

2021 Monitoring Report Key Points

July 2021

Certified public Accountants and
Auditing Oversight Board



About the 2021 Monitoring Report

Purpose of publication

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

Structure

- The Report comprises the following four sections (I-IV). In "I. Overview of the Audit Sector," we have added information. In "II. The CPAAOB monitoring", the report delivers the new wording of assessments related to the over rating of inspection results, and renews the recent trends with auditing, such as the impact and response to spread of COVID-19 and the responses to key audit matters (KAM), in "IV. Responses to Changes with Auditing."(main revisions for the 2021 edition)

I. Overview of the Audit Sector

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

- Example content (1) Concentration of audit engagements at large sized audit firms (market share by type of audit firm [FY2019])

II. CPAAOB's Monitoring

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

- Example content (2) Situation with overall ratings

III. Operation of Audit Firms

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

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

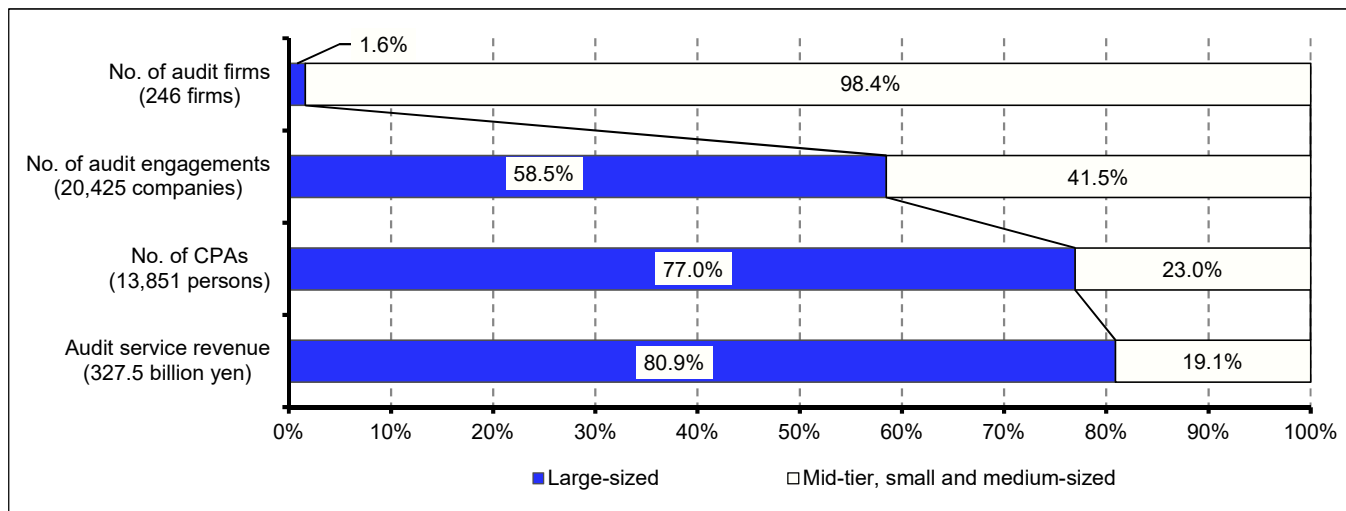
IV. Responses to Changes with Auditing

Describes recent key trends with audit firms

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

- Approximately 81% of audit service revenue is marked by large-sized audit firms (four firms).
- In recent years, the ratio of large-sized audit firms has been on a downward trend in the number of audit engagements, audit service revenue.
- The same oligopolistic tendency is also seen in the United States and the UK.

Market share by type of audit firm (FY2019)



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

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

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

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

Example content (2) Situation with overall ratings

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

Overall ratings (Covers inspections completed in PY2016-20)

Overall rating description	Details	大手監査法人、 準大手監査法人	中小規模監査事務所
Generally satisfactory	Given when operation of services is deemed to be satisfactory	-	-
Satisfactory with minor deficiencies	Given when there are issues needing to be fixed, but operation of services is deemed to be satisfactory on the whole	11	3
Unsatisfactory	Given when operation of services is deemed to be unsatisfactory	7	5
Unsatisfactory and in need of immediate remediation	Given when operation of services is deemed to be unsatisfactory and in need of immediate remediation	-	5
Extremely unsatisfactory	Material deficiencies with the quality control environment and audit engagements were identified and voluntary remediation cannot be expected to be implemented by the audit firm (recommendation is made to the FSA Commissioner)	-	5

(Note 1) Firms are notified of their overall ratings following regular inspections. Regular inspections take place once every two years in the case of large sized audit firms, once every three years in the case of second tier audit firms, and as necessary in the case of small and medium sized audit firms partnerships, and solo practitioners.

(Note 2) the CPAAOB will make the review of assessment result descriptions in overall ratings, starting with inspections to be launched in PY2021.

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

Action required of audit firms

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

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

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

The Audit Firm Governance Code

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

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

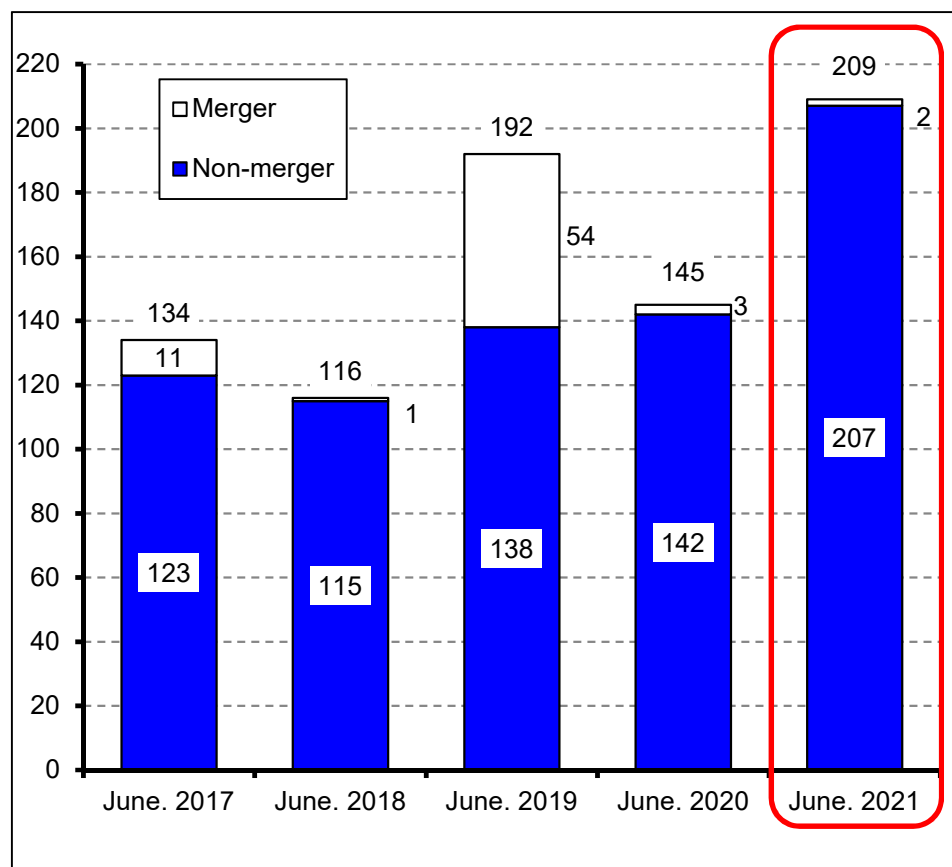
	Former senior management	Academic expert	Attorney and legal experts	Former ministry/ agency officials	Other
Large	10	1	1	1	—
Mid-tier	5	1	1	2	2
Small-medium	—	3	1	—	—

(Note) Prepared by the CPAAOB based on PY2020 inspections and data released by audit firms

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

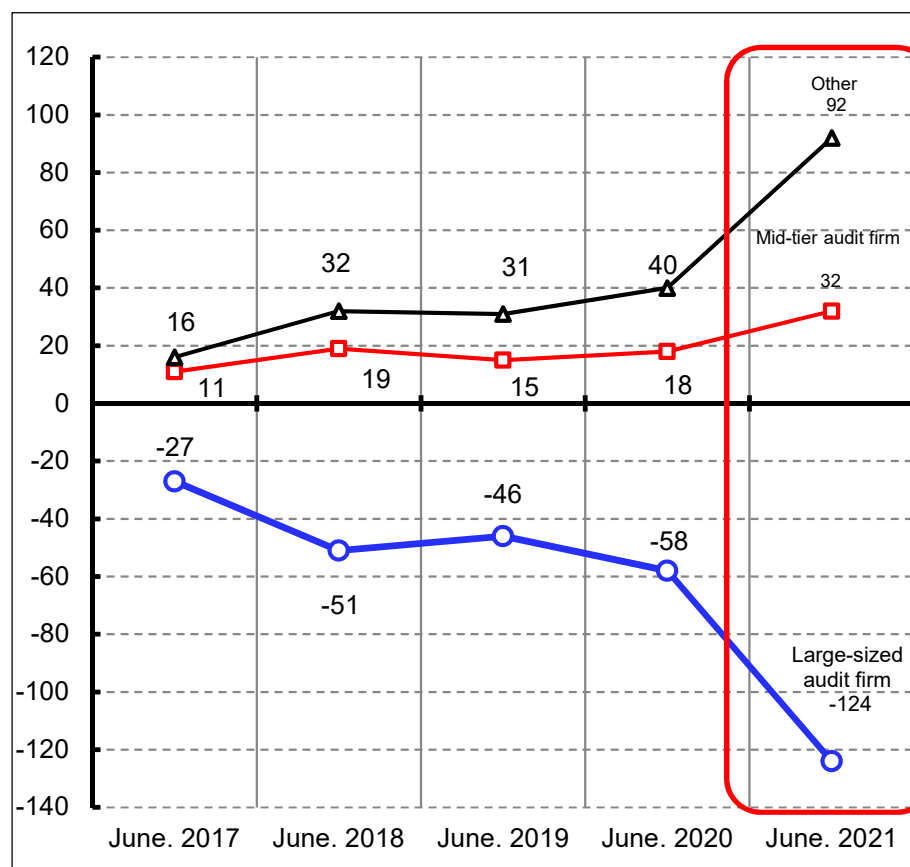
- Even if changes due to merger are excluded, the number of changes of accounting auditors is at its highest level in five years.
- Breaking things down by size of audit firm reveals an ongoing shift from large-sized audit firms to second-tier or smaller audit firms.

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



(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

Changes by size of audit firm (unit: companies)

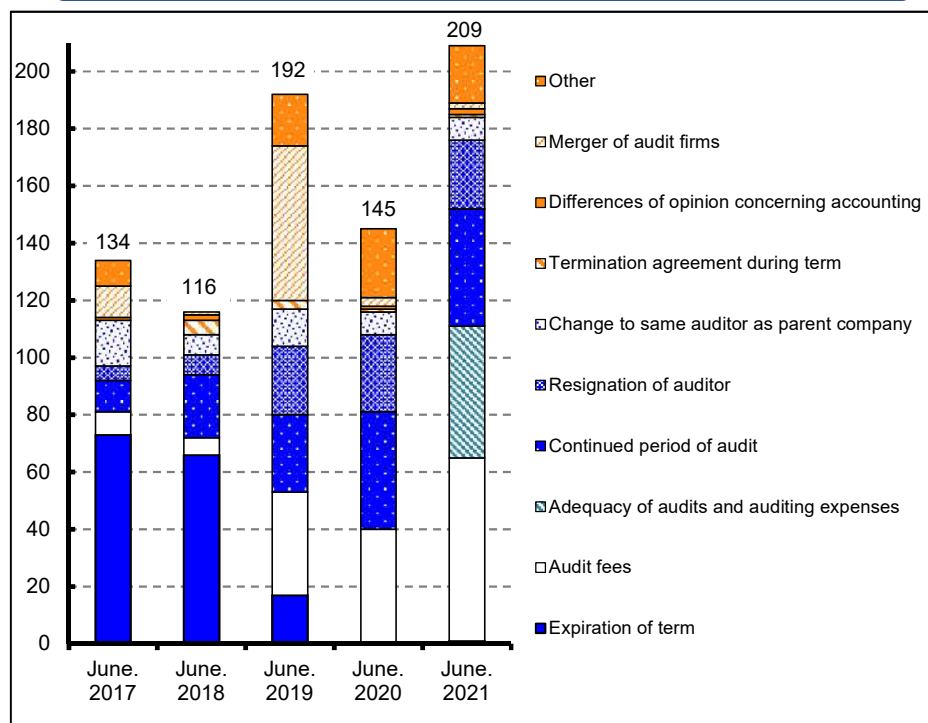


(Note 1) Net increases/decreases in the number of changes

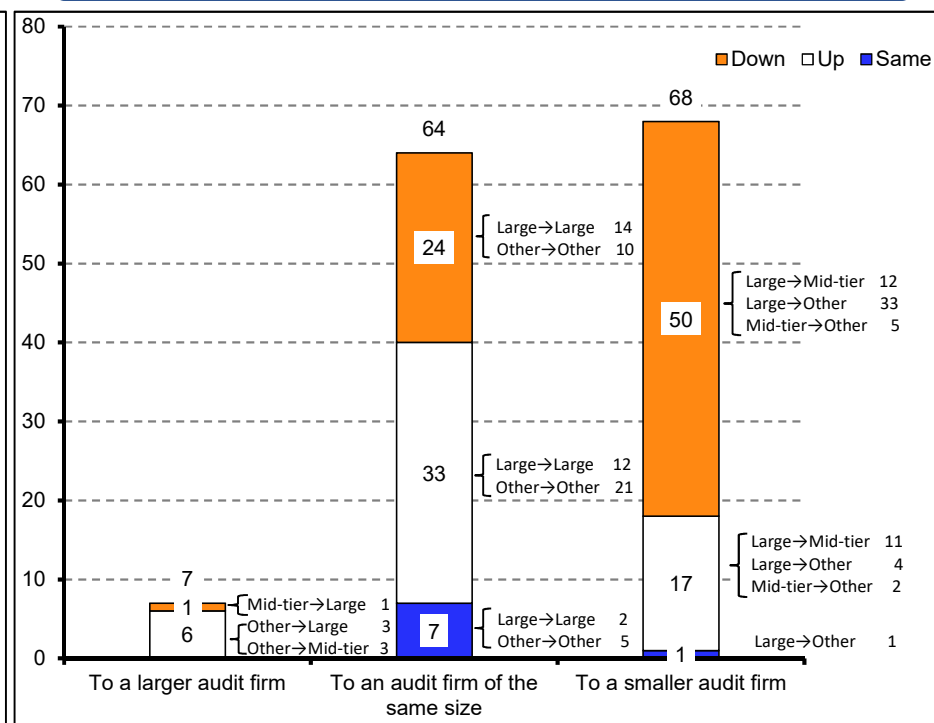
Example content (4) Changes of accounting auditors (2/2)

- Cases in changes of accounting auditors solely based on expiration of term have been decreasing sharply since June 2019. After June 2020, audit fee hike and prolongation of audit term are on the rise. Above all, in June 2021, the cases to describe the suitability of audit fee and business scale have been common.
- Regarding audit fees before and after changes, approximately 70% of changes to a smaller audit firm resulted in lower fees. Among these, changes from a large-sized audit firm to a small and medium-sized audit firm, partnership, or solo practitioner saw fees drop in over 90% of cases.

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



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



(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.

(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