



# 2021 Monitoring Report

Certified Public Accountants and Auditing Oversight Board  
July 2021



## **Introduction**

The Certified Public Accountants and Auditing Oversight Board (hereafter “CPAAOB”) conducts examinations and inspections etc. (monitoring) of audit firms from the viewpoint of safeguarding the public interest and protecting investors, in order to improve the quality and ensure the reliability of audits performed by certified public accountants (CPAs).

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 across 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.

Since CPAAOB launched publishing this sort of report under the title “Monitoring Report” in July 2016, we have updated the data about audit firms and audited companies, and also made revisions, such as adding the latest information obtained through the CPAAOB’s monitoring activities.

The CPAAOB releases the “2021 Monitoring Reports” compiled incorporating achievements and so forth of monitoring in the program year 2020 (from July 2020 through June 2021).

(Major revisions for the 2021 version)

### **I. Overview of the Audit Sector**

We have included information on the overview of certified public accountants (CPAs) and audit firms, the auditing of audited companies and initial public offerings (IPOs) and so forth.

### **II. Monitoring by the CPAAOB**

In addition to updating information related to monitoring, we have elaborated the Basic Plan for Monitoring Audit Firms and so forth in the program year 2021.

### **III. Operation of Audit Firms**

In addition to updating data, we have enhanced the description of firm-wide support for auditing work and added columns about audit firms’ working environment transition and training programs making use of virtual reality.

### **IV. Responses to Changes in the Environment Surrounding Audit**

Based on recent changes in the environment surrounding auditing, we have enhanced the description of audit utilizing information technology (IT) and of responses to enterprises exploring overseas operations. As recent trends related to auditing, furthermore, we have described the impacts of and responses to the spread of infections with COVID-19, responses to key audit matters (KAMs), and audit-related criteria and important reports.

To improve the audit quality, the CPAAOB considers it important to spur interest and raise awareness of accounting auditing among not only market participants, such as auditors or investors but also people on a broader basis. We welcome your comments and requests to further improve the content of our monitoring report.

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## (Abbreviations)

Abbreviations used in this Report shall be defined as follows:

CPAAOB	Certified Public Accountants and Auditing Oversight Board
JICPA	Japanese Institute of Certified Public Accountants
Stock exchange	Financial instruments exchange
CPA Act	Certified Public Accountants Act
FIEA	Financial Instruments and Exchange Act
QCSCS	Quality Control Standards Commission Statements No.1
ASCS	Auditing Standards Committee Statements

## (Terms)

Terms used in this Report shall be defined as follows:

Monitoring	Monitoring consists of inspections and non-inspection monitoring. Non-inspection monitoring involves gathering information through the collection of reports related to audit firms, interviews, and exchange of opinions and cooperation with audit firms and others.
Fiscal year (FY)	The year starting in April and ending in March of the following year, unless otherwise stated
Program year (PY)	The year starting in July and ending in June of the following year
Audit firm	Audit firms, partnerships (persons providing audit and attestation services jointly with other CPAs), and solo practitioners
Large-sized audit firm	An audit firm that has more than approximately 100 domestic listed audited companies and whose full-time staff performing actual audit duties total at least 1,000. In this report, they specifically refer to KPMG Azsa LLC, Deloitte Touche Tohmatsu LLC, Ernst & Young ShinNihon LLC, and PricewaterhouseCoopers Aarata LLC.

Mid-tier audit firm	An audit firm whose business scale is second only to large-sized audit firms. In this report, this will refer to five audit firms: Gyosei & Co., BDO Sanyu & Co., Grant Thornton Taiyo LLC, Crowe Toyo & Co., and PricewaterhouseCoopers Kyoto.
Small and medium-sized audit firm	An audit firm other than large-sized and mid-tier audit firms
Foreign audit firm	An audit firm that is based on a foreign country but provides audit and attestation services for financial documents etc. that are disclosed domestically within Japan
Accounting auditor	A CPA or audit firm
Domestic listed company	Listed companies other than foreign companies. Note that listed companies refers to companies that are listed on a financial instruments exchanges (“exchange”).
Listed financial institution	Among domestic listed companies, refers to securities companies and insurance companies.
Audited company	Companies that undergo audits
Audit engagement	Audit and attestation services carried out by an audit firm for an individual audited company
Business report	A document submitted by an audit firm to the FSA each program year that contains the audit firm’s financial statements and an overview of its operations
Audit Firm Governance Code	“Principles for Organizational Operation of Audit firms” published by the FSA on March 31, 2017
Big Four global accounting firms	The global networks of the four largest accounting firms: Deloitte Touche Tohmatsu, Ernst & Young, KPMG, and PricewaterhouseCoopers
Big Six global accounting firms	The global networks of the Big Four accounting firms, BDO and Grant Thornton



Network firm	An accounting firm belonging to the same global accounting firms
IFRS	International Financial Reporting Standards; accounting standards established by the International Accounting Standards Board (IASB) that have been adopted by many countries/regions
KAM	Key Audit Matters -- The Financial Instruments and Exchange Act requires audit firms to describe KAMs in their audit reports.

(Sources)

Where sources are not indicated, the information has been prepared based on data etc. on audit firms obtained by the CPAAOB in the course of its monitoring etc.

(Timing and timeframe of data collection)

To reflect the most up-to-date information, the timing and timeframe of data collection are not uniform; the timing and timeframe of data collection are listed in the notes inside or underneath each figure. Component ratios have been rounded down to the nearest whole number, and may not add up evenly to 100.

# I. Overview of the Audit Sector



## **I. Overview of the Audit Sector**

### **A. CPAs**

#### **1. Introduction of the CPA system**

A certified public accountant system was introduced in Japan in 1948. The Securities and Exchange Act was promulgated in 1947, requiring companies that issue or solicit investment in shares, corporate bonds or other securities to submit reports. The issuer is required to obtain audit attestation from certified public accountants (CPAs) by the full overhaul of the 1948 Securities and Exchange Act (now the Financial Instruments and Exchange Act ("FIEA")) as well as the promulgation/enforcement of the Certified Public Accountants Act ("CPA Act").

Accordingly, the Certified Public Accountants Management Committee was established to conduct CPA examinations, etc. (becoming the CPA Examination and Investigation Board in 1952 after a transfer of jurisdiction, and expanded/restructured into the current Certified Public Accountants and Auditing Oversight Board in 2004). The Corporate Accounting Principles were released in 1949, and the Audit Standards in 1950.

The present CPA Act clearly sets out the mission and professional responsibilities of CPAs as given below. CPAs must always be self-aware of this mission and these professional responsibilities in performing their duties regardless of audit attestation services or non-audit services.

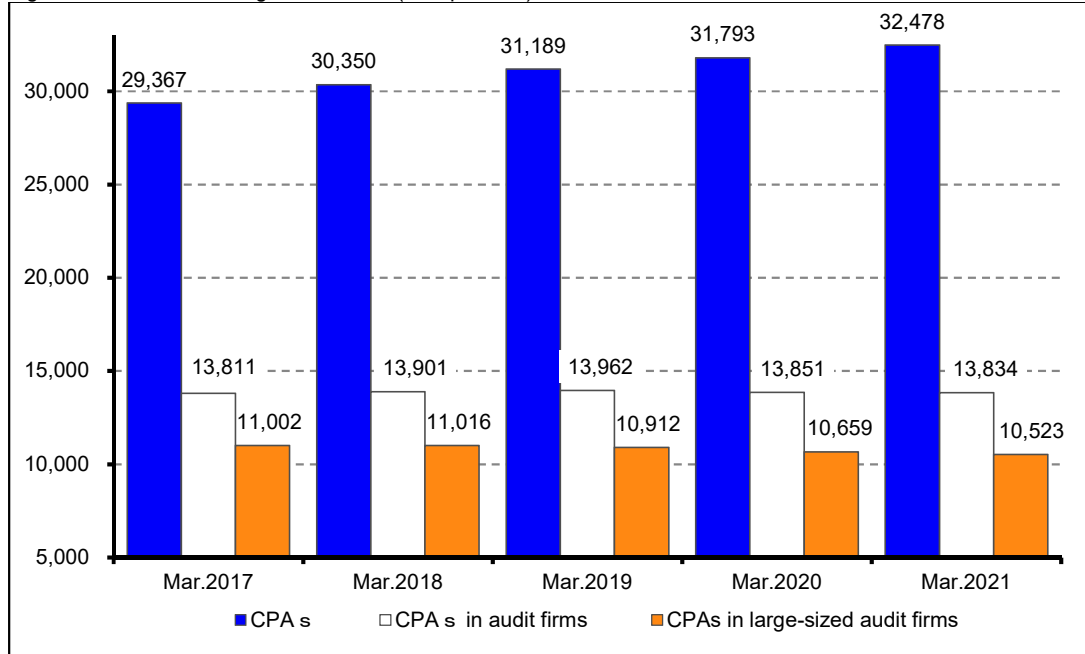
"The mission of certified public accountants, as professionals on auditing and accounting, shall be to ensure matters such as the fair business activities of companies, etc., and the protection of investors and creditors by ensuring the reliability of financial documents and any other information concerning finance from an independent standpoint, thereby contributing to the sound development of the national economy." (Article 1)

"A certified public accountant shall always maintain his/her dignity, endeavor to acquire knowledge and skills, and provide services with fairness and integrity from an independent standpoint." (Article 1-2)

#### **2. CPAs**

The number of registered CPAs has been gradually increasing over the past few years. However, the number of the registered CPAs belonging to audit firms has stayed flat and their proportion of the overall total of registered CPAs has dropped year by year from 47.0% at the end of March 2017 to 42.6% at the end of March 2021. Of the registered CPAs belonging to audit firms, around 80% at large-sized audit firms (Figure I-1-1).

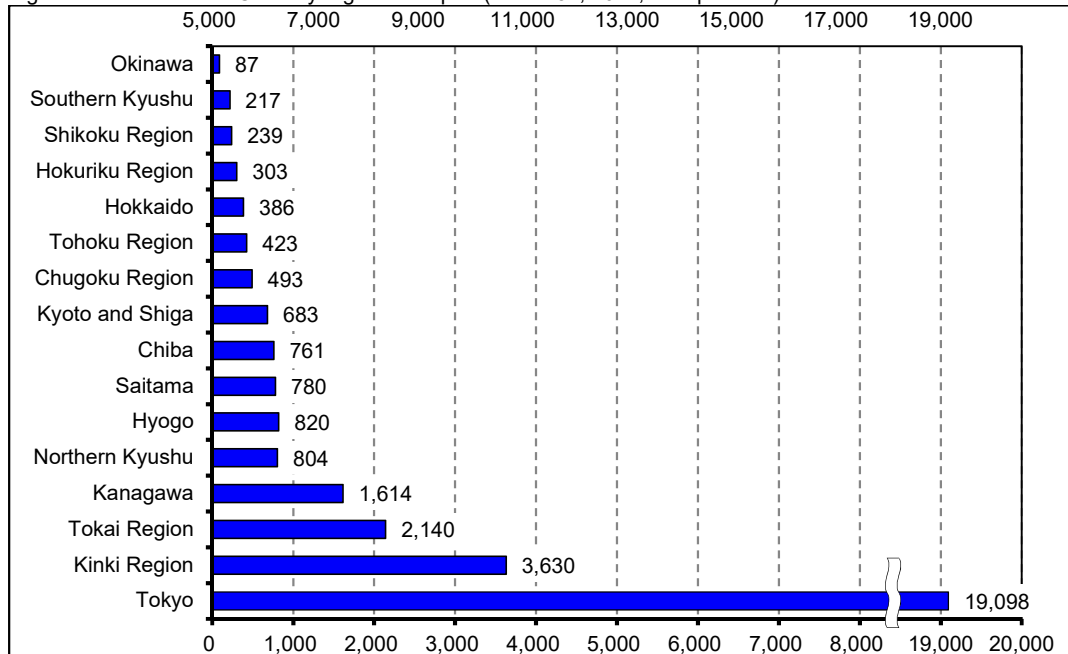
Figure I-1-1. Number of registered CPAs (unit: persons)



(Source) Prepared by the CPAAOB based on data from the JICPA

CPAs must be members of the JICPA (Article 46-2 of the CPA Act) and must belong to a regional chapter, i.e., one of the JICPA branches established across Japan (16 regional chapters as of March 31, 2021). Around 70% of CPAs are based in the Tokyo metropolitan area (Tokyo, Kanagawa, Saitama, Chiba) (Figure I-1-2).

Figure I-1-2: Number of CPAs by regional chapter (March 31, 2021; unit: persons)

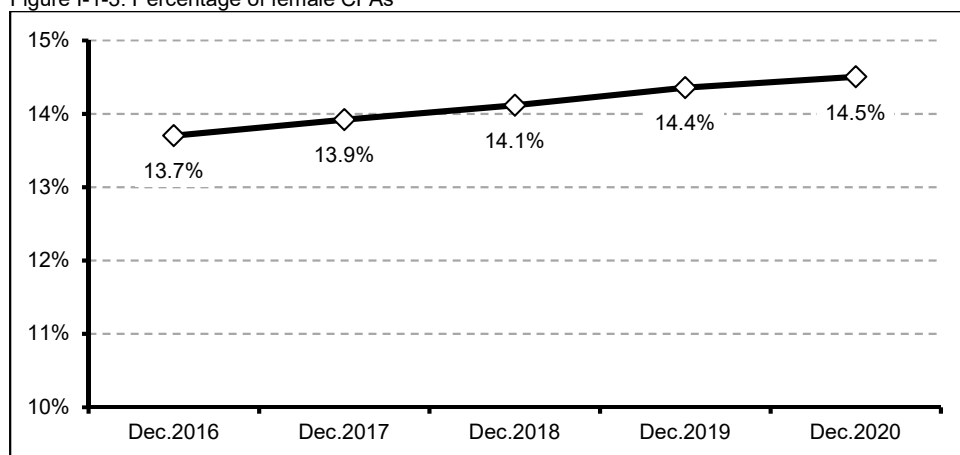


(Source) Prepared by the CPAAOB based on data (e.g. survey of numbers of members) from the JICPA

### 3. Percentage of Female CPAs

The percentage of women among the total number of registered CPAs is gradually increasing (Figure I-1-3), and at the end of 2020 the figure topped 14.5%, which is the same as the level for female tax accountants<sup>1</sup>. On the other hand, it is still lower than the percentages of female attorneys<sup>2</sup> and female CPAs in the UK and US<sup>3</sup>.

Figure I-1-3: Percentage of female CPAs



(Source) Prepared by the CPAAOB based on data from the JICPA

#### ■ Efforts to explore Female CPAs ■

The Japanese Institute of Certified Public Accountants (hereinafter JICPA) is promoting arrangements to further empower female CPAs, such as the use of maiden names, support for employment and return to work, exemption or relief from continuing professional education (CPE) and membership fees during absence from work for childbirth, childrearing and other reasons. There are some large-sized audit firms nurturing female executives and providing support for women CPAs at each life stage.

CPAs' way of work is changing because of a further increase in the use of remote work and other developments resulting from such factors as the spread of COVID-19 infections. At large-sized and mid-tier audit firms in particular, the way of work in disregard of work hours and places is becoming a common practice due to the introduction of telework and online meetings, promotion of paperless operations and so forth. Now that remote auditing work has become applicable, conditions where women CPAs can build up their careers while achieving a work-life balance are developing.

To encourage more women to take the CPA examination, the JICPA disseminates female CPAs' messages about the attractiveness and worthiness of their work and career plans through lectures at high schools and universities and the pamphlet of the CPA examination. The number of women submitting applications for the examination and passing it has been showing an upward trend in recent years. While 24.6% of all CPAs were women in 2020, the ratio of successful female applicants for the examination came 10.4%, almost the same as 10.0% for men.

<sup>1</sup> According to a survey of female participation in policy making conducted by the Cabinet Office's Gender Equality Bureau, the percentage of female tax accountants is 15.1%.

<sup>2</sup> According to the White Paper on Attorneys 2020, the percentage of females is 19.0%.

<sup>3</sup> The percentage of female CPAs in the U.S. and the U.K. is as follows:

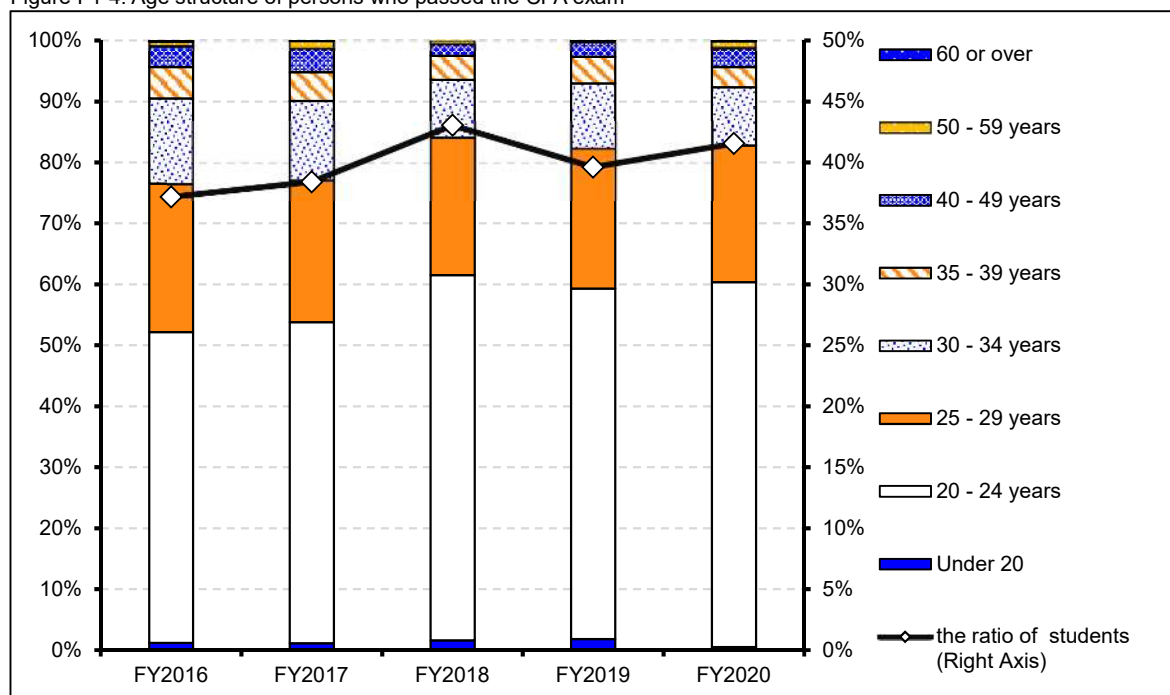
US: According to a survey of employment at accounting firms in 2018 conducted by the AICPA and included in its "2019 Trend Report," the percentage of females is 42%.

UK: According to the Financial Reporting Council's "Key Facts and Trends in the Accountancy Profession 2020," there are several CPA institutes in the UK, and the average female membership for them is 37%.

#### 4. Age Structure of Persons who Passed the CPA exam

Breaking down the age structure of persons who passed the CPA examinations, we see that the largest age group is 20-24 years. People in this group accounted for 59.9% of those who passed it in 2020. As for occupation, the ratio of students (excluding persons enrolled in courses at vocational schools etc.) is the highest. Among them, the proportion enrolled in universities (including junior colleges) was 41.6% in the 2020 examinations (Figure I-1-4).

Figure I-1-4: Age structure of persons who passed the CPA exam



(Source) Prepared by the CPAAOB based on data from the CPAAOB survey of persons who passed the CPA exam



## B. Audit Firms

Audit firms, i.e., CPA firms engaged in providing audit and attestation services, numbered 2,291 at the end of March 2020, but they vary by service and business format.

Audit and attestation services cover both statutory audits and non-statutory audits. Statutory audits are CPA audits required by the law. When CPA audits were first introduced, the only statutory audits were FIEA audits, but thereafter CPA audits under the Companies Act were introduced, and then educational corporation audits under the Act on Subsidies for Private Schools. There are now a multitude of statutory audits, including audits of labor unions, credit unions, social welfare corporations and medical corporations, etc. A more detailed explanation of audit and attestation services is provided on page 23 (“C. Audited Companies, 1. Types of Audit and Attestation Services”).

There are three types of entities providing audit and attestation services: audit firms, partnerships, and solo practitioners. Audit firms are established pursuant to the CPA Act for the purpose of organizationally performing audit and attestation services. When the audit firm system was forged in 1966, the tasks involved in audit and attestation services had increased in volume and complexity as corporations subsequently grew larger in scale and management became more multifaceted. Numerous incidents of fraudulent accounting were occurring at the time, bringing into question the *raison d’être* of CPAs. The system of audit firms was therefore introduced to improve audit quality for promoting the conduct of organizational audits.

The CPAAOB classifies audit firms by scale into large-sized audit firms, mid-tier audit firms, and small and medium-sized audit firms. The firms were classified as shown below based on their size and the audit services they provide (Figure I-2-1), and the CPAAOB mainly monitors those audit firms conducting FIEA audits of domestic listed companies.

Figure I-2-1: Classifications of audit firms (as of March 31, 2020)

Audit firm	Number of firms	Statutory audits			Non-statutory audits
		FIEA audits (Note 4)	Companies Act audits	Other	
Large-sized audit firms	4	○	○	○	○
Mid-tier audit firms	5	○	○	○	○
Small and medium-sized audit firms	2,282	○ (Note 4)	○	○	○
(Breakdown)	Small and medium-sized audit firms	(249)			
	Partnerships (Note1)	(56)			
	Solo practitioners (Note 1)	(1,977)			

(Note 1) The number of audit offices in fiscal 2019 (book closing date from April 1, 2019, till March 31, 2020) listed in copies of audit summaries or audit implementation reports submitted to the JIPCA.

(Note 2) The symbol “O” in the table above means that audits concerned can be conducted.

(Note 3) Audit firms are required to register with the JIPCA to audit domestic listed companies. For more information, see the column “JIPCA’s Registration System for Listed Company Audit Firms” (page 27)

(Note 4) For solo practitioners to provide audit and attestation services to listed companies, they are required by law and each exchange’s securities listing regulations to provide them jointly with other CPAs, etc.

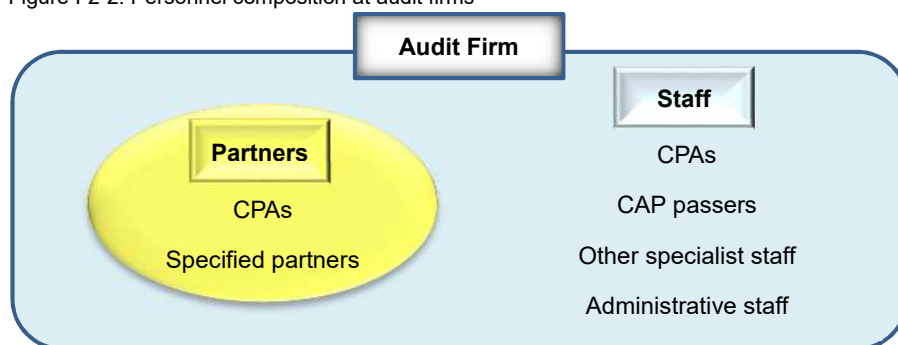
# 1. Organizational Structure of Audit Firms

Audit firms are established through investment by groups including five or more CPAs, and their defining characteristics are that the persons who invested (partners) are directly engaged in management and that they ensure organizational discipline via mutual monitoring. Some audit firms comprise only partners, but those of a certain scale ordinarily employ CPAs (CPAs who have not invested in order to become partners of the audit firm), CPA passers (persons who have passed the CPA exam but have not been registered as CPAs after undergoing practical training and providing assistance with audit work), and other experts as staff.

In the past, partners of audit firms were limited to CPAs, but in today's more sophisticated economy and society, a partner is required to have a wide range of knowledge including management, law, IT, pension mathematics to ensure appropriate operational management of the audit firm and to provide effective organizational audit services. Accordingly, as a result of legal revisions in 2007, a "specified partner system" allowed non-CPAs to be partners at an audit firm. However, CPAs must comprise at least 75% of the audit firm's partners if specified partners join the firm. In FY2020 large-sized audit firms had 121 specified partners among a total of 1,859 partners.

The personnel composition of an audit firm is outlined below (Figure I-2-2), and explained in more detail in "III. Operation of Audit Firms, A. Operations Management System, 3. Human Resources of Audit Firms." (page 71).

Figure I-2-2: Personnel composition at audit firms



(Source) Prepared by the CPAAOB with reference to page 55 of "New CPA/Audit firm Audit System - Ensuring Fair Financial/Capital Markets" (Dai-ichi Hoki Co., Ltd., 2009), Yuichi Ikeda and Hidenori Mitsui, ed.

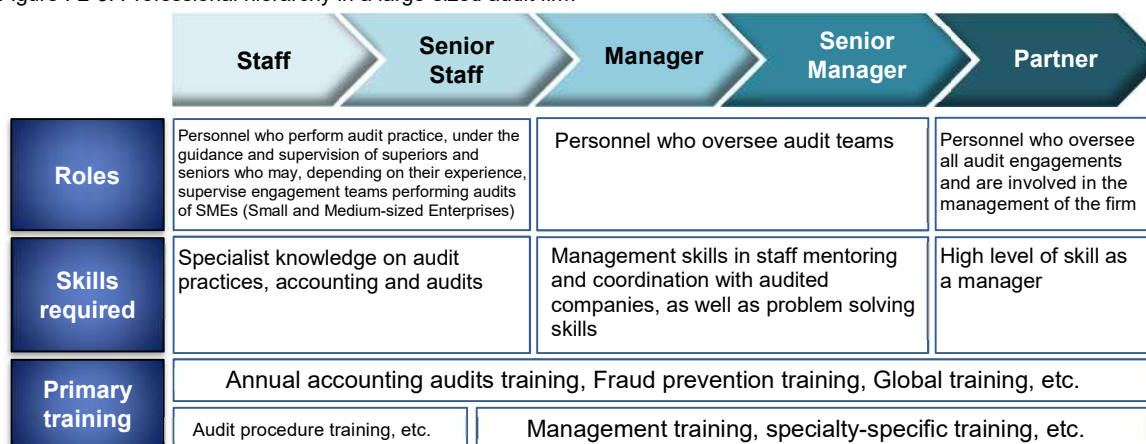
	Large-sized audit firm	Mid-tier audit firm	Small and medium-sized audit firm
Partners	More than 150 up to approx. 600	Approx. 30 up to 100	Up to approx. 30
Full-time staff	Approx. 2,900 up to approx. 6,400	Approx. 170 up to 800	Up to approx. 80

(Note) See "Figure III-1-3: Characteristics of each type of audit firm" (page 64) for Characteristics of organizational structure based on audit firm size.

In response to the increasing complexity and internationalization of corporate activities at domestic listed companies, especially major ones, audit firms grow bigger. The large-sized audit firms responsible for the majority of audits of major listed companies have workforces exceeding several

thousand people; even mid-tier audit firms now frequently have more than 200 people. As audit firms grow in scale, they introduce job classification system defined by abilities, experience, etc. for effective management of organization. (Figure I-2-3). It is standard practice for personnel to move up the ranks from staff and senior staff to manager, senior manager and, if selected, to partner. The expanding size of audit firms and the increasing complexity of their organizational administration has made the difficulty of ensuring audit quality even more apparent. In response to this situation, Principles for Effective Management of Audit Firms (the Audit Firm Governance Code) were formulated in March 2017, and are now being adopted, particularly by large-sized audit firms and mid-tier audit firms.

Figure I-2-3: Professional hierarchy in a large-sized audit firm



(Note) For details, see “III. Operation of Audit Firms, A. Operations Management System, 4. Organizational Structure for Providing Audit Services” (page 75) and “5. Organizational Structure for Supporting Audit Services” (page 78).

## 2. Development of Quality Control Structures by Audit Firms

To ensure audit quality, it is important that audit firms develop/administer appropriate quality control structures to serve as a foundation for having their partners perform audit services properly.

Following revisions made in 2003, the CPA Act legally mandated that an audit firm shall develop the operation control structure in order to perform its services fairly and accurately, and the revisions made in 2007 clarified that the following is included in the operation control structure (Article 34-13 (2) of the CPA Act):

- a. Measures for securing the fair execution of services
- b. Formulation and implementation of policy on service quality control
- c. Measures for eliminating the possibility of persons other than partners who are CPAs from having an inappropriate influence on the execution of audit and attestation services provided by partners who are CPAs

The 2007 revision of the CPA Act thus transformed the formulation and implementation of the service

quality control policy into legal obligations for audit firms as part of their development of the operation control structure. Service quality control means to take the necessary measures for preventing the occurrence of a situation that would deteriorate the appropriateness, fairness or credibility of services (Article 34-13 (3) of the CPA Act).

A Cabinet Office Ordinance (the Ordinance for Enforcement of the Certified Public Accountants Act) specifically stipulates the following regarding matters concerning the implementation of services (Article 26 of the Ordinance):

- a. Observance of professional ethics and securing of independence with regard to services
- b. Conclusion and renewal of contracts pertaining to services
- c. Employment, education, training, evaluation, and appointment of partners in charge of services and any other persons
- d. Implementation of services and reviews thereof (including the following matters)
  - Consultation of expert opinions (solicitation of opinions on specialist matters from persons having expert knowledge and experience with regard to the services)
  - Resolution of differences of opinion in audits (differences in determinations between the persons implementing the audit and attestation services or between such persons and persons engaging in a review of the audit and attestation services)
  - Reviews of audit and attestation services

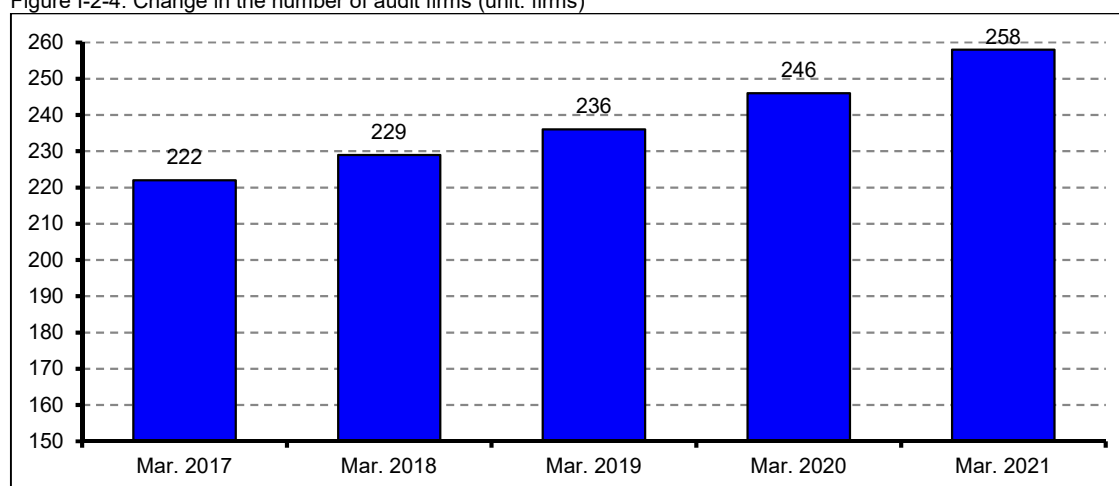
The aforementioned regulations on service quality control have been consistent with the “Quality Control Standards for Audits” (2005), which were established by the Business Accounting Council, and incorporate all six component elements of these quality control standards: a. responsibility for quality control, b. professional ethics and independence, c. conclusion and renewal of audit contracts, d. employment, education, training, evaluation and appointment of engagement teams, e. implementation of services, and f. monitoring of the system of quality control.

Furthermore, the “Quality Control Standards on Audits” were formulated for audit and attestation services, but the services requiring development of quality control as part of firm’s operation control structure are not limited to audit and attestation services but encompass all of audit firm’s operations. Consequently, audit firms need to comply with professional ethics in their services other than audit and attestation services as well.

### 3. Number of Audit firms

The number of audit firms has been on an upward trend in recent years. As of March 31, 2021, there were 258 firms, and four firms disappeared as a result of dissolution or merger and 16 were established in the period April 2020-March 2021, ending up with a net increase by 12 firms (Figure I-2-4) year on year. See “4. Mergers of Audit Firms” (page 20) for details on mergers from FY2016 onwards.

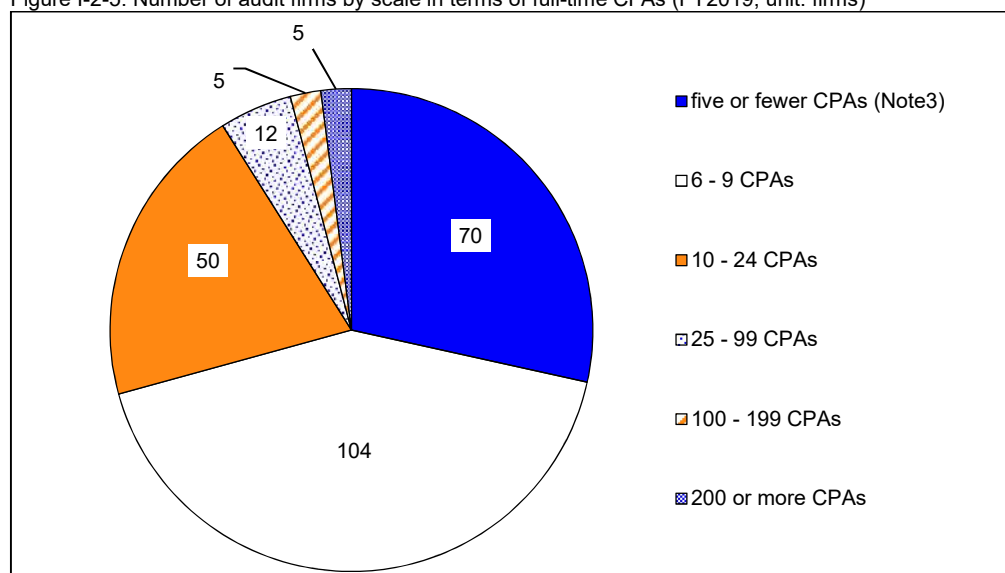
Figure I-2-4: Change in the number of audit firms (unit: firms)



(Source) Prepared by the CPAAOB based on data (e.g. survey of numbers of members) from the JICPA

Classification by the number of full-time CPAs belonging to each audit firm reveals that firms with fewer than 25 CPAs make up over 90% of the total (Figure I-2-5).

Figure I-2-5: Number of audit firms by scale in terms of full-time CPAs (FY2019; unit: firms)



(Note 1) The number of full-time CPAs is the total of partners who are CPAs and full-time staff who are CPAs.

(Note 2) Data on 246 audit firms was collected from operational reports submitted by these firms in FY2019.

(Note 3) An audit firm where the number of partners who are CPAs drops to four or fewer should be dissolved, but six months is granted as suspended term as stipulated in the CPA Act.

## 4. Mergers of Audit Firms

There have been 7 mergers of audit firms since FY2016 (Figure I-2-6). The main reasons for the mergers were to reinforce management infrastructure and to expand business.

Figure I-2-6: Audit firms involved in mergers from FY2016 (March 31, 2021)

FY	Surviving firm	Disappearing firm
2016	ARK MEIJI AUDIT & Co.	Hijiribashi Audit Corporation
	Seiyo Audit Corporation	Kudan Audit Corporation
2017	(No mergers)	
2018	Grant Thornton Taiyo LLC	Yusei Audit & Co.
	Toho Audit Corporation	Aoyagi Accounting Office
2019	Sohken Audit Corporation (Sohken Nichiei Audit Corporation)	Nichiei Audit Corporation
2020	Ark LLC	Kinki Daiichi Audit Corporation
	Nishi-Nihon Audit Corporation (Kowa Audit Corporation)	Hibiya Audit Corporation

(Note) Names in parentheses show the name of the surviving firm as of March 31, 2021.

(Source) Prepared by the CPAAOB from materials made publicly available by audit firms

Reports collected from mid-tier audit firms (five firms) in PY2020 showed that four of them considered mergers as an option for their future business strategies.

The collection of reports from small and midsize audit firms (involving 43 firms) in the same program year found that roughly 30% of them were either considering mergers in specific terms or were willing to consider mergers if they find a promising merger partner.

## **5. Financial Condition (Operating Revenue, Proportion of Audit and Attestation Services and Non-audit and Attestation Services)**

Audit firms offer not only audit and attestation services but – non-audit services as opposed to audit and attestation services such as assurance services, support for initial public offerings and introduction of IFRS, and financial advisory services for organizational realignment and so forth.

Operating revenues over the five years until FY2020 (FY2019 in the case of small and medium-sized audit firms) showed an uptrend at large-sized and mid-tier audit firms, while those at small and medium-sized audit firms began to increase in FY2017 after declining in FY2016.

Revenues from audit and attestation services roughly accounted for 75% of operating revenues at large-sized audit firms, while the ratio was about 90% at mid-tier and small and medium-sized audit firms (Figure I-2-7). For audit firm groups' operating revenues, see "III. Operation of Audit Firms, A. Operations Management System, 6.Audit Firm Groups" (page 81)

Characteristics of audit firms, classified by size, were as follows:

### **a. Large-sized audit firms**

The proportion of audit service and attestation revenue has ranged between 70% and 80% at three of the four firms, but at the remaining firm it has hovered at around 50%.

Large-sized audit firms operate based on their organizational view that performing non-audit services provides opportunities to acquire a wide variety of business experiences to foster personnel, obtaining a broad range of experiences and knowledge serves to enhance audit quality, and the policy of non-audit service is effectively playing role of attracting talent.

### **b. Mid-tier audit firms**

While audit and attestation service revenues have been rising at all firms, the ratio of them in operating revenues has been hovering at around 90%. There was a wide variation in revenues between mid-tier audit firms, and the gap may change depending on future developments, such as mergers.

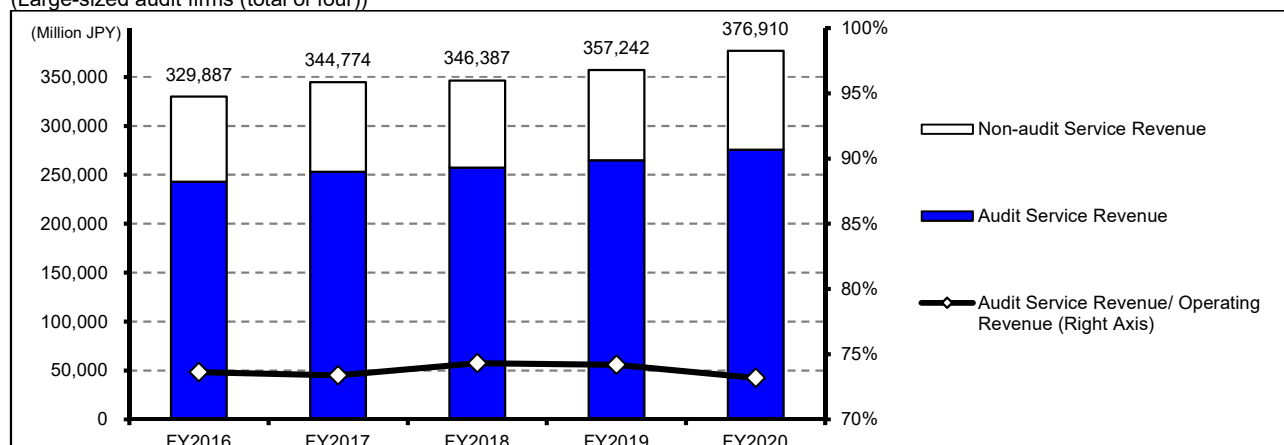
Mid-tier audit firms were aiming to expand the non-audit services, as specifically, performing non-audit services provides opportunities to acquire a wide variety of business experiences to foster personnel, obtaining a broad range of experiences and knowledge serves to enhance audit quality, and a policy of non-audit services is effectively playing a role of attracting talent. However, due to reasons such as limitations in terms of headcount, mid-tier audit firms find themselves not to be placed to rapidly expand a proportion of the revenues of non-audit services.

### **c. Small and medium-sized audit firms**

The operating revenues of small and medium-sized audit firms are moderate on the whole, but mergers among some of the largest firms in this category were recently expanding their business.

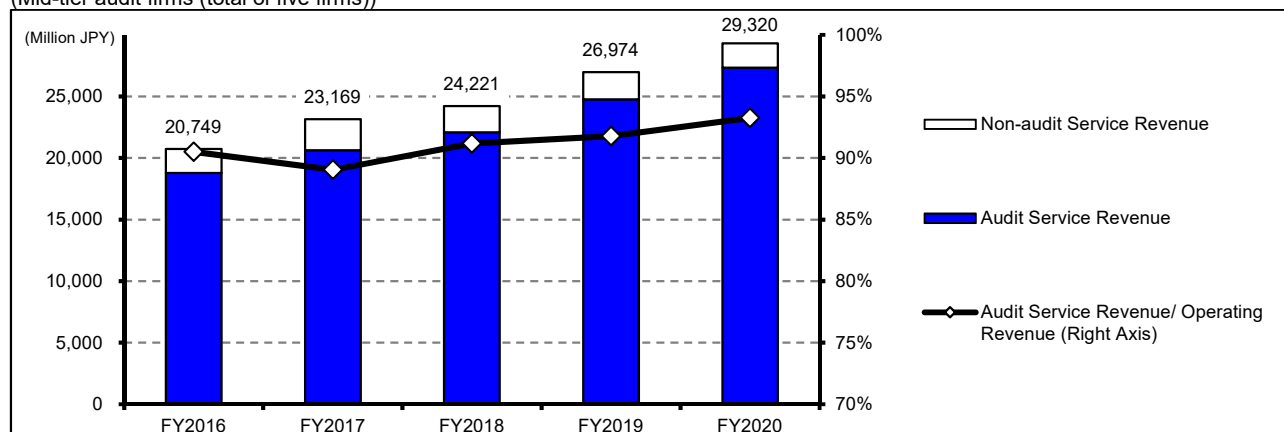
Figure I-2-7: Operating revenues, breakdowns of operating revenues, and proportions of audit and attestation service revenues to total operating revenues

(Large-sized audit firms (total of four))



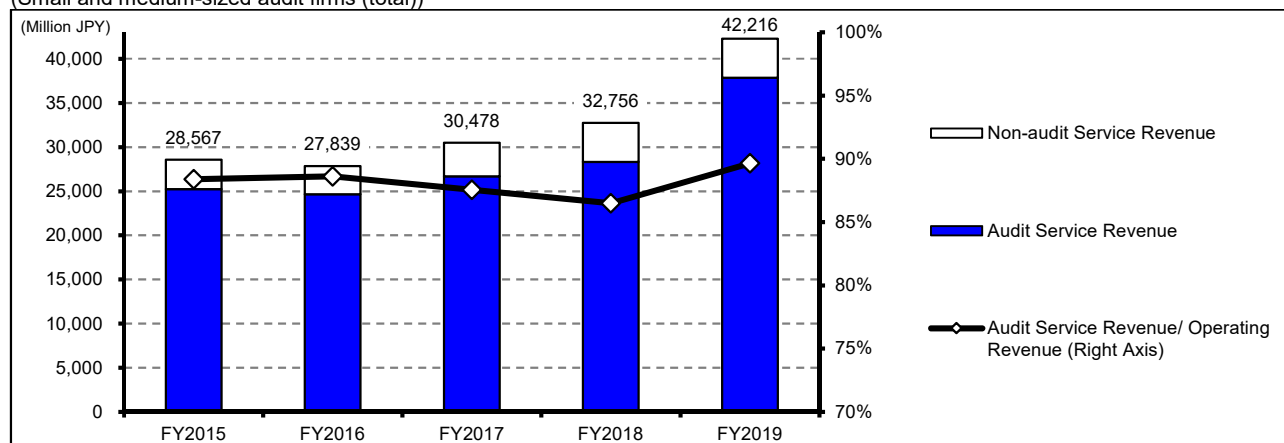
(Note) In FY2017, one audit firm changed its fiscal year-end, so calculations are based on eight-month figures. As a result, FY2017 operating revenues are calculated by extrapolating eight-month operating revenues to one-year periods (by multiplying figures by 12 months/8 months) for the audit firm that changed its fiscal year-end.

(Mid-tier audit firms (total of five firms))



(Note) In FY2016 one firm changed its fiscal year-end, closed its books after a 15-month fiscal year, and did not submit its report within the program year. As a result, when aggregating the figures, FY2015 data was used for the FY2016 operating revenues for this firm. Operating revenues for FY2017 represent 15 months' worth of operating revenues.

(Small and medium-sized audit firms (total))



(Note 1) As fiscal year-end varies widely among small and medium-size audit firms, their results in FY2020 have yet to be tallied. This report therefore covers their results through FY2019 (from April 2019 through March 2020). The number of small and medium-sized audit firms differs each fiscal year. For FY2019, the results of 229 firms were tallied.

(Note 2) Audit and attestation service revenues greatly increased as a whole because of a steep rise at a firm.

(Reference material) Prepared by the CPAAOB based on operational reports submitted by audit firms.



## C. Audited Companies

Audit and attestation services differ by content and status due to statutory audits mandated by different regulations and audited companies' business scale, etc.

### 1. Types of Audit and Attestation Services

As previously noted (see "B. Audit Firms" (page 15)), audit and attestation services include statutory audits, which are based on such laws as the FIEA, the Companies Act, the Act on Subsidies for Private Schools, and the Labor Union Act and non-statutory audits whose objectives and content are decided by the parties involved. The types of audit and attestation services provided by audit firms are shown below (Figure I-3-1).

Figure I-3-1: Types of audit and attestation services

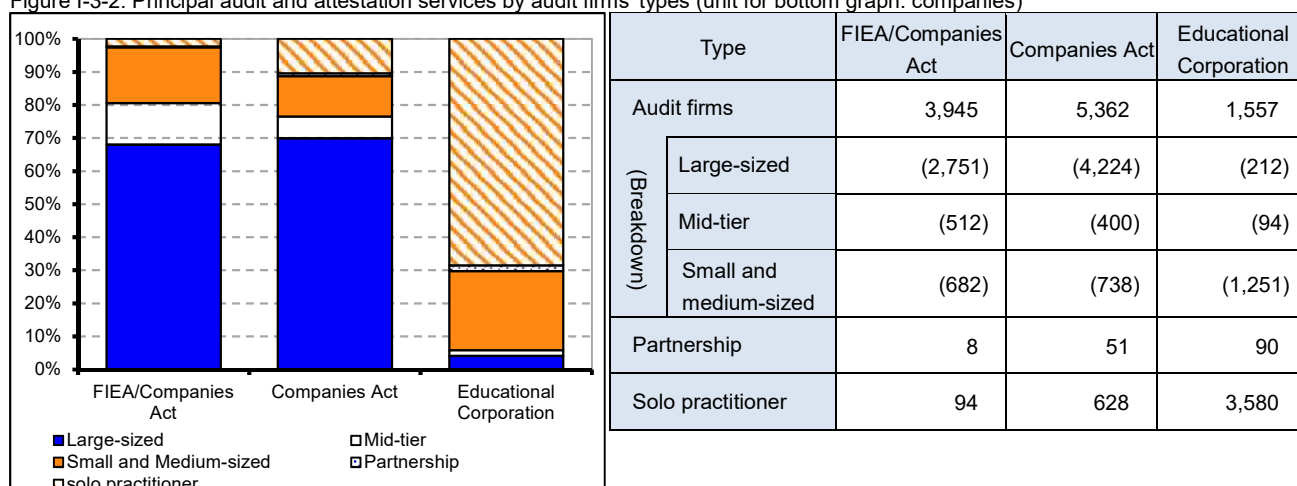
Type	Statutory audits						Non-statutory audits	Total
	FIEA / Companies Act	FIEA	Companies Act	Act on Subsidies for Private Schools	Labor Union Act	Other		
Number of companies	3,991	333	5,377	1,679	423	3,460	5,162	20,425
Percentage	19.5	1.6	26.3	8.2	2.1	17.0	25.3	100.0

(Note 1) The number of audited companies has been aggregated from operational reports submitted by audit firms in FY2019.

(Note 2) "FIEA/Companies Act" denotes operations where audit and attestation under both the FIEA and Companies Act are required, while "FIEA" and "Companies Act" denote operations where audit and attestation under the respective act only is required.

Audit firms, partnerships and solo practitioners are the entities that provide audit and attestation services. Looking at the entities providing audit and attestation services, about 70% of FIEA/Companies Act audits and Companies Act audits are conducted by large-sized audit firms, while about 70% of educational corporation audits are conducted by solo practitioners (Figure I-3-2).

Figure I-3-2: Principal audit and attestation services by audit firms' types (unit for bottom graph: companies)



(Note) Data was aggregated from audits conducted from the term ended April 2019 to the term ended March 2020. The figures do not match with the figures in Figure I-3-1 because the collection period is different.

(Source) Prepared by the CPAAOB based on data from the JICPA

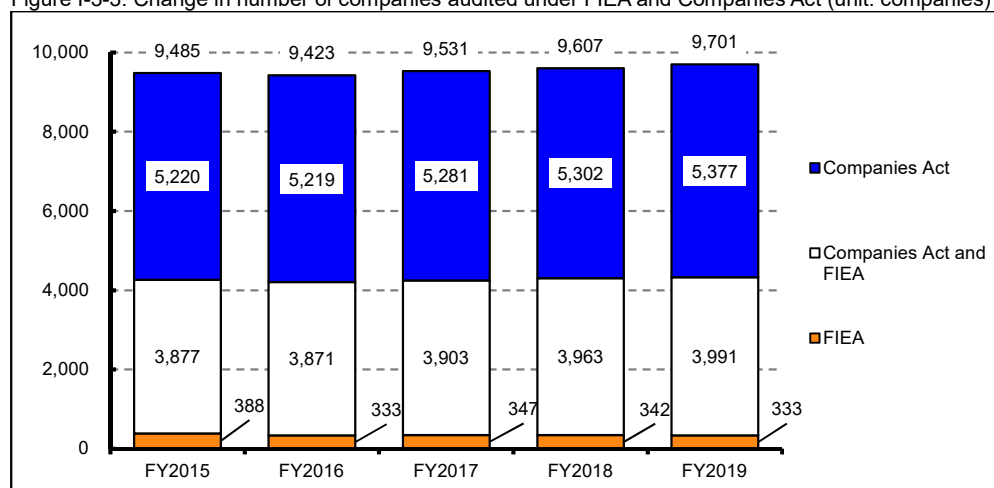
## 2. FIEA and Companies Act Audits

The results of analysis of audited companies etc. and listed companies that are subject to statutory audits under the FIEA and the Companies Act are as follows:

- a. Number of companies audited under the FIEA and the Companies Act and share by scale of audit firm

There has been no significant change in the number of companies audited under the FIEA or the Companies Act (Figure I-3-3). With regard to share by scale of audit firm, large-sized audit firms' share has been going down, mid-tier and small and medium-sized audit firms' share have been going up annually (Figure I-3-4).

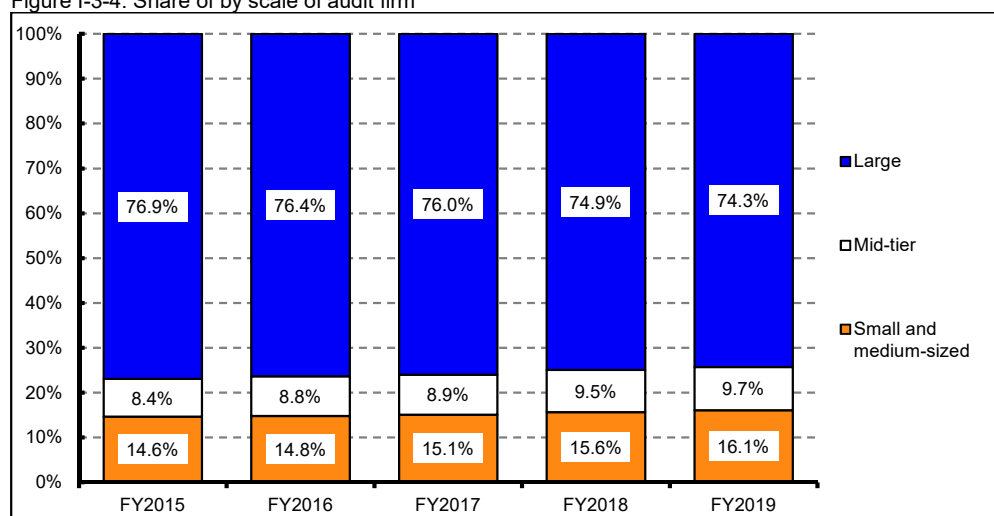
Figure I-3-3: Change in number of companies audited under FIEA and Companies Act (unit: companies)



(Note 1) The number of audited companies is compiled based on operational reports submitted by audit firms.

(Note 2) Figures for mid-tier audit firms that changed their closing month in FY2016 are compiled using FY2015 data as the number of audited firm for FY2016 is unknown.

Figure I-3-4: Share of by scale of audit firm



(Note 1) The number of audited companies is compiled based on operational reports submitted by audit firms.

(Note 2) Figures for mid-tier audit firms that changed their closing month in FY2016 are compiled using FY2015 data as the number of audited firm for FY2016 is unknown.

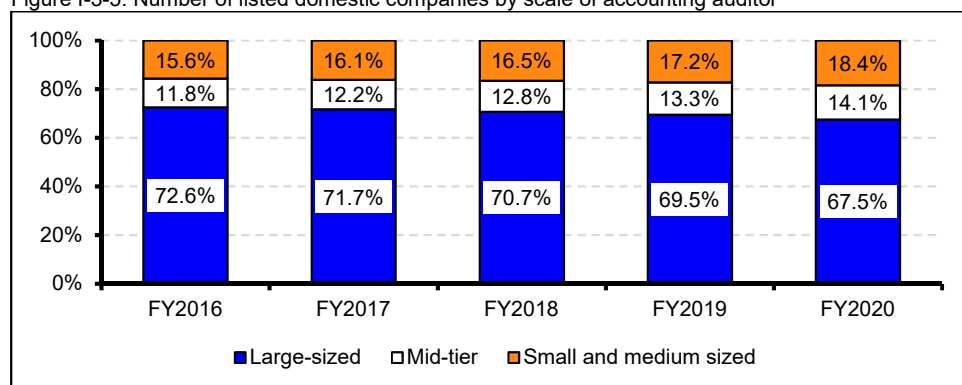
b. Share of listed domestic companies by scale of audit firms

Audits at about 70% of listed domestic companies are conducted by large-sized audit firms, but in terms of market capitalization, large-sized audit firms have about 90% share and this trend has been persisting for many years. This is because listed domestic companies with large market capitalizations conduct operations on a large scale, and their operations are complex as well as international by nature. As a result, their audits require a large number of audit personnel and various specialist capabilities, which likely makes it difficult for firms other than large-sized audit firms to handle their audits (Figures I-3-5 and I-3-6).

At the end of FY2020, there were 3,813 domestic listed companies, and 2,574 of them were audited by large-sized audit firms, 537 of them were audited by mid-tier audit firms, and 702 were audited by small and medium-sized audit firms. Meanwhile, the market capitalization of domestic listed companies was 758,041 billion yen, of which large-sized audit firms handled 683,642.8 billion yen, mid-tier audit firms handled 44,987.8 billion yen, and small and medium-sized audit firms handled 29,400.2 billion yen.

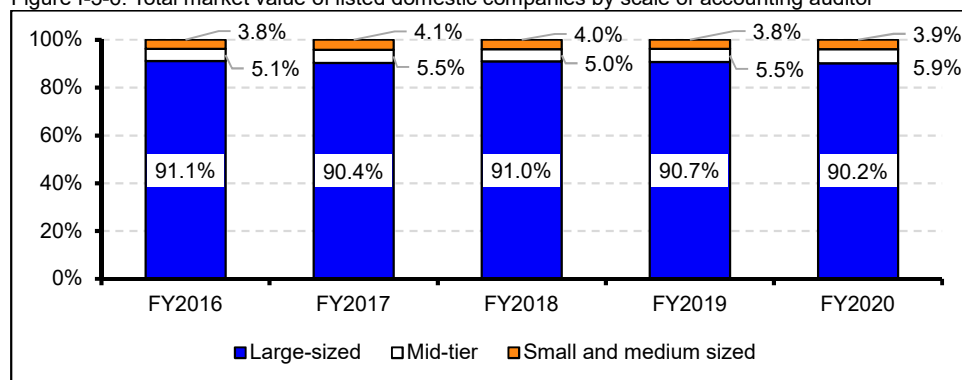
Among the top 20 companies in terms of market capitalization at the end of FY2020 (accounting for about 26% of total market capitalization), 17 companies were audited by large-sized audit firms.

Figure I-3-5: Number of listed domestic companies by scale of accounting auditor



(Source) Prepared by the CPAAOB based on data from Quick and exchanges

Figure I-3-6: Total market value of listed domestic companies by scale of accounting auditor

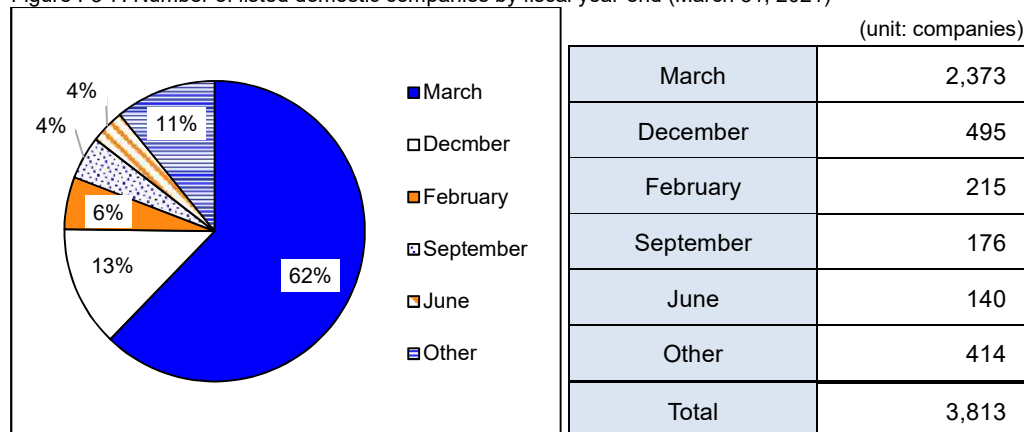


(Source) Prepared by the CPAAOB based on data from Quick and exchanges

c. Number of listed domestic companies and total market value by fiscal year-end

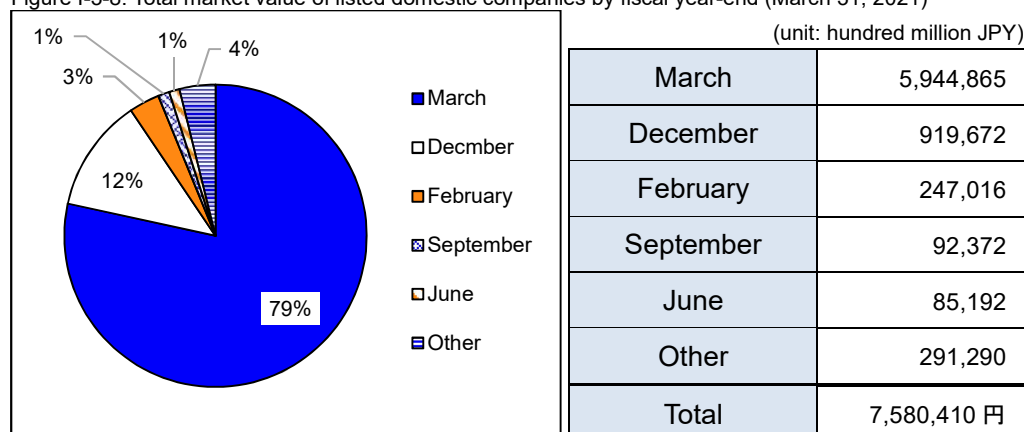
A look at when listed domestic companies close their books reveals that 64% do so at the end of March, and that they account for 79% of the total market capitalization, which explains why audit operations are heavily concentrated in specific periods (Figures I-3-7 and I-3-8).

Figure I-3-7: Number of listed domestic companies by fiscal year-end (March 31, 2021)



(Source) Prepared by the CPAAOB based on data from QUICK and exchanges

Figure I-3-8: Total market value of listed domestic companies by fiscal year-end (March 31, 2021)



(Source) Prepared by the CPAAOB based on data from QUICK and exchanges

## ■ JICPA's Registration System for Listed Company Audit Firms ■

With the aim of strengthening the quality control structures of audit firms that audit listed companies, which have a major impact on society, and securing the trust of the capital markets in financial statement audits, the JICPA introduced a registration for listed company audit firms on April 1, 2017. The system requires firms that audit domestic listed companies to register with the JICPA as "listed company audit firms." The names and addresses of registered audit firms, descriptions of their quality control systems, quality control reviews, and other information are disclosed via the "list of registered firms" and the "list of associate registered firms" on the JICPA's website. There were 128 firms in the list of registered firms as of the end of June 2021.

The list of registered firms includes audit firms whose registration has been approved based on the results of quality control reviews. The list of associate registered firms, meanwhile, includes audit firms who have applied for registration, but whose registration is currently under review because, for example, the quality control review has not been completed. Each of the lists can be viewed on the JICPA's website.

The audit firms in the list of registered firms regularly undergo quality control reviews, and based on the results of these reviews, such as action as removing them from the list may be taken.

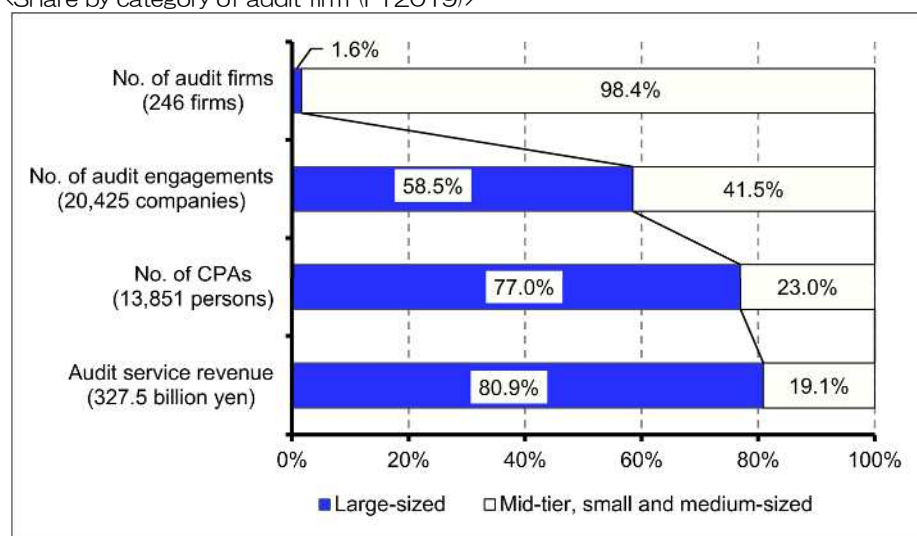
Stock exchanges' securities listing regulations etc. also stipulate that the accounting auditors of listed domestic companies must be audit firms registered on the list of registered firms or the list of associate registered firms.

## ■ Concentration at Large-sized Audit Firms ■

Among the 246 audit firms as of the end of FY2019, large-sized audit firms accounted for a large portion of the number of audit and attestation engagements, the number of CPAs and audit and attestation service revenues.

The share of large-sized audit firms in the number of audit and attestation engagements, audit service revenues and other categories has been on the decline in recent years as a result of operations management related to the continuation of their audit service contracts. See "III. Operation of Audit Firms, E. Acceptance of New Audit Engagements and Changes of Accounting Auditors" (page 93).

<Share by category of audit firm (FY2019)>

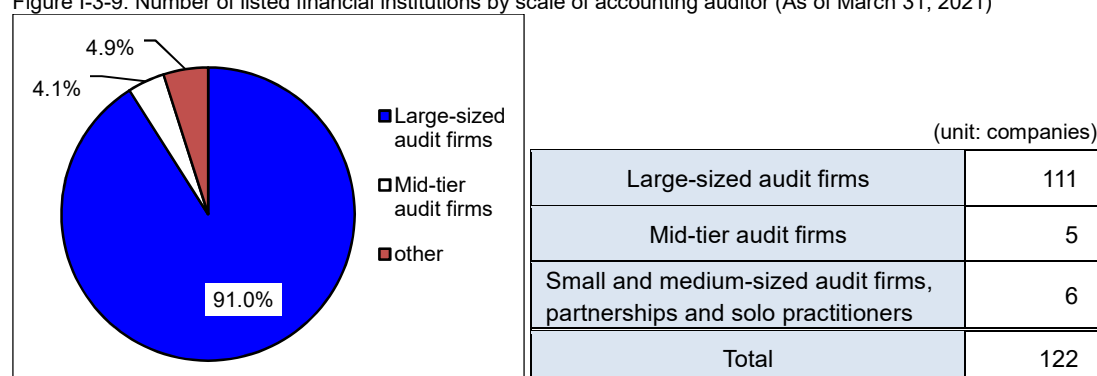


(Note 1) Compiled based on FY2019 JICPA member data and operational reports submitted by audit firms

### 3. Audits of Financial Institutions

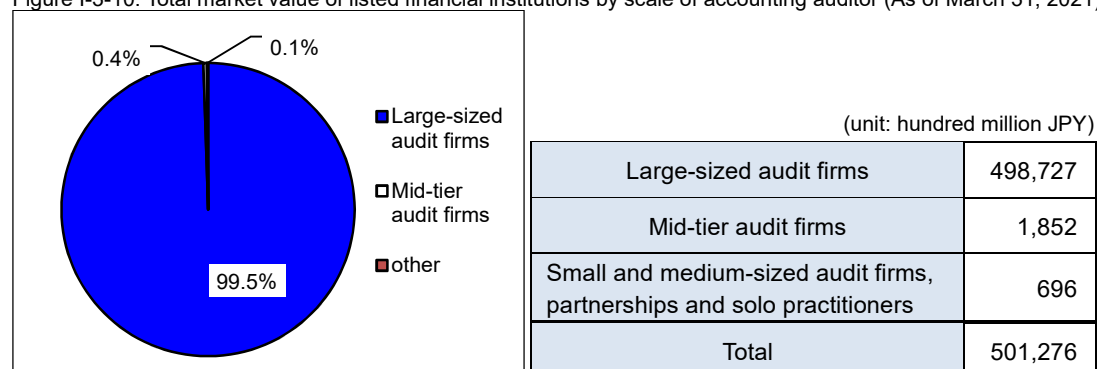
91% of listed financial institutions (122 companies) were audited by large-sized audit firms, and in terms of market capitalization, large-sized audit firms handled 99%. So compared with all domestic listed companies, large-sized audit firms' share presented a further increase (Figures I-3-9 and I-3-10). For information about domestic listed firms as a whole, see 2. FIEA and Companies Act Audits (page 24). Large-sized audit firms are pursuing initiatives to enable them to cope with accounting and audit practices that are designed to the listed financial institutions. These include establishing organizational and audit structures specifically for the financial sector and providing education/training to audit practitioners.

Figure I-3-9: Number of listed financial institutions by scale of accounting auditor (As of March 31, 2021)



(Source) Prepared by the CPAAOB based on data from QUICK and exchanges

Figure I-3-10: Total market value of listed financial institutions by scale of accounting auditor (As of March 31, 2021)



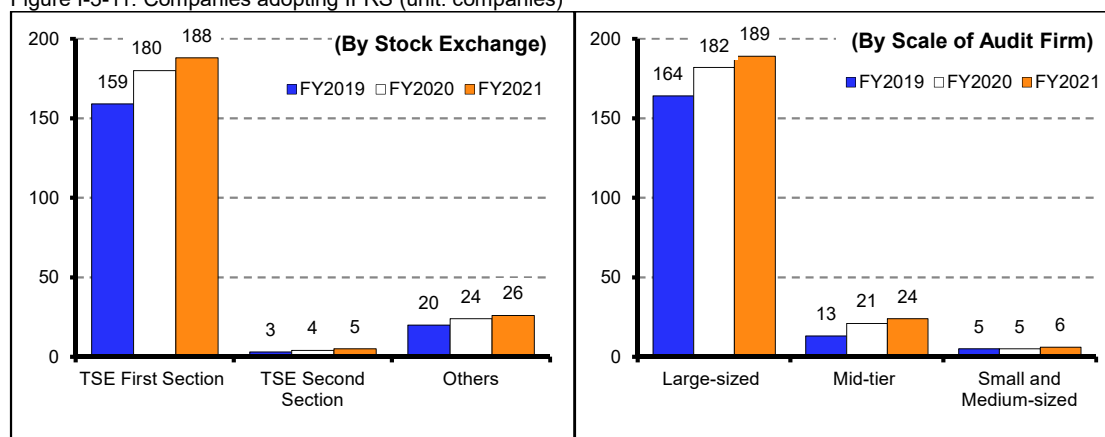
(Source) Prepared by the CPAAOB based on data from QUICK and exchanges

## 4. Companies Adopting IFRS

The following figures show the listing markets for companies that have adopted IFRS and the scale of the accounting auditors for these companies (Figures I-3-11).

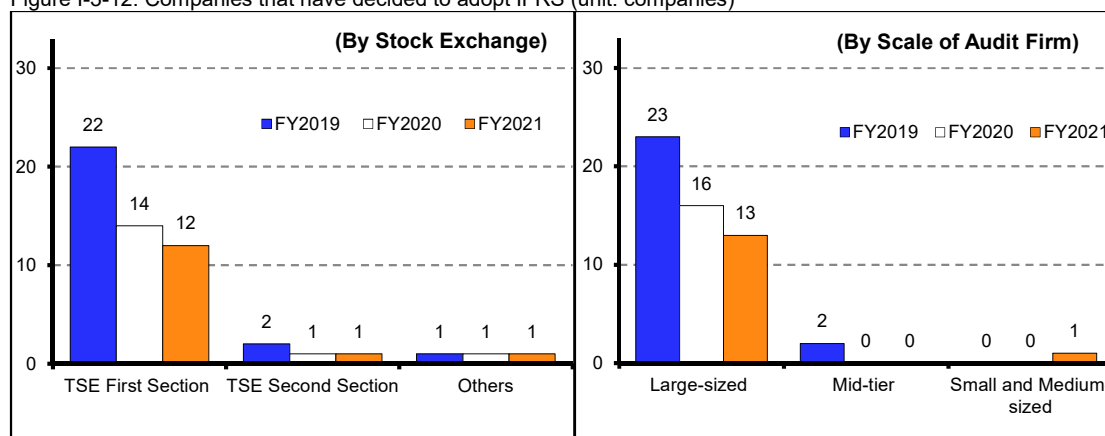
The majority of companies that have adopted IFRS are listed on the First Section of the Tokyo Stock Exchange, and many of them operate internationally. Audit contracts are concentrated in large-sized audit firms which are able to collaborate with global networks. A similar situation is seen with companies that have decided to adopt IFRS (companies in which the business execution organ has decided to adopt IFRS and has publicly disclosed this) (Figure I-3-12).

Figure I-3-11: Companies adopting IFRS (unit: companies)



(Source) Prepared by the CPAAOB based on data from exchanges

Figure I-3-12: Companies that have decided to adopt IFRS (unit: companies)



(Source) Prepared by the CPAAOB based on data from exchanges

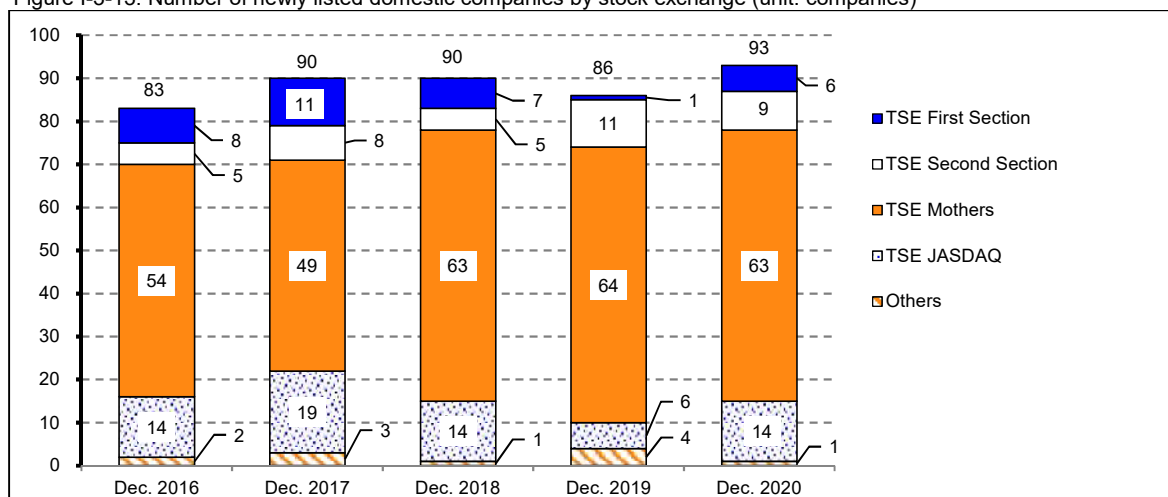
## 5. Audits of Initial Public Offerings

The number of IPOs (excluding listings on the Tokyo Pro Market) came to 93 at the end of the year through December 2020, up from the previous year but almost leveling off over the past five years. Listings on the Tokyo Stock Exchange's Mothers market were particularly large in number (Figure I-3-13).

A look at shares by size of audit firms reveals that large-sized audit firms still possess a large share (Figure I-3-14). However, the shares held by each of the large-sized audit firms have changed, which likely reflects changes in the business administration policies and IPO operations embedded in each firm. For information about the policies, organizational structures, etc. of audit firms regarding the acceptance of IPO audit engagements, see III. Operation of Audit Firms, A. Operations Management Environment, 1. Organizational Structure of Audit Firms (page 61).

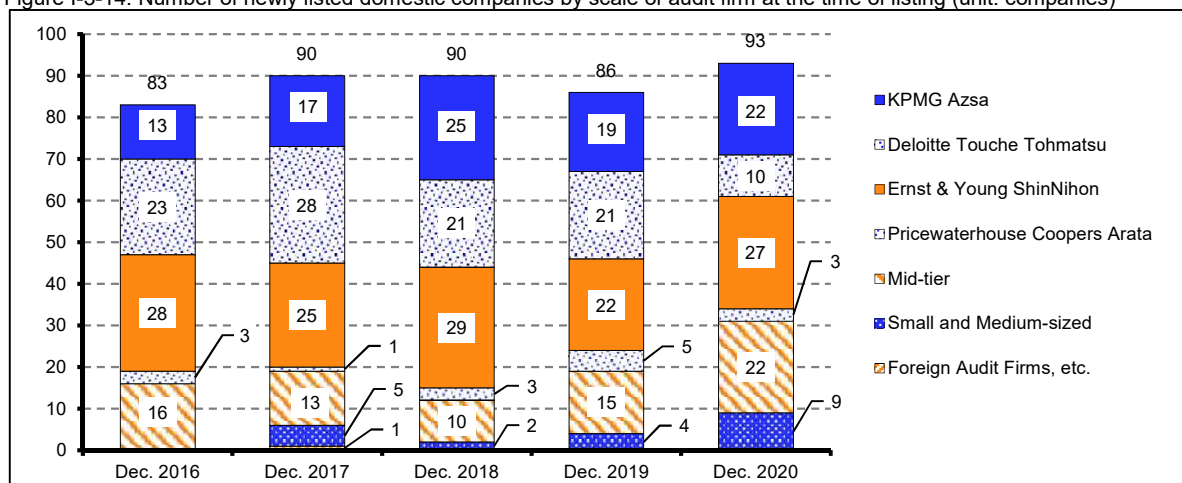
The share of large-sized audit firms was 67% in the year through December 2020. The share of med-tier and small and medium-sized audit firms showed an uptrend.

Figure I-3-13: Number of newly listed domestic companies by stock exchange (unit: companies)



(Source) Prepared by the CPAAOB based on data from exchanges

Figure I-3-14: Number of newly listed domestic companies by scale of audit firm at the time of listing (unit: companies)



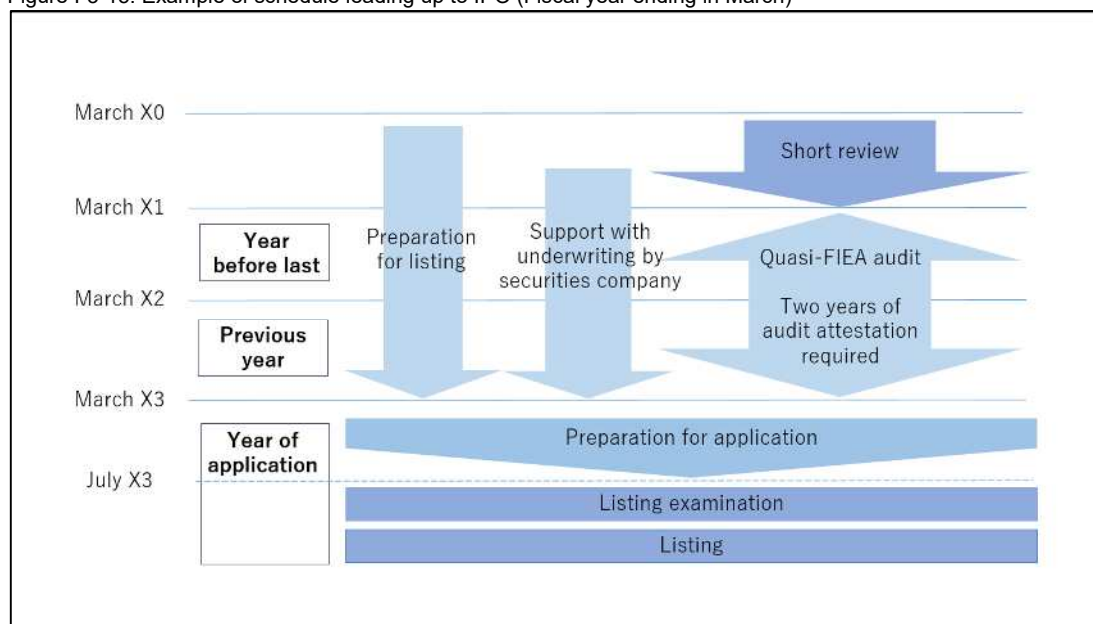
(Source) Prepared by the CPAAOB based on data from exchanges



Most audit firms regard the acceptance of IPO audit engagements as a part of their mission of audit firms since assisting with IPOs may contribute not only to companies' growth but also to socioeconomic development.

However, IPO audits often entail a relatively high audit risk such as vulnerability in the internal control structure of the audited company. As a result, before accepting IPO audit engagements, many audit firms follow their policies to conduct more rigorous risk assessments than normal audit engagements.

Figure I-3-15: Example of schedule leading up to IPO (Fiscal year ending in March)



(Source) Prepared by the CPAAOB

### ■ IPO support services ■

Stock exchange rules stipulate that for listing, a company needs to have its financial statements audited for the two years prior to the year in which it will be listed (application year), with the type of audit being equivalent to that prescribed in Article 192-2, paragraph of the FIEA (below, “quasi-FIEA audit” ). Furthermore, before concluding a quasi-FIEA audit contract, a short review is conducted so as to identify and resolve issues ahead of listing. This is the typical workflow when preparing for listing. Companies often ask CPAs and audit firms for support with conducting the short review and resolving issues, and CPAs and audit firms accept these engagements as non-audit work. The IPO-related support services that CPAs and audit firms provide as non-audit work include the following:

- Short reviews
- Support with establishing management structures
- Support with establishing internal control structures
- Support with speeding up bookclosing procedures
- Support with preparing listing application documentation



## II. The CPAAOB monitoring



## II. The CPAAOB monitoring

### A. Overview of System and Situation with Implementation

#### 1. Legal Position of the CPAAOB

The CPAAOB is an administrative body<sup>4</sup> serving as a council that was established in April 2004 in accordance with Article 35-1 of the CPA Act and Article 6-2 of the Act for Establishment of the Financial Services Agency. It comprises a chairperson and a maximum of nine members (who serve three-year terms). Although the members are part time, one full-time member can be appointed.

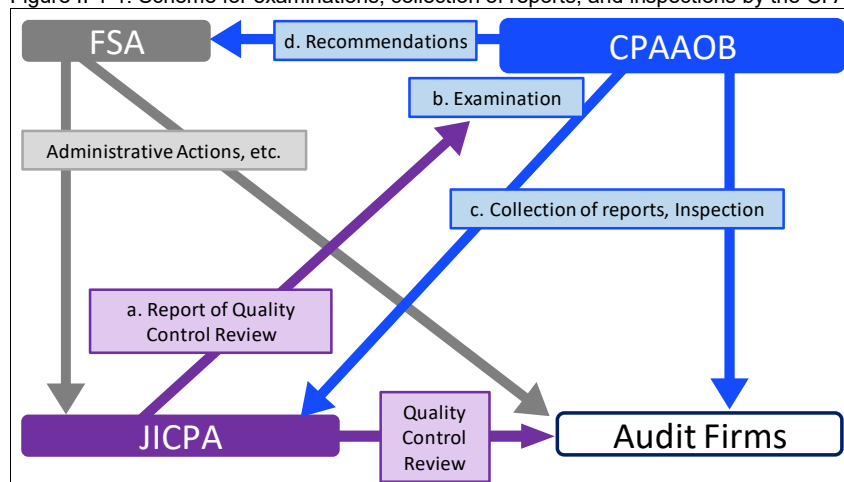
The CPAAOB receives and examines reports concerning quality control reviews by the JICPA, collects reports from and conducts inspections of the JICPA and audit firms etc. Based on the results of inspections etc., the CPAAOB recommends administrative actions or other measures to the FSA Commissioner when necessary.

#### 2. Overview of Examinations, Collection of Reports, and Inspections by the CPAAOB

Figure II-1-1 shows the relationship between examinations, collection of reports, and inspections by the CPAAOB on the one hand, and the JICPA quality control reviews, the FSA's administrative actions, etc. on the other.

Based on the JICPA quality control review reports (a), the CPAAOB assesses whether the JICPA has carried out the quality control reviews properly and whether the audit firms have properly performed its audit services (b), and collects reports from the JICPA, audit firms, etc. and conducts on-site inspections when deemed necessary (c). If it finds it to be necessary as results of inspections, the CPAAOB recommends administrative actions or other measures to the FSA Commissioner (d).

Figure II-1-1: Scheme for examinations, collection of reports, and inspections by the CPAAOB



<sup>4</sup> Appointed by the Prime Minister with the consent of both houses of the Diet from persons with an understanding of and insight concerning matters relating to CPAs

### 3. Report of JICPA Quality Control Review

The JICPA is the only organization of CPAs in Japan established in accordance with Article 43 of the CPA Act. To maintain the integrity of its member CPAs and audit firms and improve/promote audit and attestation services, the JICPA provides members with guidance, liaison and supervision and performs administrative tasks pertaining to the registration of CPAs and specified partners.

The quality control reviews are conducted by the JICPA to maintain/improve suitable qualitative standards for audit services and to ensure public trust in audits. More specifically, the JICPA reviews the administration of audit engagements conducted by audit firms, reports its findings to the audit firms and, when necessary, recommends improvements and monitors these improvements<sup>5</sup>

Quality control reviews were introduced by the JICPA in FY1999 as self-regulations, and in 2003 a revision to the CPA Act made it mandatory for the JICPA to conduct reviews of the administration of audit and attestation services by audit firms and report its findings of these reviews to the CPAAOB.

The JICPA regularly submits to the CPAAOB monthly and annual reports and provides quality control review reports as needed. The specific information reported is as follows:

- a. Review plan
- b. Details on any deficiencies observed during reviews and the audit firms' perspectives
- c. "Quality Control Review Reports" and "Recommendation for Improvement Reports" provided by the JICPA to audit firms based on review findings
- d. Specific measures based on review findings (warnings, severe warnings, recommendation to withdraw from audit engagements)
- e. "Remediation plan" prepared by the audit firm and submitted to the JICPA

Quality control reviews evaluate the audit firms' quality control systems by means of the extent to which the systems have made progress as well as how effective the systems have been in place. Specifically, they confirm whether their quality control systems (all policies and procedures for quality control pertaining to audit, including quality control procedures relevant to audit engagements) have been suitably and sufficiently developed in compliance with quality control standards<sup>6</sup>, and whether these quality control systems are operating effectively.

In addition, quality control reviews comprise regular reviews, which are conducted on the overall quality control of an audit firm, and special reviews on quality control related to the audit firm's specific sector or audit service.

In FY2020, there was a total of 40 reviewers (as of September 1, 2020) who conducted regular reviews of 56 audit firms.

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<sup>5</sup> For details concerning quality control reviews, see the JICPA website and the annual report from the Quality Control Committee.

<sup>6</sup> The Public Accountant Act and other laws and regulations, auditing criteria, correspondence criteria for addressing fraud risks in auditing, quality control criteria related to auditing, the JICPA's rules and regulations, and so forth.

## 4. Examination

### a. Overview

The CPAAOB receives quality control review reports from the JICPA, and then reviews the reports to examine the appropriateness of these quality control reviews and audit services performed by the audit firms. More specifically, the CPAAOB confirms the context of quality control reviews and the instruction to audit firms on necessary remediation measures, and analyses the findings of quality control reviews as well as the details of remediation plans submitted to the JICPA. In addition to considering the need for inspection and collecting reports in light of the outcomes of the analysis, the CPAAOB engages in exchanges of opinions with the JICPA concerning matters such as the effectiveness of quality control reviews. Still, the CPAAOB also utilizes information from the relevant FSA departments, relevant organizations, etc. on the occasion of the examination.

### b. State of implementation of reviews and results

The CPAAOB examined quality control reviews conducted in FY2020 by the JICPA in PY2020 and an overview of the review was given below.

#### i. FY2020 quality control reviews

Conclusions of quality control reviews, conducted on 56 audit firms in FY2020, were approved for 55 of them by May 31, 2021. Specifically, no significant deficiencies were confirmed at 52 audit firms, while significant deficiencies were observed at two audit firms, and extremely significant deficiencies were observed at one audit firm, respectively. In addition, improvements were recommended to 54 audit firms.

Figure II-1-2: FY2020 quality control reviews (unit: audit firms)

Classification	Reviewed parties	Conclusions			Recommendations for improvement	
		Conclusion finding no significant deficiencies	Conclusion finding significant deficiencies	Conclusion finding extremely significant deficiencies	Yes	No
Audit firms	39	39	0	0	38	1
Partnerships	0	0	0	0	0	0
Solo practitioner	17	13	2	1	16	0
Total	56	52	2	1	54	1

(Note 1) "Unqualified conclusion," "qualified conclusion" and "adverse conclusion" were abolished in FY2020 and "conclusion finding no significant deficiencies," "conclusion finding significant deficiencies" and "conclusion finding extremely significant deficiencies" are instead mentioned in "quality control review reports."

(Note 2) Conclusion finding significant deficiencies is declared when there is significant concern about serious compliance violations of standards as well as laws and regulations applicable to an audit firm as a professional expert in the development and management of its quality control system.

(Note 3) Conclusion finding extremely significant deficiencies is declared when there is significant concern about extremely serious compliance violations of standards as well as laws and regulations applicable to an audit firm as a professional expert in the development and management of its quality control system.

(Note 4) Even if declaration finding no significant deficiencies is declared to an audit office, a recommendation for improvement is issued where an issue worthy of a recommendation for improvement is observed.

(Note 5) As the conclusion for one of the 56 audit firms reviewed had yet to be made as of May 31, 2021, it was not included in the state above.

(Reference) Prepared by the CPAAOB based on data from the JICPA.

## ii. Examination of FY2020 quality control reviews

The following examinations and verifications were conducted on quality control review reports from the JICPA to examine and analyze the appropriateness of its reviews.

- Examination of the policies for FY2020 quality control reviews, confirmation of efforts for improvement, and examination of improvements in review operations.
- Analysis of the cases of significant deficiencies or extremely significant deficiencies as a result of quality control reviews of audit firms and of specific deficiencies and contents, etc. pointed out amid quality control reviews
- Analysis of specific deficiencies pointed out in quality control review reports and instruction for improvements to examine whether the JICPA has effectively prompted audit firms for fulfillment

As a result of the above-mentioned examinations, qualitative improvements were found to have been made about quality control reviews in FY2020, such as:

- To strengthen the risk-based approach, review plans were made while taking into account the results of past quality control reviews and risk assessments performed at selection stage of audit engagements covered by the past reviews. After the commencement of reviews, furthermore, flexible steps were taken, such as correspondingly extending the review period and stepping up reviewers as occasion demanded.
- To ensure that issues pointed out with specific audit engagements are not cast aside as marginal documentation problems (presentation errors in audit papers) but as based on the reality of deficiencies, measures, such as revising review procedures and providing training to reviewers, have been taken. As a result, improvements in the quality control reviews have been achieved as in the case of a persistent decline in the ratio of documentation deficiencies pointed out.

As a feature of the FY2020 quality control review, issues pointed out about communication with auditors and others decreased greatly from the previous year.



## 5. Collection of Reports

### a. Overview

The CPAAOB may collect reports from the JICPA or audit firms when necessary. With limited inspection resources at its disposal, it is important for the CPAAOB to make effective use of the collection of reports so as to ensure and enhance audit quality at all audit firms in Japan. In this view, we wield collection reports in consideration of the sizes, their operations management environments, the results of the CPAAOB inspections and JICPA's quality control reviews, and so on.

#### i. Collection reports for large-sized and mid-tier audit firms

In the case of large-sized audit firms and mid-tier audit firms, we periodically analyze quantitative and qualitative information concerning their business management (governance) environments and operations management system so as to contribute to further effective inspection. We also attempt to grasp the adoption of IT and cybersecurity measures in connection with audit engagements. In addition, we employ the information through the collection reports to perform comparative analysis of audit firms and to identify sector-wide issues, etc.

#### ii. Collection of reports from small and medium-sized audit firm, partnership and solo practitioner

In the case of small and medium-sized audit firm, partnership and solo practitioner, we select firms partly based on the results of quality control reviews. We then gather and analyze information about measures taken to address issues pointed out amid quality control reviews, their operations management system, their quality control system, and so on. Furthermore, in many cases, as small and medium-sized audit firms are sensitive to the leadership of top management, we recognize the current status of audit quality and top management's awareness toward audit quality, and conduct interviews as necessary.

#### iii. Collection reports for small and medium-sized audit firm, partnership and solo practitioner (follow-up after notification of inspection results)

With regard to problems that small and medium-sized audit firms were notified of in inspection results, we monitor the measures to address them after a set period of time following the notification and make sure the progress made such as hearings when necessary.

#### iv. Collection reports for audit firms in need of particularly immediate remediation

As a result of inspection, where the overall rating of the firm's business administration is that it is "unsatisfactory and in need of immediate remediation," we wield collection reports at the time of the notification of the inspection results, and prompt the firms to make improvements (for information about overall ratings, see "7. Notification of Inspection Results" (page 47)).

b. Implementation

i. Collection of reports from large-sized audit firms and mid-tier audit firms

In PY2020, the CPAAOB collected reports from all large-sized audit firms and mid-tier audit firms in order to review their business management (governance) environments, operations management system, etc. Furthermore, we analyzed the information through the collection of reports to ensure the effective and efficient inspection, and also conducted firm-wide fact-finding of business management (governance) environments and operations management environments at large-sized audit firms and mid-tier audit firms.

ii. Collection of reports from small and medium-sized audit firms

In PY2020, reports were collected on matters related to recommendations for improvement, management policies, organizations and manpower, implementation of training and other programs, matters related to the global network of audit firms, the effects of and responses to COVID-19 infections, and so forth from 65 small and medium-sized audit firms chosen mainly from those subject to quality control reviews in PY2018 on the basis of results of the reviews.

Of the small and medium-sized audit firms from which reports were collected, face-to-face or remote hearings were separately held with 16 firms (which were notified of having significant deficiencies or violations of auditing criteria, etc., matters subjected to improvement recommendations in excess of the average number, matters deserving heed in connection with audit risks, etc. at audited companies, and so forth).

On the occasion of these interviews, with the aim of embedding proper audit quality control, we conveyed our concerns over the problems, and focused on asking questions about the firms' quality control systems (including their responses to review results), the management policy of the representatives, organization, human resources, and so on.

Given the context of the interviews, since we valued the operations management environments at certain audit firms as concerns, and bear in mind that we would leverage the reference information for the future reviews, inspections, etc.

- The head of an audit firm was not proactively involved in efforts to detect core reasons leading to improvement recommendations through the root cause analysis, and went over-dependent on the staff in charge of quality control. In addition, the firm shuns systematic efforts to achieve the recommendations for the improvement, although the staff in charge of quality control was not given enough time to fulfill the responsibilities.
- An audit firm attributes root causes of the recommendations for the improvements to its system to be over-dependent on staff in acquisition of knowledge and enhancement of ability to audit practitioners. In response, the firm took only pro forma steps without introducing effective improvement measures in line with the system, such as preparing a training program in consideration of audit practitioners' knowledge, ability and experience.

- The head of an audit firm concurrently served as the official in charge of quality control and the manager of its office due to a labor crunch and the sudden retirement of a staff member. Under the circumstances, the firm failed to detect root causes of the recommendations for the improvement and even came to face operational problems due to a delay in the planned introduction of a performance evaluation system.

iii. Collection of reports from small and medium-sized audit firms (follow-up after notification of inspection results)

In PY2020, among small and medium-sized audit firms that had been notified of inspection results by the CPAAOB in past fiscal years, the CPAAOB collected reports from two audit firms for which about one year had passed since the notification in order to confirm the improvements that had been made to address the findings observed during the inspection.

iv. Collection of reports from audit firms in need of particularly urgent remediation

In PY2020, the CPAAOB collected the reports from two audit firms notified of the “need for immediately improving inadequate operating management systems” as a result of the overall assessment of inspections in PY2019 and PY2020, on the implementation of improvements, including remediation plants while they were simultaneously notified of inspection results.

These firms included one which, with an inadequate auditing system, was found to have a large number of deficiencies in auditing specific listed domestic companies but has yet to achieve an integrated and systematic organizational operation as an audit firm and needs to establish and run an adequate organizational operation.

## 6. Inspections

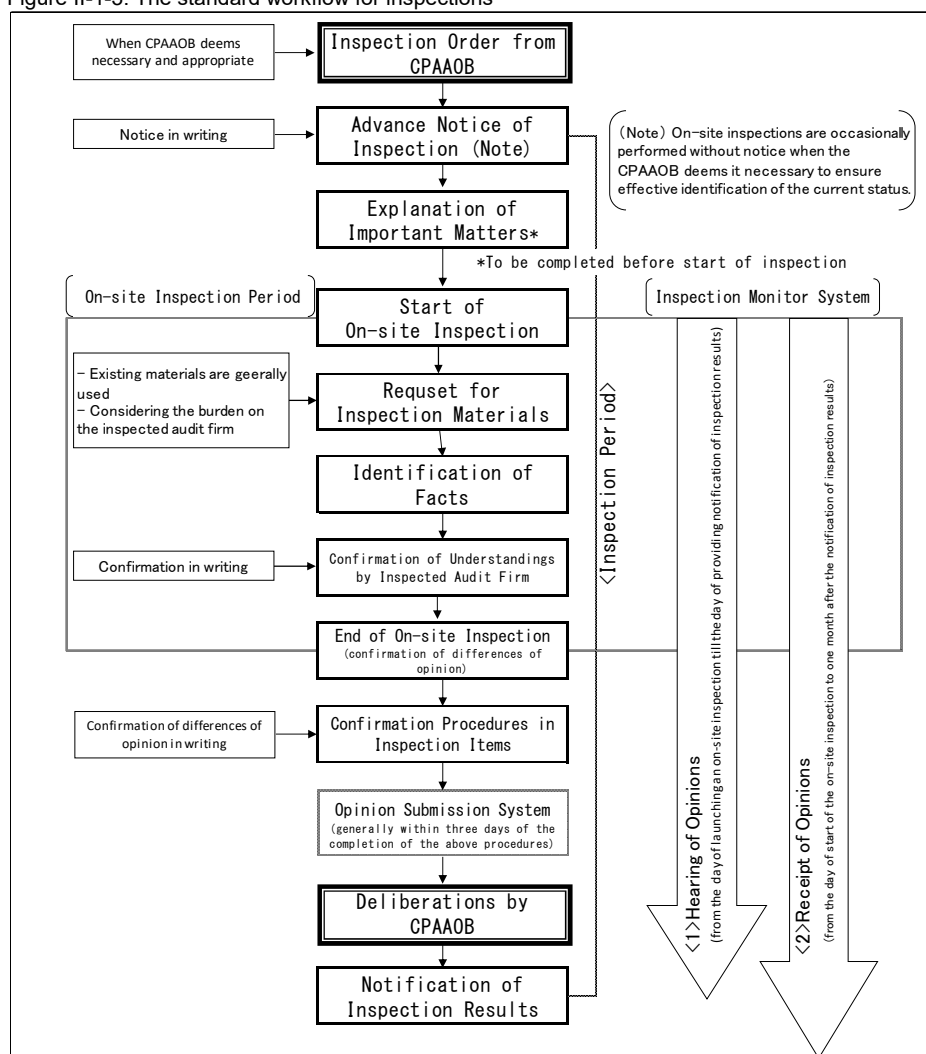
### a. Overview

When deemed necessary and appropriate for the public interest or the protection of investors as the result of 4. or 5. above, the CPAAOB inspects audit firms (Article 49-3-2 of the CPA Act). Furthermore, when deemed necessary for ensuring the proper administration of the JICPA, the CPAAOB also inspects the JICPA (Article 46-12-1 of the CPA Act).

Basic matters concerning the CPAAOB's inspections, procedures for inspections, the handling of inspection results, etc. are prescribed in the "Basic Guidelines on Inspections Conducted by the Certified Public Accountants and Auditing Oversight Board" (latest revised in April 2021).

The standard workflow on inspections for audit firms in accordance with the Basic Guidelines is depicted below (Figure II-1-3).

Figure II-1-3: The standard workflow for inspections



\* An inspection starts on the day of conducting it (the day of notification in the case of an inspection with advance notice and the day of launching an on-site inspection in the case of without advance notice) and ends on the day of notifying inspection results.

The following is an explanation of the main components of the standard workflow:

i. Inspection order from the CPAAOB

The CPAAOB issues an order to inspectors to inspect an audit firm.

ii. Explanation of important matters

Before the on-site inspection, the inspectors explain to the responsible person at the audit firm the authority for and the purpose of the inspection, the inspection methods, an overview of the inspection monitor system and the opinion submission system, and other necessary matters.

iii. On-site inspection

Generally, the inspectors visit the audit firm and inspect its operations management environment, quality control environment, and audit engagements. The audit engagements inspected are selected based on the size of the audit firm, the key points of the basic plan on monitoring, and the audited company's audit risks.

Inspectors examine whether the audit firm's procedures on quality control comply with regulations, auditing standards and quality control policies established by the audit firm through the inspection of books, records and other materials and interviews of the audit firm's executives and staffs.

Furthermore, inspectors obtain confirmation of facts and background information (findings) identified during the inspection in writing from the responsible person at the audit firm.

iv. Confirmation procedures on inspection items

After the on-site inspection, the CPAAOB communicates to the audit firm any problems discovered during the inspection, solicits the views of the audit firm on these problems, and confirms with the audit firm matters whether there are any discrepancies of opinion between the CPAAOB and the audit firm.

v. Opinion submission system

If there is a chasm of opinion, the audit firm may submit its opinion to Secretary-General of Executive Bureau in writing, usually within a three-day period (excluding weekends and public holidays) from the day on which the procedures for confirmation of inspection items were completed. Furthermore, if it receives a request from the audit firm to extend the submission period, the CPAAOB considers extending the submission period by up to two days.

If an opinion is submitted by an audit firm, a person (hereinafter "the head of the CPA Examination Division, etc."), designated by the head of the CPA Examination Division of the CPAAOB Executive Bureau Planning Management or the head of the Planning Management and CPA Examination Division, review the opinion and facts concerned, compile the results of the review and submit them to the CPAAOB.

The results, if approved by the CPAAOB, is conveyed to the audit firm through the head of the CPA Examination Division, etc.

vi. Inspection monitor system

The CPAAOB accepts opinions from audit firms about inspectors' inspection methods and so forth to grasp the CPAAOB' inspections and help ensure that they are conducted properly and efficiently.

Inspection monitoring is conducted by "asking for opinions" and "receiving opinions," and the head of the CPA Examination Division, etc. takes action, when necessary, such as giving instructions to inspectors.

b. State of implementation of inspections

i. Recent conduct of inspections

The frequency of inspections differs depending on the size of the audit firm.

The CPAAOB conducts regular inspections of large-sized audit firms once every two years and, since PY2016, has run follow-up inspections designed to verify improvements in the program year following the regular inspection.

Inspections of mid-tier audit firms are generally conducted once every three years.

Inspections of small and medium-sized audit firms are conducted as necessary, in light of deficiencies pointed out in quality control reviews.

Details of the inspections conducted during the past five years are presented below (Figures II-1-4 and II-1-5).

Figure II-1-4: State of implementation of inspections in the past five years (based on commencement of inspections)  
(unit: audit firms)

Fiscal/PY	2016 (Notes 1, 2)	2017 (Note 2)	2018 (Note 2)	2019 (Note 2)	2020 (Note 2)
Large-sized audit firms	4(2)	4(2)	4(2)	4(2)	4(2)
Mid-tier audit firms	2	2	1	2	2
Small and medium-sized audit firms, partnerships and solo practitioners	5	3	5(1)	3	4
Foreign audit firms, etc. (Note 3)	1	0	0	1	0
Total	12(2)	9(2)	10(3)	10(2)	10(2)

(Note 1) The data collection period was changed to the program year from July 2016. The number of inspections conducted between April and June 2016 is also included in PY2016 because it was a transitional year.

(Note 2) Figures in parentheses are the number of follow-up inspections.

(Note 3) See "B. Foreign Audit Firms" (page 52) for information on foreign audit firms etc.

(Source) Prepared by the CPAAOB based on results of inspections by the CPAAOB

Figure II-1-5: Number of inspections, inspectors, inspection periods and number of audit engagements

	Large-sized audit firms	Mid-tier audit firms	Small and medium-sized audit firms
Number of inspections (case)	9	8	13
Average number of inspectors (headcount)	8.2	7.0	5.4
Average inspection period (calendar days)	155.4	129.1	118.6
Average number of inspected audit engagements (companies)	5.8	5.1	3.2

(Note 1): Inspections conducted and completed in the five years from FY2016 through 2020 are covered. Inspections of foreign audit firms and others, follow-up inspections, cases involving the submission of opinions and cases recommended to the Commissioner of the FSA were excluded because they involved procedures different from those of normal inspections.

(Note 2) Inspections started on the inspection date (in the case of inspections with advance notice; the date on which notice of the inspection was made; in the case of inspections with no advance notice; the date on which the on-site inspection started) and ended on the date on which notification of the inspection results was issued (calendar day basis).

(Source) Prepared by the CPAAOB based on the results of inspections by the CPAAOB

## ii. Deficiencies

### a. Characteristics of deficiencies identified through inspections of quality control environment

Results of the CPAAOB inspections in and after PY2018 were as follows:

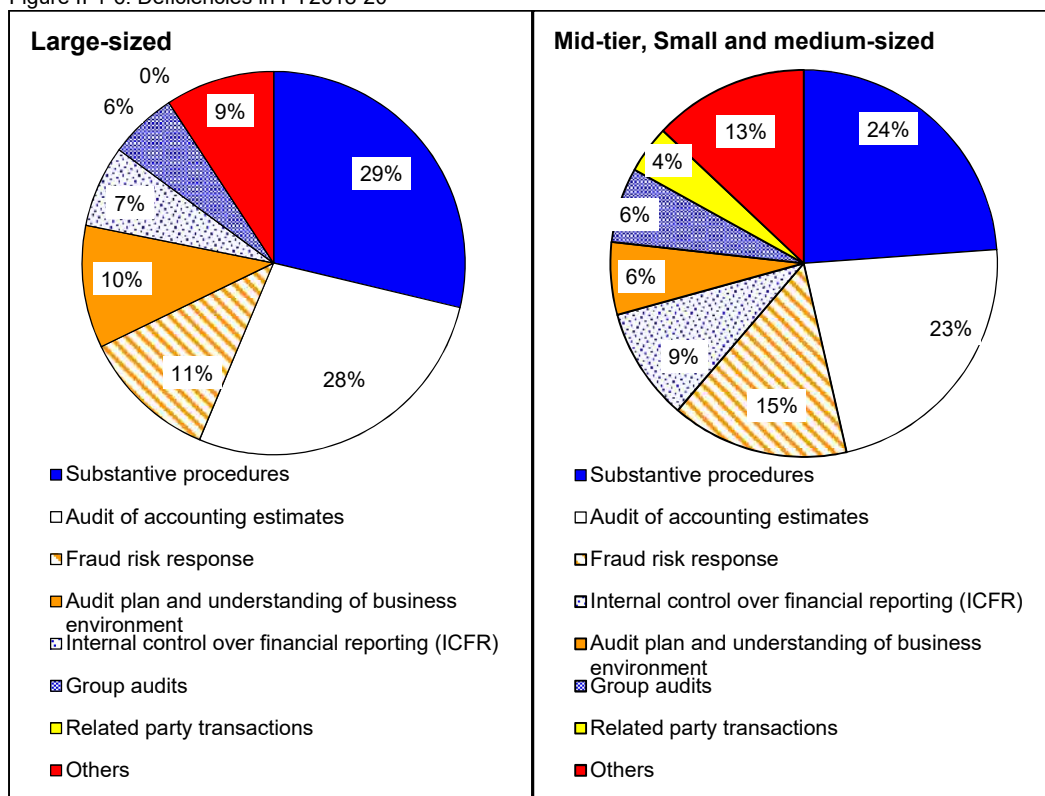
Large-sized audit firms tended to shift primal responsibility for quality control from the quality control section to the business section, which was closer to the vanguard of auditing, at their headquarters. The results of recent inspections presented the outstanding issues, such as adequate cooperation between the quality control and business sections at the headquarters, penetration of improvement measures into audit sites (where auditing services are actually performed), and the need to reconfirm the importance of professional ethics (for information on the organization of large audit firms, see “III. Operation of Audit Firms, A. Operations Management System, 1. Organizational Structure of Audit Firms” (page 61)).

Although mid-tier audit firms made structural improvements to take systematic approaches, they faced problems such as insufficient communication between the quality control and business sections, inadequate utilization of personnel - non-CPAs or other professionals - and the accompanied need of implementing training and other programs to nurture human resources. In addition, the management team, including a top, lacked the adequate awareness of the need to ensure and enhance quality control and to work together with the quality control section.

Small and medium-sized audit firms neither were adequately aware of the need to establish systematic and integrated business management systems nor fully understood the levels of quality control and auditing procedures required by the existing auditing standards. In addition, there were firms that were not fully capable of auditing the listed companies with high risk.

- b. Characteristics of deficiencies identified through inspections of audit engagements
- Deficiencies identified through inspections of audit engagements from PY2018 to PY2020 can be classified in line with the ASCS structure as follows (Figure II-1-6).

Figure II-1-6: Deficiencies in PY2018-20



(Note) Classifications of deficiencies noted at five large-sized audit firms (total), five mid-tier audit firms, and 10 small and medium-sized audit firms

(Source) Prepared by the CPAAOB based on the results of inspections by the CPAAOB

Regardless of the size of audit firms, deficiencies in substantive procedures (audit procedures, such as analytical verification procedures and detailed tests that were conducted with regard to transaction types, account balances, and footnotes to tackle the risk of material misstatements) were the most common. Deficiencies related to the audit of accounting estimates formed the second largest share, followed by deficiencies involving responses to fraud risks, understanding of audit plans and corporate environments, audit of internal control on financial statements and group auditing. The CPAAOB therefore performed inspections with a focus on such deficiencies.

The CPAAOB encourages inspected audit firms to take their initiatives in improving their operation through its reviews, by analyzing the causes of the deficiencies identified in the inspections and sharing them through dialogue with the inspected audit firms. You can see the Case Report from Audit Firm Inspection Results for detailed information about examples of deficiencies identified during the inspections and their causes.



## 7. Notification of Inspection Results

### a. Inspection results notification

The responsible person at the audit firm is notified of the inspection results in writing (inspection results notification).

The current inspection results notification contains the information shown in Figure II-1-7<sup>7</sup>.

Figure II-1-7: Items included in inspection results notification

1. Key points
2. Inspection viewpoints
3. Measures against deficiencies developed by the inspected audit firm to ensure the proper execution of services with the aim of maintaining and improving quality control (quality control environment)
4. Conduct of audit services (audit engagements)

### b. "Key points" section

Among the sections in an inspection results notification, the "Key points" section elaborates deficiencies identified during the CPAAOB inspections that are regarded as significant. It comprises three subsections (operations management environment, quality control environment and audit engagements) and confers an overall rating based on the comprehensive situation individually.

The overall rating of the operation of services at the inspected audit firm is presented at the beginning of the "Key points" section of the inspection results notification, as shown in Figure II-1-8.

Figure II-1-8: Example of key points

5. Key points  
As a result of our inspection of your audit firm, we discovered within the scope of our inspection the following results relating to the operation of your firm.
  - (1) Operations management environment  
...(presents problems with its governance and operation of services)
  - (2) Quality control environment  
...(presents deficiencies in the system of quality control)
  - (3) audit engagements  
...(presents deficiencies in audit services)

The CPAAOB has included overall ratings of audit firms' operation of services in the inspection results notification since the inspections commenced in PY2016. The aims are to accurately

<sup>7</sup> Overall ratings will not be given for ad hoc inspections or follow-up inspections of large-sized audit firms as the inspection results notifications in those cases differ from the ones of regular inspections

convey the CPAAOB's assessment to audit firms and to ensure proper understanding of their level of quality control among audit and supervisory board members etc. of audited companies, to whom the inspection results notification is provided.

c. Overall rating grades

As far as inspections launched by PY2020 are concerned, the overall rating takes the form of one of the following five grades and is based on the assessment results of audit firms' operations management environment, quality control environment and audit engagements. Each grade is assessed with the following descriptions (for changes in the description of assessments that will take effect starting with inspections in PY2021, see "g. Review of assessment result descriptions in overall ratings."

1. "Generally satisfactory"

The description is used when the operation of services is deemed satisfactory, e.g., there are almost no deficiencies in the quality of control environment and audit engagements.

2. "Satisfactory with minor deficiencies"

The description is used when the operation of services is deemed satisfactory on the whole though there are problems that need to be fixed, e.g., there are no significant deficiencies despite the presence of some deficiencies in the operations management environment, the quality control management or audit engagements.

3. "Unsatisfactory"

The description is used when the operation of services is deemed unsatisfactory, e.g., there are significant deficiencies in the operations management environment, the quality control management or audit engagements that need to be fixed.

4. "Unsatisfactory and in need of immediate remediation"

The description is used when the operation of services is deemed unsatisfactory and in need of immediate remediation.

5. "Extremely unsatisfactory"

The description is used when significant deficiencies are identified in the quality control environment and audit engagements, and voluntary remediation by the audit firm cannot be expected.

In the case of an audit firm rated as "unsatisfactory and in need of immediate remediation," we collect a report at the time of the notification of inspection results and encourage the firm to promptly make improvements (for more details, see "5. Collection of Reports" (page 39). In the case of an audit firm rated as "extremely unsatisfactory," we make recommendations concerning administrative actions and other measures to the Commissioner of the FSA.

d. Distribution of overall ratings

The distribution of overall ratings for regular inspections launched and completed between PY2016 and PY2020 is shown below (Figure II-1-9)

No audit firms were qualified as “generally satisfied,” the highest grade in the overall rating scheme. All audit firms, therefore, were rated as “satisfactory with minor deficiencies” or lower based on the assessment of their operations management environment, quality control and audit engagements.

Many small and medium-sized audit firms, partnerships and solo practitioners had overall ratings lower than those of large-sized and medium-tier audit firms. This is because the CPAAOB mainly selects small and medium-sized audit firms for the inspection - their quality control environment needs to be confirmed immediately.

At small and medium-sized audit firms with low overall ratings, there was insufficient awareness of quality control among the top management. In addition, partners and staff members lacked an understanding of recent environmental changes pertaining to accounting and auditing of the quality control levels required by the current audit standards.

Figure II-1-9: Overall ratings for inspections in PYs 2016/2020 (based on commencement of inspections) (unit: audit firms)

Overall rating	Large-sized and mid-tier audit firms	Small and medium-sized audit firms, partnerships and solo practitioners
Generally satisfactory	-	-
Satisfactory with minor deficiencies	11	3
Unsatisfactory	7	5
Unsatisfactory and in need of immediate remediation	-	5
Extremely unsatisfactory	-	5

(Note) Totals for audit firms subject to regular inspections that were commenced and completed between PY2016 and PY2020

e. Communication of “key points” to audit and supervisory board members etc. of all audited companies

Audit firms are required to communicate the “key points” in their inspection results notifications and the action they are taking in response to them to audit and supervisory board members etc. of all audited companies<sup>8</sup>.

In addition, audit firms are required to communicate the details of the deficiencies and the action to them to the audit and supervisory board members etc. of audited companies where their audit engagements were selected for the inspections.

To accurately convey inspection results, the CPAAOB requests audit firms to inform auditors and

<sup>8</sup> The ASCS requires audit firms to convey in writing to the audit and supervisory board members etc. the details of inspection results notifications and the measures for improvements (ASCS 260, No. 16, A31-2).

others at audited companies of “key points”, starting inspection launched in PY2016.

Moreover, for the purpose of enabling audit and supervisory board members etc. of audited companies to compare inspection results with those for other audited firms and better understand the business administration levels of audit firms, we have published the distribution of overall ratings in d. above since the 2019 Monitoring Report.

f. Handling of inspection results

An inspected audit firm is required to obtain prior consent from the CPAAOB to disclose<sup>9</sup> inspection results to a third party. In recent years, there has been a large number of requests to the CPAAOB from audit firms for prior consent for the disclosure of inspection results and others as requested by directors at audited companies, auditors and directors (including outside directors) at parent companies of audited firms and potential audited companies (e.g., companies considering which accounting auditors to appoint).

But an inspected audit firm does not need to obtain the CPAAOB’s prior consent if it conveys inspection results to auditors and others at audited companies, mentioned above in (5), and presents them to the JICPA based on rules of the JICPA Quality Control Committee’s rules pertaining to the handling of notification documents for inspection results.

This approach is expected to facilitate communication between auditors and others at audited companies and audit firms through the utilization of inspection results and improve the effectiveness of quality control reviews by the JICPA.

We hope that not only audit and supervisory board members etc. of audited companies but also the directors etc. of audited companies and potential audited companies make use of the CPAAOB inspection results etc. in order to confirm the establishment and implementation of quality control systems by accounting auditors.

g. Review of assessment result descriptions in overall ratings

To make grades in the overall rating regime more understandable and review the description of assessment results for them, the CPAAOB is going to make the following reviews (underlined changes), starting with inspections to be launched in PY2021, from the viewpoint of adding a number to each grade and balancing the description of assessment with assessment standards (content). (Figure II-1-10)

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<sup>9</sup> Details on disclosing inspection results to third parties are listed on the CPAAOB website.

Figure II-1-10: Changes of assessment result descriptions in overall ratings

Grade	Before change	After change
1	<p><u>"Generally satisfactory"</u></p> <p>Given when the operation of services is deemed to be satisfactory, e.g., there are almost no deficiencies in the quality control environment or audit engagements.</p>	<p><u>"Favorable (overall rating: 1)"</u></p> <p>Given when the operation of services is deemed to be favorable, e.g., there are almost no deficiencies with respect to the <u>operations</u> /quality control <u>system</u> and audit engagements.</p>
2	<p><u>"Satisfactory with minor deficiencies"</u></p> <p>Given when there are problems needing to be fixed, but operation of services is deemed to be satisfactory on the whole, e.g., there are no significant deficiencies but there are some deficiencies in the operations management environment, the quality control environment, or audit engagements.</p>	<p><u>"Generally Favorable with some deficiencies requiring remediation (overall rating: 2)"</u></p> <p>Given when operation of services is deemed to be generally favorable with some deficiencies requiring remediation, e.g., there are no significant deficiencies, but some deficiencies with respect to the operation/quality control system and/ or audit engagements.</p>
3	<p><u>"Unsatisfactory"</u></p> <p>Given when the operation of services is <u>deemed to be unsatisfactory</u>, e.g., there are significant deficiencies in the operations management environment, the quality control management or audit engagements that need to be fixed.</p>	<p><u>"Unfavorable with significant deficiencies requiring remediation (overall rating: 3)"</u></p> <p>Given when the operation of services is <u>deemed to be unfavorable</u>, e.g., there are significant deficiencies requiring remediation with respect to the operation/quality control system and/or audit engagement.</p>
4	<p><u>"Unsatisfactory and in need of immediate remediation"</u></p> <p>Given when the operation of services is deemed to be unfavorable and in need of immediate remediation.</p>	<p><u>"Unfavorable with significant deficiencies with respect to operation control system etc. requiring immediate voluntary remediation (overall rating: 4)"</u></p> <p>(No change from what is shown on the left)</p>
5	<p><u>"Extremely unsatisfactory"</u></p> <p>Given when significant deficiencies are identified with respect to the quality control system and audit engagements, and voluntary remediation by the audit firm cannot be expected.</p>	<p><u>"Extremely unacceptable (overall rating: 5)"</u></p> <p>(No change from what is shown on the left)</p>

As mentioned above, the latest review will change the description of assessment results to make grades in the overall rating regime more understandable. The CPAAOB therefore will not change the standards (content) based on which inspection results are classified into one of the five grades.

## B. Foreign Audit firms

### 1. System for Foreign Audit Firms

Financial statements which shall be submitted under the FIEA by domestic listed companies must generally require an audit attestation by Japanese CPAs or audit firms. However, if the issuer is a foreign company, its financial statements generally undergo audit attestation by CPAs or audit firms in the home country. Therefore, to avoid duplicate audits, an exception is granted in cases where the issuer company has taken an audit attestation deemed to be equivalent to that prescribed under the FIEA.

With the aim of further enhancing the soundness of Japan's capital markets, the CPA Act was amended in 2007 to require foreign CPAs and audit firms auditing the financial statements of foreign companies, etc. subject to the FIEA disclosure rules to submit the notification to the FSA Commissioner.

Having submitted the notification to the FSA, the audit firms are regarded as foreign audit firms (Article 1-3(7), Article 34-35 (1) of the CPA Act) and are subject to inspection and supervision by the CPAAOB and the FSA.

Based on the "Approach to Inspections and Supervision of Foreign Audit Firms (published on September 14, 2009), the CPAAOB generally collects reports from foreign audit firms once every three years, most recently having collected from 79 foreign audit firms in 29 countries/regions in PY2018. The CPAAOB also conducted an inspection of one foreign audit firm each in 2014, 2017 and 2019.

### 2. Foreign Audit Firms

Regarding the locations of foreign audit firms that have registered with the FSA, the largest number are based in Europe, with the second largest number being headquartered in the Asia-Pacific region (Figure II-2-1).

The top countries/regions are France, with eight firms, the Cayman Islands, with seven firms, and the U.S., Ireland and Hong Kong, with six firms. Foreign audit firm registrations are published and updated as "Registered Foreign Audit Firms" on the FSA website.

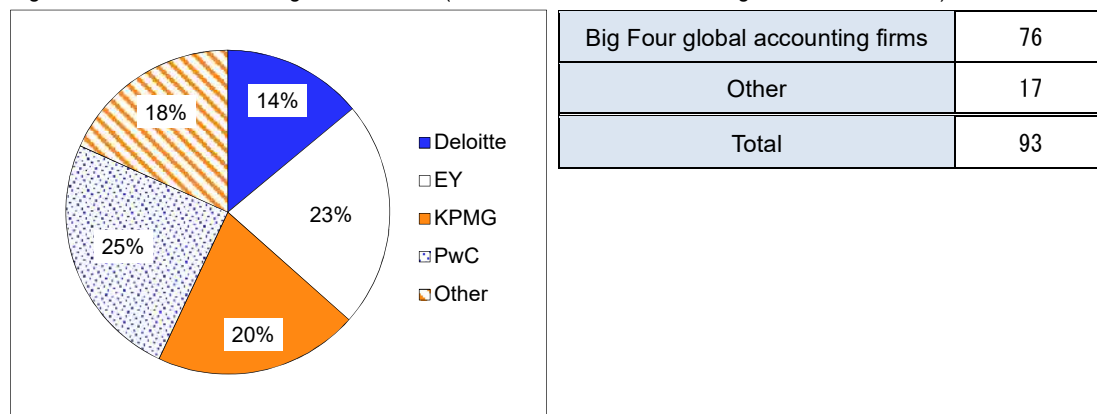
Figure II-2-1: Number of registered foreign audit firms, etc. (as of March 31, 2021)

	Number of countries/regions	Number of foreign audit firms, etc.
Europe	15	54
Asia-Pacific	9	28
North America	2	9
Central/South America	1	1
Middle East	1	1
Total	28	93

(Source) Prepared by the CPAAOB based on information from the FSA website

Out of the foreign audit firms, around 80% is affiliated with one of the Big Four global accounting firms (Figure II-2-2).

Figure II-2-2: Affiliation to the global networks (as of March 31, 2021, unit in right-hand table: Firms)



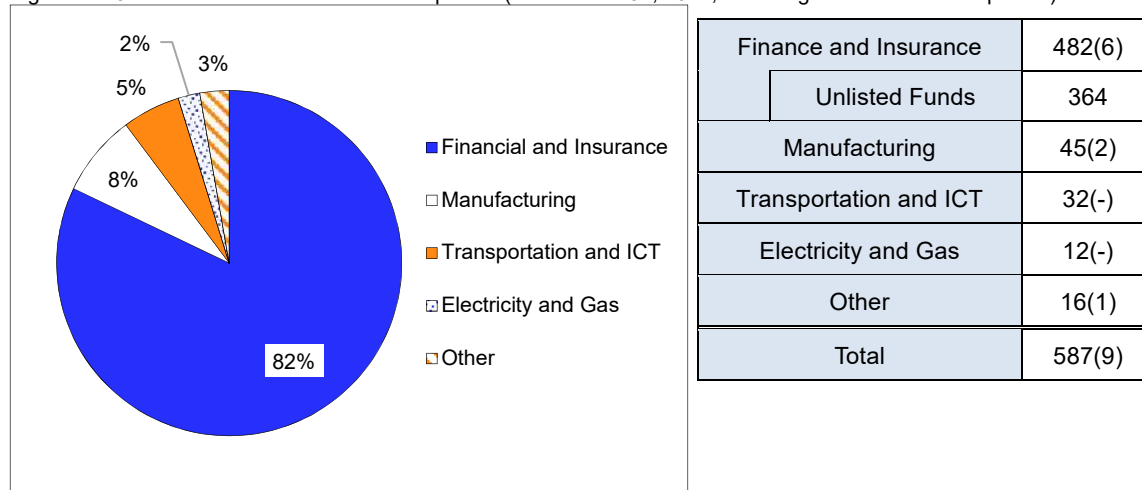
(Note) Compiled the foreign audit firms under the Big Four global

### 3. Audited Companies

Securities issued by foreign companies that are subject to the FIEA disclosure regulations include not only shares issued by companies listed in Japan, but also bonds issued by foreign companies, beneficiary certificates issued by foreign investment trusts, and foreign investment securities. Among foreign companies currently subject to disclosure rules, most are unlisted funds (foreign investment trusts and foreign investment securities).

Regarding the business sectors of companies audited by foreign audit firms, 82% are classified as finance and insurance, and around 75% of these are unlisted funds (Figure II-2-3).

Figure II-2-3: Business sector of audited companies (as of March 31, 2021; unit in right-hand table: companies)



(Note) Figures in parentheses are the number of companies (including funds) listed in Japan  
(Source) Prepared by the CPAAOB based on information on the FSA website

## **C. The CPAAOB monitoring Perspectives, Objectives etc. (Basic Policy and Basic Plan)**

During the 15 years since its establishment in April 2004, the CPAAOB has endeavored to reinforce trust that investors place in the capital markets based on its mission to enhance the fairness and transparency of Japanese capital markets by raising the quality and ensuring the reliability of audits by CPAs.

As part of these efforts, the CPAAOB formulates a Basic Policy for Monitoring Audit Firms each cycle (three years) and a Basic Plan for Monitoring Audit Firms, which is based on the Basic Policy, each program year. In this way, the CPAAOB articulates the perspectives and objectives of monitoring, priorities for each program year, and so on.

### **1. Basic Policy for Monitoring Audit Firms**

The entire text of the Basic Policy for Monitoring Audit Firms for the CPAAOB's 6th Cycle (April 2019 – March 2022) is presented on the CPAAOB's website, but monitoring perspectives, objectives, etc. are summarized below:

#### **[Monitoring Perspectives]**

The CPAAOB always acts in the public interest from the standpoint of citizens and takes full advantage of its entitlements to conduct effective monitoring based on the scalability of audit firms, their operations management environments, and the degree of risk of audited companies.

Through monitoring, we aim to ensure the reliability of audits in the capital markets by continuously encouraging audit firms to independently ensure and improve audit quality.

Moreover, we share useful information obtained through monitoring with relevant parties such as relevant FSA departments and the JICPA, and also proactively provide information to the general public. In addition, we have been cooperating and sharing information with the International Forum of Independent Audit Regulators (IFIAR) and foreign audit regulatory authorities, and as necessary, reflect international discussions concerning the accounting audits through this cooperation, as well as developments with the global networks, in the monitoring conducted by the CPAAOB.

#### **[Objectives of Monitoring and Basic Approach to Achieving Them]**

The main focus of monitoring performed by the CPAAOB is not on whether specific audit opinions are appropriate, but rather, is aimed at encouraging improvements in the effectiveness of quality control reviews performed by the JICPA, and ensuring that audit engagements, including audit quality control conducted by audit firms and foreign audit firms, are performed appropriately.

To achieve such objectives, the CPAAOB performs monitoring as follows:

- Given that the entities responsible for ensuring proper business administration are audit firms, we conduct effective monitoring that encourages them to act independently.
- We conduct monitoring that emphasizes whether the quality control environments



established by audit firms for the purpose of ensuring and improving audit quality are effective. For example, we verify that they are not only adhering to audit standards formally, but also demonstrating the kind of professional skepticism needed to identify accounting fraud, and examine whether audit firms are always keeping an eye on business risks and assessing audit-related risks.

- We conduct ongoing monitoring of whether business management environments established based on the Audit Firm Governance Code are contributing to ensuring proper business administration at the audit firms concerned.

## **2. Basic Plan for Monitoring Audit Firms in Program Year 2021**

The entire text of the Basic Plan for Monitoring Audit Firms in Program Year 2021 (July 2021 - June 2022) is presented on the CPAAOB's website).

While the CPAAOB conducts inspections and non-inspection monitoring on a face-to-face basis in principle, it introduced and carried out remote inspections and remote non-inspection monitoring of certain audit firms in PY2020 in response to the spread of COVID-19 infections to enhance the efficiency and effectiveness of monitoring and reduce the burden on audit firms. In PY2021, the CPAAOB will review its monitoring method by taking into account the audit document digitization and so forth at audit firms to further improve the efficiency and effectiveness of monitoring through such means as expanding the coverage of monitoring.

With regard to the quality control standards and so forth in Japan, deliberations are underway at the Business Accounting Council (audit task force) to revise the quality control standards for auditing, based on revisions and so on to the international quality control standards (ISQM1, ISQM2 and ISA220). The CPAAOB will not only keep tabs on audit firms' preparedness for the revisions and response to them but also carry out further deliberations to review the content, means, posture and so forth of its monitoring, based on the revisions' effects and others on audit firms' quality control.

The following are mainly key audit matters of monitoring:

### **[Basic Plan for Non-Inspection Monitoring]**

#### **a. Collection of reports**

In the case of large-sized and mid-tier audit firms, the CPAAOB continuously calls for, through the collection of reports, qualitative and quantitative information required for reviewing business management (governance) and operations management environments established in response to the Audit Firm Governance Code, as well as for the investigation of tie-ups with the global network of audit firms, auditing methods including the utilization of IT, cybersecurity measures, and steps taken to ensure compliance with laws and regulations, such as the Act on Prevention of Transfer of Criminal Proceeds, etc. The CPAAOB will also keep tabs on KAM-related audits in addition to the auditing, inspection and other stances for listed financial institutions, the audit of

which requires advanced special knowledge of and an understanding of IT.

In the case of small and medium-sized audit firms, the CPAAOB collects reports, whenever appropriate, based on the results of JICPA quality control reviews, to encourage the audit firms to ensure proper audit quality management.

b. Review of JICPA quality control reviews and cooperation with JICPA

In the case of issues, etc. identified about the effectiveness of quality control reviews through monitoring of audit firms, the CPAAOB shares the issues with the JICPA and prompts measures, through continual working-level dialog with the JICPA, to enhance the effectiveness of quality control reviews. The CPAAOB and the JICPA will continue concrete and substantive deliberations as the cooperation is extremely important to ensure and improve the quality of auditing the entirety of audit firms in Japan.

c. Collection and analysis of information on audit firms

The CPAAOB engages in periodic dialogue with executives, including the top management, of large-sized and mid-tier audit firms to grasp the latest developments concerning operations management environments at audit firms and problems and the audit sector. As executives, including the top management, have a mighty influence on the organizational culture, the CPAAOB will continue its dialogue and endeavor to deepen the discussion. Taking advantage of such opportunities, the CPAAOB will also figure out preparedness for revision of the quality control standards, etc. and responses to it.

Through exchanges of views, cooperation and so forth, the CPAAOB will enhance information sharing with relevant bodies, such as FSA departments, the JICPA, financial instruments exchanges and the Japan Audit & Supervisory Board Members Association, as well as with international audit regulatory bodies, foreign audit regulators and the global network of audit firms. Furthermore, the CPAAOB will endeavor to upgrade its capability of collecting and analyzing data, information, etc. in accordance with risks facing audit firms.

[Basic Inspection Plan]

a. Large-sized audit firms

The CPAAOB generally inspects large-sized audit firms every year (with regular inspections and follow-up inspections conducted in alternate years). In follow-up inspections, the CPAAOB does not inspect audit engagements in principle, starting in PY2020, taking the burden on audit firms into account, but it does endeavor to perform the work efficiently and effectively, placing the focus on verification of remedy measures taken to address issues pointed out during regular inspections. The following are the principal inspection and verification points in inspecting large-sized audit firms (an asterisk is given to newly added or partially revised principal inspection and verification points):

- To verify the awareness and action of executives, including the top management, with respect to quality control and their impact on the operations management environment and quality management environment of audit firms.
- To verify the effectiveness of the governance system (especially supervision and evaluation bodies) from the operational standpoint of whether it contributes to the establishment and improvement of quality control at audit firms.
- To verify the state of discussions with management, etc. and communication with auditors, etc. (especially on audit of KAMs and accounting estimates) (\*)
- To verify the state of group audits, including overseas subsidiaries
- To verify the state of education/training and human resources development for audit assistants, IT specialists, etc.
- To verify formalities and others related to statements, such as the procedure of deciding on KAMs and auditing action (\*)
- To verify the assessment of internal control in auditing financial statements, the state of internal control audits and the state of measures to address fraud risk, including the application of the standards for dealing with fraud risk in auditing.
- To verify the state of reaction to monitoring activities by the global network of audit firms
- To confirm the state of reaction to the revision of the quality control standards, etc. (\*)
- To confirm the state of reaction to the clarification of all procedures related to “other statements”(\*)
- To confirm the state of reaction including the improvement of environments for IPO audits (\*)

b. Mid-tier audit firms

The CPAAOB inspects mid-tier audit firms every three years in principle.

While the principal inspection and verification points are almost the same as for large-sized audit firms, the inspection of mid-tier audit firms had the following characteristics:

The CPAAOB verifies whether mid-tier audit firms have integrated business management, operations management and other environments, including their local offices (for details of the principal inspection and verification points, see the “Basic Plan for Monitoring Audit Firms in Program Year 2021” on the CPAAOB’s website).

c. Small and medium-sized audit firms

In the case of small and medium-sized audit firms, when selecting firms to be inspected, the CPAAOB will examine the immediate need of confirming an audit firm’s quality control system and conduct the inspection after taking into account such factors as JICPA quality control review results and the degree of risk pertaining to audited companies.

With regard to the principal inspection and verification points for small and medium-sized audit

firms, the inspection of the firms had the following characteristics (an asterisk is given to newly added revised principal inspection and verification points; for details of principal inspection and verification points, see the “Basic Plan for Monitoring Audit Firms in Program Year 2021” on the CPAAOB’s website):

- To verify the operations management environment, including the awareness and involvement of the top management and partners and organizational unity pertaining to quality control.
- To verify audit resources, including sufficient and appropriate experiences and capabilities to cope with risks at audited companies.
- To verify audit procedures and fraud risk assessment, especially for the recognition of earnings and accounting estimates from the standpoint of whether professional skepticism is exercised.
- To verify an audit firm’s response when auditors are changed(\*)

### III. Operation of Audit Firms



### III. Operation of Audit Firms

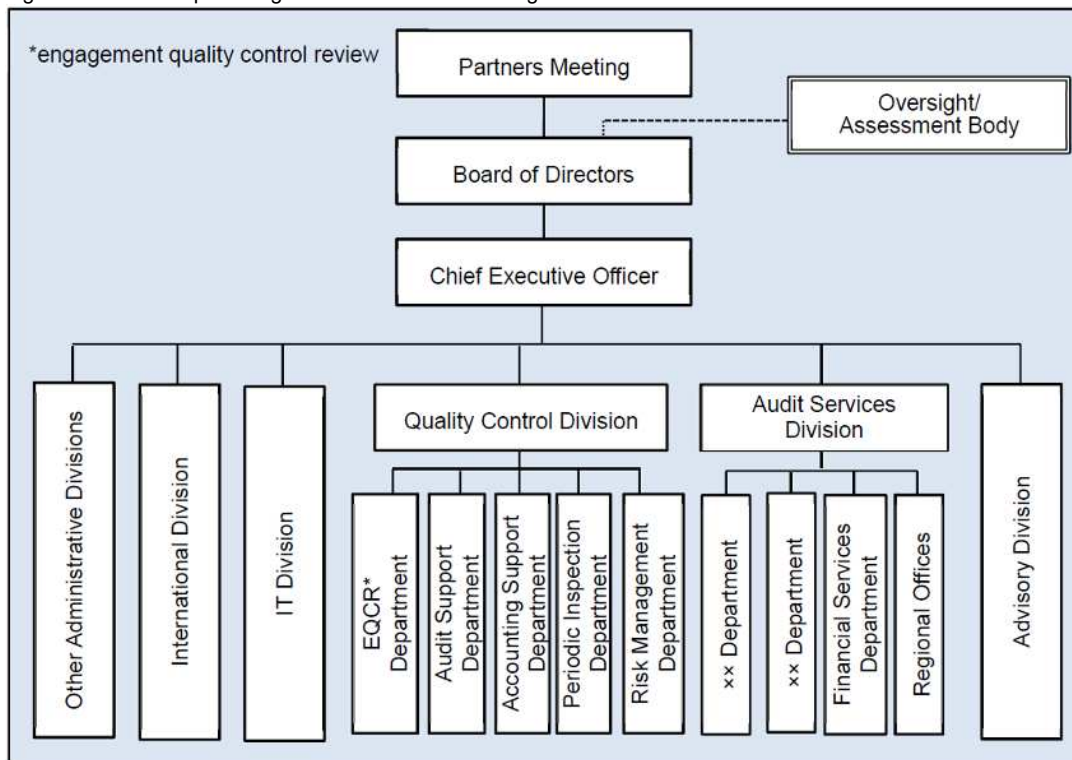
#### A. Operations Management Environment

##### 1. Organizational Structure of Audit Firms

The characteristics of the organizational structure of each type of audit firm, as categorized by size, are shown below.

Large-sized and mid-tier audit firms have a board of directors under the partners meeting, the highest decision-making body composed by all partners, to make important decisions and administer corporate operations. There is also an oversight/assessment body to oversee and assess the effectiveness of management functions from a standpoint independent of the firm's management. The audit services division is divided into several departments that serve different regions or handle different services, and there is also a quality control division that supports audit services. The structures of large-sized audit firms are well-organized than those seen at small and medium-sized audit firms (Figure III-1-1). Large-sized audit firms have established sector-specific departments for conducting audits of listed financial institutions, for example. This department might be referred to as the "Financial Services Division" and form part of the Audit Services Division.

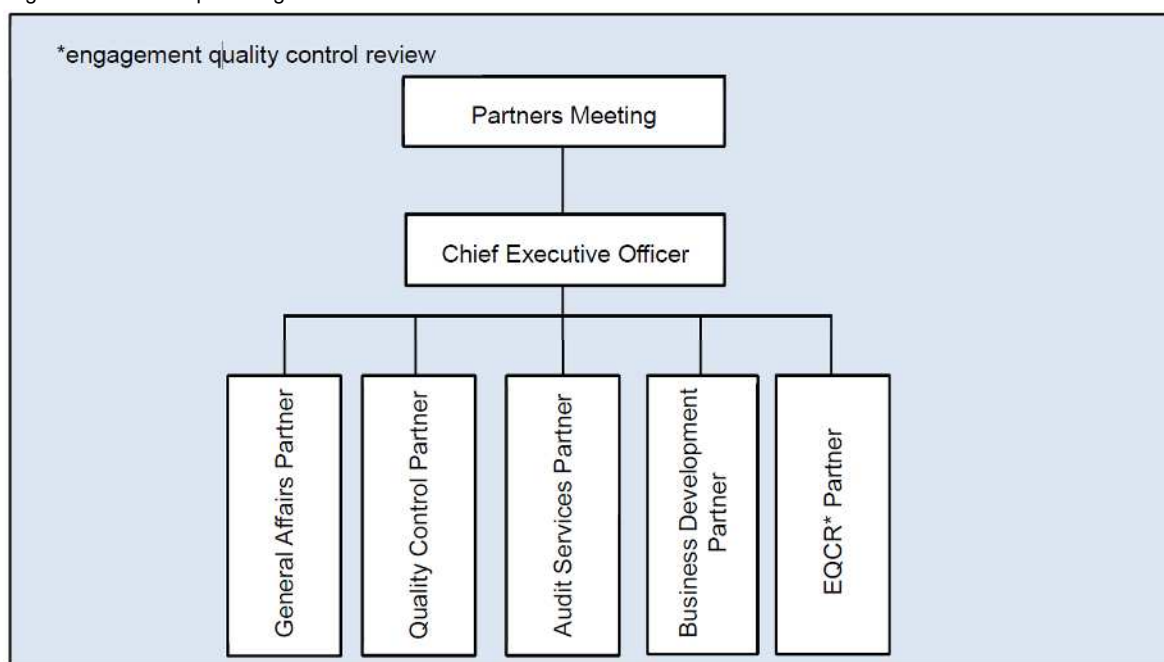
Figure III-1-1: Example of organizational structure at large-sized and mid-tier audit firms



(Note) The organizational structure of mid-tier audit firms is often simpler than the structure shown in the above figure.

On the other hand, the majority of small and medium-sized audit firms do not have siloed audit engagement division and their organizational decisions are made by partners meeting without the establishment of the board of directors or oversight/assessment body due to the human resource constraint. Similarly, they manage quality control by assigning a person in charge instead of establishing a department for the purpose. However, with this management, the level of quality control depends on the ability and involvement time of the person in charge, and knowledge and experience are less likely to be accumulated in the organization in the audit firm. Therefore, the quality management system of small and medium-sized audit firms are weaker than that of major audit firms (Figure III-1-2).

Figure III-1-2: Example of organizational structure at small and medium-sized audit firms



Characteristics of organizational structure based on audit firm size are as follows: (Figure III-1-3)

Large-sized audit firms strategically assign full-time staff members to sections divided in accordance with their operations and are promoting efforts to improve the quality of audits through the specialization and stratification of operations, such as transferring certain quality control functions to a section in charge of audit engagements. Recently, large-sized audit firms have the tendency to shift principal responsibility for quality control from the quality control section to the business section, which is closer to the vanguard of auditing, at their headquarters. The practice is ending up with a certain amount of achievements, and for this, cooperation between the two sections needs to be strengthened.

At mid-tier audit firms, head-office functions are being strengthened through, for example, increases in the headcount of the head-office as a way of responding to rises in the number of audited companies. At some firms, however, the operations environment has not been adequately modified to ensure that consistent quality is maintained as the business operations expand.

At small and medium-sized audit firms, staff members have dual caps of audit engagement as well as



quality control. However there are some cases that partners and full-time staff sometimes do not devote adequate time to quality control, due to the situation where the partners are also often allowed to engage in their side job and/or proportion of part-time staff are relatively high. Furthermore, at some small and medium-sized audit firms, quality control management is run by multiple audit departments independently, not by centralized firm-wide quality control system.

Figure III-1-3: Characteristics of each type of audit firm

	Large-sized audit firm	Mid-tier audit firm	Small and medium-sized audit firms
Number of partners	Between 150 and 600	Approx. 30 to 100	Up to approx. 30 (Note)
Number of full-time personnel	Approx. 2,900 to 6,400	Approx. 170 to 800	Up to approx. 80 (Note)
Decision-making bodies	<ul style="list-style-type: none"> <li>The highest decision-making body is the partners meeting</li> <li>A board of directors and an executive committee are set up under the partners meeting</li> </ul>	<ul style="list-style-type: none"> <li>The highest decision-making body is the partners meeting</li> <li>A board of directors is set up under the partners meeting</li> </ul>	<ul style="list-style-type: none"> <li>Most decisions are made at the partners meeting</li> <li>Larger firms have a board of directors beneath the partners meeting</li> </ul>
Oversight/assessment bodies	<ul style="list-style-type: none"> <li>A body is established to supervise/assess business execution bodies such as the board of directors</li> <li>Subcommittees is established for "nomination" (nominations of chief operating officers and other executives), "compensation" (evaluation of executives/partners, compensation decisions, etc.), and "audit" (accounting and audit areas other than accounting). A public interest subcommittee is also established to monitor business execution from a public-interest standpoint</li> <li>Third parties with independence ("independent third parties") serve as members of oversight/ assessment bodies and subcommittees</li> </ul>	<ul style="list-style-type: none"> <li>Oversight/assessment bodies are established but their powers are limited compared with those at large-sized audit firms</li> <li>Many firms do not establish subcommittees for nomination, compensation, and audit</li> <li>While audit firms use independent third persons as constituent members of oversight/assessment bodies, involvement by the independent third persons is limited to advice and suggestions to executive bodies at many audit firms.</li> </ul>	<ul style="list-style-type: none"> <li>Many firms have systems of checks and balances between partners without establishing oversight/assessment bodies.</li> <li>Many firms do not appoint independent third parties</li> </ul>
Design of business operation departments	<ul style="list-style-type: none"> <li>Multiple audit services departments are established, and firm-wide operation including regional offices is also conducted</li> <li>A department specializing in financial services is established</li> <li>Departments in charge of quality control, risk management are established</li> </ul>	<ul style="list-style-type: none"> <li>Management of firms, including regional offices, in addition to the establishment of multiple audit engagement sections</li> <li>A department in charge of quality control are established</li> </ul>	<ul style="list-style-type: none"> <li>Many firms appoint partners to handle the particular services without establishing particular departments</li> <li>Larger audit firms have set up organizations that resemble those of mid-tier audit firms</li> </ul>
Number of offices	<ul style="list-style-type: none"> <li>There are many cases of setting up regional offices on a nationwide scale in addition to the three big cities (Tokyo's 23 wards, Osaka City and Nagoya City).</li> </ul>	<ul style="list-style-type: none"> <li>Besides the firm's main office, there are often also offices in metropolises (Tokyo, Osaka and Nagoya)</li> </ul>	<ul style="list-style-type: none"> <li>Many firms only have a main office</li> </ul>
Design of quality control divisions	<ul style="list-style-type: none"> <li>A quality control division comprises various departments for functions such as revising and distributing audit manuals, providing advice on accounting procedures, IFRS and US accounting standards, and conducting engagement quality control reviews and periodic inspections in relation to its system of quality control</li> <li>A risk management department, which is responsible for monitoring of audit contracts, independence, and audit risks, is established</li> <li>Audit services departments also often have quality control functions</li> </ul>	<ul style="list-style-type: none"> <li>Some of the departments under a quality control division</li> <li>Some also have a department for engagement quality control reviews</li> </ul>	<ul style="list-style-type: none"> <li>Many firms appoint partners to handle both quality control and audit engagements without establishing quality control departments</li> <li>Some small firms' representatives are also in charge of quality control</li> </ul>

(Reference) Prepared by the CPAAOB from CPAAOB inspections, collected reports and operational reports in PY2020.

(Note) Excluding an audit firm having a wide gap between the number of partners and that of full-time staff members.

## 2. Efforts in Response to Audit Firm Governance Code

The Audit Firm Governance Code states principles for effective management of audit firms. The code is primarily intended for large-sized audit firms with many partners and staff that conduct audits of major listed companies, but there is nothing to hamper applying the code voluntarily. The code allows audit firms to adopt it on a comply-or-explain basis. It is important that large-sized audit firms and other audit firms put the five principles into practice in ways suited to their own distinct circumstances in order to implement it and achieve effective organizational administration.

### Principle 1: The Role to Be Accomplished by an Audit Firm

An audit firm has the public interest role to ensure the credibility of corporate financial information through the audits, seek to protect stakeholders such as participants in the capital market and thereby contribute to the sound development of the national economy. In order to accomplish this role, the audit firm should encourage its members to have frank and openminded dialogue, enhance mutual development, promote their full competence, and continuously enhance the audit quality on a firm-wide basis.

### Principle 2: Organizational structure (management functions)

An audit firm should have effective management in order to develop its organizational operations as a whole for the continuous enhancement of the audit quality.

### Principle 3: Organizational structure (oversight/assessment functions)

An audit firm should have a function to oversee and assess the effectiveness of its management from the independent viewpoint and thereby support to enhance the effectiveness of the management.

### Principle 4: Operation

An audit firm should develop an operational structure to effectively manage its operations. An audit firm should also strengthen the people retention and development and proactively engage in a dialogue and discussion within the firm and with audited companies about the possible enhancement of audit quality.

### Principle 5: Ensuring transparency

An audit firm should ensure full transparency to allow stakeholders in the capital market to appropriately assess its audit quality, by explaining the status of the Code's implementation. The audit firm should also effectively utilize the internal and external assessment of its efforts for improvement in its management and operations.

As of July 1, 2021, all large-sized audit firms and mid-tier audit firms as well as eight small and medium-sized audit firms had announced adoption of the Audit Firm Governance Code<sup>10</sup>.

When it comes to the status to adopt each principle of the Code from the viewpoint of the firms' scalability, large-sized and mid-tier audit firms have adopted all the principles. Few small and medium-sized audit firms have adopted all of the principles, with oversight/assessment functions within organizational structure (Principle 3) and ensuring transparency (Principle 5) often not being adopted, in particular.

As described above, because of the situation where there is size-based variation in the application of oversight/assessment functions within organizational structure (Principle 3) and ensuring transparency (Principle 5), we examine the efforts that audit firms are making with respect to these two principles.

<sup>10</sup> Sources: a list of audit firms adopted "Principles for Effective Management of Audit Firms (The Audit Firm Governance Code)", the FSA website

- a. Oversight/assessment functions within organizational structure (Principle 3)
  - i. Strengthening oversight/assessment functions through the utilization of independent third parties

- (i) Large-sized audit firms

Large-sized audit firms are taking steps to incorporate a public interest perspective and the knowledge of independent third persons in order to strengthen their oversight/assessment bodies. As methods of achieving this, two patterns have been observed: A pattern of including independent third persons as outside committee members in existing oversight/assessment bodies (Pattern 1) and a pattern of setting up separate and independent bodies such as a public interest committee (Pattern 2) (Figure III-1-4).

Pattern 1: independent third persons are directly involved as outside members in the processes pursued by nomination, compensation, and audit subcommittees.

Pattern 2: independent third persons are not directly involved in these processes by setting up separate and independent bodies such as a public interest committee comprising outside members.

Note that all large-sized audit firms state whether independent third parties are involved in each of the processes of “nomination,” “compensation,” and “audit” in the reports etc. concerning audit quality that they publish annually.

- (ii) Mid-tier audit firms

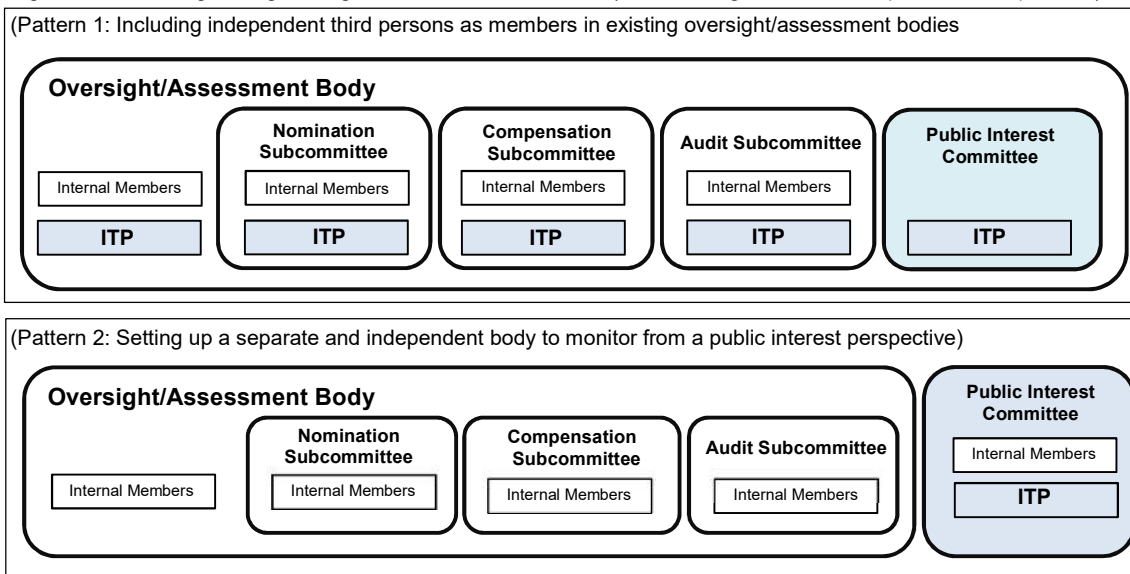
The publication of the Audit Firm Governance Code has prompted mid-tier audit firms to make efforts to establish independent bodies, such as public-interest committees that are comprised of independent third parties as oversight/assessment bodies. However, with the exception of some firms, they have not established subcommittees for “nomination,” “compensation,” and “audit,” so involvement by independent third parties in nomination, compensation, and audit processes is more limited than at large-sized audit firms. There are also firms that have not clarified the selection methods, term, and powers of independent third parties.

- (iii) Small and medium-sized audit firms

Five out of eight small and medium-sized audit firms have not established oversight/assessment bodies on the grounds that they could exercise mutual supervision. At some of the firms that have not established oversight/assessment bodies, however, independent third parties take part in meetings relating to business administration.

Note that many firms do not clearly define specific procedures for each process of “nomination”, “remuneration”, and “audit”.

Figure III-1-4: Strengthening oversight/assessment functions at (ITP in this figure means independent third persons)



## ii. Efforts to utilize the knowledge and experience of independent third persons

### (i) Large-sized audit firms

In seeking to incorporate a public interest perspective and the knowledge and experience of independent third persons listed in a. above, it is important to provide independent third persons in a timely and appropriate manner with necessary information about audit firms such as organizational administration, nomination and dismissal in members of executive bodies, and matters concerning assessment and compensation. It is also important to seek comments of these independent third persons timely.

Under the pattern in which independent third persons are included as constituent members of existing oversight/assessment bodies (Pattern 1 in Figure III-1-4), firms provide information to them and receive opinions from them through their participation in meetings of the oversight/assessment bodies. There are also efforts to improve the effective use of independent third persons by raising the ratio of outside members who are independent third persons in the oversight/assessment bodies and subcommittees.

On the other hand, where the independent organizations are set up separately (Pattern 2 in Chart III-1-4 above), the audit firm provides information to independent third parties through internal committees, etc., and receives opinions from independent third parties, and has opportunities to exchange opinions regularly with the CEO. In Pattern 2, since independent third persons are members of bodies that are independent of existing oversight/assessment bodies, it is particularly important to ensure that effective discussions are conducted by providing independent third persons with the information they need in a timely and appropriate manner. To provide independent third persons with necessary information in a timely and appropriate manner, some firms confer independent third persons the right to attend meetings of executive bodies, including those of group firms, and the power to

demand information. Other firms have taken such steps as establishing a secretariat to assist outside committee members, who are independent third persons.

(ii) Mid-tier audit firms

Many mid-tier audit firms have established independent bodies such as public interest committees with independent third persons constituting the membership of these bodies. However, unless the independent third persons are provided with the information they need in a timely and appropriate manner, there are potential risks that the oversight/assessment bodies will not function adequately. With regard to this point, some firms are endeavoring to ensure that required information is provided, for example, conferring on independent third persons the right to attend meetings of executive bodies and the right to demand information. Nevertheless, some firms have not authorized to confer independent third persons the authority to obtain information.

iii. Experience/expertise of independent third persons

When it comes to independent third persons among the members of oversight/assessment bodies, it is necessary to assign persons with the expected knowledge and experience based on the size of audit firm, its governance structure and organizational issues. Furthermore, consideration needs to be given not only to independence from the audit firm, but also independence from companies that the firm audits.

Large-sized and mid-tier audit firms tend to assign people with managerial experience at general business companies, while small and medium-sized audit firms prefer academics or attorneys (Figure III-1-5).

The number of independent third persons assigned is three or four at large-sized audit firms, one to three at mid-tier audit firms, and one at small and medium-sized audit firms. Some large-sized and mid-tier audit firms assign independent third persons to chair their oversight/assessment bodies and “nomination,” “compensation” and “audit” subcommittees in order to improve the effective use of them.

Figure III-1-5: Experience/expertise of independent third persons (unit: persons)

	Former senior management	Academic expert	Attorneys and legal experts	Former ministry/agency officials	Other
Large-sized audit firms	10	1	1	1	—
Mid-tier audit firms	5	1	1	2	2
Small- and medium-sized audit firms	—	3	1	—	—

(Reference) Prepared by the CPAAOB from CPAAPB inspections and reference material released by each audit firm in PY2020. The number is the total of independent third persons at firms grouped by scale. If more than one is assigned at a firm, the number is the total of them.

b. Ensuring transparency (Principle 5)

i. Explanations of application of each of the principles of the Audit Firm Governance Code and efforts to improve audit quality

(i) Large-sized audit firms

Large-sized audit firms issue annual reports etc. concerning their audit quality and disclose them on their websites. These reports etc. describe how they are applying each of the principles of the Audit Corporate Governance Code and the action they are taking to improve audit quality. The reports etc. include detailed information about their organizational structure, quality controls, human resources development, global networks they belong to, and so on. In recent years, they devote considerable space to explanations of work style reform and effective utilization of IT. Some firms also report the results of action taken to address issues identified the previous year and issues to be tackled in the following year, while others disclose attendance by independent third persons at executive meetings etc. some firms gave accounts for measures to address key audit matters (KAMs) and COVID-19 infections, according to reports on the quality of audits, etc., issued in FY2020.

(ii) Mid-tier audit firms

Mid-tier audit firms issued reports on the quality of audit, etc., mainly to explain their organizational structure and quality control, and they have posted them on their websites. The reports are more simplified in content than those released by large audit firms. They include reports omitting explanations of audit quality indexes, plans to develop human resources such as educational programs and training curriculums, and so forth, which are available in reports by large audit firms. Some firms released the assessment of current efforts to improve the quality of audits by constituent members, such as results of in-house questionnaires about quality control.

(iii) Small and medium-sized audit firms

Four out of eight of the firms that have declared adoption of the Audit Firm Governance Code publish reports etc. concerning audit quality. Those that do not publish reports etc. concerning audit quality merely provide brief descriptions on their websites of their application of the Audit Firm Governance Code. Reports etc. concerning audit quality and explanations on websites tend to contain fewer items and more concise than those of mid-tier audit firms, and they sometimes include no specific description of organizational structure.

ii. Dialogue with stakeholders in the capital market for the further improvements in their audit qualities

(i) Large-sized audit firms

Large-sized audit firms have conducted surveys of and dialogues with chief financial officers (CFOs), auditors and others of audited companies on the quality of audits. Specifically, they

have worked on securing dialogue with market participants and others on a broader basis through measures such as hosting sessions, in the presence of independent third persons, to exchange opinions with institutional investors and analysts.

(ii) Mid-tier audit firms

Some mid-tier audit firms appeared to conduct surveys, related to the quality of audits, of CFOs, auditors and others of audited companies. There are also cases in which firms make use of the meetings held for investors by the JICPA or exchanges instead of hosting sessions individually.

(iii) Small and medium-sized audit firms

Most of the small and medium-sized audit firms that have declared adoption of the Audit Firm Governance Code and their responses are no more than exchanging information between engagement teams and the chief financial officers (CFOs), audit and supervisory board members etc. of audited companies.



### 3. Human Resources of Audit Firms

#### a. Partners and full-time personnel

At most large-sized audit firms, most CPA exam passers being hired immediately after they have passed the essay exam while only a small proportion of CPAs (including persons who have passed the CPA exam) are recruited mid-career. In general, the CPA exam passers hired become CPAs at the audit firm concerned, and some of them are internally selected for promotion to managerial positions. Furthermore, some of them are later promoted to partner (for details, see “I. Overview of the Audit Sector, B. Audit Firms, 1. Organizational Structure of Audit Firms” (page 16)).

Many mid-tier audit firms and small and medium-sized audit firms, meanwhile, find it difficult to recruit enough CPA examination passers and thus tend to have a larger portion of CPAs hired midcareer. The recruits are mainly CPAs who have left large-sized audit firms, and in this way they are endeavoring to secure the necessary headcount for audit engagements etc.

In many cases, such CPAs who have left large-sized audit firms establish a new audit firm.

The number of partners and full-time staff members, analyzed on the basis of scale, has generally leveled off at large audit firms since FY2017 and has been on the rise at mid-tier audit firms during the same period. At small and medium-sized audit firms, it turned upward in FY2017 due in part to the establishment of new firms after showing a downward trend until FY2016.

As far as the structure of manpower is concerned, the number of CPA examination passers, etc. has generally hovered at all audit firms in disregard of scale. In contrast, the number of staffs other than CPAs, including CPA examination passers, has been on the rise at mid-tier audit firms and small and medium-sized audit firms in recent years. At large-sized audit firms, meanwhile, the number of non-CPA staffs dropped in FY2020 because some of them transferred administrative staff members to other group firms. According to the latest data, non-CPA staffs account for 32% of the total workforce at large-sized audit firms, 30% at mid-tier audit firms, and 27% at small and medium-sized audit firms. Compared with FY2016 (FY2015 in the case of small and medium-sized audit firms), the ratio rose sharply from 22% and 15% at mid-tier audit firms and small and medium-sized audit firms, respectively, and slightly from 31% at large-sized firms (see Figure III-1-6).

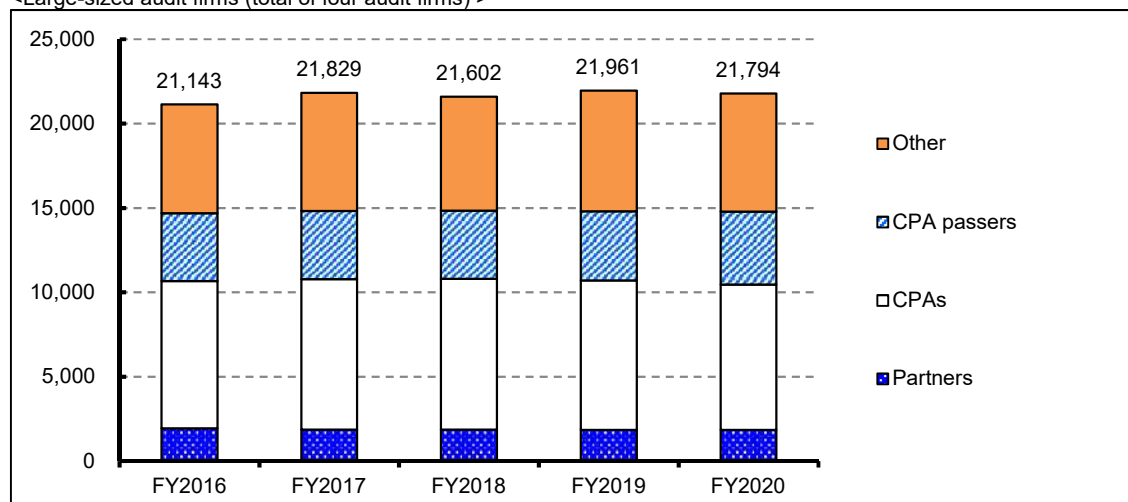
Audit firms have increased their non-CPA personnel to deal with the audited companies promoting IT, to improve operational efficiency, to address personnel shortages, and to facilitate CPAs to focus more on judgmental tasks, and so on. Among these personnel are IT experts who conduct IT audits with the use of technologies to support engagement teams in carrying out audit procedures, and audit assistants who support engagement teams by sending/receiving balance confirmation letters, preparing various reports, and sorting data.

Some large-sized audit firms have improved their operations by establishing specialist organizations to centrally manage such things as audit assistants' work/procedures, skill

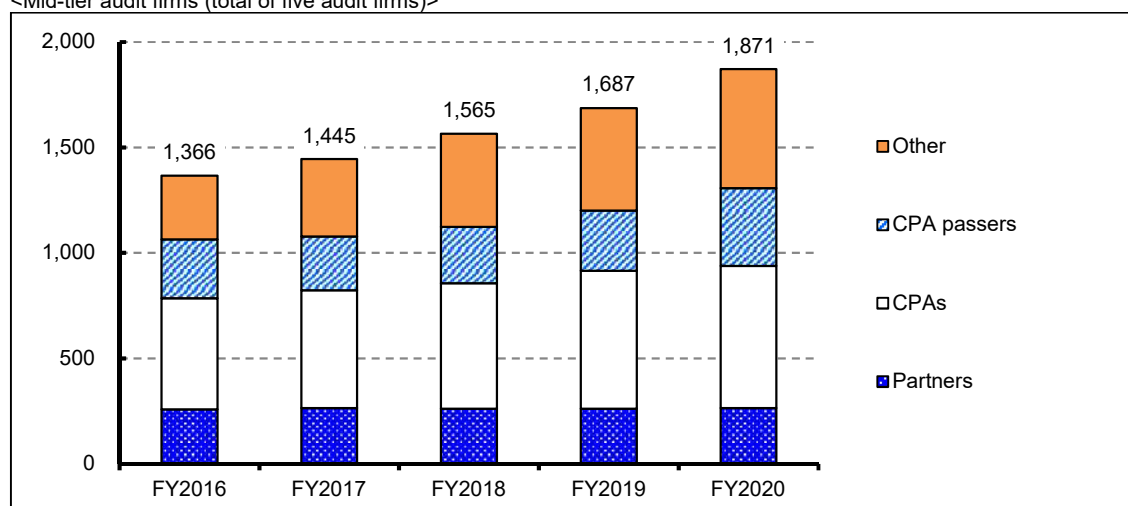
development, and job allocations.

Figure III-1-6: Change in the number of partners and full-time personnel (unit: persons)

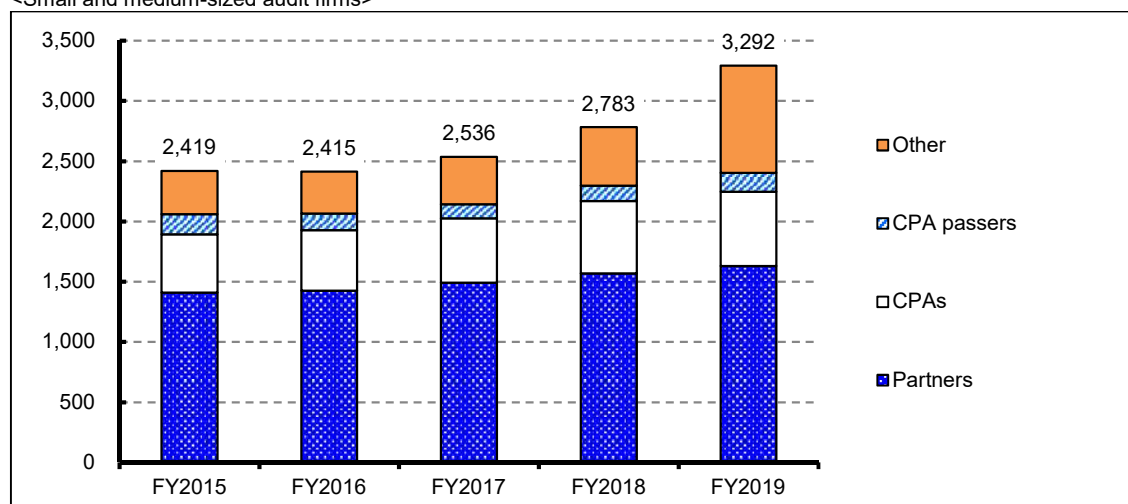
<Large-sized audit firms (total of four audit firms) >



<Mid-tier audit firms (total of five audit firms) >



<Small and medium-sized audit firms>



(Note 1) The data are aggregates of personnel for each fiscal year based on audit firm's operational reports. The book-closing months of small and medium-sized audit firms vary widely, so figures for FY2020 have not yet been compiled. As a result, the figures for small and medium-sized audit firms only cover the period to up to FY2019.

(Note 2) The number of small and medium-sized audit firms varies from year to year, but 229 such firms are included in the figures for FY2019.

## ■ Introduction of remote work at audit firms ■

Amid infections with the novel coronavirus starting to spread around the world in early 2020, Japanese government declared a national state of emergency in April 2020 and January and April in 2021 to combat the COVID-19 pandemic. Anti-coronavirus measures are being promoted throughout the entire society in the country.

With the COVID-19 posing behavioural restrictions, the way of auditing services has been greatly changed. Audit firms have replaced the conventional method of auditing procedures at audited companies with the new ways on a remote basis, especially working from home.

< Examples of audit firms promoting remote work >

- Financial support for improvement of infrastructures on working environments at home to promote remote work
- Utilization of tools to facilitate communication with audited companies and within auditing teams
- Improvement of work shift and support programs to manage work and childrearing
- Implementation of healthcare programs under remote work environments via video streaming and other means provided by industrial physicians, healthcare nurses, etc.
- Review of training programs, on-the-job training and performance evaluation system under remote work environments

### b. Side businesses by partners

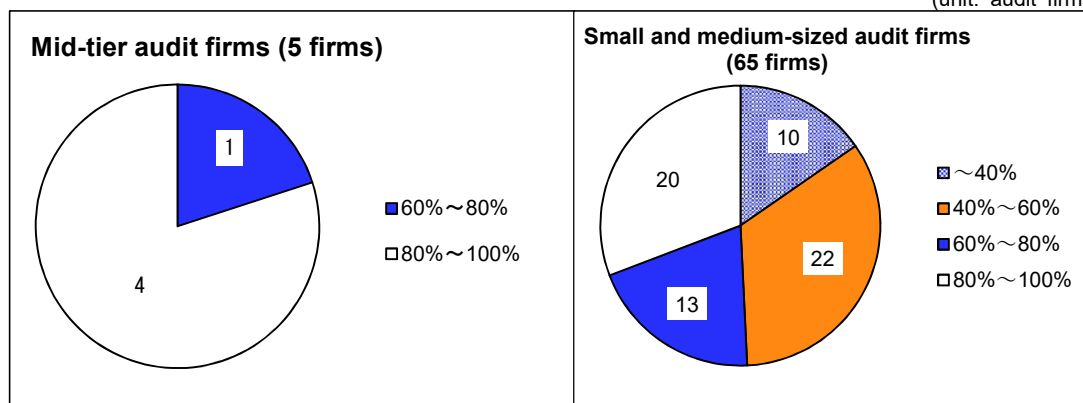
Large-sized audit firms do not permit dual work by partners at tax accountant offices or solo audit practitioners in principle.

While there are mid-tier audit firms that, like large-sized audit firms, do not permit dual work by partners, the ratio of partners having dual work is about 40% at some of them.

Most small and medium-sized audit firms permit dual work as many partners are already operating a tax accountant office on their own when they joined them.

Figure III-1-7 shows hours spent on audit engagements by partners, including those engaging in dual work, at mid-tier audit firms and small and medium-sized audit firms. At about half of small and medium-sized audit firms, hours spent on audit engagements by them account for less than 60% of their total work hours.

Figure III-1-7: Number of audit firms by percentage of time spent by partners engaged in the audit firm's operations  
(unit: audit firms)



(Source) Prepared by the CPAAOB based on partner's declarations collected in PY2020 the CPAAOB inspections and collection of reports

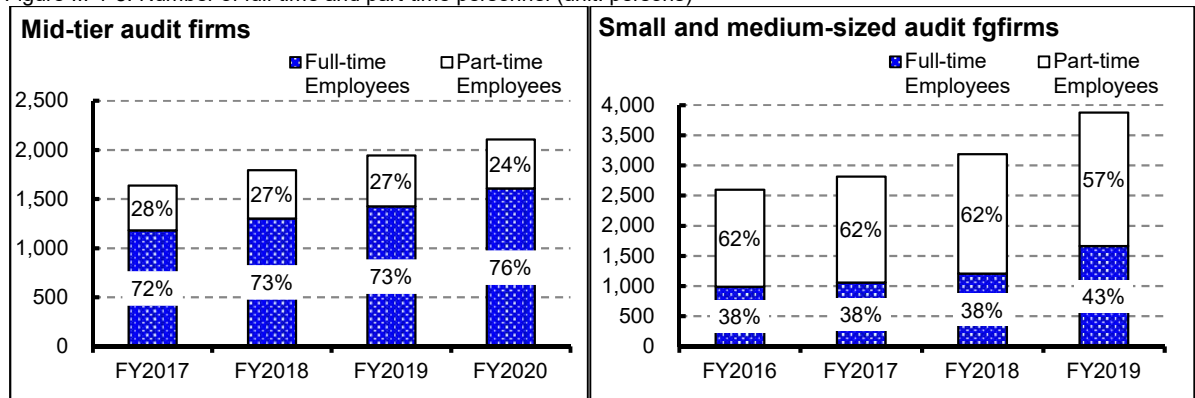
c. Part-time personnel

Part-time staff members account for an extremely low; around 3% to the total headcount at large audit firms.

While the ratio hovers at around 20% to 30% at mid-tier audit firms as a whole, it varies among them and stands close to 50% at some of them.

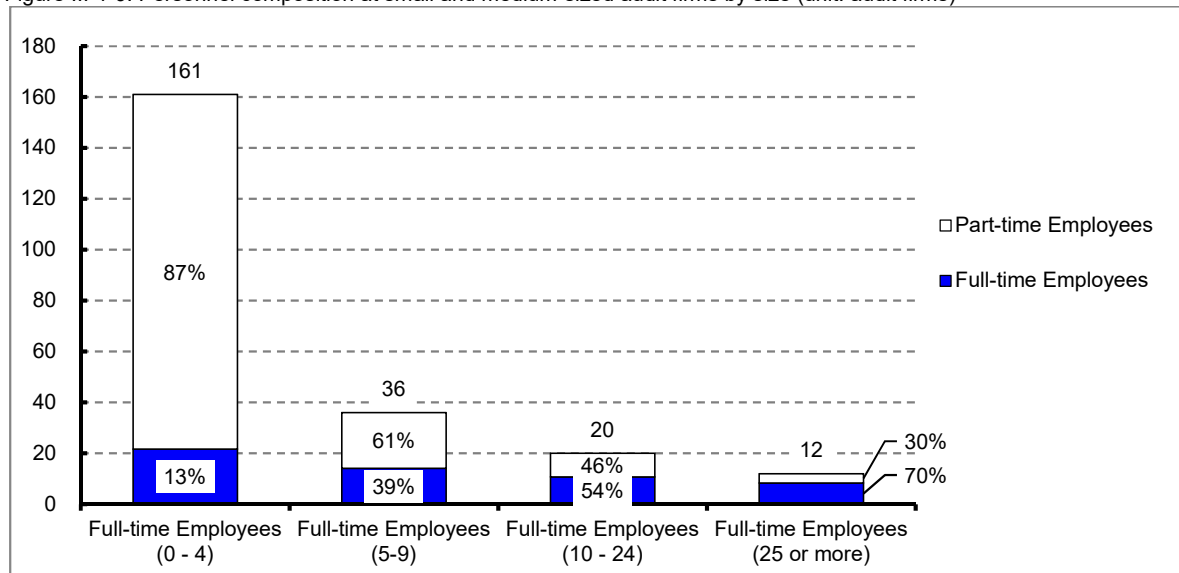
The ratio of part-time staff members stands at around 60% at small and medium-sized audit firms, some of which rely on them as the audit assistants needed for their operation (see Figure III-1-8). In particular, around 70% of small and medium-sized audit firms with a full-time staff of four or less, the ratio of a part-time staff of which accounts for over 80% (see Figure .III-1-9).

Figure III-1-8: Number of full-time and part-time personnel (unit: persons)



(Note) The data is based on operational reports submitted by audit firms

Figure III-1-9: Personnel composition at small and medium-sized audit firms by size (unit: audit firms)



(Note) The 229 audit firms were classified by the number of full-time personnel based on the operational reports submitted by small and medium-sized audit firms in FY2019, after which the number of fulltime and part-time employees was totaled and the composition ratios of full-time and part-time personnel calculated.

## 4. Organizational Structure for Providing Audit Services

An audit engagement team, as an audit service provider, is required to exercise professional skepticism<sup>11</sup>, carry out appropriate risk assessments and risk-response procedures and perform proper audit procedures for improving audit quality. The CPAAOB endeavors to understand the engagement team's status through its inspections of audit engagements, and to ascertain the conduct of audit services including other monitoring activities.

This section elaborates the status of engagement teams.

An engagement team consists of an executive partner who takes primary responsibility, CPAs serving as audit assistants and other audit assistants. Other audit assistants include CPA exam passers and other audit assistants (staff members who are not qualified to be involved in the audit of financial statements by CPAs, etc.). If the business activities of an audited company are complicated and extensive in scale, IT, tax and other in-house experts join the team. As occasion demands, corporate value assessment and fraud experts of a group audit firm may also join the team. While the general job classification-based formation of an engagement team (Note 1), formed by a large-sized audit firm to audit a big domestic listed company, is shown in Figure III-1-10, large-sized audit firms are implementing measures to reduce clerical work by CPAs at audit sites (where auditing services are actually performed), as mentioned in (5) organizational structure to support audit engagements. As a result, the number of members and job classification-based formation of engagement teams may change depending on the progress made in the measures.

Figure III-1-10: Example of the composition and main roles of engagement team members at a large-sized audit firm

		Position	Principal roles
Three engagement partners		Partner	Control of audit services, communication with the senior management of the audited company
Assistants to the engagement partners	One senior manager/Manager	Senior manager/Manager	Management of engagement team, management of financial statement audits
	One senior manager/Manager	Senior manager/Manager	Management of foreign component audits
	10 CPAs	Manager/Senior staff	Performance of audit procedures in significant audit areas
	13 qualified assistants (CPA passers, etc.)	Staff	Performance of procedures for assessing the design and effectiveness of internal controls, performance of audit procedures other than important audit procedures
	Four unqualified assistants	Assistant	Data processing, reconciliation of administrative vouchers, other tasks not requiring significant decisions, management of sending/ collection of balance confirmation letters, administration of engagement documentation
	Seven in-house experts (Note 2)	Partner, manager, senior staff, etc.	Assessment of IT control, verification of corporate tax, etc. treatment and of adequacy of retirement benefit obligations at audited companies

(Note 1) An example of an engagement team auditing a company having consolidated sales of approximately 1.6 trillion JPY that requires approximately 15,000 hours for audit engagements.

(Note 2) In-house experts are assigned to engagement teams as needed

<sup>11</sup> An attitude with a questioning mind, being alert to conditions which may indicate possible misstatement due to error or fraud, and a critical assessment of audit evidence.

The general features of the composition of engagement teams were as follows.

At large-sized audit firms, experienced CPAs exert audit procedures for key audit areas under the guidance and supervision of engagement partners. Inexperienced CPAs, CPA passers, etc. usually cover audit procedures for audit areas other than important audit areas. Audit assistants help with audit services by performing such administrative tasks as sending balance confirmation letters. As mentioned above, furthermore, there are cases such as large-sized audit firms consolidating services done by audit assistants at a newly established center for enabling CPAs to concentrate on work requiring their professional judgment by reducing their workload (see Column “Example of Establishment of Organization for Performing Clerical Work Relating to Audits” (page 80))

Although human resource for audit teams is limited, engagement teams at mid-tier audit firms have a structure of job demarcation in a merit-based manner as in the case of large-sized audit firms. Some mid-tier audit firms appear to step up the recruitment of audit assistants.

As human resource for audit teams at small and medium-sized audit firms is limited, some firms are unable to assign enough audit assistants to their teams. Compared with large-sized audit firms, therefore, the burden on members with primary responsible for auditing tends to be heavier because they may engage in audit procedures (Figure III-1-11).

#### < Structure of the engagement team in an audit of a financial institution >

To audit listed financial institutions subject to accounting and auditing procedures greatly different from those applicable to ordinary business enterprises, large-sized audit firms have set up mechanisms capable of performing an audit based on professional knowledge and experience, such as the establishment of financial business sections destined to audit the financial institutions. An engagement team to audit a listed financial institution involves knowledgeable members about the financial institution audit in such manners as forming a team mainly from a financial business section or deploying a primary responsible member from the section.

#### < Structure of the engagement team in an audit of an IPO >

No audit firm has an organization specializing in IPO audit, which is conducted by an existing audit section. To address risks inherent in IPOs (vulnerability of internal control, etc.), large-sized and mid-tier audit firms adopt such measures as primarily assigning workers well versed in IPO audit.

Many large-sized and mid-tier audit firms have established special organizations, such as an IPO support team to cope with requests for IPO-related services from companies aiming for IPOs or improve the quality of IPO audit. (For the development of environments for IPO audit, see IV. Responses to Changes in the Global Environment Surrounding Audits, E. Recent Trends with Accounting Audit, 6. Report from the Liaison Council on the Appointment of Audit Firms for Initial Public Offering (IPO) Audits (page 131)).

Figure III-1-11: Typical engagement team composition and main roles of team members

		Large-sized audit firms	Mid-tier audit firms	Small and medium-sized audit firms
Engagement partners		<ul style="list-style-type: none"> <li>• Setting material audit areas and assessing audit risks</li> <li>• Reviewing audit procedures performed by assistants</li> <li>• Communicating management and the audit and supervisory boards</li> </ul>	<ul style="list-style-type: none"> <li>• Setting material audit areas and assessing audit risks</li> <li>• Reviewing audit procedures performed by assistants</li> <li>• Conducting audit procedures in material audit areas</li> <li>• Communicating with management and the audit and supervisory boards</li> </ul>	<ul style="list-style-type: none"> <li>• Setting material audit areas, assessing audit risks, and drafting audit plans</li> <li>• Reviewing audit procedures performed by assistants</li> <li>• Conducting audit procedures (including material audit procedures)</li> <li>• Communicating with management and the audit and supervisory boards</li> </ul>
Assistants to the engagement partners	CPAs	<ul style="list-style-type: none"> <li>• Draw up an audit plan</li> <li>• Implement the audit procedure in key audit areas</li> <li>• Inspect the audit procedure implemented by other audit assistants</li> </ul>	<ul style="list-style-type: none"> <li>• Draw up an audit plan</li> <li>• Implement the audit procedure</li> <li>• Inspect the audit procedure implemented by other audit assistants</li> </ul>	<ul style="list-style-type: none"> <li>• Implement the audit procedure (including data analysis and sending, collection and management of balance confirmation documents)</li> <li>• Inspect the audit procedure implemented by other audit assistants</li> </ul>
	CPA Passers, etc.	<ul style="list-style-type: none"> <li>• Conducting audit procedures</li> </ul>	<ul style="list-style-type: none"> <li>• Conducting audit procedures</li> </ul>	<ul style="list-style-type: none"> <li>• Conducting audit procedures</li> <li>• Not employed in most small audit firms</li> </ul>
	Unqualified assistants	<ul style="list-style-type: none"> <li>• Data setting</li> <li>• Administration of sending/ collection of balance confirmation letters, administration of audit documentation</li> </ul>	<ul style="list-style-type: none"> <li>• Data setting</li> <li>• Administration of sending/ collection of balance confirmation letters, administration of audit documentation</li> </ul>	<ul style="list-style-type: none"> <li>• Not employed in most small audit firms</li> </ul>

(Source) Prepared by the CPAAOB based on the CPAAOB inspections

## 5. Organizational Structure for Supporting Audit Services

With audited companies becoming larger in scale and promoting the sophistication and internationalization of operations, audit firms need to not only provide expertise and develop IT-driven tools and systems but also support engagement teams through such means as setting up environments that contribute to efficient and effective implementation of operations.

Accordingly, the CPAAOB monitoring focuses not only on audit engagements but also on whether audit firms take measures to ensure the appropriateness of audit services (the environment for supporting audit services) tailored to the firm's scale and characteristics. This section provides an overview of the environment for supporting audit services. We will also provide some examples, mainly from large-sized audit firms, of environments for identifying audit risk and efforts to promote the development of IT-driven tools and systems and separate a clerical tasks.

### a. Overview of environment for support

To ensure appropriate services, large-sized audit firms have assigned an average of over 100 full-time personnel to their quality control divisions, and have established various departments: risk management, periodic review in relation to a system of quality control, accounting support, audit support, consultation, IT, and international services (Figure III-1-12). See "B. Engagement Quality Control Reviews" (page 83) and "C. Monitoring of Systems of Quality Control" (page 86) for information on engagement quality control reviews and periodic reviews. A number of large-sized audit firms are strengthening quality control functions within their audit operation divisions, and are taking steps to gather information on the firm's quality control in a timely manner and to provide support to engagement teams. Audit firms, especially large ones, are developing, in addition to digitizing audit working papers, analytical tools to recognize unusual figures in journal entry data, AI-based tools to identify fraud risks, communications tools to facilitate the online exchange of information and reference material between audited companies and engagement teams, etc. (For progress in the digitization of auditing services, see IV. Responses to Changes in the Global Environment Surrounding Audits, A. Usage of Technology in Audit and Cybersecurity Efforts, 1. Progress with the Adoption of IT in Audit Engagements (page 107).

In addition, there is a case involving the establishment of organizations by audit firms, especially large ones, to specialize in clerical work for sending balance confirmation documents and entering data, etc. (For details, see Column "Example of Establishment of Organization for Performing Clerical Work Relating to Audits" (page 80)). With regard to the confirmation of balances, Audit Confirmation Center GK, jointly founded by large-sized audit firms in November 2018, has developed a system to confirm claims and obligations, provided an online platform related to the confirmation of balances, and started sending balance confirmation documents, among other operations. As such, large-sized audit firms, which are relatively stable financial-wise and have adequate human resources, are further reinforcing support in recent years to streamline



operations by engagement teams through the development of various IT-based tools, division of clerical work and so forth.

Mid-tier audit firms have also quality control divisions, but they are smaller than those of large-sized audit firms. Furthermore, they are pushing ahead with the digitalization of audit working papers by, for example, adopting the audit-paper management systems used by their affiliated network. Small and medium-sized audit firms do not have a quality control section and instead appoint a person in charge of quality control. At many of them, representatives concurrently take charge of quality control. Note that most small and medium-sized audit firms have not digitalized audit papers, and instead are producing audit papers using, for example, widely-available software.

While large-sized audit firms are taking steps for engagement teams, mid-tier audit firms and small and medium-sized audit firms have the bottleneck in financial foundations and human resources compared with large-sized audit firms, which may make it difficult to operationalize the same means with large-sized audit firms. As a result, variation in the environment for audit engagement support appears to be further expanding among large-sized audit firms, mid-tier audit firms, and small and medium-sized audit firms.

Figure III-1-12: Example of a support system at a large-sized audit firm

Support departments		Roles
Quality control division	Risk management department	Ensuring independence, approving acceptance and continuance of audit engagements, responding to risk of fraud, etc.
	Periodic inspection department	Ongoing monitoring and implementing periodic review in relation to a quality control system
	Accounting support department	Responding to technical inquiries concerning accounting standards, procedures, etc.
	Audit support department	Responding to technical inquiries concerning audit standards, manuals, and procedures
	Engagement quality control review department	Performing engagement quality control review as well as the higher-level reviews against material or high risk issues
IT division		Auditing IT areas of audited companies, supporting engagement teams with the use of IT audit tools
International division		Collecting/providing local information overseas and liaising with network firms, etc

#### b. Management of risk information

Audit firms develop and maintain the firm-wide management of risk information to handle high-risk audit engagements and to respond to the risk of fraud.

Specifically, large-sized audit firms handle this as follows (Figure III-1-13).

Figure III-1-13: Examples of management of risk information at large-sized audit firms

[Actions taken by risk management department]

- Developing a database of past fraud cases and sharing that information within the audit firm
- Selecting high-risk audit engagements and implementing continued monitoring and support to engagement teams by gathering information
- To maintain and improve a system to obtain expertise from exogenous and endogenous an audit firm and issue instructions for the launch of higher-level review when a suspicious situation is identified - the presence of a material misstatement or misstatements as a result of fraud.
- Organizing a team of experts for investigating fraud within an audit firm or its group companies
- Establishing and operating a desk for receiving reports from whistleblowers inside or outside the audit firm

[Actions taken by engagement teams]

- Addressing the risk of fraud through the use of data analysis tools
- Seeking expertise from the quality control department and undergoing a high-level engagement quality control review in the risk of fraud or considering high-risk matters

■Example of Establishment of Organization for Performing Clerical Work Relating to Audits■

There are cases of large-sized audit firms setting up organizations to intensively carry out clerical work for audit services in order to enable CPAs and others to concentrate on tasks requiring their professional judgement. Work performed by such organizations is not limited to menial tasks, such as sending and collecting balance confirmation documents, checking the disclosure of financial statements, and entering and processing data for use by CPAs in audits but is expanded to confirmation work in certain audit services, such as management assessment procedure related to internal control.

Organizations of such kind are located within an audit firm' s existing office or newly established near Tokyo and regional cities. While their workload is done mainly by audit assistants at the organizations, audit firms carry out the provision of guidance and supervision in order to ensure a certain level of quality for the work, such as providing training programs for audit assistance and CPAs' consultation process for their works.

## 6. Audit Firm Groups

### a. Group structure

Many large-sized and mid-tier audit firms have formed their own audit firm groups that use a common brand and cooperate with each other in providing services. Besides the audit firms, these groups generally include consulting companies that carry out financial due diligence, advisory companies that provide financial advice on M&A deals, and tax accountant firms. The average number of companies in a large-sized audit firm's group is around 15, while that in a mid-tier audit firm group is around four.

In terms of group structure, there are many examples of firms setting up holding company like companies to manage a global brand and putting the group companies on par with the audit firm, but there are also audit firms directly investing in group companies (excluding tax accountant and attorney firms) and making them subsidiaries.

Groups are generally administered by councils comprising representatives from the principal firms belonging to the group that develop systems to coordinate their interests and discuss joint business efforts.

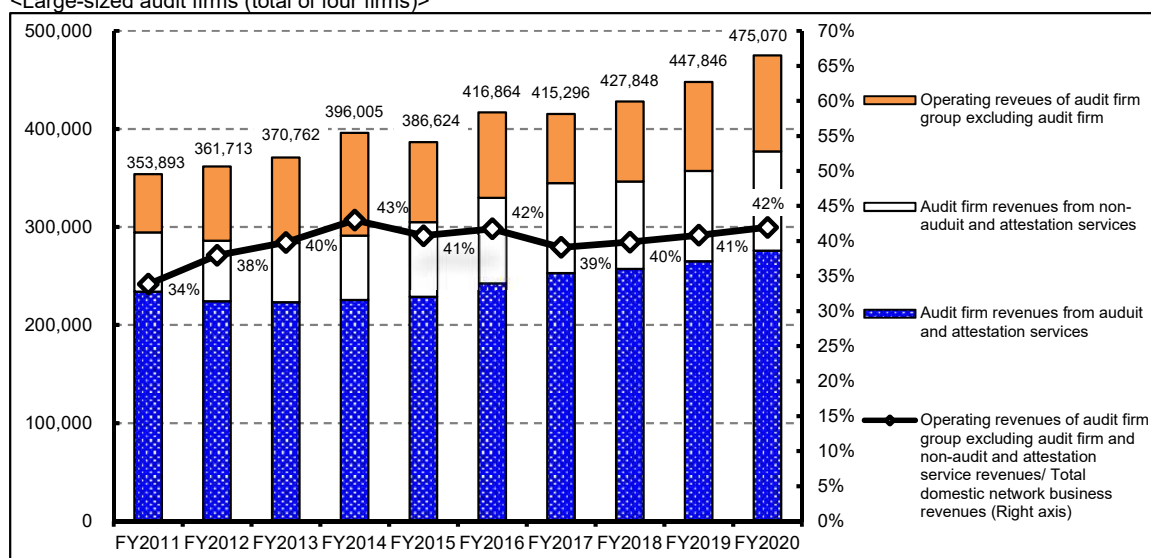
### b. Group operating revenues

The ratio of non-audit and attestation revenue to operating revenue at audit firm groups (revenue from firms other than subsidiaries, etc. is excluded; firms other than subsidiaries, etc. include those logging tens of billions of yen in operating revenue) steadily rose from 34% in FY2011 to 43% in FY2014. In recent years, however, the ratio has hovered at around 40% as certain large-sized audit firms spun off non-audit and attestation services and subsidiaries from them, subsidiaries and so forth in FY2015 and FY2017 (Figure III-1-4). (For audit firms' operating revenue, see "I. Overview of the Audit Sector, B. Audit Firms, 5. Financial Condition (Operating Revenue, Proportion of Audit and Attestation Services and Non-audit and Attestation Services)" (page 21).)

At mid-tier audit firm groups, the ratio of non-audit and attestation revenue has stayed lower than at large-sized audit firms, moving roughly in a range between 10% to 14% from FY2011 through FY2020. There is a wide variety in group revenue structure between large-sized and mid-tier audit firm groups as audit and attestation revenue accounts for a large portion of total group revenue at the latter (Figure III-1-15).

Regarding small and medium-sized audit firms, few firms have group companies other than tax accountant firms or other tax-related firms, which indicates that non-audit services seem to be provided by the audit firms.

Figure III-1-14: Changes in operating revenues of audit firm group excluding audit firm and non-audit and attestation service revenues' share of these operating revenues (unit: million JPY (left axis))  
<Large-sized audit firms (total of four firms)>



(Note 1) Operating revenue of audit firm groups excludes revenue from firms, other than subsidiaries, etc. within the group but includes revenue from subsidiaries offering intra-group services.

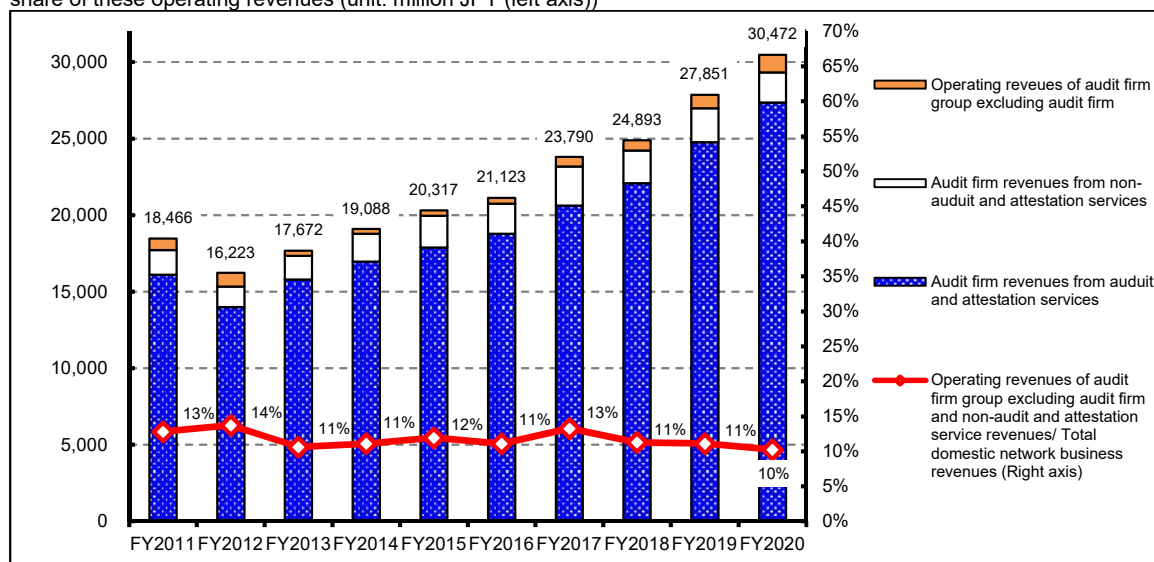
(Note 2) Non-audit and attestation service revenues are the total of the non-audit and attestation revenue of the audit firm and the revenues of the subsidiaries etc. of the audit firm.

(Note 3) One audit firm group changed its fiscal year-end in FY2017, so the FY2017 operating revenues for that audit firm group covers an eight-month period. As a result, FY2017 operating revenues are calculated by extrapolating eight-month operating revenues to one-year periods (by multiplying figures by 12 months/8 months) for the audit firm group that changed its fiscal year-end.

(Note 4) In FY2015 and FY2017, certain large-sized audit firms spun off businesses that perform non-audit and attestation services or subsidiaries from the audit firm or its subsidiaries etc.

(Source) Prepared by the CPAAOB based on operational reports submitted by audit firms

Figure III-1-15: Changes in operating revenues of audit firm group excluding audit firm and non-audit and attestation service revenues' share of these operating revenues (unit: million JPY (left axis))



<Mid-tier audit firms (Total of five firms)>

(Note 1) Operating revenues of audit firm group excluding audit firm and domestic network firm revenues do not include operating revenues from tax accountant and attorney firms

(Note 2) Non-audit and attestation service revenues are the total of audit firm revenues from non-audit services and domestic network firm revenues

(Note 3) One audit firm group changed its fiscal year-end in FY2016, and it did not submit its report within the program year, so the FY2016 operating revenues for that audit firm group covers a fifteen-month period. As a result, when aggregating the figure, FY2015 data was used for the FY2016 operating revenues for the audit firm group. Operating revenues for FY2017 represent 15 month worth of operating revenues.

(Source) Prepared by the CPAAOB based on operational reports submitted by audit firms

## B. Engagement Quality Control Reviews

The “IV. Reporting Standards 1. General Principles” in Auditing Standards require auditors to be undertaken a review prior to the expression of the audit opinion in order to confirm that their opinion has been formulated appropriately in accordance with audit standards generally accepted as fair and reasonable. The review is therefore the final safeguard for ensuring the appropriate audit opinion. In the assessment, how objectively the audit team conducts the audit procedure, makes the material decision, and assesses the audit opinion etc. is to have substantial impact on the audit quality.

There are three main forms of engagement quality control reviews adopted by audit firms: a. the concurring review partner form (a review is performed by a partner other than the engagement partner), b. the council form (an engagement quality control review is performed by a council), and c. the combination form (both the concurring review partner form and council form are adopted).

### a. Concurring review partner form

An engagement quality control review conducted based on the concurring review partner form normally involves the engagement quality control (EQC) reviewer, who is appointed for each audit engagement, performing the entire review from the audit planning stage to the expression of the audit opinion. This means that a deeper review can be possible. For example, efforts are made to accumulate information on the audited company and the engagement team, and throughout the period of the audit, the review examines whether the engagement team is responding appropriately to changes in the circumstances of the audited company.

However, in the case of the concurring review partner form, the quality of the review is heavily influenced by the abilities of specific EQC reviewers. At some small and medium-sized audit firms, the review of all audit engagements is handled by a specific reviewer, and in such cases the quality of review for the audit firm as a whole is affected by the abilities of this specific reviewer.

### b. Council form

The council form encompasses not only cases where engagement quality control reviews are conducted by a single council, but also cases where there are multiple levels of councils. In the case of the multi-level councils, important matters etc. involved in the expression of the audit opinion are determined in advance, with a high-level council undertaking the review of these matters. There are also cases where specialist councils are established, covering such areas as finance, non-profit, and internal controls.

Since reviews conducted based on the council form involve collaboration among multiple EQC reviewers, they allow for more multi-faceted investigations than the case with the concurring review partner form.

On the other hand, as the conclusions are those of the council and not the individual EQC reviewers, each of the reviewers - members of the council - may feel less of a sense of responsibility. Furthermore, as multiple reviewers examine a single issue, the total time required

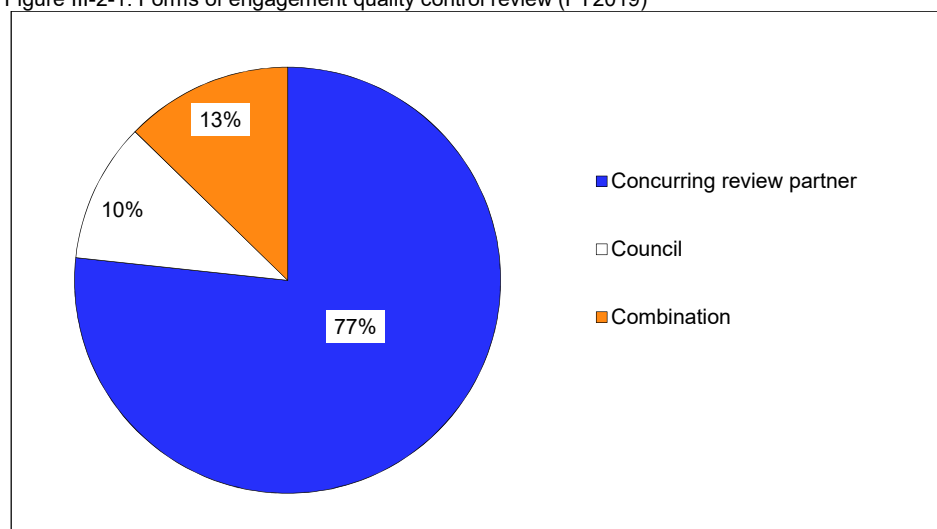
for the review is normally longer than with the concurring review partner form.

c. Combination form

The combination form can involve the concurring review partner form being adopted, with important matters etc. involved in the expression of the audit opinion being determined in advance and a council undertaking the review of these matters. It can also involve deciding whether to use the concurring review partner form or the council form for each audit engagement after considering the risks etc. relating to the engagement.

The forms of engagement quality control review are shown below (Figure III-2-1)

Figure III-2-1: Forms of engagement quality control review (FY2019)



(Note) Aggregated the status of 236 audit firms based on operational reports submitted by the audit firms

Many large-sized audit and mid-tier audit firms have adopted both the concurring review partner method and the council method. For example, a reviewer conducts reviews of risk assessments performed by the audit team, the appropriateness of risk-response procedures, etc., while material matters for investigation are brought up before a review committee at headquarters. Furthermore, during reviews, some firms have reinforced independence from executive departments in the review division to ensure that decisions harmful to the public interest are not made, while others consult with bodies etc. featuring third parties in the case of important matters that would likely have a substantial social impact.

Note that large-sized audit firms, when reviewing audits of listed financial institutions, are taking steps such as establishing a council for dealing exclusively with finance-related issues, and having this council deliberate with regard to the review.

Around 80% of small and medium-sized audit firms, however, employ the concurring review partner form, though some perform engagement quality control reviews using the council form or the combination form.

Regarding the appointment of reviewers, many firms select them among personnel who meet previously-defined eligibility requirements for reviewers in terms of knowledge, experience, competence, position,

etc., and they are appointed by the review division or the quality control division in the consideration of the circumstances of audited companies. At some firms, however, the audit operations department etc. make the list of candidates who are then approved by the review division, the board of directors of the firm, etc.

The inspection section and others often monitor inspection results, etc. and time spent for inspection. In addition, there are cases in which the inspection section and others use the ratio of time involving inspectors of audit services, executive partners, etc. as audit quality indexes.

There also are audit firms implementing programs to further improve audit functions, such as reinforcing the information sharing among inspectors, carrying out inspection-related compulsory training programs and increasing the number of workers primarily engaging in inspections.

## **C. Monitoring of Systems of Quality Control**

Audit firms should take primary responsible for maintaining and improving audit quality, and in this sense, it is important for them to positively take the initiative in improving audit quality.

For this, it is important for audit firms to understand and continuously have remediation in place on audit engagements in a timely manner. The CPAAOB inspects the monitoring of audit firms' quality control systems.

Furthermore, when an audit firm is a member of the global networks, it is sometimes the case that the global network, with the aim of ensuring consistency of high audit quality at network firms across countries, demands that network firms conduct domestic audit engagements in line with the global network policy, and that network firms verify that the global network policy is being followed (referred to below as "global reviews"). Given that large-sized audit firms have introduced the global review system into the quality control systems, the CPAAOB describes how those firms utilize global reviews in this section.

### **1. Periodic Inspections**

Once an audit has completed, the audit firm is required to conduct procedures to ascertain whether an engagement team performed audits in accordance with the system of quality control prescribed by the audit firm (periodic inspections of audit services). This inspection must be performed for at least one of the audits that each engagement partner has conducted during a certain period (e.g. three years) (QCSCS (47), A61).

Although the periodic inspections are being conducted at all audit firms, factors such as the number of inspections, the number of inspector involved and tools used differ depending on the sizes of the firm. Audit firms belonging to the Big Four global networks, in particular, are asked to perform periodic inspections based on the network's periodic inspection framework and verification tools (Figure III-3-1).

Furthermore, regardless of their size, the results of the inspections and the identified deficiencies are shared for raising risk awareness to all partners and staff at each firm through in-house training, etc. Moreover, the inspection results are usually reflected on performance evaluation of engagement partners at large-sized audit firms and some mid-tier audit firms to boost the effectiveness of audit quality improvements.

In recent years, some large audit firms have set up a section tasked with monitoring audit services to enhance the objectivity and effectiveness of monitoring in their quality control systems. They conduct periodic verification mainly by members of the section.



Figure III-3-1: Overview of the periodic inspections conducted in FY2020

	Large-sized audit firms	Mid-tier audit firms	Other
Number and method of selection of audit engagements to be inspected	Each engagement partner is mandatory inspected at least once every three years. Additional inspections may also be performed based on the scalability and complexity of audited companies.	Each engagement partner is mandatory inspected at least once every three years. Additional inspections may also be performed based on the scalability and complexity of audited companies.	Each engagement partner is mandatory inspected at least once every three years.
Inspectors	Under the supervision of quality control, partners and assistants who are not involved in inspected audit engagements	Under the supervision of quality control, partners and assistants who are not involved in inspected audit engagements	Workers not involved in audit services (including those outside an audit firm concerned) under the supervision of a partner in charge of quality control.
Number of inspectors	Between around 40 and 190	Between a few and around 20	Between one and around 20
Number of engagements handled by each inspector	One to two engagements	One to two engagements	One to four engagements
Inspection framework (procedures, assessment policy), tools to be used	Conducted under the Inspection framework and tools provided by the global network. Regarding responses to specifically Japanese auditing standards, many firms have partially tailored the global network's tools, such as adding items.	Conducted based on an inspection framework determined by the firm independently and tools.	Conducted based on an inspection framework determined by the firm independently. Many firms use "Checklist for Periodic Inspections" and "Audit Service Review Procedures" provided by JICPA.
Use of inspection results	Inspection results are shared within the firm and reflected in evaluations of partners and staff.	Inspection results are shared within the firm. Some firms reflected them in evaluations of partners and staff.	Inspection results are shared within the firm.

(Note) The number of verifications per verifier was calculated by dividing the number of audits subjected to periodic verifications conducted in FY2020 by the number of verifiers involved.

(Source) Prepared by the CPAAOB based on information obtained through the CPAAOB inspections or the collection of reports

## 2. Utilization of Global Reviews

The Big Four global networks are focusing more on the implementation of high quality audit engagements. For this reason, they require network firms in each country to comply with a detailed audit manual provided by the global network, and conduct global reviews to confirm whether network firms comply with the manual. Large-sized audit firms and some mid-tier audit firms undergo a global review by the global network every year.

Global networks other than the Big Four sometimes require their member firms to comply with the audit manual provided by the global network to the same degree as that of the Big Four, but most of them operationalize more relaxed rules than the Big Four. Given that global networks do not necessarily require their member firms to conform to local or international auditing standards, there is a wide variation in the nature and frequency of global reviews (for information on ties with global networks, see “IV. Responses to Changes in the Global Environment Surrounding Audit, B. Responses to Overseas Expansion of Companies, 2. Ties with Global Networks, b. Relationships with global networks” (page 116)).

While all large and mid-tier audit firms are subject to the global review, most small and medium-sized audit firms, belonging to the global networks, are not reviewed (Figure III-3-2).

Figure III-3-2: Overview of global reviews

	Large-sized audit firms	Mid-tier audit firm	Other
Whether global reviews are performed	All firms are reviewed	All firms are reviewed	Only some firms are reviewed
Frequency of global reviews	Every year	Every year to once every four years	Typically once every three years
Global reviewers	In most cases, the global review is performed by global network reviewers.	In most cases, the global review is performed by global network reviewers.	In most cases, the global review is performed by reviewers appointed by the global network. Sometimes the results of self-inspections using a checklist for global reviews are reviewed.

(Note) Few small and medium-sized audit firms etc. are members of global networks. See “IV. Responses to Changes in the Global Environment Surrounding Audit, B. Responses to Overseas Expansion of Companies, 2. Ties with Global Networks (page 115)”.

(Source) Prepared by the CPAAOB based on information obtained through the CPAAOB inspections or the collection of reports

## D. Education, Training and Evaluation of Engagement Teams

In order to maintain and improve audit quality, audit firms need to provide their engagement teams with opportunities to acquire necessary expertise and also need to evaluate them appropriately. It is particularly important to train and properly evaluate the engagement teams who can exercise the professional skepticism needed to detect accounting fraud. The CPAAOB monitors and inspects recruit, training, assignment, evaluation/compensation, etc.

In this section we elaborate audit firms' human resource development, education, training, and evaluation of its engagement teams (including engagement partners).

### 1. Human Resource Development

To deal with changes to the auditing environment and the deepening complexity of audit methodologies, large-sized and mid-tier audit firms have been developing medium to long-term policies for developing human resources and offering education and training, in the context of which they have also provided personnel with a variety of career opportunities (Figure III-4-1).

Figure III-4-1: Examples of career opportunities at large-sized and mid-tier audit firms

- Carrying out work rotations and inter-organizational transfers (inclusive of regional offices)
- Involving personnel in advisory and other non-audit services and quality control activities
- Placing personnel overseas at network firms
- Seconding personnel to locations outside the audit firm (e.g., domestic group firms, JICPA and other relevant organizations, other companies, etc.)

### 2. Education and Training of Engagement Teams

The quality control standards require audit firms to establish policies and procedures to provide it with reasonable assurance that they have sufficient personnel with the competence, capabilities, experience and commitment to ethical principles necessary to perform engagements in conformance with professional standards and applicable legal and regulatory requirements (QCSCS (28)).

To meet this requirement, audit firms have developed structures for educating and training their engagement teams in proportion to their size (Figure III-4-2).

Figure III-4-2: Examples of systems for education/training

<p>Large-sized and mid-tier audit firms</p>	<ul style="list-style-type: none"> <li>• Establishing a training section within the human resources department to design and operate training programs for each job classification and level of experience</li> <li>• Audit firms implement a series of training programs for updating accounting and auditing standards, utilization of monitoring tools, responses to fraud risks, results of periodic verifications, inspections by the CPAAOB, quality control reviews by the JICPA and so forth, professional ethics and independence, information security and auditing.</li> <li>• Conducting examinations to measure understanding of training</li> <li>• Audit firms provide support for acquiring language-related qualifications and implement language training programs at home and abroad (including online training)</li> <li>• In addition to the above, periodic training on issues specific to financial institutions is provided to personnel working on the audits of listed financial institutions. Briefings on the latest industry trends are also organized</li> </ul>
<p>Small and medium-sized audit firms, partnerships and solo practitioners</p>	<ul style="list-style-type: none"> <li>• Providing opportunities to attend training sessions held at the JICPA headquarters or regional chapters, or to study by watching JICPA training DVDs in most audit firms</li> <li>• Sharing results of periodic inspections, the CPAAOB inspections, and JICPA quality control reviews within firms</li> </ul>

Large-sized and mid-tier audit firms have education and training sections, and they have developed training programs based on job classification and experience in conjunction with their global audit networks. Furthermore, by deploying e-learning systems, they enable individuals to access to education and training based on their learning level at times and locations that are convenient for them. Even among small and medium-sized audit firms, partnerships and solo practitioners, some of the comparatively larger ones have introduced level-based training systems and e-learning systems, while others are providing opportunities for education and training by covering the cost of tuition fees for external training programs. On the other hand, many small and medium-sized audit firms, partnerships and solo practitioners have difficulties in providing training programs that are suitable to personnel's experience and capability and situation in their audited companies. Specifically, due to a lack of human resources capable of providing their own educational and training programs, many firms are only confirming that their partners and staff are undergoing the Continuing Professional Education provided institutionally by JICPA (i.e. whether they have obtained the required number of credits) or just having personnel watch DVDs supplied by the JICPA.

(Education and training needed for IFRS adoption)

As the number of companies adopting IFRS have now exceeded 200 in Japan, there has been an increasing number of partners and staff involved in audits of audited companies subject to IFRS, especially at large-sized audit firms. For that reason, the CPAAOB monitors the training structures relating to IFRS, with key examples shown below (Figure III-4-3).

Figure III-4-3: Examples of education/training related to IFRS

Large-sized and mid-tier audit firms	<ul style="list-style-type: none"> <li>• Introducing in-house IFRS certification, and providing periodic training on updates of the standards for certified personnel</li> <li>• Setting up sections within the firm specializing in the interpretation and specific application of IFRS, and distributing necessary guidelines within the firm</li> <li>• Audit firms dispatch officials to the networks they belong to for understanding the IFRS and examining the application policy of them or hold periodic sessions to exchange views with the organizations concerned.</li> </ul>
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#### ■ Programs using virtual reality technology ■

Now that the widespread practice of remote work amid the COVID-19 pandemic has made it difficult to conduct human resources development programs centering on OJT, some large-sized audit firms have developed training programs making use of virtual reality technology. Dealing with accounting fraud, for example, a program enables a trainee to learn how fraudulent practices, such as fictitious booking, occur and experience the process as an auditor and from the standpoint of an audited company. The program thus contributes to the reinforcement of professional skepticism as a CPA.

### 3. Evaluation of Engagement Team Members

The appropriate performance evaluation of engagement team members demonstrates that the audit firm is committed to audit quality, and ongoing effort is particularly important for fostering the organizational culture that forms the foundation of audit quality. The QCSCS stipulate, for example, that performance evaluation, compensation and promotion procedures give due recognition and reward to the development and maintenance of competence and commitment to ethical principles (including independence) (QCSCS (28), A24).

#### a. Evaluation of partners

Large-sized and mid-tier audit firms evaluate partners based on their contribution to audit quality and the management of the firms and the acceptance of new contracts. Recently, however, they have adopted evaluation methods placing emphasis on audit quality. For example, large-sized audit firms make assessment as mentioned in Figure III-4-4.

Figure III-4-4: Examples of evaluations of partners at large-sized audit firms

- Partners are usually evaluated in various areas, including team management and a business development based on "Performance Evaluation Rules." In the case of partners who provide audit services, there is an emphasis on quality control.
- Partners are evaluated with an emphasis on audit quality, including global capabilities
- Skills and performance evaluations are conducted and quality control as well as ethics/compliance are given considerable weight in skills evaluations.
- Assessments made during periodic inspections in relation to firm's system of quality control (see "C. Monitoring of System of Quality Control, 1. Periodic Inspections" (page 86) for details) as well as the results of quality control reviews etc. are reflected in the performance evaluations of engagement partners.

The results of performance evaluation are provided to partners, and the partners are usually expected to take the action deemed necessary, such as setting goals for addressing areas required improvement. Some audit firms adjust partner compensation and assignment of audited companies based on evaluation results. The firms occasionally restrict partners' involvement in audit engagements when evaluation results are extremely poor.

Many small and medium-sized audit firms, partnerships and solo practitioners, however, do not conduct periodic evaluations of partners, and even when they do, they have not often articulated policies and procedures for the evaluations.

b. Evaluation of staff

Audit firms evaluate personnel in accordance with their evaluation standards and determine promotions based on the results of the evaluations.

Large-sized and mid-tier audit firms generally promote to managers after approximately a seven to 10 year and to partners, following a selection process, after a further seven to 10 year. As small and medium-sized audit firms rarely hire newly qualified CPAs, they often hire mid-career CPAs on the assumption that they are going to be promoted to partners. Many large-sized and mid-tier audit firms evaluate personnel based on their understanding of auditing standards related to audit quality, communications skills within an engagement team, management skills (including capacities for an international issue) and so forth. Although small and medium-sized audit firms evaluate personnel in a similar manner, many of them have not established a policy of recruit or promotion systems on evaluation results.

## **E. Acceptance of New Audit Engagements and Changes of Accounting Auditors**

Since the acceptance of new audit engagements has a significant impact not only on the quality level of audit engagements but also on an audit firm's operation, the CPAAOB also reviews this matter through the monitoring activities, and endeavors to understand the reasons for changes in accounting auditors and the impact of the acceptance of the new audit engagements on quality control at the audit firm as a whole.

Characteristics of large-sized and mid-tier audit firms as well as small and medium-sized audit firms, partnerships and solo practitioners in the process of the acceptance of new audit engagements are described below.

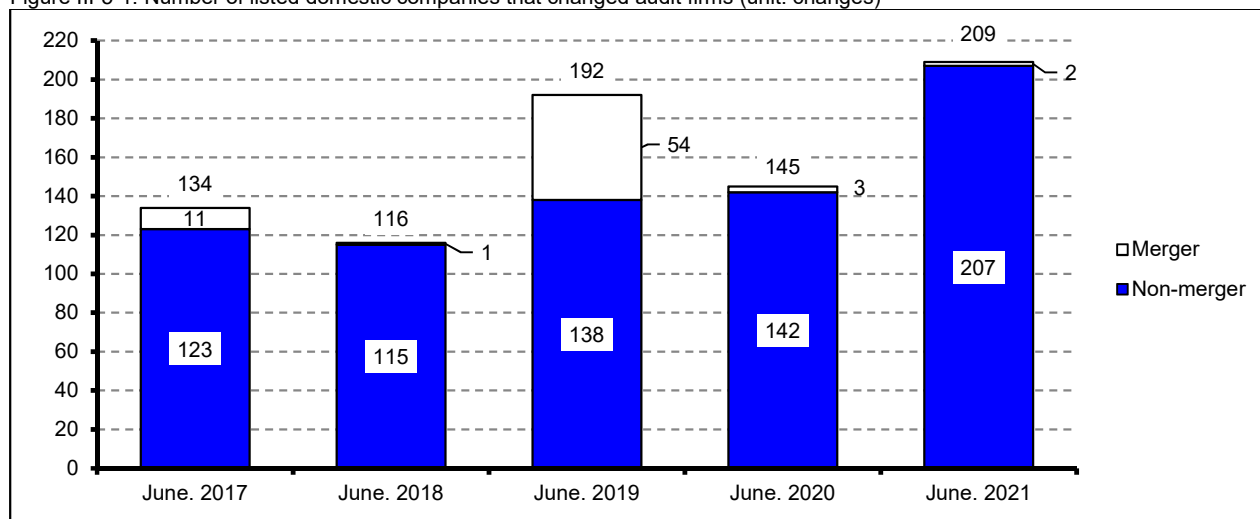
Providing non-audit and attestation services to companies other than audited companies, large-sized audit firms could deepen the relationships with the audited companies. In the meantime, there is a case that they receive the proposal on audit engagement. Still, on the occasion of changing an accounting auditor, an audited company often asks for audit proposals to a number of audit firms. In such a case, an audit firm often acts in an organized manner, such as involving a partner familiar with the industry for the conclusion of a new audit contract.

In contrast, the conclusion of new audit contracts by mid-tier audit firms and small and medium-sized audit firms in particular tends to be made through acquaintances of their partners or workers, etc. This is because they tend to receive requests based on personal connection of their partners or other personnel.

The section below analyzes the acceptance of new audit engagements and changes in accounting auditors, and the connection between details ascertained through monitoring activities and publicly available information.

There were 209 cases of changing auditors at domestic listed companies in the year to June 2021, the largest number over the last five years (Figure III-5-1). During that five-year period, changes in the year to June 2019, included many mergers such as those between mid-tier audit firms. Excluding changes through mergers, the cases have been on the rise since the year to June, 2018. In particular, there was a sharp increase of 65 in the year from June 2020 to June 2021 up to 207, the largest number. For information on mergers, see "I. Overview of the Audit Sector, B. Audit Firms, 4. Mergers of Audit Firms" (page 20).

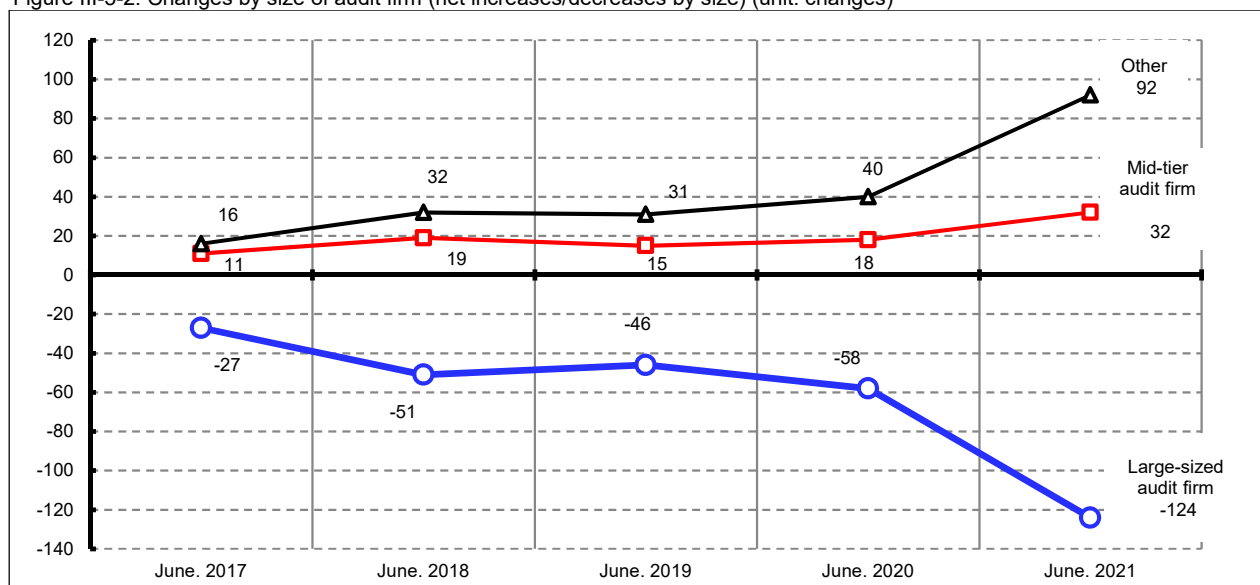
Figure III-5-1: Number of listed domestic companies that changed audit firms (unit: changes)



(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.

As can be seen from changing auditors by audit firm size reveals that the trend of changing from large-sized audit firms to mid-tier audit firms or small and medium-sized audit firms, partnerships and solo practitioners continued into the year to June 2021 (Figures III-5-2 and III-5-3). This trend was likely related to business administration in connection with the continuance of audit contracts with large-sized audit firms. For information about business administration in connection with continuance of audit contracts at large-sized audit firms, see “3. Reasons for Changes in Accounting Auditors as Identified Through Monitoring Activities” (page 97).”

Figure III-5-2: Changes by size of audit firm (net increases/decreases by size) (unit: changes)



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

(Note 2) Aggregates of 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



Figure III-5-3: Total changes by size (unit: changes)

From/To			June 2020	June 2021	Increase/Decrease
Large-sized	→	Large-sized	28	19	▲9
	→	Mid-tier	24	42	18
	→	Other	38	87	49
Mid-tier	→	Large-sized	1	2	1
	→	Mid-tier	0	0	0
	→	Other	8	12	4
Other	→	Large-sized	3	3	0
	→	Mid-tier	3	4	1
	→	Other	40	40	0
Total			145	209	64

(Note 1) Aggregates of 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

(Note 2) "Other" in the figure refers to small and medium-sized audit firms, partnerships and solo practitioners.

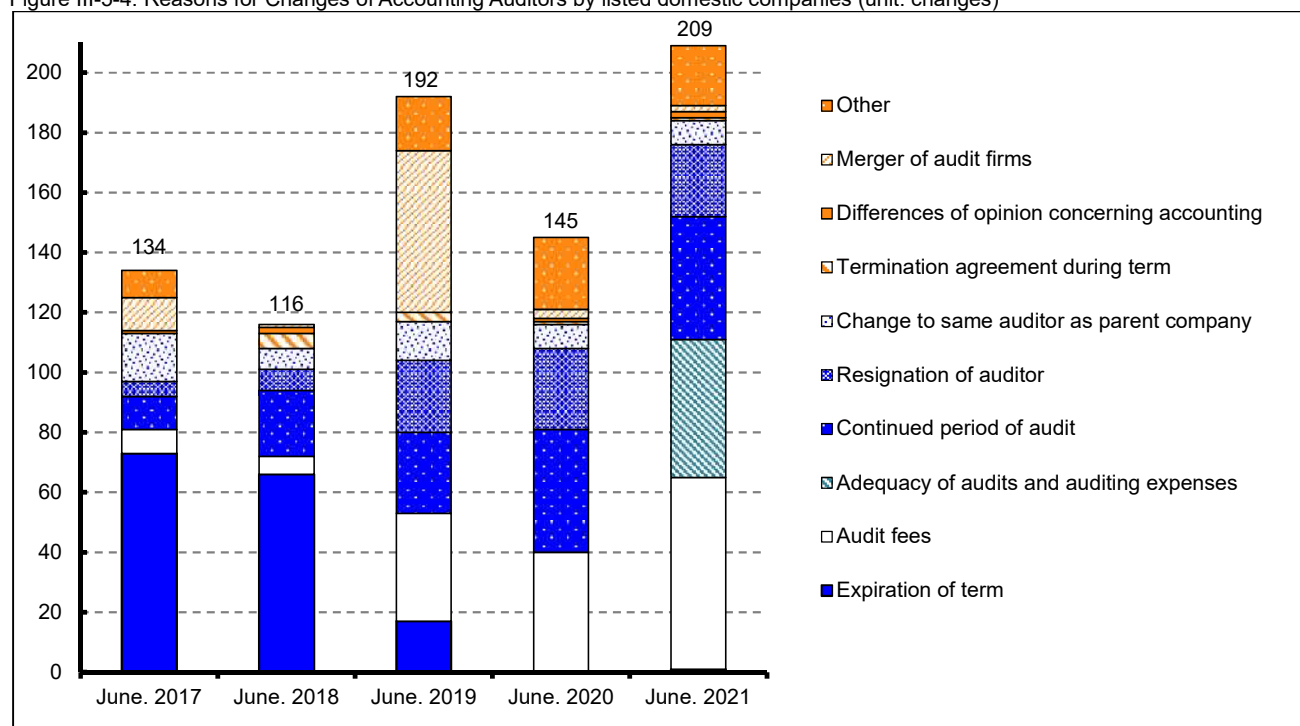
(Note 3) Effects of mergers included those in three mergers involving small and medium-sized audit firms in the year to June 2020 and two in the year to June 2021. As the mergers were made between firms of the same scale, they did not affect the figures in Figure III-5-2, which shows a net increase or decrease in the number of transfers categorized by scale.

## 1. Reasons for Change of Accounting Auditors Given in Timely Disclosures by Audited Companies

When a listed domestic company changes its accounting auditors, the company shall disclose the change and reason for the change immediately (Article 402 of the Securities Listing Regulations, Tokyo Stock Exchange).

Under the regulations above, the most common reason for the changes was just described as “the expiration of the audit contract” in the disclosures and in many cases, any substantial reason have not being given in the disclosures made in the period until June 2018 (Figure III-5-4). After June 2019, more companies giving the additional explanation in addition to expiration of the audit contract as the reason, and there was a sharp drop in the number of companies only giving expiration of the audit term as the reason. Since the year to June 2020, there have been many cases to be proposed increase in audit fees and the prolongation of continuous audit terms. In many cases in the year to June 2021, auditors opted for change after examining the correspondence between audit services based on the scale of companies and audit fees in comparison with other audit firms. An increase in reasons; the period of continuous audits was considered to reflect a requirement to describe continuous audits in financial statements under the “Cabinet Office Ordinance on the Corporation Information, etc.” revised in January 2019.

Figure III-5-4: Reasons for Changes of Accounting Auditors by listed domestic companies (unit: changes)



(Note 1) Compiled by the CPAAOB based on timely disclosures by listed domestic companies choosing new auditors by the end of June each year.

(Note 2) In the case of two or more reasons disclosed, the classification was made based on principal reasons.

(Note 3) Prior to the year to June 2020, the “adequacy of audits and auditing expenses” was included in “others.” While there was no reference to it in the year to June 2017 or the year to June 2018, it was mentioned in four cases in the year to June 2019 and eight in the year to June 2020.

## **2. Reasons for Change of Accounting Auditors during Fiscal Term**

In the year to June 2021, there were 209 cases including 12 in which companies changed auditors in the middle of fiscal year. While the reason; four of the 12 cases, was audit fees, the remainder included such reasons as audit firms' proposals for cancellation of contracts or resignation from the role due to improper accounting and other reasons at audited companies and cancellation of agreements for discrepancies in opinion over accounting process and so forth.

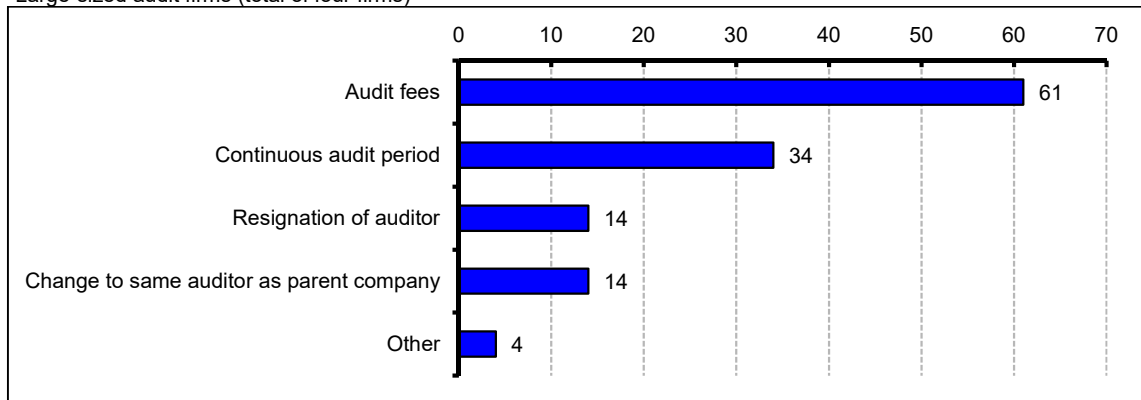
## **3. Reasons for Changes of Accounting Auditors as Identified Through Monitoring Activities**

This section lays out reasons for changing accounting auditors ascertained through monitoring activities in PY2020 rather than through timely disclosure by audited companies. The number of changes obtained through the CPAAOB monitoring does not match the number obtained through company disclosure for the following reasons: inspections were not conducted and reports were not collected from all audit firms in PY2020 and the number includes the previous year's figures due to the timing of inspections and collection of reports.

### **a. Large-sized audit firms**

Predecessor accounting auditors at large-sized audit firms pointed to audit fees as the primary reason for the changes, similar to the previous year, according to the results of inspections and the collection of reports. Next came "continuous audit period," of which there were many instances. (Figure III-5-5). In many cases, both "audit fees" and "continuous audit period" are referred to as the reason for the changes. This is likely due to large-sized audit firms administering business through the analysis of audit engagements or the firm-wide basis. Specifically, audited companies consider changes in accounting auditors while taking into account the "continuous audit period," "audit fees, etc.," when considering whether to renew audit contracts, the firms look at whether the level of audit risk is commensurate with the audit fees, whether the audit risk is at a level applicable to continuously serve as an auditor, whether the personnel required for the audit engagement can be secured, and so on.

Figure III-5-5: Reasons for changes in accounting auditors according to the predecessor auditors (unit: changes)  
<Large-sized audit firms (total of four firms)>

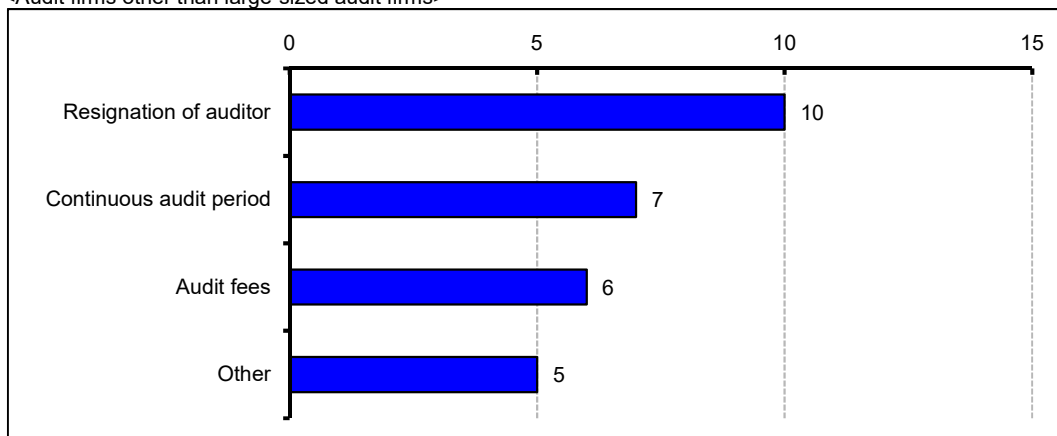


(Note 1) Based on data from 105 changes identified through inspections and report collection during PY2020

(Note 2) If there was more than one reason, that change is included in the figure for each reason (a cumulative total of 127)

- b. Mid-tier audit firms and small and medium-sized audit firms, partnerships and solo practitioners  
“Resignation proposed by auditors, etc.” formed the largest number of reasons for 25 cases of changing auditors (who replied as former auditors) recognized through the inspection of mid-tier audit firms and small and medium-sized audit firms and the collection of reports from them. Conceivable factors behind the reason include the shortage of auditors, extreme deterioration of credible relationship between audited companies and auditors as a result of improper accounting operations and so forth, bleak audited companies’ performance and increased audit risks accompanied by fragile accounting systems (Figure III-5-6).

Figure III-5-6: Reasons for changes in accounting auditors according to the predecessor auditor (unit: changes)  
<Audit firms other than large-sized audit firms>



(Note 1) Based on data from 25 changes for which the reason was identified in reports collected from five mid-tier audit firms and 43 small and medium-sized audit firms, 22 solo practitioners

(Note 2) If there was more than one reason, that change is included in the figure for each reason (a cumulative total of 28)

## F. Audit Fees

### 1. Rules on Audit Fees

Audit fees are determined through negotiations between auditors and audited companies. The JICPA has set guidelines for the calculation of audit fees to serve as a reference.

On the other hand, the JICPA's Code of Ethics states that an audit firm may quote whatever fee deemed appropriate based on the content and value of services, while the quotation of a low fee without due foundation may make it difficult to offer professional services of a certain level. Therefore, the code calls for examination of safeguards, such as those mentioned below, to ensure a certain level of audit quality.

- a. To win audited companies' understanding of the basis of audit fees and the contents and terms of services offered.
- b. To assign an appropriate time and qualified staff to the task

### 2. Methods for Calculating Audit Fees

The JICPA's "Guidelines for the Calculation of Audit Fees" give "hourly rates" and "fixed fees and hourly rates" as possible approaches. These methods are used when calculating estimated amount. The actual audit fee is determined through negotiations with audited companies (Figure III-6-1).

Figure III-6-1: Methods for calculating estimated audit fees

Methods	Methods for calculating estimated audit fees
Hourly rates	Audit fees are calculated by multiplying the number of hours an audit team spend by a certain unit price (hereinafter referred to as the "charged rate").
Fixed fees and hourly rates	<p>Audit fees comprise two components: the fixed fee (a fixed amount) and the hourly rates (a variable amount).</p> <p>The fixed fee is determined based on the factors such as the type of audit (FIEA audits, Companies Act audits, etc.) and the size of audited companies (capital, assets, sales, etc.), while the hourly rates are calculated by multiplying the time planned to spend on the audit by the charged rate.</p>

(Source) Prepared by the CPAAOB based on "Guidelines for the Calculation of Audit Fees" (October 2003), JICPA

#### ■ New Methods of Calculating Audit Fee Estimates ■

With the development of IT, some audit firms are conducting R&D on audit techniques. At present, audit fees tend to be calculated based on the hours audit team members directly spend on the audit engagement, but as such R&D expenses are expected to increase, there is a movement to explore new methods of calculating audit fees estimates.

According to the reports collected in PY2020, audit fee estimates are calculated as follows.

a. Large-sized audit firm

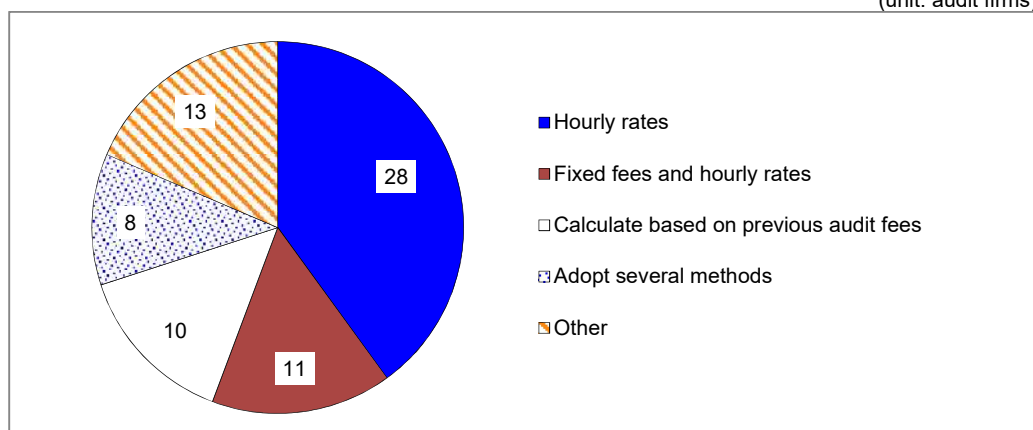
All large-sized audit firms state that they adopt the hourly rates approach for audit fee estimates. Hourly rates are set for each hierarchy level of employee, and the rate is determined while considering indirect costs associated with firm management and quality control such as the payrolls of administrative departments and IT system-related expenses.

Some large-sized audit firms charge a wide variety of rates, taking into account not only job classification but also the complexity of the audit engagement and each audit service provided.

b. Mid-tier audit firms and small and medium-sized audit firms, partnerships and solo practitioners

Many firms charge fees based on the hourly rates approach. There are also firms that combine basic and service execution fees, calculate fees on the basis of fees in the past, or use a number of calculation methods (Figure III-6-2).

Figure III-6-2: Methods for calculating estimated audit fees (mid-tier and small and medium-sized audit firms)  
(unit: audit firms)



(Note) Aggregated from reports collected from mid-tier and small and medium sized audit firms in PY2020

Regarding the hourly rates approach, 70% of mid-tier audit firms and small and medium-sized audit firms, partnerships and solo practitioners do not set charged rates by job classification (Figure III-6-3).

Figure III-6-3: Setting of rates corresponding to job classification (mid-tier and small and medium-sized audit firms)

Settings	Number of audit firms	Percentage
Rates set	21	30%
Rates not set	49	70%
Total	70	100%

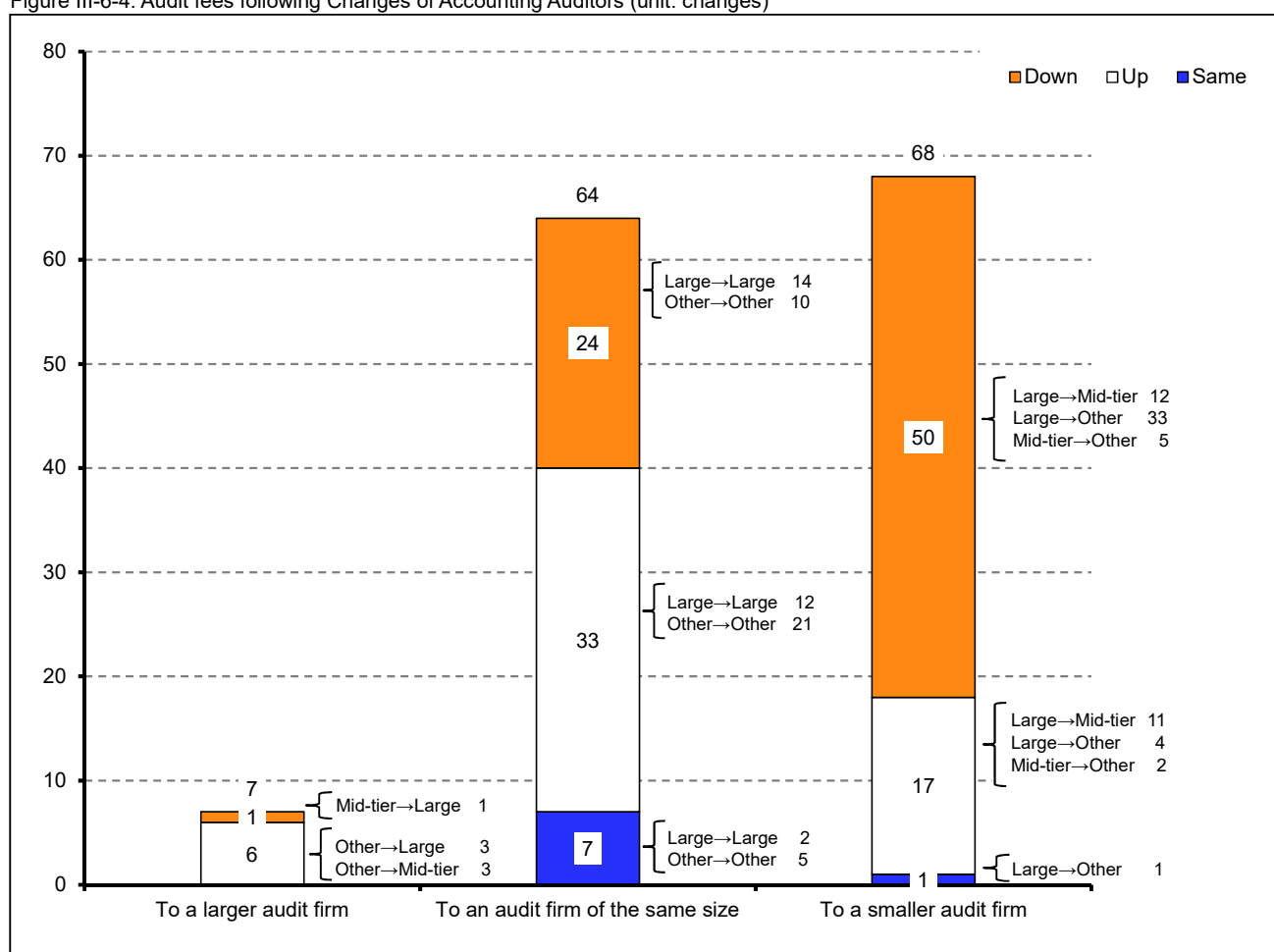
(Note) Aggregated from reports collected from mid-tier and small and medium-sized audit firms in PY2020

### 3. Audit Fees Before and After Changes in Accounting Auditors

As audit fees are often reviewed after changing auditors, the CPAAOB analyzed pre- and post-transfer fees, finding differences in the margin of rise or fall in them depending on the scale of new accounting auditors.

Audit fees often rise in changes to bigger audit firms. In moves from an office to another of the same scale, fees rose in about 50% transfers (33 of 64 cases) but dropped in some 40% (24 of 64 cases). In changes to a smaller firm, audit fees decreased in approximately 70% (50 of 68 cases). Changes from a large-sized audit firm to a small or medium-sized firm resulted in audit fee falls in some 90% (33 of 38 cases).

Figure III-6-4: Audit fees following Changes of Accounting Auditors (unit: changes)



(Note 1) Based on changes in accounting auditors between July 2020 and June 2021 where the audit fees before and after the changes were publicly disclosed

(Note 2) Breakdowns of these changes are shown in the graph

(Note 3) "Other" in the figure refers to small and medium-sized audit firms, partnerships and solo practitioners.

(Sources) Prepared by the CPAAOB based on timely disclosures of changes in accounting auditors securities reports submitted by June 2021

#### 4. Dependence of Fees (Safeguards)

When the audit fees of a specific audited company represent a certain rate to the total revenues<sup>12</sup> of the audit firm, etc.<sup>13</sup>, there could be a case that audit firms are placed to be suffered with conflict of interests - unfavorable from the independence perspective - or unreasonable pressure from the audited companies due to the concern about losing the source of revenue.

The JICPA's "Guidelines on Independence" stipulates that where the audit fees from a particular listed domestic company represent more than 15% of the audit firm's revenues for two consecutive years, the audit firm must examine which of the safeguards below would be appropriate:

- a. Prior to the issuance of the audit opinion on or after the second year's financial statements, the audit firm requests a professional accountant, who is not a member of the audit firm, to performs an engagement quality control review of that engagement
- b. After the audit opinion on or after the second year's financial statements has been issued and before the issuance of the audit opinion on the third year's financial statements, the audit firm requests a professional accountant, who is not a member of the firm to perform a periodic inspection of that engagement, or the JICPA to perform a quality control review of that engagement

With regard to the recent revision of the Code of Ethics of the International Ethics Standards Board for Accountants pertaining to fees, see IV. Responses to Changes in the Global Environment Surrounding Audits, E. Recent Trends with Accounting Audits, 1. Trends with International Standards on Auditing and Code of Ethics (page 128).

No large-sized audit firms adopted safeguards. Of 74 mid-tier audit firms and small and medium-sized audit firms traced through inspections and the collection of reports in PY2020, one mid-tier audit firm resorted to safeguards for two operations and 15 small and medium-sized firms did so for 22 operations. The mid-tier audit firms addressed the question of safeguards through inspection, etc. before the expression of opinions by third-party CPAs, while the small and medium-sized audit firms did so through inspection, etc. before the expression of opinions by third-party CPAs, periodic reviews after the expression of opinions and so forth (Figure III-6-5).

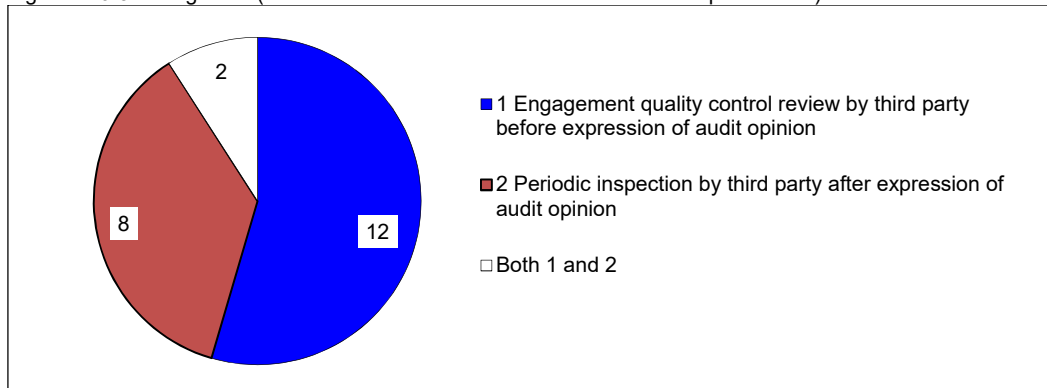
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<sup>12</sup> Total of audit and attestation revenue and non-audit and attestation revenue (various advisory services, tax processing and so forth)

<sup>13</sup> Audit firms and business enterprises that control business enterprises and audit firms through their contracts, human relations and so forth.



Figure III-6-5: Safeguards (small and medium-sized audit firms and a solo practitioner)



(Note) Data aggregated from 65 reports collected from small and medium-sized audit firms, partnerships and solo practitioners in PY2020



## IV. Responses to Changes in the Global Environment Surrounding Audits



## **IV. Responses to Changes in the Global Environment Surrounding Audits**

### **A. Usage of Technology in Audit and Cybersecurity Efforts**

#### **1. Progress with the Adoption of IT in Audit Engagements**

In recent years, the use of IT in audit engagements, including AI, by audit firms, mainly large-sized audit firms and mid-tier audit firms, has been increasing significantly. This is partly because audited companies are rapidly digitizing their accounting records, transaction records, etc. with the society digitalized, and in conjunction with this, audit firms also need, as “workstyle reforms” are introduced, to perform audit engagements more efficiently and effectively. This is affecting the nature of audits, and large-sized and mid-tier audit firms are moving proactively, either jointly with their global networks or independently, to deploy or develop IT-driven audits.

Here we elaborate audit firms’ strategies at present; how audit firms are developing their audits. Potentially, the spread of COVID-19 may serve as a trigger for the further adoption of IT in audit engagements.

##### **a. From audit sampling to full audit**

If transaction records, such as material documents for stock changes, are kept on paper, it is difficult to confirm that all of them match accounting records in implementing audit procedures. Some transaction and accounting records, therefore, are extracted as samples for verification (audit sampling). If original transaction records are digitalized, auditing tools make it possible to confirm consistency between all transaction records and accounting records. This kind of accurate method is starting to be adopted by audit firms, especially large-sized audit firms.

The use of AI to detect unusual transactions and so forth, which can lead to accounting fraud, is also dawning.

##### **b. Task automation (RPA<sup>14</sup>) and centralization**

When performing audit procedures, CPAs are typically used to aggregate figures from transaction records stored in paper or electronic form by themselves, but routine tasks such as data processing, aggregation, etc. progress has been made with automation of data manipulation and of audit procedures with the use of analytical tools.

##### **c. Unification of audit tools**

Audit firms that are members of the global networks use audit tools provided by the global networks (see “B. Responses to Overseas Expansion of Companies, 2. Ties with Global Networks” (page 115) for further details). Collected R&D and IT operation of the global networks promotes

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<sup>14</sup> Stands for “Robotic Process Automation,” and involves the use of technology such as artificial intelligence to make office work more efficient or to automate it entirely. It is achieved using software robots that can operate software etc. in the same way as humans. Also referred to as “digital labor” or “virtual knowledge workers.”

the efficiency of IT investment, and feedback from their member firms on remedies or requests of audit tools may be beneficial to the global networks enabling to improve security and refine functions of the audit tools.

However, there are also cases of Japanese audit firms independently developing/deploying analytical tools and implementing them as detecting system on accounting fraud.

d. Faster and broader analysis of risks

In the past, audit firms performed risk analysis that involved the measurement of indications of fraudulent accounting etc. in audited companies' financial information. Recently, however, mainly large-sized audit firms have been developing tools that predict future fraud using non-financial information and AI, which enables to make audit judgements based on more sophisticated analysis. Additionally, integrating the results of analysis of non-financial information such as reputation about audited companies, audit firms are expected to become possible to analyze a broader range of risks.

e. From ex post facto audit to real-time audit

At present, most audit work are centered on the period after the date of the fiscal year end, but with the aim of setting up a more comfortable working environment by leveling audit work throughout a period, and making audits more sensitive to risks and more likely to uncover frauds at an early stage, audit firms are exploring the applicability of audit techniques for the day-to-day analysis of transactions etc. conducted by audited companies (real-time audit).

a., b., and c. above are fields in which progress is being made with deployment in large-sized audit firms, while d. and e. are areas that are expected to be applied in the future. The introduction of these advanced audit techniques requires that originals of transaction records etc. of audited companies are kept in electronic form. The handover of this data also requires the consent of the audited company concerned. In other words, it requires the understanding and cooperation of audited companies. As a result, progress is gradual.

Figure IV-1 presents information on the adoption of the audit tools etc. discussed above based on the size of the audit firm. It shows that large-sized audit firms, which audit numerous large companies, which possess vast amounts of data, are taking the lead in the adoption of audit tools etc.

Small and medium-sized audit firms, partnerships and solo practitioners, on the other hand, are making scarcely any progress with the use of audit tools. This is because they are small, and have little need for audit tools that offer massive processing capabilities.

As the improvement of IT skills on the part of partners and full-time staff, who actually operate auditing tools, is indispensable to promote the use of IT, audit firms, especially large-sized ones, are nurturing IT experts through the introduction of auditing tools and training about data analyses.

Figure IV-1: Utilization of IT in audit operations at large-sized audit firms and mid-tier audit firms

Status	Large-sized audit firms	Mid-tier audit firms
Installed	<ul style="list-style-type: none"> <li>• Electronic audit documentation system (audit paper preparation and audit procedure management)</li> <li>• Journal analysis tools (analysis of transaction details (journals) and detection of abnormal transactions)</li> <li>• Evidence reconciliation tools (precise methods for cross-checking data from outside with all sales data at audited companies)</li> <li>• File exchange system (used for exchanging data with audited companies)</li> <li>• RPA (automation of data input and manipulation)</li> <li>• Debt/credit balance confirmation system (automation of the external confirmation of the existence/accuracy of transactions)</li> </ul>	<ul style="list-style-type: none"> <li>• Electronic audit documentation system (audit paper preparation and audit progress management)</li> <li>• Journal analysis tools (analysis of transaction details (journals) and detection of abnormalities)</li> </ul>
Being installed/introduced at some firms	<ul style="list-style-type: none"> <li>• AI (fraud forecasting abnormal transactions using past financial information)</li> <li>• Audit databases (storing knowhow etc. on an in-house database to disseminate it)</li> </ul>	<ul style="list-style-type: none"> <li>• Evidence reconciliation tools</li> <li>• File sharing systems</li> <li>• RPA</li> </ul>
Under development	<ul style="list-style-type: none"> <li>• AI (fraud forecasting using non-financial information)</li> <li>• Drones (improved efficiency in physical inventory count)</li> <li>• Utilization of blockchains</li> <li>• Text analysis (digitalization and analysis on documents )</li> </ul>	<ul style="list-style-type: none"> <li>• AI (fraud forecasting using past financial information)</li> </ul>

(Source) Prepared by the CPAAOB based on information obtained through the collection of reports, etc.

### ■Efforts to Promote Use of IT across the Audit Industry■

Large-sized audit firms jointly established Audit Confirmation Center GK in November 2018 for online confirmation of transactions at audited companies. The center represents the first case of joint system development by audit firms in the industry.

The online implementation of the work, which used to be done by postal mail, has helped streamline investment in IT beyond the global networks that audit firms belong to and consolidate clerical work through such effects as unification of entry formats and reduction of burden on audited companies and respondents to questions. As the COVID-19 pandemic has not yet ended, online implementation is expected to be utilized more in the future.

## 2. Cybersecurity Efforts

As mentioned earlier, large-sized audit firms in particular are embedding audit tools and exchanging data with audited companies via e-mail and file exchange systems. These use cases have been permeating as data volume has risen and transaction data has become more digitized.

At the same time, the risks posed by information leaks due to cyberattacks and other factors have

risen, as seen in the damage inflicted by cyberattacks on audit firms overseas. Now that the information leaks in audited companies, in particular, cause serious damage to the audit firm's trust, bolstering cybersecurity steadily is a must.

Accordingly, the CPAAOB has been focusing on the following.

a. Monitoring of audit firms

The CPAAOB reviews audit firms' cybersecurity measures through periodic collection of reports, interviews and dialog. These approaches have enabled us to identify the following efforts common to large-sized audit firms:

- Establishing basic information security policies and promoting information protection inclusive of cybersecurity across the global network as a whole
- Setting up organizations responsible for cybersecurity (CSIRT<sup>15</sup>) and, as necessary, recruiting experts in-outside the audit firm
- Identifying the data held by the audit firm, rating the materiality, and developing regulations for data use as well as contingency plans for information security incidents and cyberattacks
- Undergoing reviews by the global network to externally confirm the effectiveness of the audit firm's information security environment, making improvements in the environment, collecting information on cyberattacks and information security countermeasures, and utilizing this information to develop and improve the information security environment

Mid-tier audit firms are also taking similar steps to large-sized audit firms, but at some of them it is unclear whether they have established an environment capable of promptly and properly responding in the case of taking damage stemming from a cyberattack. The potential reasons are the global network tends to get less involved in them than large-sized audit firms and the rules on information security etc. are incompatible with actual circumstances.

b. International efforts for cybersecurity issues

The International Forum of Independent Audit Regulators (for information about IFIAR, see the Column "International Forum of Independent Audit Regulators (IFIAR)" (page 118) comprises audit regulatory authorities from Japan and other countries, and continually holds dialogues with the Big Six global audit firms and, with regard to cybersecurity, they also exchange views on the assignment of experts and other aspects concerning the development and operation of a secure environment.

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<sup>15</sup> CSIRT (Computer Security Incident Response Team) is the collective term for the organizations responsible for dealing with incidents pertaining to computer security.



#### ■Participation by Audit Firms in Cybersecurity Exercises■

To further improve the entire financial industry' s ability to deal with incidents, the FSA has been conducting cross-industry cybersecurity drills (Delta Wall) since FY2016. Audit firms participated in the drills for the first time in the autumn of 2019, and the fifth cybersecurity exercise was held in the autumn of 2020.

The drills confirmed coordinated readiness and procedure, with participation by the management, to deal with information within and without an organization when an incident occurred, assuming a leakage of customer information or occurrence of damage by an intrusion of malware from outside.

Analytical results of general trends and so forth, found by the drills, were fed back to not only participant audit firms and but also the entire auditing industry for enhancing readiness and awareness for dealing with cybersecurity at audit firms.

## B. Responses to Overseas Expansion of Companies

### 1. Group Audits

Many listed companies are operating in other countries by establishing subsidiaries and other entities, while M&As targeting overseas businesses are on the rise in recent years. For this, companies are necessitated to address many issues, such as establishing a system to manage overseas subsidiaries, examining complicated economic transactions, and dealing with different accounting standards. At present, serious accounting fraud incidents often come out at overseas subsidiaries. With the importance of group audits growing under the circumstances, audit firms are strengthening measures to address them. In addition, audit firms are exploring countermeasures because the global COVID-19 pandemic is greatly affecting the procedures and methods of group audits. A brief overview of group audits and auditing procedures follow:

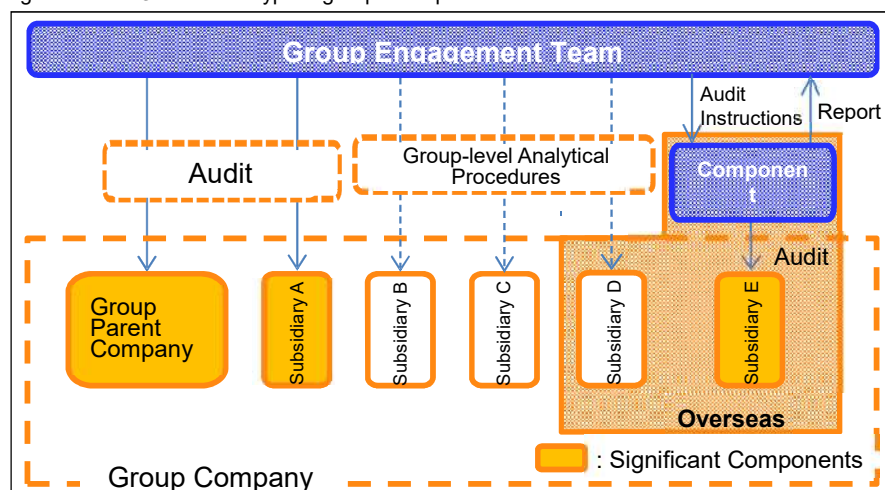
#### a. Overview of Group audits

When auditors at a parent company (hereinafter referred to as “group audit team”) perform an audit of group financial statements for certification, the work covers the parent as well as subsidiaries and others (each company and other entity that serves as a unit for preparation of financial information included in group financial statements is called a “component unit”). For example, an internationally operating manufacturer has many component units (subsidiaries) not only in Japan but also overseas, such as subsidiaries set up in countries with reasonable labor force and sales subsidiaries.

Components such as subsidiaries are classified as either “material components” or “non-material components” depending on factors such as their financial importance and significance of risks requiring special consideration, and group engagement teams determine the proportional audit procedures that shall be performed for each category of component (ASCS 600 (8), (23), (25), (27)).

The following figure illustrates typical group audit procedures (Figure IV-2-1):

Figure IV-2-1: Overview of typical group audit procedures



b. Determination of Material Components

When determining the material components, the group engagement team is required to identify and assess the risks of material misstatement through obtaining an understanding of the entity and its environment (ASCS 600 (16)). During this process, the key members of the group engagement team need to discuss the possibility of there being a material misstatement in the financial statements due to fraud or error, and must focus in particular on the risks of material misstatements resulting from fraud.

In recent years, there have been cases of fraud etc. discovered at overseas subsidiaries that would affect group financial statements. It has therefore become more important to perform risk assessments based on an adequate understanding of the environment of overseas subsidiaries. To be more specific, possible measures could establish a department at a head office tasked with managing foreign subsidiaries, nurturing a group management environment for performing internal audits of foreign subsidiaries, and internal controls at foreign subsidiaries.

If a component is deemed to be financially important, or it is deemed that a component could contain significant risks in relation to the group financial statements, the group engagement team needs to identify the component as a material component.

c. Audit Procedures for Material Components

The group engagement team needs to conduct audit procedures for material components. However, the general approach is to ask a local auditor (the component auditor) to perform the audit procedure when the group engagement team faces certain restrictions on conducting the audit procedures, such as a case that material component is located overseas. In such cases, they need to provide the local auditor of the material component with audit instructions covering the expected work, the purpose of the work, and the format and content of the auditors' report for the communication with the group engagement team (ASCS 600 (39)).

■ Selection of executive partners for auditing component units ■

Among the global networks, there are cases in which member firms are making efforts to improve the effectiveness of group audits by facilitating communication. When, for example, a group audit team at such a firm performs an audit of overseas component units, the firm demands the selection of executive partners with experience in auditing related businesses.

The approaches to group audit procedures taken by audit firms of different sizes are as follows (Figure IV-2-2).

Figure IVI-2-2: Approach to group audit procedures taken by audit firms of different sizes

	Large-sized audit firms	Mid-tier audit firms	Other
Group audit manual	Incorporating the global network's group audit manual into the firm's audit manual	Many firms incorporated the global network's group audit manual into the firm's audit manual, but some prepared their own	Many firms prepared their own group audit manual
Audit instructions	Using the global network's template for audit instructions	Many firms used the global network's template for audit instructions, but some prepared own templates	Many firms prepared their own templates for audit instructions, but some used templates provided by the global network

(Note) Regarding "Other" in the figure, of the 65 firms from which reports were collected in PY2020, information is presented for 10 firms conducting audit engagements for which group audit is required. Among these, just two firms are affiliated with their global networks and using the group audit manual or audit instructions provided by the global networks.

(Source) Prepared by the CPAAOB based on information obtained through the CPAAOB inspections or the collection of reports

#### d. Communication with component auditors

If effective dialogue between the group engagement team and the component auditors does not exist, there is a risk that the group engagement team may not obtain sufficient audit evidence on which to base the group audit opinion.

The group audit team therefore not only received audit instructions and reports on the results but also visited auditors at component units in addition to telephone conferences with them, among other practices. The physical visit, however, went unfeasible due to the COVID-19, the group audit team is maintaining communication via alternative means, such as online meetings. Still, there are cases in which the team is unable to receive reports on the results from auditors at component units in a timely manner due to lockdowns and other developments in countries where they are located as a result of the pandemic. Ordinarily, large-sized audit firms and some mid-tier audit firms provide support for their group audit teams, such as facilitating communication between them and auditors at component units and providing local information by establishing international business support sections inside their organizations and dispatching Japanese representatives to their main overseas business outlets. The pandemic has increased the importance of such practices.

#### ■ Group audits using IT during the COVID-19 pandemic ■

Some large-sized audit and mid-tier audit firms have adopted guidance on the use of an online meeting system as an alternative to group audit teams' visits to overseas outlets to facilitate communication with auditors at component units amid the COVID-19 pandemic. The guidance includes how specifically a group auditor can use screen-sharing functions to examine audit documents, prepared by an auditor at a component unit, via mutual communication by means of an online conference system. It also notes, among others, the need to increase the frequency of communication because the amount of information obtained online is limited in comparison with a physical visit.

## 2. Ties with Global Networks

Large-sized audit firms, mid-tier audit firms, and some small and medium-sized audit firms, partnerships, and solo practitioners contracted the member firm agreement and belong to global networks in order to facilitate audits of audited companies exploring overseas operations by leveraging the global network's know-how such as audit manuals.

### a. Membership of global networks

All large-sized and mid-tier audit firms as well as some small and medium-sized audit firms, partnerships, and solo practitioners that need to audit the overseas operations of audited companies belong to global networks, and are moving forward with the establishment of structures for group audit (Figures IV-2-3 and IV-2-4). Note, however, that not all small and medium-sized audit firms, partnerships, and solo practitioners that are expected to conduct group audits belong to global networks (for details, see “1. Group Audits, c. Audit Procedures for Material Components” (page 113).

Figure IV-2-3: Number of audit firms belonging to global networks<sup>16</sup> (FY2019) (unit: audit firms)

Large-sized audit firms	4
Mid-tier audit firms	5
Small and medium-sized audit firms	22
Total	31

(Source) Prepared by the CPAAOB based on operational reports

Figure IV-2-4: List of global networks to which large-sized and mid-tier audit firms belong

Audit firm	Global network
KPMG AZSA LLC	KPMG International Cooperative (KPMG)
Deloitte Touche Tohmatsu LLC	Deloitte Touche Tohmatsu Limited (DTT)
Ernst & Young ShinNihon LLC	Ernst & Young Global Limited (EY)
PricewaterhouseCoopers Aarata LLC	PricewaterhouseCoopers International Limited (PwC)
GYOSEI & CO.	NEXIA International Limited (NEXIA)
BDO Sanyu & Co.	BDO International Limited (BDO)
Grant Thornton Taiyo LLC	Grant Thornton International Limited (GT)
Crowe Toyo & Co.	Crowe Global
PricewaterhouseCoopers Kyoto	PricewaterhouseCoopers International Limited (PwC)

(Source) Prepared by the CPAAOB based on data from publicly disclosed materials from each audit firm (as of July 1, 2021)

The operating revenues of global networks comprise revenues from audit services, tax related services and advisory services, and a breakdown of the top-ranking global networks in terms of operating revenues is shown below (Figure IV-2-5). The scale of the Big Four global networks is

<sup>16</sup> Among small and medium-sized audit firms, the firms that have concluded cooperative relations (alliances) with overseas audit firms are included.

particularly prominent.

Figure IV-2-5: Operating revenues of global networks (unit: billion USD)

	DTT	PwC	EY	KPMG	BDO	GT
Operating revenues	476	430	372	292	103	57
Audit services (Share of operating revenues)	99 (21%)	176 (41%)	128 (35%)	111 (38%)	43 (42%)	23 (40%)
Tax-related services (Share of operating revenues)	87 (18%)	107 (25%)	98 (26%)	64 (22%)	23 (22%)	13 (23%)
Advisory services (Share of operating revenues)	290 (61%)	147 (34%)	146 (39%)	117 (40%)	37 (36%)	21 (37%)

(Source) Prepared by the CPAAOB based on data from publicly disclosed materials from each global network (2020 accounting year).

In Japan, the Big Four global networks<sup>17</sup> share of audit services is 96% of the 225 companies that comprise the Nikkei Stock Average (Nikkei 225). Overseas, they account for even larger shares of audit services, auditing 99% of the 500 companies comprising the S&P 500 index in the U.S. and 97% of the 350 companies with the largest market capitalizations on the London Stock Exchange (FTSE 350 index), meaning that the situation in these countries is the same as in Japan (Figure IV-2-6).

Figure IV-2-6: Big Four global networks' share of audit services for large listed companies in Japan, the U.S., and the U.K.

	Japan	US	UK
Big Four global networks' share (based on number of companies)	96%	99%	97%

(Sources) Japan: Compiled by the CPAAOB from QUICK and exchange data (as of March 31, 2021)

U.S.: Compiled by the CPAAOB from Bloomberg data (as of March 31, 2021)

U.K.: "DEVELOPMENTS IN AUDIT 2020, OCTOBER 2020," Financial Reporting Council

#### b. Relationships with global networks

Network firms comprising global networks are responsible for a range of areas including quality control instead of enabling to use the networks' logos and brand, to share mutual business and know-how. The nature and degree of these responsibilities vary depending on the scale of the global network. In general, the larger global audit network would be more impactful on its member firms.

##### i. Large-sized audit firms

Each of the large-sized audit firms belongs to one of the Big Four audit firms (Deloitte Touche Tohmatsu, Ernst & Young, KPMG, and PricewaterhouseCoopers) and has established close relationships with them. Specifically, they not only have the right to use the networks' logos and brand, but are also involved in the operation performed by the networks. For example, their CEOs and PICOQCs opine from the perspective of Japan as members of high level network

<sup>17</sup> Refers to large-sized audit firms and PwC Kyoto, which is a mid-tier audit firm.

committees, while members of oversight/assessment bodies at large-sized audit firms take part in global meetings.

Embedding audit manuals and tools prepared by the networks, and the large-sized audit firms perform audits in accordance with them subject to the networks' standards. When it comes to other quality control issues including quality control reviews, independence, they have adopted the standards and the procedures prepared by the networks.

Some large-sized audit firms, in addition to using the network's manuals and tools, dispatch the personnel like PICOQC etc. to the global firm in order to directly reflect the views of Japan in the initiatives taken at the network level, such as the revision of audit manuals and the development of audit tools.

They also regularly undergo global reviews conducted by the networks in order to confirm that audit quality, particularly for audit engagements, is secured at the level required by the networks (see "III. Operation of Audit Firms, C. Monitoring of Systems of Quality Control, 2. Utilization of Global Reviews" (page 88) for details.).

Furthermore, in conjunction with business expansion in recent years in the Asia-Pacific region and, most notably, in Japan and China, some firms have appetite to manage member firms on a regional basis, while large Japanese audit firms, which are members of the global networks, tend to play a central role by participating as board members in organizations established in the Asia Pacific region.

#### ii. Mid-tier audit firms

All mid-tier audit firms are affiliated with global audit networks. However, the extent of their ties differs depending on size of the networks. Some have formed alliances that are at the same level of those of the large-sized audit firms, while others maintain moderate ties, only having the right to use the networks' logos and brand and getting referral of audit engagements from network firms in other countries, but not implementing audit manuals. Although all mid-tier audit firms undergo global reviews, there are substantial differences in terms of the frequency and the review area.

#### iii. Small and medium-sized audit firms, partnerships, and solo practitioners

The networks to which small and medium-sized audit firms, partnerships and solo practitioners belong only allow them to use their logos and brand and to be introduced to audit engagements in network firms' countries. Some of the small and medium-sized audit firms, partnerships and solo practitioners do not leverage audit manuals or undergo global reviews.

### ■International Forum of Independent Audit Regulators (IFIAR)■

The International Forum of Independent Audit Regulators (IFIAR) is an international organization founded in 2006 and comprising independent audit regulators tasked with inspecting audit firms, among other responsibilities. It is committed to improving audit quality globally through its member regulators' cooperation and alignment (as of March 2021, it had members from 54 jurisdictions including Japan). The IFIAR opened its secretariat in Japan in April 2017 as the first international organization in financial regulations having the secretariat of its headquarters in Japan. In April 2021, a counsellor in the FSA's Strategy Development and Management Bureau, concurrently serving as head of the Office of Japanese Delegation for IFIAR, was elected for the vice chair of the IFIAR.

Japan is the foundation and board member, and the chair of the CPAAOB, inspectors and others have actively participated in various meetings associated with the IFIAR to establish and reinforce cooperative relations with regulators of other member countries. Japan is also trying to improve audit quality globally through dialogues with top executives and other leaders of the six largest global networks.

### ■IFIAR Symposium: Towards the Realization of High Quality Audits■

The Japan Network for IFIAR was established in December 2016 for such purposes as creating a network of various audit-related stakeholders operating in Japan and supporting the IFIAR's secretariat set up in Japan. Members are organizations related to accounting, audit and tax affairs as well as economic communities, financial and capital markets and so forth.

In 2021, the Japan Auditing Association and the JICPA, which are members of the network, jointly held an IFIAR symposium "Toward the Realization of High Quality Audits - The Vision of Audit in the New Normal." In the seminar, a keynote address on trends in discussions at the IFIAR and a panel discussion - efforts to achieve high-quality audits and improve the credibility of audit reports - were presented.



## C. Effects of and Responses to the COVID-19

With the rapid spread of COVID-19 infections in around March 2020, there were concerns over enormous impacts made on corporate account settlements, audits and so forth. In this situation, in April 2020, the “Networking Group on the Corporate Disclosure, Financial Reporting and Audit of Listed Companies in Consideration of the Impact of the COVID-19 (Novel Coronavirus) Infection,” ; the FSA as its secretariat and comprised of the Accounting Standards Board of Japan, the JICPA, government ministries and agencies, and other members, was established to share the recognition of the prevailing situation and responses toward the financial year-end in March 2020.

The council discussed efforts by its members and others, the declaration of a state of emergency and countermeasures based on a package of emergency stimulus measures and issued a statement under its name to call for deliberations on the management of annual general shareholders meetings in an unusual manner, such as postponing general meetings and holding follow-up meetings.

Following the declaration of a state of emergency, the FSA revised a Cabinet Office ordinance to uniformly postpone the filing deadline of financial statements and other reports until the end of September to give business enterprises and audit firms enough time for account settlements and audits. In addition, the ASBJ announced the consideration in accounting estimates as a summary of the Discussion, while the JICPA announced a series of “Audit Consideration related to COVID-19,” involving such issues as attendance at inventory count, confirmation of outstanding balances, accounting estimates, terms for extraordinary losses, self-assessment by financial institutions, and depreciation and allowances. Based on the summary of the Discussion published by the ASBJ, furthermore, the FSA announced the Notice in May 2020 to clearly expect that specific and upgraded disclosures would be made about the effects of COVID-19 infections in financial and non-financial information in financial statements. The FSA also released “Q&A on the Disclosure of Narrative Information Regarding the Impact of COVID-19 Infection - Key Points for Better Disclosure for Investors -” to encourage the promotion of efforts to upgrade the disclosure of information.

The trajectory of efforts made by members of the liaison council, “Corporate Disclosure, Financial Reporting and Audit of Listed Companies in Consideration of the Impact of the COVID-19 (Novel Coronavirus) Infection (Outline)” was released under the Networking Group's name on July 2, 2020.

The uniform postponement treatment of the financial statements and other reports has not persisted in March 2021. Based on the declaration of a state of emergency, however, the FSA announced the procedures to delay the deadline of submitting financial statements and other reports. While the ASBJ updated the summary of the Discussion in accounting estimates, the Ministry of Justice updated the treatment in the case that general shareholders meetings could not be held as scheduled. In addition, the JICPA and the Japan Audit and Supervisory Board Members Association released a joint statement on countermeasures related to account settlements in March 2021.

The CPAAOB will carry out monitoring to confirm the effects of COVID-19 infections on audit services and countermeasures taken by audit firms.

## **1. Effects on and responses by audited companies**

### **a. Announcement of earnings reports and presentation of financial statements**

As of the end of June 2020, 1,732 (74.1%) of companies, which published the reports scheduled in March 2020 by May 15 or within 45 days after the end of the business year. A total of 2,317 companies (99.2%) announced their results by the end of June.

Note that the FSA's notice to postpone the filing deadline of financial statement till the end of September 2020, around 3,000 companies were scheduled to publish the financial statements between January and May. Among them, only one failed to file a financial statement by then as it was in the process of liquidation. In a nutshell, all companies were considered to have completed the procedures without turmoil.

### **b. Disclosure of financial statements**

The FSA placed information disclosure pertaining to the effects of COVID-19 infections as a key theme in its 2020 review of financial statements made public in April 2021. The review thus covered the disclosure of additional information on the assumption of effects caused by novel coronavirus infections in accounting estimates.

According to the FSA's review of additional information disclosed on the assumption of effects caused by coronavirus infections, many companies were found to show positive attitude to provide enough information to investors though the content of disclosed information varied in terms of detail. As for the information related to accounting estimates, the review found cases in which the content of information was leeway to be upgraded, and in this regard, the FSA signaled ways toward improvement, such as clarifying materiality on accounting estimates and/or mentioning uncertainties of estimates and assumption impactful on business performance on the occasion of preparing balance sheets.

Effects on financial information at audited companies included those on accounting estimates, assumptions related to going concerns and future plans for accounting estimates.

## 2. Effects on and responses by audit firms

Auditing in March 2020 encountered restraints involving such cases as reception of reference materials from audited companies, physical inventory counting, confirmation procedures and group audits related to affiliated companies overseas due to the rapid spread of coronavirus infections. However, suitable measures were taken, such as the use of remote tools and implementation of alternative procedures albeit with the gaps in light of scalability and other factors.

For the auditing in March 2021, serious problems, such as a long delay in audit procedures and the absence of audit opinions, were not observed as countermeasures partly because of the knowhow in the previous year.

### a. Physical attendance of workers at audit firms

The rapid spread of coronavirus infections since around March 2020 has prompted audit firms to adopt a principle to work from home. If staffs come to office due to unavoidable circumstances, audit firms carried out auditing work while taking measures to ensure the safety of workers and prevent the spread of infection, such as temperature taking before coming to office, staggered commuting and maintenance of social distance in office premises.

Since the first declaration of a state of emergency, officially announced in April 2020, was lifted, audit firms have maintained the principle to work from home and set the ratio of working from home in accordance with the state of infections so as to continue efforts to prevent the spread of infections.

### b. Countermeasures taken by quality control sections at audit firms

At large-sized and mid-tier audit firms, quality control sections surveyed the audit teams to understand their problems they faced and newly recognized risks, and then proposed guidance for how to address them and disseminated it widely. They also supported audit teams as occasion demanded.

Some large audit firms shared anti-coronavirus measures with overseas member firms belonging to the same global networks, due to the background that the firms in Japan were placed to have addressed issues under the spread of coronavirus infection in advance in light of the differences in the accounting period.

### c. Effects on audit procedure

As the coronavirus pandemic has increased uncertainties about the future business plans of certain audited companies, an audit team closely examined the assumptions in going concerns and future plans used for accounting estimates. It also examined whether additional information about assumptions pertaining to the effects of coronavirus infections in making accounting estimates were appropriately disclosed.

Since the rapid spread of coronavirus infections, IT-based audits - office visit to audited

companies, etc. is no need (so-called “remote audits”) - have permeated. Specifically, an audit firm received reference materials as digital data from audited companies and held an online conference system. Under the circumstances, there were the cases in which audit firms provided guidance for remote audits, prepared by the JICPA, the global networks or others, to audit teams. The guidance demands, among others, that an audit firm, after receiving digitalized reference materials from an audited company, obtain their originals and confirm their authenticity, and carefully distinguish the audit format between face-to-face and remote audits based on risks. Still, at audited companies with affiliated firms overseas, accounting auditors delayed the submission of audit reports under the accounting law to secure a sufficient days for audit procedures as a delay in the reception of audit reports from auditors at component units overseas. In addition, there were audited companies reviewing their internal control systems due to the introduction of telework, digitalization of in-house documents, and computerization of authorization process and so on. Audit firms thus needed to carefully examine anew whether the revised internal control systems were effectively dealing with risks.

d. Effects on operation of audit firms

Audit firms dealt with the way of working based on the principle to work from home by using an online conference system to facilitate communication within the firm. While utilizing screen-sharing and other functions of an online conference system for remote training of workers, audit firms maintained that they, in consideration of the risk of coronavirus infections, carried out face-to-face training as much as possible; they planned to continue combining remote and face-to-face training programs. As a result of advances in remote auditing, some large-sized audit firms launched programs to support flexible work style, such as operating other regional offices without human transfers and business trips.

### **3. Effects on and responses by inspection authorities, etc.**

The CPAAOB presented in its “Basic Plan for Monitoring Audit Firms” in PY2020 that it will “review the way of monitoring audit firms to make it more efficient and effective for both audit firms and the CPAAOB,” using the spread of coronavirus infections as an opportunity. Taking the effects of coronavirus infections on audits into account, therefore, the CPAAOB adopted a remote method of monitoring in PY2020 for inspection and non-inspection monitoring of some audit firms as a result of reviewing the conventional method on a basis of office visit.

Based on progress in computerization of audit work papers at audit firms, the CPAAOB remotely inspected some audit firms at the CPAAOB’s office in principle without office visit to the firms.

In conventional on-site inspection, inspectors used to visit audit firms in principle. Remote inspection used the CPAAOB’s office as its principal venue for inspection where inspectors reviewed digitalized audit work papers and other necessary documents from audit firms or through audit firms’ electronic audit work papers systems. For hearings with members of audit firms, efforts to reduce face-to-face conversation and moving of staffs, such as the use of online conference systems, were made.

Despite these and other measures taken, the inspection is considered to have maintained its effectiveness in general. It also offered benefits in terms of efficiency, such as a steep drop in traveling time spent by members of audit firms’ regional offices, but on the other hand, there were cases requiring different approaches away from conventional inspection in terms of communication format between audit firms and the CPAAOB.

In non-inspection monitoring including the collection of reports were also taken to reduce face-to-face communication and the transfer of people, such as holding online conference system-based interviews.

Taking the state of COVID-19 infections into account, the CPAAOB will carry out inspection in a manner more efficient and effective for both the board and audit firms, including an expansion of remote monitoring.

Among measures taken by entities other than the CPAAOB, the JICPA, which took the degree of risks into consideration under the existing framework for the sake of dealing with coronavirus infections, narrowed down the number of audit firms subject to its normal quality control review in FY2020 from its original plan and changed the schedule of the review following the spread of infections. In addition, it remotely reviewed some audit firms.

Inspection and regulatory authorities in countries around the world were adopting countermeasures against COVID-19 infections. According to the IFIAR’s report on the “2020 Inspection Findings Survey” published in March 2021, some 70% of its member inspection and regulatory authorities increased remote inspections in 2020.

## **D. Treatment of key audit matters**

The Business Accounting Council began considering the transparency of audit reports in September 2017 to upgrade the provision of information pertaining to accounting audits and introduced amendments to the auditing standards, featuring a requirement that “key audit matters” (KAMs) should be mentioned in addition to opinions on the adequacy of balance sheets in audit reports. Principal amendments are as follows:

- Auditors take into consideration the following matters out of those they discussed with audit and supervisory board members and others in the process of auditing:
  - Matters in which risks requiring special consideration were detected or which were deemed to have a high risk of material misstatements
  - Degree of judgement by auditors about matters involving material judgment by management, including matters in which assessments are recognized as highly uncertain
  - Effects on audits from material matters or transactions taking place in the relevant year
- Taking the above-mentioned issues, auditors as professionals narrow down especially important matters, confirm KAMs, and mention the following in a section set for them in audit reports.
  - Content of KAMs
  - Reference to related balance sheets in case of disclosure
  - Reasons for confirming KAMs by auditors in auditing balance sheets for the relevant year
  - Responses to audits by auditors

Although it has become mandatory to mention KAMs under the Financial Instruments and Exchange Act since account settlements in the year to March 2021, a voluntary application was applicable starting in the year to March 2020. For the application of KAMs, audit firms provided explanations to and consultation with audited companies and conducted the confirmation of KAMs, preparation and revision of drafts, and internal training.

### **1. Analysis of early KAM applications**

With the voluntary application starting in the year to March 2020, KAMs were disclosed in audit reports on 56 companies in the period by the end of February 2021. The number of KAMs per company, mentioned in audit reports on consolidated balance sheets, and the number of KAMs by audit area were as follows:

Figure IV-4-1 (Number of KAMs in consolidated balance sheet per company)

Number of KAMs	Number of companies	Breakdown by accounting standards		
		Japanese standards	IFRS	U.S. standards
1	14	9	5	-
2	27	9	13	5
3	13	7	5	1
4	1	1	-	-
5	1	1	-	-
Total number of companies	56	27	23	6

(Reference) Prepared by CPAAOB using analysis report on voluntary applications of KAMs compiled by JICPA

Figure IV-4-2 (Number of KAMs by audit area)

Audit area	Number (consolidated)	Number (unconsolidated)
Assessment of fixed assets	22	6
Assessment of goodwill	20	-
Revenue recognition	15	12
Estimate of loan-loss reserves	11	4
Assessment of shares in affiliated companies	-	19
Others	49	19
Total	117	60

(Reference) Prepared by CPAAOB using analysis report on voluntary applications of KAMs compiled by JICPA

Based on results of the voluntary application in the year to March 2020, the JICPA released “Analysis Report on Early Application of KAMs” in October 2020 and the Japan Audit and Supervisory Board Members Association released “Actual State and Analysis of Early Application of KAMs” in November 2020. Following were analytical findings and other information from the reports:

The number of the voluntary application fell short of expectation due in part to COVID-19 infections. They also showed a tendency of inclining toward certain industry sectors. They did not necessarily live up to the expectation beneficial to accumulation of practical operations but provided many useful cases in practices for mandatory applications.

With regard to relations between the description of KAMs and the disclosed information by audited companies, which would become an issue for the application of KAMs, a principal staff of financial statements and auditors had enough discussions in the process of checking KAMs to upgrade described information and explanatory notes. As a result, there were few cases of KAMs in which information undisclosed by audited companies were mentioned. While mentioned KAMs often

covered areas related to accounting estimates, there also were those involving the recognition of earnings and IT systems.

The early application of KAMs confirmed the following effects:

- As KAMs have clarified how audit opinions are formed, the value of information in audit reports has increased, as has the trustworthiness and transparency of audits.
- In descriptions on KAMs, information has been disclosed about areas used to undisclosed. As a result, information disclosed by audited companies, such as analyses of business and other risks and management's financial conditions, business results and cash flows, has been upgraded.
- Investors, shareholders, analysts and other users of balance sheets have deepened the understanding of audits thanks to the descriptions of KAMs.
- In considering KAMs, management, audit and supervisory board members and other people concerned with audits have deepened their communication and, thus, audit quality has improved.

## **2. Responses by audit firms in the year to March 2021**

Large-sized and mid-tier audit firms have dealt with the mandatory application of KAMs, introduced in the year to March 2021, in manners mentioned below:

### **a. Development of guidance for preparation of KAMs**

Large-sized and mid-tier audit firms have prepared guidance and descriptive examples, based on related reports and other information compiled by the Auditing Standards Committee, in order for audit teams to comply to work out KAMs properly.

### **b. Training**

Analyzing the voluntary application in the year to March 2020, etc., large-sized and mid-tier audit firms carry out training sessions, based on actual cases, about points of attention concerning explanations of good examples on KAMs and the disclosure of explanatory notes and narrative information accompanied by the introduction of KAMs. With a workshop format adopted, sessions, including those for actual drafting of KAMs by an audit team for explanation of points to note in drafting KAMs, feature training needed for audit teams to properly deal with KAMs in actual work.

### **c. Quality control section's support for audit team**

As in-depth communication with the management, audit and supervisory board members and others of an audited company is necessary to introduce KAMs, the quality control section clarifies the specific content of communication and schedule in the process from an audit plan to issuance



of an audit report so that the audit team can systematically implement measures to deal with KAMs.

In addition, the quality control section monitors the audit team's handling of KAMs to help the introduction of KAMs progress as planned.

The quality control section, furthermore, develops a system that enables a reviewer of its choice to review KAMs drafted by the audit team and holds a consulting session on a regular basis to give advice, if requested by the audit team, in a timely manner.

d. Combination of review and professional opinion

Specific cases, such as treating the non-disclosure of KAMs and assumption related to a going concern as KAMs, are subjected to conference-format reviews at the headquarters as they require more careful treatment than usual.

To introduce KAMs, regulations for inquiries about professional opinions have been amended to subject the entry of KAMs to inquiries about professional opinions.

## **E. Recent Trends with Auditing**

Some of the recent trends shaping accounting audits are described below.

### **1. Trends with International Standards on Auditing and Code of Ethics**

The development of international auditing standards and ethics standards is underway at the International Auditing and Assurance Standards Board (IAASB) and the International Ethics Standards Board for Accountants (IESBA) established in the International Federation of Accountants (IFAC) comprising of accountants around the world. As recent major changes in the International Standards on Auditing (ISA) set out by the IAASB, Quality Control for an Audit of Financial Statements (ISA220) was revised, while ISQC1 (Quality Control for Firms that Perform Audits and Reviews of Financial Statements, and Other Assurance and Related Services Engagements) was revised to International Standard on Quality Management 1 (ISQM1; Quality Management for Firms that Perform Audits or Reviews of Financial Statements, or Other Assurance or Related Services Engagement) and International Standard on Quality Management 2 (ISQM2; Engagement Quality Reviews) - standalone standard in review for engagement. The revisions were finalized in December 2020. ISQM1 is scheduled to come into effect on December 15, 2022, and ISQM2 and ISA220 are due to take effect in a given business year from that date onward (voluntary application is possible). As recent amendments on the IESBA's ethics code in compliance with ISQM2, Objectivity of an Engagement Quality Reviewer and Other Appropriate Reviewers was added in January 2021. In April of the same year, furthermore, the revision concerning non-assurance services banning on providing non-assurance services to audited companies was published for the sake of reinforcing the independence of auditors, as well as the revision concerning fee-related provisions was published for the sake of enhancing the independence of auditors and the transparency of audit fee-related information. The revision concerning the ratio of audit fees from an audited firm; public interest entity to the total fees of the audit firm (so-called fee dependency) requires the firm to step down as the auditor if the audit fee exceeds the ratio to the total fees for more than a specific period.

### **2. Trends in domestic auditing standards and code of ethics**

In addition to the above-mentioned revisions to the international quality control standards, deliberations on amendments to Japan's quality control standards and other regulations, including the introduction of a quality control system, have been underway at the audit subcommittee of the Business Accounting Council since February 2021.

With regard to the code of ethics, the JICPA is reviewing the structure and composition of its code of ethics by reference to the IESBA Code of Ethics to revise JICPA's ethical rules for facilitating understanding and adherence to them. In February 2020, the JICPA carried out the public consultation on the revision of its ethical rules. The revised ethical regulations in question embrace

the reinforcement of fee-related independence, including the degree of dependence on fees, based on the revised international code of ethics.

### **3. Expansion of Disclosure of Descriptive Information**

In response to the publication of the Report by the Working Group on Corporate Disclosure compiled in June 2018, in January 2019 the Cabinet Office Ordinance on the Disclosure of Corporate Affairs, etc. was revised, and as a result, companies are required (effective from the year to March 2020) to provide more substantial disclosures in their annual securities reports with respect to descriptive information such as “management policy, operating environment, issues to be tackled, etc.,” “risks to business etc.,” and “analysis of operating and financial review, management discussion.” In addition, the principles-based guidance “Principles regarding the Disclosure of Narrative Information” was released to encourage companies to upgrade disclosed information beyond boilerplate compliance with the regulations. In March 2019, furthermore, “Best Practices for the Disclosure of Narrative Information” was published to make favourable cases of disclosure by some companies practiced widely. The list of good examples has been updated in due course. In November 2020, “Best Practices for the Disclosure of Narrative Information 2020,” with the addition of those related to “COVID-19 infections” and “ESG” (environment, society and governance), was released (final update in March 2021).

Concerning the disclosure of cross shareholding policy, “Cross-Shareholdings: Key Points for Better Disclosure for Investors (Examples), which was first published in November 2019, was released anew in March 2021 in the form of updated examples of disclosure.

Although narrative information is not subject to auditing, it elaborates the assessment of a company’s medium and long term vision, outlook and earnings needed to better understand its financial information that is subject to auditing. There are calls for upgrading the disclosure of narrative information as it is considered necessary for making investment judgments. With the demand rising for upgrading the disclosure of non-financial information as well, auditors’ procedures about descriptions other than audited balance sheets and audit reports have been clarified. In addition, the Auditing Standards Committee’s Report 720 has been revised to require the inclusion of necessary descriptions in audit reports.

### **4. Efforts to address disclosure of sustainability**

Efforts to deal with medium and long term sustainability are given priority to these days with social interest growing in ESG. For example, the Corporate Governance Code, revised in June 2021, calls for listed companies to proactively tackle tasks related to medium and long term sustainability (including ESG elements) in order to enhance their corporate values on long-sighted basis. In addition, the Stewardship Code, revised in 2020, has added the need for taking sustainability into consideration.

To achieve carbon neutrality by 2050, furthermore, it is important that financial institutions as well as financial and capital markets fulfill their functions appropriately. In this context, the FSA established the Expert Panel on Sustainable Finance in December 2020 to discuss challenges and necessary measures. In a report released in June 2021, the panel made a wide range of proposals, including one to upgrade the corporate disclosure of information on sustainability.

Internationally, there are a number of standards for corporate disclosure of sustainability in addition to proposals by the Task Force on Climate-Related Financial Disclosures (TCFD), an initiative to disclose risks and opportunities for corporate finances brought about by climate change, to investors and others. Among them are the Sustainability Accounting Standards Board (SASB) of the U.S. and the International Integrated Reporting Council (IIRC) Framework. The International Financial Reporting Standards Foundation, principal organizer of the International Financial Reporting Standards (IFRS), has since last year been working to establish an International Sustainability Standards Board to work out standards for the disclosure of internationally integrated and comparable information on sustainability.

Domestically, the FSA and other government ministries and agencies concerned have been supporting financial institutions and business corporations voluntarily promoting disclosures in line with the TCFD's proposals. To upgrade the disclosure of climate-related information while ensuring the autonomy and flexibility of private companies, the Corporate Governance Code, revised in June 2021, stipulates that companies listed on the Tokyo Stock Exchange's Prime Market should promote efforts to improve the quality and quantity of disclosures based on the TCFD's proposals or equivalent international frameworks.

## **5. Rotation system for audit firms**

In Europe, a so-called rotation system<sup>18</sup> for audit firms was introduced in June 2016 as a means of ensuring the independence of audit firms.

The FSA conducted a survey of trends in the Japanese audit market and the situation in Europe where the system was already in place in order to identify the advantages and disadvantages when introducing this system in Japan. The FSA then published a preliminary report of its findings in July 2017, a secondary report in October 2019.

In surveying partner rotation and other practices, the second report found cases in which a worker who had worked as an assistant for a long period was found to have been continuously involved in auditing the same company as an executive partner for a relatively long period after assuming the post of partner. Furthermore, fact-finding concerning the rotation of audit firms showed that to ensure the smooth rotation of audit firms was important to secure sufficient time for preparations and the establishment of internal structures. However, the audit market was oligopolistic, and available options were limited, so the view was expressed that this would be an outstanding issue toward

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<sup>18</sup> A system whereby companies are obligated to change the audit firm that conducts their audits at fixed intervals

considering the enhancement of the system.

Following the release of the second report, JICPA issued a chairman's notice in February 2020 stating that a "Team Members' Rotation" program to rotate not only executive partners but also assistants in auditing companies with an especially high degree of social influence<sup>19</sup> would be practiced as its voluntary regulation, effective from April 1, 2021, the launch of the business year, by taking audit results and other factors into account in order to reinforce the independence of audit firms.

## **6. Report from the Liaison Council on the Appointment of Audit Firms for Initial Public Offering (IPO) Audits**

As an issue concerning the selection of audit firms for IPOs, it has been pointed out that the number of companies seeking for IPOs is on the increase, but due to a supply-and-demand imbalance, some companies cannot receive the necessary audits. For more information about IPOs, see I. Overview of the Audit Sector, C. Audited Companies, 5. Audits of Initial Public Offerings (page 30).

On the other hand, there is a concern that audit firms easily take audit engagements without the necessary personnel, audit hours, etc., which would be likely to deteriorate audit quality. For this end, audit quality must be ensured.

Given the concern over these problems, in December 2019 the FSA established the Liaison Council on the Appointment of Audit Firms for Initial Public Offering (IPO) Audits, with the aim of promoting liaison among relevant parties concerning the selection etc. of audit firms for IPOs. The Council then published a report in March 2020. The report presents expected actions taken by each relevant party, namely audit firms, the JICPA, securities companies, venture capital providers, securities exchanges, etc. to enable large-sized audit firms to continue to perform a vital function in IPO audits to forge an environment for delivering high-quality audits for companies seeking for IPOs. The actions suggested include reviewing organizational structures and the allocation of personnel, the establishment/clarification of consultation desks, and so on. Based on the report, many large-sized and mid-tier audit firms have set up IPO support teams and other special bodies as liaison offices in case of requests for IPO-related services from IPO preparatory companies and for the purpose of improving the audit quality, etc. of IPO audits.

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<sup>19</sup> Companies having an especially high degree of social influence are generally defined as those that are listed and have a market capitalization of more than 500 billion yen.

### ■ IPO Accounting Audit Forum ■

An “IPO Accounting Audit Forum,” hosted by the JICPA, was held on November 30, 2020, to provide companies eyeing an IPO, securities houses, venture capitalists and others with an opportunity to share information and establish a network. Specifically, the forum enabled participants to share the JICPA’s “list of small and medium-sized audit firms to audit companies planning to carry out IPOs,” which was mentioned in the liaison council’s report, and held panel discussions on such themes as the current state of IPOs and proposals for growth and audit firms’ efforts to support IPOs.

The FSA gave accounts for the background that the meeting of the Liaison Council on the Appointment of Audit Firms for Initial Public Offering (IPO) Audits was held, the current state, challenges and other matters related to the appointment of audit firms for IPOs and development of environments to provide high-quality audits to companies wishing to make an IPO.

## (Reference materials)

CPAAOB website

<https://www.fsa.go.jp/cpaaob/>

FSA website

<https://www.fsa.go.jp/>

JICPA website

<https://jicpa.or.jp/>

Japan Exchange Group website

<https://www.jpx.co.jp/>

Basic Policy for Monitoring Audit Firms

<https://www.fsa.go.jp/cpaaob/shinsakensa/kihonhoushin/20190517.html>

Basic Plan for Monitoring Audit Firms (PY2021)

<https://www.fsa.go.jp/cpaaob/shinsakensa/kihonkeikaku/20210709/20210709-1.html>

Case Report from Audit Firm Inspection Results

<https://www.fsa.go.jp/cpaaob/shinsakensa/kouhyou/20210709/20210709-3.html>

JICPA 2020 Annual Report

[https://jicpa.or.jp/specialized\\_field/20210625ejb.html](https://jicpa.or.jp/specialized_field/20210625ejb.html)

On the Disclosure of Inspection Result, etc., to Third Parties (Japanese)

<https://www.fsa.go.jp/cpaaob/shinsakensa/kouhyou/20150611.html>

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