



2022 Monitoring Report

Certified Public Accountants and Auditing Oversight Board
July 2022

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 "2022 Monitoring Reports" compiled incorporating achievements and so forth of monitoring in the program year 2021 (from July 2021 through June 2022).

(Major revisions for the 2022 version)

I. Overview of the Audit Sector

We have updated information on the overview of certified public accountants (CPAs) and audit firms, audited companies and audits of 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 Policy for Monitoring Audit Firms for the CPAAOB's 7th Cycle (April 2022 – March 2025) and the Basic Plan for Monitoring Audit Firms and so forth in the program year 2022.

III. Operation of Audit Firms

In addition to updating data concerning the operation of audit firms, we have altered the column about remote work adopted by audit firms in accordance with the present circumstances.

IV. Responses to Changes in the Environment Surrounding Audit

Based on recent changes in the environment surrounding auditing, we have updated information about the impacts of and responses to the spread of COVID-19, responses to key audit matters (KAMs), and other recent trends related to auditing, and described an example of an audit firm's structure relating to the reporting of KAMs.

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.

Contents

Introduction	1
(Abbreviations)	5
(Terms)	5
I. Overview of the Audit Sector	8
A. CPAs	9
1. Introduction of the CPA system	9
2. CPAs	9
3. Percentage of Female CPAs	11
4. Age Structure of Persons who Passed the CPA exam	12
B. Audit Firms	12
1. Organizational Structure of Audit Firms	13
2. Development of Quality Control Structures and Responses by Audit Firms ...	15
3. Number of Audit firms	16
4. Mergers of Audit Firms	17
5. Financial Condition (Operating Revenue, Proportion of Audit and Attestation Services and Non-audit and Attestation Services)	18
C. Audited Companies	20
1. Types of Audit and Attestation Services	20
2. FIEA and Companies Act Audits	21
3. Audits of Financial Institutions	24
4. Companies Adopting IFRS	25
5. Audits of Initial Public Offerings	26
II. The CPAAOB monitoring	28
A. Overview of System and Situation with Implementation	29
1. Legal Position of the CPAAOB	29
2. Overview of Examinations, Collection of Reports, and Inspections by the CPAAOB	29
3. Report of JICPA Quality Control Review	30
4. Examination	31
5. Collection of Reports	32
6. Inspections	35
7. Notification of Inspection Results	40
B. Foreign Audit firms	44
1. System for Foreign Audit Firms	44
2. Foreign Audit Firms	44
3. Audited Companies	45

C. The CPAAOB monitoring Perspectives, Objectives etc. (Basic Policy and Basic Plan)	46
1. Basic Policy for Monitoring Audit Firms	46
2. Basic Plan for Monitoring Audit Firms in Program Year 2022	47
III. Operation of Audit Firms	50
A. Operations Management System	51
1. Organizational Structure of Audit Firms.....	51
2. Efforts in Response to Audit Firm Governance Code.....	54
3. Human Resources of Audit Firms	60
4. Organizational Structure for Providing Audit Services.....	64
5. Organizational Structure for Supporting Audit Services	66
6. Domestic Audit Firm Groups.....	69
B. Engagement Quality Control Reviews	71
C. Monitoring of Systems of Quality Control	73
1. Periodic Inspections	73
2. Utilization of Global Reviews	74
3. Monitoring before expression of audit opinions	75
D. Education, Training and Evaluation of Audit Personnel.....	75
1. Human Resource Development.....	76
2. Education and Training of Engagement Teams.....	76
3. Evaluation of Engagement Team Members.....	78
E. Acceptance of New Audit Engagements and Changes of Accounting Auditors .	79
1. Reasons for Change of Accounting Auditors Given in Timely Disclosures by Audited Companies	81
2. Reasons for Change of Accounting Auditors during Fiscal Term	82
3. Reasons for Changes of Accounting Auditors as Identified Through Monitoring Activities.....	83
F. Audit Fees	84
1. Rules on Audit Fees	84
2. Methods for Calculating Audit Fees	84
3. Audit Fees Before and After Changes in Accounting Auditors	86
4. Dependence of Fees (Safeguards).....	86
IV. Responses to Changes in the Global Environment Surrounding Audits.....	88
A. Usage of Technology in Audit and Cybersecurity Efforts	89
1. Progress with the Adoption of IT in Audit Engagements	89
2. Cybersecurity Efforts.....	92
B. Responses to Overseas Expansion of Companies	93
1. Group Audits	93

2. Ties with Global Networks.....	95
C. Effects of and Responses to the COVID-19	99
D. Treatment of key audit matters	101
1. Processes and key points for deciding on and reporting KAMs.....	101
2. Responses by audit firms.....	101
3. Analyses of KAMs reported in the first year of mandatory application and recommendations	103
E. Recent Trends with Auditing.....	104
1. Trends with International Standards on Auditing and Code of Ethics	104
2. Trends in domestic auditing standards and code of ethics	104
3. Expansion of Disclosure of Descriptive Information	105
4. Efforts to address disclosure of sustainability.....	105
5. Partial amendment of the Certified Public Accountants Act and the Financial Instruments and Exchange Act.....	107
(Reference materials).....	108

Column

Efforts to ensure empowerment of female CPAs.....	11
JICPA's Registration System for Listed Company Audit Firms.....	23
Concentration at Large-sized Audit Firms.....	24
IPO support services.....	27
Report of the Liaison Council on the Appointment of Audit Firms (External Auditors) for Initial Public Offering (IPO) Audits.....	27
Promotion of remote work at audit firms.....	62
New Methods of Calculating Audit Fee Estimates.....	84
Amendments to IESBA's (International Ethics Standards Board for Accountants) ethics code for audit fees.....	87
Effective audit using AI.....	91
Introduction of electronic audit documentation by small and medium-sized audit firms.....	91
Participation by Audit Firms in Cybersecurity Exercises.....	92
Expanded use and risks of cloud services.....	93
International Forum of Independent Audit Regulators (IFIAR).....	98
Effects of international situation on auditing.....	99

(Abbreviations)

Abbreviations used in this Report shall be defined as follows:

CPA AOB	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 banks, 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.

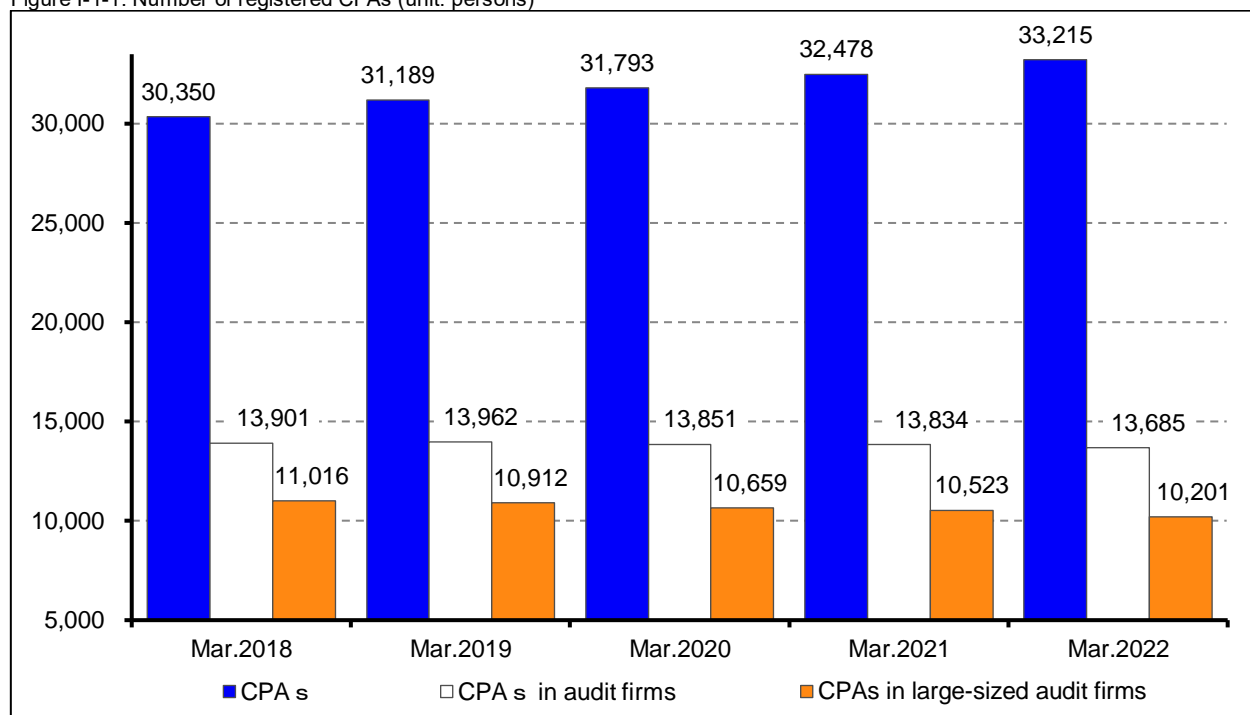
"The mission of certified public accountants, as professionals on auditing and accounting, shall be to ensure matters such as the fair business activities of companies, etc., and the protection of investors and creditors by ensuring the reliability of financial documents and any other information concerning 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 45.8% at the end of March 2018 to 41.2% at the end of March 2022. Of the registered CPAs belonging to audit firms, around 70% at large-sized audit firms (Figure I-1-1).

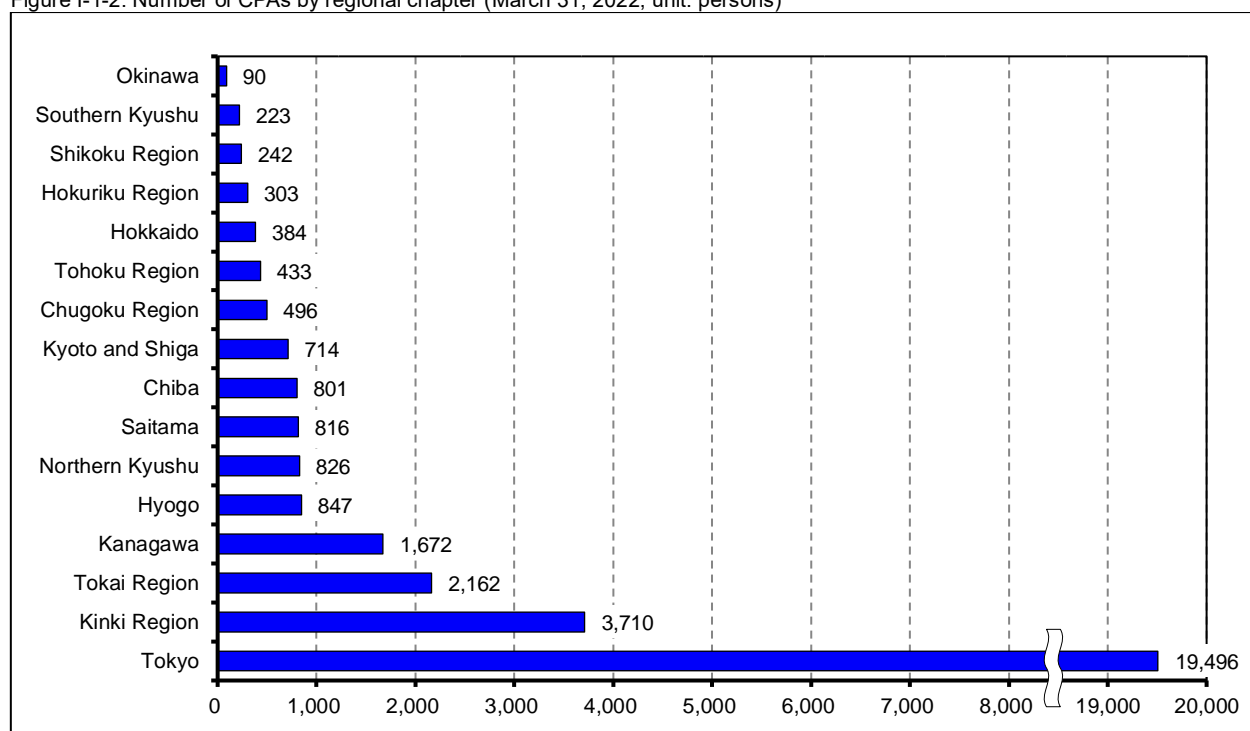
Figure I-1-1. Number of registered CPAs (unit: persons)



(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, 2022). 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, 2022; unit: persons)

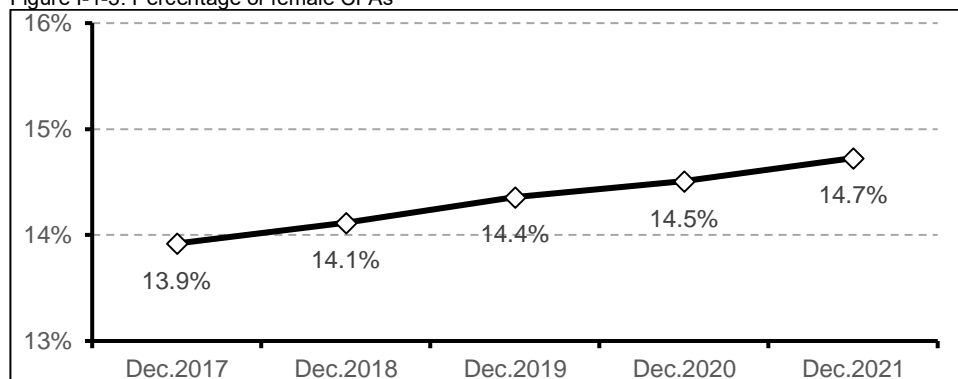


(Source) Prepared by the CPAAOB based on data (e.g. survey of numbers of members) from the JICPA

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 2021 the figure topped 14.7%, which is the same as the level for female tax accountants¹. On the other hand, it is still lower than the percentages of female attorneys² and female CPAs in the UK and US³.

Figure I-1-3: Percentage of female CPAs



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

■ Efforts to ensure empowerment of 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 that are nurturing female executives and providing support for female CPAs at each life stage, holding training sessions and seminars to develop an organizational culture to accept diverse working styles, and offering support for creating networks.

The draft Act Partially Amending the Certified Public Accountants Act and the Financial Instruments and Exchange Act, which was enacted in May 2022, reviewed the restriction on services based on the marital relationship of audit firms' partners. When the spouse of an audit firm's partner serves as an officer, etc. of a company, the audit firm was conventionally prohibited from offering audit and attestation services to the relevant company. However, through the review, the restriction on services becomes applicable only when the relevant partner becomes involved in audit and attestation services. This is expected to expand opportunities for female CPAs to exercise their abilities.

To encourage more females to take the CPA examination, the CPAAOB 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. Although the number of successful female examinees decreased in 2021 compared to the previous year, the number of females submitting applications for the examination and passing it has been showing an upward trend in recent years. While 21.8% of all successful examinees were women in 2021, the ratio of successful female examinees was 8.7%, almost the same as 9.9% for men.

¹ According to a survey of female participation in policy making conducted in 2021 by the Cabinet Office's Gender Equality Bureau, the percentage of female tax accountants is 15.2%.

² According to the White Paper on Attorneys 2021, the percentage of females is 19.3%.

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

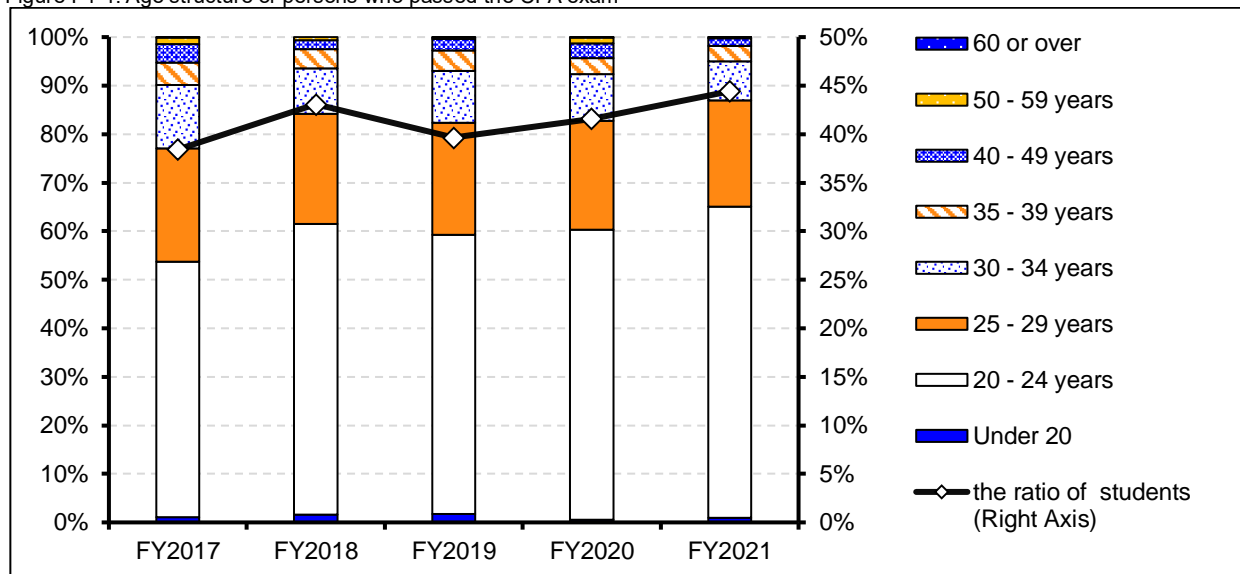
US: According to a survey of employment at accounting firms in 2020 conducted by the AICPA and included in its "2021 Trend Report," the percentage of females is 46%.

UK: According to the Financial Reporting Council's "Key Facts and Trends in the Accountancy Profession 2021," 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 64.2% of those who passed it in 2021. 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 44.4% in the 2021 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 2,376 at the end of March 2021, 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, credit associations, agricultural cooperatives, social welfare corporations and medical corporations, etc. A more detailed explanation of audit and attestation services is provided on page 20 ("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. Additionally, 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 (except for foreign companies, the same hereafter).

Figure I-2-1: Classifications of audit firms (as of March 31, 2021)

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	2,367	○ (Note 4)	○	○	○
(Breakdown)	Small and medium-sized audit firms	(253)			
	Partnerships (Note 1)	(54)			
	Solo practitioners (Note 1)	(2,060)			

(Note 1) The number of audit offices in fiscal 2020 (book closing date from April 1, 2020, till March 31, 2021) listed in copies of audit summaries or audit implementation reports submitted to the JIPCA.

(Note 2) The symbol "○" 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 23)

(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.

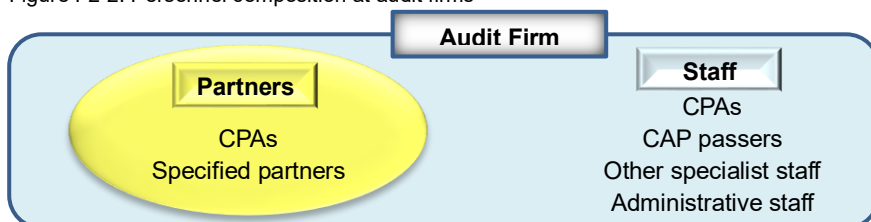
1. Organizational Structure of Audit Firms

Audit firms are established through investment by persons 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 examination 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, partners are required to have a wide range of knowledge and experience 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 FY2021 large-sized audit firms had 127 specified partners among a total of 1,951 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 60).

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	Approx. 170 up to approx. 600	Approx. 30 up to 100	Up to approx. 40
Full-time staff	Approx. 2,800 up to approx. 6,600	Approx. 200 up to 800	Up to approx. 90

(Note) See "Figure III-1-3: Characteristics of each type of audit firm" (page 53) 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 have more than 200 people.

As audit firms grow in scale, they necessitate introducing 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. In recent years, some large-sized audit firms hire a larger number of audit assistants (staff without qualifications relating to financial statement audits, such as a qualification of CPA) to reduce the workload of CPAs and enable them to concentrate on duties requiring professional judgment.

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

	Staff	Senior Staff	Manager	Senior Manager	Partner
Roles	Personnel who perform audit practice, under the guidance and supervision of superiors and seniors who may, depending on their experience, supervise engagement teams performing audits of SMEs (Small and Medium-sized Enterprises)		Personnel who oversee audit teams		Personnel who oversee all audit engagements and are involved in the management of the firm
Skills required	Specialist knowledge on audit practices, accounting and audits		Management skills in staff mentoring and coordination with audited companies, as well as problem solving skills		High level of skill as a manager
Primary training	Annual accounting audits training, Fraud prevention training, Global training, etc.				
	Audit procedure training, etc.		Management training, specialty-specific training, etc.		

(Note) For details, see "III. Operation of Audit Firms, A. Operations Management System, 4. Organizational Structure for Providing Audit Services" (page 64) and "5. Organizational Structure for Supporting Audit Services" (page 66).

2. Development of Quality Control Structures and Responses 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.

Furthermore, the "Standard on Quality Control for Audits" were formulated for audit and attestation services in 2005, 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.

- a. In association with the "Quality Control Standards for Audits," the International Standard on Quality Management (ISQM) 1 (ISQM1: Quality Management for Firms that Perform Audits or Reviews of Financial Statements, or Other Assurance or Related Services Engagements), which is an international quality management standard, and other standards were newly established or revised. Accordingly, the Audit Standard Committee of the Business Accounting Council commenced deliberations in February 2021, and a written opinion on the revision of the Quality Control Standards for Audits was compiled at the general meeting of the Council in November 2021. The revised Quality Control Standards for Audits (hereinafter referred to as the "Revised Standards") require individual audit firms to introduce a quality control system based on a risk-based approach, under which they should set their own quality goals,
- b. distinguish quality risks that hinder the achievement of such quality goals and assess them one by one,
- c. determine policies or procedures for dealing with those assessed quality risks and implement them, and
- d. make improvements based on the analysis of root causes of defects, if any.

Additionally, the Revised Standards state that the quality control system should include the following as component elements:

- a. Process to assess risks of the audit firm;
- b. Governance and leadership;
- c. Professional ethics and independence;
- d. Conclusion and renewal of audit engagements;
- e. Implementation of services;
- f. Resources for operational management of the audit firm;
- g. Information and communication;
- h. Monitoring of the quality control system and improvement process; and
- i. Succession among audit firms.

Furthermore, the Revised Standards newly require the top officer in charge of an audit firm's quality

control system to evaluate the system at least once a year by setting a base date and draw a conclusion as to whether the system provides reasonable assurance to the audit firm that the purpose thereof is surely achieved.

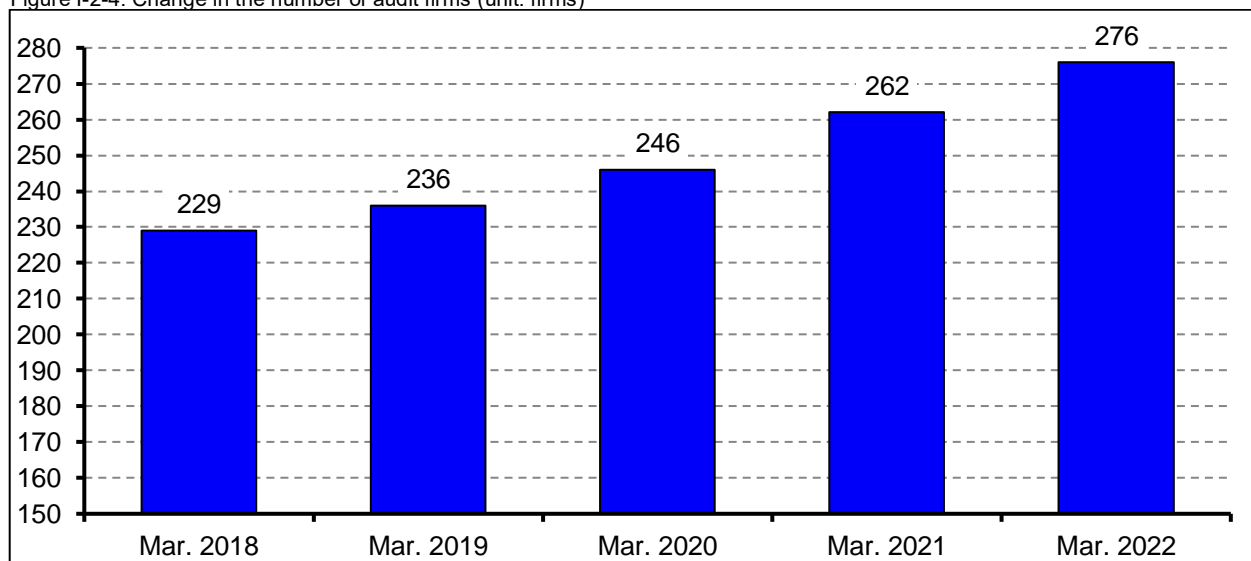
The Revised Standards are to be applied to audits of financial statements for a business year or an accounting period starting on or after July 1, 2023 (for audit firms other than large-sized audit firms under the Certified Public Accountants Act, for a business year or an accounting period starting on or after July 1, 2024).

Large-sized audit firms have taken the lead in commencing efforts to adapt to ISQM1, whose application will be started in December 2022, and to other standards in collaboration with global networks, and are also proceeding with measures to comply with the Revised Standards. Many large-sized audit firms have already compiled component elements of their quality control systems as required by the Revised Standards and have commenced a dry run for applying the Revised Standards and are proceeding with documentation of their internal rules. Furthermore, some large-sized audit firms have ascertained challenges for ongoing development and operation of their quality control systems, such as whether there are any quality risks yet to be identified and what measures should be taken to avoid losing substance in two or more years after commencing the application, and are discussing relevant countermeasures.

3. Number of Audit firms

The number of audit firms has been on an upward trend in recent years. As of March 31, 2022, there were 276 firms, and five firms disappeared as a result of dissolution or merger and 19 were established in the period April 2021-March 2022, ending up with a net increase by 14 firms (Figure I-2-4) year on year. See "4. Mergers of Audit Firms" (page 17) for details on mergers from FY2017 onwards.

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



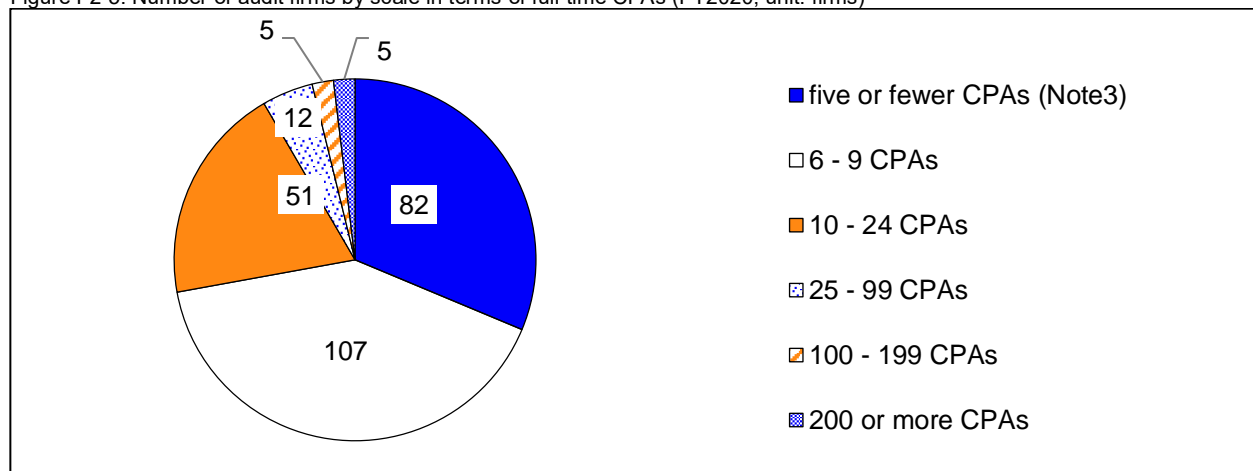
(Note 1) The number of audit firms as of the end of March 2021 is adjusted based on the data obtained after publishing the 2021 Monitoring Report.

(Note 2) The number of limited liability audit firms as of the end of March 2022 was 40.

(Source) Prepared by the CPAAOB based on data (e.g. survey of numbers of members) from the JICPA and reports of individual audit firms. The list of limited liability audit firms is published on the FSA website.

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 (FY2020; 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 262 audit firms was collected from operational reports submitted by these firms in FY2020 (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 6 mergers of audit firms since FY2017 (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 FY2017 (March 31, 2022)

FY	Surviving firm	Disappearing firm
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
2021	Yasaka Kaikeisha Audit Corporation	Keihin Audit Corporation

(Note) Names in parentheses show the name of the surviving firm as of March 31, 2022.

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

Reports collected from mid-tier audit firms (five firms) in PY2021 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 34 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 such as assurance services other than audit and attestation services and financial advisory services (support for initial public offerings, introduction of IFRS, organizational realignment and so forth). Operating revenues over the five years until FY2021 (FY2020 in the case of small and medium-sized audit firms) showed an uptrend all at large-sized, mid-tier and small and medium-sized audit firms.

Revenues from audit and attestation services roughly accounted for 75% of operating revenues at large-sized audit firms, while the ratio was about 95% and 90% respectively 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. Domestic Audit Firm Groups" (page 69).

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

a. Large-sized audit firms

The ratio of audit service and attestation revenues, which has been around 75% for large-sized audit firms as a whole, Seeing the ratio of each large-sized audit firm, the ratio has ranged between 70% and 85% at three of the four firms, but at the remaining firm it has hovered at around 50%.

Large-sized audit firms operate certain extent of non-audit services based on their organizational policy that performing non-audit services provides their personnel with opportunities to acquire a wide variety of business experiences to grow, a broad range of experiences and knowledge through non-audit services serves to enhance audit quality, and non-audit service is effective for attracting talent.

b. Mid-tier audit firms

Audit and attestation service revenues have been rising at all firms, and the ratio of them in operating revenues has mostly maintained a level over 90%.

As mid-tier audit firms' business is centered on audit and attestation services, they provide non-audit services that are considered useful when conducted together with audit and attestation services or only within a limited range based on their individual circumstances, including available staff members.

There was a wide variation in revenues between mid-tier audit firms, and the gap may change depending on future developments, such as mergers.

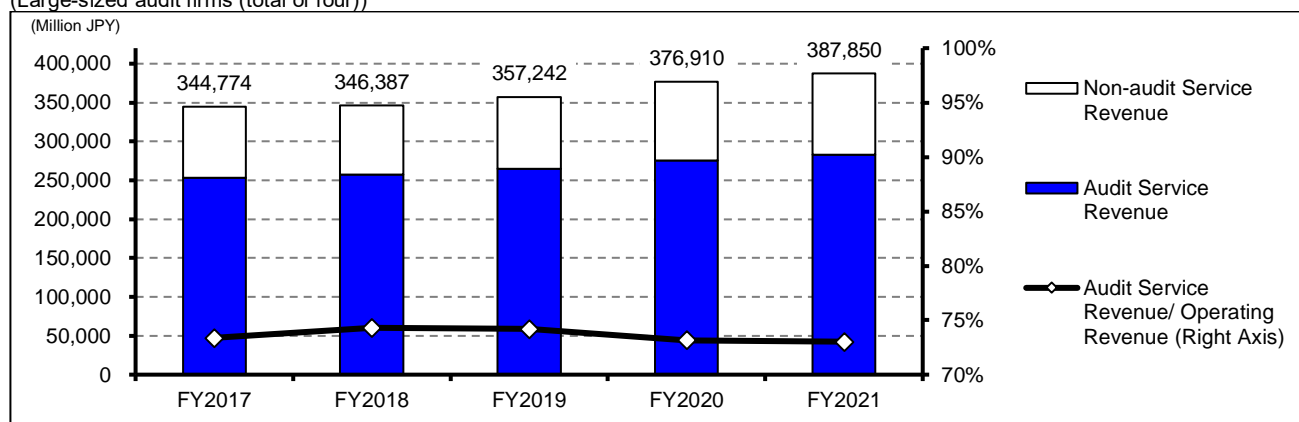
c. Small and medium-sized audit firms

The ratio of audit and attestation service revenues has been around 90%.

The operating revenues of small and medium-sized audit firms are moderate on the whole, but some of the largest firms in this category are expanding their business through newly concluding audit engagements with companies for which mainly large-sized audit firms had cancelled audit

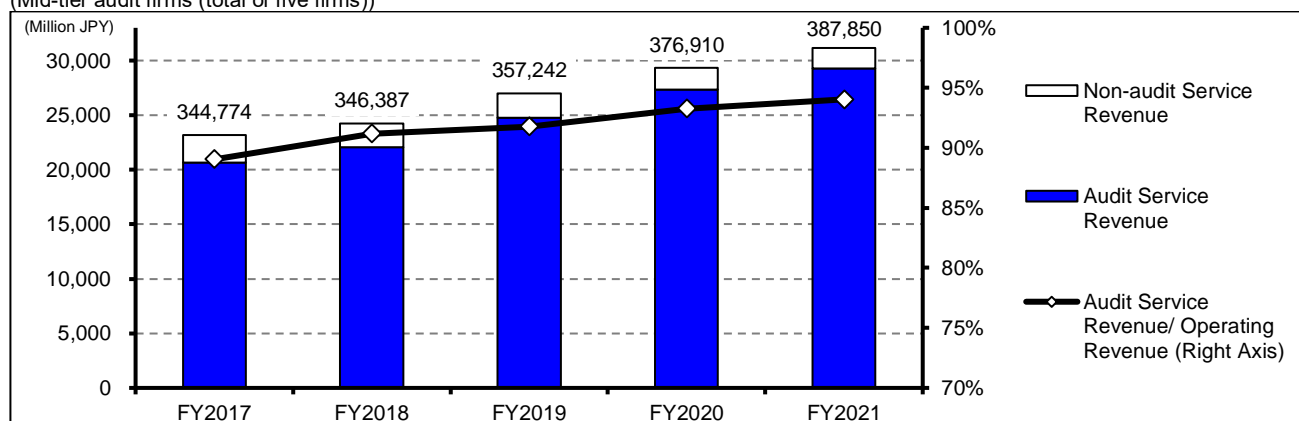
engagements. For changes in accounting auditors, see "III. Operation of Audit Firms, E. Acceptance of New Audit Engagements and Changes of Accounting Auditors" (page 79).

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))



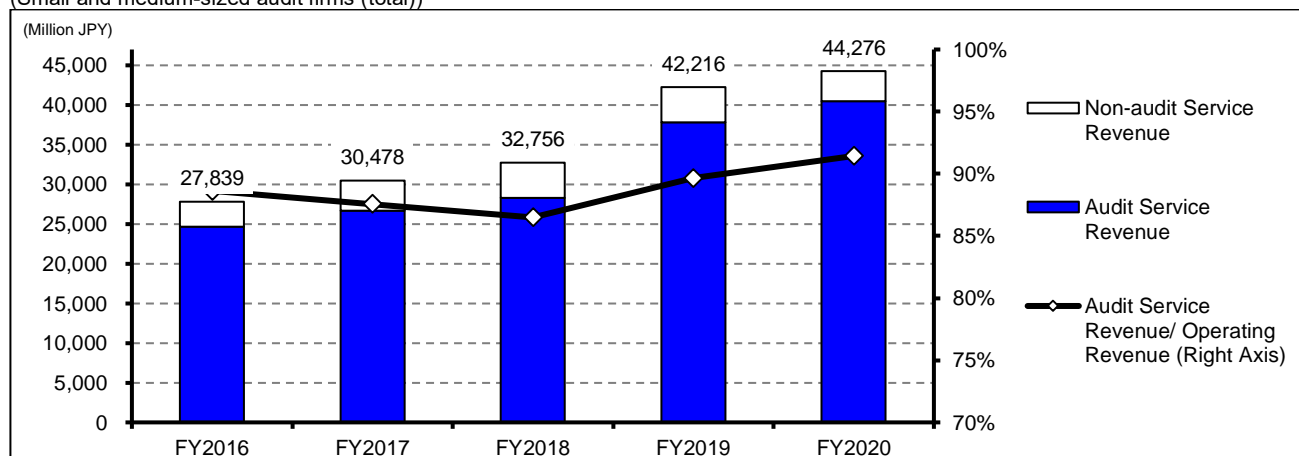
(Note) In FY2017, one audit firm changed its fiscal year-end, so calculations are based on eight-month figures. As a result, FY2017 operating revenues are calculated by extrapolating eight-month operating revenues to one-year periods (by multiplying figures by 12 months/8 months) for the audit firm that 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, operating revenues of this firm 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 FY2021 have yet to be tallied. This report therefore covers their results through FY2020 (from April 2020 through March 2021). The number of small and medium-sized audit firms differs each fiscal year. For FY2020, the results of 237 firms were tallied.

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

(Source) 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 12)), 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 by audit firm

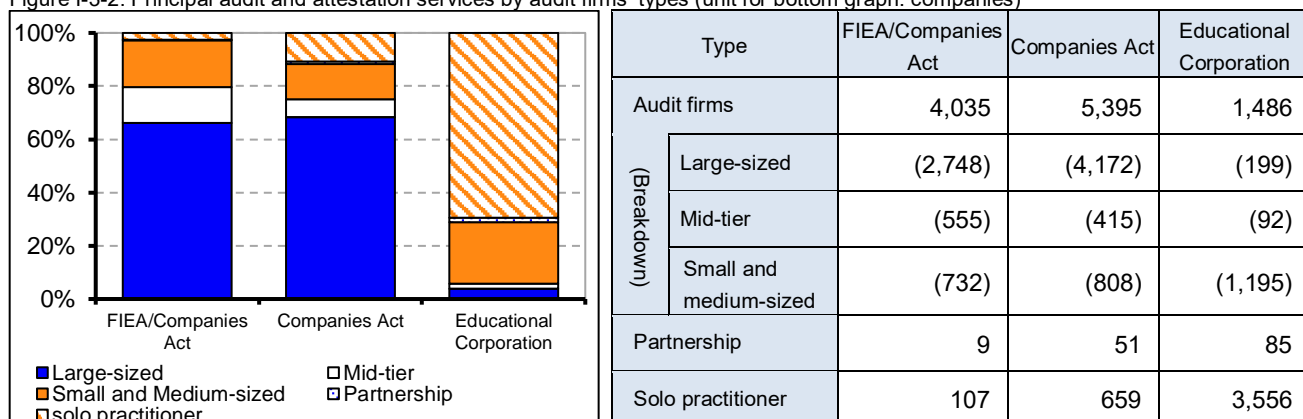
Type	Statutory audits						Non-statutory audits	Total
	FIEA / Companies Act	FIEA	Companies Act	Act on Subsidies for Private Schools	Labor Union Act	Other		
Number of companies	4,035	310	5,450	1,591	421	3,662	5,242	20,711
Percentage	19.5	1.5	26.3	7.7	2.0	17.7	25.3	100.0

(Note 1) The number of audited companies has been aggregated from operational reports submitted by audit firms in FY2020.

(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 1) Data was aggregated from audits conducted from the term ended April 2020 to the term ended March 2021. The figures do not match with the figures in Figure I-3-1 because the collection period is different.

(Note 2) The figures in the column "FIEA/Companies Act" include services requiring audit and attestation only under the FIEA, in addition to services requiring audit and attestation under the FIEA and the Companies Act.

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

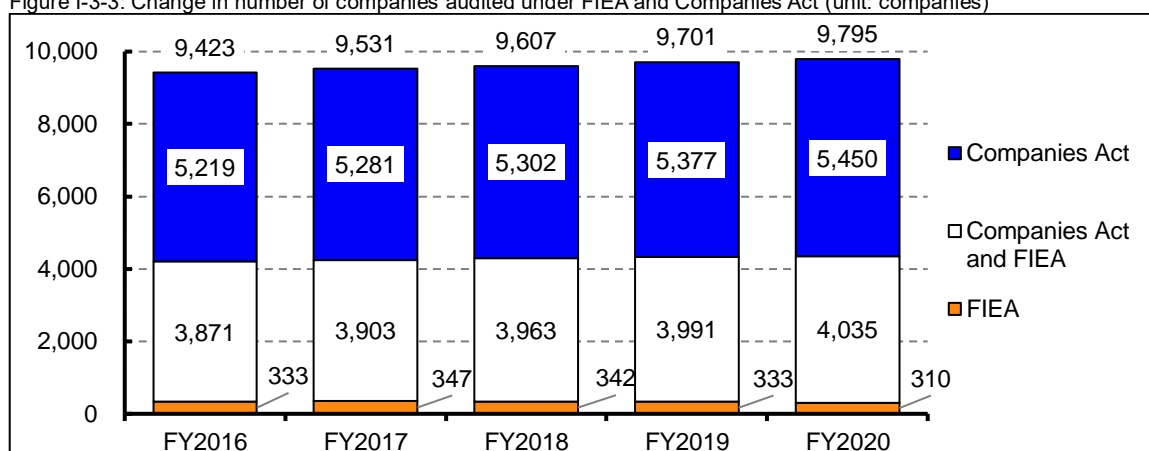
2. FIEA and Companies Act Audits

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).

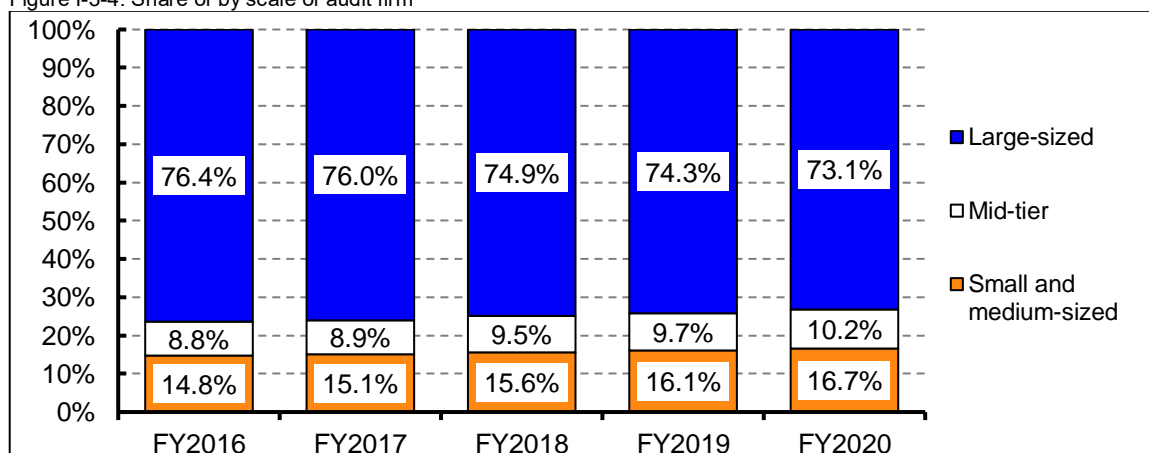
Figure I-3-3: Change in number of companies audited under FIEA and Companies Act (unit: companies)



(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

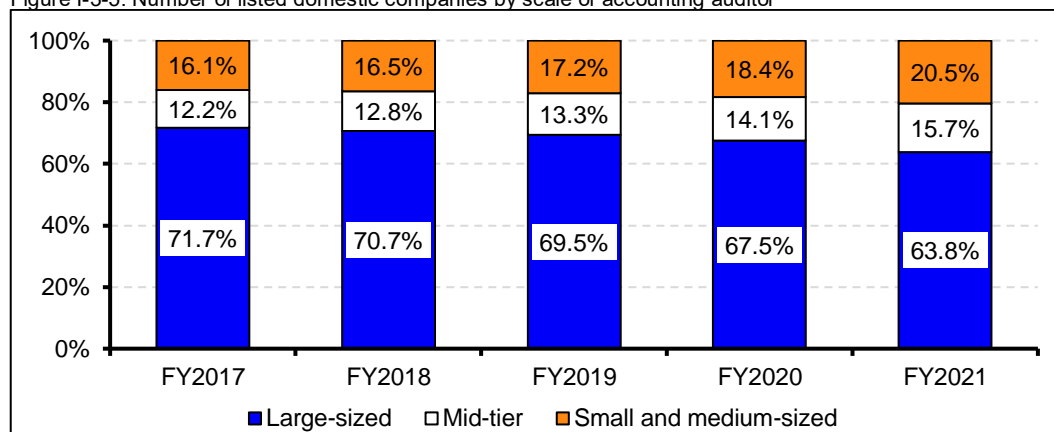
Audits at about 60% of listed domestic companies are conducted by large-sized audit firms, but in terms of market capitalization, large-sized audit firms have about 90% share and this trend has been persisting for many years. This is because listed domestic companies with large market

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 FY2021, there were 3,866 domestic listed companies, and 2,468 of them were audited by large-sized audit firms, 606 of them were audited by mid-tier audit firms, and 792 were audited by small and medium-sized audit firms. Meanwhile, the market capitalization of domestic listed companies was 738,910.9 billion yen, of which large-sized audit firms handled 666,912.5 billion yen, mid-tier audit firms handled 44,224.3 billion yen, and small and medium-sized audit firms handled 27,774 billion yen.

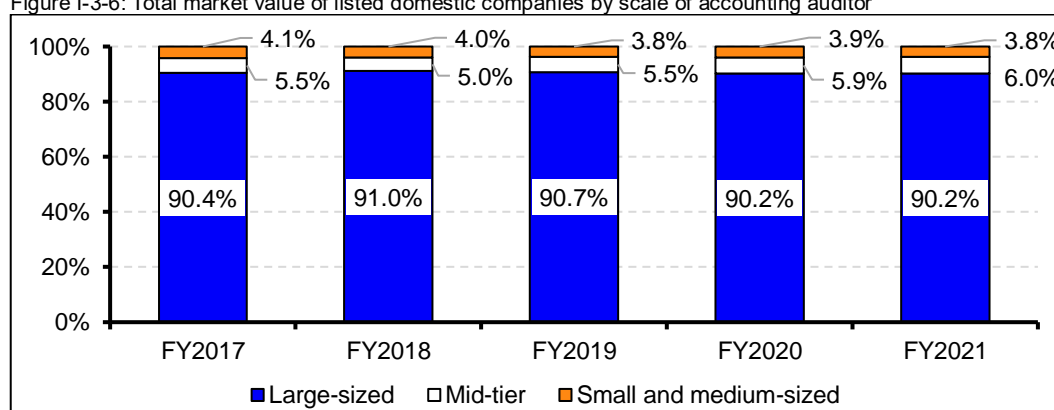
Among the top 20 companies in terms of market capitalization at the end of FY2021 (accounting for about 28% of total market capitalization), 18 companies were audited by large-sized audit firms.

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

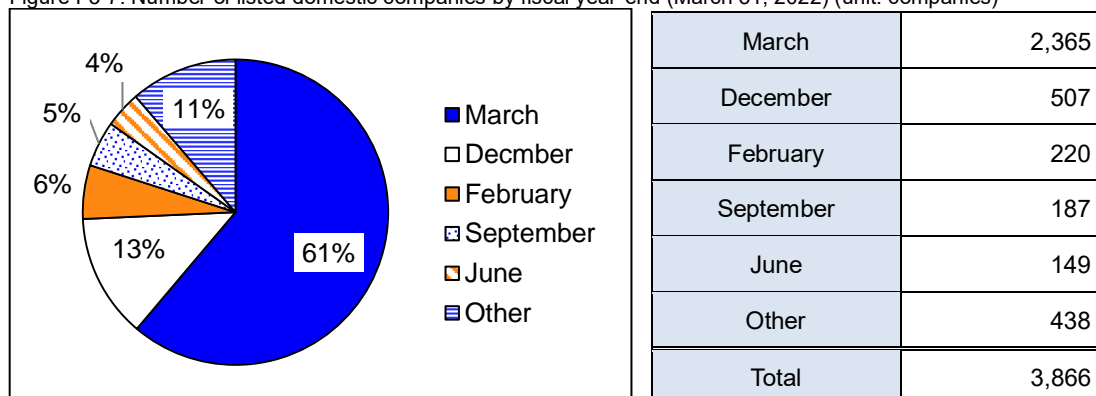


(Source) Prepared by the CPAAOB based on data from Quick and exchanges

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

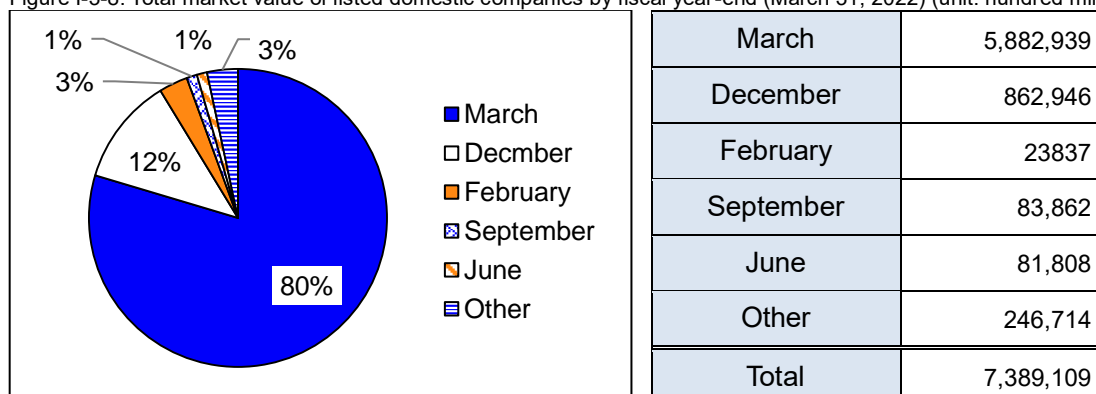
A look at when listed domestic companies close their books reveals that 61% do so at the end of March, and that they account for 80% of the total market capitalization, which explains why audit operations are heavily concentrated in specific periods (Figures I-3-7 and I-3-8).

Figure I-3-7: Number of listed domestic companies by fiscal year-end (March 31, 2022) (unit: companies)



(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, 2022) (unit: hundred million JPY)



(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 in 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 overview 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 125 firms in the list of registered firms as of the end of June 2022.

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.

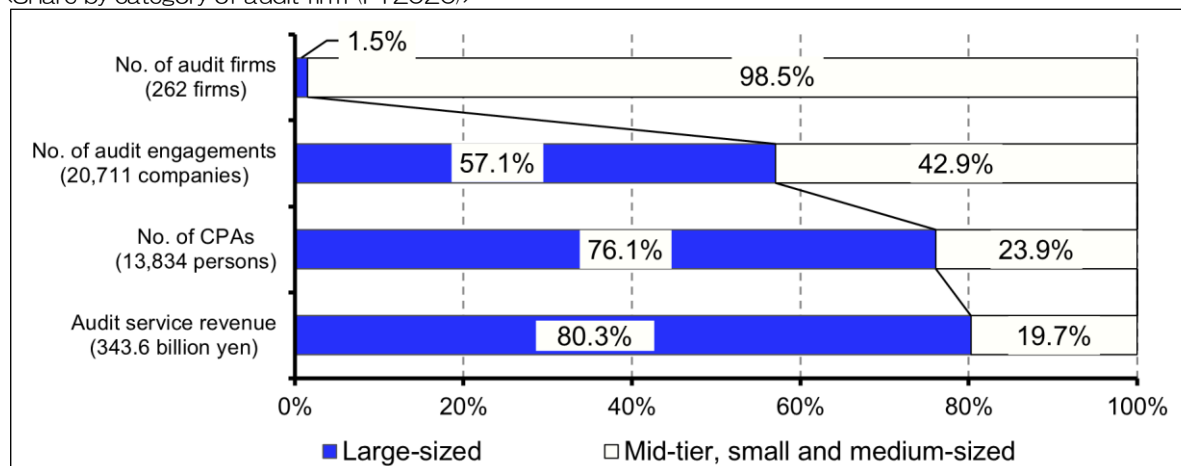
In May 2022, the Certified Public Accountants Act was amended and a legal registration system for audits of listed companies was introduced. The JICPA is required to properly implement this newly introduced registration system and is expected to fully exercise its knowledge and expertise as a body consisting of vocational experts professional organization and further enhance self-regulatory functions. For details, see "IV. Responses to Changes in the Global Environment Surrounding Audits E. Recent Trends with Auditing" (page 104).

■ Concentration at Large-sized Audit Firms ■

Among the 262 audit firms as of the end of FY2020, 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 79).

<Share by category of audit firm (FY2020)>

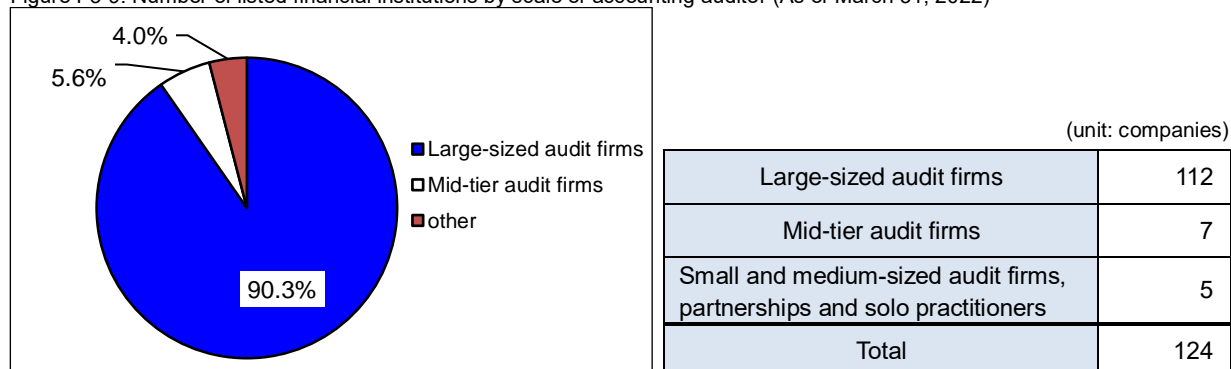


(Note 1) Compiled based on FY2020 JICPA member data and operational reports submitted by audit firms

3. Audits of Financial Institutions

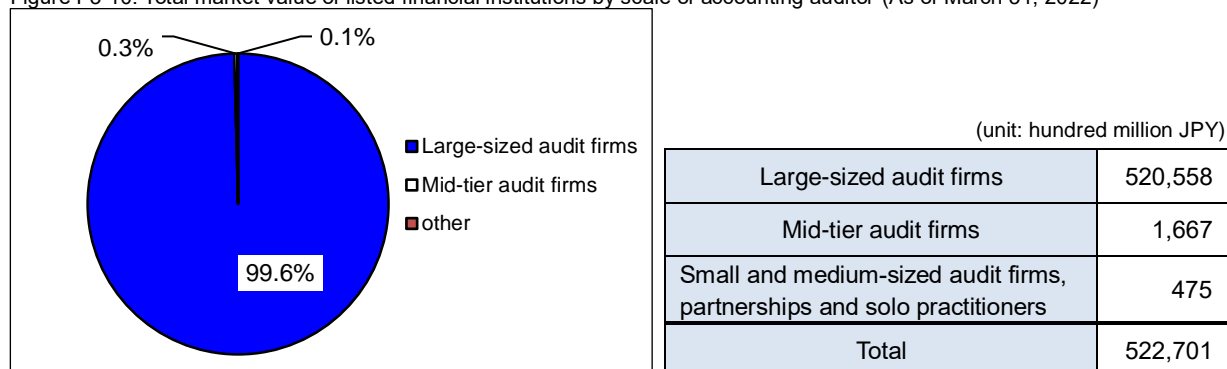
90% of listed financial institutions (124 companies) were audited by large-sized audit firms, and in terms of market capitalization, large-sized audit firms handled 99%. So compared with all domestic listed companies, large-sized audit firms' share presented a further increase (Figures I-3-9 and I-3-10). For information about domestic listed firms as a whole, see 2. FIEA and Companies Act Audits (page 21). 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, 2022)



(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, 2022)



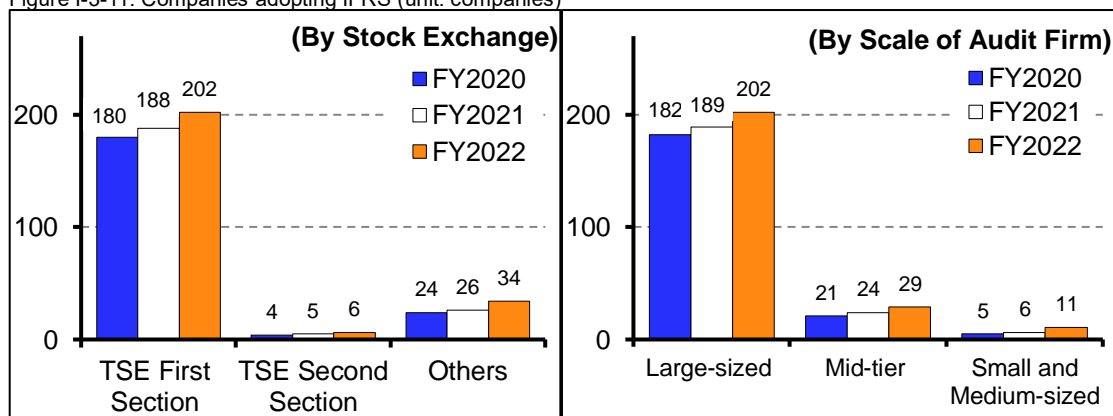
(Source) Prepared by the CPAAOB based on data from QUICK and exchanges

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 as of the end of March 2022 (Figures I-3-11).

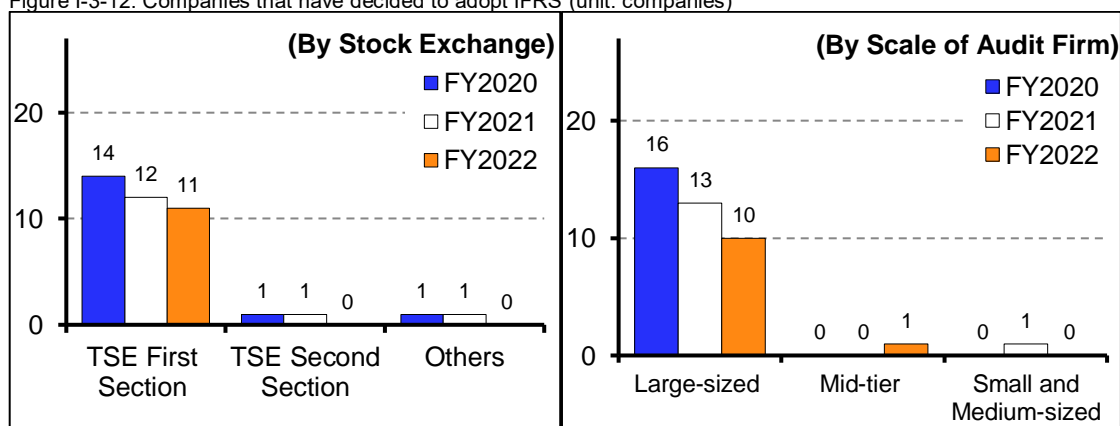
The majority of companies that have adopted IFRS are listed on the First Section of the Tokyo Stock Exchange, and many of them operate internationally. Audit contracts are concentrated in large-sized audit firms which collaborate with large global networks. A similar situation is seen with companies 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

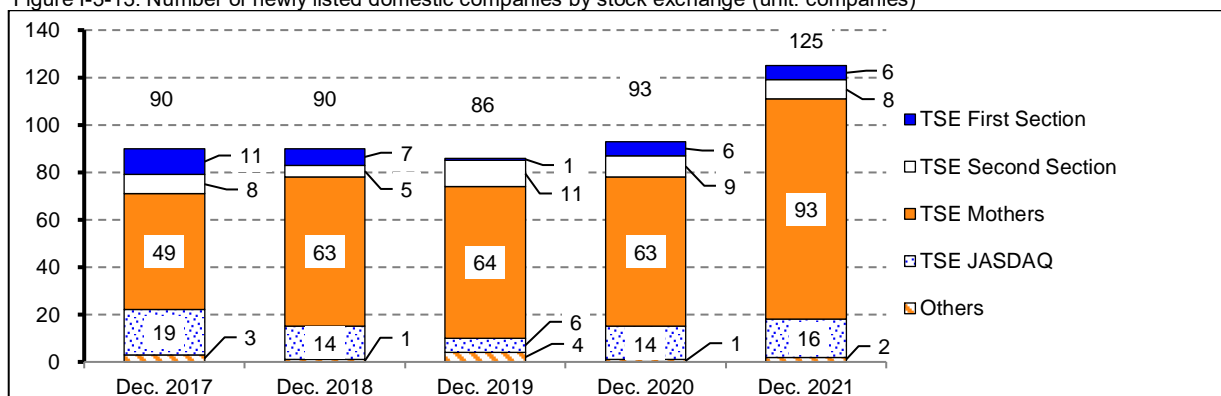
5. Audits of Initial Public Offerings

The number of IPOs (excluding listings on the Tokyo Pro Market) for the period from January 2021 to December 2021 (hereinafter referred to as the "year through December 2021") came to 125, up from the previous year, and listings on the Tokyo Stock Exchange's Mothers market were particularly large in number (Figure I-3-13). In the year through December 2021, IPOs increased due to such reasons as that the future was more foreseeable than in the previous year, backed by strong share prices. The increase in listings on the Tokyo Stock Exchange's Mothers market has been partially resulted from an increase in the number of IPO audit engagements accepted by mid-tier audit firms.

Seeing shares by size of audit firms, large-sized audit firms maintain 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 operation 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 System, 1. Organizational Structure of Audit Firms (page 51).

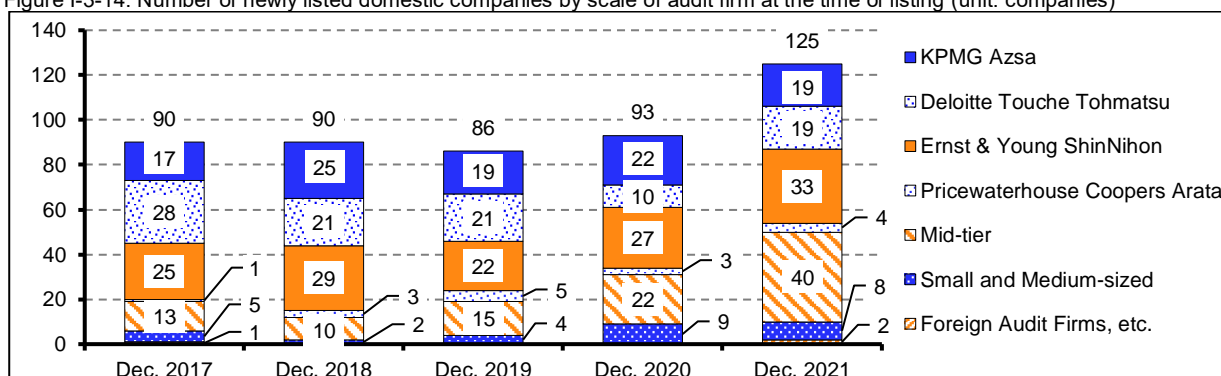
The share of large-sized audit firms was 60% in the year through December 2021. While the share of med-tier and small and medium-sized audit firms showed an uptrend.

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)

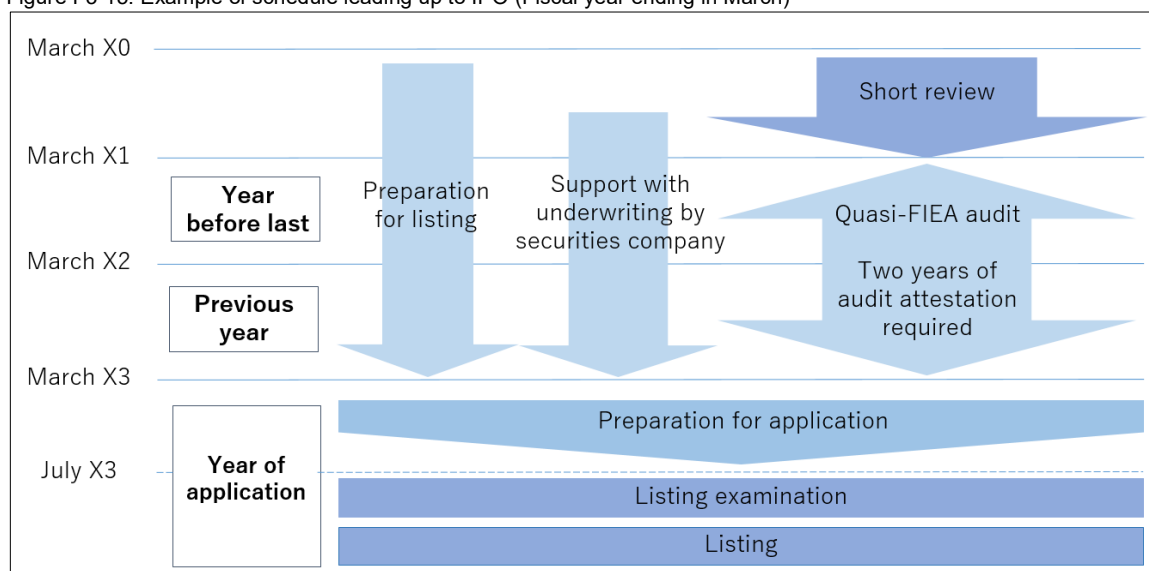


(Source) Prepared by the CPAAOB based on data from exchanges

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

However, IPO audits often entail a relatively high audit risk, such as vulnerable internal control structure of the audited company, and there were cases where improper accounting had already been practiced by the time of IPO. Accordingly, before accepting IPO audit engagements, many audit firms follow their policies requiring 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

■ Report of the Liaison Council on the Appointment of Audit Firms (External Auditors) for Initial Public Offering (IPO) Audits ■

In December 2019, the FSA established the Liaison Council on the Appointment of Audit Firms for Initial Public Offering (IPO) Audits, and the Council published its report in March 2020.

As an initiative for environmental development to provide high-quality audits to companies intending to be IPOs, the report presents initiatives expected respectively for audit firms, the JICPA, securities companies, venture capitals, exchanges and other related parties. For example, large-sized audit firms that are expected to fulfil significant functions in IPO audits continuously, are recommended to review their organizational structure and personnel distribution and set up a consultation service and clarify availability.

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 body⁴ 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.

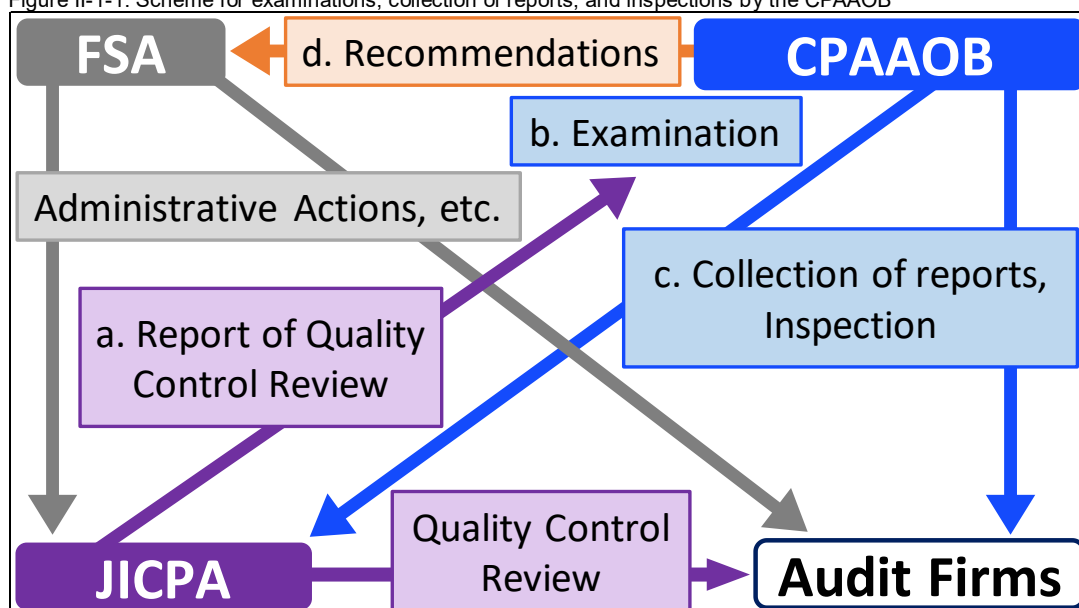
The CPAAOB receives and examines reports concerning quality control reviews by the JICPA, collects reports from and conducts inspections of the JICPA and audit firms etc. Based on the results of inspections etc., the CPAAOB recommends administrative actions or other measures to the FSA Commissioner when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



⁴ 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 an 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 guides, connects, supervises its members 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 JIPCA reviews the administration of audit engagements conducted by audit firms, reports results to the audit firms and, when necessary, recommends improvements and monitors the status of improvements⁵.

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 updates the status of quality control review 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 standards⁶, 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 FY2021, there was a total of 38 reviewers (as of July 1, 2021) who conducted regular reviews of 75 audit firms.

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

⁶ 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 examinations and results

The CPAAOB examined quality control reviews conducted in FY2021 by the JICPA in PY2021 and an overview of the review was given below.

i. FY2021 quality control reviews

Conclusions of quality control reviews, conducted on 76 audit firms in FY2021, were approved for 75 of them by June 30, 2022. Specifically, no significant deficiencies were confirmed at 69 audit firms, while significant deficiencies were observed at six audit firms, and no extremely significant deficiencies were observed. In addition, improvements were recommended to 73 audit firms (Figure II-1-2).

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	56	50	6	0	55	1
Partnerships	2	2	0	0	2	0
Solo practitioner	17	17	0	0	16	1
Total	75	69	6	0	73	2

(Note 1) 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 2) 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 3) 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 4) As the conclusion for one of the 75 audit firms reviewed had yet to be made as of June 30, 2022, it was not included in the state above.

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

ii. Examination of FY2021 quality control reviews

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

- Examination and confirmation of the policies for FY2021 quality control reviews, efforts for improvement, and improvements in each review operation.
- Identification of significant deficiencies or extremely significant deficiencies as a result of quality control reviews of audit firms and analysis of items and contents of specific deficiencies 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, the following were found in quality control reviews in FY2021:

- 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, the ratio of documentation deficiencies to total deficiencies is decreasing.
- In order to strengthen the risk-based approach, the JICPA conducted the following:
 - (i) understand audit firms' operation control structures; and
 - (ii) made review plans while taking into account the results of past quality control reviews and risk assessments performed at the selection stage of audit engagements; after the commencement of reviews, furthermore, flexibly extend the review period and increase reviewers depending on the change of the situation (hereinafter referred to as "flexible review").

As a result, issues pointed out with individual audit engagements have increased, while in some matters such as quality control structures, outcomes could not be confirmed,

The JICPA will further deepen understanding of audit firms' operation management structures and will continue efforts to conduct flexible review. The CPAAOB will continuously check the effectiveness of quality control reviews.

As a feature of the FY2021 quality control review, issues pointed out about audit of accounting estimates increased 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 their business formats, 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) system and operations management system so as to contribute to further effective inspection. We also attempt to grasp the status of digitization in audit engagements and cybersecurity measures taken by each audit firm. 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 especially influenced by the leadership of top management, we understand top management's awareness towards the current status of audit quality and efforts for improvement. And we conduct hearings 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 notified as results of inspections to small and medium-sized audit firm, partnership and solo practitioner, we follow up the progress of improvement through collecting reports about their mitigation after a set period of time or conducting hearings as needed.

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 "Unsatisfactory and in need of immediate remediation in operations management system,.etc (Overall rating 4)," 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 40)).

b. Implementation

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

In PY2021, the CPAAOB collected reports from all large-sized audit firms and mid-tier audit firms in order to review their business management (governance) system, operations management system, etc. Furthermore, we analyzed the information through the collection of reports and utilized the analysis results to ensure effective and efficient inspection, and also

conducted inter-corporation fact-finding of business management (governance) system and operations management system at large-sized audit firms and mid-tier audit firms.

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

In PY2021, reports were collected from 43 small and medium-sized audit firms (mainly from those subject to quality control reviews in PY2020) chosen on the basis of results of the reviews. The reports contained recommendations for improvement issued by quality control review, matters related to business management (organizations and manpower, arrangement and implementation of training, etc.), matters related to the global network of audit firms, the impact of and responses to COVID-19 infections, key audit matters (KAMs) and so forth.

Of the 43 firms, 11 firms (those deemed to have concerns about operating management systems according to their reports, founded in the recent past and larger than a set scale, etc.) were subjected to face-to-face or online hearings.

At the hearing, we have intensively heard about the development of quality control systems including responses to review findings, top management's management policy, organizations and human resources, and so forth, while conveying the CPAAOB's awareness of problems, to promote the establishment of quality control that can ensure proper audit services.

While the hearings identified concerns about the quality control system, etc. at certain audit firms as described below, firms larger than a set scale were found to have distinctive cases of management system, etc., in comparison to other firms. These results will be used as important reference information in future examination, inspection and so forth.

- To address recommendations for improvement in the previous review, top management of a firm has been trying to figure out root causes but received the same recommendations in the latest review due to inadequate efforts.
- Although a firm has implemented measures to address recommendations for improvement, all audit staff has possibly carried them out without fully understanding the purport of the measures because review results are not shared with part-time staff but only among partners.
- A firm is prompting the appointment of new partners, conscious of the change of generation as an urgent issue due to the high average age of its existing partners. But such effort has failed to advance as candidates decline to join on the grounds that partners have unlimited liabilities.
- Firms larger than a certain scale have adopted distinctive programs, such as computerization of audit working papers, exchange of personnel with member firms of a global network they belong to, and dispatch of employees to quality control reviewers.

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

In PY2021, among small and medium-sized audit firms etc. that had been notified of inspection results by the CPAAOB in past program years, the CPAAOB collected reports from one audit

firm 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, three firms were assessed to be "unsatisfactory and in need of immediate remediation". In PY2021, of the three, one firm, from which a report was collected simultaneously with the notification of inspection results, continually reported the improvement of operations management. Another firm reported the implementation of improvement efforts, including an improvement plan simultaneously with the notification of inspection results.

These firms include those in which the implementation of audit services is unsatisfactory and there are many deficiencies in the audit of specific companies listed in Japan, in which integrated organizational management is not implemented and the development and implementation of organized operations management system are unsatisfactory, and in which an organizational culture to place emphasis on the quality of audit services has yet to be fostered and the development and implementation of quality control system are unsatisfactory.

6. Inspections

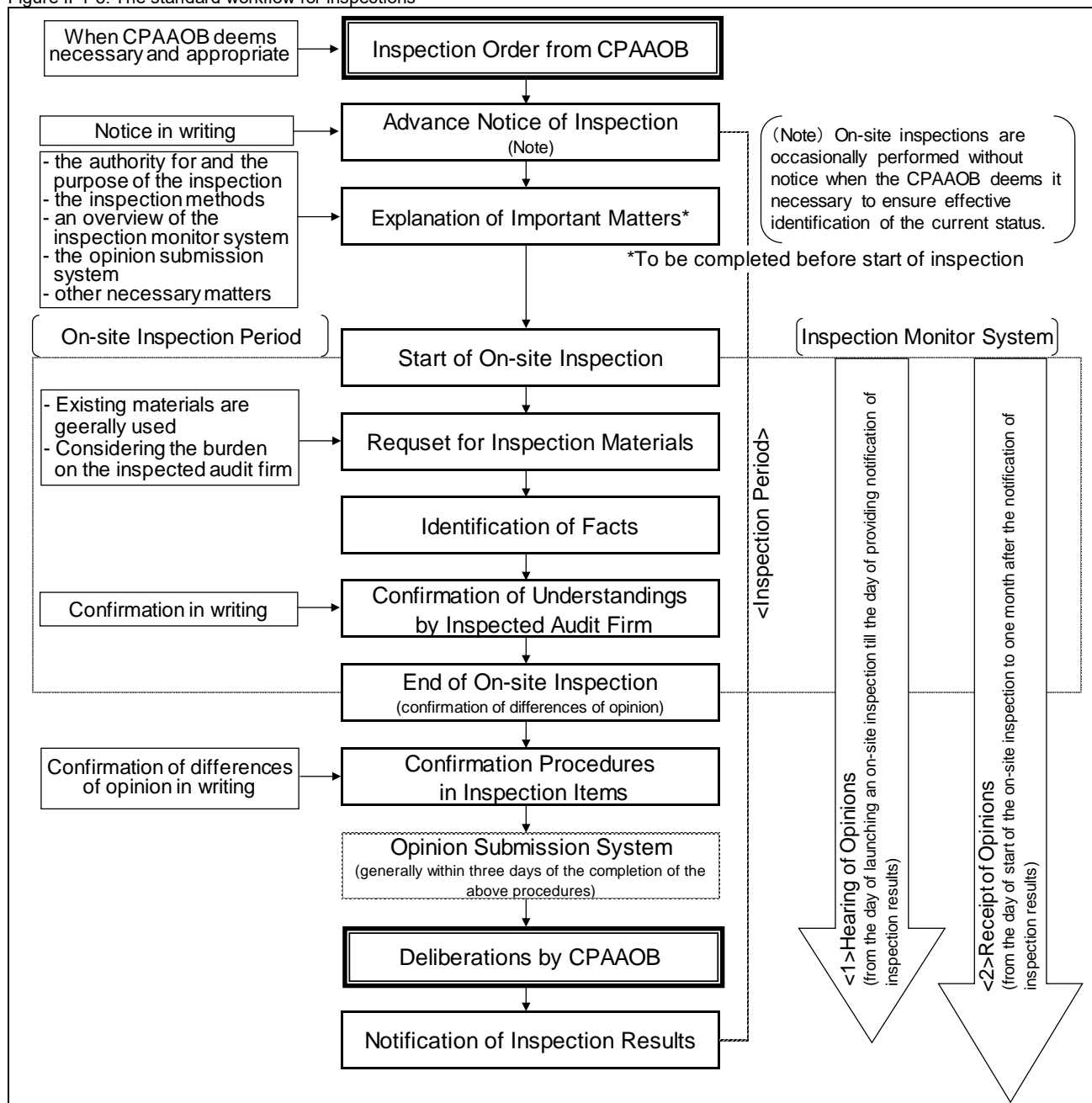
a. Overview

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 2022).

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	2017 (Note 2)	2018 (Note 2)	2019 (Note 2)	2020 (Note 2)	2021 (Note 2)
Large-sized audit firms	4(2)	4(2)	4(2)	4(2)	4(2)
Mid-tier audit firms	2	1	2	2	1
Small and medium-sized audit firms, partnerships and solo practitioners	3	5(1)	3	4	4
Foreign audit firms, etc. (Note 2)	0	0	1	0	0
Total	9(2)	10(3)	10(2)	10(2)	9(2)

(Note 1) Figures in parentheses are the number of follow-up inspections.

(Note 2) See "B. Foreign Audit Firms" (page 44) 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)	8	7	12
Average number of inspectors(headcount)	9.1	7.1	5.6
Average inspection period(calendar days)	175.3	131.7	130.6
Average number of inspected audit engagements (companies)	6.4	5.0	3.2

(Note 1): Inspections conducted and completed in the five years from PY2017 through 2021 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) Inspection period means the period(calendar day basis)between 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 the date on which notification of the inspection results was issued. Corrected in PY2022 due to errors in the previous period of inspections.

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

ii. Deficiencies

a. Characteristics of deficiencies identified through inspections of quality control system

Results of the CPAAOB inspections in and after PY2019 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 audit sites, 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 verification of effectiveness, etc. (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 51)).

Although mid-tier audit firms made structural improvements to take systematic approaches, they are facing problems amid expansion of operations, such as the need to strengthen the functions of the headquarters, and to verify the penetration of quality control measures into audit sites and their effectiveness. 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.

It was found that small and medium-sized audit firms etc. lack understanding of the levels of quality control and auditing procedures required by the existing auditing standards, or do not fully understand the means and the depth of analysis concerning causes of deficiencies pointed out in quality control review, etc., which is necessary for preventing an occurrence of similar deficiencies. In addition, there were firms that were not fully capable of auditing the listed companies with high risk.

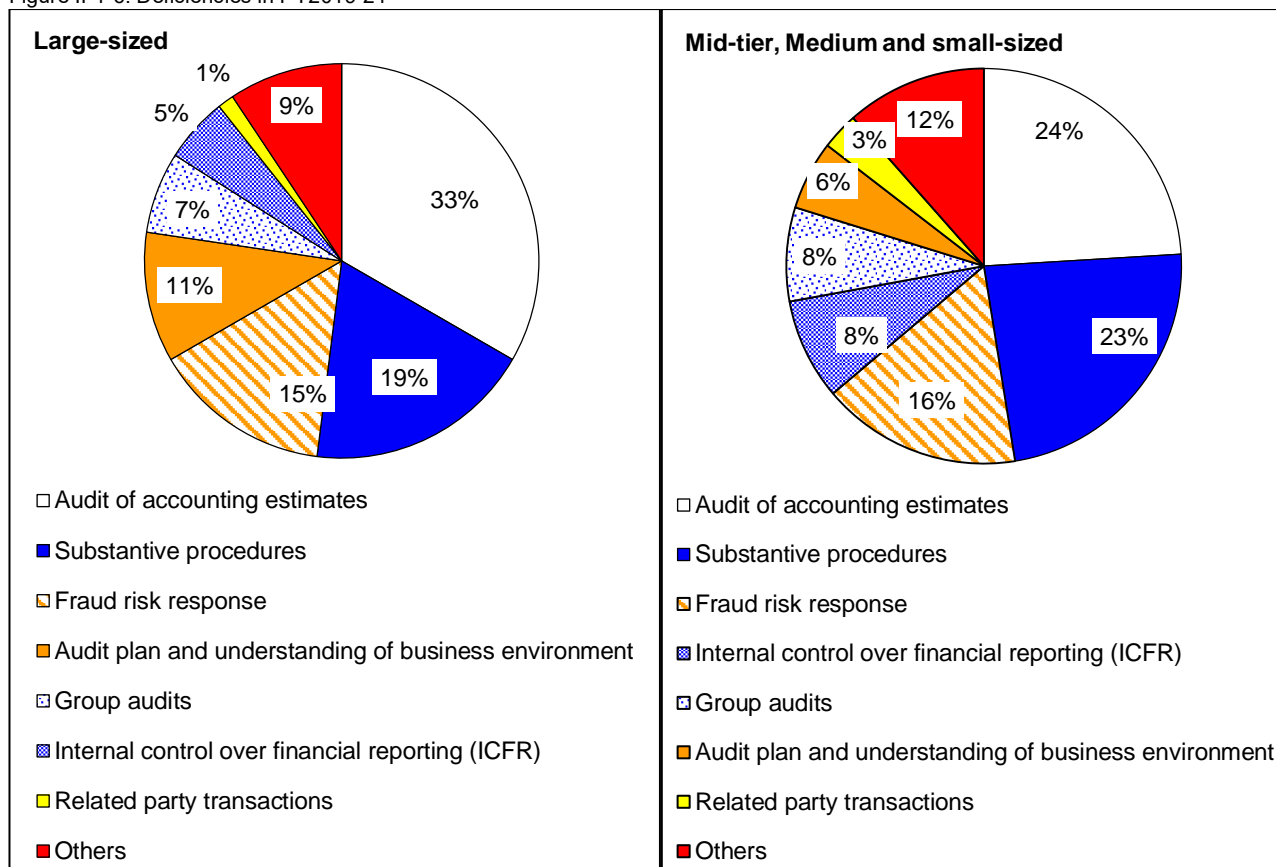
b. Characteristics of deficiencies identified through inspections of audit engagements

Deficiencies identified through inspections of audit engagements from PY2019 to PY2021 can be classified in line with the ASCS structure as follows (Figure II-1-6).

Regardless of the size of audit firms, deficiencies related to the audit of accounting estimates were the most common, followed by 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 address the risk of material misstatements). In addition, deficiencies concerning dealing with fraud risk were continually found. 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.

Figure II-1-6: Deficiencies in PY2019-21



(Note) Classifications of deficiencies noted at four large-sized audit firms (total), five mid-tier audit firms, and 11 small and medium-sized audit firms

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

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-1-7⁷.

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)

a. “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

⁷ 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

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

<p>1. Key points</p> <p>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.</p> <p>(1) Operations management environment</p> <p>...(presents problems with its governance and operation of services)</p> <p>(2) Quality control environment</p> <p>...(presents deficiencies in the system of quality control)</p> <p>(3) audit engagements</p> <p>...(presents deficiencies in audit services)</p>
--

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 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.

b. Overall rating grades

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 system, quality control system and audit engagements. Each grade is assessed with the following descriptions (for changes in the description of assessments that took effect starting with inspections in PY2021, see "II. The CPAAOB Monitoring A. Overview of System and Situation with Implementation 7. Notification of Inspection Results g. Review of assessment result descriptions in overall ratings" in 2021 Monitoring Report.

"Satisfactory" (Overall rating: 1)

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

"Generally Satisfactory with minor deficiencies" (Overall rating: 2)

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 system, quality

control management or audit engagements.

"Unsatisfactory due to presence of significant deficiencies that need to be fixed" (Overall rating: 3)

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

"Unsatisfactory and in need of immediate remediation in operations management system, etc." (Overall rating: 4)

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

"Extremely unsatisfactory" (Overall rating: 5)

The description is used when significant deficiencies are identified in the quality control system 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 (overall rating 4)," 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 32). In the case of an audit firm rated as "extremely unsatisfactory (overall rating: 5)," we make recommendations concerning administrative actions and other measures to the Commissioner of the FSA.

c. Distribution of overall ratings

The distribution of overall ratings for regular inspections launched and completed between PY2016 and PY2021 is shown below (Figure II-1-9).

No audit firms were qualified as "satisfied (overall rating: 1)," the highest grade in the overall rating scheme. All audit firms, therefore, were rated as "generally satisfactory with minor deficiencies (overall rating: 2)" or lower based on the assessment of their operations management system, 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 based on recommendations in quality control reviews, etc. - 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 awareness of recent environmental changes pertaining to accounting and auditing understanding of adequate 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
Satisfactory" (Overall rating: 1)	-	-
Generally satisfactory with minor deficiencies" (Overall rating: 2)	4	3
Unsatisfactory due to presence of significant deficiencies that need to be fixed" (Overall rating: 3)	5	6
Unsatisfactory and in need of immediate remediation in operations management system, etc." (Overall rating: 4)	-	6
Extremely unsatisfactory" (Overall rating: 5)	-	8

(Note 1) Totals for audit firms subject to regular inspections that were commenced and completed between PY2016 and PY2021

(Note 2) For audit firms underwent multiple regular inspections in the period under review, overall ratings in the latest inspection are tallied.

In the PY2021 version of the "Certified Public Accountants and Auditing Oversight Board's Annual Report", all overall ratings in multiple regular inspections in the period under review were tallied.

d. 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 companies⁸.

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 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.

e. Handling of inspection results

An inspected audit firm is required to obtain prior consent from the CPAAOB to disclose⁹ 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 directions) at parent companies of audited firms and potential audited companies (e.g., companies considering which accounting auditors to appoint).

However, 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),

⁸ 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).

⁹ Details on disclosing inspection results to third parties are listed on the CPAAOB website.

and presents them to the JICPA based on rules of the JICPA Quality Control Committee's detailed operational rules pertaining to the handling of notification documents for inspection results.

This approach is expected to facilitate communication between auditors and others of 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 status of establishment and implementation of quality control systems by accounting auditors.

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 35 foreign audit firms in 14 countries/regions in PY2021. 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.

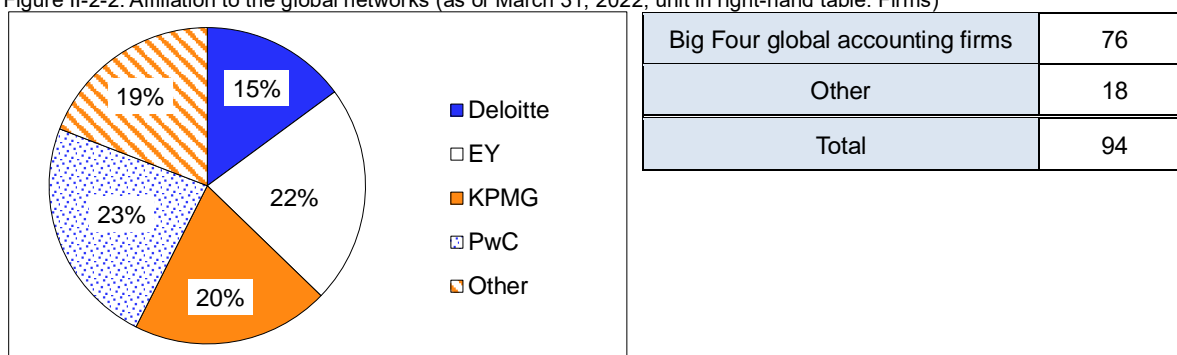
Figure II-2-1: Number of registered foreign audit firms, etc. (as of March 31, 2022)

	Number of countries/regions	Number of foreign audit firms, etc.
Europe	15	56
Asia-Pacific	10	27
North America	2	9
Central/South America	1	1
Middle East	1	1
Total	29	94

(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, 2022; unit in right-hand table: Firms)



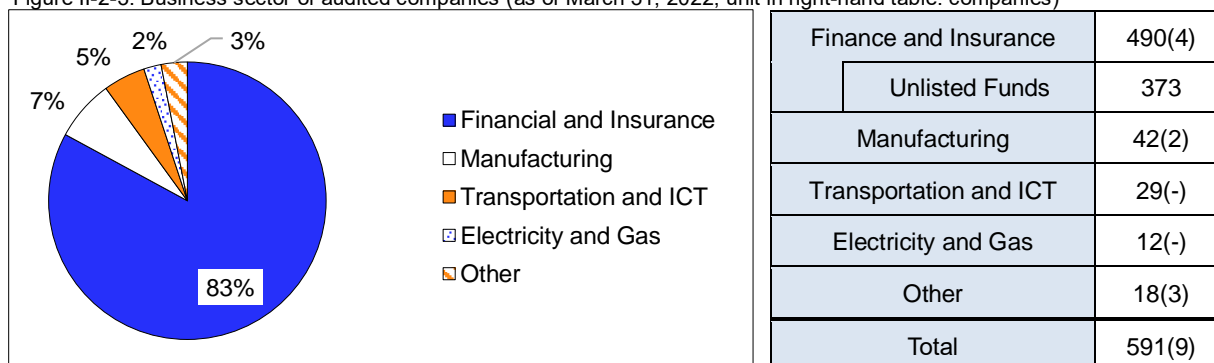
(Note) Compiled the foreign audit firms under the Big Four global

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, 83% are classified as finance and insurance, and around 76% of these are unlisted funds (Figure II-2-3).

Figure II-2-3: Business sector of audited companies (as of March 31, 2022; 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)

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 objectives and approach for 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 2022 – March 2025) is presented on the CPAAOB's website, but monitoring perspectives, objectives, etc. are summarized below:

[Principal Points in the Basic Policy]

The 7th Cycle of the CPAAOB will encourage audit firms on a continuous basis to voluntarily ensure and improve the quality of audits and achieve the appropriate management of operations, including the quality control of audits, through effective and efficient monitoring, taking into account rapid changes around audit firms, such as the digitization of the entire society, spread of COVID-19 infections and changes in the international situation, including the Ukraine problem. In particular, the following points will be emphasized in monitoring.

- Confirmation and validation of preparedness for smooth introduction of quality control system and responses to it at audit firms

As the standard on quality control for audits has been revised, audit firms will be required to introduce a quality control system based on the following risk approaches(*):

- a. To set quality objectives
- b. To identify and assess quality risks that will block the achievement of quality objectives
- c. To determine and implement a policy or process of addressing assessed quality risks, and
- d. To correct deficiencies, if any, based on root causes

The 7th Cycle of monitoring by the CPAAOB will lay weight on audit firms' preparedness for the introduction of such a system and responses to it and post-introduction improvement and operation of the system.

(*) The revised quality control standards will become applicable, starting with the auditing of financial statements in the business year or fiscal period that will begin after July 1, 2023 (In the case of audit firms other than large-sized audit firms as defined by the Certified Public Accountants Act, the application will take effect in the business year or fiscal period that will begin after July 1, 2024).

- Securement and improvement of service quality at audit firms that audit listed firms

In auditing listed companies, the replacement of large-sized audit firms with mid-tier or small and medium-sized audit firms continues. The role of mid-tier, small and medium-sized audit firms in

auditing listed companies is thus expanding.

As a result, the 7th Cycle will put greater emphasis on the inspection of small and medium-sized audit firms considered in need of immediately ensuring and improving the quality of audits.

2. Basic Plan for Monitoring Audit Firms in Program Year 2022

The entire text of the Basic Plan for Monitoring Audit Firms in Program Year 2022 (July 2022 - June 2023) is presented on the CPAAOB's website), but monitoring priorities, etc. are summarized below.

[Basic Plan for Monitoring (Non-inspection basic plan)]

a. Examination of JICPA's quality control reviews and cooperation with JICPA

The CPAAOB examines the effectiveness of the JICPA's quality control reviews and shares findings with the JICPA through the exchange of opinion and other processes to encourage the JICPA to adopt measures to ensure and improve the quality of audits. Based on the legalization of the Registration System for Listed Company Audit Firms, the CPAAOB will encourage further improvement in the effectiveness of the quality control review.

b. Collection of reports

Quantitative and qualitative information on the operations management system, etc. at large-sized and mid-tier audit firms is collected and analyzed on a regular basis from the viewpoint of efficiently implementing inspections.

For small and medium-sized audit firms etc., information matching their scale and features is collected and analyzed at the CPAAOB's discretion, taking into account results of the JICPA's quality control reviews, audit risks related to listed company and so forth. Hearings are also conducted on reports, when necessary, to encourage voluntary efforts to ensure and improve the quality of audits.

In collecting reports, responses to the revision of the quality control standards, the process of accepting and cancelling audit contracts and so forth are principal inspection and verification points. Small and medium-size audit firms etc. are especially examined on whether they have established appropriate operations management and quality control systems as auditors of listed companies. In addition, the operations policy of their top management and the earnings and financial structures of them, which greatly affects the securement and improvement of audit quality, are primarily figured out.

c. Collection, analysis, etc. of information pertaining to audit firms

Regular dialogues with executives, including the top management, of large-sized and mid-tier audit firms are held in a bid to collect the latest information on their operations management system, etc. and share awareness of problems. As the number of listed companies audited by small and medium-sized audit firms etc. is increasing, dialogues with small and medium-sized audit firms etc., which engage in services including the audit of listed companies, are conducted when necessary.

[Basic Inspection Plan]

The CPAAOB inspects all audit firms with common key inspection matters described hereafter: commitment of the management of audit firms to improve audit quality, effectiveness of operations management and quality control system, fraud risks, accounting estimates, recognition of earnings, implementation of audit procedures pertaining to group audits, etc. Inspections are held as follows.

a. Large-sized audit firms

The CPAAOB in principle 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, taking the burden on audit firms into account. It primarily inspects the implementation of measures and so forth to address issues pointed out during regular inspections. (There are cases in which reports are collected in places of inspections to confirm the exercise of remedy measures.)

In the inspection of large-sized audit firms, the CPAAOB primarily pays attention to the monitoring of audit engagements by the quality control section, deficiencies in audit procedures in case of fraudulent accounting at an audited company, including a case in which an audit firm is involved from the stage of preparations for an initial public offering (IPO), post-factum verification of their causes and implementation of remedy measures, etc.

b. Mid-tier audit firms

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

In the inspection of mid-tier audit firms, the CPAAOB primarily pays attention to the awareness of quality control among management, including the top managements, cooperation between the quality control section and the vanguard of auditing (business section), and monitoring of audit engagements by the quality control section.

c. Small and medium-sized audit firms

In the inspection of small and medium-sized audit firms etc., the CPAAOB examines the immediate need of confirming their quality control systems and carries out the inspection taking into account such factors as the JICPA's quality control review results and the degree of risks pertaining to audited companies. Given an increase in the role of small and medium-size audit firms in auditing listed companies, the CPAAOB will place more importance on the inspection of them.

The inspection of small and medium-sized audit firms etc. especially pays attention to their efforts to foster an organizational culture to respect law and professional ethics as well as partners and staff members' professional ethics and awareness of independence and legal and other forms of compliance, etc.

d. Foreign audit firms and others

In the case of foreign audit firms and others, the CPAAOB will inspect those selected based on

results of reports collected in PY2021 and other factors. It will take the spread of COVID-19 infections and other conditions into account for inspecting them. It will also conduct advance consultation and coordination with audit and supervisory authorities in jurisdictions that foreign audit firms, etc. belong to.

III. Operation of Audit Firms

III. Operation of Audit Firms

A. Operations Management System

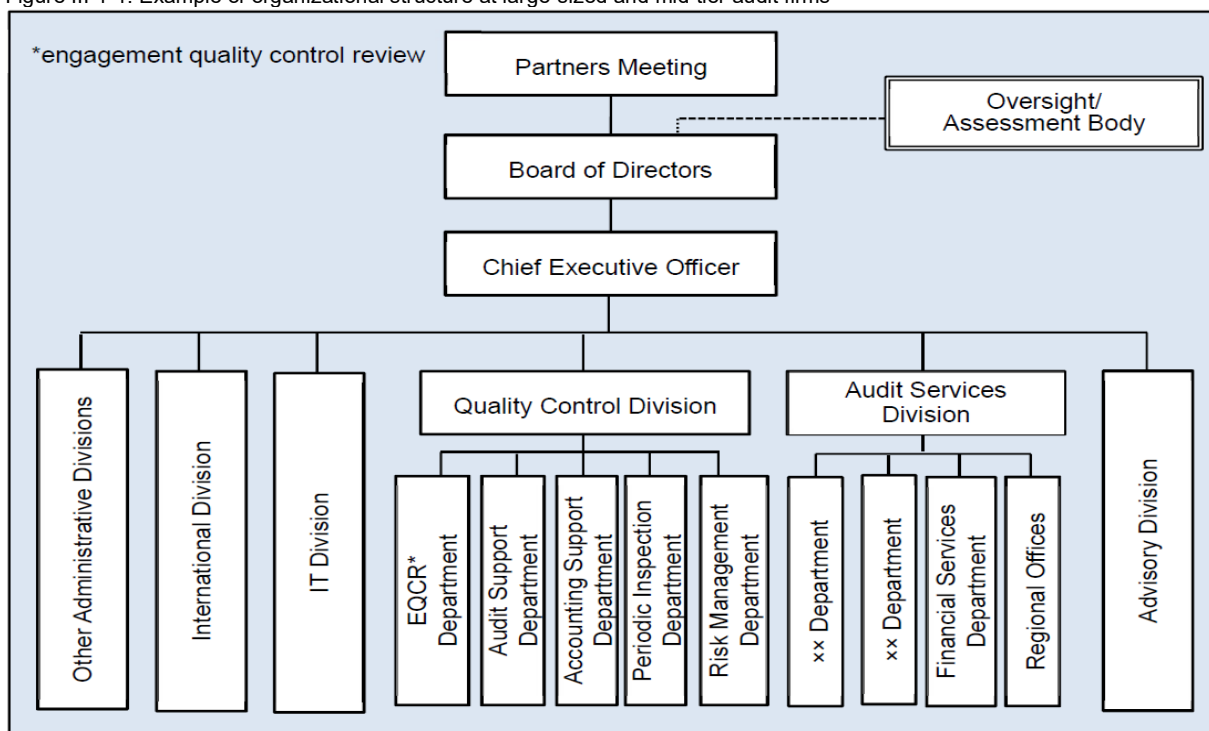
1. Organizational Structure of Audit Firms

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. Large-sized and mid-tier audit firms have structures more focused on functions than those seen at small and medium-sized audit firms (Figure III-1-1).

Large-sized audit firms have established sector-specific departments within the audit services division, for example, financial service division. 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

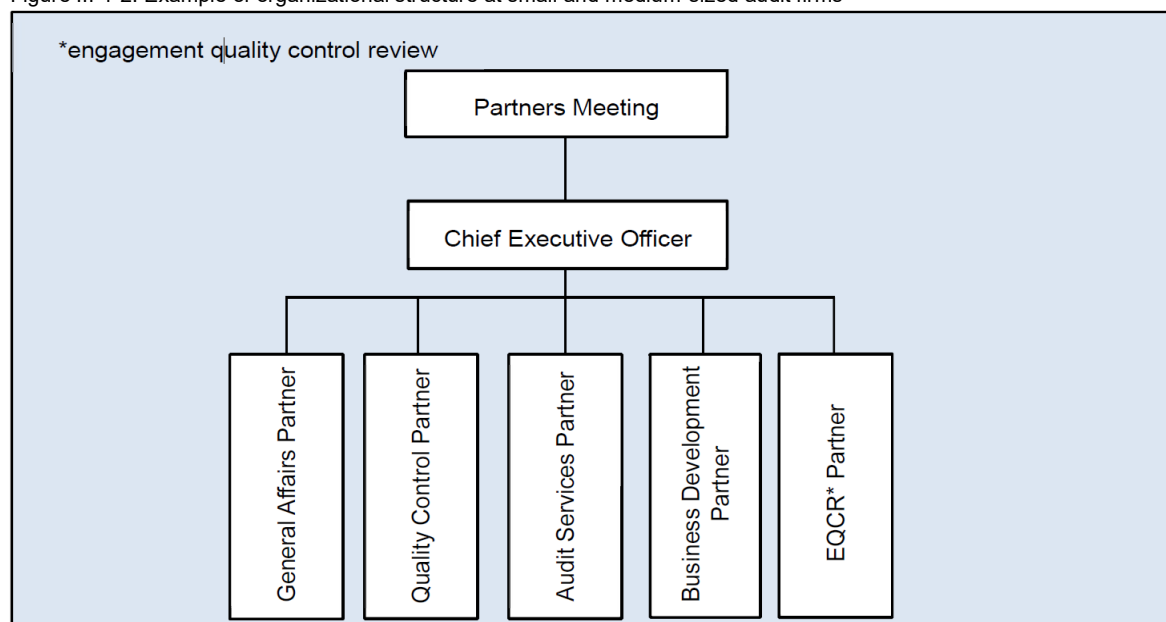


(Note) The organizational structure of mid-tier audit firms is often simpler than the structure shown in the above figure.

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 hierarchization of operations, such as transferring certain quality control functions to a section in charge of audit engagements. As a recent trend, principal responsibility for quality control is shifting from the quality control section at the headquarters to the audit services section, which is closer to audit site. There are cases in which the audit services section sets up a quality control committee to monitor auditing by the audit services section in cooperation with the quality control section at the headquarters and an independent monitoring section is established under an official concurrently in charge of the quality control and audit services sections to monitor the development of the quality control organization and the effectiveness of its operation.

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 system 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 such as operating their own accounting office 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	Approx. 170 to 600	Approx. 30 to less than 100	Up to approx. 40 (Note)
Number of full-time personnel	Approx. 2,800 to 6,600	Approx. 200 to over 800	Up to approx. 90 (Note)
Decision-making bodies	<ul style="list-style-type: none"> The highest decision-making body is the partners meeting A board of directors and an executive committee are set up under the partners meeting 	<ul style="list-style-type: none"> The highest decision-making body is the partners meeting A board of directors is set up under the partners meeting 	<ul style="list-style-type: none"> Most decisions are made at the partners meeting Larger firms have a board of directors beneath the partners meeting
Oversight/assessment bodies	<ul style="list-style-type: none"> A body is established to supervise/assess business execution bodies such as the board of directors 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 Third parties with independence ("independent third parties") serve as members of oversight/ assessment bodies and subcommittees 	<ul style="list-style-type: none"> Oversight/assessment bodies are established but their powers are limited compared with those at large-sized audit firms Many firms do not establish subcommittees for nomination, compensation, and audit 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. 	<ul style="list-style-type: none"> Many firms have systems of checks and balances between partners without establishing oversight/assessment bodies. Many firms do not appoint independent third parties
Design of business operation departments	<ul style="list-style-type: none"> Multiple audit services departments are established, and firm-wide operation including regional offices is also conducted A department specializing in financial services is established Departments in charge of quality control, risk management are established 	<ul style="list-style-type: none"> Management of firms, including regional offices, in addition to the establishment of multiple audit engagement sections A department in charge of quality control are established 	<ul style="list-style-type: none"> Many firms appoint partners to handle the particular services without establishing particular departments Larger audit firms have set up organizations that resemble those of mid-tier audit firms
Number of offices	<ul style="list-style-type: none"> 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). 	<ul style="list-style-type: none"> Besides the firm's main office, there are often also offices in metropolises (Tokyo, Osaka and Nagoya) 	<ul style="list-style-type: none"> Many firms only have a main office
Design of quality control divisions	<ul style="list-style-type: none"> 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 A risk management department, which is responsible for monitoring of audit contracts, independence, and audit risks, is established Audit services departments also often have quality control functions 	<ul style="list-style-type: none"> Some of the departments under a quality control division Some also have a department for engagement quality control reviews 	<ul style="list-style-type: none"> Many firms appoint partners to handle both quality control and audit engagements without establishing quality control departments Some small firms' representatives are also in charge of quality control

(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 open-minded 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, 2022, all large-sized audit firms and mid-tier audit firms as well as nine small and medium-sized audit firms had announced adoption of the Audit Firm Governance Code¹⁰.

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.

¹⁰ 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

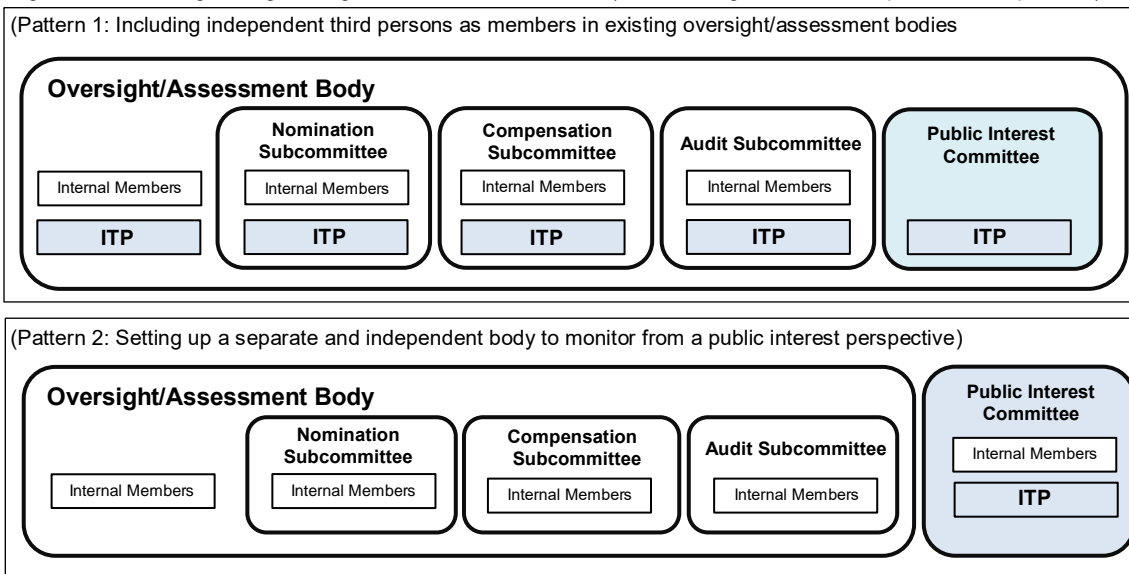
The publication of the Audit Firm Governance Code has prompted mid-tier audit firms to make efforts to establish independent bodies, such as public-interest committees that are comprised of independent third parties as oversight/assessment bodies. However, with the exception of some firms, they have 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 provide independent third persons with the information they need in a timely and appropriate manner so that effective discussions are conducted. 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 constituting of independent third person . 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 determined the authority that allows independent third persons to obtain information proactively.

(iii) Small and medium-sized audit firms

Oversight/assessment bodies established in small and medium-sized audit firms often consist of in-house partners and independent third parties. In many cases, the audit firms provide information to independent third parties through the oversight/assessment bodies and exchange opinions at meetings of business execution bodies. The range of information provided to independent third parties and that of business execution bodies' meetings attended by independent third persons differ from audit firm to audit firm. The degree of utilization of knowledge of outside experts thus varies.

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	2	—	—

(Reference) Prepared by the CPAAOB from CPAAPB inspections and reference material released by each audit firm in PY2021. 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 audit quality indicator (AQI) 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, and gave accounts for measures for disclosure of non-financial information and responses to new Quality Control Standards in FY2021.

(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

Six out of nine 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 and dialogues, related to the quality of audits, of chief financial officers (CFOs), auditors and others of audited companies. Recently, 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.

The current Audit Firm Governance Code has not been reviewed since it was drawn up in March 2017 and is said to include principles and rules that do not fit in with the management of small and medium-sized audit firms. A report released by the Subcommittee on the Certified Public Accountant System of the Financial System Council in January 2022 said that it is plausible to require audit firms, which audit listed companies, to comply with the Audit Firm Governance Code as a form of discipline. But as the current code is formulated with the organizational management of large audit firms in mind, the report recommended that amendments to the code should be examined so as to equally contribute to the securement of quality in the auditing of listed companies by mid-tier audit firms and small and medium-sized audit firms and adopt principles for the effectiveness of audits in accordance with the scale and other factors of audit firms.

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 13).

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.

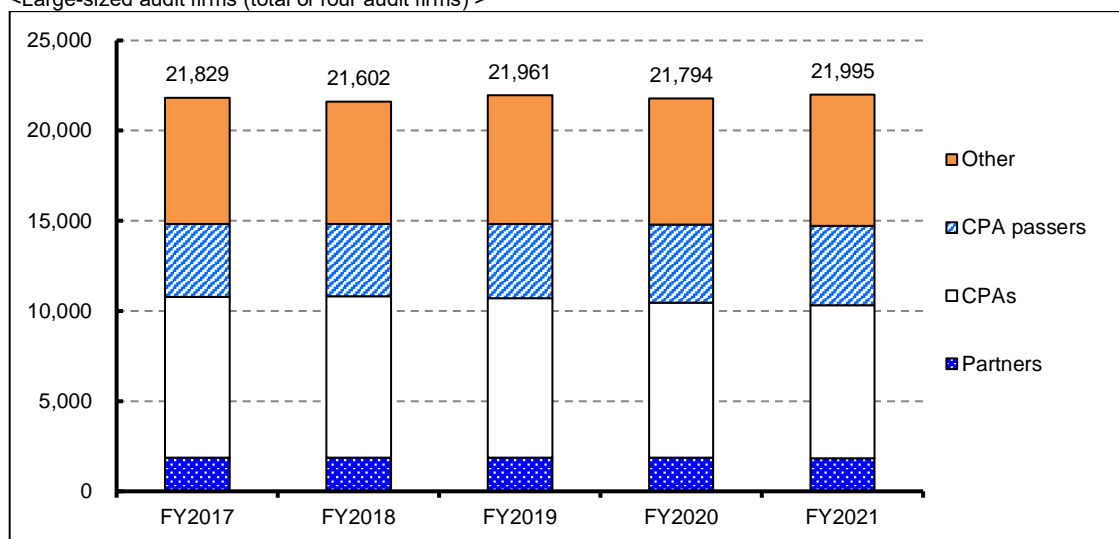
The number of partners and full-time staff members, analyzed on the basis of scale, has generally leveled off at large audit firms since FY2017 and has been on the rise at mid-tier audit firms during the same period. At small and medium-sized audit firms, it turned upward in FY2017 due in part to the 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. turned to increase in or after FY2019 at all audit firms in disregard of scale. The number of staff members other than CPAs and CPA examination passers, has also been on the rise at all audit firms in recent years. According to the latest data, non-CPA staffs account for 33% 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 FY2017 (FY2016 in the case of small and medium-sized audit firms), the ratio rose sharply from 25% and 14% at mid-tier audit firms and small and medium-sized audit firms, respectively, and slightly from 32% at large-sized firms (see Figure III-1-6).

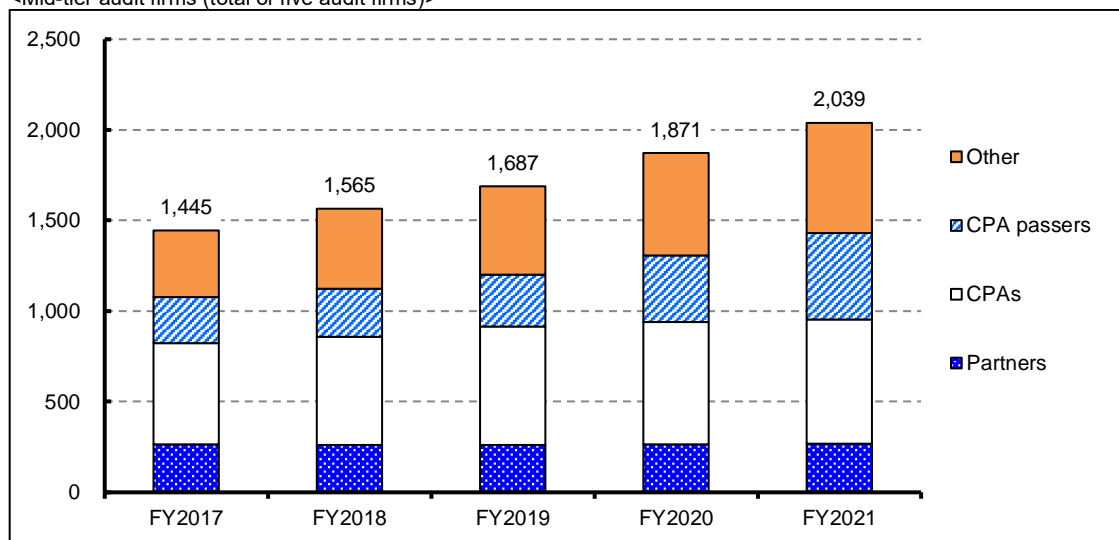
Audit firms have increased their staff members other than CPAs and CPA examination passers, to deal with the audited companies promoting IT, to improve operational efficiency, to address personnel shortages, and to facilitate CPAs to focus more on judgmental tasks, and so on. Among these personnel are IT experts who conduct IT audits with the use of technologies and support engagement teams in carrying out audit procedures using IT, 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 specialized organizations to centrally manage such things as audit assistants' work/procedures, skill development, and job allocations.

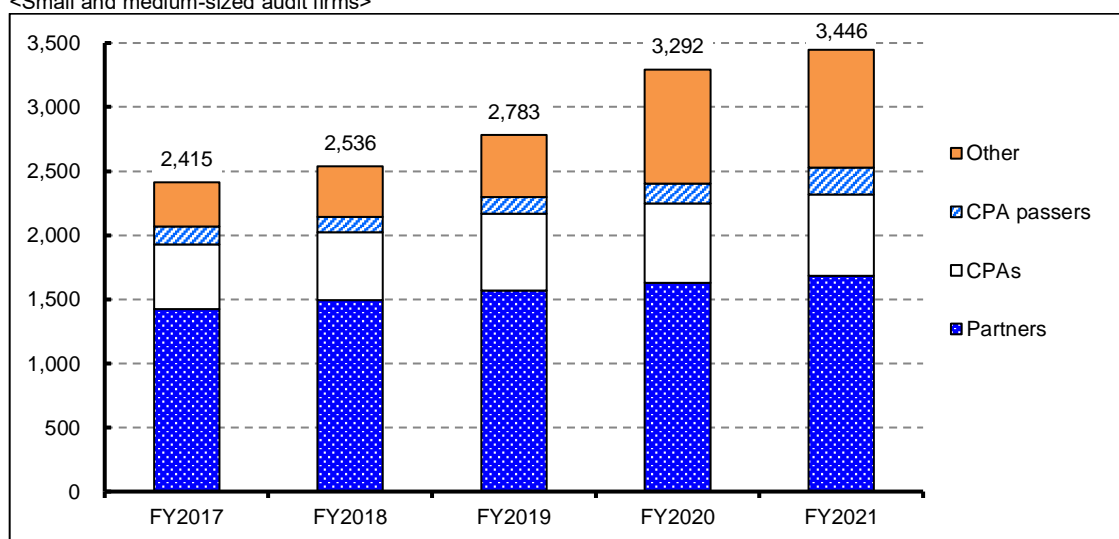
Figure III-1-6: Change in the number of partners and full-time personnel (unit: persons)
 <Large-sized audit firms (total of four audit firms) >



<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 FY2020.

(Note 2) The number of small and medium-sized audit firms varies from year to year, but 237 such firms are included in the figures for FY2020.

■ Promotion of remote work at audit firms ■

Amid the global spread of novel coronavirus infections since early in 2020, society-wide anti-infection efforts have been underway in Japan as in other countries.

Under the unavoidable behavioral restrictions as part of anti-coronavirus measures, the way of offering audit services has greatly changed. Audit firms have been promoting operations incorporating remote work on top of the conventional method of sending auditors to client companies.

Audit firms continued efforts, as mentioned in the chart below, in PY2021 to select optimum places of work based on purposes in order to simultaneously implement anti-coronavirus measures and high-quality audit services effectively and efficiently.

Place of work	Main purposes
Home	<ul style="list-style-type: none"> • Efforts for new ways of work • Anti-coronavirus measures, etc.
Audit firm	<ul style="list-style-type: none"> • Promotion of communication within the audit team • Human resources development through training and other programs, etc.
Audited companies	<ul style="list-style-type: none"> • Promotion of communication with audited companies • Reading of original texts and others, etc.

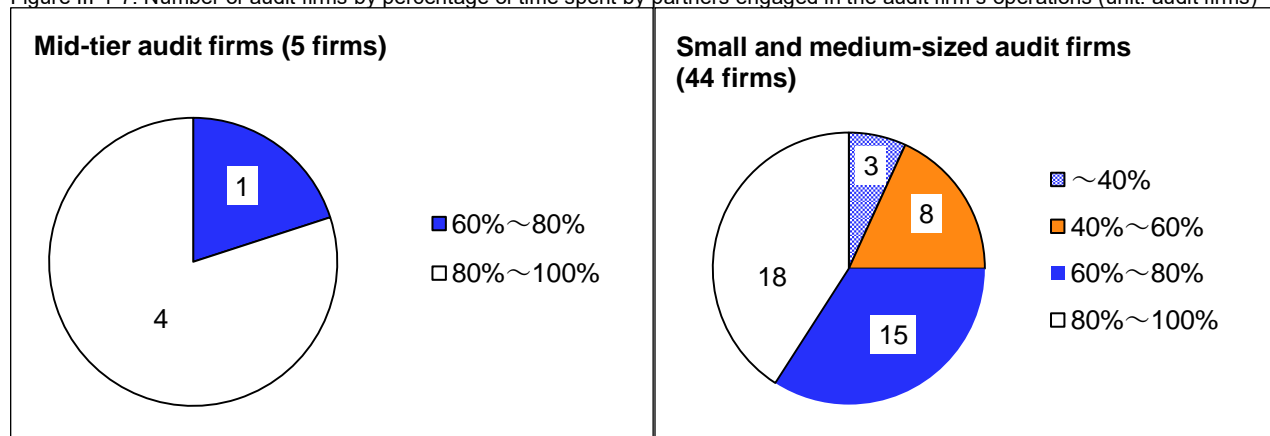
b. Side businesses by partners

Large-sized audit firms do not permit dual work by partners at tax accountant offices or solo private accountant offices 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 those having dual work among all partners is about 60% 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 ratios of 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 as ascertained through inspections and collection of reports.

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 PY2021 the CPAAOB inspections and collection of reports

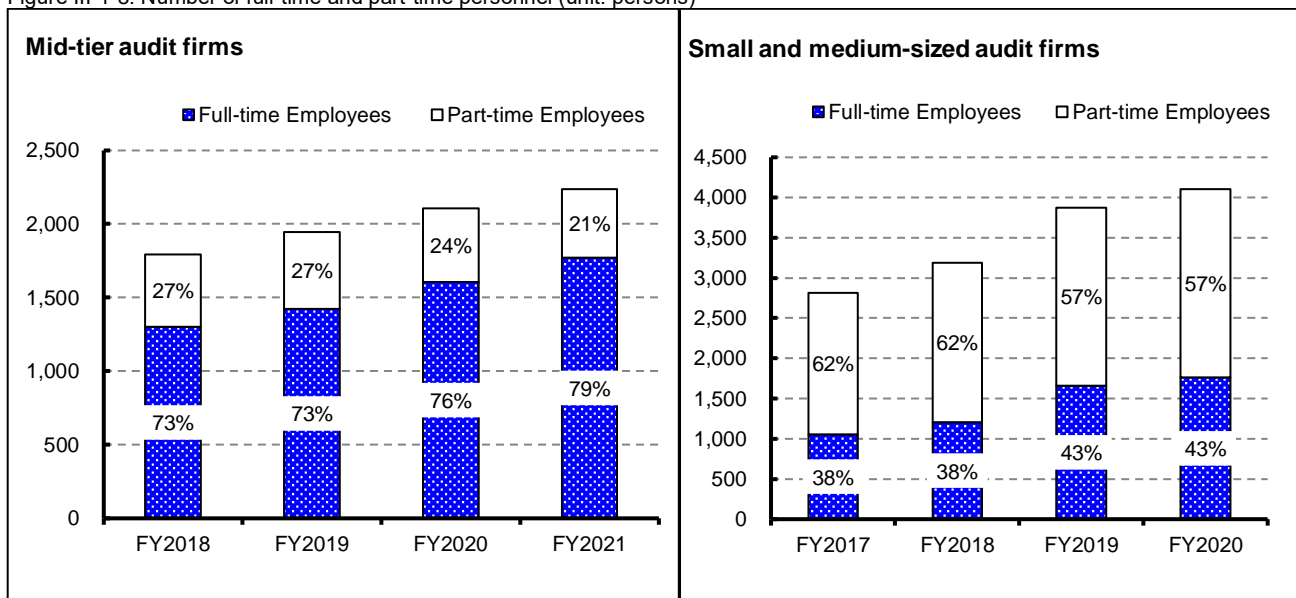
c. Part-time personnel

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 40% at some of them.

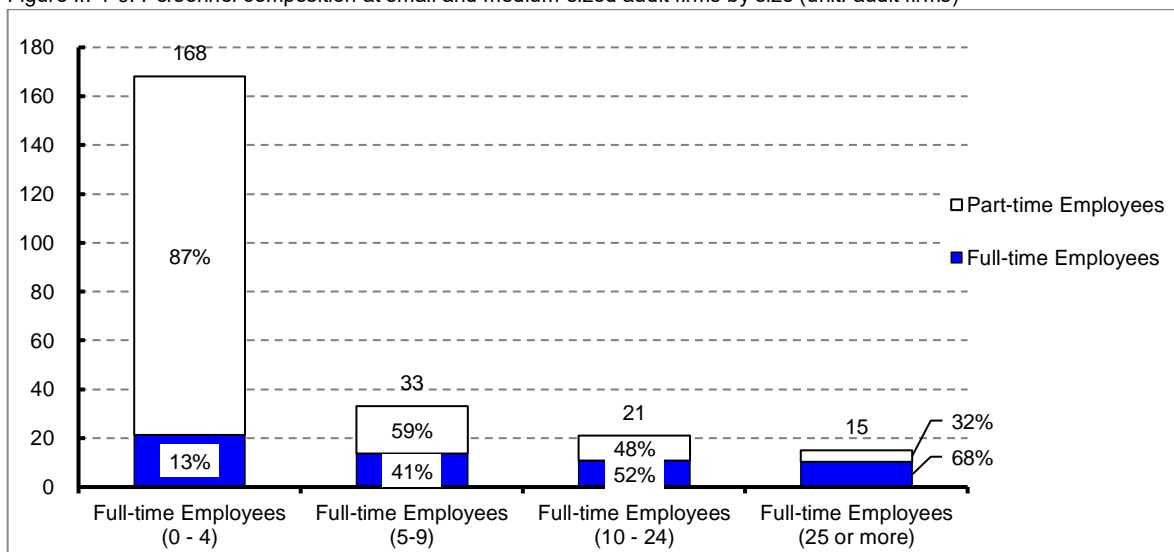
The ratio of part-time staff members stands at around 60% at small and medium-sized audit firms, some of which rely on them as the audit assistants needed for their operation (see Figure III-1-8). In particular, at audit firms with a full-time staff of four or less which occupies around 70% of small and medium-sized firms, 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 237 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 FY2020, 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 skepticism¹¹, 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. 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 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

¹¹ 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 instruction and supervision of engagement partners. Inexperienced CPAs, CPA examination 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 separately established center for enabling CPAs to concentrate on work requiring their professional judgment by reducing their workload.

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 resources 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 members with primary responsibility for auditing tend to play larger roles, such as needing to 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.

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

(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 support system

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: contract management, periodic review in relation to a system of quality control, accounting support, audit support, engagement quality control review, IT, international services, and risk

management (Figure III-1-12). See "B. Engagement Quality Control Reviews" (page 71) and "C. Monitoring of Systems of Quality Control" (page 73) 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 introducing, 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 69).

In addition, there is a case where large-sized audit firms establish organizations in charge of not only menial tasks, such as sending and collecting balance confirmation documents, checking the descriptions of securities reports, and entering and processing data for use by CPAs in audits but also confirmation work in certain audit services, such as management assessment procedure related to internal control, in order to enable CPAs and others to concentrate on tasks requiring their professional judgement. 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' check process for their works. With regard to the confirmation of balances, Audit Confirmation Center GK, jointly founded by large-sized audit firms in November 2018, has jointly developed a system to confirm receivables and obligations, provided an online platform related to the confirmation of balances, and is being entrusted with operations to send balance confirmation documents, etc. 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 international network. There are many cases that small and medium-sized audit firms do not have a quality control section and instead appoint a person in charge of quality control or top management 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 take steps like 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	Contract management department	Approving acceptance and continuance of audit engagements
	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
Risk management division		Responding to inquiries concerning professional ethics and independence, collecting and analyzing risk information, supporting responses to risk of fraud, 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

<p>[Actions taken by risk management department]</p> <ul style="list-style-type: none"> • Developing a database of past fraud cases and sharing that information within the audit firm • Selecting high-risk audit engagements through gathering information for past and current years and implementing continued monitoring and support to engagement teams • Establishing a procedure to obtain internal or external expert advice when a situation which indicates material fraudulent misstatement or a suspicion of material misstatement caused by fraud is identified , Issuing instructions for the launch of higher-level review • 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 <p>[Actions taken by engagement teams]</p> <ul style="list-style-type: none"> • 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 	
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6. Domestic Audit Firm Groups

a. Structure of domestic audit firm groups

Many large-sized and mid-tier audit firms have formed their own audit firm groups that use common brand of global networks they have joined. And within the group, audit firm and other entities cooperate with each other in providing services in Japan (hereinafter, such groups are referred to as "domestic audit firm groups"). Besides the audit firms, these groups generally include consulting companies, financial advisory companies that carry out financial due diligence and provide financial advice on M&A deals, tax accountant firms, and attorney firms ("group companies"). 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 structure of a domestic group to which large-sized audit firms belong, 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 entities of certified experts such as tax accountant firms or attorney firms, etc.) and making them subsidiaries.

Domestic groups to which large-sized audit firms belong generally establish 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

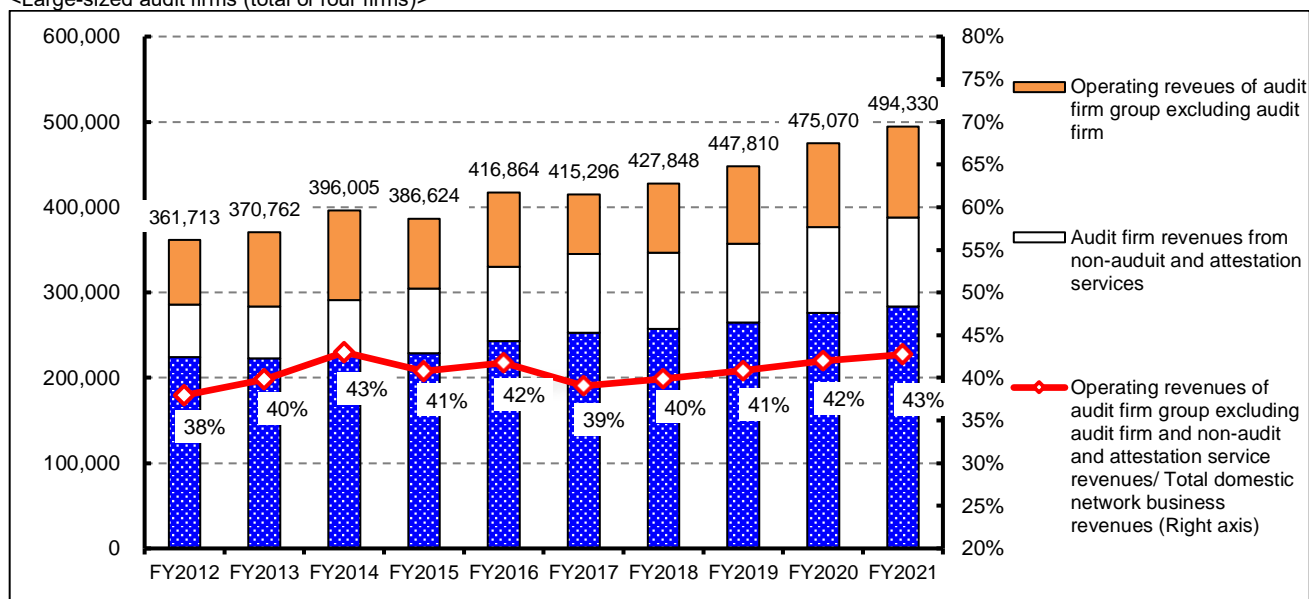
The ratio of non-audit and attestation revenue to operating revenue at groups consisting of audit firms and their subsidiaries, etc. ("audit firm groups")¹² had steadily risen to reach 43% in FY2014. The ratio once decreased to 39% as certain large-sized audit firms spun off non-audit and attestation services and subsidiaries from them, subsidiaries and so forth in FY2015 and FY2017, but it has been on an upward trend in recent years due to increases in revenue of group companies (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 18).)

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% and 14% from FY2012 through FY2021. Group revenue structure of mid-tier audit firm groups is largely different from large-sized audit firms 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, which indicates that non-audit services seem to be provided by the audit firms.

¹² Some group companies that do not have capital relationship with an audit firm have operating revenue of several tens of billions yen.

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 revenues of audit firm groups include revenues from companies that fall under subsidiaries, etc. of an audit firm within the group, in principle, as well as revenues from subsidiaries, etc. offering intra-group services.

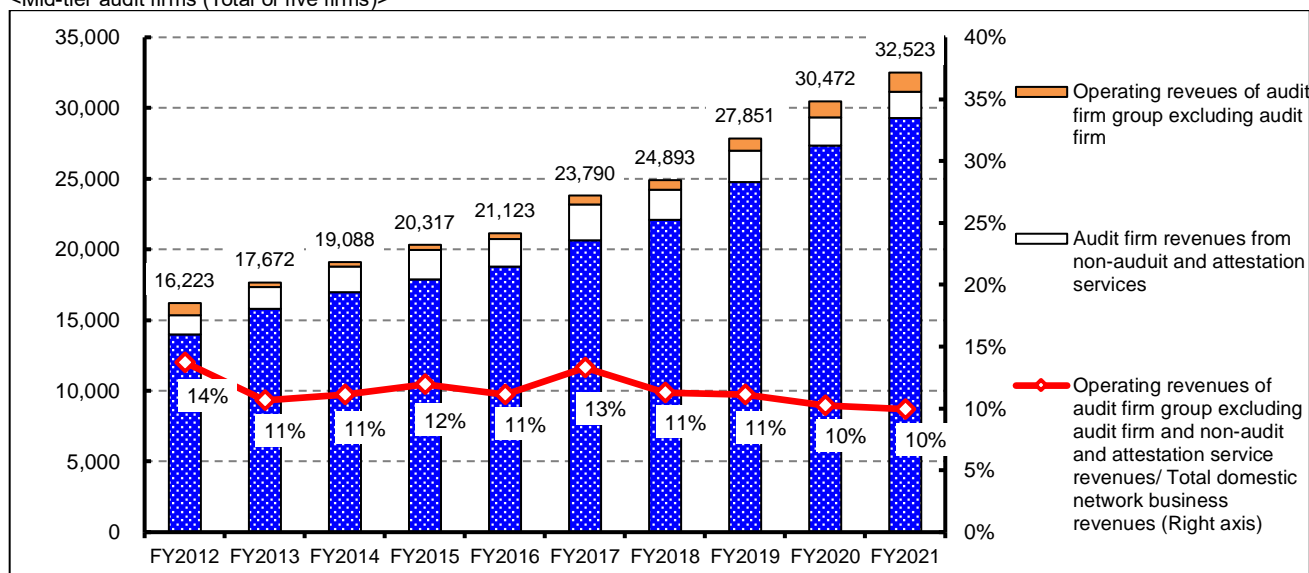
(Note 2) Non-audit and attestation service revenues are the total of the non-audit and attestation revenue of the audit firm and the revenues of the subsidiaries etc. of the audit firm.

(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 or subsidiaries that perform non-audit and attestation services

(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 groups include revenues from companies that fall under subsidiaries, etc. of an audit firm within the group, in principle.

(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 style

An engagement quality control review 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. For large-sized audit firms, the review is conducted with regard to the entirety of audit engagements, from planning to forming an audit opinion, throughout the period of the audit.

However, in the case of the concurring review partner style, 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 style

The council style 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 style.

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

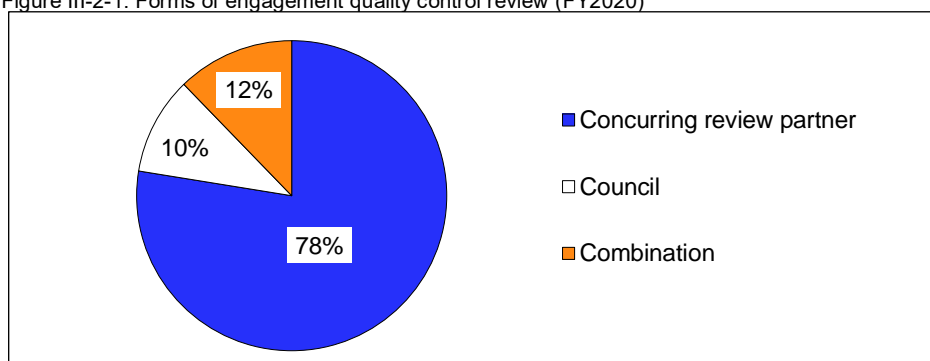
for the review is normally longer than with the concurring review partner style.

c. Combination style

The combination style can involve the concurring review partner style 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 style or the council style 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 (FY2020)



(Note) Aggregated the status of 247 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 style and the council style. 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 style, though some perform engagement quality control reviews using the council style or the combination style.

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 FY2021

	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 mandatorily 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	Persons not involved in inspected 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 180	Between a few and around 20	Between one and around 15
Number of engagements handled by each inspector	One to two engagements	One to two engagements	One to five 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 each firm's own inspection framework. Many firms use "Checklist for Periodic Inspections" and "Audit Service Review Procedures" provided by JICPA as inspection tool.
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 FY2021 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 95).

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.()

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

3. Monitoring before expression of audit opinions

Monitoring is conducted prior to the expression of audit opinions especially by large audit firms as a measure to improve the quality of audits in recent years.

Monitoring before the expression of audit opinions is an operation assigned to a reviewer, designated by the quality control sector or audit services sector, to promptly find problems in quality control and prompt the audit team to take timely remedies.

Monitoring, furthermore, is often carried out in audit areas involving high risks, such as fraud or going concern, and those where deficiencies are continuously detected through external inspections and internal regular inspections, such as accounting estimates.

D. Education, Training and Evaluation of Audit Personnel

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

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

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 in quality control activities and advisory and other non-audit services
- Placing personnel overseas at network firms
- Seconding personnel to locations outside the audit firm (e.g., domestic group firms, JICPA and other relevant organizations, business companies, etc.)

In addition, programs aimed at retaining human resources have been introduced, such as the adoption of flexible working arrangements, review of personnel evaluation programs, including compensation, and provision of various career plans through counseling and of work opportunities matching career plans. Some audit firms provide on-the-job training for young staff members on a one-to-one basis. There also are firms where counseling sessions are held on a group basis, such as those involving staff members of the same generation, to attend to their motivation. Among other cases, a mentor system that enables workers to seek advice on their personal problems helps reduce the rates of turnover and absence from work, while the turnover rate is monitored as a audit quality index along with efforts to improve work environments for the enhancement of workers' interest in audit services.

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"> · Establishing a training section within the human resources department to design and operate training programs for each job classification and level of experience · 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. · Conducting examinations to measure understanding of training · Audit firms provide support for acquiring language-related qualifications and implement language training programs at home and abroad (including online training) · 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
<p>Small and medium-sized audit firms, partnerships and solo practitioners</p>	<ul style="list-style-type: none"> · 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 · Sharing results of periodic inspections, the CPAAOB inspections, and JICPA quality control reviews within firms

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 and having decided to adopt IFRS have now exceeded 250 in Japan, there has been an increasing number of partners and staff involved in audits of companies adopting 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"> • Introducing in-house IFRS certification, and providing periodic training on updates of the standards for certified personnel • Setting up sections within the firm specializing in the interpretation and specific application of IFRS, and distributing necessary guidelines within the firm, in addition to providing advice to and having consultations on specific issues with audit teams <p>Audit firms dispatch personnel to the organizations within the networks they belong to that interpret the IFRS and examine the application policy of them. Or they hold periodic sessions to exchange views with the organizations concerned.</p>
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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 exploitation of new business. In particular, 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

<ul style="list-style-type: none"> • 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 73) for details) as well as the results of quality control reviews etc. are reflected in the performance evaluations of engagement partners.
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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.

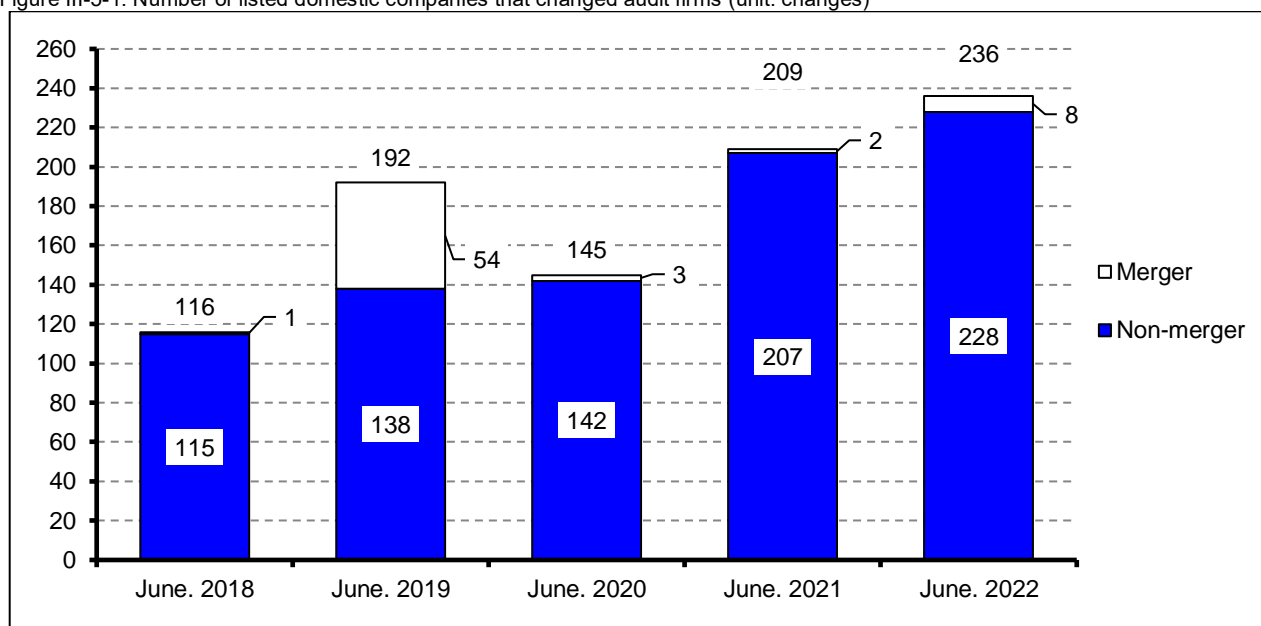
Large sized audit firms occasionally receive the proposal on audit engagement through providing non-audit and attestation services to companies other than audited companies and deepening the relationships with them. Still, on the occasion of changing an accounting auditor, an audited company often asks for audit proposals to multiple audit firms. In such a case, an audit firm often acts in an organized manner for accepting a new audit contract, such as involving a partner familiar with the industry.

In contrast, the conclusion of new audit contracts by mid-tier audit firms and small and medium-sized audit firms is being made through introduction by acquaintances of their partners or workers, etc., or by receiving inquiries via firms' websites or requests for audits from customers to which they provide non-audit and attestation services.

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 236 cases of changing auditors at domestic listed companies in the year to June 2022, 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 changes caused by 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. For information on mergers, see "I. Overview of the Audit Sector, B. Audit Firms, 4. Mergers of Audit Firms" (page 17).

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

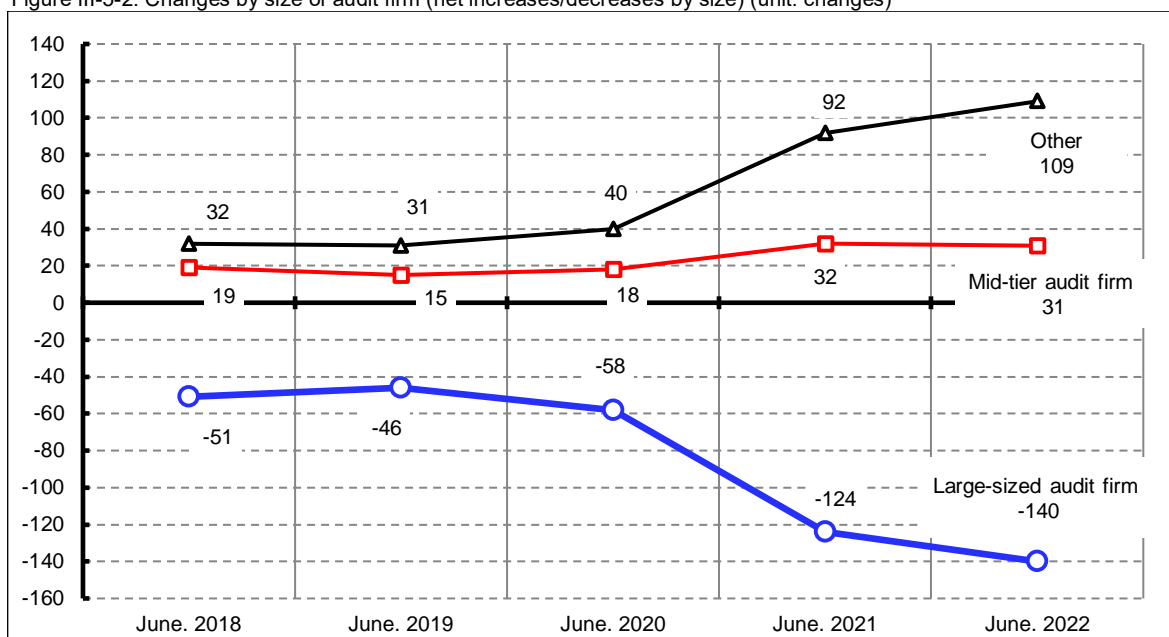


(Note) The figures above show the number of companies that had decided on an incoming auditor by the end of June of each period, based on timely disclosures of listed domestic companies.

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 2022 (Figures III-5-2 and III-5-3). This trend is likely in connection with business administration at large-sized audit firms related to the continuance of audit contracts. For information about business administration concerning continuance of audit contracts at large-sized audit firms, see "3. Reasons for Changes in Accounting Auditors as Identified Through Monitoring Activities" (page 83).

The above-mentioned shift from large audit firms to mid-tier as well as small and medium-sized audit firms indicates an increase in the role of small and medium-sized audit firms in auditing listed companies. But the recent inspection of small and medium-sized audit firms by the CPAAOB discovered inadequate systems to properly conduct audit services, making it imperative for them to maintain and improve their audit quality. As a result, the CPAAOB will put greater emphasis on the inspection of small and medium-size audit firms.

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 2021	June 2022	Increase/Decrease
Large-sized	→	Large-sized	19	19	0
	→	Mid-tier	42	45	3
	→	Other	87	97	10
Mid-tier	→	Large-sized	2	1	▲ 1
	→	Mid-tier	0	5	5
	→	Other	12	15	3
Other	→	Large-sized	3	1	▲ 2
	→	Mid-tier	4	2	▲ 2
	→	Other	40	51	11
Total			209	236	27

(Note 1) Aggregates of number of companies that had decided on a successor 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 two mergers involving small and medium-sized audit firms in the year to June 2021 and eight in the year to June 2022. 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.

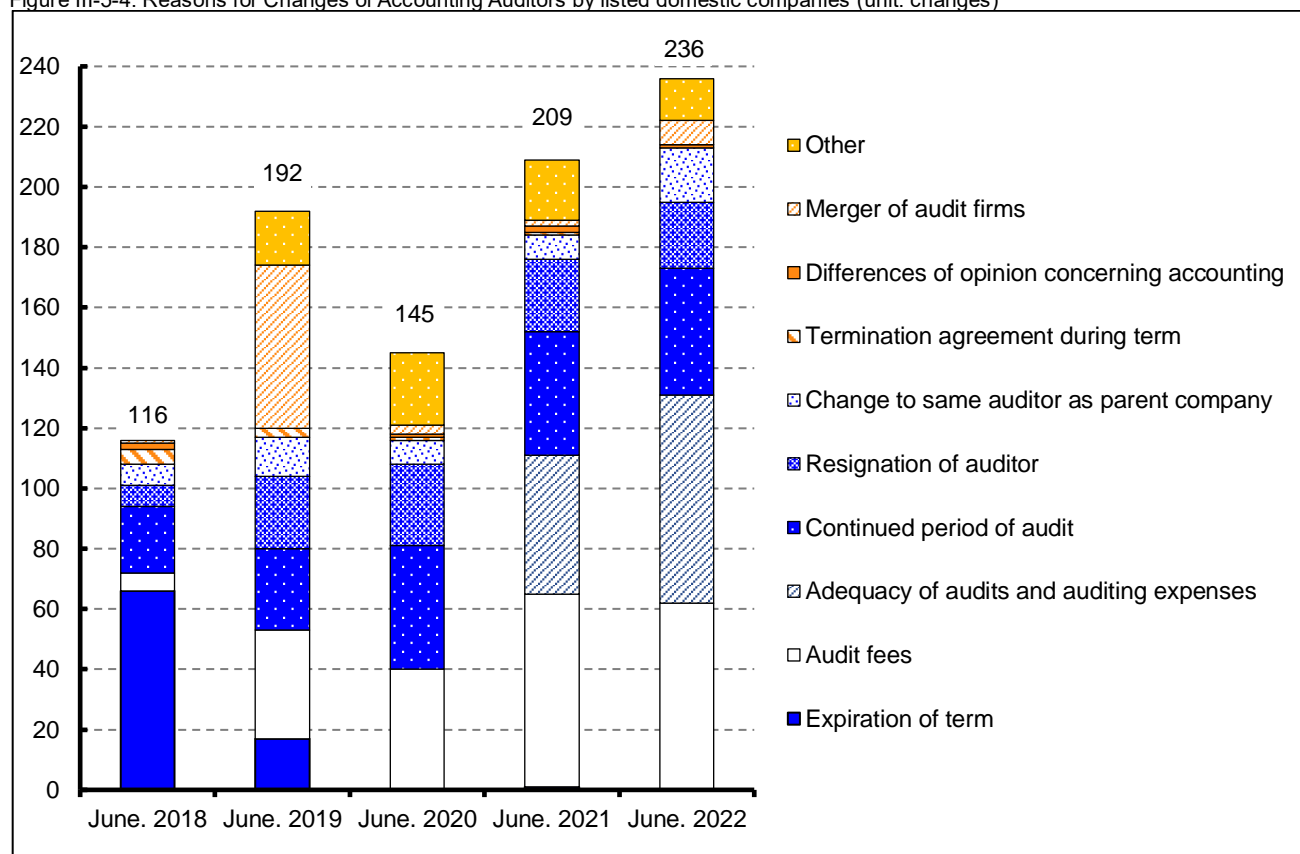
1. Reasons for Change of Accounting Auditors Given in Timely Disclosures by Audited Companies

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 year to June 2018 (Figure III-5-4). After the year to June 2019, more companies gave 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. In the year to June 2022, there were many cases of proposed increase in audit fees and the prolongation of continuous audit term, and cases where companies opted for change after examining the audit services based on their scale and the adequacy of audit fees in comparison with other audit firms.

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 fees" was included in "others." While there was no reference to it in 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 2022, in five cases, out of 236 cases, companies changed auditors in the middle of the fiscal year. Cancellation of contracts or resignation from the role due to improper accounting and other reasons at audited companies was the reason for many cases.

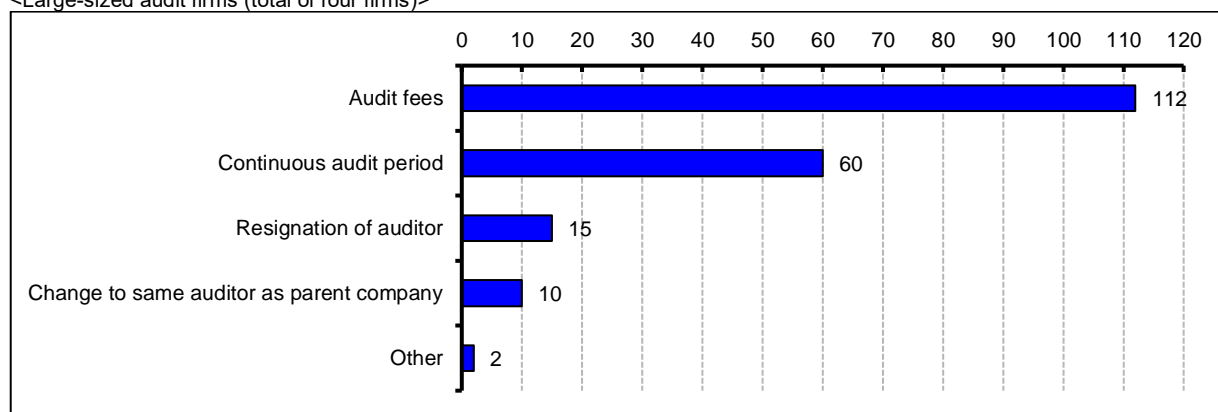
3. Reasons for Changes of Accounting Auditors as Identified Through Monitoring Activities

This section lays out reasons for changing accounting auditors ascertained through monitoring activities in PY2021 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 PY2021 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 142 changes identified through inspections and report collection during PY2021

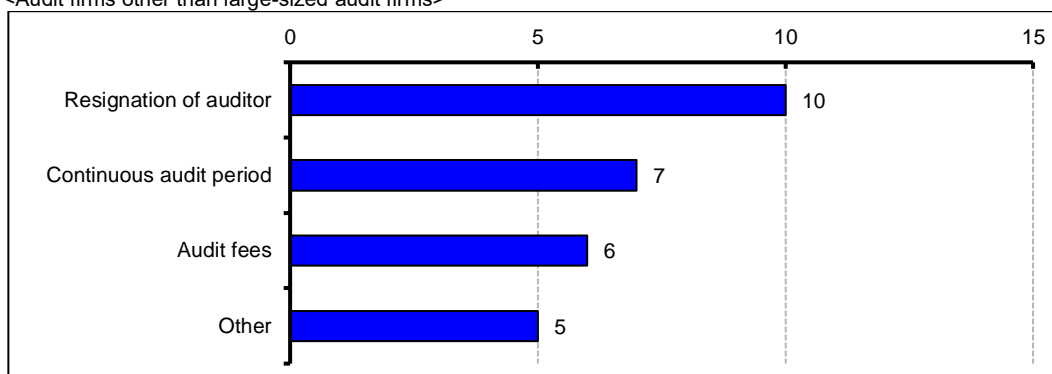
(Note 2) If there was more than one reason, that change is included in the figure for each reason (a cumulative total of 199)

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 22 cases of changing auditors (who replied as former auditors) identified 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, in addition to bleak

audited companies' performance, detection of improper accounting operations, 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 22 changes for which the reason was identified through the inspection by the CPAAOB in PY2021 and reports collected from five mid-tier audit firms and 35 small and medium-sized audit firms, 9 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 24)

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).

■ 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.

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	Audit fees comprise two components: the fixed fee (a fixed amount) and the hourly rates (a variable amount). 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.

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

According to the reports collected in PY2021, audit fee estimates are calculated as follows.

a. Large-sized audit firm

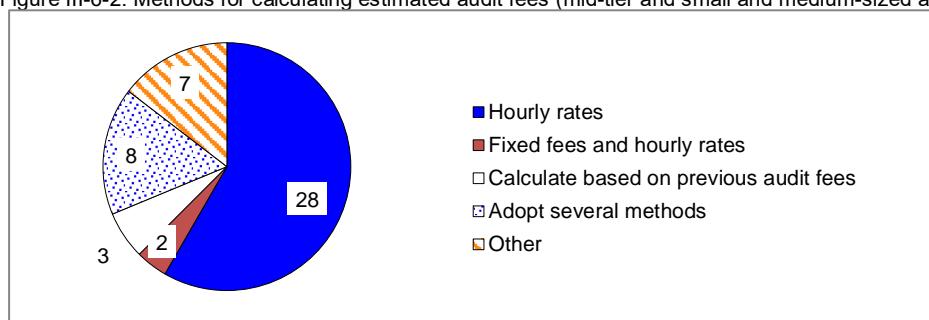
All large-sized audit firms state that they adopt the hourly rates approach for audit fee estimates. Hourly rates are set for each hierarchy level of employee, and the rate is determined while considering indirect costs associated with firm management and quality control such as the payrolls of administrative 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	13	27%
Rates not set	35	73%
Total	48	100%

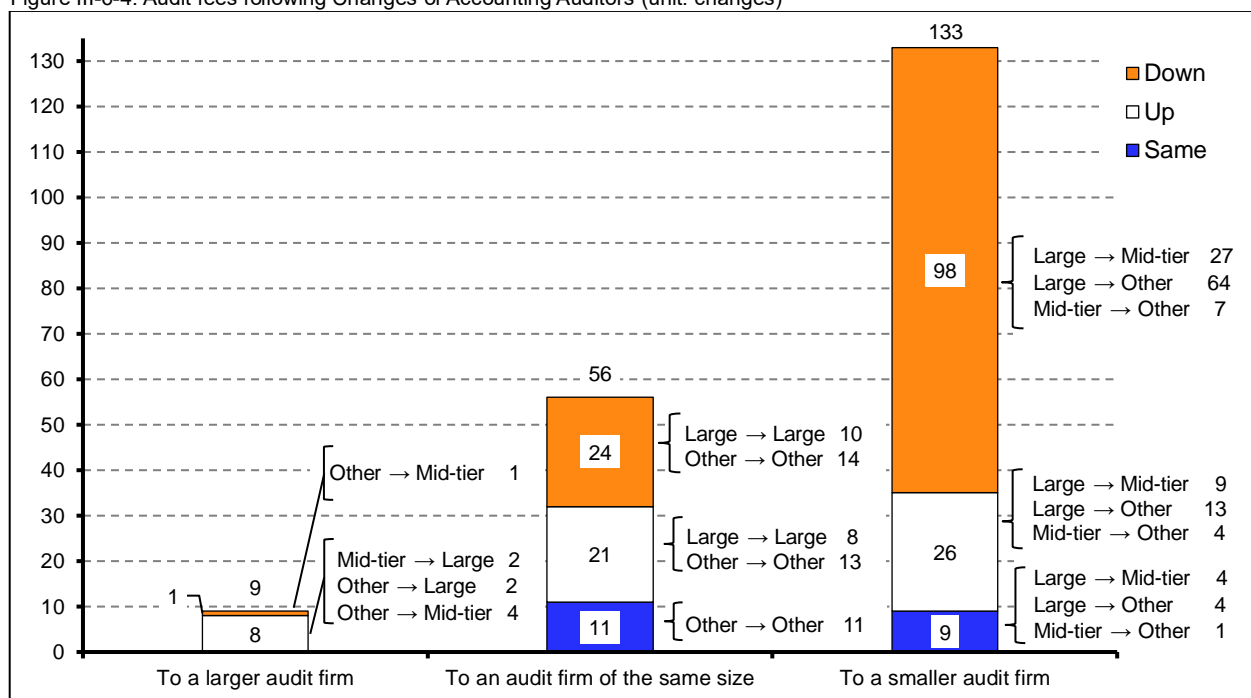
(Note) Aggregated from reports collected from mid-tier and small and medium-sized audit firms in PY2021

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 40% transfers (21 of 56 cases) but dropped in some 40% (24 of 56 cases). In changes to a smaller firm, audit fees decreased in approximately 70% (98 of 133 cases). Changes from a large-sized audit firm to a small or medium-sized firm resulted in audit fee falls in some 80% (64 of 81 cases).

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



(Note 1) Tabulated timely disclosures of changes in accounting auditors by listed domestic companies (from July 2020 to June 2021) are included, provided that 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 and securities reports submitted by June 2022

4. Dependence of Fees (Safeguards)

When the audit fees of a specific audited company represent a certain rate to the total revenues¹³ of the audit firm, etc.¹⁴, 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

¹³ Total of audit and attestation revenue and non-audit and attestation revenue (various advisory services, tax processing and so forth)

¹⁴ Audit firms and business enterprises that control business enterprises and audit firms through their contracts, human relations and so forth.

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:

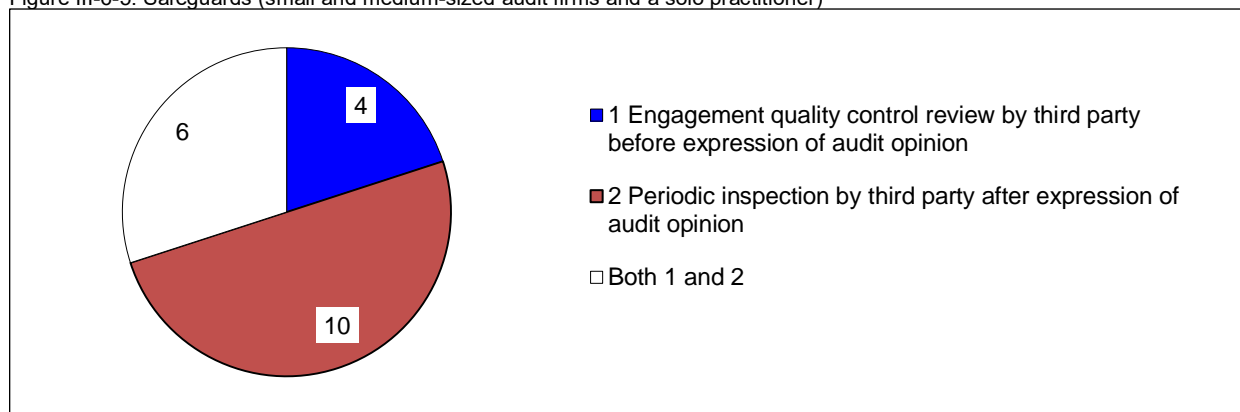
- a. Prior to the issuance of the audit opinion on or after the second year's financial statements, the audit firm requests a professional accountant, who is not a member of the audit firm, to perform an engagement quality control review of that engagement
- b. After the audit opinion on or after the 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 104).

No large-sized and mid-tier audit firms breached the threshold (15%). Of 44 small and medium-sized audit firms traced through inspections and the collection of reports in PY2021, 16 small and medium-sized firms resorted to safeguards for 20 engagements.

Small and medium-sized audit firms addressed the question of safeguard through inspection, etc. before the expression of opinions by third-party CPAs, who are not members of the audit firm, internal periodic inspections after the expression of opinions and so forth (Figure III-6-5).

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



(Note) Tallied for 16 audit firms (20 engagements) out of 44 audit firms that were inspected or from which reports were collected in PY2021.

■ Amendments to IESBA's (International Ethics Standards Board for Accountants) ethics code for audit fees ■

The IESBA released amendments to its ethics code for audit fees in April 2021, calling for appropriate management of reliance on audit fees from audited companies. When reliance on audit fees for audited companies, which are public interest entities, exceeds a set threshold level, reports to auditors and others, disclosure of the situation in question, a pre-audit review, a ban on the provision of audit services and so forth are required

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. 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 95) for further details). Audit tools in question not only have the function of preparing and storing working papers but also include audit support tool functions, such as those for safe transfer of data and materials to and from audited companies, and timely tracing of progress in auditing, including work by the team of auditing subsidiaries.

Collected R&D and IT operation of the global networks promotes 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 forecasting system on accounting fraud.

b. Task automation (RPA¹⁵)

While certified public accountants have heretofore conducted standardized work for the implementation of audit procedures, such as processing and collection of data, by themselves, the introduction of audit support tools has advanced in recent years. The tools in question include a one-stop function from the extraction to analysis of data. With the function, the automatization of work, such as processing data and drafting working papers, is making headway. For example, it has become possible to automatically extract information needed for analytical work from data, collected in a lump from an audited company's core operation system, and produce findings inside an audit support tool.

¹⁵ RPA is short for robotic processing automation and represents efforts to streamline and automatize office work by means of artificial intelligence and other technologies. It is realized by software robotics that operates software and other programs like humans. It is also called "digital labor" and "virtual knowledge worker."

c. Sophistication and expansion of data analytics

Amid the increasing introduction of audit support tools, the improvement of their functions has made it possible to multilaterally analyze all accounting data of an audited company. Findings by a broad-ranged analysis, many of which are currently used to assess risks at the time of working out an audit plan, are expected to be used in the entire auditing process through the formation of audit opinions.

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, the advancement of AI development has been facilitating the development and introduction of tools to predict future fraud using non-financial information and means to detect abnormal transactions that may lead to fraudulent accounting from among large amounts of accounting records, which enables audit judgements to be made based on more sophisticated analysis. Accordingly, integrating the results of analysis of non-financial information such as reputation about audited companies, audit firms are expected to be able to analyze a broader range of risks.

d. 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, by the use of the aforementioned IT tools, audit firms are exploring the applicability of audit techniques for the day-to-day analysis of transactions etc. (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. is an area 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, and the handover of the data also requires the consent of the audited company concerned. Additionally, time is required for data cleansing to enable utilization of data for RPA and data analytics. Due to these problems, progress is gradual. Regarding c. above, although the accuracy of fraud detection tools is becoming better than before, individual audit firms are developing tools that can detect abnormal transactions with higher fraud risks and fraud employing more complicated means.

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 lagging in the use of audit tools compared with large-sized audit firms. 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. At the same time, they are recruiting experienced IT engineers from outside in order to develop their IT systems earlier.

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

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

■ Effective audit using AI ■

Some large audit firms are increasing the use of AI in auditing work. Specifically, AI analyzes listed companies' trends of fraud in the past from their security reports, improper accounting data and others. They maintain that the practice can effectively detect signs of fraud at audited companies' subsidiaries and on a per account basis and automatize 30% to 40% of entire auditing work, especially financial data analysis and confirmation of documents.

With the introduction of AI, audit practitioners are expected to concentrate more strongly on tasks requiring experience, such as those involving fraud risks and accounting estimates.

■ Introduction of electronic audit documentation by small and medium-sized audit firms ■

In March 2021, a mid-tier audit firm, two small and medium-sized audit firms and a general business company founded and began operating the Audit Digital & Innovation Consortium (ADIC) to provide small and medium-sized audit firms with a common IT infrastructure for the safe use of the electronic audit documentation system (for the electronic and integrated management of audit papers, audit firms are obligated to prepare and store them in order).

The three audit firms have already adopted the shared IT infrastructure and are operating it on a scale of more than 500 users. In the future, they plan to create a knowledge network as a small and medium-sized audit firms' community and carry out a project that will contribute to the digital transformation of audits, including audit tools other than the electronic audit documentation system.

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.

[Monitoring of audit firms]

- The CPAAOB reviews audit firms' cybersecurity measures through periodic collection of reports, hearings and dialog. These approaches have enabled us to identify the following efforts common to large-sized audit firms and some of mid-tier 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 ¹⁶) and, as necessary, recruiting experts in-outside the audit firm
- Identifying the data held by the audit firm, rating the materiality, and developing policies for data use as well as contingency plans for information security incidents and cyberattacks
- Undergoing reviews by the global network to confirm the effectiveness of the audit firm's information security system, making improvements in the system, collecting information on cyberattacks and information security countermeasures, and utilizing this information to develop and improve the information security system.

■ 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 have kept participating in the drills since 2019, including the sixth exercise held in October 2021.

The drills confirmed initial responses to an incident, technological responses such as an investigation into the attack, information linkage, continuation of business and other issues. To enable the management and many sections concerned (systems, public relations, business and others) to take part, the drills were held in the form of participation from their workplaces.

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

¹⁶ CSIRT (Computer Security Incident Response Team) is the collective term for the organizations responsible for dealing with incidents pertaining to computer security.

■Expanded use and risks of cloud services■

The use of cloud-based online storage services is increasing these days as business enterprises have improved developed telework environments. To expand technology-based services, audit firms are also increasing investment in the IT field, including cloud technology.

But there are risks in services via cloud technology. In a 2021 report on data leaks and breaches, major American telecommunication company Verizon said the problem most frequently occurred through servers. With regard to risks concerning accompanied by the use of cloud services, the JICPA stressed the importance of understanding recognizing service providers' internal control on the risk of inappropriate access.

As the personal information protection law was amended in April 2022 to toughen control on the storage of data overseas and other matters of concern, personal information needs to be treated more strictly.

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. A brief overview of group audits and auditing procedures follow:

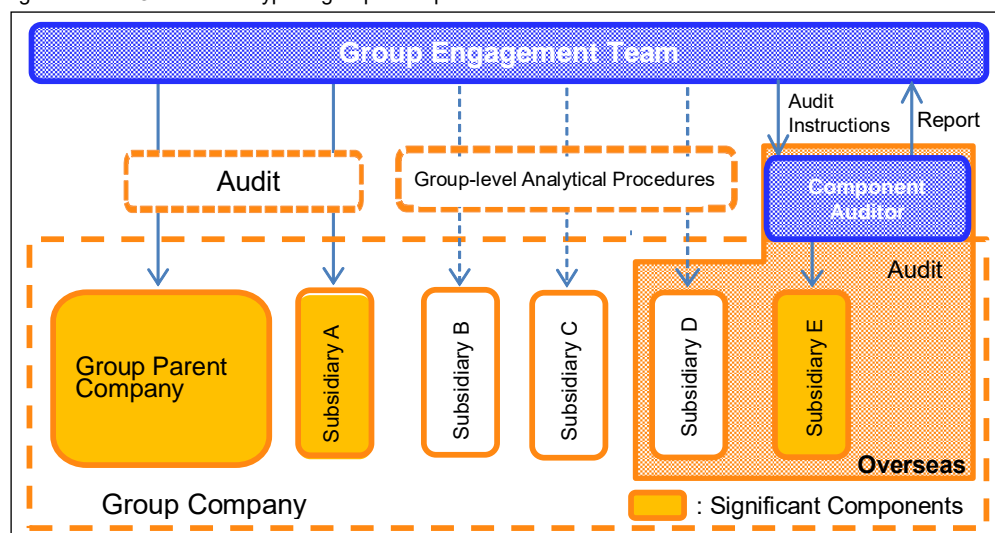
a. Overview of Group audits

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 consolidated subsidiaries and head offices and branches, etc. (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 existence of risks requiring special consideration, and group engagement teams determine the proportional audit procedures that shall be performed according to the classification of each component (ASCS 600 (8), (23), (25), (27)).

The following figure illustrates overview of 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 of the group caused by fraud or error, and must focus in particular on the risks of material misstatements resulting from fraud.

In recent years, there have been many cases of fraud etc. discovered at overseas subsidiaries that would seriously affect group financial statements. It has therefore become more important to perform risk assessments based on an adequate understanding of the group management system such as establishing a department at a head office tasked with managing foreign subsidiaries or performing internal audits to foreign subsidiaries and group environment including internal control of overseas subsidiaries.

If a component is deemed to be financially important for the group, 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

A group audit team decides which kinds of audit work should be performed for component units' financial information. As for material components that may involve risks requiring special consideration concerning group financial statements, one or more of audits described below must be performed : audit on component units' financial information based on the overall materiality of component unit , audit on the balances of one or more special accounts related to risks requiring special consideration about group financial statements, audit on kinds of transactions or disclosure and others, and special audit procedures related to risks requiring special consideration about group financial statements (ASCS 600 (26)).

The approaches to group audit procedures taken by audit firms of different sizes are as follows

(Figure IV-2-2).

Figure IV-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 43 firms from which reports were collected in PY2021, information is presented for 23 firms conducting audit engagements for which group audit is required in cases where there is any component overseas. 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 and appropriate audit evidence on which to base the group audit opinion (ASCS 600 (39)).

The group audit team therefore not only sent and received audit instructions and reports on the audit results and grasped the situation by phone or e-mail, etc., but also visited auditors of component units, among other practices. The physical visit, however, went unfeasible due to 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 restrictions in countries where they are located. 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.

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 94).

Figure IV-2-3: Number of audit firms belonging to global networks¹⁷ (FY2021) (unit: audit firms)

Large-sized audit firms	4
Mid-tier audit firms	5
Small and medium-sized audit firms	23
Total	32

(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, 2022)

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 particularly prominent.

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

	DTT	PwC	EY	KPMG	BDO	GT
Operating revenues	502	451	399	321	118	66
Audit services (Share of operating revenues)	105 (21%)	171 (38%)	136 (34%)	114 (36%)	50 (42%)	28 (43%)
Tax-related services (Share of operating revenues)	89 (18%)	110 (24%)	105 (26%)	70 (22%)	26 (22%)	14 (21%)
Advisory services (Share of operating revenues)	308 (61%)	170 (38%)	158 (40%)	137 (42%)	42 (36%)	24 (36%)

(Source) Prepared by the CPAAOB based on data from publicly disclosed materials from each global network (2021 accounting year).

In Japan, the Big Four global networks' share of audit services is 97% of the 225 companies that

¹⁷ Among small and medium-sized audit firms, the firms that have concluded cooperative relations (alliances) with overseas audit firms are included.

comprise the Nikkei Stock Average (Nikkei 225). Overseas, they account for even larger shares of audit services as shown below for the 500 companies comprising the S&P 500 index in the U.S. and 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)	97%	99%	93%

(Sources) Japan: Compiled by the CPAAOB from QUICK and exchange data (as of March 31, 2022)

U.S.: Compiled by the CPAAOB from Bloomberg data (as of March 31, 2022)

U.K.: "Key Facts and Trends in the Accountancy Profession, July 2021," 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 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 74) 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) ■

Established in 2006, the International Forum of Independent Audit Regulators (IFIAR) is an international organization comprising independent audit regulators that conduct inspections and other tasks on audit firms to improve the audit quality globally through cooperation and collaboration between authorities concerned. (As of June 2022, it had members from 54 countries and jurisdictions, including Japan.) The IFIAR opened an office in Tokyo in April 2017 and became the first international financial organ with an outlet of its headquarters in Japan. In April 2021, a deputy commissioner in the Strategy Development Management Bureau of the FSA who was concurrently serving as the director of the Office of Japanese Delegation for IFIAR was elected vice chair of the IFIAR.

Japan is a founding member of the IFIAR and a member of its board. While the chairperson of the CPAAOB as well as inspectors and others have actively participated in various meetings of the IFIAR to establish and strengthen cooperative relations with regulators of other countries, Japan has been striving to improve the audit quality globally through participation in activities by the IFIAR, such as dialogues with leaders of the six large global networks. Now that an FSA official, as mentioned above, has assumed the post of vice chair of the IFIAR since April 2021, Japan is further strengthening its support for the IFIAR to contribute to the role of leading the overall management of the organ as a member of its management team.

■ Effects of international situation on auditing ■

The international situation, including the recent Ukrainian problem and lockdowns in Shanghai, is exerting considerable effects on not only business activities by globally operating companies but also auditors' work, such as the withdrawal of four large global networks from Russia. The JICPA has taken countermeasures, including the release in April 2022 of "Audit Considerations for the Fiscal Year Ended March 31, 2022 (Summary) (Regarding audit responses in light of the current international situation surrounding Ukraine)" as a digest of matters of concern pertaining to "Consideration of whether or not the risk assessment needs to be revised based on the situation" " and so forth under the current international situation.

In addition, the IFIAR has posted a consolidated version of Russia-related guidance issued by member audit regulators, auditors organizations, and so forth on its website (<https://www.ifiar.org/members/ukraine-russia/>).

C. Effects of and Responses to the COVID-19

The spread of COVID-19 infections, which started in around March 2020 and still continues, is affecting account settlements, audits, and so forth.

In April 2020, following the spread of COVID-19 infections, the Accounting Standards Board of Japan (ASBJ) announced the consideration in accounting estimates as a summary of the Discussion (supplemented in May 2020 and updated in February 2021), and the JICPA announced a series of "Audit Consideration related to COVID-19," involving such issues as attendance at inventory count, confirmation of outstanding balances, reliability of audit evidence, group audits, accounting estimates, assumptions related to going concerns, terms for extraordinary losses, self-assessment and impairment and allowances by financial institutions, and acquisition of management representation letters.

Based on the summary of the Discussion announced by the ASBJ, the FSA additionally released a written request in May 2020 to express its strong expectation that concrete and enhanced disclosure on the impact of COVID-19 infections would be made as financial and non-financial information in security reports. The FSA also released the "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 enhance the disclosure of information.

Looking back on efforts made by members of the liaison council pertaining to responses to financial reporting and audits based on the effects of COVID-19, the "Our Responses to Financial reporting and audit of listed companies in consideration to the Impact of the COVID-19 Infection (Main Points)" was released under its name in July 2020.

For PY2021, furthermore, the FSA released the "Notice regarding the deadline for submission of annual securities and other reports in connection with COVID-19 infection" .In addition, the JICPA announced the following points of attention in auditing for members in consideration of an increase in remote auditing work environments for auditors due to the adoption of remote work by audited companies:

- Confirmation by means of e-mail
- Remote observation of inventory taking

- Authenticity of evidence converted into PDF format
- In case of restrictions on visiting inspection of components and others
- Remote meeting and use of remote meeting tools

In its "Notice regarding the implementation of review of securities reports" released in April 2021, the FSA designated the review of COVID-19 infection-related nonfinancial information ("business policies and strategies, etc.," "business risks" and "analysis by the management of financial conditions, operating results and the cash flow status") and financial information ("notes based on accounting standards pertaining to the disclosure of accounting estimates" and "additional information") as a key theme. As prospects for the impact of the COVID-19 disease, etc. may differ between companies, the appropriateness of them is not subject to the review. On the assumption that prospects differ between companies, therefore, the review will examine whether information is disclosed in a manner to enable investors and others to fully understand companies' specific conditions and ways of thinking.

The CPAAOB understands the effects of COVID-19 infections on audit firms through dialogues with and the collection of reports from them.

Specifically, auditing methods, such as the observation of inventory taking and confirmation of outstanding balances, and the management of audit firms are reviewed based on advances in the introduction of IT at audited companies and the effects of COVID-19 infections.

Regarding responses to workers' physical attendance, large-sized and mid-tier audit firms adopt a hybrid system combining remote work and office work, while limiting the attendance rate of workers. In the meantime, some small and medium-sized audit firms have developed a remote work environment but leave each audit team to decide whether to come to the office or not.

From the perspective of responses in audit procedures, communications in group audits are made mainly through the use of remote conference systems, and there were also cases where the number of audit team members who visit audited companies is limited depending on workers' physical attendance at audited companies.

For alleviating workers' mental burden, some audit firms recommend providing an opportunity for communication other than through a remote conference system, such as by setting office days for each of the audit teams, mainly for young workers with less experience in audit practices.

Partially triggered by the spread of COVID-19, the CPAAOB presented the "Consideration of Monitoring Methods" in the Basic Plan for Monitoring Audit Firms and so forth in PY2021.

In PY2021 as well, the CPAAOB reviewed 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 remote inspection.

The CPAAOB's office was used as the principal venue for remote inspections, where inspectors conducted inspections using online methods, reviewing digitalized audit work papers and other documents submitted from audit firms or through audit firms' electronic audit work papers systems. For interviews with members of audit firms, efforts to reduce face-to-face conversation and moving of staff

members were made by the active use of online conference systems, while maintaining face-to-face meeting to some extent in consideration of the effectiveness of interviews.

D. Treatment of key audit matters

From the perspective of enhancing the transparency of and the provision of information pertaining to audits conducted under the Financial Instruments and Exchange Act, entries of "key audit matters" (KAMs) in audit reports come to be required, starting with accounting audits for the fiscal year ending March 31, 2021.

1. Processes and key points for deciding on and reporting KAMs

- a. 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 and decide the matters to which they paid special attention:
 - Matters in which risks requiring special consideration were identified 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 high uncertainty of estimate is identified
 - Effects on audits from material matters or transactions taking place in the relevant year
- b. Out of the matters to which they paid special attention, auditors as professionals narrow down especially important matters, decide them as KAMs, and mention the following in a section set for them in audit reports.
 - Content of KAMs
 - Reference to disclosure in related financial statements where applicable
 - Reasons why auditors considered the matter especially important in the audit of financial statements in current fiscal year and determined it as KAMs.
 - Auditor's responses in audit

2. Responses by audit firms

Recent monitoring found the following responses by large-sized and mid-tier audit firms upon mandatory application of KAMs. Centered on large-sized audit firms, some audit firms have developed a system for KAMs, including communications with audited companies (Figure IV-4-1).

- a. Development of guidance for preparation of KAMs
 - Preparation and dissemination of guidance and descriptive examples with which audit teams comply when preparing KAMs

b. Provision of training

- Training to provide explanation of good examples on KAMs based on analyses of actual application cases
- Training to provide explanation of points of attention concerning the notes in financial statements and narrative information accompanied by the introduction of KAMs
- Training with a workshop format adopted, wherein audit teams actually draft KAMs
- Training to provide explanation of points to note in drafting KAMs

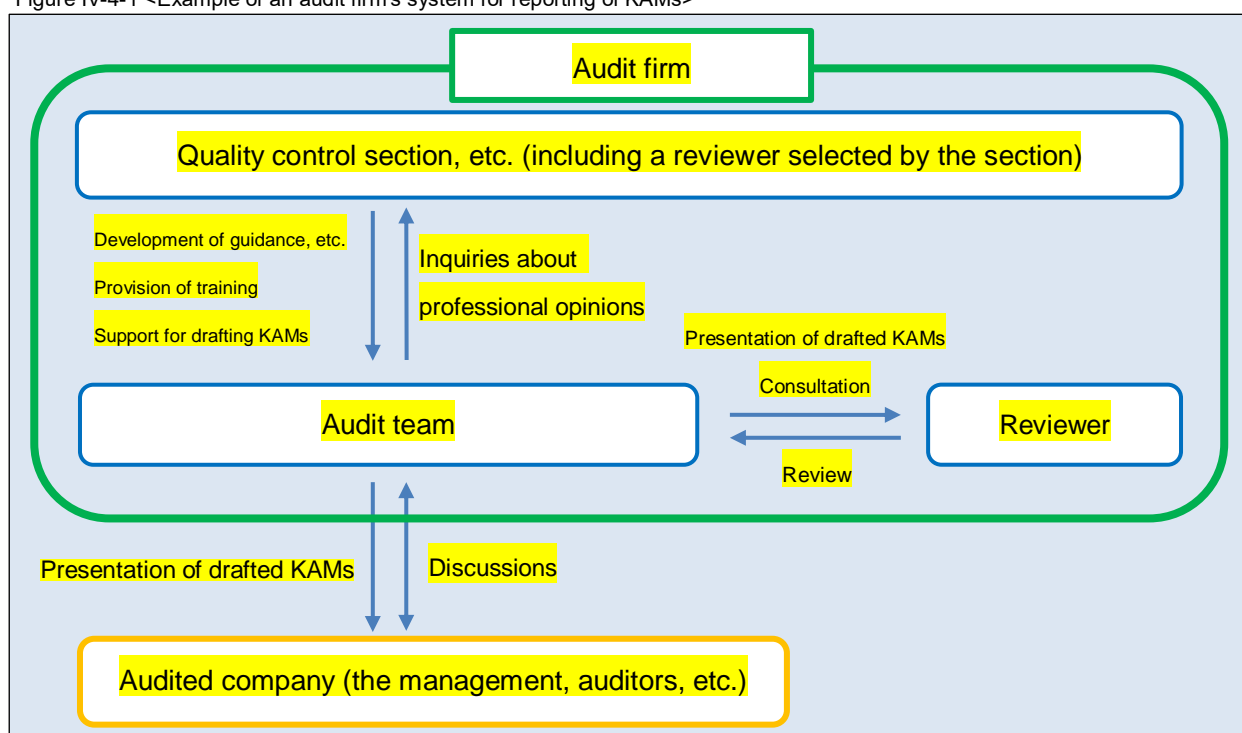
c. Quality control section's support for audit team

- Clarification of the specific content of communication and schedule to achieve in-depth communication throughout the year with the management, audit and supervisory board members and others of an audited company
- Monitoring and follow-up of audit teams' handling of KAMs
- Review by a reviewer selected by the quality control section of KAMs drafted by audit teams
- Holding of consulting sessions regarding KAMs on a regular basis

d. Reviews and inquiries of professional opinions

- Request for conference-format reviews by the headquarters in specific cases, such as treating the non-disclosure of KAMs and assumption related to a going concern as KAMs
- Request for inquiries about professional opinions regarding entries of KAMs in cases falling under specific cases defined by revised policies for inquiries about professional opinions

Figure IV-4-1 <Example of an audit firm's system for reporting of KAMs>



3. Analyses of KAMs reported in the first year of mandatory application and recommendations

Handling of KAMs in the year ending March 31, 2021 has been analyzed by the FSA and other related organizations, and they made recommendations (Figure IV-4-2).

Figure IV-4-2 < Analyses of KAMs reported in the first year of mandatory application >

Organizations that published their analyses, timing of publication, published documents, and web links
<p>Japanese Institute of Certified Public Accountants (October 2021)</p> <p>Report on analysis of KAMs reported in the first year of mandatory application (the year to March 2021)</p> <p>Aggregate results of the questionnaire survey with members in the first year of mandatory application of KAMs</p> <p>https://jicpa.or.jp/specialized_field/20211029fgf.html (Available in Japanese)</p>
<p>Japan Audit & Supervisory Board Members Association (December 2021)</p> <p>Involvement of auditors, etc. in the process of consideration in the first year of mandatory application of KAMs</p> <p>https://www.kansa.or.jp/support/library/post-2551/ (Available in Japanese)</p>
<p>Securities Analysts Association of Japan (February 2022)</p> <p>Good examples of KAMs helpful for securities analysts</p> <p>https://www.saa.or.jp/standards/account/questionnaire/index.html (Available in Japanese)</p>
<p>Financial Services Agency (March 2022)</p> <p>Characteristic examples of KAMs and points to note in making entries</p> <p>https://www.fsa.go.jp/news/r3/sonota/20220304-2/20220304-2.html (Available in Japanese)</p>

In the analyses above, recommendations for the second year are also made based on actual entries of reported KAMs. Major recommendations are as follows.

- Stylization and uniformity of contents of KAMs should be avoided. It is not preferable to merely follow entries in the previous year or use similar entries across audit firms. It is important to describe situations unique to each company concretely.
- It is important to devise subtitles, make annotations with numbers, ascertain potential impact, and consider the influence to be caused by putting KAMs into the accounting standard and assumptions.
- If selecting the same items in KAMs as in the previous year, it is preferable to describe why these items continue to be important in the relevant year and how they have changed from the previous year, thereby supplementing the content or deepening explanations of the report in the previous year.
- If omitting any items in KAMs that were entered in the previous year, it is very important to enter the reason therefor from the perspective of user convenience.

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 professional accountancy associations around the world. As recent major changes in the International Standards on Auditing (ISA) set out by the IAASB, "Quality Management for an Audit of Financial Statement" (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 Engagements) 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 for audits in a given business year from that date onward (voluntary early 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 a 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 fee dependency remains high amount for more than a specific period.

The IESBA also published the amendment of the IESBA Code of Ethics, "Definitions of Listed Entity and Public Interest Entity in the Code," in April 2022. Accordingly, each jurisdiction is required to review the definition of PIE, in light of their individual circumstances, starting from audits for the business year that starts on December 15, 2024, onward (voluntary early application is possible).

2. Trends in domestic auditing standards and code of ethics

Based on recent revisions to the international quality control standards, the Business Accounting Council published the Written Opinion on the Revision of the Quality Control Standards for Audit in November 2021. Then, in June 2022, Quality Control Standards Commission Statements No.1 titled "Quality Control at Audit Firms," Quality Control Standards Commission Statements No.2 titled

"Review for Auditing," and Auditing Standards Committee Statements 220 titled "Quality Control in Auditing" were revised.

With regard to the code of ethics, the JICPA is reviewing its code of ethics by reference to the IESBA Code of Ethics, and published a draft on revision of JICPA's ethical rules in November 2021. 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, and the JICPA is concurrently reviewing the Practice Guidance as well.

3. Expansion of Disclosure of Descriptive Information

In January 2019, the Cabinet Office Order on Disclosure of Corporate Affairs was amended, and as a result, companies came to be required to provide more substantial disclosures in their annual securities reports with respect to descriptive information such as "management policy, management environment, pressing issues to address, etc.," "risks to business etc.," and "management analysis of financial positions, operating results and cash flow." 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 favorable cases of disclosure by some companies practiced widely. The list of good examples has been updated in due course. From December 2021 to March 2022, favorable cases of disclosure of information on business status and sustainability-related information, in which social interest is increasing in recent years, were compiled, and were published and updated as "Best Practices for the Disclosure of Narrative Information 2021."

Although narrative information is not subject to auditing, it elaborates a company's business strategies and risk information 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 financial statements and audit reports have been clarified. In addition, the Auditing Standards Committee's Statement 720 has been revised to require the inclusion of necessary descriptions in audit reports (to be applicable from audits for business years that end on or after March 31, 2022).

4. Efforts to address disclosure of sustainability

These days, Efforts to deal with medium and long term sustainability are advanced 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 March 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. Based on proposals in a report of the Expert Panel released in June 2021, the FSA compiled the basic idea and ways to have dialogues with financial institutions, and published the Supervisory Guidance on Climate-related Risk Management and Client Engagement (draft) in April 2022.

Internationally, in November 2021, the International Financial Reporting Standards Foundation, principal organizer of the International Financial Reporting Standards (IFRS), established the International Sustainability Standards Board (ISSB) to work out standards for the disclosure of internationally consistent and comparable information on sustainability. In March 2022, the ISSB published a draft of the General Requirements for Disclosure of Sustainability-related Financial Information and Climate-related Disclosures Standards, and is planning to undergo public consultation procedures (seeking public comments for a period of 120 days until July 29) and finalize the standards by the end of 2022. In Europe, the European Commission published a draft of the Corporate Sustainability Reporting Directive (CSRD) in April 2021 and plans to expand the coverage of companies that are required to disclose sustainability-related information and introduce detailed requirements and assurance of reporting. In the United States as well, the Securities and Exchange Commission (SEC) published draft regulations to make climate-related information disclosure mandatory in March 2022 and underwent public consultation procedures (seeking public comments until June 17, 2022).

The International Auditing and Assurance Standards Board (IAASB) and the International Ethics Standards Board for Accountants (IESBA) commenced deliberations on frameworks for the assurance and ethics regarding international sustainability reporting. The issue of the assurance and ethics is also deliberated by the Task Force on Sustainable Finance of the International Organization of Securities Commissions (IOSCO).

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 proposals of the Task Force on Climate-related Financial Disclosures (TCFD). 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, new market segment which commenced operation in April 2022, should promote efforts to improve the quality and quantity of disclosures based on the TCFD's proposals or equivalent international frameworks.

Domestic related parties are collaboratively responding to the initiatives of the IFRS Foundation, and the Sustainability Standards Board of Japan (SSBJ) was newly established under the Financial Accounting Standards Foundation on July 1, 2022, for the purpose of presenting opinions regarding the standards being worked out by the ISSB and developing domestic standards based on the former.

5. Partial amendment of the Certified Public Accountants Act and the Financial Instruments and Exchange Act

In November 2021, based on recent environmental changes surrounding auditing, the Advisory Council on the Systems of Accounting and Auditing of the FSA published a summary of discussions whose key points are arrangements for ensuring confidence in auditing, improving the capacity and capabilities of certified public accountants and achieving high-quality accounting audits. Based on this summary of discussions, the Financial System Council's Subcommittee on Certified Public Accountant System had discussions on the certified public accountants system, including an institutional framework to require a high degree of discipline in audits of listed companies. In January 2022, the Subcommittee compiled the Report of the Financial System Council's Subcommittee on Certified Public Accountant System – For Ensuring the Quality of Audits of Listed Companies and Having Certified Public Accountants Exert Their Capabilities.

Based on the aforementioned report, the FSA submitted a draft of the Act Partially Amending the Certified Public Accountants Act and the Financial Instruments and Exchange Act to the 208th ordinary session of the Diet, with the aim of ensuring the reliability of auditing and encouraging certified public accountants to exert and enhance their capabilities, thereby further enhancing the reliability of corporate financial documents. The following are incorporated in the draft Act:

- Introduction of a registration system for audits of listed companies, etc.
- Review of restrictions on audit firm partners' services based on their marital status
- Review of qualification requirements for certified public accountants
- Review of the authority to conduct on-site inspections of the Certified Public Accountants and Auditing Oversight Board

The draft Act was enacted on May 11, 2022.

The FSA plans to amend relevant government Orders, etc. for the enforcement of the amended Acts.

(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/english/oversight/20220706/20220706.html>

Basic Plan for Monitoring Audit Firms (PY2022)

<https://www.fsa.go.jp/cpaaob/english/oversight/20220928/20220928.html>

Case Report from Audit Firm Inspection Results

<https://www.fsa.go.jp/cpaaob/shinsakensa/kouhyou/20220715/20220715-3.html>

JICPA 2022 Annual Report

<https://jicpa.or.jp/english/files/AnnualReport2022.pdf>

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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<https://www.fsa.go.jp/cpaaob/english/index.html>