

# I. Operations Management System (Root Cause Analysis)

## **1. Operations Management System and Root Cause Analysis**

### **(1) Necessity of Root Cause Analysis**

It is noted that a number of audit firms do not conduct root cause analysis for deficiencies identified in the quality control review or the CPAAOB inspection.

As the scope of the quality control review and the CPAAOB inspection are highly limited, it is likely that, in addition to identified deficiencies, there remain undetected deficiencies with same root causes. If improvement measures are taken without root cause analysis, the effects will be temporary and similar deficiencies are likely to recur. In such cases, improvement in the quality control system will be ineffective and/or insufficient, thus will not lead to fundamental improvement of the audit quality as a whole.

On the contrary, perfunctory improvement measures would only increase ineffective and unnecessary tasks for audit frontline, which hinder effective and efficient audit. Audit firms should recognize the importance of root cause analysis to realize substantial improvements of audit quality.

In recent years, large-sized audit firms have started root cause analysis of identified deficiencies as part of their quality control system, in addition to just informing them.

For example, the quality control division performs thorough analysis of direct causes of deficiencies by interviews or questionnaires with the audit team, and then considers what kinds of root causes exist in the operations management system or the quality control system for better improvement measure.

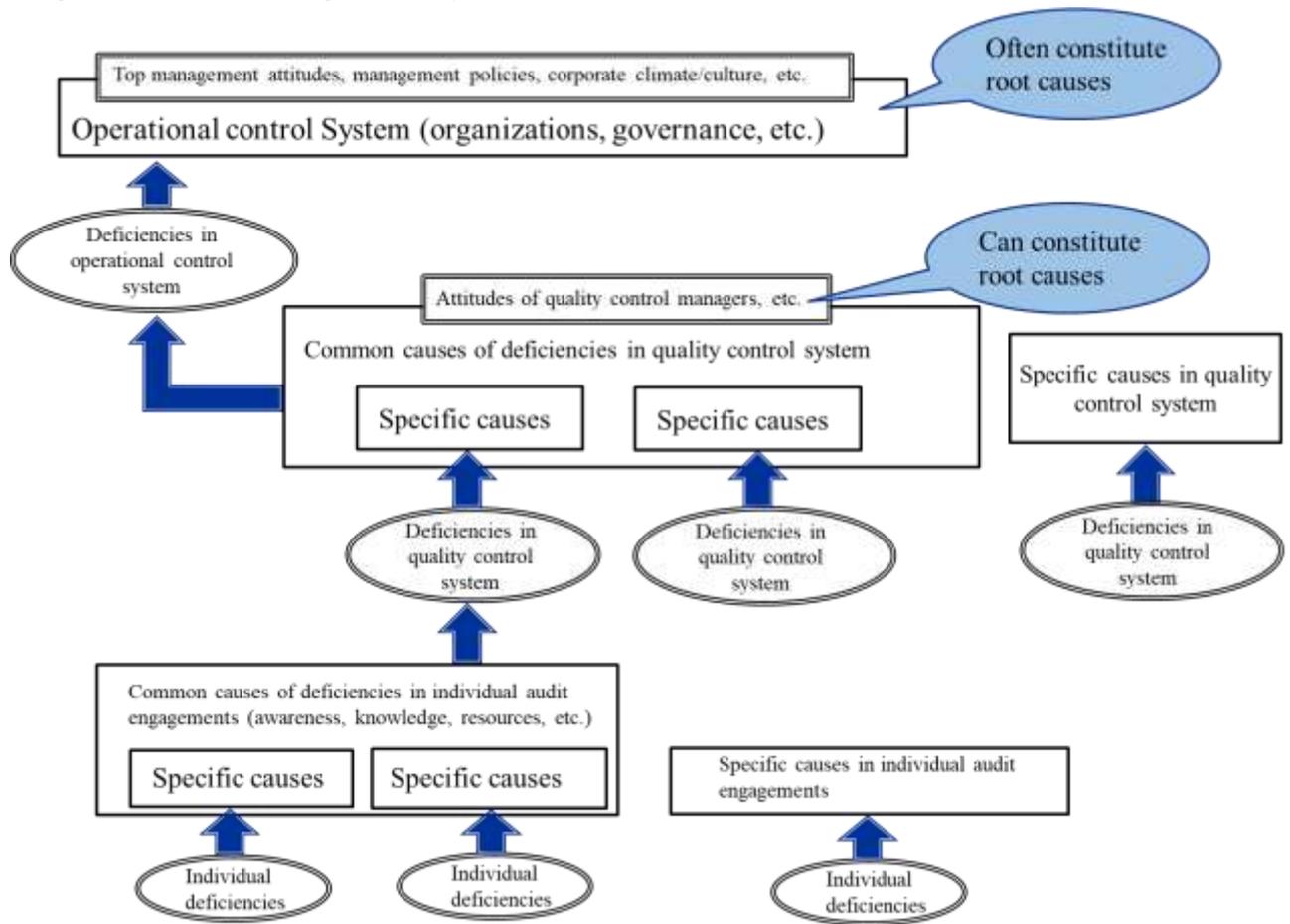
### **(2) Root Cause Analysis**

In root cause analysis, it is important to accurately identify the direct causes of deficiencies as a first step. In direct cause analysis, it is necessary not only to consider the knowledge, awareness, and experience of individual assistants to engagement partner, but also to consider other aspects of the audit, such as situation of the audit teams and the audited companies. .

Direct causes can be divided into "specific causes," which is unique to individual deficiencies, and "common causes" which is common to multiple deficiencies. Further analysis of common causes often leads to root causes of deficiencies.

In the past inspections, the root causes were frequently related to "tone at the top", "business strategy", or "corporate culture" in the operations management system. Accordingly, it is especially necessary to pay attention to the effectiveness of the operations management system. In addition, the root causes sometimes exist in the quality control system (i.e. attitudes of PICOQC) (see [Figure 1]).

[Figure 1] Reference image: Identify deficiencies and root causes



The followings are examples of root cause analysis by CPAAOB.

## [Large-sized audit firms]

### [Case 1]



At the audit firm, multiple deficiencies, including significant ones, are identified with regard to some audit engagements subject to inspection.

One of the direct causes is a lack of critical mindset in the audit team to confirm consistency among audit evidences, when auditing the revenue recognition policy or the significant accounting estimates. The common causes of deficiencies in the quality control system were as follows: the quality control headquarters has not implemented sufficient measures for the audit teams to have critical mindset, and the EQC reviewer or the periodic inspection reviewer does not sufficiently perform critical review against the audit team's procedures. Further investigations into the root causes have revealed that the top management has believed that, by the introduction and implementation of audit quality improvement measures, every engagement team would proactively address all accounting and audit issues to obtain sufficient appropriate audit evidence. Furthermore, the top management has believed that a risk-based appointment of EQC reviewers and the measures to secure sufficient preparation period for internal periodic review would raise awareness of the reviewers to conduct in-depth reviews.

### [Case 2]

At the audit firm, multiple deficiencies, including significant ones, are identified with regard to some audit engagements subject to inspection.

The direct causes of these deficiencies are as follows: the audit teams do not sufficiently perform critical review against management's assertions concerning the timeliness of accounting treatment for accounting estimates; and the audit teams do not recognize the need to reconsider if sufficient audit procedures are performed to the areas where the risk of material misstatement is deemed relatively low. Furthermore, there were common causes for deficiencies in the quality control system as follows: the quality control headquarters does not give clear instructions to the audit divisions regarding the width and the depth of audit procedures to be performed, and the quality control headquarters does not sufficiently collaborate with the audit divisions to check the effectiveness of quality improvement measures.

Further considerations into the root cause have revealed that the top management does not sufficiently recognize the need to monitor the close collaboration between the quality control division and the audit divisions to realize the effect of improvement measures.

### [Case 3]



At the audit firm, multiple deficiencies, including significant ones, are identified with regard to some audit engagements subject to inspection.

The direct causes of these deficiencies are as follows: the audit teams do not pay sufficient attention

to reconsider the risk assessment of audited companies according to changes in the corporate environment, especially for audit areas where the risk of material misstatements are deemed relatively low. Also, the audit teams do not pay sufficient attention to consider if appropriate audit procedures have been performed responding to the identified audit risks. Furthermore, the common cause of the deficiencies in the quality control system is that the quality control headquarters does not give sufficient instruction for the audit divisions to ensure if appropriate risk assessments and audit procedures are performed. Further investigations into the root cause has revealed that the top management has believed that, only by implementation of audit quality improvement measures, the audit teams would perform appropriate risk assessments and audit procedures. Also, the top management does not sufficiently recognize the need to check the execution status of the measures in the audit frontline.

### **[Mid-tier audit firms]**

#### **[Case 1]**

At the audit firm, multiple deficiencies, including significant ones, are identified with regard to some audit engagements subject to inspection.

The direct causes of these deficiencies include a tendency to follow the previous year's audit procedures and a lack of professional skepticism to challenge management assertions. Also, a common cause of the deficiencies in the quality control system is that the PICOQC has not recognized the resource shortage in the quality control division as the main reason of the deficiencies being undetected and/or unremedied.

Further analysis of the root cause has revealed that the CEO does not recognize the need to check the adequacy and effectiveness of the quality control system by himself. For example, the CEO has failed to grasp that the top management does not recognize the resource shortage under the business expansion, and the CEO has believed that the enhancement of the headquarters function and the improvement of the quality control system would be realized only by leaving them to the division heads.

Another root cause is that the CEO and other executives do not pay sufficient attention to monitoring the penetration and the effectiveness of quality control measures in the audit frontline, in spite of the insufficient commitment of the engagement partners to their duties and the insufficient audit quality improvements in the audit teams.

#### **[Case 2]**



At the audit firm, a wide range of deficiencies, including significant ones, are deficiencies, identified in all audit engagements subject to inspection.

The direct causes of these deficiencies are that the engagement teams do not sufficiently understand the audit standards and the level of procedures required under the current audit standards, and that

they do not sufficiently understand the significant assumptions used by the audited company when auditing accounting estimates. They also do not critically examine the management's assertions about the significant assumptions, thus failing to exercise professional skepticism. The common causes of deficiencies are as follows; the quality control headquarters has believed that, only by communication of the quality control policies, procedures and measures through training, etc, the audit team would deal with them appropriately, and the quality control headquarters does not pay sufficient attention to monitoring the penetration and effectiveness of them for better ones. Another common cause is that each partner does not have proper critical attitude when conducting audit working paper review, engagement quality control review, and internal periodic inspection and does not appropriately fulfill the responsibility as audit partner. Further investigation into the root cause has revealed the followings: the CEO and other executives do not have sufficient compliance mindset to the professional ethics and the internal rules, and do not pay sufficient attention to fostering a quality-first culture and to building an effective operations management system; they are so focused on the early realization of full-time engagement of the partners and staffs that they have lacked sufficient attention to improvement of the firm's audit quality, despite that they have been aware of constant shortage of the resources and the skills; and furthermore, the CEO and other partners do not accurately grasp the situations that the professional staffs, including themselves, do not understand the audit standards and the level of procedures required under the current audit standards, and do not have critical attitude toward management assertions when auditing accounting estimates.

### [Case 3]

At the audit firm, multiple deficiencies are identified in all audit engagements subject to inspection; especially a number of deficiencies, including significant ones, are identified at a particular regional office.

Those deficiencies in the audit engagements have common causes; the engagement partners and staffs do not have sufficient understanding of the level of audit procedures required under the current audit standards, do not keep professional skepticism for response to fraud risk and audit in accounting estimates, and do not pay sufficient attention to reconsidering risk assessment and audit procedure every year. In addition, the deficiencies at a particular regional office have a common cause that the lead engagement partner put such an excessive reliance on the other engagement partner, a main person performing the audit procedures, that he does not pay proper attention to his work.

The common cause in the quality control system is the PICOQC has not recognized the need to cooperation between the quality control division and audit divisions under the belief that the audit division should lead the improvement measures. The common cause for a particular regional office is the top management has believed that appropriate audit team would be organized at the regional office only by assigning appropriate audit partner, so that he does not provide any additional support

to the regional office.

Further investigations into the root causes have revealed that the CEO does not like to demonstrate a strong leadership in planning and implementing audit quality improvement measures for prompt improvements, rather values autonomy of the quality control division and the audit divisions. In addition, the top management does not recognize the necessity of strong collaboration between the quality control division and the audit divisions by valuing autonomy in those divisions. Furthermore, despite the concern about the audit quality at a regional office, the top management has not recognized a need to proactively support the regional office because they have a belief that the regional office is able to make improvements on their own.

### **[Small and medium-sized audit firms]**

#### **[Case 1]**

Deficiencies are identified in the quality control system at this audit firm, and a number of deficiencies, including significant ones, are also identified in the audit engagements subject to inspection.

The common causes of the deficiencies in the audit engagements are as follows: audit teams does not sufficiently understand the level of procedures required under the current audit standards, such as assessment and response to fraud risks and audit of accounting estimates; audit partners put such an excessive reliance on assistants to engagement partner that they do not perform in-depth review of the audit documentation. The common causes of the deficiencies in the quality control system are as follows: the CEO and the PICOQC do not perform a root cause analysis of deficiencies identified in the quality control reviews and daily monitoring activities (including periodic inspections) in order to prevent similar deficiencies from recurring; and they do not recognize the situation that the assistants to engagement partner do not have sufficient understanding of the level of procedures required under the current audit standards.

Further investigations into the root cause has revealed that the CEO and the PICOQC have a belief that their audit quality is sufficient as they did not receive any significant deficiencies in the past quality control reviews, resulting they does not pay sufficient attention to the improvement of their audit quality. In addition, they have not demonstrated leadership to improve audit quality due to their belief that audit quality would be improved only by establishment of quality control system.

#### **[Case 2]**



At the audit firm, a wide range of deficiencies, including significant ones, are identified in the audit engagements subject to inspection. The common causes of the deficiencies in the audit engagements are as follows; the engagement team does not have sufficient understanding of the accounting standards, the audit standards, and the level of procedures required by the audit standards; and the engagement team lacks professional skepticism and does not critically test the management

assumptions when auditing accounting estimates. The common causes of deficiencies in the quality control system are as follows: the CEO and other partners do not share a mindset to ensure appropriate audit quality through in-depth reviews of audit procedures each other and do not foster an appropriate firm culture; in addition, the CEO and the PICOQC do not recognize the needs to check the penetration and effectiveness of the improvement measures for deficiencies and actually do not execute such checks. Further investigation into the root causes has revealed that the CEO is not willing to take a leadership for more effective and systematic operations management system and quality control system to ensure appropriate audit quality. Furthermore, the CEO and the PICOQC have believed that the firm's audit quality has been at an appropriate level because the audit partners have extensive audit experience and the professional staffs came from large-sized audit firms, and they do not accurately understand the level of the firm's audit quality.

### [Case 3]

Although the audit firm is small, it has two audit divisions since its foundation. Each division independently manages its audit engagements, financial affairs, and personnel affairs, which has created a firm culture that values independence of each division. Furthermore, only engagement partners work on a full-time basis, while all professional staffs work on a part-time basis.

Under these circumstances, at the audit firm, multiple deficiencies, including significant ones, are identified in the quality control system. In addition, a number of deficiencies, including significant ones, are identified in the audit engagements subject to inspection.

The deficiencies in the audit engagements have common causes as follows; the engagement partners and the staffs do not sufficiently understand the level of audit procedures required by the audit standards and do not keep professional skepticism such as critical mindset to challenge management assertions; and part-time staffs do not have a sense of belonging to the firm and do not pay sufficient attention to maintain and improve the audit quality. The common causes in the quality control system are as follows; the CEO and the PICOQC do not sufficiently understand how to perform root cause analysis to prevent the deficiencies from recurring, and placed so much reliance on audit team members that have sufficient capabilities based on their past audit experiences.

Further analysis of root causes has revealed that the CEO and the PICOQC are not aware that all audit team members, including themselves, do not sufficiently understand the audit standards and the levels of quality control system and the audit procedures required by the standards. In addition, the CEO and the PICOQC have believed that the firm's current operations management system is appropriate, since no significant deficiencies were detected in the past quality control reviews, etc. As a result, they do not recognize the need to transform the firm's operations management system, such as integration of the two divisions and/or employment of more full-time staffs.

As shown in the above cases, the root causes of deficiencies are often in the operations management system or the quality control system, and eliminating these root causes is necessary in order to remediate the

deficiencies.

Audit firms, large-sized ones in particular, are currently making efforts to establish and strengthen organizational operations in accordance with the Audit Firm Governance Code. They should give due consideration to the effectiveness of those efforts so that the efforts can contribute to ensuring and improving audit quality.

### **(3) Specific Examples of Root Causes**

The following are specific examples of root causes identified in inspections, including those mentioned in 1. (2) Root Cause Analysis.

It is necessary to work on substantial resolution of root causes, such as problems with the operations management system of the audit firm.

#### **[Large-sized audit firms]**

Large-sized audit firms often have issues in the operation of quality control system. Since large-sized audit firms have thousands of employees, they often run its business by multiple divisions which have hundreds of people each, including local offices. Under such circumstances, in order to improve the level of quality control throughout the entire organization, it is necessary not only to set up a formality of quality control system, but also to ensure penetration of quality improvement measures through every audit team by strong management leadership and collaboration with audit frontline. In recent years, large-sized audit firms have started to establish a quality control system not only at headquarters level but also with the audit frontline in order to make quality improvement efforts sustainable, therefore the importance of audit frontline for the audit quality improvement has been increasing. However, in efforts to improve audit quality, there are cases where the firm's management have left the efforts to audit frontline to value autonomy of audit frontline, or cases where communication between the firm's management and the audit frontline has been insufficient. As a result, there are such issues that the actual situation of audit frontline has not been sufficiently understood, or the improvement measures have not been sufficiently monitored. Therefore, the firm's management, including the quality control division, needs to sufficiently check the penetration and effectiveness of improvement measures with appropriate understanding of the audit frontline.

The followings are specific examples of root causes of deficiencies at large-sized audit firms identified by the CPAAOB's inspections:



- The top management has believed that, by the introduction and implementation of audit quality improvement measures, every engagement team would proactively address all accounting and audit issues to obtain sufficient appropriate audit evidence. Furthermore, the top management has believed that a risk-based appointment of EQC reviewers and the measures to secure sufficient

preparation period for internal periodic review would raise awareness of the reviewers to conduct in-depth reviews. (With regard to root cause analysis regarding this example, also refer to [Large-sized audit firms] [Case 1] on p. 9)

- The top management does not sufficiently recognize the need to monitor the close collaboration between the quality control division and the audit divisions to realize the effect of improvement measures. (With regard to root cause analysis regarding this example, also refer to [Large-sized audit firms] [Case 2] on p. 9).



- The top management has believed that, only by implementation of audit quality improvement measures, the audit teams would perform appropriate risk assessments and audit procedures. Also, the top management does not sufficiently recognize the need to check the execution status of the measures in the audit frontline. (With regard to root cause analysis regarding this example, also refer to [Large-sized audit firms] [Case 3] on p. 9).



- The top management has believed that audit responses for areas other than significant risk areas would be improved only by notifications.
- The top management and the quality control headquarters have believed that all engagement partners and team members have a full understanding of the purpose and the importance of the CPA registration system, and have believed that they appropriately handle CPA information, such as headcount or audit hours, when preparing the public documents.

### **[Mid-tier audit firms]**

It is recognized that mid-tier audit firms are making efforts to improve the quality control system, however, it is also recognized that enhancement of the headquarters function is insufficient. Furthermore, there are situations where top managements' awareness of the quality control has not caught up with the firms' growth, where firms are heavily dependent on part-time staffs and non-CPA assistants in the execution of audit engagements, and where a particular regional office has an audit quality issue. The root causes of deficiencies are different from firm to firm due to the difference in operations management systems, size of operations, and its history.

Accordingly, each firm needs to conduct substantial root cause analysis for effective improvement of the audit quality.

The followings are specific examples of root causes of deficiencies at Mid-tier audit firms identified by the CPAAQB's inspections:

- The CEO does not recognize the need to check the adequacy and effectiveness of the quality control system by himself. For example, the CEO has failed to grasp that the top management does not recognize the resource shortage under the business expansion, and the CEO has believed that the enhancement of the headquarters function and the improvement of the quality control system

would be realized only by leaving them to the division heads. Another root cause is that the CEO and other executives do not pay sufficient attention to monitoring the penetration and the effectiveness of quality control measures in the audit frontline, in spite of the insufficient commitment of the engagement partners to their duties and the insufficient audit quality improvements in the audit teams. (With regard to root cause analysis regarding this example, also refer to [Mid-tier audit firms] [Case 1] on p. 10)



- The CEO and other executives do not have sufficient compliance mindset to the professional ethics and the internal rules, and do not pay sufficient attention to fostering a quality-first culture and to building an effective operations management system. In addition, they are so focused on the early realization of full-time engagement of the partners and staffs that they have lacked sufficient attention to improvement of the firm's audit quality, despite that they have been aware of constant shortage of the resources and the skills. Furthermore, the CEO and other partners do not accurately grasp the situations that the professional staffs, including themselves, do not understand the of audit standards and the level of procedures required under the current audit standards, and do not have critical attitude toward management assertions when auditing accounting estimates. (With regard to root cause analysis regarding this example, also refer to [Mid-tier audit firms] [Case 2] on p.10)
- The CEO does not like to demonstrate a strong leadership in planning and implementing audit quality improvement measures for prompt improvements, rather values autonomy of the quality control division and the audit divisions. In addition, the top management does not recognize the necessity of strong collaboration between the quality control division and the audit divisions by valuing autonomy in those divisions. Furthermore, despite the concern about the audit quality at a regional office, the top management has not recognized a need to proactively support the regional office because they have a belief that the regional office is able to make improvements on their own. (With regard to root cause analysis regarding this example, also refer to [Mid-tier audit firms] [Case 3] on p.11)
- The members of the Management Committee have believed that the resource issues (human, time) were resolved by measures such as reconsidering staff assignment, monitoring the ratio of audit partner hour to the total, and increasing the headcount of audit assistants.
- The top management, including the CEO, has lacked awareness of taking initiative in making sincere efforts to maintain and improve audit quality, and does not demonstrate leadership for an appropriate level of audit quality in the firm. In addition, because no significant quality control issues were noted as a result of improvement measures taken in response to the deficiencies identified in the external inspections, the top management has believed that their insufficient understanding of audit standards has already been resolved and their audit quality has been improved to an appropriate level. As a result, the top management has not yet accurately grasped, the level of audit quality at the firm as a whole.



### [Small and medium-sized audit firms]

Small and medium-sized audit firms are different in size and history, and the level of quality control systems differ from firm to firm. However, all of them have relatively small organizations, and it is difficult to provide audit teams with organizational support. The level of operation management and quality control is often affected by the abilities of the CEO and other individuals and their relationship. It is important that the CEO demonstrates leadership in quality control because there are many cases in which the low level of awareness and involvement of the CEO in quality control affects the quality control culture of the firm. It should also be noted that in the event of a significant change in the business environment, such as a merger, the CEO should demonstrate full leadership to appropriately update the quality control system in line with the change. The followings are the specific examples of root causes at small and medium-sized audit firms identified in the CPAAOB inspections. In recent inspections, "the CEO's insufficient demonstration of leadership toward quality improvement" and/or "failure to accurately grasp the level of audit quality at the firm" have often been identified as root cause.

- The CEO and the PICOQC have a belief that their audit quality is sufficient as they did not receive any significant deficiencies in the past quality control reviews, resulting they does not pay sufficient attention to the improvement of their audit quality. In addition, they have not demonstrated leadership to improve audit quality due to their belief that audit quality would be improved only by establishment of quality control system. (With regard to root cause analysis regarding this example, also refer to [Small and medium-sized audit firms] [Case 1] on p.12)
- The CEO is not willing to take a leadership for more effective and systematic operations management system and quality control system to ensure appropriate audit quality. Furthermore, the CEO and the PICOQC have believed that the firm's audit quality has been at an appropriate level because the audit partners have extensive audit experience and the professional staffs came from large-sized audit firms, and they do not accurately understand the level of the firm's audit quality. (With regard to root cause analysis regarding this example, also refer to [Small and medium-sized audit firms] [Case 2] on p.12)
- Although the audit firm is small, it has two audit divisions since its foundation. Each division independently manages its audit engagements, financial affairs, and personnel affairs, which has created a firm culture that values independence of each division. Furthermore, only engagement partners work on a full-time basis, while all professional staffs work on a part-time basis. Under these circumstances, the CEO and the PICOQC are not aware that all audit team members, including themselves, do not sufficiently understand the audit standards and the levels of quality control system and the audit procedures required by the standards. In addition, the CEO and the PICOQC have believed that the firm's current operations management system is appropriate, since no significant deficiencies were detected in the past quality control reviews, etc. As a result, they do not recognize the need to transform the firm's operations management system, such as



integration of the two divisions and/or employment of more full-time staffs. (With regard to root cause analysis regarding this example, also refer to [Small and medium-sized audit firms] [Case 3] on p.13)

- Each partner, including the CEO, does not have critical mindset to other partners' audit quality, and does not pay attention to the improvement of the firm's audit quality. In addition, each partner, including the CEO, is expanding a wide range of non-audit services through affiliated companies, which has made them to lower the priority of the audit quality.
- The CEO and the PICOQC does not demonstrate leadership to maintenance and improvement of the audit quality. In addition, they are not aware that professional staffs, including themselves, have lacked an understanding of current audit standards and/or the level of quality control and audit procedures required by the standards.
- The CEO has failed to create a firm culture to put priority on the professional ethics, so that the partners and the staffs have extremely lacked the attention to the importance of keeping professional integrity and credibility. In addition, the CEO and the PICOQC have believed that the understanding of the level of procedures required by the current audit standards has been wide spread throughout the firm as a result of the recruitment of CPAs who have extensive work experience at large-sized audit firms and the execution of sufficient in-house trainings training.
- The audit firm is working on the operational improvements responding to the Business Improvement Order (improvement of operations management system) by the FSA and the several improvement recommendations by the quality control reviews.

Under this situation, the aforementioned order or the recommendations have not been recognized as the fundamental issue at the firm, because each partner of the firm has been engaged in large volume of non-audit service as their own private business, resulting lower attention to the audit quality at the firm. Moreover, the CEO and the PICOQC have lacked the attention to make the quality control system more effective, and have not demonstrated the leadership for better audit quality. Furthermore, each partner at the firm has not been aware of the need to monitor the quality of other audit engagements one another, which is a lack of responsibility as an audit partner. Thus, the firm does not foster a good corporate culture, in which each partner actively interact one another for better audit quality, and has not prepared for conducting organized audits.

- The audit firm merged with the other firm recently. The CEO has not recognized the importance of integration of the management structures with regard to personnel evaluations, compensation, engagement team assignments, and others. Furthermore, the partners at the firm have continued specific audit engagements for many years and have lost professional skepticism in assessing audit risks in light of the latest corporate environment.
- The CEO thinks that important management issues should be discussed among limited members such as the CEO, the PICOQC, and the EQC reviewers; and does not think it necessary to share those issues with all partners. As such, the CEO has not fostered a collaborative firm culture for better audit quality, and thus has not prepared for conducting organized audits in the firm.



- The audit firm comprises a small number of partners and staffs who have no work experience at other audit firms, and has not changed its management style since its foundation. For many years, a limited number of listed companies has been main audit clients for the firm, and as a result, total fee received from those main clients to the firm (fee dependency) is high.  
Under the circumstance, the CEO, who is also a PICOQC, has placed top priority on keeping the relationships with the main clients and has believed that there was no issue with the audit quality and the firm's management style. In addition, the CEO/PICOQC has not recognized the need to keep attention to the necessary qualifications as certified public accountants, such as audit quality, professional ethics and independence. He has also not been aware of the need to have organized operations management system and quality control systems. Moreover, as a result of the firm management run only by the CEO/PICOQC for a long time, other partners have not been aware of the need to fulfill their responsibilities.
- When evaluating partners, the CEO has placed more importance on quantitative factors such as the number of audit engagement in charge, the number of new audit engagement, etc; on the other hand, the CEO has placed less importance on audit quality aspects. In this way, the CEO has not paid sufficient attention to the design and operation of quality control system that places more importance on the audit quality.
- The president and the PICOQC have not sufficiently recognized the lack of understanding for the purpose of the current audit standards and the level of quality control and audit procedures required under the standards. Also, the president and the PICOQC have believed that their partners have sufficient audit capabilities due to their rich experience in the past, so that they put excessive reliance on them.
- The president and the PICOQC have not been aware of the need to establish an organized quality control system because they have believed that there are no problems in the current firm operations. Furthermore, they have not recognized that there is a lack of understanding for the purpose of the current audit standards and/or the level of quality control and audit procedures required under the standards.
- The CEO has the highest priority on issuing an unqualified audit opinion in time, so that he has not exercised the professional due care, and has not paid sufficient attention to fulfill the role and responsibility as an audit firm, which is entrusted by the society. Other engagement partners, including the PICOQC, is going along with the CEO and do not keep other engagement partners' quality in check.
- The audit firm is established by partners who were colleagues at a large-sized audit firm. As the audit firm comprises a small number of partners, the CEO and the PICOQC have believed that they understand the partners' abilities each other and they are demonstrating their abilities. In addition, since no significant deficiencies have been pointed out in the past quality control reviews, the CEO and the PICOQC have believed that the firm has minimum level of quality control system

in place according to the size. Accordingly, they have not sufficiently recognized the need to develop an organized quality control system.

## **2. Response to the Audit Firm Governance Code**

Based on the economic and social situation surrounding the accounting audits, the Act for Partial Amendment of the Certified Public Accountants Act and the Financial Instruments and Exchange Act were enacted and promulgated in May 2022, and the related government orders were promulgated in January 2023 and came into effect in April 2023. The Act introduced a registration system of audit firms that engage in audits of listed companies in order to ensure the reliability of accounting audits and to contribute to further demonstration and improvement of the CPA's ability. As a result, audit firms that engage in audits of listed companies are obliged to establish a system to conduct its operations in accordance with the Audit Firm Governance Code and a system to realize an enhanced information disclosure.

The Audit Firm Governance Code was established in 2017. Based on the above laws and regulations, the Expert Review Committee on the Audit Firm Governance Code held discussions and revised the Audit Firm Governance Code in March 2023 to require effective disciplines suited to the size and the nature of audit firms. The purpose of the revision was to: (i) make small and medium-sized audit firms that engage in audits of listed companies to easily adopt the code; and (ii) enhance disclosure regarding the globalization of audit firms and others.

The Audit Firm Governance Code has been developed for organized business operation by audit firms that engage in audits of listed companies, but it does not exclude voluntary adoption by other audit firms. On this basis, each audit firm is required to determine if the Audit Firm Governance Code should be implemented for effective organizational management at their own discretion based on its size and characteristics.

For more information such as the adoption status by audit firm size, please refer to the "2024 Monitoring Report".

## **3. Responses to the Revision of Quality Control Standards**

The Business Accounting Council of Japan published an opinion letter on the revision of quality control standards for audits ("Quality Control Standards") (November 16, 2021). The opinion letter included the introduction of a quality management system (a management method in which audit firms: (i) set quality objectives; (ii) identify and assess quality risks that hinder the achievement of quality objectives; (iii) define and implement policies or procedures to address the assessed quality risks; and (iv) make remediations based on root cause analysis if there are deficiencies), according to the revisions of international quality control standards such as "International Quality Management Standard 1" (Quality Management at Audit Firms - ISQM1), "International Quality Management Standard 2" (ISQM2), and

"Quality Control for Financial Statement Audits" (ISA220). The revised Quality Control Standards are required to be implemented from the audits of financial statements for fiscal years starting on or after July 1, 2023 (for audit firms other than large-scale audit firms under the Certified Public Accountants Act, for fiscal years starting on or after July 1, 2024).

The JICPA published Quality Control Standards Statement No. 1, Practical Guidance No. 3 (Q & A on Quality Control at Audit Firms and Audit Engagements, and Reviews of Audit Engagements) (February 16, 2023) and Quality Control Standards Statement No. 1, Practical Guidance No. 4 (Tools for Quality Control at Audit Firms) (last amended on January 17, 2024) for applying the revised quality control standards.

For more information about responses by the size of audit firms, please refer to the "2024 Monitoring Report".