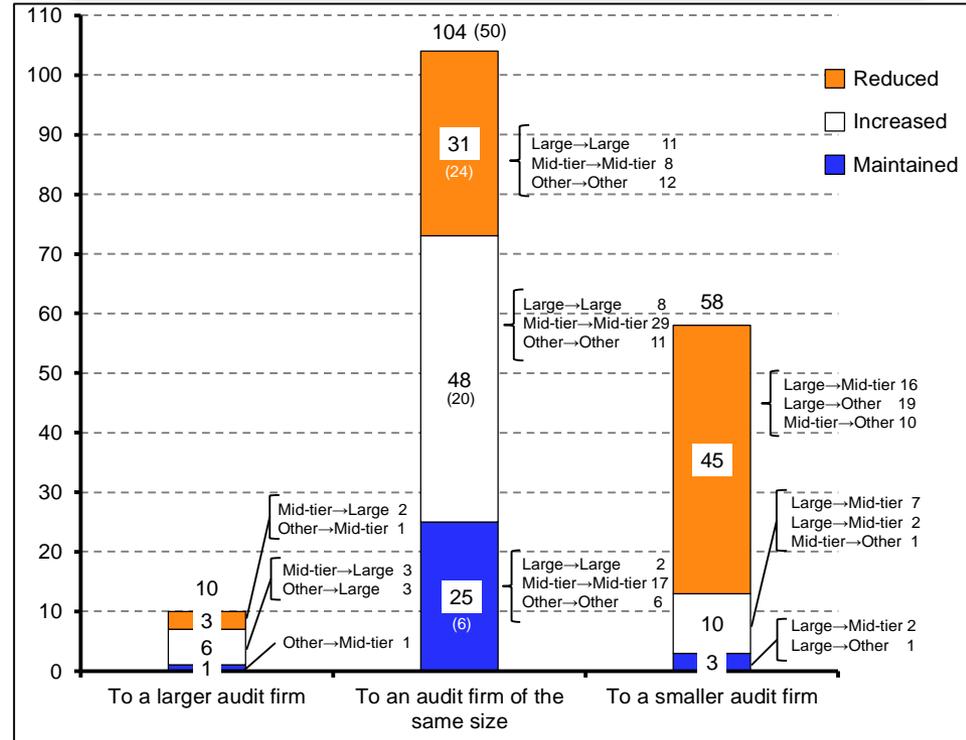
- The most common reason for changes of accounting auditors in the year to June 2018 was the expiration of the audit term, with substantial reasons not being given in many cases. As a result of the cabinet ordinance being revised and disclosure being required in practice, in the year to June 2019, there was a sharp drop in the number of companies giving only expiration of the audit term as the reason.
- Regarding audit fees before and after changes, approximately 80% of changes to a smaller audit firm resulted in lower fees. Among these, changes from a large-sized audit firm to a small and medium-sized audit firm, partnership, or solo practitioner saw fees drop in over 80% of cases.

Reasons for changes in accounting auditors by listed domestic companies (unit: companies)



(Note) The figures above show the number of companies that had decided on an incoming auditor by the end of June of each period, based on timely disclosures by listed domestic companies.

Audit fees following changes in accounting auditors (unit: companies)



(Note 1) Based on changes in accounting auditors between July 2018 and June 2019 where the audit fees before and after the changes were publicly disclosed

(Note 2) Figures in parentheses exclude the 54 cases that were due to mergers among second-tier audit firms and small and medium-sized audit firms in the year to June 2019.

(Note 3) Prepared based on timely disclosures of changes in accounting auditors and annual securities reports