

2024 Monitoring Report

Certified Public Accountants and Auditing Oversight Board
July 2024

Introduction

The Certified Public Accountants and Auditing Oversight Board (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 our 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 the CPAAOB launched publishing this type of report under the title "Monitoring Report" in July 2016, we have updated the data on 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 "2024 Monitoring Report" compiled incorporating achievements and so forth of monitoring in the program year 2024 (from July 2023 through June 2024).

The CPAAOB has recently reviewed the content of the "Activities of the Certified Public Accountants and Auditing Oversight Board" from the perspective of facilitating and streamlining the acquisition of information by readers. Accordingly, information related to examination and inspection of audit firms, which had been included only in the "Activities of the Certified Public Accountants and Auditing Oversight Board", is now included in the Monitoring Report.

(Composition of the Monitoring Report and major revisions for the 2024 version)

I. Overview of the Audit Sector

This part presents the overview of CPAs, audit firms, and audited companies. We have added the status of audit firms' responses to the revised Standard on Quality Control of Audits.

II. Monitoring by the CPAAOB

This part presents a whole picture of CPAAOB's monitoring including inspection. In addition to updating information related to monitoring, we have elaborated the Basic Plan for Monitoring Audit Firms and so forth in the program year 2024.

III. Operation of Audit Firms

This part presents the structure of audit firms and their operation, including the status of digitalization of audit and group audit. This part also presents the status of changes of accounting auditors and variations of audit fee.

IV. Responses to Changes in the Global Environment Surrounding Audits

This part presents the changes of regulations and institutions caused by recent movement of audit environment. We have described the changes related to small and mid-sized audit firms whose responsibility as auditors of domestic listed companies became more significant recently. We have also described the movement of the disclosure and assurance of sustainability.

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.

Contact us:
Monitoring and Inspection Division,
Executive Bureau of the CPAAOB
iiu.cpaaob@fsa.go.jp

Contents

Introduction	1
(Abbreviations)	6
(Terms)	6
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.....	12
4. Age Structure of Persons who Passed the CPA exam	13
B. Audit Firms	14
1. Organizational Structure of Audit Firms.....	15
2. Development of Quality Control Structures and Responses by Audit Firms.....	16
3. Number of Audit firms	19
4. Mergers of Audit Firms.....	19
5. Financial Condition (Operating Revenue, Proportion of Audit and Attestation Services and Non-audit and Attestation Services)	20
C. Audited Companies.....	23
1. Types of Audit and Attestation Services	23
2. FIEA and Companies Act Audits	24
3. Audits of Financial Institutions	27
4. Companies Adopting IFRS	27
5. Audits of Initial Public Offerings	28
II. Monitoring by the CPAAOB	31
A. Overview of System and Situation with Implementation.....	32
1. Legal Position of the CPAAOB	32
2. Overview of Examinations, Collection of Reports, and Inspections by the CPAAOB	32
3. Report of JICPA Quality Control Review	33
4. Examination	34
5. Collection of Reports.....	36
6. Inspections	39
7. Notification of Inspection Results.....	44
8. Recommendation.....	47
B. Foreign Audit firms	48
1. System for Foreign Audit Firms	48
2. Foreign Audit Firms	48
3. Audited Companies	49
C. The CPAAOB monitoring Perspectives, Objectives etc.	50

1. Basic Policy for Monitoring Audit Firms	50
2. Basic Plan for Monitoring Audit Firms for Program Year 2024	51
3. Strengthening Monitoring.....	53
4. Cooperation with Related Organizations	53
5. Communication of Monitoring Information.....	54
III. Operation of Audit Firms	55
A. Operations Management System	56
1. Organizational Structure of Audit Firms.....	56
2. Efforts in Response to Audit Firm Governance Code.....	59
3. Human Resources of Audit Firms	66
4. Organizational Structure for Providing Audit Services.....	70
5. Organizational Structure for Supporting Audit Services	72
6. Usage of Technology in Audit and Cybersecurity Efforts.....	74
7. Responses to Overseas Expansion of Companies	80
8. Treatment of Key Audit Matters	85
9. Domestic Audit Firm Groups.....	88
B. Engagement Quality Control Reviews	91
C. Monitoring of Systems of Quality Control	93
1. Periodic Inspections.....	93
2. Utilization of Global Reviews	94
3. Monitoring Before Expression of Audit Opinions	95
D. Education, Training and Evaluation of Audit Personnel.....	96
1. Human Resource Development.....	96
2. Education and Training of Engagement Teams.....	96
3. Evaluation of Engagement Team Members.....	98
E. Acceptance of New Audit Engagements and Changes of Accounting Auditors	100
1. Reasons for Change of Accounting Auditors Given in Timely Disclosures by Audited Companies	102
2. Reasons for Change of Accounting Auditors during Fiscal Term	102
3. Reasons for Changes of Accounting Auditors as Identified Through Monitoring Activities.....	103
F. Audit Fees	105
1. Rules on Audit Fees	105
2. Methods for Calculating Audit Fees	105
3. Audit Fees Before and After Changes in Accounting Auditors	106
4. Dependence of Fees (Safeguards).....	107
IV. Responses to Changes in the Global Environment Surrounding Audits	109
A. Trends Surrounding Small and Medium-Sized Audit Firms	110
1. Changes in the Environment Surrounding Audits by Small and Medium-Sized Audit Firms	110

2. Response by the JICPA to Small and Medium-Sized Audit Firms	110
3. Response by the CPAAOB	113
B. Recent Trends with Auditing	114
1. Trends in International Auditing Standards and Ethical Standards	114
2. Revision of the Code of Ethics by JICPA.....	114
3. Other Trends in Financial Reporting Systems.....	115
C. Trends in Sustainability Disclosure and Assurance.....	118
1. Trends in Sustainability Disclosure	118
2. Trends in Assurance on Sustainability Disclosures	121
(Reference materials).....	127

Column

Initiatives to improve the attractiveness of audit services.....	11
Share of Large-sized Audit Firms.....	27
IPO support services.....	31
Disclosure of Audit Quality Indicators (AQIs).....	68
Effective audit using AI.....	81
Average working hours at large-sized and mid-tier audit firms.....	82
CPA and Anti-Money Laundering and Countering the Financing Terrorism (AML/CFT)	83
International Forum of Independent Audit Regulators (IFIAR).....	89
Reasonable and limited assurance engagements for sustainability information	130
Knowledge required for sustainability information assurance	131

(Abbreviations)

The formal names of the 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 Japan 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 four audit firms: Gyosei & Co., BDO Sanyu & Co., Grant Thornton Taiyo LLC, and Crowe Toyo & Co.
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
Large audit firm	An audit firm that provided audit and attestation services to more than 100 listed companies. etc. in the most recent fiscal year. In this report, we refer to six audit firms including Large-sized audit firm, BDO Sanyu & Co. and Grant Thornton Taiyo LLC.

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.
Listed financial institution	Among domestic listed companies, refers to banks, securities and commodity futures companies and insurance companies in the industry categories.
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, and amended on March 24, 2023
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 FIEA 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 of listed securities 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

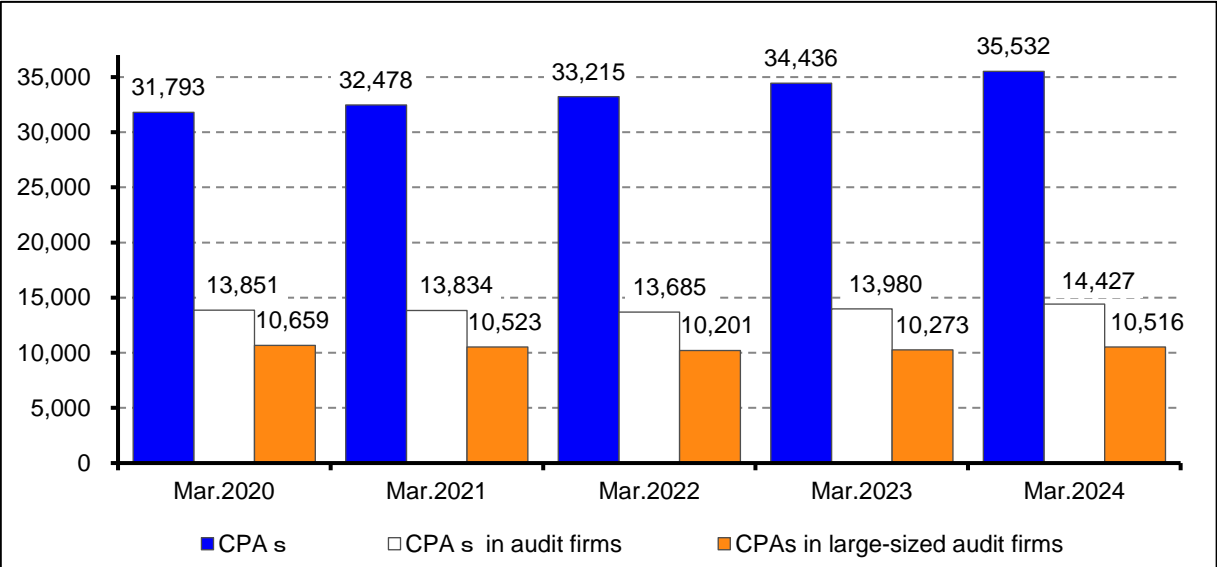
To become a certified public accountant, a person must pass the certified public accountant examination, satisfy certain requirements (business assistance, professional accountancy education program, etc.), and be registered on the roster maintained by the Japanese Institute of Certified Public Accountants (Articles 3, 17, and 18 of the CPA Act).

The number of registered CPAs has been gradually increasing over the past few years. However, but the number of CPAs working at audit firms has not increased as much as the number of registered CPAs. The ratio of the number of CPAs working at audit firms to the total number of registered CPAs has been declining year by year, and continued to decline from 43.6% at the end of March 2020 to 40.6% at the end of March 2024. Of the registered CPAs belonging to audit firms, around 70% at large-sized audit firms (Figure I-1-1).

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

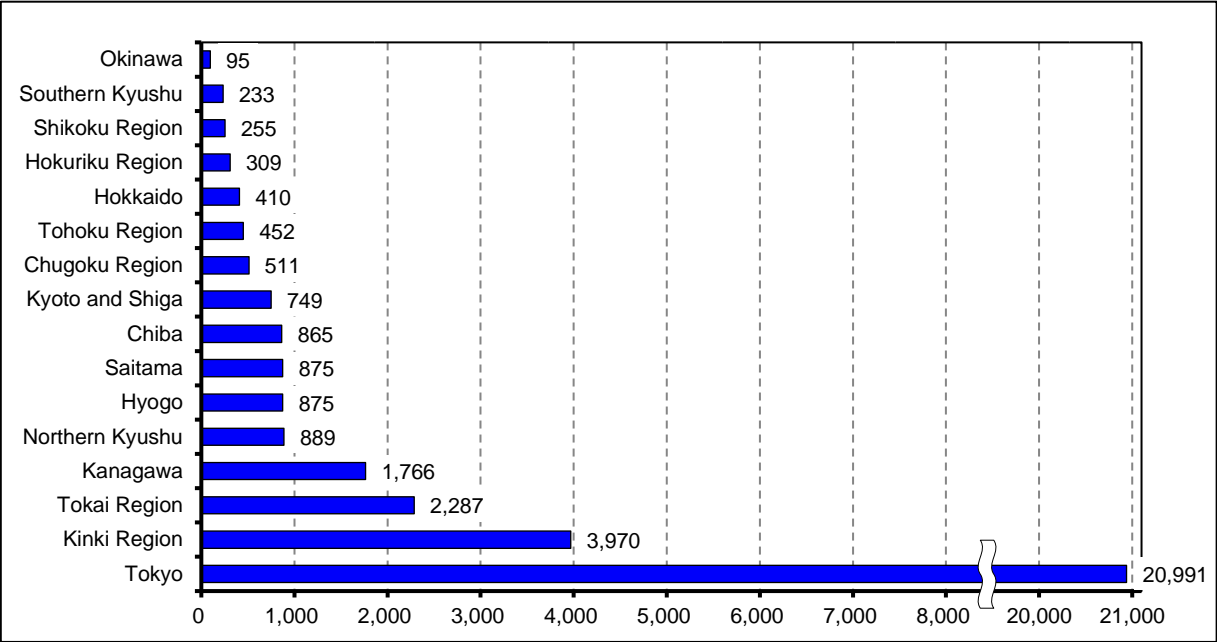
31, 2024). Around 70% of CPAs are based in the Tokyo metropolitan area (Tokyo, Kanagawa, Saitama, Chiba) (Figure I-1-2).

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



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

Figure I-1-2: Number of CPAs by regional chapter (March 31, 2024; unit: persons)



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

■ Initiatives to Improve the Attractiveness of Audit Services ■

The number of registered CPAs increased from 24,964 at the end of March 2013 to 34,436 at the end of March 2023 (37.9% increase). On the other hand, the number of personnel working at audit firms has not increased as much as the number of registered personnel, from 12,799 at the end of March 2013 to 13,980 at the end of March 2023 (9.2% increase). With the growing needs for audits in terms of both quality and quantity, there are concerns about a shortage of personnel in charge of audits. Improving the attractiveness of audit services and securing audit professionals are not issues unique to Japan and many countries are taking action. The International Federation of Accountants (IFAC) reported that more than 300,000 accountants in the United States, representing 17% of registered accountants, left their jobs between 2020 and 2022, and that the number of students applying to become an accountant has fallen by 2.6 million over the past decade.

As a background to this situation, IFAC states that the factors that caused personnel difficulties for small and medium-sized audit firms are now affecting the audit industry as a whole; specifically, (I) declining the number of applicants, (ii) increasing the opportunities for employment in other fields, and (iii) concerns about achieving work-life balance and flexible working styles. The Association of Chartered Certified Accountants in the United Kingdom (ACCA) has cited three reasons why young accountants do not want to audit services: (i) dissatisfaction with pay, (ii) lack of flexibility in working styles such as remote work, (iii) exhaustion from working long hours, and (iv) concern about being replaced by technology. In Japan as well, the increase in mechanical and monotonous work, long working hours, and inability to realize the results of one's own work are reported as reasons why accountants do not find audit attractive.

By classifying the above factors into (I) decline in motivation and incentive to engage in audit services or to belong to audit firms, (ii) increase in workload due to the refinement of audit standards and manuals, and (iii) increase in opportunities for employment in other fields, we would like to introduce the efforts of audit firms to increase the attractiveness of engaging in audit services and to secure personnel engaging audit services.

(I) Initiatives to address declining motivation and incentive to engage in audit services or to belong to audit firms

- Flexible timing of promotion, including earlier promotion for capable staff and promotions that take into account the preference for work-life balance;
- Career diversification (creating the promotion paths allow for the acquisition of expertise in addition to the promotion path from staff to partners);
- Providing work opportunities for non-audit work, such as tax and advisory services, as well as expanding opportunities for short-term secondments to external organizations and interdepartmental transfers;
- Enhancing communication within small groups and mentoring programs, as well as developing the sense of commitment by increasing opportunities for bottom-up proposals and awards, etc.

(II) Efforts to address workloads associated with the refinement of audit standards and manuals

- Creation of a function to centrally manage and equalize assignments handled by each partner/staff
- Greater flexibility in working locations and hours through remote work and flexible working hours
- Strengthening overtime management and restricting network access at night and on holidays
- Improving efficiency by introducing IT system and transferring operations to a service delivery center (an organization established to perform non-judgemental tasks such as sending and collecting balance confirmation letters)

In particular, large-sized audit firms are actively introducing IT system and transferring operations to service delivery centers, with the aim of reducing working hours and allowing audit staff to focus on tasks requiring high-level judgment.

(III) Initiatives to respond to the increase in employment opportunities in other fields

In recent years, the fields in which CPAs play an active role have expanded, and there are a growing number of careers in which CPAs can make a tangible contributions to organizations and society, such as accounting managers of business companies, CFOs of start-ups, consulting firms, and NPOs.

Under these circumstances, the message that "audit is a social infrastructure that ensures the fairness of capital markets," which has been a source of attraction for audit services, has become relatively less convincing, and audit firms have yet to find effective measures to address this situation. Furthermore, audit firms' compensation tends to be less favorable than that of business companies and consulting firms. It is not easy for audit firms to increase audit fees, which are the source of their salaries, and therefore they have not found effective measures to increase the economic attractiveness of audit services.

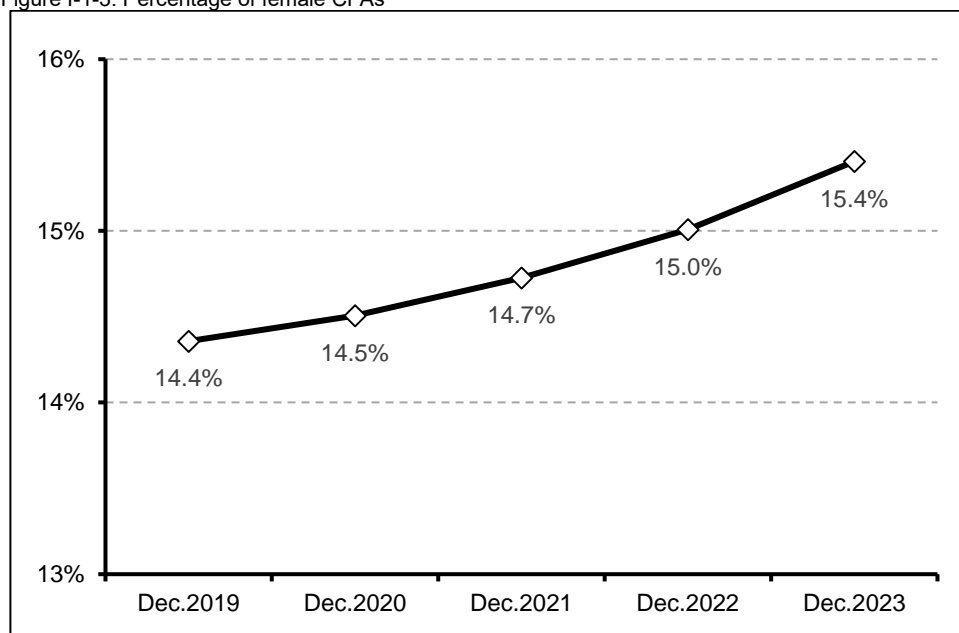
Some firms have attempted to promote the attractiveness of auditing by hiring people who want to take the CPA exam and giving them the opportunity to experience audit practice at an early stage. However, given that most CPA candidates find employment after passing the essay exam, these efforts remain on a small scale.

Some large-sized audit firms are planning to expand the scope of audit and assurance beyond financial information to include third-party evaluation of information security, AI assurance, and evaluation of governance effectiveness. Providing CPAs with a wide range of assurance opportunities that are not limited to the adequacy of financial statements may be a way to increase the attractiveness of the audit profession compared to other types of careers.

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 2023 the figure reached 15.4%, which is the same as the level for female tax accountants¹. On the other hand, it is still lower than the percentages of female attorneys and female CPAs in the UK².

Figure I-1-3: Percentage of female CPAs



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

¹ According to "2023 Survey on Women's Participation in Policy and Decision-making Processes" by the Cabinet Office's Gender Equality Bureau, the percentage of female tax accountants was 15.6% at the end of March, 2023, and the percentage of female attorneys was 19.9% at the end of September, 2023.

² The percentage of female CPAs in the U.K. is as follows:

UK: According to the Financial Reporting Council's "Key Facts and Trends in the Accountancy Profession 2023," there are several CPA institutes in the UK, and the average female membership for them is 38%.

■ Efforts to ensure empowerment of female CPAs ■

The Japanese Institute of Certified Public Accountants (JICPA) intends to increase the share of successful female examinees to 30% by 2030 and the share of female members and semi-members to 30% by 2048. And it 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 development (CPD) and membership fees during absence from work for childbirth, childrearing and other reasons. There are some large-sized audit firms that are setting KPIs such as the share of female executives, 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.

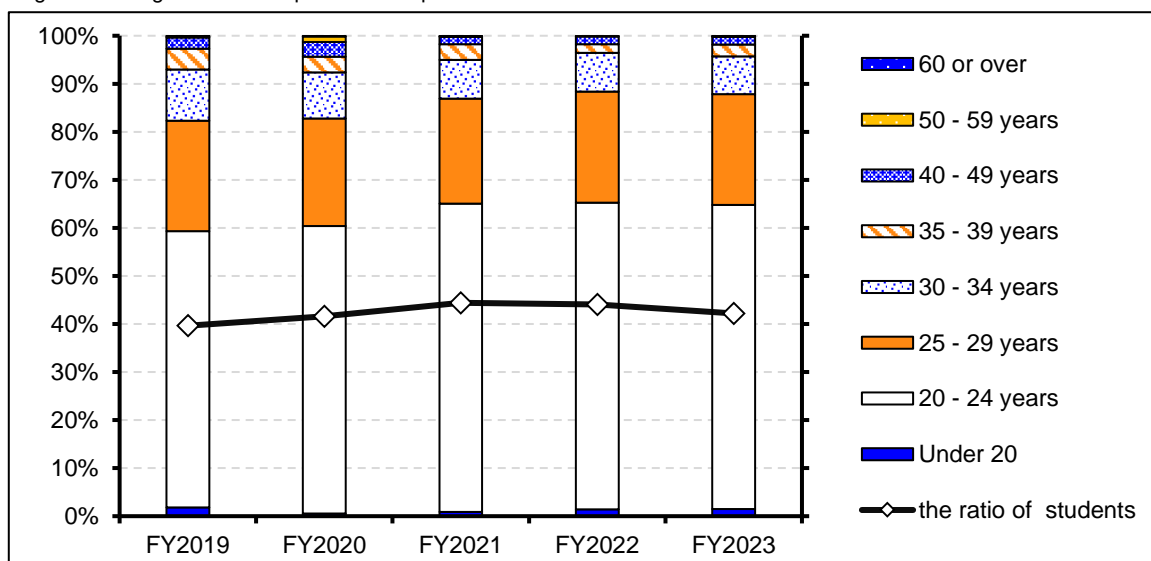
Furthermore, large-sized audit firms are working to promote DEI (Diversity, Equity & Inclusion) and are promoting initiatives that enable each staff member to maximize performance regardless of gender identity, sexual orientation, etc. The report on audit quality lists major initiatives such as the development of guidelines and norms, awareness-raising through group activities within the firm, and participation in external events.

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. In 2023, 22.3% of all successful examinees were women. The ratio of successful female examinees was 6.37%, while 8.05% for male examinees. Although these ratios of successful female examinees decreased compared to the previous year, the number of successful female examinees increased. Females submitting applications for the examination and passing it has been showing an upward trend in recent years.

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 71.8% of those who passed it in 2023. 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 42.2% in the 2023 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 2,382 at the end of March 2023, 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. Further explanation of audit and attestation services is provided on [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, 2023)

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 (Note 2)	○	○	○	○
Small and medium-sized audit firms	2,373	○ (Note 5)	○	○	○
(Breakdown)	Small and medium-sized audit firms				
	Partnerships (Note 1)				
	Solo practitioners (Note 1)				

(Note 1) The number of audit offices in fiscal 2022 (book closing date from April 1, 2022, till March 31, 2023) listed in copies of audit summaries or audit implementation reports submitted to the JIPCA.

(Note 2) As of December 1, 2023, PricewaterhouseCoopers Kyoto (PwC Kyoto), a mid-tier audit firm, merged with PricewaterhouseCoopers Arata LLC (PwC Arata), a large-sized audit firm. The above figures represent the number of audit firms before the merger.

(Note 3) The symbol "○" in the table above means that audits concerned can be conducted.

(Note 4) Registration as a registered auditor of listed companies etc. is required to audit listed companies. For information on the registration system for listed company auditors, see "[IV. Responses to Changes in the Global Environment Surrounding Audits, 1. Trends Surrounding Small and Medium-sized Audit Firms](#)".

(Note 5) 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.

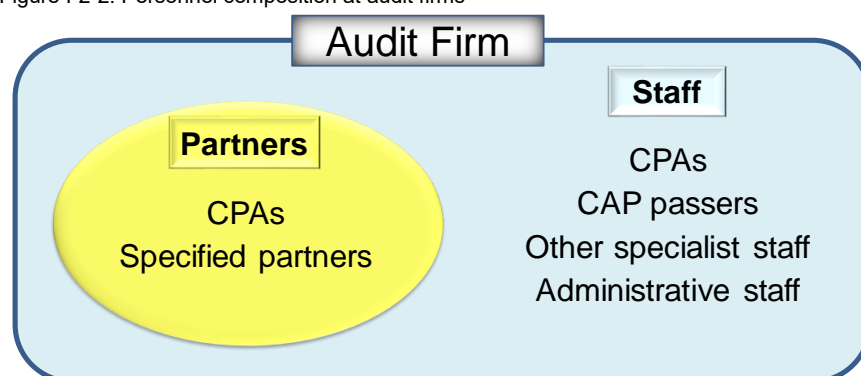
1. Organizational Structure of Audit Firms

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 FY2023 large-sized audit firms had 145 specified partners among a total of 1,845 partners.

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

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. 190 up to approx. 580	Approx. 40 up to 90(Note2)	Up to approx. 40(Note3)
Full-time staff	Approx. 2,800 up to approx. 7,300	Approx. 200 up to 900(Note2)	Up to approx. 100(Note3)

(Note1) See "Figure III-1-3: Characteristics of each type of audit firm" (page 61) for Characteristics of organizational structure based on audit firm size.

(Note2) The number of partners and full-time staff is calculated based on the business report of PricewaterhouseCoopers Japan LLC³ (PwC Japan) before its establishment, and does not take into account the impact of the merger of PwC Aarata and PwC Kyoto.

(Note3) The fiscal years of small and medium-sized audit firms cover a wide range of months, and the figures for FY2023 have not yet been compiled. For this reason, small and medium-sized audit firms are included up to FY2022. Excluding an audit firm whose number of partners and full-time staff members is much higher than others.

³ Limited Liability Audit Corporations (LLC): An audit firm in which the individual partners assume unlimited joint and several liability only with respect to the audit attestation (specified attestation), in which the partners are involved as designated limited liability partners, and other operations are the responsibility of the partners to the extent of their capital contributions

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. As for the situation of amendments of Audit Firm Governance Code, refer to [III. Operation of Audit Firms A. Operations Management System 2. Efforts in Response to Audit Firm Governance Code](#).

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

Figure 1-2-3. 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 audit supervisor
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](#)" and "[5. Organizational Structure for Supporting Audit Services](#)".

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.

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

- a. set their own quality objectives,
- 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 root cause analysis 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 effective for 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).

According to interviews with large-sized audit firms, they are moving ahead of the ISQM1, which went

into effect in December 2022, in cooperation with the global networks. They are receiving risk assessment tools from the global networks and are adding evaluation items based on the Revised Standards' own requirements while taking into account the quality goals and quality risks set by global networks.

Regarding the operation of quality control systems, at many large-sized audit firms, the persons responsible for each division have process owners identify quality risks and policies and procedures for dealing with risks, and assess risks under the steering committee, which comprehensively manages responses to quality risks. Some firms have person in charge of monitoring compliance with the relevant standards from independent standpoint.

The number of quality goals, quality risks, and policies and procedures to address these risks varies from firm to firm ranging from 15 to 200 in quality goals, 117 to 271 in quality risks, and 352 to 1,236 in policies and procedures to address the risks.

The timelines for the evaluation of quality management systems also vary between firms, and the reporting time of evaluation results spread over the period from December 2023 to September 2024. Regarding the overall evaluation results, one firm reported that it gave an overall evaluation that included conformance to the standards, while the other firm gave an evaluation based on ISQM1. Both firms concluded that the quality control system provided reasonable assurance that the objectives of the system were being achieved.

According to reports collected during PY2019, mid-tier audit firms are taking action based on risk assessment tools provided by their global networks, and some mid-tier audit firms have been applying the revised standards since July 1, 2023. Regarding the risk assessment process, similar to large-sized audit firms, they are developing the quality goals, quality risks and the policies and procedures based on the items shown in the global network's tool as well as adding evaluation items based on the Revised Standards' own requirements.

In addition, as part of the efforts to penetrate and establish the quality management system in the workplace, meetings and training sessions such as partner meetings are held. Some firms have stated a quality control committee held once every three months, with at least one member from each regional office participating.

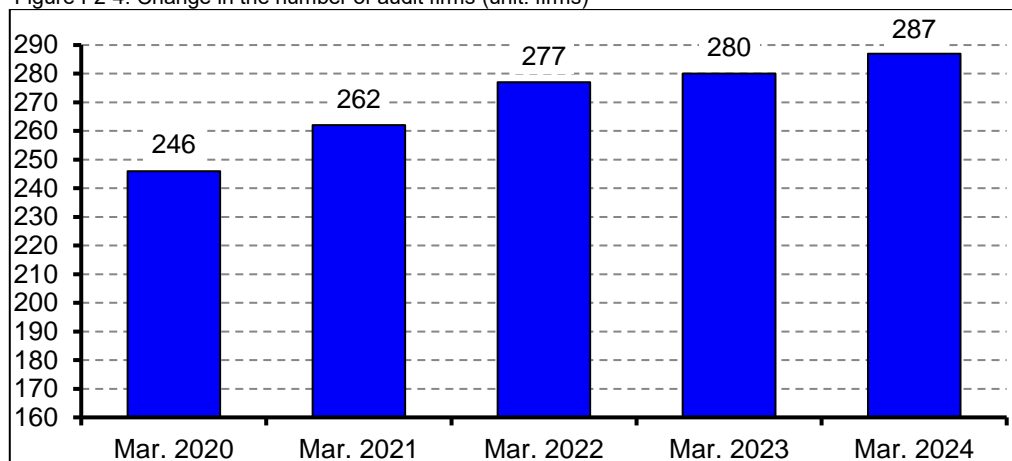
According to the collection of reports from 55 small and medium-sized audit firms in PY2023, approximately half of the firms (45%) are in the process of establishing frameworks and rules for the Revised Standards. On the other hand, the other half of the firms (55%) are only gathering information and have not yet started establishing specific frameworks⁴ (Data was aggregated for 53 audit firms out of 77 firms).

⁴ It should be noted that the answers of the collection of reports were as of June 30, 2023, which may be different from the current situation.

3. Number of Audit firms

The number of audit firms has been on an upward trend in recent years. As of March 31, 2024, there were 287 firms, and 5 firms disappeared as a result of dissolution or merger and 12 were established in the period April 2023-March 2024, ending up with a net increase by 7 firms (Figure I-2-4) year on year. See "[4. Mergers of Audit Firms](#)" for details on mergers from FY2019 onwards.

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



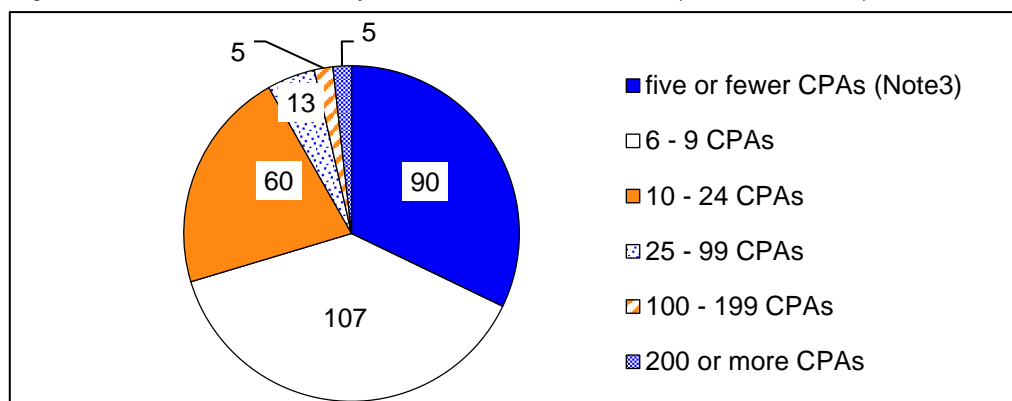
(Note1) The number of audit firms as of the end of March 2022 is adjusted based on the data obtained after publishing the previous Monitoring Report.

(Note2) The number of limited liability audit firms as of the end of March 2024 was 36.

(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 (FY2021; 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 280 audit firms (excluding dissolved and disappearing firms during the period) was collected from operational reports submitted by these firms in FY2023

(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.

(Note 4) The timing of the submission of the business reports of each audit firm differs depending on the financial year, and for the sake of compiling the data for this report, information for 2022 is used for small and medium-sized audit firms (the same applies to the subsequent figures).

4. Mergers of Audit Firms

There have been 9 mergers of audit firms since FY2019 (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 FY2019 (March 31, 2024)

FY	Surviving firm	Disappearing firm
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
2022	Kyoritsu Audit Corporation (Kyoritsu-Shinmei Audit Corporation)	Shinmei Audit Corporation
	Moore Shisei Audit Corporation (Moore Mirai Audit Corporation)	Kisaragi Audit Corporation
	SKIP Audit Corporation	Godai Audit Corporation
2023	Souken Nichiei Audit Corporation (Fujimi Audit Corporation)	Seinan Audit Corporation, Nagoya Audit Corporation
	PricewaterhouseCoopers Aarata LLC (PricewaterhouseCoopers Japan LLC)	PricewaterhouseCoopers Kyoto

(Note) Names in parentheses show the name of the surviving firm as of March 31, 2024.

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

Reports collected from mid-tier audit firms (five firms at the time of collection of reports) in PY2023 showed that many of them considered mergers as an option for their future business strategies. As stated in Figure I-2-6, PwC Kyoto, mid-tier audit firm, merged with PwC Arata, large-sized audit firm, and changed the name to PwC Japan as of December 1, 2023.

The collection of reports from small and midsize audit firms (involving 53 firms) in the same program year found that roughly 51% of them 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 FY2023 (FY2022 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 70% 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, 9. Domestic Audit Firm Groups](#)".

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 60% 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%.

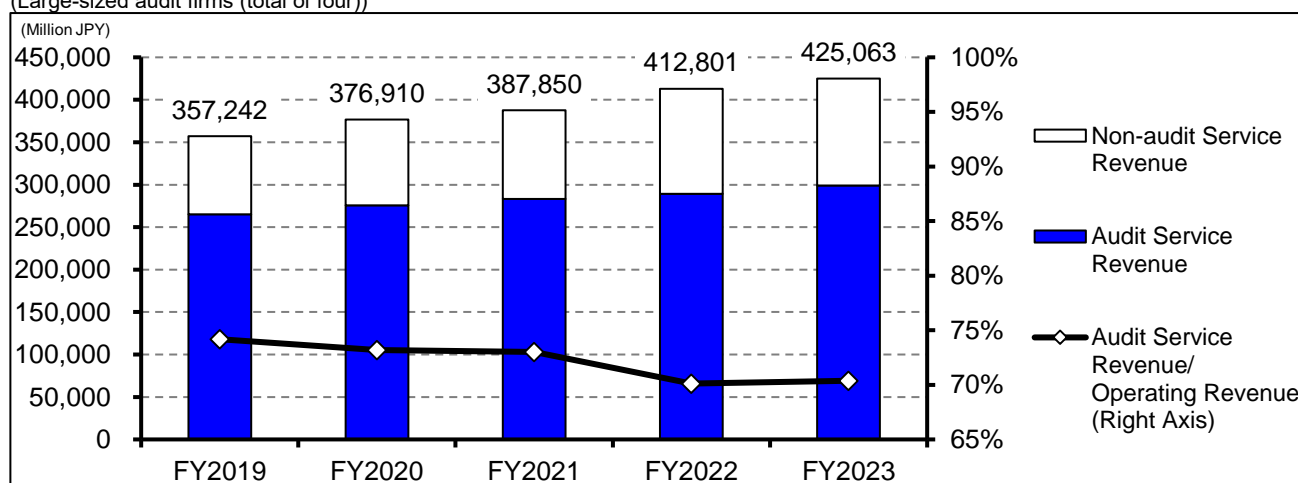
As mid-tier audit firms' business is centered on audit and attestation services, they provide non-audit services that are considered useful when conducted together with audit and attestation services or only within a limited range based on their individual circumstances, including available staff members.

c. Small and medium-sized audit firms

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

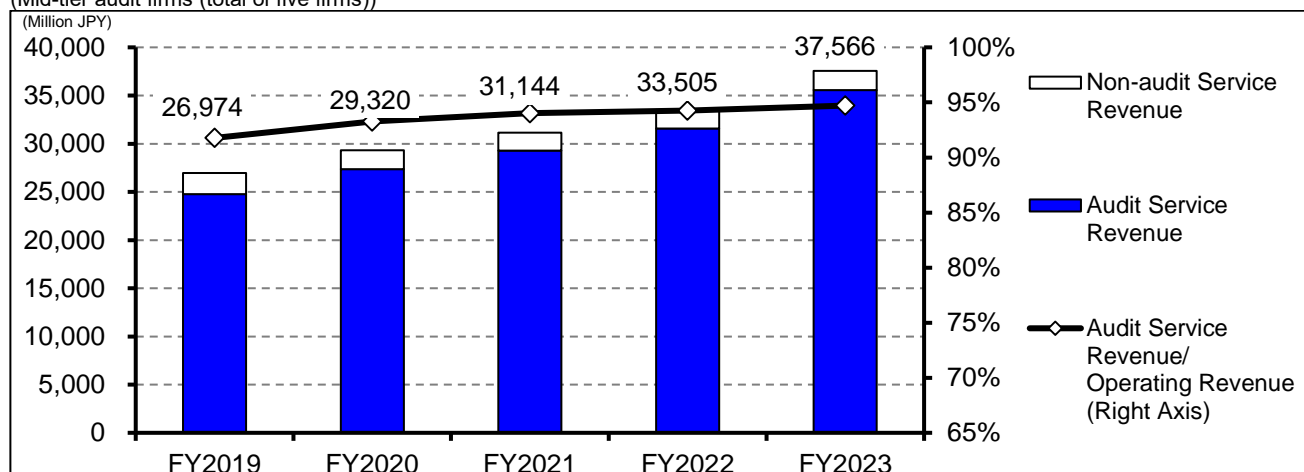
The operating revenues of small and medium-sized audit firms are moderate on the whole, but some of the largest firms in this category are expanding their business through newly concluding audit engagements with companies for which mainly large-sized audit firms had cancelled audit engagements. In particular, since 2021, the number of companies audited has increased by around 100 per year due to changes in auditors, resulting in a significant increase in revenue from audit and attestation services. For changes in accounting auditors, see "[III. Operation of Audit Firms, E. Acceptance of New Audit Engagements and Changes of Accounting Auditors](#)".

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))



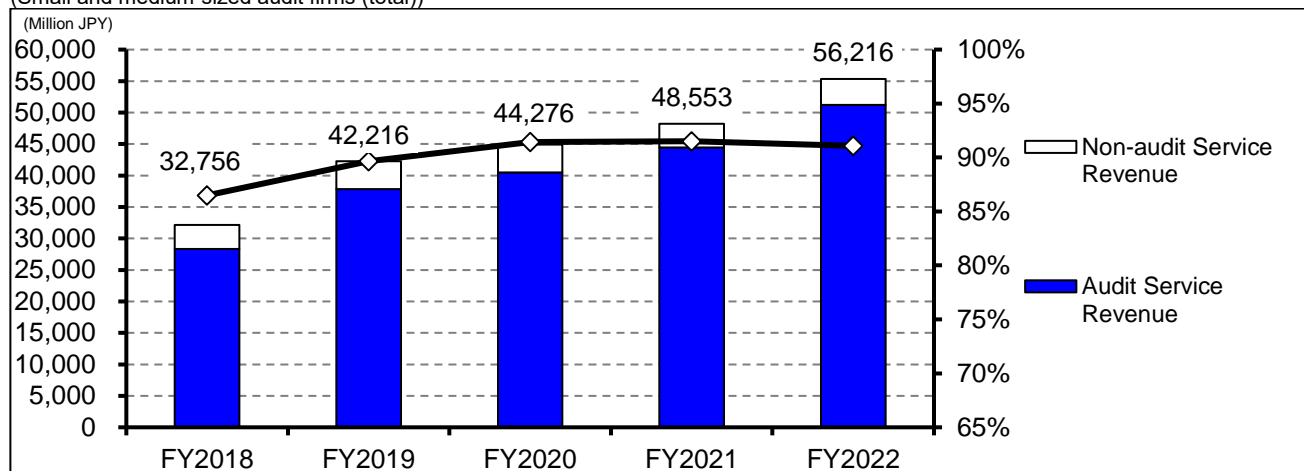
(Note) The business report, including those for FY2023, is prepared for the financial year before the establishment of PwC Japan and does not take into account the effects of the merger of PwC Arata and PwC Kyoto.

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



(Note) The business report, including those for FY2023, is prepared for the financial year before the establishment of PwC Japan and does not take into account the effects of the merger of PwC Arata and PwC Kyoto

(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 FY2023 have yet to be tallied. This report therefore covers their results through FY2022 (from April 2022 through March 2023). The number of small and medium-sized audit firms differs each fiscal year. For FY2022, the results of 270 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

1. Types of Audit and Attestation Services

As previously noted in “[B. Audit Firms](#)”, 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

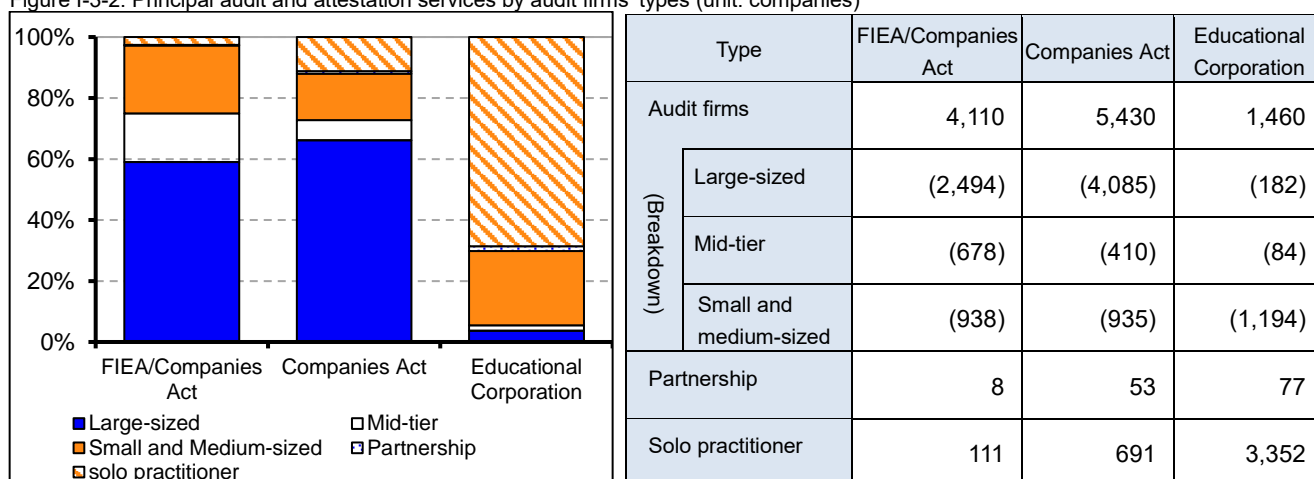
Type	Statutory audits						Non-statutory audits	Total
	FIEA / Companies Act	FIEA	Companies Act	Act on Subsidies for Private Schools	Labor Union Act	Other		
Number of companies	4,094	308	5,465	1,535	436	4,270	5,579	21,687
Percentage	18.9	1.4	25.2	7.1	2.0	19.7	25.7	100.0

(Note 1) The number of audited companies has been aggregated from operational reports submitted by audit firms in FY2022

(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 60~70% 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: companies)



(Note 1) Data was aggregated from audits conducted from the term ended April 2022 to the term ended March 2023. 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

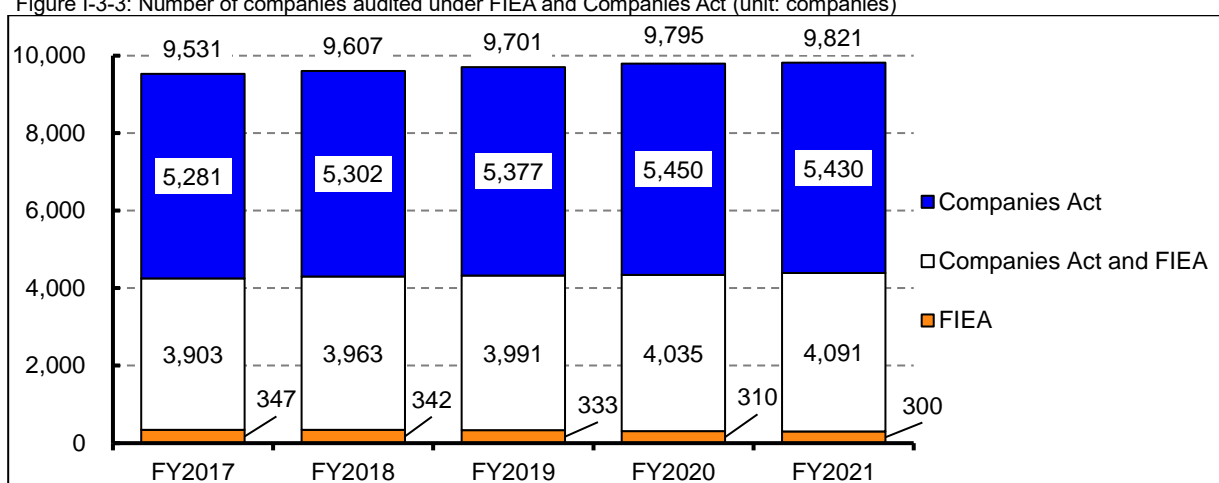
2. FIEA and Companies Act Audits

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

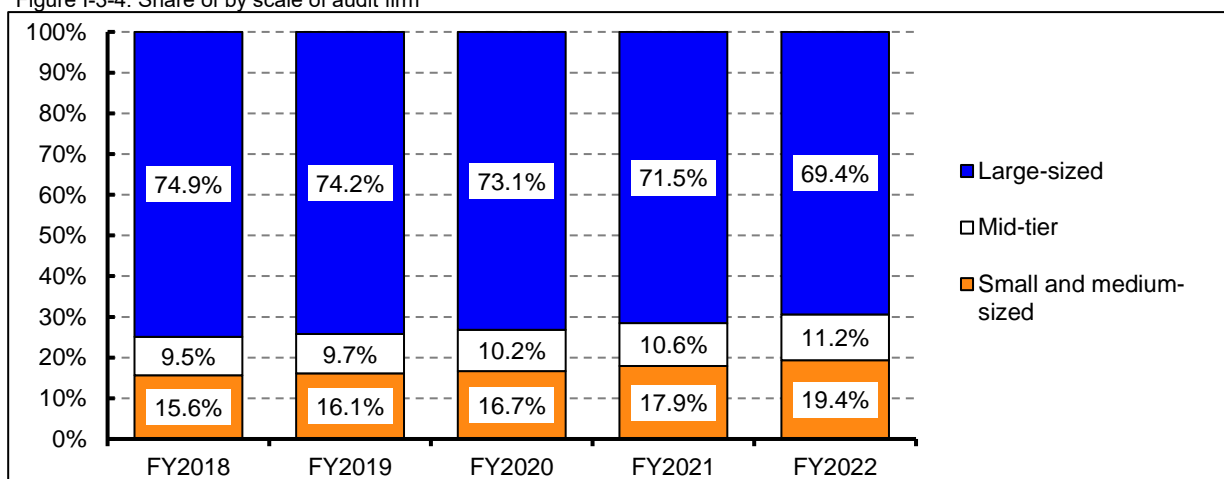
There has been no significant change in the number of companies audited under the FIEA or the Companies Act (Figure I-3-3). With regard to share by scale of audit firm, large-sized audit firms' share has been going down, mid-tier and small and medium-sized audit firms' share have been going up annually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

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



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

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



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

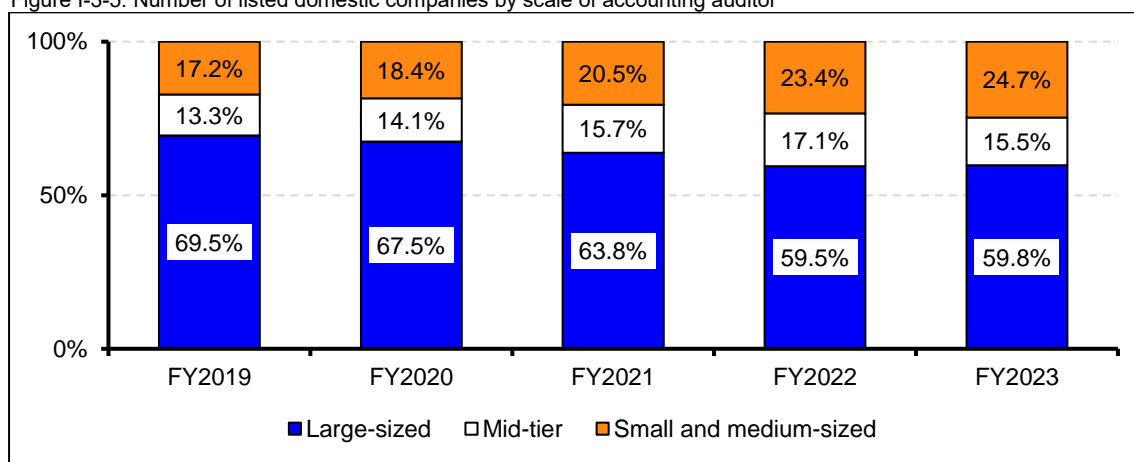
- b. Share of listed domestic companies by scale of audit firms

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 FY2023, there were 3,930 domestic listed companies, and 2,349 were audited by large-sized audit firms, 610 were audited by mid-tier audit firms, and 971 were audited by small and medium-sized audit firms. Meanwhile, the market capitalization of domestic listed companies was 750,156.9 billion yen, of which large-sized audit firms handled 704,046.5 billion yen, mid-tier audit firms handled 19,873.3 billion yen, and small and medium-sized audit firms handled 26,236.7 billion yen.

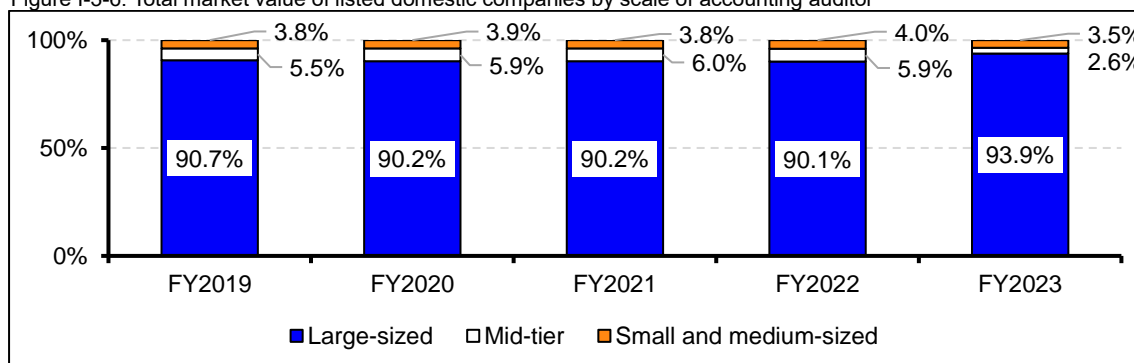
Figure I-3-5: Number of listed domestic companies by scale of accounting auditor



(Note) The number of listed domestic companies audited by mid-tier audit firms up to FY2022 is the total of five audit firms: Gyosei & Co., BDO Sanyu & Co., Grant Thornton Taiyo LLC, Crowe Toyo & Co, and PwC Kyoto. The number of listed domestic companies audited by mid-tier audit firms in FY2023 is the total of four audit corporations: Gyosei & Co., BDO Sanyu & Co., Grant Thornton Taiyo LLC, and Crowe Toyo & Co., due to the merger of PwC Arata and PwC Kyoto in December 2023.

(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



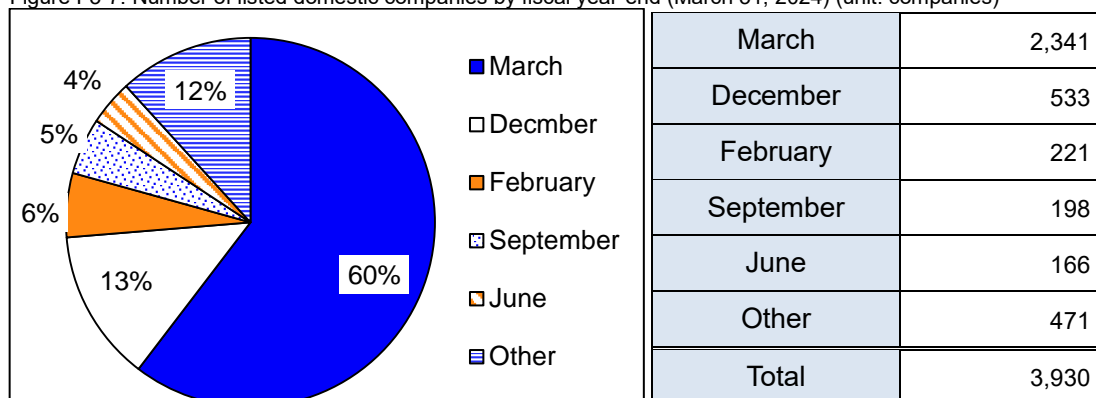
(Note) The ratio of mid-tier audit firms up to FY2022 is the total of five audit firms: Gyosei & Co., BDO Sanyu & Co., Grant Thornton Taiyo LLC, Crowe Toyo & Co, and PwC Kyoto. The ratio of mid-tier audit firms in FY2023 is the total of four audit corporations: Gyosei & Co., BDO Sanyu & Co., Grant Thornton Taiyo LLC, and Crowe Toyo & Co., due to the merger of PwC Arata and PwC Kyoto in December 2023.

(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

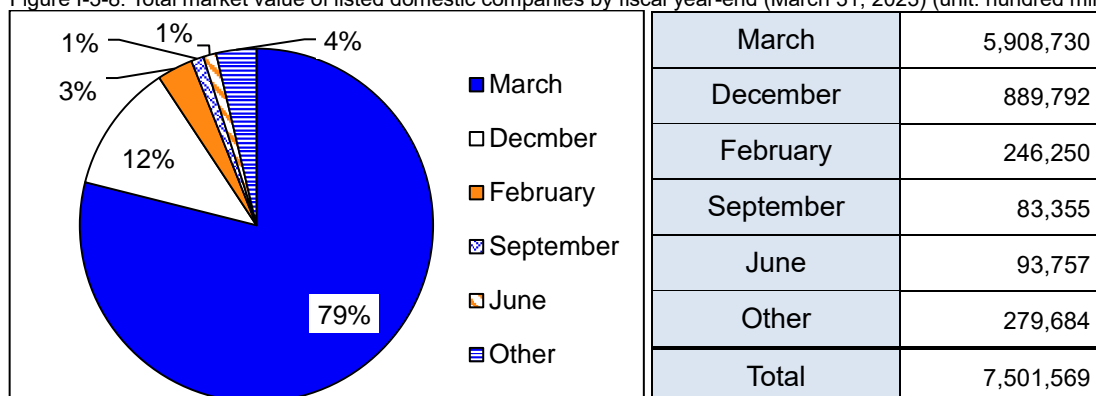
60% of listed domestic companies close their books at the end of March, and that they account for 79% of the total market capitalization. This fact explains why audit operations are heavily concentrated in specific periods (Figures I-3-7 and I-3-8).

Figure I-3-7: Number of listed domestic companies by fiscal year-end (March 31, 2024) (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, 2023) (unit: hundred million JPY)



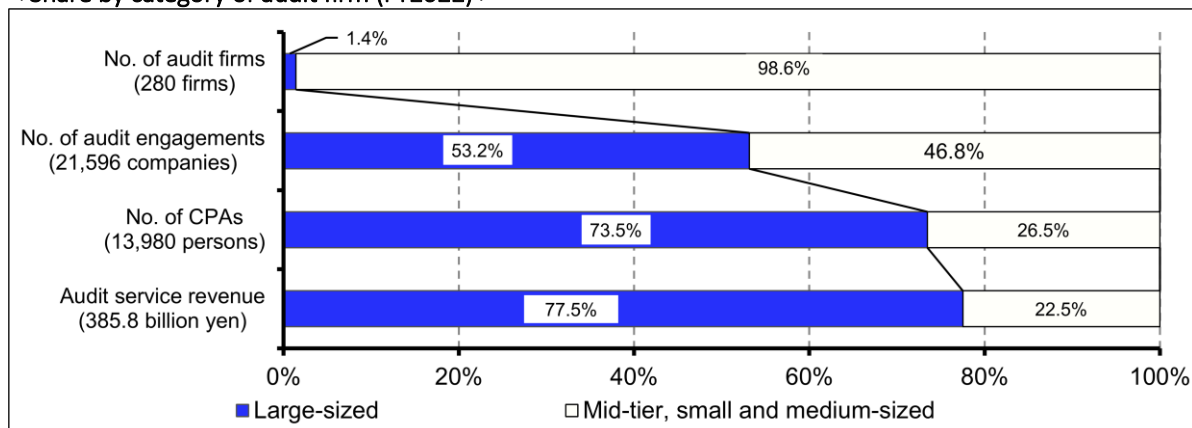
(Source) Prepared by the CPAAOB based on data from QUICK and exchanges

■ Share of Large-sized Audit Firms ■

Among the 281 audit firms as of the end of FY2022, 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”](#).

< Share by category of audit firm (FY2022) >



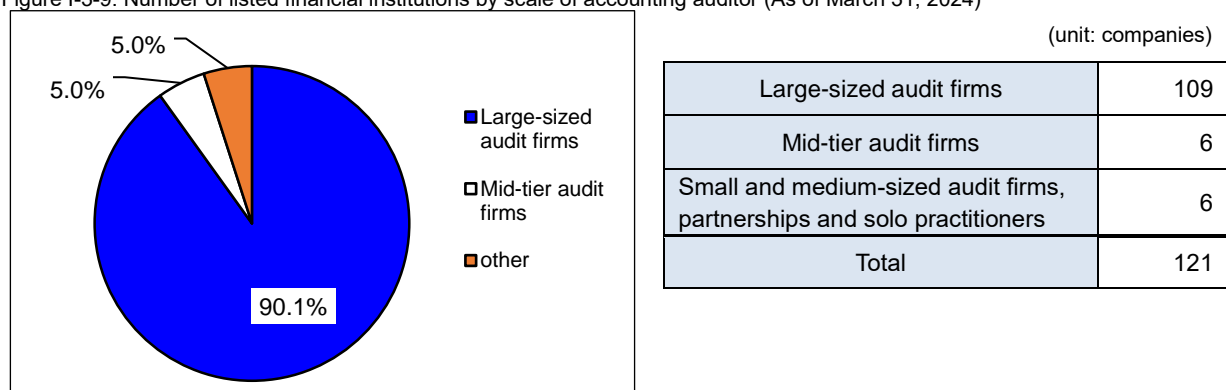
(Note) Compiled based on FY2022 JICPA member data and operational reports submitted by audit firms

3. Audits of Financial Institutions

90% of listed financial institutions (121 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”](#).

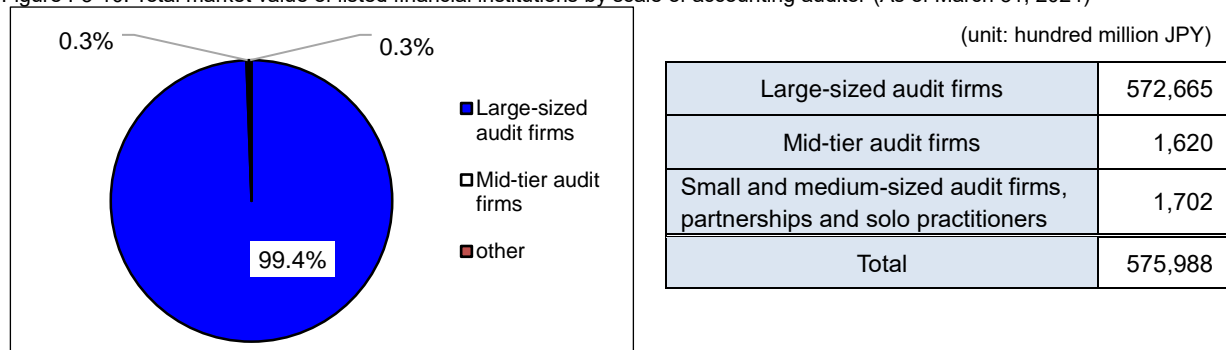
To cope with accounting and audit practices that are designed to the listed financial institutions, large-sized audit firms are establishing departments specializing in financial services in their audit operations divisions, and some mid-tier audit firms have established support systems that specialize in handling inquiries about the accounting procedures of financial institutions.

Figure I-3-9: Number of listed financial institutions by scale of accounting auditor (As of March 31, 2024)



(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, 2024)



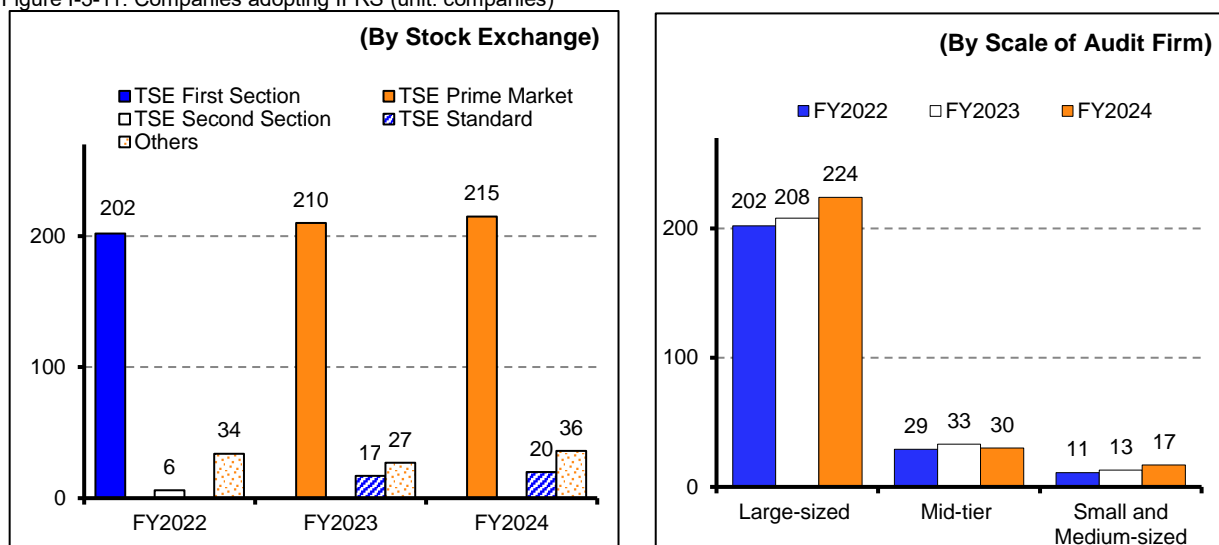
(Source) Prepared by the CPAAOB based on data from QUICK and exchanges

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 2024 (Figures I-3-11).

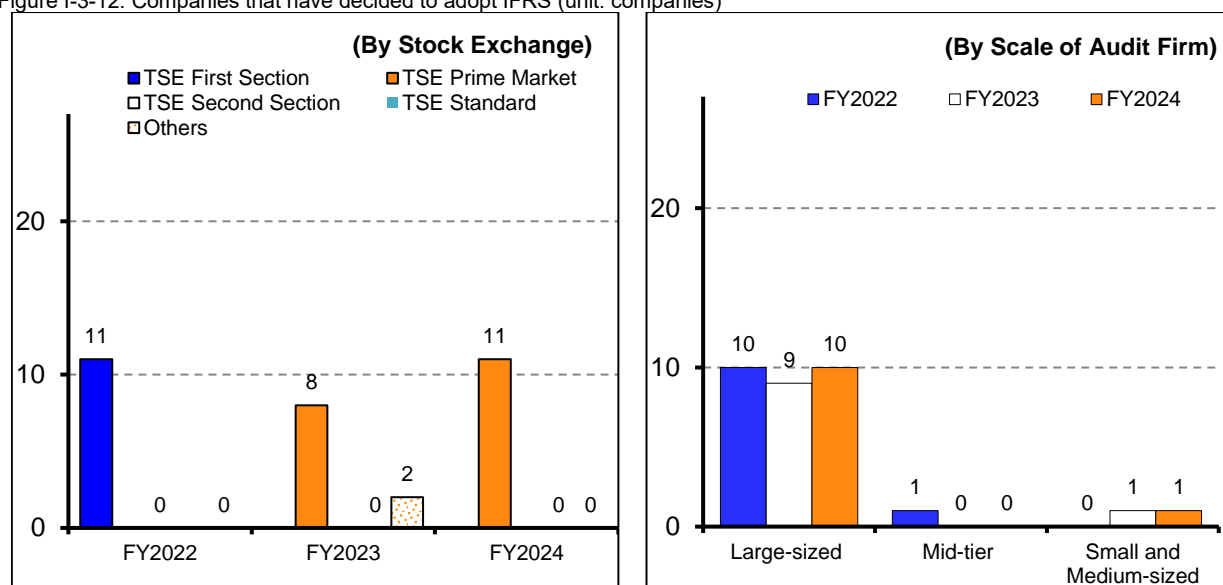
The majority of companies that have adopted IFRS are listed on the Prime Section of the Tokyo Stock Exchange, and many of them operate internationally. Audit contracts are concentrated in large-sized audit firms which collaborate with large global networks. A similar situation is seen with companies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

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



(Note1) As the TSE changed the market segmentation in April 2022, the former segmentation data are included in the chart.
 (Note2) PwC Arata and PwC Kyoto merged on December 1, 2023 to form PwC Japan, and the former PwC Kyoto is classified as a large-sized audit firm for the fiscal year ended March 31, 2006 in the status of Scale of Audit Firm.
 (Source) Prepared by the CPAAOB based on data from exchanges

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



(Note1) As the TSE changed the market segmentation in April 2022, the former segmentation data are included in the chart.
 (Note2) PwC Arata and PwC Kyoto merged on December 1, 2023 to form PwC Japan, and the former PwC Kyoto is classified as a large-sized audit firm for the fiscal year ended March 31, 2006 in the status of Scale of Audit Firm.
 (Source) Prepared by the CPAAOB based on data from exchanges

5. Audits of Initial Public Offerings

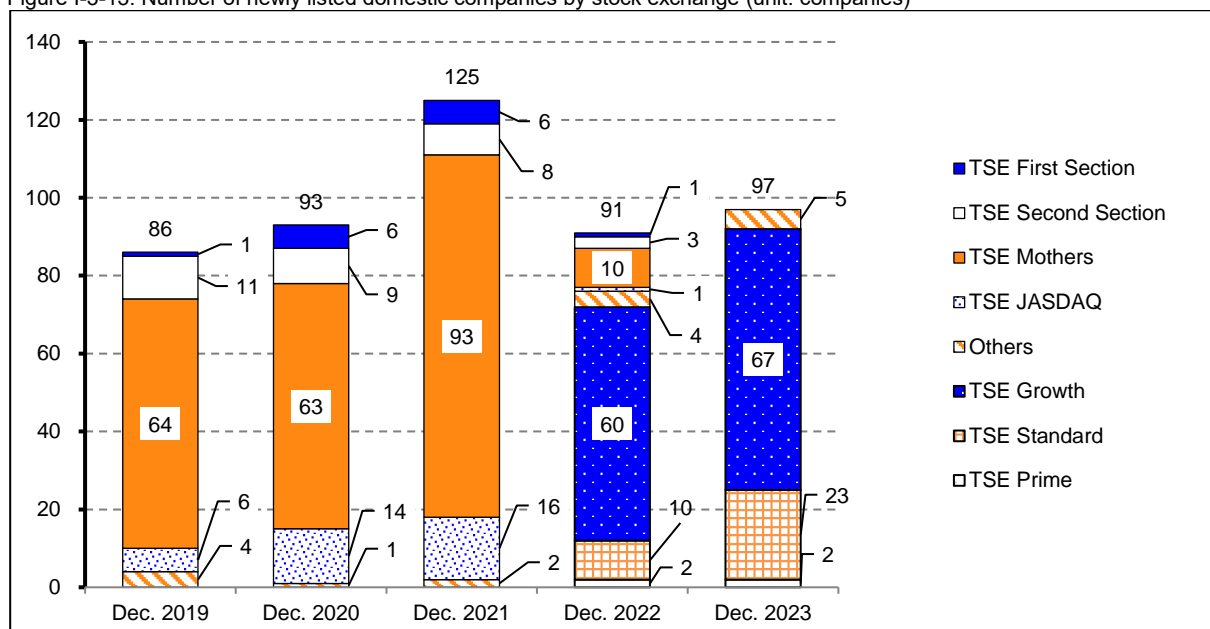
The number of IPOs (excluding listings on the Tokyo Pro Market) for the period from January 2023 to December 2023 (hereinafter referred to as the "year through December 2023") came to 97, which has increased from the previous year. Listings on the Tokyo Stock Exchange's Mothers and Growth market were particularly large in number (Figure I-3-13).

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 organizational structures, etc. of audit firms regarding the acceptance of IPO audit engagements, see “[III. Operation of Audit Firms, A. Operations Management System, 4. Organizational Structure for Providing Audit Services](#)”.

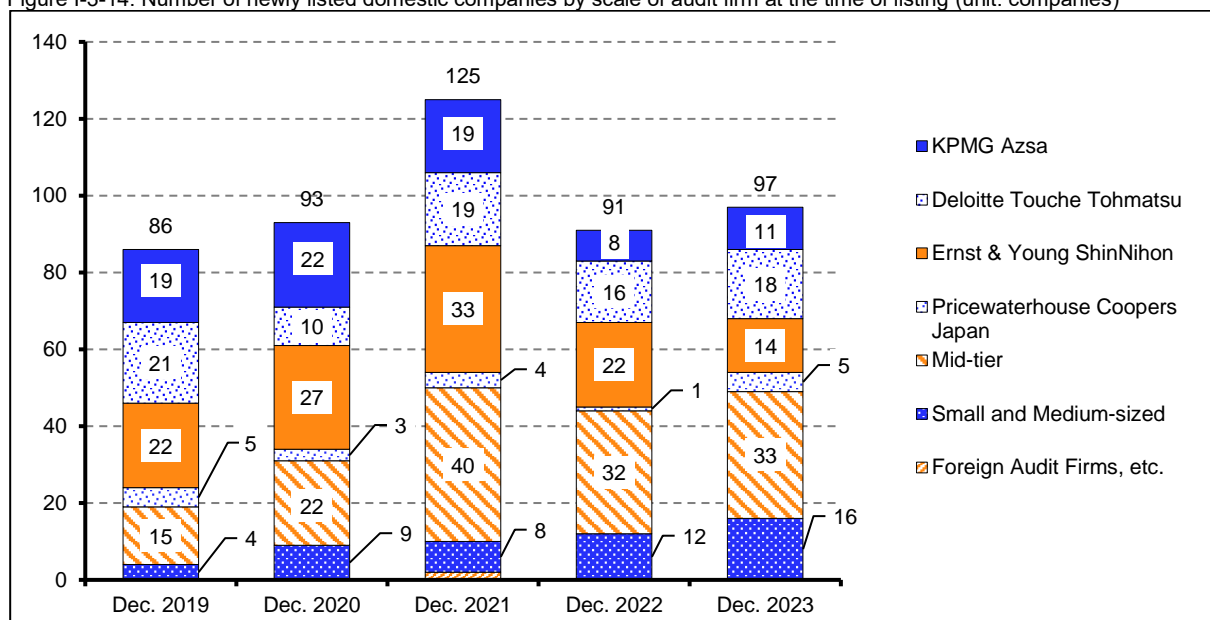
The share of large-sized audit firms was 49% in the year through December 2023. While the share of mid-tier and small and medium-sized audit firms showed an uptrend.

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)



(Note) PwC Arata and PwC Kyoto merged on December 1, 2023 to form PwC Japan. Companies those newly listed from the former PwC Kyoto before the merger are classified as mid-sized audit firms.

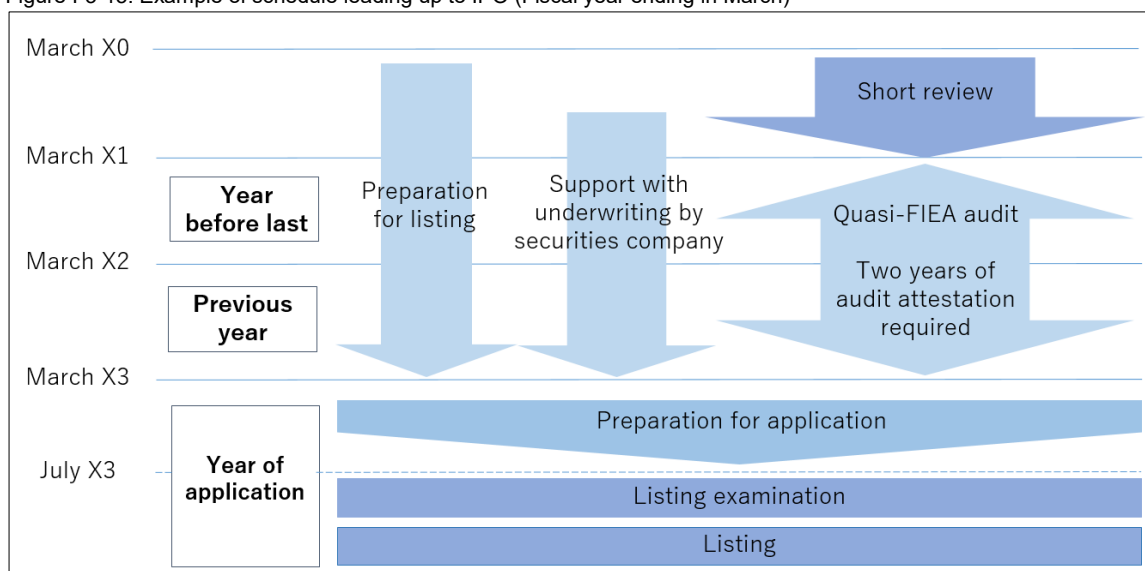
(Source) Prepared by the CPAAOB based on data from exchanges

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 are 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 ■

Article 192-2, paragraph of the FIEA 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). (This type of audit is described as “quasi-FIEA audit”). Furthermore, before concluding a quasi-FIEA audit contract, a short review is conducted so as to identify and resolve issues ahead of listing. This is the typical workflow when preparing for listing. Companies often ask CPAs and audit firms for support with conducting the short review and resolving issues, and CPAs and audit firms accept these engagements as non-audit work. The IPO-related support services that CPAs and audit firms provide as non-audit work include the following:

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

II. Monitoring by the CPAAOB

II. Monitoring by the CPAAOB

A. Overview of System and Situation with Implementation

1. Legal Position of the CPAAOB

The CPAAOB is an administrative body⁵ 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.

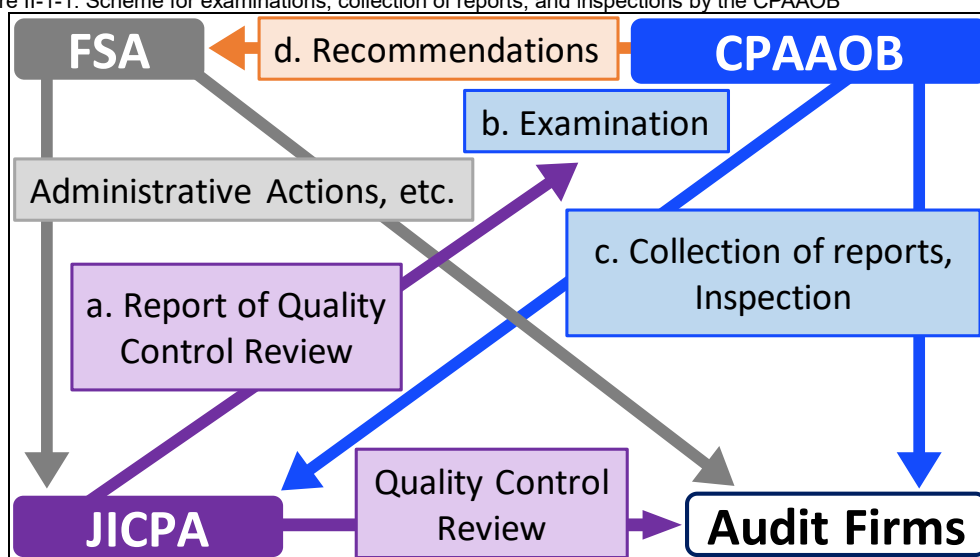
The CPAAOB receives and examines reports concerning quality control reviews by the JICPA, collects reports from and conducts inspections of the JICPA and audit firms etc. Based on the results of inspections etc., the CPAAOB recommends administrative actions or other measures to the FSA Commissioner when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



⁵ 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 and the registration of auditors of listed companies.

The quality control reviews are conducted by the JICPA to maintain/improve suitable qualitative standards for audit services and to ensure public trust in audits. More specifically, the JICPA reviews the administration of audit engagements conducted by audit firms, reports results to the audit firms and, when necessary, recommends improvements and monitors the status of improvements⁶.

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. Plan of Quality Control Review
- b. Details on any deficiencies observed during the Quality Control Review 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 of the Quality Control Review (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 standards⁷, and whether these quality control systems are operating effectively.

Domestic Quality Control Standards and Quality Control Standards Statements were revised in response to the revision of international quality control standards, and the JICPA is now responsible for confirming the design and operation of audit quality systems, including risk assessment systems implemented by audit firms, such as setting audit quality objectives, recognition, evaluation, and handling of quality risks.

⁶ For details concerning quality control reviews, see the JICPA website and the annual report from the Quality Control Committee.

⁷ The provisions of the Certified Public Accountants 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, which are related to audit quality control.

In addition, quality control reviews comprise regular reviews, which are conducted on the overall quality control of an audit firm, special reviews on quality control related to the audit firm's specific sector or audit service, and "Review for the examination of registration" conducted for applicants for the auditors of listed companies under the Registration System of Auditors of Listed Companies (Introduced as a legal registration system due to the revision of the CPA Act in May 2022 (effective from April 2023)).

With the introduction of the Registration System for Auditors of Listed Companies, the JICPA is responsible for "confirmation of the eligibility" of auditors of listed companies and the applicants during the Quality Control Review. In the process of conducting quality control reviews, the JICPA checks whether auditors of listed companies fulfill their obligations for system development set forth in the Ordinance for Enforcement of the CPA Act. With regard to the system for publishing the evaluation results of the status of quality control of services, if such publication has not been conducted, or if the published matters are significantly different from the actual situation, the JICPA will consider revoking or rejecting the registration, And if an extremely significant deficiency or a significant deficiency is found as a result of a quality control review, and a recommendation to decline is made, the auditor is subject to examination for revocation of registration.

In addition, to improve its quality control review system, the JICPA plans to increase reviewers over three years from FY2023, and to enhance reviewers' qualities and knowledge, which are necessary for examining audit firms' operation management system including information disclosure system, through educational program for reviewers. It will also take effort to recruit and cultivate sufficient reviewers through formulating reviewers' career plan.

In FY2023, there was a total of 41 reviewers (as of August 1, 2023) who conducted regular reviews of 81 audit firms and "the review for the examination of registration" for 5 audit firms.

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 (regular reviews) conducted in FY2023 by the JICPA in PY2023 and an overview of the review was given below.

i. FY2023 quality control reviews

Regarding the regular reviews, no significant deficiencies were confirmed at 71 audit firms, while significant deficiencies were observed at five audit firms, and extremely significant deficiencies were observed at five audit firms. In addition, and one audit firm received disclaimer of conclusion (Figure II-1-2).

Figure II-1-2: FY2023 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	55	54	1	0	55	0
Partnerships	1	1	0	0	1	0
Solo practitioners	25	16	4	5	25	0
Total	81	71	5	5	81	0

(Note1) 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.

(Note2) 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.

(Note3) 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.

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

The status of implementation and conclusions of the quality control review (review for the examination of registration) in FY2023 showed no significant deficiencies in all five offices where the review was conducted.

ii. Examination of FY2023 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 FY2023 quality control reviews, efforts for improvement, and improvements in each review operation.
- Identification of significant deficiencies or extremely significant deficiencies identified as a result of quality control reviews of audit firms and analysis of items and contents of specific deficiencies identified during quality control reviews
- Analysis of specific deficiencies identified 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 identified in quality control reviews in FY2023.

- When drafting the quality control review plan, the number of site visit days and reviewers

were increased in order to conduct the confirmation of eligibility in accordance with the introduction of the registration system for auditors of listed companies. In addition, even after the quality control review started, the quality control review plan was flexibly changed in response to changes in circumstances.

- In regular reviews, regarding the quality control reviews, the average number of issues and findings identified per audit firm conducting audits of listed companies has increased significantly. In addition, the average number of findings per audit engagement at small and medium-sized audit firms has also increased.

In light of the expectation from society to confirm the eligibility of audit firms conducting audits of listed companies, the JICPA has strengthened its supervisory function of quality control review with a new perspective and as part of its high level of discipline for audit firms conducting audits of listed companies, etc.

In the FY 2023 quality control reviews, the JICPA adopted a new perspective, the "Guidelines for Confirmation of Eligibility of Audit Firms Conducting Audits of Listed Companies, etc." to confirm the eligibility of audit firms conducting audits of listed companies, etc. As a result, as mentioned above, the number of quality control-related issues has increased significantly. The CPAAOB will continue to check the effectiveness of quality control reviews.

As for the quality control area of the quality control review, many findings were related to fostering a culture that emphasizes audit quality, information security, wrap-up of audit files and management and retention of audit work papers, and formulation of policies and procedures regarding consultation on difficult or contentious matters, etc. In the area of audit engagements, there tend to be many deficiencies related to the audit of accounting estimates, and Identifying, assessing and addressing the risk of material misstatements including fraud risk.

5. Collection of Reports

a. Overview

The CPAAOB may collect reports from the JICPA or audit firms when necessary. To ensure and enhance audit quality at all audit firms in Japan with limited inspection resources at its disposal, it is necessary that the CPAAOB continually understands challenges that audit firms are facing with effective use of collection of reports. In this view and the perspective of promoting audit firms to develop proper operation management system and quality control system (hereafter "operation management system etc.," the CPAAOB wiled collection reports regarding the status of development and implementation of operation management system etc. (including the status of implementing measures of improvement) in audit firms considering their scale and characteristics, the results of the CPAAOB inspections and JICPA's quality control reviews.

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

In the case of large-sized audit firms and mid-tier audit firms, the CPAAOB periodically analyze

quantitative and qualitative information concerning their operation management system etc. so as to contribute to further effective inspection. Particularly, it collects information related to the status of development and implementation of operation management system etc. under effective governance and efficiently functioning management (including the efforts to optimize operations such as developing audit methods utilizing digital technology and the efforts to develop and secure human resources). It also understands the measures regarding cybersecurity.

Further, it utilizes the information through the collection reports to perform comparative analysis of audit firms and to identify sector-wide issues, etc.

With regard to large-sized audit firms, follow-up inspections are conducted for the purpose of verifying the status of improvements in the program year following regular inspections. However, there are some cases where such verifications are conducted through collection of reports instead of follow-up inspections. (For details, see [“II. CPAAOB Monitoring, 6. Inspections, b. State of implementation of inspections, i. Recent conduct of inspections”](#)).

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, the CPAAOB selects firms partly based on the results of quality control reviews. It then gather s and analyzes 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 CEO, it understands CEO's awareness towards the current status of audit quality and efforts for improvement. And it conducts 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, the CPAAOB understands the progress of improvement through collecting reports and facilitates audit firms' voluntary improvements after a set period of time. It also conducts 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)," the CPAAOB wields 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"](#)).

b. Implementation

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

In PY2023, the CPAAOB collected reports from all large-sized and mid-tier audit firms in order to review their operations management system including items such as the status of response to the revised quality control standards, their process of acceptance and termination of audit engagements, the status of measures against the occurrence of CPA qualifications misstatements, the status of audit tools utilizing digital technology, assurance related to non-financial information, and the status of providing audit services to IPO preparing companies. Furthermore, it analyzed the information through the collection of reports and utilized the analysis results to ensure effective and efficient inspection, and also conducted inter-firm fact-finding of operations management system etc. at large-sized and mid-tier audit firms.

It also verified the efforts to remedy deficiencies of regular inspections at two large-sized audit firms through collecting reports instead of conducting follow-up inspection.

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

In PY2023, reports were collected from 77 small and medium-sized audit firms (53 small and medium-sized audit firms and 24 solo practitioners), selected mainly based on the results of quality control reviews in PY2022. The reports contained items related to recommendations for improvement issued by quality control review, matters related to operations management system, the status of response to the revised quality control standards, matters related to the global network, KAMs, the status of assurance service related to non-financial information, etc. Of the 77 firms, 9 firms (those with a relatively large number of items requiring improvement, a large number of new audit engagements with listed companies, and audit risks of audited companies that require attention) were interviewed individually, either in person or remotely, from the perspective of encouraging them to voluntarily ensure and improve audit quality. In order to hold in-depth discussion, inspectors also participated in the hearings.

At the interview, while conveying the CPAAOB's awareness to promote the quality control for appropriate audits, we have proactively listen about the development of quality control systems including responses to the findings at the review, CEO's management policy and governance, policy on recruitment and training, the responses to the revision of audit system, and so forth. The results of interview will be used as important reference for such as the future inspection.

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

In PY2023, among small and medium-sized audit firms etc. that had been notified of inspection results by the CPAAOB in past program years, no audit firms were required to monitor the status of their response to the notified problems, and therefore, the CPAAOB did not collect reports after a certain period of time has passed since the notification of inspection results.

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

In PY2023, seven firms assessed as "unsatisfactory and in need of immediate remediation" as results of inspections conducted in PY2020 and PY2022 continually reported the status of their

improvements. Also, two firms assessed as "unsatisfactory and in need of immediate remediation" as results of inspections conducted in PY2023 submitted their reports simultaneously with the notification of inspection results. These firms include those that were found to have the following issues:

- The firm lacks awareness of the need to improve audit quality, and has not demonstrated leadership in establishing an effective and systematic operational control management to ensure appropriate audit quality.
- The firm has relies on the competence and responsibility of each executive partner to ensure audit quality in each individual audit engagement, and a leadership has not been demonstrated in maintaining and improving audit quality throughout the firm.
- The firm lacks awareness to foster a culture that emphasizes audit quality and to establish an effective and systematic operations management including quality control, such as insufficient awareness to comply with professional ethics and internal rules.
- The firm lacks awareness of sincere efforts to maintain and improve audit quality, and does not exercise leadership in ensuring an appropriate level of audit quality throughout the firm.

6. Inspections

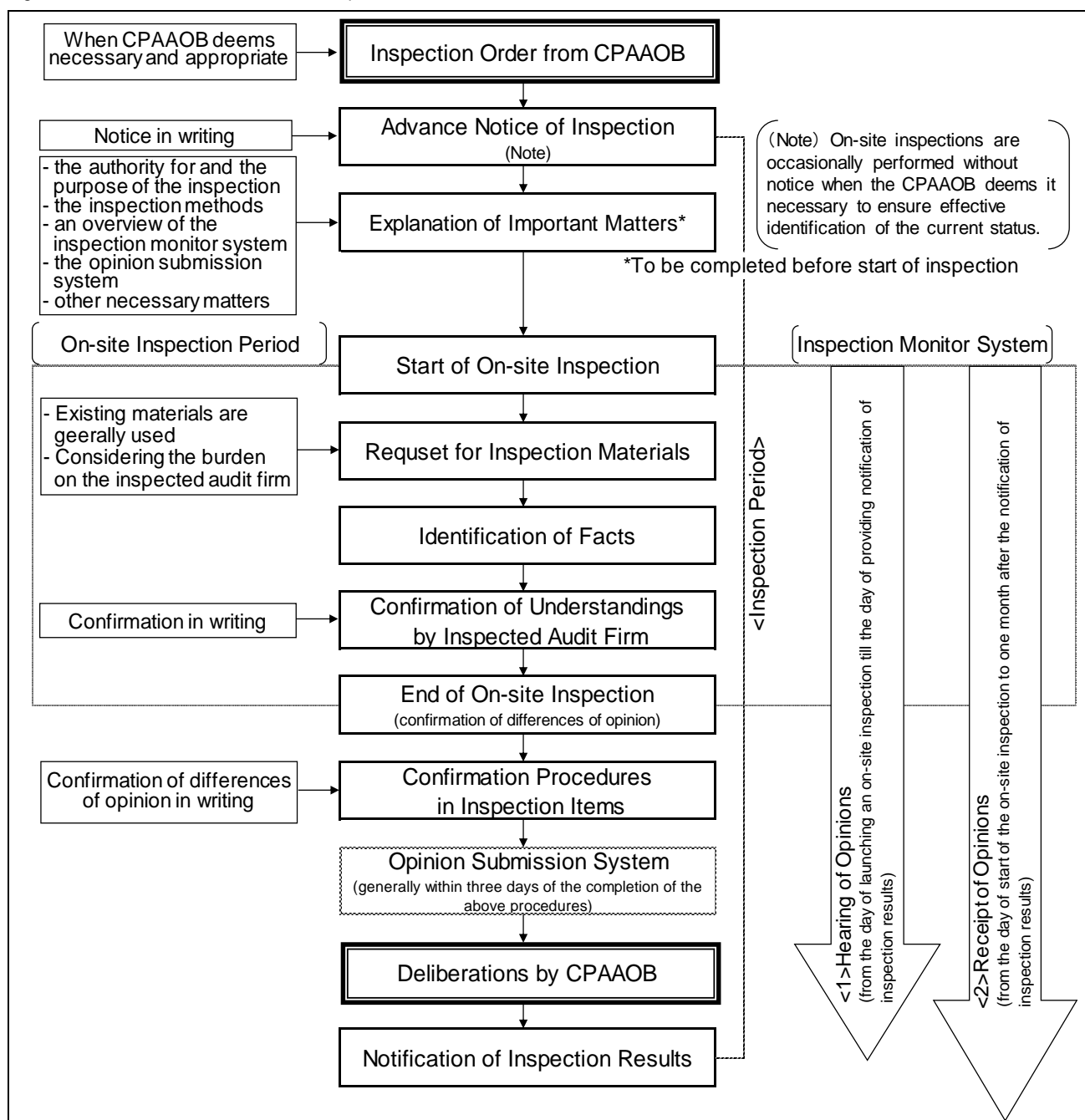
a. Overview

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" (lately revised in June 2024).

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



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 system, quality control system, 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 staff.

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

Since FY2020, the CPAAOB has used remote inspections, such as reviewing audit reports, etc., using a laptop borrowed from the audit firm and conducting interviews via a web conferencing system, in addition to the traditional in-person interviews. The CPAAOB will continue to conduct inspections utilizing both inspection methods.

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 designated by the head of the Planning, Management and CPA Examination Division (hereinafter "the CPA Examination Division"), of the CPAAOB Executive Bureau or the head of the CPA Examination Division, review the opinion and facts concerned, compile the results of the review and submit them to the Board of the CPAAOB.

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

vi. Inspection monitor system

The CPAAOB accepts opinions from audit firms about inspectors' inspection methods and so forth to grasp the CPAAOB's 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 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, runs follow-up inspections designed to verify improvements in the program year following the regular inspection. As to follow-up inspections, there are some cases in which remedial measures are examined through collection of reports in place of follow-up inspections.

Mid-tier audit firms are generally inspected once every three years and will be inspected once every two years from PY2025. For PY2024 inspection plan, see "[C. CPAAOB Perspectives and Objectives of Monitoring, etc., 2. Basic Plan for Monitoring Audit Firms for Program Year 2024.](#)"

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 during the past five years are as 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	2019 (Note 1)	2020 (Note 1)	2021 (Note 1)	2022	2023
Large-sized audit firms	4(2)	4(2)	4(2)	2	2
Mid-tier audit firms	2	2	1	2	2
Small and medium-sized audit firms, partnerships and solo practitioners	3	4	4	5	5
Foreign audit firms, etc. (Note 2)	1	0	0	1	0
Total	10(2)	10(2)	9(2)	10	9

(Note1) Figures in parentheses are the number of follow-up inspections.

(Note2) See "[B. Foreign Audit Firms](#)" for information on foreign audit firms etc.

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

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

	Large-sized audit firms	Mid-tier audit firms	Small and medium-sized audit firms
Number of inspections(case)	9	8	10
Average number of inspectors(headcount)	9.0	7.9	5.7
Average inspection period(calendar days)	221.1	165.8	130.7
Average number of inspected audit engagements (companies)	6.2	5.0	3.0

(Note1) Inspections conducted and completed in the five years from PY2019 through PY2023 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.

(Note2) 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.

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

ii. Deficiencies

(i) Characteristics of deficiencies identified through inspections of quality control system

Results of the CPAAOB inspections in and after PY2020 were as follows:

Large-sized audit firms tended to shift primal responsibility for quality control from the quality control section at their headquarters to the audit services section, which was closer to the audit sites. The results of recent inspections presented the outstanding issues, such as inadequate cooperation between the quality control section and audit services sections, need for penetration of improvement measures into audit sites (where auditing services are actually performed), and the verification of effectiveness of such improvement measures, 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](#)").

Although mid-tier audit firms have made structural improvements to take systematic approaches, they are still facing problems such as the limitation of the number of personnel responsible for quality control and the awareness of the CEO about the need to ensure and enhance quality control and to cooperate with the quality control section.

It was found that small and medium-sized audit firms etc. do not fully understand the level of quality control and audit procedures required by the existing auditing standards, or do not performed sufficient root cause analysis, concerning causes of deficiencies pointed out in quality control review, etc., which is necessary to prevent the occurrence of similar deficiencies. In addition, there were firms that were not fully capable of auditing high-risk listed companies.

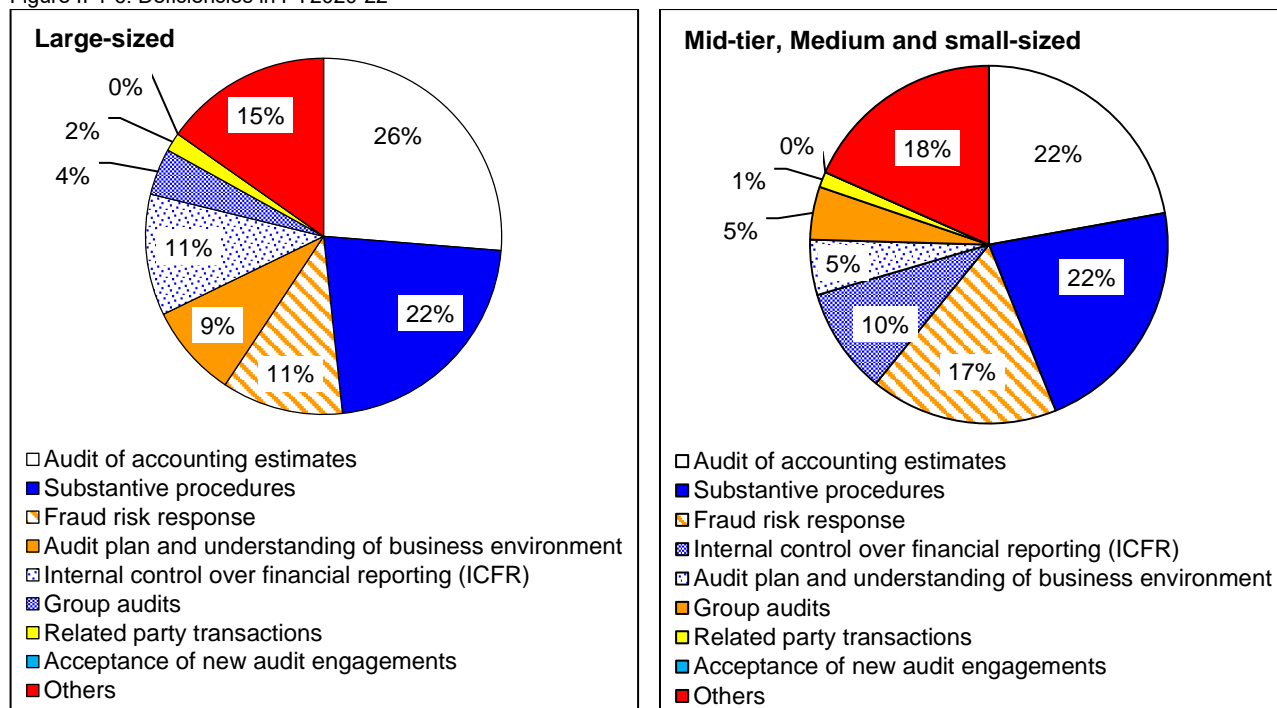
(ii) Characteristics of deficiencies identified through inspections of audit engagements

Deficiencies identified through inspections of audit engagements from PY2021 to PY2023 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. The CPAAOB therefore performed inspections with a focus on such deficiencies.

The CPAAOB encourages inspected audit firms to take their initiatives in improving their operation, by analyzing the causes of the deficiencies identified in the inspections and sharing them through dialogue with the inspected audit firms. The Case Report from Audit Firm Inspection Results is available for detailed information about examples of deficiencies identified during the inspections and their causes. (For the overview of the Case Report, see "[C. The CPAAOB Monitoring Perspectives, Objectives etc., 5. Communication of Monitoring Information](#)".)

Figure II-1-6: Deficiencies in PY2020-22



(Note) Classifications of deficiencies noted at six (total number of inspections) large-sized audit firms, five mid-tier audit firms (total number of inspections), and 10 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. The current inspection results notification contains the information shown in Figure II-1-7⁸.

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

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

b. “Key points” section

Among the sections in an inspection results notification, the “Key points” section elaborates deficiencies identified during the CPAAOB inspections that are regarded as significant. It comprises three subsections (operations management system, quality control system and audit engagements) and confers an overall rating according to the status of these subsections.

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.

⁸ As Overall ratings will not be given for ad-hoc inspections (Unlike conventional inspections, this is a flexible and simple inspection with a narrow focus on verification items) or follow-up inspections of large-sized audit firms, the inspection results notifications in those cases differ from the ones of regular inspections

Figure II-1-8: Example of key points

1. Key points

As a result of our inspection of your audit firm and within the scope of our inspection, we discovered the operation of your firm is ... (one of five overall rating grades).

(1) Operations management system

... (presents problems with its governance and operation of services)

(2) Quality control system

...(presents deficiencies in the system of quality control)

(3) audit engagements

...(presents deficiencies in audit services)

The CPAAOB has included overall ratings of audit firms' operation of services in the inspection results notification since the inspections commenced in PY2016. The aims are to accurately convey the CPAAOB's assessment to audit firms and to ensure proper understanding of their level of quality control among audit and supervisory board members etc. of audited companies, to whom the inspection results notification is provided.

c. Overall rating grades

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.

"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)," the CPAAOB collects a report at the time of the notification of inspection results and encourages the firm to promptly make improvements (for more details, see "[5. Collection of Reports, b. Implementation, iv Collection of reports from audit firms in need of particularly urgent remediation](#)"). In the case of an audit firm rated as "extremely unsatisfactory (overall rating: 5)," the CPAAOB make recommendations concerning administrative actions and other measures to the Commissioner of the FSA.

d. Distribution of overall ratings

The distribution of overall ratings in the last five years of inspections (regular inspections launched and completed between PY2019 and PY2023) is shown below (Figure II-1-9).

No audit firms were qualified as "Satisfactory (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 CEO. In addition, partners and staff members lacked an awareness of recent environmental changes pertaining to accounting and auditing and did not understand adequate levels required by the current audit standards.

Figure II-1-9: Overall ratings for inspections in the last five years (based on commencement of inspections) (unit: audit firms)

Overall rating	Large-sized audit firms	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	-	-
Unsatisfactory due to presence of significant deficiencies that need to be fixed" (Overall rating: 3)	-	2	3
Unsatisfactory and in need of immediate remediation in operations management system, etc." (Overall rating: 4)	-	3	6
Extremely unsatisfactory" (Overall rating: 5)	-	-	7

(Note1) Totals for audit firms subject to regular inspections that were commenced and completed between PY2019 and PY2023

(Note2) For audit firms underwent multiple regular inspections in the period under review, overall ratings in the latest inspection are tallied.

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

Audit firms are required to communicate the "key points" in their inspection results notifications

and the action they are taking in response to them to audit and supervisory board members etc. of all audited companies⁹.

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.

It is expected that the audit and supervisory board members etc. of audited companies, will use the communicated information not partially but comprehensively to better understand the status of the establishment and implementation of the audit firm's quality control system and to communicate with the audit firm in a fulfilling manner.

f. Handling of inspection results

An inspected audit firm is required to obtain prior consent from the CPAAOB to disclose¹⁰ inspection results to a third party. In recent years, the CPAAOB has received a large number of requests from audit firms for prior consent to disclose inspection results and other information as requested by directors at audited companies, auditors and directors (including outside directors) of parent companies of audited firms and potential audited companies (e.g., companies considering which auditors to appoint).

However, an inspected audit firm is not required to obtain the CPAAOB's prior consent if it conveys inspection results to auditors and others at audited companies, mentioned above in d., and presents them to the JICPA based on rules of the JICPA Quality Control Committee's detailed operational rules for 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 the JICPA's quality control reviews.

It is desirable 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 the establishment and implementation of quality control systems by accounting auditors.

8. Recommendation

The CPAAOB recommends that the Commissioner of the FSA take administrative disciplinary actions or other measures based on Article 41-2 of the CPA Act, if deemed necessary as a result of the inspection. No recommendation was made to the Commissioner of the FSA because there were no audit firms where management practices were deemed to be extremely inappropriate during inspections conducted in the PY 2023.

⁹ 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).

¹⁰ Details on disclosing inspection results to third parties are posted on the CPAAOB website.

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. Based on the results of analysis of the information provided by this collection, the CPAAOB also conducted an inspection of one foreign audit firm each in PY2022.

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, France and Hong Kong with seven firms, and the U.S. with six firms. Foreign audit firm registrations are published and updated as "Registered Foreign Audit Firms" on the FSA website.

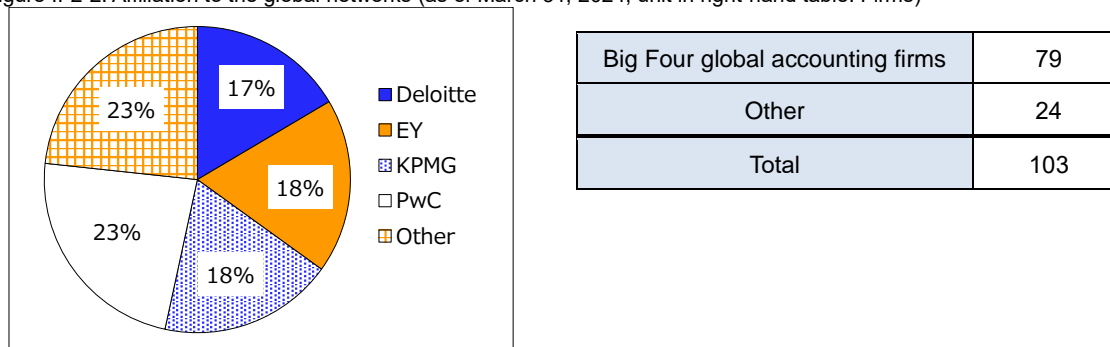
Figure II-2-1: Number of registered foreign audit firms, etc. (as of March 31, 2024)

	Number of countries/regions	Number of foreign audit firms, etc.
Europe	16	60
Asia-Pacific	10	30
North America	2	10
Central/South America	1	1
Middle East	1	2
Total	30	103

(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, 2024; unit in right-hand table: Firms)



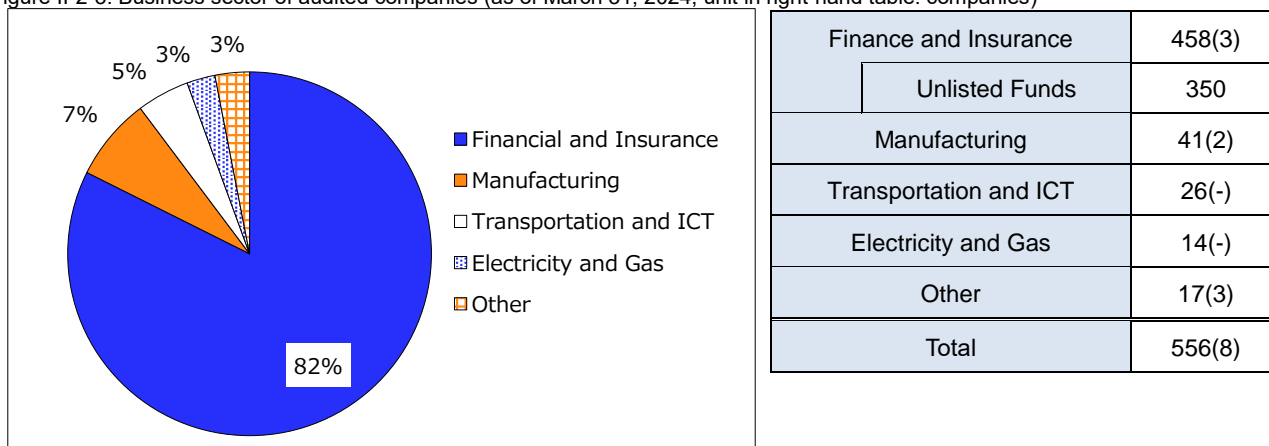
(Note) Compiled the foreign audit firms under the Big Four global

3. Audited Companies

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

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

Figure II-2-3: Business sector of audited companies (as of March 31, 2024; 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.

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 term (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 7th Term (April 2022 - March 2025, published in May 20, 2022) is presented on the CPAAOB's website, but monitoring perspectives, objectives, etc. are summarized below:

[Principal Points in the Basic Policy]

In the 7th Term, 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(*):

- (1) To set quality objectives
- (2) To identify and assess quality risks that will block the achievement of quality objectives
- (3) To determine and implement a policy or process of addressing assessed quality risks, and
- (4) To make improvements, if any, based on root causes

The 7th Term of monitoring by the CPAAOB will place emphasis 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 companies

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 growing.

As a result, in the 7th Term, the CPAAOB 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 for Program Year 2024

The full text of the Basic Plan for Monitoring Audit Firms for Program Year 2024 (July 2023 - June 2024, published in July 19, 2024) can be found on the CPAAOB website. Monitoring priorities are described below.

[Basic Plan for Monitoring (Non-Inspection Basic Plan)]

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

The CPAAOB has been encouraging the JICPA to take actions to ensure and improve audit quality through exchanges of opinions and other means. Going forward, the CPAAOB will engage in in-depth discussions with the JICPA to strengthen the quality control review system in light of the fact that quality control reviews will play an even more important role as a means of confirming the eligibility of registered auditors of listed companies.

b. Collection of reports

For large-sized audit firms and mid-tier audit firms, the CPAAOB will periodically collect and analyze quantitative and qualitative information on their operations management systems, from the viewpoint of efficiently conducting inspections.

For small and medium-sized audit firms, the CPAAOB will collect and analyze information as appropriate according to the size and characteristics of the firm, taking into account the results of the JICPA quality control reviews and audit risks associated with listed audited companies. In addition, the CPAAOB will hold hearings on the content of reports as necessary to encourage voluntary efforts to ensure and improve audit quality.

In collecting reports, priority items shall be the effectiveness of the operations management system (including the CEO's understanding of management policies and the profit and financial structure), the status of establishment and operation of a quality control system in compliance with the revised quality control standards, etc. (for large audit firms) or the status of responses to the revised quality control standards, etc. (for non-large audit firms), the status of compliance with the revised ethical rules, and the status of practical actions and responses to the abolition of the quarterly reporting system.

c. Collection and analysis of information regarding audit firms

Through periodic dialogues with executives including CEO, of large-sized and mid-tier audit firms, the CPAAOB will collect information on the latest operations management systems at each audit firm and share awareness of problems. In addition, the CPAAOB will continue to hold dialogues with small and medium-sized audit firms that conduct audits of listed companies.

[Basic Plan for Inspection]

To all audit firms, inspections shall similarly focus on matters such as the commitment of the top management of audit firms to improving audit quality, the effectiveness of the operations management system and quality control system, as well as the status of audits concerning fraud risks, revenue recognition, and accounting estimates. In addition, inspections shall be conducted as follows.

a. Large-sized audit firms

With regard to large-sized audit firms, the CPAAOB conducts inspections every year in principle (regular inspections and follow-up inspections are conducted alternately). In follow-up inspections, the CPAAOB does not, in principle, examine individual audit engagements, taking into account the burdens, etc. on the inspected firm. Instead, the CPAAOB mainly verifies the status of improvement measures for issues pointed out in regular inspections (in place of inspections, the CPAAOB may collect reports to confirm efforts toward improvement).

In conducting inspections of large-sized audit firms, the CPAAOB will pay particular attention to the implementation of monitoring of individual audit engagements by the quality control division, etc., as well as the follow-up examination of audit deficiencies and their causes in the event of inappropriate accounting treatment at audited companies, and the implementation of subsequent improvement measures.

b. Mid-tier audit firm

In light of their growing role as auditors of listed companies, from PY2025, the CPAAOB will conduct inspections of mid-tier audit firms once every two years, instead of once every three years in general.

When inspecting mid-tier audit firms, the CPAAOB shall pay particular attention to the status of efforts by management, including CEO, to foster an organizational culture that emphasizes audit quality, as well as the status of collaboration between the quality control division and the audit frontline, and the implementation of monitoring of individual audit engagements by the quality control division, etc.

c. Small and medium-sized audit firms

With regard to small and medium-sized audit firms, the CPAAOB will consider the necessity of promptly confirming their quality control systems based on the results of quality control reviews conducted by the JICPA, as well as factors such as the operation control systems of audit firms and the degree of audit risk associated with listed audited companies. In light of the growing role of small and medium-sized audit firms as auditors of listed companies and the “Registration System for Auditors of Listed Companies” introduced by the revised CPA Act, the CPAAOB will place greater emphasis on inspections of small and medium-sized audit firms also in this program year.

When conducting inspections of small and medium-sized audit firms, the CPAAOB focuses in particular on their efforts to foster an organizational culture that ensures compliance with laws, regulations, and professional ethics, as well as their partners and employees’ awareness of

professional ethics, independence, and legal compliance, and the control of audit documentation (including prevention of inappropriate correction of audit documentation).

3. Strengthening Monitoring

a. Monitoring other than inspections

In order to conduct efficient and effective monitoring, the CPAAOB holds periodic dialogues with the management of large-sized and mid-tier audit firms, including their top management, and gathers information on the latest quality control systems at each audit firm. The information collected is used effectively, for example, as a reference for understanding industry trends and identifying points of focus in conducting inspections. In addition, since PY2022, the CPAAOB has been holding dialogues with the management of relatively larger firms among small and medium-sized audit firms that conduct audits of listed companies.

b. Enhancing the capacity to conduct monitoring

In order for the CPAAOB's monitoring to appropriately respond to issues surrounding audit firms and the internationalization of accounting practices, it is important to enhance the monitoring framework such as by developing human resources and strengthening information collection and analysis. In PY2023, the CPAAOB continued to promote human resource development through active participation of its staff in international conferences and other events, and also conducted training courses aimed at acquiring expertise necessary for monitoring.

4. Cooperation with Related Organizations

In order to ensure and improve audit quality, it is important not only to monitor audit firms, but also to cooperate with organizations related to auditing and to share awareness of issues and problems surrounding audit firms. To this end, the CPAAOB has been working with relevant bureaus within the FSA, as well as with the JICPA, Stock exchange and other relevant organizations.

a. Cooperation with relevant bureaus within the FSA

With regard to issues related to audits of individual audit engagements, more effective and efficient inspections can be conducted by cooperating with the FSA's relevant bureaus that conduct supervision and inspections of the disclosure of audited companies. To this end, the CPAAOB will share information and exchange opinions with the relevant bureaus of the FSA and the SESC on issues related to disclosure and audit of listed companies, and utilize the obtained information in its monitoring. In addition, the CPAAOB also shares information with relevant bureaus of the FSA on inspection results of audit firms.

b. Cooperation with JICPA

The CPAAOB encourages further improvement of the effectiveness of the quality control reviews conducted by the JICPA, by reviewing the effectiveness of the JICPA's quality control reviews through inspections of audit firms and by sharing with the JICPA problems identified during the inspection.

Since PY 2015, the CPAAOB and the JICPA have held working-level meetings to discuss issues related to quality control reviews. Further discussions are being held to ensure that the CPAAOB inspections and the JICPA quality control reviews are as effective as possible overall.

In PY2023, the measures to improve the effectiveness of quality control reviews and to improve audit quality in small and medium-sized audit firms were discussed.

In addition to the above, the CPAAOB shares awareness of issues at the top level through exchanges of views between senior officials of the CPAAOB and the JICPA.

c. Cooperation with other related organizations

In order to conduct efficient and effective monitoring, the CPAAOB shares its awareness of issues by exchanging views with Stock exchange on the status of communication between auditors and audited companies and the status of changes in auditors, and also uses the information obtained in its monitoring.

In addition, as the roles and responsibilities of audit and supervisory board members etc. have become increasingly important in recent years, the CPAAOB regularly exchanges views with the Japan Audit & Supervisory Board Members Association on the status of communication between audit and supervisory board members etc. and auditors.

5. Communication of Monitoring Information

From the viewpoint that it is important to provide information on the results of monitoring audit firms to the general public and to increase interest in and awareness of audits, the CPAAOB has published this report, the Case Report from Audit Firm Inspection Results, and the Basic Plan for Monitoring Audit Firms ("various monitoring information").

a. Development and publication of the Case Studies of Audit Firm Inspection Results

The CPAAOB annually revises and publishes a compilation of examples of deficiencies identified during its inspections of audit firms as "Case Report from Audit Firm Inspection Results" (Case Report for PY2024 was published on July 19, 2024). The purpose of the Case Report is to present the level of audit quality expected by the CPAAOB, encourage audit firms to make voluntary efforts to ensure and improve audit quality, and to provide reference information to the directors and audit and supervisory board members, etc. of listed companies as well as investors and other market participants.

b. Communication of various monitoring information

The CPAAOB actively shares various monitoring information by holding briefings for stakeholders in various fields and contributing articles to relevant magazines. In particular, the CPAAOB Chairperson and inspectors explain about the Case Report from Audit Firms Inspection Results at training sessions run by the JICPA. In PY2023, with the aim of encouraging audit firms to make voluntary efforts to ensure and improve audit quality, the CPAAOB gave lectures at the JICPA headquarters and eight regional associations across Japan. It also gave lectures at the Institute of Internal Auditors Japan and other relevant organizations.

III. Operation of Audit Firms

III. Operation of Audit Firms

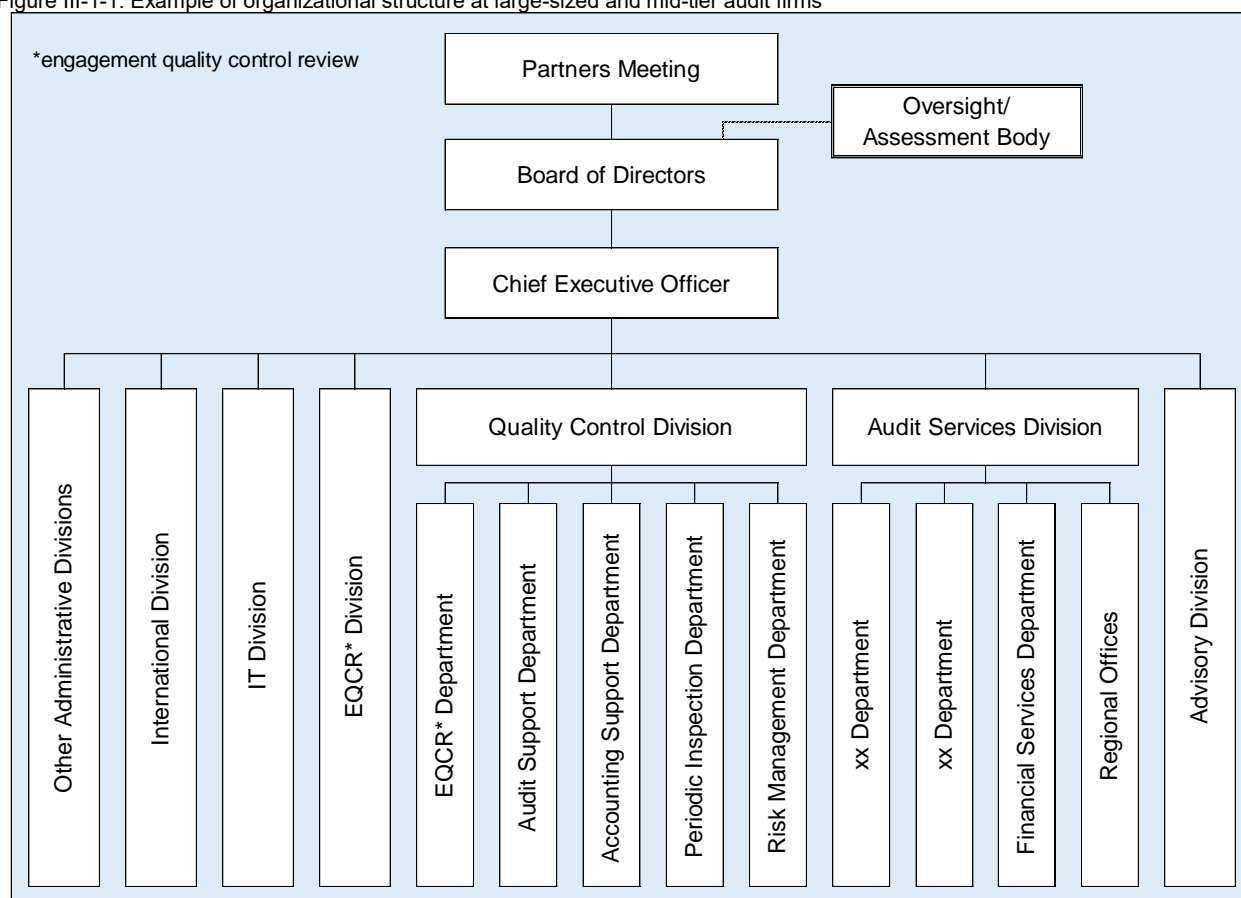
A. Operations Management System

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 and the Management Committee, which are established 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. Large-sized audit firms have established departments specializing in audits of listed financial institutions and other financial institutions (Figure III-1-1).

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

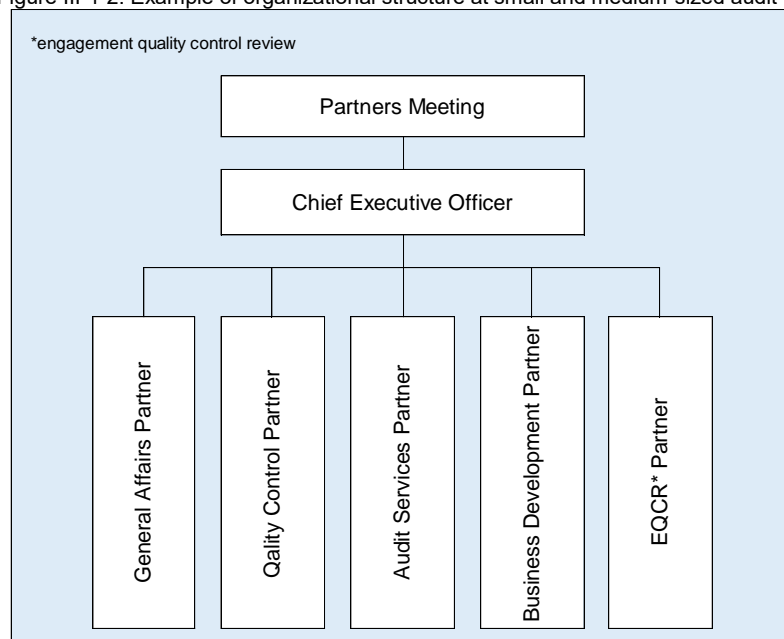


(Note) The organizational structure of mid-tier audit firms is often simpler than the structure shown in the above figure.

On the other hand, the majority of small and medium-sized audit firms do not have subdivided 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 systems 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 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.

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. 190 to 580	Approx. 40 to less than 90	Up to approx. 40 (Note)
Number of full-time personnel	Approx. 2,800 to 7,300	Approx. 200 to over 900	Up to approx. 100 (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 and management committee • 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, there are some situations where the involvement of the independent third persons is limited to advice and suggestions to executive bodies. 	<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"> • Under the quality control division, a department in charge of risk management, accounting consultations, engagement quality control reviews and periodic inspections is generally established. 	<ul style="list-style-type: none"> • Many firms appoint partners to handle both quality control and audit engagements without establishing quality control departments • In some small firms, CEO is also in charge of quality control

(Reference) Prepared by the CPAAOB from CPAAOB inspections, collected reports and operational reports in PY2023.

(Note) Excluding an audit firm whose number of partners and full-time staff members is much higher than others.

2. Efforts in Response to Audit Firm Governance Code

The Audit Firm Governance Code was formulated in March 2017, and subsequently in response to a series of government ordinances (published in January 2023 and put into effect in April) accompanying revisions to the CPA act (May 2022), which mandated audit firms that audit listed companies to establish a framework for conducting operations in line with the Code and requiring enhanced information disclosure. In line with these developments, the Code was revised in March 2023 with the aim of accompanying acceptance of small and medium-sized audit firms. The obligation to establish a system in line with the Code was effective from the beginning of the first accounting period of the audited company that began on or after July 1, 2024 (for large-sized audit firms, from July 1, 2023). The Audit Firm Governance Code has been formulated with the organizational management of audit firms that audit listed companies in mind. It is expected that the Code will be applied in a “comply or explain” manner (either implement the principles or explain the reasons for not implementing the principles). Audit firms are required that they 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 March 31, 2024, all large-sized audit firms and mid-tier audit firms as well as 12 small and medium-sized audit firms had announced adoption of the Audit Firm Governance Code¹¹.

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. Some small and medium-sized audit firms do not adopt all of the principles, with oversight/assessment functions within

¹¹ Sources: JICPA's website “List of efforts regarding effective organizational operation in audit firms”

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.

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, but they oversee and assess the process by receiving reports from internal members of the independent bodies such as a public interest committee.

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.

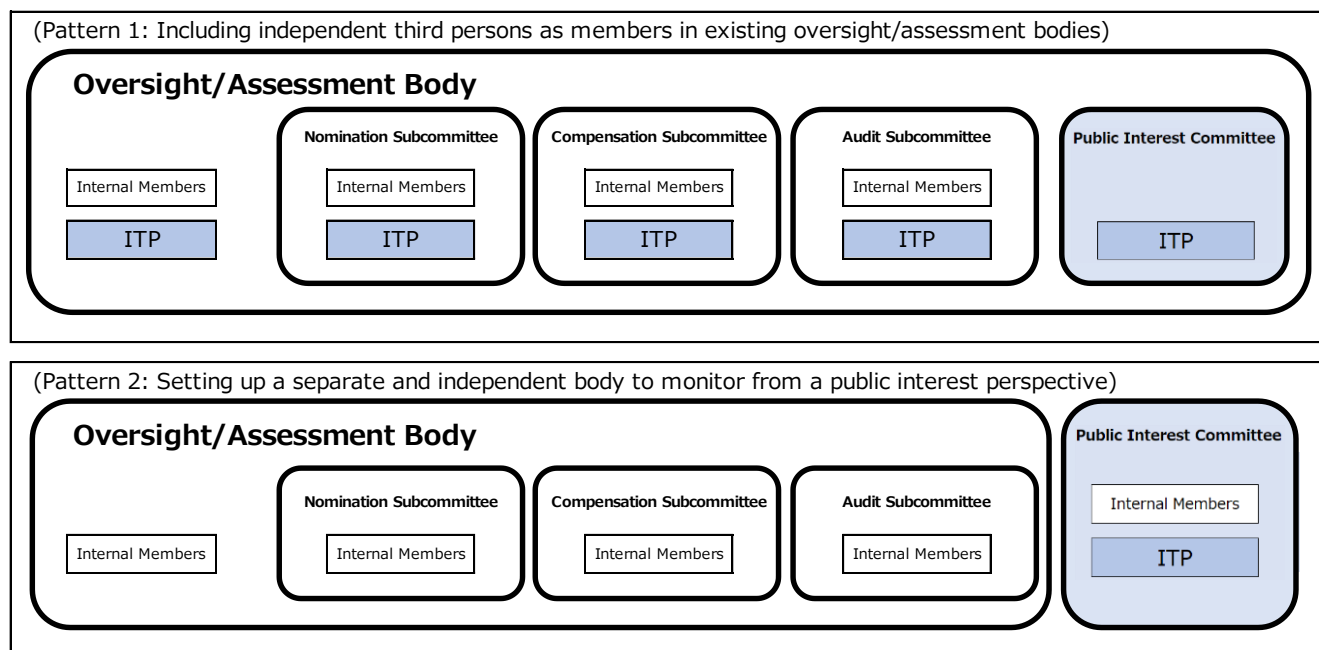
(iii) Small and medium-sized audit firms

Six out of 12 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. Also, there is a case where an audit firm

published continuous consideration of the necessity of independent third parties' involvement from the perspective of their contribution to public interest.

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 few 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 firm to firm. The degree of utilization of knowledge of outside experts also 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 (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 generally 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	2	1	—
Mid-tier audit firms	3	1	1	2	2
Small and medium-sized audit firms	2	3	1	—	1

(Reference) Prepared by the CPAAOB from CPAAPB inspections and reference material released by each audit firm in PY2023.
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 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, relationship with global networks that they belong to, and so on. In recent years, they devote considerable space to explanations of compliance with the new quality control standards, in addition to audit quality indicator (AQI), effective use of technology in auditing, and response to non-financial disclosures. 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.

(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 AQIs, plans for human resource development such as educational programs and training curriculums, etc., which are available in the reports of large audit firms. Some firms explain their measures for effective use of technology in auditing, response to non-financial disclosures, and the explanations of compliance with the new quality control standards. Also, some firms released the assessment of current efforts to improve the audit quality by constituent members, such as the results of in-house questionnaires about quality control.

(iii) Small and medium-sized audit firms

Nine out of 12 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 enforcement of relevant government orders in conjunction with the revision of the CPA act, made it obligatory for audit firms that audit listed companies to have systems in place to conduct operations in line with the Audit Governance Code and systems that require substantial information disclosure. As a result, many small and medium-sized audit firms that had not adopted the Audit Firm Governance Code in the past are now required to deal with the Code. Audit Firms are required to autonomously implement the Audit Firm Governance Code and realize effective organizational management taking into account their own size and characteristics. And the JICPA is expected to leverage its knowledge and experience obtained from self-regulation to provide sufficient guidance and supervision as a professional organization.

■ Disclosure of Audit Quality Indicators (AQI) ■

There is no established definition of audit quality, and it is difficult to measure directly.

For this reason, some large-sized audit firms, mid-tier audit firms, and small and medium-sized audit firms set up AQI, which quantifies their efforts and results of audit quality improvement according to each firm's situation, and are trying to understand the audit quality status through continuous monitoring of AQIs. The AQI at the audit firm level is also disclosed to the public through annual audit quality reports issued by audit firms, mainly large-sized and mid-tier audit firms.

When we compared the AQI statements in the most recent audit quality reports from large-sized audit firms and mid-tier audit firms, we found the following points. It should be noted that the AQIs are selected by audit firms to show a balanced picture of audit quality improvement based on their own circumstances, it is not possible to determine that there is an AQI deficiency just because an audit firm that does not report the AQI reported by other audit firms.

(Large-sized Audit Firms)

- AQIs related to IT (e.g., investment amount, tools adoption rate, etc.) are listed, given that all firms are promoting the use of IT and service delivery centers in their audits.
- In addition to IT-related AQIs, other AQIs commonly published are: AQIs related to internal quality control inspections (e.g. number of significant deficiencies identified in periodic inspections), average training hours of partners and staff, AQIs related to responses to globalization (e.g. % of staff with overseas work experience), and AQIs related to diversity (e.g. % of female staff).
- In addition to the above, many firms have posted AQI related to quality control systems (e.g., number of personnel engaged in quality control activities), AQI related to independence (e.g., results of internal inspection), results of inspections by external organizations, etc.

(Mid-tier Audit Firms)

- Commonly listed AQIs are related to personnel structure and quality control system (e.g. number of personnel), independence (e.g. response rate of independence confirmation forms, number of violations identified), and internal inspection (e.g. number of significant findings).
- Some firms also list AQIs related to the use of IT

AQIs are expected to promote constructive dialogue between audit firms and audit clients and other stakeholders as a common language, and to strengthen audit firms' PDCA cycle regarding audit quality. Audit firms are requested to continuously review the selection of AQI and the way of disclosure so that they can have constructive dialogues with stakeholders.

Figure: AQI in reports on audit quality by audit firms

	Large-sized audit firms	Mid-tier audit firms
AQIs common to all firms	<ul style="list-style-type: none"> • AQI on the use of IT and service delivery centers for audits - Investment amount, tool adoption rate, percentage of audit staff using delivery centers, etc. • AQI on internal inspection of quality control - Coverage of periodic inspection, results of periodic inspections, etc. • AQI on training - Average hours of training • AQI on globalization - % and No. of staff with overseas working experience, No. of staff with globalization process experience, etc. • AQI on diversity and inclusion - % of female employees (all employees, by job level) 	<ul style="list-style-type: none"> • Personnel Composition – No. of staff by job level • AQI on quality control system – No. of personnel and % of total staff engaged in quality control, etc. • AQI on independence - Response rate for written confirmation, No. of violations identified • AQI on internal inspection - Inspection results (No. of significant findings, etc.)

	Large-sized audit firms	Mid-tier audit firms
AQIs common to several firms	<ul style="list-style-type: none"> • Average annual working hours of auditors • Awareness Survey - % of company employees who are aware that the communication from top management includes the message that audit quality is a top priority, etc. • % of employees taking paid leave, maternity leave, etc. 	<ul style="list-style-type: none"> • Feedback from audited companies - Questionnaires to CEOs, CFOs, auditors (satisfaction with services), etc. • AQI on training - Training hours per staff, attendance rate of mandatory training, and average number of credits earned, etc. • AQI on globalization – No. of staff with overseas working experience • Results of inspections by external organizations - Administrative action by the FSA, significant deficiencies identified in the JICPA quality control review, etc.
AQIs found in only one firm	<ul style="list-style-type: none"> • AQI on sustainability assurance – No. of staff responsible for assurance on reporting, No. of responsible staff in-charge and No. of annual assurance reports issued • No. of audit staff changes – No. of transfers per year • Personnel composition • Average hours involved in audit engagements of listed companies (by job level) 	<ul style="list-style-type: none"> • AQI on the use of IT - Investment amount, tool adoption rate, percentage of investment to operating revenues • Acceptance and renewal of audit engagements – No. of listed audited companies • Restatement of financial statements accompanied by re-issuance of audit reports, etc.

3. Human Resources of Audit Firms

a. Partners and full-time personnel

In most large-sized audit firms, most CPA exam passers are hired immediately after passing the essay exam, while only a small proportion of CPAs and CPA exam passers 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”](#)).

Many mid-tier audit firms and small and medium-sized audit firms, meanwhile, find it difficult to recruit enough CPA exam 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 these firms are endeavoring to secure the necessary headcount for audit engagements etc. In many cases, new audit firms are also established by CPAs who have left from large-sized audit firms.

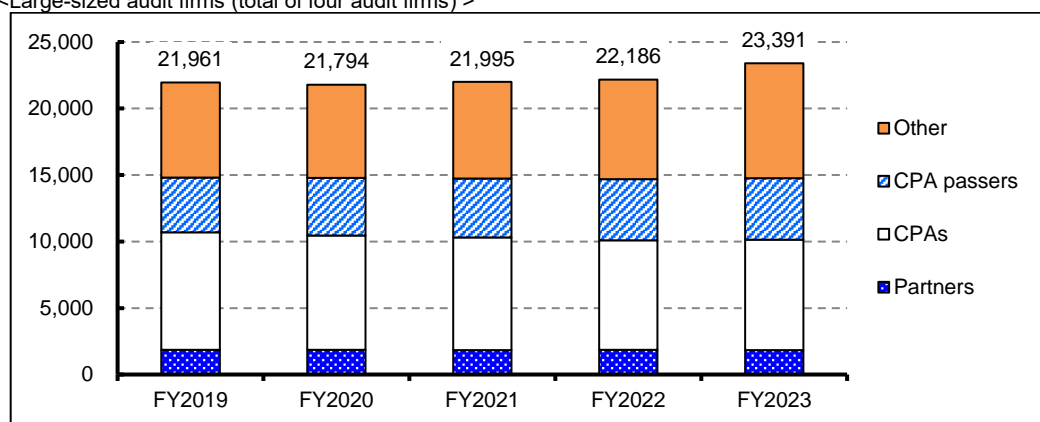
The number of partners and full-time staff members, analyzed by scale, has generally leveled off at large audit firms since FY2019, but increased in FY2023. For mid-tier audit firms, there has been increasing trend since FY2019, and the same increasing trend has been observed for small and medium-sized audit firms since FY2018, partly due to the establishment of new firms. As far as the structure of manpower is concerned, the number of CPA exam passers, etc. tends

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 37% of the total workforce at large-sized audit firms, 33% at mid-tier audit firms, and 26% at small and medium-sized audit firms. Compared to FY2019 (FY2018 for small and medium-sized audit firms), the ratio increased for both large-sized audit firms (24%) and mid-tier audit firms (30%), while the ratio remained for small and medium-sized audit firms (26%) (see Figure III-1-6).

Audit firms have increased their staff members other than CPAs and CPA exam 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 tasks requiring professional judgements, 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.

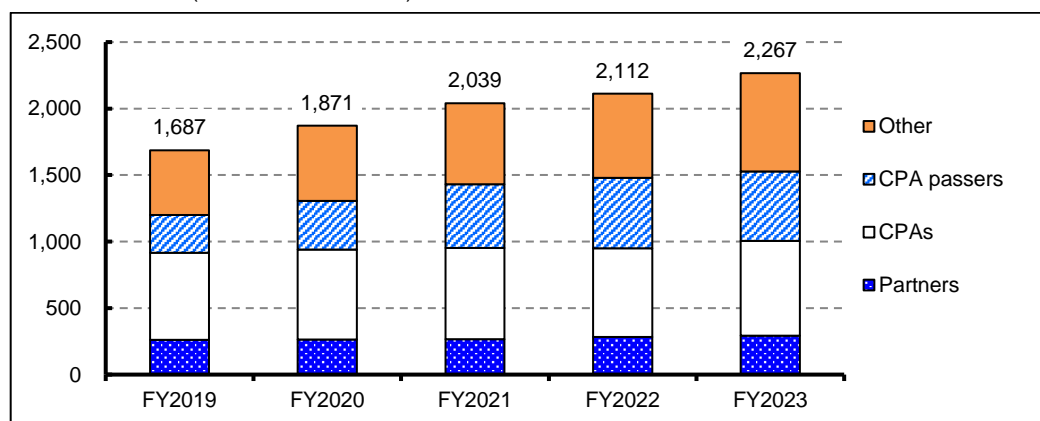
Some large-sized audit firms have improved their operations by establishing specialized organizations to centrally manage such as the work/procedures of audit assistants, skill development, and job allocations.

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) >



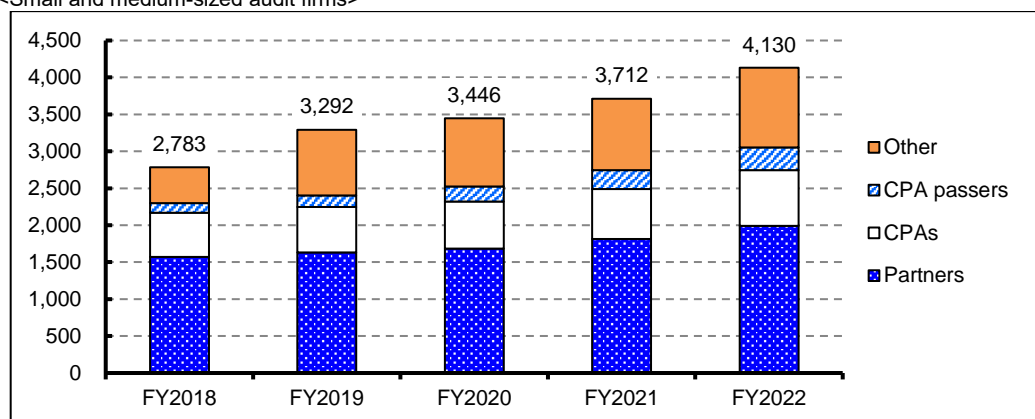
(Note) The number of PwC Kyoto in FY2023 is included in the mid-tier audit firms.

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



(Note) The number of PwC Kyoto in FY2023 is included in the mid-tier audit firms.

<Small and medium-sized audit firms>



(Note1) 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 FY2023 have not yet been compiled. As a result, the figures for small and medium-sized audit firms only cover the period to up to FY2022.

(Note2) The number of small and medium-sized audit firms varies from year to year, but 271 such firms are included in the figures for FY2022.

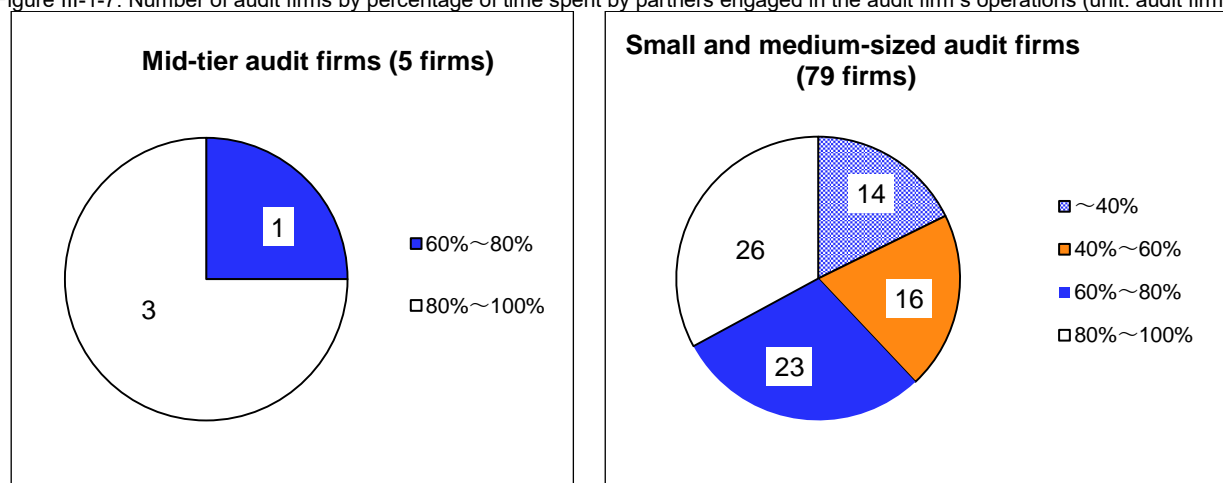
b. Side businesses by partners

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 50% 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 through the inspections and collection of reports in PY2023.

c. Part-time personnel

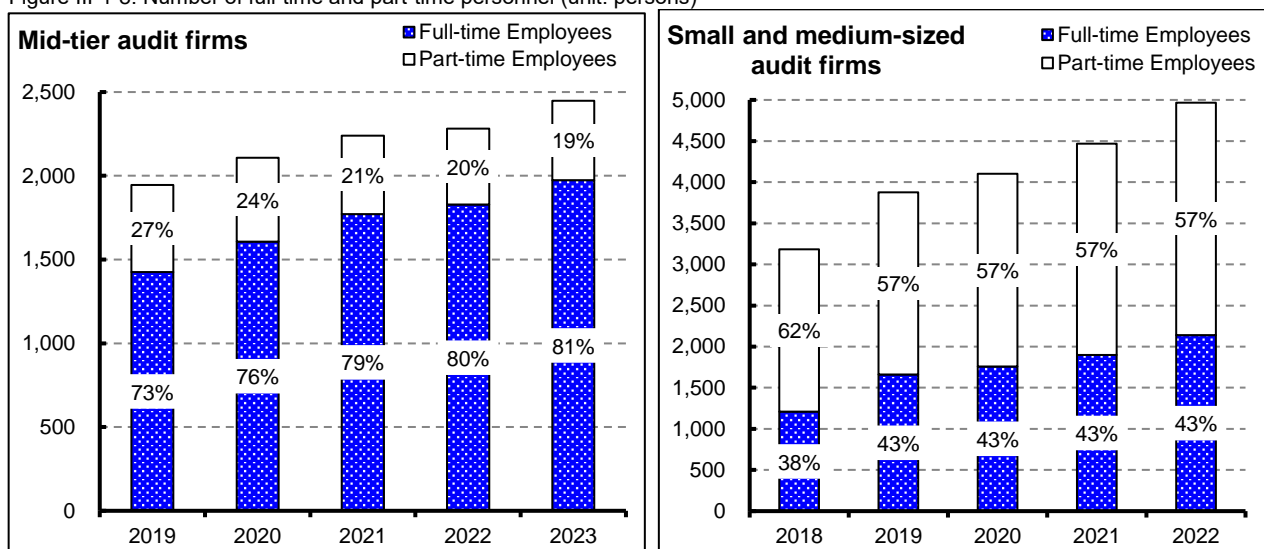
Part-time staff members account for an extremely low; around 3% to the total headcount at large

audit firms.

The ratio of part-time staff to total staff at small- and medium-sized audit firms has been on a decreasing trend, and in the last three years, the ratio has remained at around 20% in total for each firm, but there are differences among the firms.

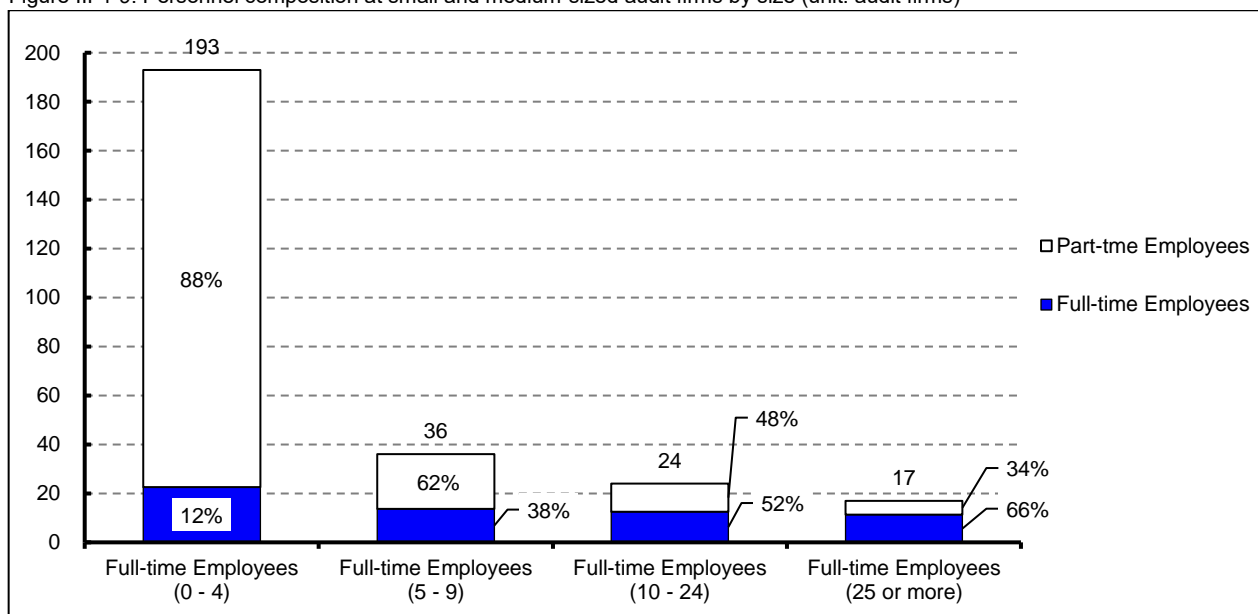
The ratio of part-time staff members has been slightly below 60% at small and medium-sized audit firms, indicating that they rely mainly on the audit assistants who are certified public accountants to support their operation (see Figure III-1-8). In particular, at audit firms with a full-time staff of 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 90% (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. The number of PwC Kyoto in FY2023 is included in the mid-tier audit firms

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



(Note) The 271 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 FY2022, after which the number of 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 skepticism¹², 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 status of the conduct of audit services through 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 for Supporting Audit Services. 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 exam passers, etc.)	Staff	Performance of audit procedures other than important audit procedures
	Four unqualified assistants	Assistant	Data processing, reconciliation of administrative vouchers, other tasks not requiring significant judgements, 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

(Note1) 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.

(Note2) In-house experts are assigned to engagement teams as needed

¹² 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.

Small and medium-sized audit firms often have audit assistants on a part-time basis due to limited human resources for audit teams, although in some firms it is difficult 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, for example, the audit manager needs 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 to 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 (Note)	<ul style="list-style-type: none"> • Drafting audit plans • Conducting audit procedures in material audit areas • Reviewing audit procedures performed by other audit assistants 	<ul style="list-style-type: none"> • Drafting audit plans • Conducting audit procedures (including material audit procedures) • Reviewing audit procedures performed by other audit assistants 	<ul style="list-style-type: none"> • Conducting audit procedures (including data analysis and sending, collection and management of balance confirmation documents) • Reviewing audit procedures performed by other audit assistants
	CPA exam Passers, etc.	<ul style="list-style-type: none"> • Conducting audit procedures other than material audit procedures 	<ul style="list-style-type: none"> • Conducting audit procedures other than material audit procedures 	<ul style="list-style-type: none"> • Conducting audit procedures other than material audit procedures • Not employed in most of smaller firms
	Unqualified assistants	<ul style="list-style-type: none"> • Data processing, reconciliation of administrative vouchers, other tasks not requiring significant judgements • Administration of sending/ collection of balance confirmation letters, administration of audit documentation 	<ul style="list-style-type: none"> • Data processing, reconciliation of administrative vouchers, other tasks not requiring significant judgements • Administration of sending/ collection of balance confirmation letters, administration of audit documentation 	<ul style="list-style-type: none"> • Not employed in most of firms

(Note) CPAs at small and medium-sized audit firms are often part-time.

(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 system for supporting audit services. We will also provide some examples, mainly from large-sized audit firms, of systems 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](#)" and "[C. Monitoring of Systems of Quality Control](#)" 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, have introduced, in addition to digitizing audit working papers, analytical tools to recognize unusual figures in journal entry data, 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 "[6. Usage of Technology in Audit and Cybersecurity Efforts, a. Progress with the Adoption of IT in Audit Engagements](#)").

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 CEOs 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.

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

6. Usage of Technology in Audit and Cybersecurity Efforts

a. 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.

i. Unification of audit tools

Audit firms that are members of the global networks use audit tools provided by the global networks (for more details, see [“7. Responses to Overseas Expansion of Companies b. Ties with Global Networks”](#)). 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.

Unified 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.

ii. Task automation (RPA¹³)

While certified public accountants have conventionally 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.

iii. 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

¹³ 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."

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.

iv. 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).

i., ii., and iii. above are fields in which progress is being made with deployment in large-sized audit firms, while iv. 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 iii. 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 III-1-14 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.

On the other hand, with regard to the use of audit tools by small and medium-sized audit firms, according to the responses received from 53 small and medium-sized audit firms in this year, 10 firms have already implemented electronic audit documentation, and 28 firms have started to consider the possibility of implementing such tools. In addition, 12 firms replied that they had already introduced journal analysis tools (analysis of transaction details (journal entries) and detection of abnormal journal entries), indicating that small and medium-sized audit firms are also making use of IT in auditing, although not to the same extent as large and medium-sized audit firms.

As the improvement of IT skills on the part of partners and 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 III-1-14: 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 (journal entries) 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 procedure management) Journal analysis tools (analysis of transaction details (journal entries) and detection of abnormal transactions)
Being installed/ introduced at some firms	<ul style="list-style-type: none"> AI (fraud forecasting abnormal transactions using past financial information, generative AI to respond to internal inquiries within the firm) 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 RPA (automation of data input and manipulation)
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 ■

Currently, there is a move towards the introduction of AI into accounting audits, mainly with large-sized audit firms seeking to improve the efficiency and sophistication of audit work, mainly in areas such as financial data analysis and document verification, by having AI learn the know-how of auditors or by using generative AI.

As specific use case, chatbots are used to respond to queries on accounting and auditing standards, internal audit manuals, etc. AI analyses the financial statements and journal entries of audited companies using data from securities reports and past inappropriate accounting, and presents the audit team with accounts showing signs of fraud and abnormal journal entries. For another case, tools have been introduced that combine large-scale language models with accountants' know-how to quickly and comprehensively extract the necessary sections for auditing from contracts and other specialized documents without omission.

On the other hand, the American Institute of Certified Public Accountants (AICPA) and others have pointed out the following issues regarding the use of AI:

- Accuracy, timeliness and comprehensiveness of data: The accuracy and timeliness of input data is impaired, or the scope of input data is restricted, resulting in erroneous outputs.
- Black-boxing decision-making processes: In the case of deep learning, multiple decision-making processes exist over many layers, and even within a single layer, multiple processes exist in parallel, making it difficult to explain the decision-making process on which the output is based.
- Algorithm bias: Any bias in the algorithm or training data will produce biased outputs.
- Data confidentiality: If AI is used outside the firm or AI is trained using data obtained from an external internet environment, confidential information inside the firm may be leaked or external confidential information may be unintentionally stolen.

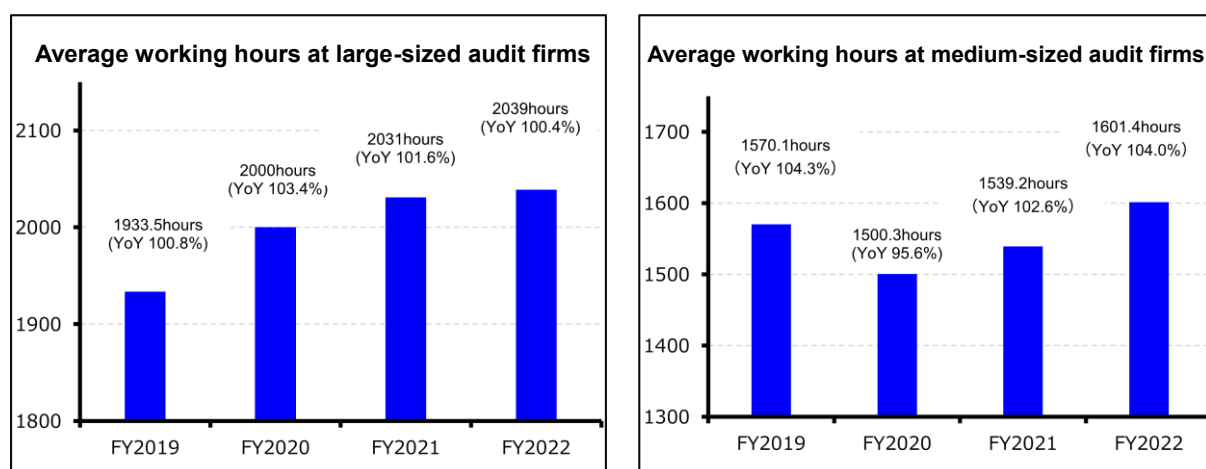
Audit firms that increase their use of AI are required to establish internal controls to address the above issues. In addition, accountants in such audit firms need to have a certain level of knowledge about data science and machine learning so that they do not rely on the output of AI.

■ Average working hours at large-sized and mid-tier audit firms ■

Some audit firms state the average annual working hours of partners, staff, etc. in their audit quality reports. The following table shows the average annual working hours and the average year-on-year rate of change for which we were able to confirm the information provided in the audit quality reports of large-sized audit firms and mid-tier audit firms over the last four years.

Although the average working hours of large-sized audit firms are longer than those of mid-tier audit firms, the rate of change from the previous year was lower for large-sized audit firms than for mid-tier audit firms, with the exception of FY2020.

Although this is a comparison of simple averages and is not a detailed analysis, it is possible that in addition to the transfer of audit services from large-sized audit firms to mid-tier audit firms and small and medium-sized audit firms, the introduction of IT tools in audit services and the transfer of operations to service delivery centers, which large-sized audit firms are actively promoting, are having an effect.



Going forward, it is possible that average annual working hours will decrease as the burden of data transfer associated with the initial introduction of IT tools is eliminated and engagement teams become more adept at using IT tools and service delivery centers. In addition, the introduction of AI-based tools may further enhance effectiveness.

b. 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 it 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 (CSIRT¹⁴) 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.

While it is generally believed that cyber-attacks are targeted at areas where security is weak, there are some cases among small and medium audit firms where the rules and regulations regarding information security, etc., do not match the actual situation. We collected reports from 53 small and medium audit firms in this year, and in the responses on cybersecurity initiatives, some firms did not mention the introduction of anti-virus software, while less than half of the firms mentioned the initiatives such as the acquiring and analyzing communication logs, updating of operating systems, and establishing incident reporting procedures.

■ CPA and Anti-Money Laundering and Countering the Financing Terrorism (AML/CFT) ■

Legal and accounting experts have a high level of expertise in law and accounting, etc., and have high social credibility. Therefore, transactions conducted through their duties and related operations can be abused as a means of money laundering and terrorist financing. The Financial Action Task Force (FATF)'s Fourth Mutual Assessment Report on Japan, published in August 2021, identifies Japan as a "Priority Follow-up Country" with inadequate measures against money laundering and terrorist financing. The FATF pointed out that Designated Non-Financial Businesses and Professions (DNFBPs), including CPAs, "have a low level of understanding of money laundering, terrorist financing risks, and AML / CFT requirements" and "Lawyers, judicial scriveners, administrative scriveners, tax accountants, and CPAs are not required to submit a suspicious transaction report. This severely compromises effectiveness."

The "Act for Partial Revision of the Act on Special Measures Concerning the Freezing of Property of International Terrorists and Other Measures Implemented by Japan in Response to United Nations Security Council Resolution 1267 and Other Resolutions, etc., in Response to International Traffic in Illicit Funds and Other Transactions" ("Revised Act") enacted on December 2, 2022, newly established the following provisions for legal/accounting experts.

- The purpose of the transaction and the beneficial owner of the corporation are added to the items to be confirmed in certain transactions (Financial consultation business for the sale and purchase of residential land and buildings, management and disposal of property, etc.) conducted by CPAs, etc.
- CPAs have been added to the list of entities subject to the suspicious transaction report (STR) obligation.

¹⁴ CSIRT (Computer Security Incident Response Team) is the collective term for the organizations responsible for dealing with incidents pertaining to computer security.

Based on the Revised Act, the FSA published in December 2023 a partially amended draft of "Points of Attention Regarding the Act on Prevention of Transfer of Criminal Proceeds" and "Guidelines for Anti-Money Laundering and Combating the Financing of Terrorism for Certified Public Accountants and Audit Firms," which have been applied since April 2024.

7. Responses to Overseas Expansion of Companies

a. Group audits

Many listed companies are operating in other countries by establishing subsidiaries and other entities, while M&A 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: Although the revised ASCS 600 "Special Consideration for Group Audits" was published in January 2023, its application begins with audits of financial statements for fiscal years beginning on or after April 1, 2024. Therefore, the descriptions in "a. Group Audits" are based on the pre-revision ASCS 600 "Group Audits."

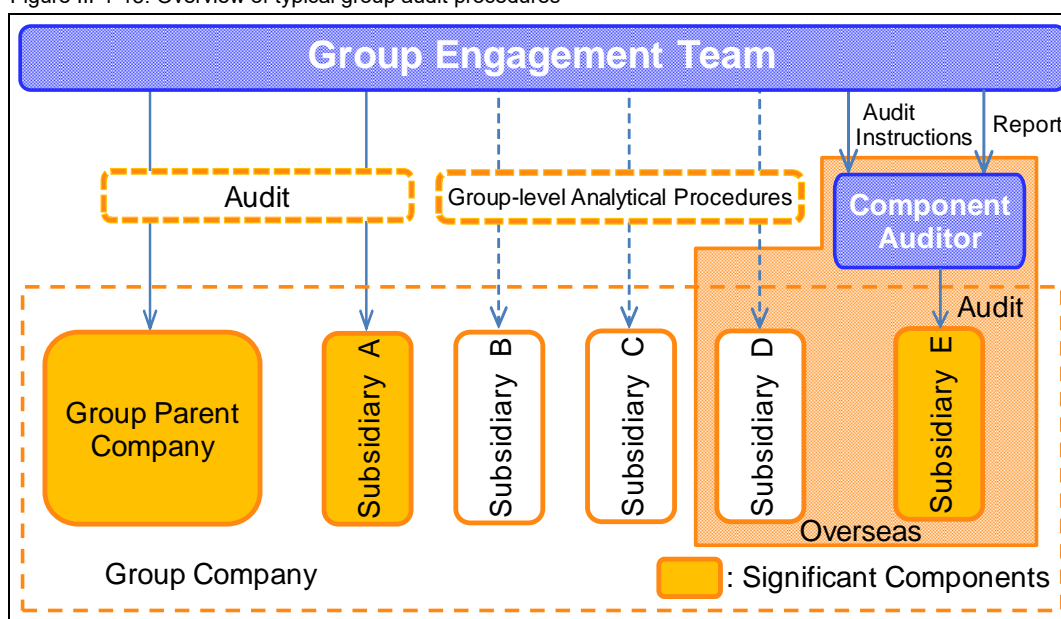
i. Overview of group audits

When auditors at a parent company ("group audit team") perform an audit attestation of group financial statements, 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), (26), (27)).

The following figure illustrates overview of typical group audit procedures (Figure III-1-15):

Figure III-1-15: Overview of typical group audit procedures



ii. 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.

iii. 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 III-1-16).

Figure III-1-16: 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 (Note1)	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.

(Note1) Documentation used by the group audit team to communicate its requirements to the component auditors.

(Note2) Regarding "Other" in the figure, of the 77 firms from which reports were collected in PY2023, information is presented for 28 firms conducting audit engagements for which group audit is required in cases where there is any component overseas. Among these, only four 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

iv. 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 communicate by visiting component auditors and online meetings. 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.

b. 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.

i. 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 III-1-17 and III-1-18). However, 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 [“7. Responses to Overseas Expansion of](#)

[Companies](#)”).

Figure III-1-17: Number of audit firms belonging to global networks¹⁵ (FY2023) (unit: audit firms)

Large-sized audit firms	4
Mid-tier audit firms	4
Small and medium-sized audit firms	17
Total	25

(Note) PwC Kyoto merged with PwC Arata on December 1, 2023, and it is not included in the mid-tier audit firms as of July 1, 2024.
(Source) Prepared by the CPAAOB based on operational reports

Figure III-1-18: List of global networks to which large-sized and mid-tier audit firms belong

Audit firm	Global network
KPMG AZSA LLC	KPMG International Limited (KPMG)
Deloitte Touche Tohmatsu LLC	Deloitte Touche Tohmatsu Limited (DTT)
Ernst & Young ShinNihon LLC	Ernst & Young Global Limited (EY)
PricewaterhouseCoopers Japan LLC	PricewaterhouseCoopers International Limited (PwC) (Note)
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

(Note) PwC Arata and PwC Kyoto merged on December 1, 2023 to form PwC Japan.
(Source) Prepared by the CPAAOB based on data from publicly disclosed materials from each audit firm (as of July 1, 2024)

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 III-1-19). The scale of the Big Four global networks is particularly prominent.

Figure III-1-19: Operating revenues of global networks (unit: billion USD)

	DTT	PwC	EY	KPMG	BDO	GT
Operating revenues	649	530	493	364	141	75
Audit services (Share of operating revenues)	123 (19%)	187 (35%)	150 (30%)	126 (35%)	59 (42%)	32 (43%)
Tax-related services (Share of operating revenues)	103 (16%)	117 (22%)	120 (24%)	79 (22%)	32 (23%)	16 (21%)
Advisory services (Share of operating revenues)	423 (65%)	226 (43%)	223 (45%)	159 (44%)	49 (35%)	27 (36%)

(Source) Prepared by the CPAAOB based on data from publicly disclosed materials of each global network (2023 accounting year).

¹⁵ Among small and medium-sized audit firms, the firms that have concluded cooperative relations (alliances) with overseas audit firms are included.

In Japan, the Big Four global networks' share of audit services is 97% of the 225 companies that 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 III-1-20)

Figure III-1-20: 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%	91%

(Sources) Japan: Compiled by the CPAAOB from QUICK and exchange data (as of March 31, 2024)

U.S.: Compiled by the CPAAOB from Bloomberg data (as of April 18, 2024)

U.K.: "Key Facts and Trends in the Accountancy Profession, August 2023," Financial Reporting Council

ii. Relationships with global networks

Network firms comprising global networks are responsible for a range of areas including quality control in exchange for 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 the Person In Charge Of Quality Control (PICOQC) opine from the perspective of Japan as members of high level network committees, while members of oversight/assessment bodies take part in global meetings.

Embedding audit manuals and tools prepared by the networks, the large-sized audit firms perform audits in accordance with them subject to the networks' standards. AS of 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 (for details, see "[C. Monitoring of Systems of Quality Control, 2. Utilization of Global Reviews](#)").

Furthermore, some firms have an appetite to manage member firms on a regional basis. In the Asia-Pacific region, large Japanese audit firms tend to play a central role by participating as board members in organizations.

(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 receiving referral of audit engagements from network firms in other countries, but are not provided with audit manuals and other information or undergo global reviews.

(iii) Small and medium-sized audit firms, partnerships, and solo practitioners

Among small and medium-sized audit firms, partnerships and solo practitioners, some firms only use the global network logos and brand and receive referrals for audit engagements where the network firm belongs, and are not provided with audit manuals or subjected to global reviews.

■ International Forum of Independent Audit Regulators (IFIAR) ■

Established in 2006, the 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 March 2024, it had members from 56 countries and jurisdictions, including Japan.) In April 2017, the Secretariat of IFIAR was established in Tokyo, becoming the first headquarters of international organization in Japan.

Secretary General of the CPAAOB and the Deputy Commissioner of Strategy Development and Management Bureau of the FSA has been serving as the Chair of IFIAR since April 2023. This is the first appointment of a Chair from Asia since IFIAR was established in 2006.

In April 2024, the 24th IFIAR Plenary Meeting was hosted by the FSA and CPAAOB in Osaka. The IFIAR Plenary Meeting is an annual gathering of IFIAR members and stakeholders. This year's meeting was attended by more than 170 participants, including audit oversight bodies from 48 jurisdictions, CEOs of the six major audit firm networks, and other stakeholders.

The meeting covered topics of increasing importance in the audit industry in recent years, including audit firm governance, sustainability assurance, and the use of technology in auditing. This was the third time for Japan to host this conference, and the first time for IFIAR to hold a conference outside of Tokyo. Many attendees spoke highly of Japan's hospitality culture, not only for the content of the conference, but also for the smooth preparation and progress of the conference and the attention to detail during the conference.

8. Treatment of Key Audit Matters

From the perspective of enhancing the transparency and the provision of information pertaining to audits conducted under the FIEA, entries of "Key Audit Matters" (KAMs) in audit reports came to be required, starting with accounting audits for the fiscal year ending March 31, 2021.

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

i. 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

ii. 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 notes 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

b. Responses by audit firms

Recent monitoring found the following responses by large-sized and mid-tier audit firms. Some audit firms have developed a system for KAMs, including communications with audited companies (Figure III-1-21).

i. Development of guidance for preparation of KAMs

- Preparation and dissemination of guidance and descriptive examples with which audit teams comply when preparing KAMs

ii. Provision of training

- Training to provide explanation of good examples on KAMs based on analyses of actual application cases
- Training with a workshop format adopted, wherein audit teams actually draft KAMs
- Training to provide explanation of points to note in drafting KAMs

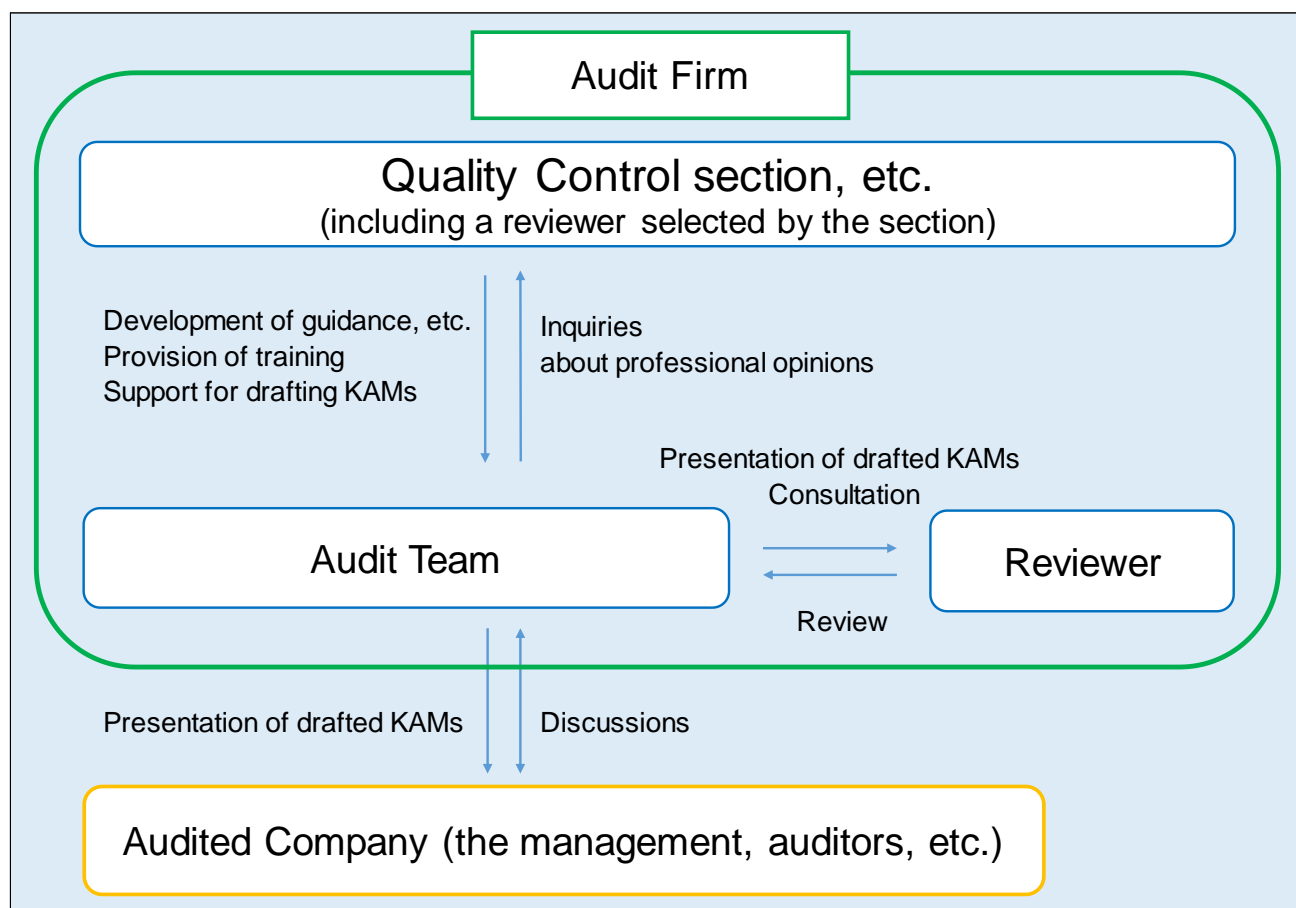
iii. Quality control section's support for audit team

- 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 of KAMs drafted by audit teams by a reviewer selected by the quality control section

iv. Reviews and inquiries of professional opinions

- Request for conference-format reviews by the headquarters and inquiries about professional opinions in specific cases, such as treating the non-disclosure of KAMs or assumption related to a going concern as KAMs

Figure III-1-21: Example of an audit firm's system for reporting of KAMs



c. Analyses of KAMs and recommendations

Regarding the KAMs in the year ending March 31, 2023, the FSA and other related organizations have released documents and other information (Figure III-1-22).

Figure III-1-22: Publication related to KAMs

Organizations that published their analyses, timing of publication, published documents, and web links
<p>Japanese Institute of Certified Public Accountants (April 2023)</p> <p>Auditing Standards Statements 701, Public knowledge document No.2, "Public knowledge document on the third year application of Key Audit Matters (KAMs)" https://jicpa.or.jp/specialized_field/20230403ffh.html</p> <ul style="list-style-type: none"> Summarizes points to keep in mind from the viewpoint of preventing boiler-plate and improving the usefulness of KAM.
<p>Securities Analysts Association of Japan (February 2024)</p> <p>Good examples of KAMs helpful for securities analysts 2023 https://www.saa.or.jp/account/account/pdf/Kam20240213.pdf</p> <ul style="list-style-type: none"> In cooperation with the JICPA, the report introduces 23 'Excellent KAMs' and two 'Special KAMs' as good examples of KAMs, and describes the points that were evaluated and the comments of the analysts in charge. This is the third and final release of this kind, following the first two in February 2007 and in February 2023.

Financial Services Agency (June 2023)

Efforts to establish and permeate the practice of Key Audit Matters (KAMs) <https://www.fsa.go.jp/news/r4/sonota/20230630-9/20230630-9.html>

- Summarizes the major efforts to made date to establish and permeate the KAM in practice.
- Although "Study Group on KAM" or "Characteristic Examples and Key Points of Key Audit Considerations (KAM)" are not planned to be held after FY 2023, the efforts to further improve KAM practices will be continued through follow-up of KAM publication and collaboration with relevant organizations.

The KAM is expected to promote constructive dialogue between auditors and stakeholders, but it also raises concerns such as boiler-plate and polarization of good and bad cases. The CPAAOB will examine the decision-making process on KAMs, the descriptions of audit responses, and the implementation status regarding audit responses based on the Basic Plan for Monitoring Audit Firms.

9. 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 ("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").

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")¹⁶ had once decreased to 39% as certain large-sized audit firms spun off non-audit and attestation services and subsidiaries from their group in FY2015 and FY2017. However, it has been on an upward trend in recent years due to increases in revenue of group companies (Figure III-1-23). For audit firms' operating revenue, see "[I. Overview of the Audit Sector, B. Audit Firms, 5. Financial Condition \(Operating Revenue, Proportion of Audit and Attestation Services and Non-audit and Attestation Services\)](#)".

At mid-tier audit firm groups, the ratio of non-audit and attestation revenue has stayed lower

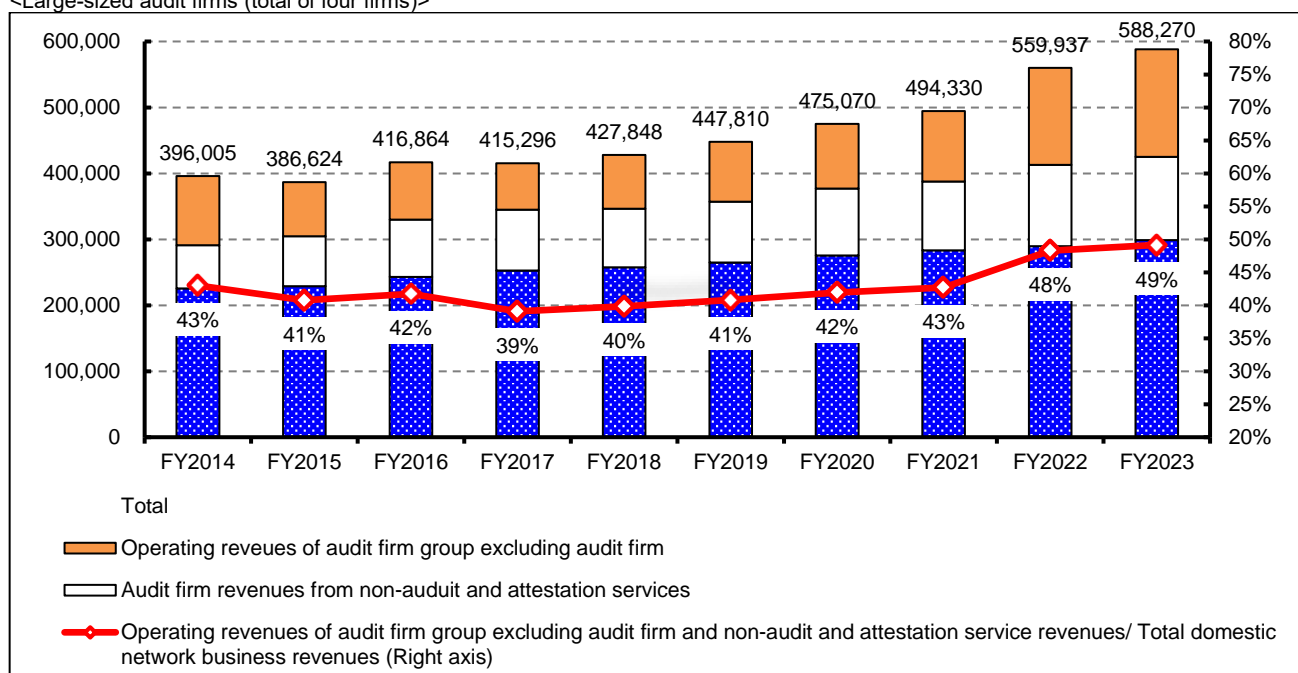
¹⁶ Some group companies that do not have capital relationship with an audit firm have operating revenue of over 100 billion yen.

than at large-sized audit firms, moving roughly in a range between 10% and 13% from FY2014 through FY2023. 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-1-24).

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.

Figure III-1-23: 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))

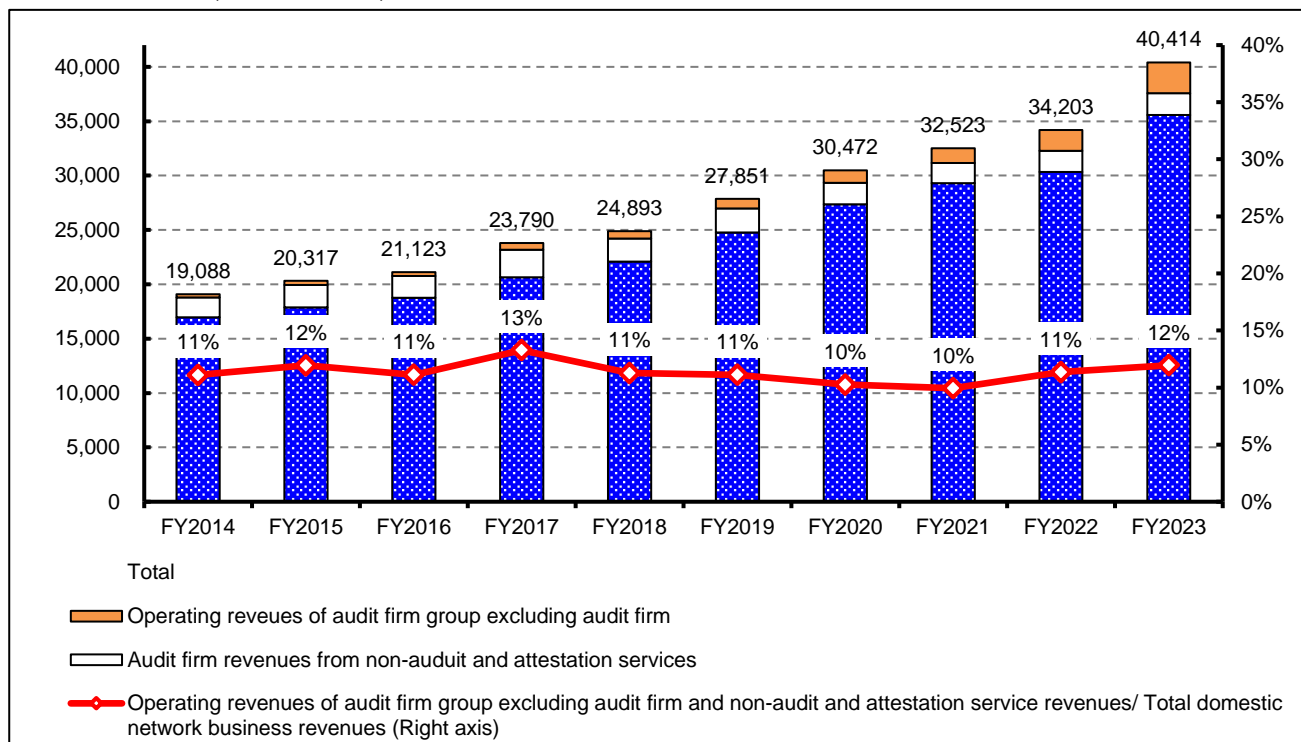
<Large-sized audit firms (total of four firms)>



- (Note1) 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.
- (Note2) 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.
- (Note3) 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.
- (Note4) In FY2015 and FY2017, certain large-sized audit firms spun off businesses or subsidiaries that perform non-audit and attestation services
- (Note5) As the operational reports, including those for fiscal year 2023, were prepared before the establishment of PwC Japan, the figures include the revenues of PwC Aarata for large-sized audit firms and PwC Kyoto for mid-tier audit firms.
- (Source) Prepared by the CPAAOB based on operational reports submitted by audit firms

Figure III-1-24: 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)>



- (Note1) Operating revenues of audit firm groups include revenues from companies that fall under subsidiaries, etc. of an audit firm within the group, in principle.
- (Note2) Non-audit and attestation service revenues are the total of audit firm revenues from non-audit services and domestic network firm revenues
- (Note3) 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.
- (Note4) As the operational reports, including those for fiscal year 2023, were prepared before the establishment of PwC Japan, the figures include the revenues of PwC Aarata for large-sized audit firms and PwC Kyoto for mid-tier audit firms.
- (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. When evaluating the audit procedure implemented by the audit team, material judgement in audit process and audit opinion, objectivity of quality control review has significant impact on the audit quality.

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

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 covers 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.

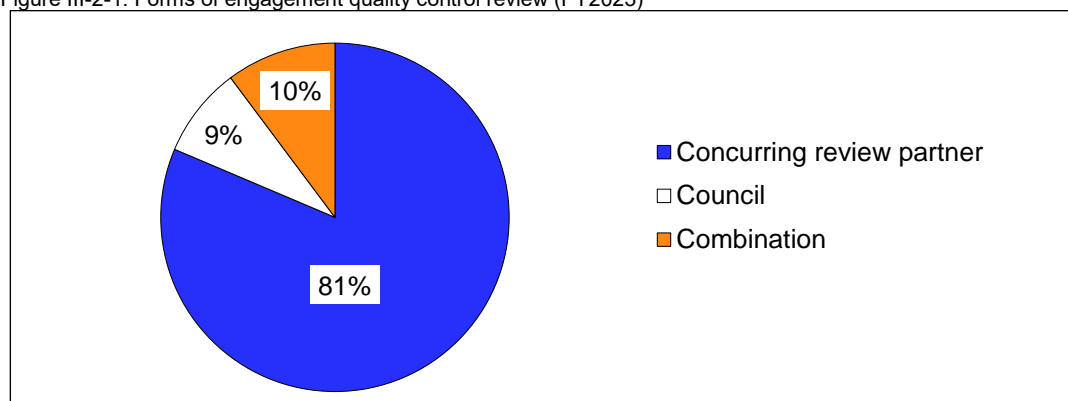
Since reviews of the council style involves the collaboration of several EQC reviewers, it allows for more multi-faceted reviews than the concurring review partner style.

c. Combination style

Under the combination style, the concurring review partner style is used in some cases, while the council style is used when the matter involved in expressing audit opinion falls under predetermined criteria. In another case, either the concurring review partner style or the council style is used, depending on the risk of each audit 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 (FY2023)



(Note1) Aggregated the status of 274 audit firms based on operational reports submitted by the audit firms

(Note2) As fiscal year-end varies widely among small and medium-size audit firms, their results in FY2023 have yet to be tallied. This report therefore covers their results through FY2022 (from April 2022 through March 2023).

(Note3) The business report is prepared for the financial year before the establishment of PwC Japan and PwC Arata and PwC Kyoto are counted as separate entities.

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 at a review committee at headquarters. Furthermore, during reviews, some firms consult with bodies etc. featuring third parties in the case of important matters that would likely have a substantial social impact to ensure that decisions harmful to the public interest are not made.

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.

In large-sized and mid-tier audit firms, the review division and others often monitor the review results, etc. and the time spent by reviewers.

There also are audit firms implementing programs to further improve review functions, such as reinforcing the information shared among reviewers, carrying out review-related compulsory training programs and conducting quality control reviews by reviewers belonging to quality control division at headquarters in higher risk audit engagements compared to ordinary engagements.

C. Monitoring of Systems of Quality Control

Audit firms are 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 the levels of quality control in audit engagements in a timely manner and continuously have remediation in place. 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 (hereinafter referred to as "global reviews"). Given that large-sized and mid-tier 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 (hereinafter referred to as "periodic inspections"). 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 (amended in February 2019) (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.

Large-sized and mid-tier 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 inspection 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 to four 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 approximately once every three years.
Inspectors	Under the supervision of quality control partner, partners and assistants who are not involved in inspected audit engagements (Inspection team is mainly composed of staff belonging monitoring division.)	Under the supervision of quality control partner, 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 50 and 200	Between a few and around 20	Between one and around 20
Number of engagements handled by each inspector	One to two engagements	One to two engagements	One to six 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.	Some firms conduct under the inspection framework provided by the global network, while others conduct based on each firm's own inspection framework 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 tools.
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.

(Note1) The number of engagements per inspector was calculated by dividing the number of audits subjected to periodic inspections conducted in FY2023 by the number of inspectors involved.

(Note2) The business report is prepared for the financial year before the establishment of PwC Japan and PwC Arata and PwC Kyoto are counted as separate entities.

(Note3) As fiscal year-end varies widely among small and medium-size audit firms, their results in FY2023 have yet to be tallied. This report therefore covers their results through FY2022 (from April 2022 through March 2023).

(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 the detailed quality control provisions and audit manuals provided by the global network, and conduct global reviews to confirm whether network firms comply with those provisions and manual in periodic inspections and individual audit work.

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 [“III. Operation of Audit Firms, A. Operations Management System, 7. Responses to Overseas Expansion of Companies, b. Ties with Global Networks, ii. Relationships with global networks”](#).

While all large-sized audit firms are subject to the global review, some mid-tier audit firms are not. Few of the small and medium-sized audit firms that are part of the global networks are 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	Some firms are not 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 including remote work and flextime, 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 an 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 (amended in February 2019) (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

Large-sized and mid-tier audit firms	<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 including data analysis tool, responses to fraud risks, key points by industrial sector, attendance to particular issues related to IPO audit, results of periodic inspections, 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
Small and medium-sized audit firms, partnerships and solo practitioners	<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 e-learning 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 auditors' experience and capability and situation in their audited companies. Thus, many firms are only confirming that their partners and staff are undergoing the Continuing Professional Development provided institutionally by JICPA (i.e. whether they have obtained the required number of credits).

(Education and training needed for IFRS adoption)

As the number of companies adopting and having decided to adopt IFRS in Japan has now exceeded 280, large-sized audit firms in particular are working to develop partners and staff involved in audits of companies adopting IFRS. 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

<p>Large-sized and mid-tier audit firms</p>	<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>
---	--

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 (amended in February 2019) (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 (for details, see “C. Monitoring of System of Quality Control, 1. Periodic Inspections”) as well as the results of quality control reviews etc. are reflected in the performance evaluations of engagement partners.

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

Some 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.

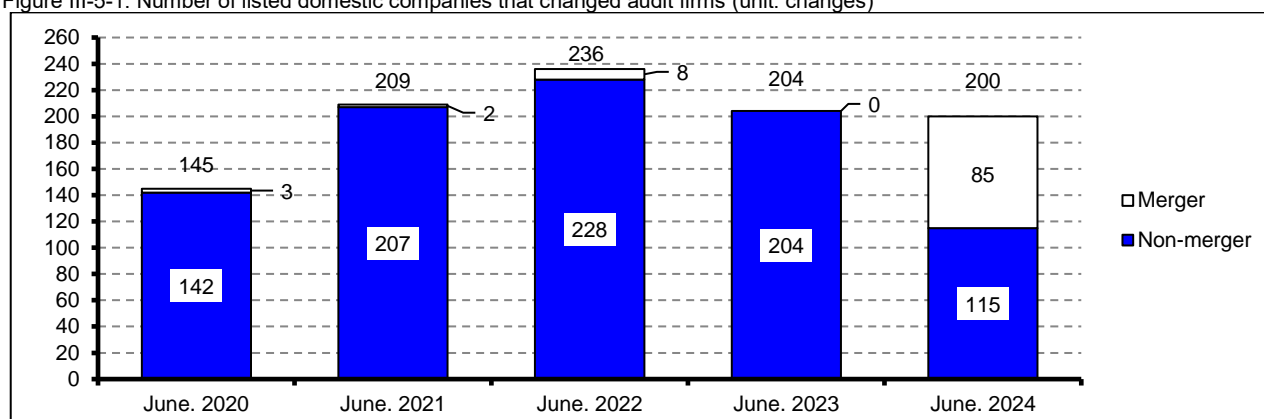
Large-sized and mid-tier audit firms establish rough standard of promotion by employees' seniorities. They generally promote to managers after approximately a seven to 10 year and to partners, following a selection process. As small and medium-sized audit firms rarely hire newly qualified CPAs, they 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, some 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. 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 200 cases of changing auditors of domestic listed companies in the year to June 2024. Of these, changes due to the mergers of audit firms accounted for 85 cases, including mergers between large-sized and mid-tier audit firms (76 cases) and mergers between small and medium-sized audit firms. Excluding those due to mergers, the number of changes has been on a downward trend since reaching a peak at the year to June 2022 (Figure III-5-1). For information on mergers, see "[I. Overview of the Audit Sector, B. Audit Firms, 4. Mergers of Audit Firms](#)".

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



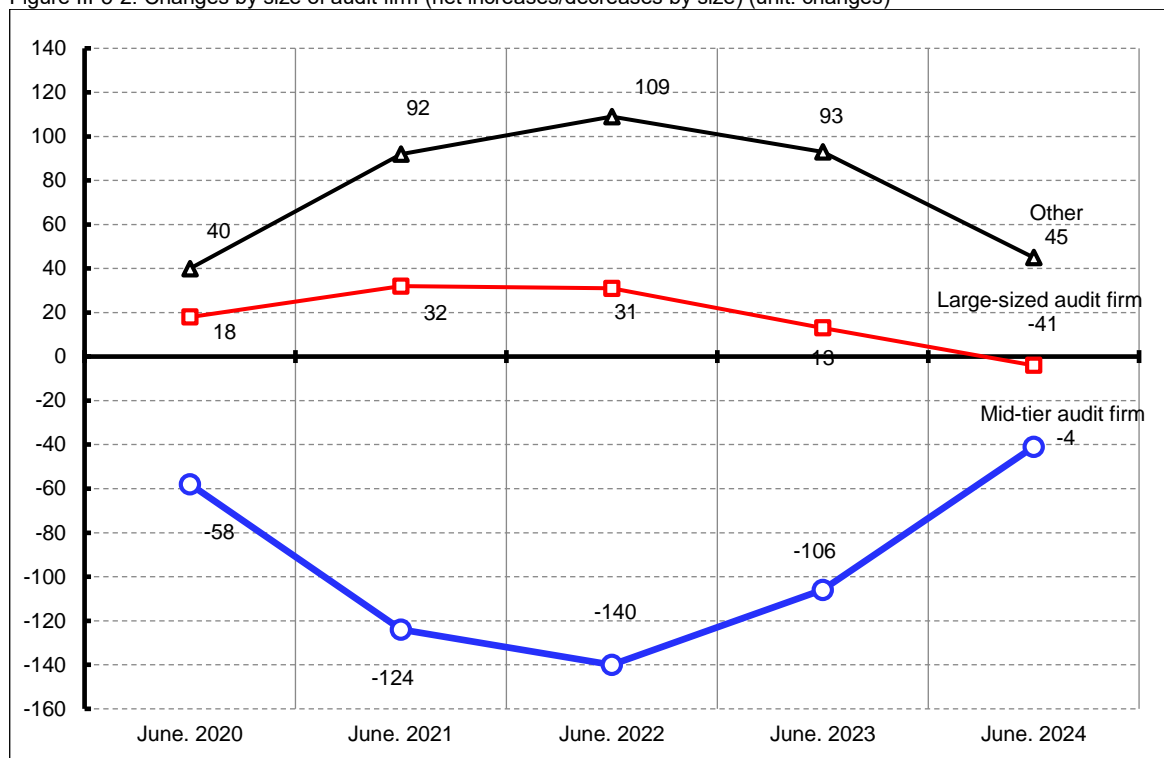
(Note) The number of companies that had decided on an incoming auditor by the end of June of each period based on timely disclosure of listed domestic companies.

As can be seen from changing in audit firms by size for the reasons other than audit firm mergers, the number of changes tended to decrease in the year to June 2024, but changing from large-sized audit firms to mid-tier audit firms or small and medium-sized audit firms, partnerships and solo practitioners still continued (Figures III-5-2 and III-5-3). This trend can be attributed to the factors such as audit firms (mainly large-sized firms) considering whether to continue the audit contracts, taking into account audit fees, audit risks and the staff required to perform the audit engagement, and audited companies selecting auditors, taking into account the length of continuous audit periods and the reasonableness of audit fees, have come to an end. 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](#)".

The above-mentioned shift from large audit firms to mid-tier as well as small and medium-sized audit firms indicates an increasing the role of small and medium-sized audit firms in auditing listed companies.

However, the CPAAOB's recent inspection of small and medium-sized audit firms identified 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 place greater emphasis on inspections of small and medium-size audit firms.

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



(Note1) Net increases/decreases in the number of changes

(Note2) 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

(Note3) Figures in the above table do not include changes due to mergers of audit firms.

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

From/To	June 2023	June 2024	Increase/Decrease
Large-sized → Large-sized	17	12	▲5
→ Mid-tier	26	10	▲16
→ Other	85	40	▲45
Mid-tier → Large-sized	0	5	5
→ Mid-tier	1	0	▲1
→ Other	17	11	▲6
Other → Large-sized	5	4	▲1
→ Mid-tier	4	2	▲2
→ Other	49	31	▲18
Total	204	115	▲89

(Note1) Aggregates of number of companies that had decided on an successor auditor by the end of June of each period, based on timely disclosures by listed domestic companies

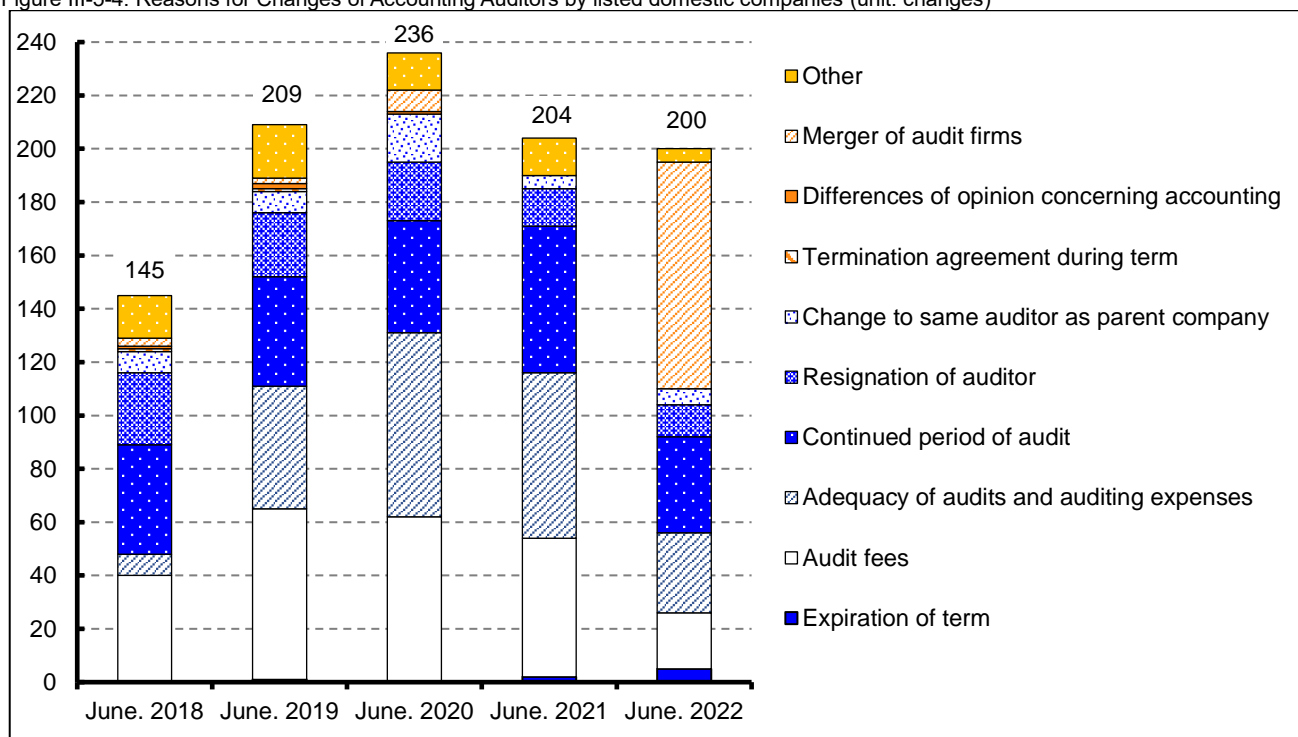
(Note2) "Other" in the figure refers to small and medium-sized audit firms, partnerships and solo practitioners.

(Note3) Figures in the above table do not include changes due to mergers of audit firms.

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 immediately (Article 402 of the Securities Listing Regulations, Tokyo Stock Exchange). In this case, the substantial reason for the change and the background thereof must be specifically disclosed. Under the regulations above, many firms stated the proposal of increase in audit fees as well as the adequacy of audit work in light of the size of the company's business and the reasonableness of audit fees as reasons for changes. In addition, in many cases, the reason for changes in auditors is stated as a result of comparison with other audit firms in consideration of the prolonged continuous audit period of the current auditor. (Figure III-5-4). In the year to June 2023, except for mergers of audit firms, many companies stated that the change of auditor was due to these reasons.

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



(Note1) Compiled by the CPAAOB based on timely disclosures by listed domestic companies choosing new auditors by the end of June each year.

(Note2) In the case of two or more reasons disclosed, the classification was made based on principal reasons.

2. Reasons for Change of Accounting Auditors during Fiscal Term

There were no case of changes in auditors during the period in the year to June 2024. In the year to June 2023, in one cases, out of 204 cases, companies changed auditors in the middle of the fiscal year. The reason of this change is that the auditor proposed to resign due to conflict of views between auditor and audited company, and so on.

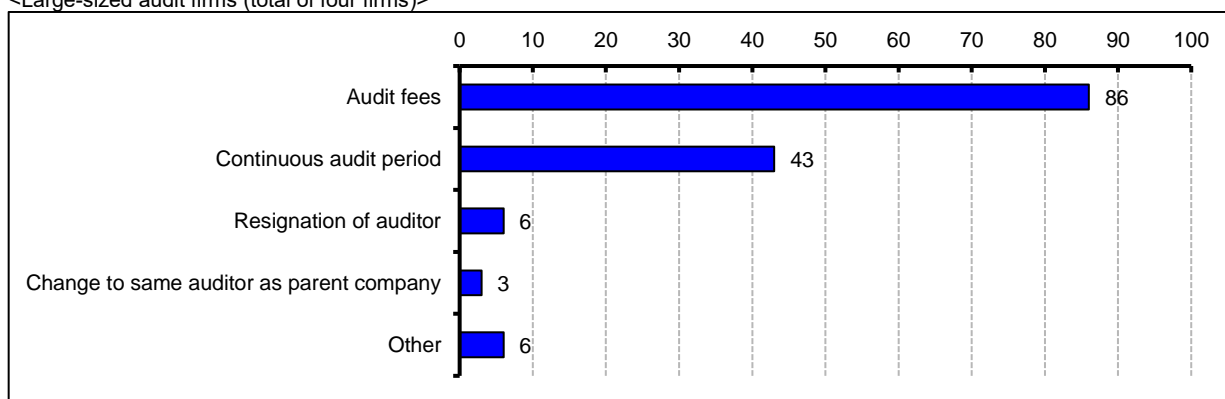
3. Reasons for Changes of Accounting Auditors as Identified Through Monitoring Activities

This section lays out reasons for changing accounting auditors ascertained through monitoring activities in PY2023 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 PY2023 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" while 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 when considering whether to renew audit contracts.

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)>



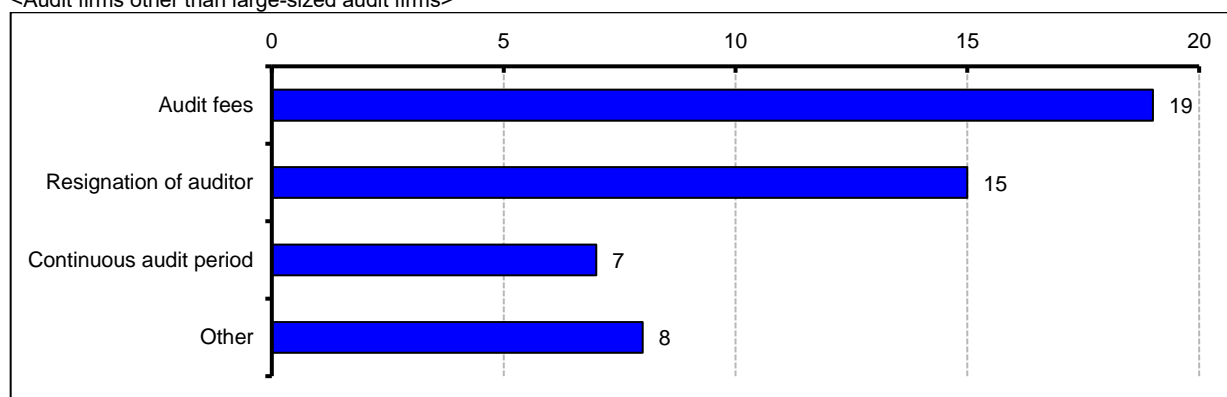
(Note1) Based on data from 107 changes identified through inspections and report collection during PY2023. On December 1, 2023, PwC Arata and PwC Kyoto merged to form PwC Japan. The reasons for the changes in PY 2023 were obtained from PwC Arata prior to the merger.

(Note2) If there was more than one reason, that change is included in the figure for each reason (a cumulative total of 144)

- #### b. Mid-tier audit firms and small and medium-sized audit firms, partnerships and solo practitioners
- "Audit fee" was the most common reason among 45 cases of changing auditors (who replied as former auditors) that were identified through the inspection of mid-tier audit firms and small and medium-sized audit firms and the collection of reports from them. "Resignation proposed by auditors" formed the second largest number of reasons. 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. "Other" included the objective of unifying auditors with parent companies as well as the desire of the audited company to replace its auditor with a firm that has specialized knowledge and experience in the business in which the audited company is expanding (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>



(Note1) Based on data from 45 changes for which the reason was identified through the inspection by the CPAAOB in PY2023 and reports collected from five mid-tier audit firms, 54 small and medium-sized audit firms and 24 solo practitioners. On December 1, 2023, PwC Aarata and PwC Kyoto merged to form PwC Japan. The reasons for the changes in PY 2023 were obtained from PwC Aarata prior to the merger.

(Note2) If there was more than one reason, that change is included in the figure for each reason (a cumulative total of 49)

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, most recently amended in July 2022, 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 according to applicable technical and professional standards. Therefore, the quotation of a low fee causes auditor's self-interest that disturbs auditor from observing the principles concerning proper capacity and attention required to professional specialists.

2. Methods for Calculating Audit Fees

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

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

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

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

According to the reports collected in PY2023, audit fee estimates are calculated as follows.

a. Large-sized audit firm

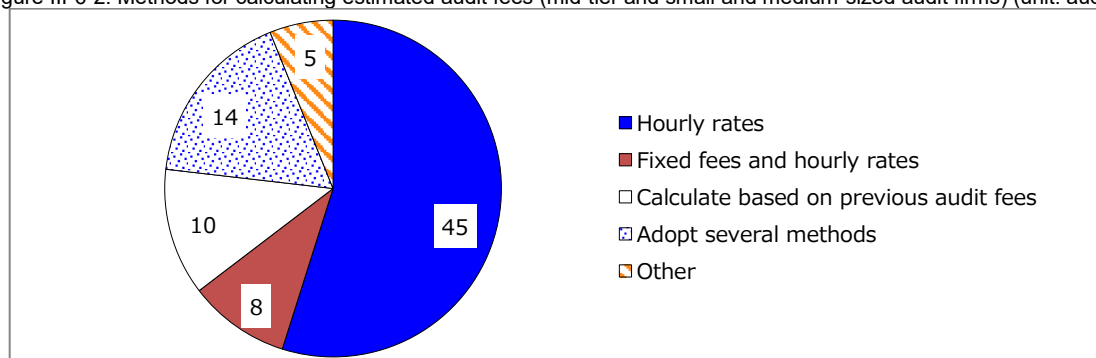
All large-sized audit firms state that they adopt the hourly rates approach for audit fee estimates. Hourly rates are set for each hierarchy level of employee, and the rate is determined while considering indirect costs associated with firm management and quality control such as the payrolls of administrative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

Some large-sized audit firms set elaborate charge rates, taking into account not only job classification but also the complexity of the audit engagement and each 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 multiple 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)



(Note1) Aggregated from reports collected from mid-tier and small and medium sized audit firms in PY2020

(Note2) Data for PwC Kyoto (currently PwC Japan), which merged with PwC Aarata in December 2023, is aggregated by including pre-merger information for mid-tier audit firms.

Regarding the hourly rates approach, 60% 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	33	40%
Rates not set	49	60%
Total	82	100%

(Note1) Aggregated from reports collected from mid-tier and small and medium sized audit firms in PY2023

(Note2) Data for PwC Kyoto (currently PwC Japan), which merged with PwC Aarata in December 2023, is aggregated by including pre-merger information for mid-tier audit firms.

3. Audit Fees Before and After Changes in Accounting Auditors

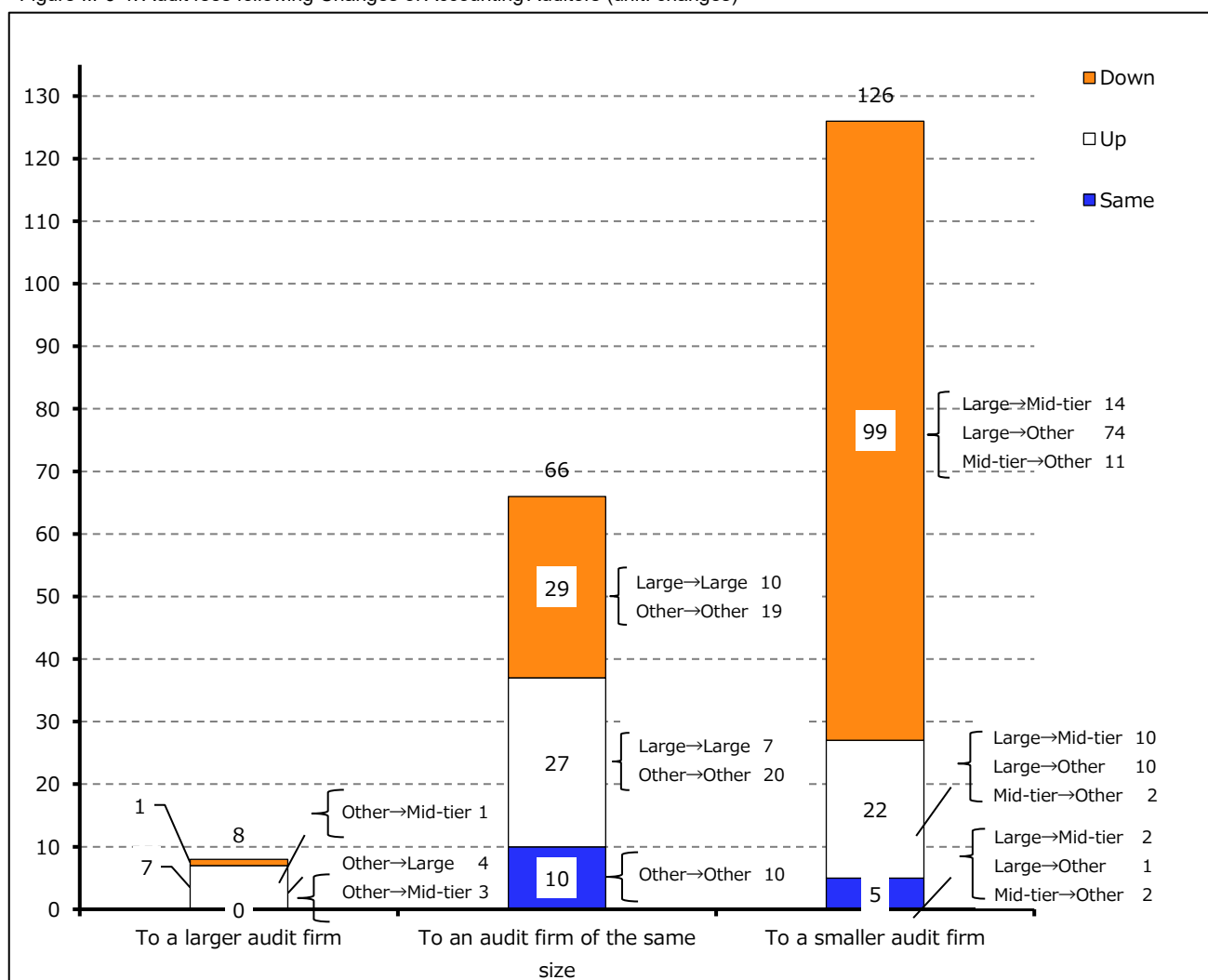
As audit fees are often reviewed after changing auditors, the CPAAOB analyzed pre- and post-transfer fees for 200 cases of changes in auditors at listed domestic companies that submitted timely disclosure from July 2022 to June 2023, and found that the differences in the margin of rise or fall in them depending on the scale of new accounting auditors.

Audit fees often rise in changes to bigger audit firms.

In moves from an audit firm to another of the same scale, fees rose in about 40% of transfers (27 of 66 cases) but dropped in some 40% (29 of 66 cases).

In changes to a smaller firm, audit fees decreased in approximately 80% (99 of 126 cases). Changes from a large-sized audit firm to a small or medium-sized firm resulted in audit fee falls in some 90% (74 of 85 cases).

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



(Note1) Tabulated timely disclosures of changes in accounting auditors by listed domestic companies (from July 2022 to June 2023) are included, provided that the audit fees before and after the changes were publicly disclosed

(Note2) Breakdowns of these changes are shown in the graph

(Note3) "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 2024

4. Dependence of Fees (Safeguards)

When the audit fees of a specific audited company represent a certain rate to the total revenues¹⁷ of the audit firm, etc.¹⁸, significant reliance on a specific company and the concern about losing the source of revenue affect the level of self-interest that disturbs auditors from maintaining their independence and generate unreasonable pressure from the audited company.

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

- a. Prior to the issuance of the audit opinion on or after the second year's financial statements, the

¹⁷ Total of audit and attestation revenue and non-audit and attestation revenue (various advisory services, tax processing and so forth)

¹⁸ Audit firms and business enterprises that control business enterprises and audit firms through their contracts, human relations and so forth.

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

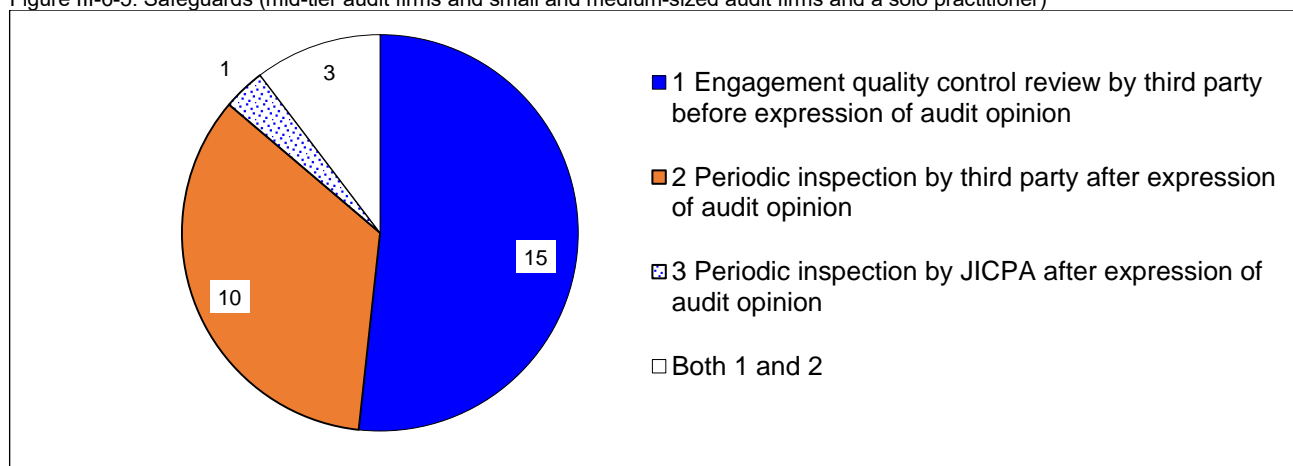
- b. After the audit opinion on or after the second year's financial statements has been issued and before the issuance of the audit opinion on the third year's financial statements, the audit firm requests a professional accountant, who is not a member of the firm to perform a periodic inspection of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

As of March 31, 2023, the "Guidelines for Independence" was abolished as a result of the revision of the Code of Ethics by the JICPA and the publication of the Practical Guidance on the Code of Ethics No.1, "Q&A on the Code of Ethics (Practical Guidance)." Rules on remuneration dependency were newly established in the revised "Code of Ethics", and a pre-audit opinion review is mandatory as a safeguard in cases where the reliance on remuneration for a particular audited company exceeds or is likely to exceed 15% for two consecutive years.

With regard to the status of implementing safeguards according to the previous "Guidelines for Independence," no large-sized audit firms breached the threshold (15%). Of 83 mid-tier audit firms and small and medium-sized audit firms traced through inspections and the collection of reports in PY2023, one mid-tier audit firm resorted to safeguards for one engagement while 18 small and medium-sized firms resorted to safeguards for 28 engagements.

These audit firms addressed the question of safeguard through reviews before the expression of opinions and periodic inspections after the expression of opinions, conducted by third-party CPAs, who are not members of the audit firm, and so forth (Figure III-6-5).

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



(Note) Tallied for 19 audit firms (29 engagements) out of 83 audit firms that were inspected or from which reports were collected in PY2023.

IV. Responses to Changes in the Global Environment Surrounding Audits

IV. Responses to Changes in the Global Environment Surrounding Audits

A. Trends Surrounding Small and Medium-Sized Audit Firms

1. Changes in the Environment Surrounding Audits by Small and Medium-Sized Audit Firms

In recent years, there has been a continuing trend of changing accounting auditors for audits of listed domestic companies from large-sized audit firms to mid-tier/small and medium-sized audit firms and the role of small and medium-sized audit firms as auditors of listed domestic companies is increasing. In addition, the Quality Control Standards for Audits were revised in November 2021 to require the introduction of a quality control system based on a risk approach in order to maintain and improve audit quality. In order to strengthen independence, the Code of Ethics were also revised in October 2022 (for specific details on the revision of the Code of Ethics, please refer to [“B. Recent Trends with Auditing, 2. Revision of the Code of Ethics by JICPA”](#)).

In light of these changes in the audit environment, the revision of the CPA Act in May 2022 introduced a legal registration system for auditors of listed companies in place of the self-regulatory registration system for auditors of listed companies, which had been conducted by the JICPA. The registration of audit firms, etc. that conduct audits of listed companies had been conducted by the Quality Control Committee of the JICPA, which had been responsible for the review system. Since April 1, 2023, it has been conducted by the “Registration Review Committee for Auditors of Listed Companies”, which was newly established within the JICPA. The Committee consists of seven members, three of whom are members of the JICPA and four of whom are non-members. This has added further transparency and objectivity to the screening of registrations and decisions on cancellation of registrations. The revised Ordinance for Enforcement of the CPA Act (“Ordinance for Enforcement”) requires registered auditors of listed companies to establish a framework for information disclosure and business operations in accordance with the Audit Firm Governance Code amended in March 2023, to be applied from the beginning of the first accounting period of audited companies that starts on or after July 1, 2024 (July 1, 2023 for large-sized audit firms).

2. Response by the JICPA to Small and Medium-Sized Audit Firms

In response to 1. above, the JICPA is responding to changes in the environment surrounding audits of small and medium-sized audit firms from three perspectives: (i) confirmation of eligibility through quality control reviews following the introduction of the legal registration system for auditors of listed companies, (ii) enhancement of information disclosure by small and medium-sized audit firms, and (iii) support for strengthening the foundations of small and medium-sized audit firms.

- a Confirmation of eligibility through quality control reviews in connection with the introduction of the legal registration system for auditors of listed companies, etc.

In accordance with the revision of the CPA Act, the JICPA is required to conduct quality control reviews to confirm whether the operational control systems of registered auditors are in

compliance with laws and regulations, etc. for conducting audits of listed companies, etc. fairly and appropriately ("confirmation of eligibility"). In response, the JICPA published the Guideline for confirmation of eligibility of audit firms engaged in the audit of listed companies ("Guideline"). This Guideline provide viewpoints and standards for judging whether an entity who intends to be registered in the list of auditors of listed companies, etc. ("applicant for registration") or a registered listed company auditor has a sufficient system to fairly and appropriately perform audit and attestation services pertaining to financial documents of listed companies. At the same time, the purpose of the Guidelines is for audit firms conducting audits of listed companies to perform self-assessments to check for deficiencies in the items described in the Guidelines, and if any deficiencies are identified, to take voluntary improvement measures. In "4. How to Use the Guidelines at Audit Firms" of the Guidelines, the JICPA requires audit firms conducting audits of listed companies to perform self-assessments, stating that "An applicant for registration or a registered listed company auditor shall perform self-assessments to determine whether the conditions at the audit firm are not in the situation described in the Attachment, and if any deficiency is identified, shall immediately plan and implement voluntary improvement measures."

The JICPA not only requires applicants for registration to perform self-assessment, but also examines the assessment results and encourages them to improve the system to enable them to apply for registration through quality control reviews and other communication for items where the assessment results are not satisfactory.

b Enhancement of information disclosure by small and medium-sized audit firms

Under the Ordinance for Enforcement, registered listed company auditors are required to establish a system for : (i) appropriately evaluating the status of operations management system and publishing the results of the evaluation and the reasons for the evaluation, etc. (Article 93); (ii) publishing the status of business management, etc. (Article 95); and (iii) conducting business in accordance with the Audit Firm Governance Code and publishing the status of application of the Code (Article 96).

The publication under Article 93 of the Ordinance for Enforcement is made by making explanatory documents containing matters set forth in the Order of Enforcement available for public inspection. However, the publication under Article 95 and 96 of the Ordinance for Enforcement does not specifically designate the subject and media in which the information should be described. This is because it is not appropriate to require registered listed company auditors to disclose a uniform set of items, and they are expected to proactively determine the disclosure items they consider important and to carry out substantial information disclosure through originality and ingenuity.

As part of its self-regulation, the JICPA has been encouraging small and medium-sized audit firms to annually publish the "Annual Report on Audit Quality Management" ("annual report"), in

accordance with Article 95 and Article 96 of the Ordinance of Enforcement. Also, the JICPA published "Guidance for the Preparation of Annual Reports on the Management of Audit Quality" in September 2023, and presented the concept of disclosure by small and medium-sized audit firms so that their information disclosure would be more substantial.

Small and medium-sized audit firms are required to prepare their first annual report for the first fiscal year ending on or after the first day of the first audited company's accounting period beginning on or after July 1, 2024, and to publish the report within six months of the first day of the first fiscal year ending on or after July 1, 2024. (For example, if an audit firm whose fiscal year ends in June and the first audited company whose accounting period begins on or after July 1, 2024 has a fiscal year that ends in March, the beginning of the audited company's accounting period is April 1, 2025, and the audit firm is required to report on the fiscal year ending June 30, 2025 and to publish its annual report by the end of December 2025. The audit firms are required to publish their annual reports by the end of December 2025 for the reporting period ending in June.)

c Support for strengthening the fundamentals of small and medium-sized audit firms

The JICPA accelerate efforts to strengthen the business foundation of small and medium-sized audit firms and improve audit quality through enhancement of information disclosure and various support measures. These efforts are led by the Small Medium Practices Policy Committee and the Small and Medium-Sized Audit Firms Liaison Council, and represented as follows.

- Publication of guidance for revised Quality Control Standards
For QCSCS, Practical Guidance No.3 (Q&A on Quality Control and Engagement Quality Control Reviews for Audit Firms and Audit Engagements) and Practical Guidance No.4 (Tools for Quality Control at Audit Firms) were published.
- Training for Compliance with the revised Code of Ethics
- Opinion Exchange Meeting with Capital Market Participants
- Support for recruitment and training of small and medium-sized audit firms
- Maintenance of overseas office directory
- Interactive training for small and medium-sized audit firms
In order to foster and support small and medium-sized audit firms and strengthen the individual consultation function, former reviewers of quality control reviews serve as lecturers, and opinions and information are exchanged and shared through Q&As and discussions with the participation of a small number of firms.
- Support for digitalization of small and medium-sized audit firms
Identifying the state of IT infrastructure development and the use of IT-based audit methods at small and medium-sized audit firms. Providing support for the development of IT infrastructure, including cybersecurity measures, and the development of IT-based audit tools. Specific digitalization support measures include the establishment of a shared IT

infrastructure environment (support for the creation of a platform for use by small and medium-sized audit firms of an electronic audit documentation system) and hosting of IT communities (networking among IT personnel at small and medium-sized audit firms).

- Holding regular meetings to exchange opinions with small and medium-sized audit firms, etc.

3. Response by the CPAAOB

The revised Quality Control Standards, as "Points to Note Regarding Implementation of the Revised Quality Control Standards," state that it is particularly important for small and medium-sized audit firms to be provided with necessary support from a medium - to long-term perspective, and that the administrative authority should strive to ensure proactive quality control by audit firms through inspections by the CPAAOB, while supporting the efforts of the JICPA. The CPAAOB is making efforts to place greater emphasis on inspections to small and medium-sized audit firms based on the Basic Policy for Monitoring Audit Firms for the 7thTerm.

B. Recent Trends with Auditing

1. Trends in International Auditing Standards and Ethical Standards

The International Auditing and Assurance Standards Board (IAASB) and the International Ethics Standards Board for Accountants (IESBA), both established within the International Ethics and Auditing Federation (IFEA)¹⁹, are engaged in the development of international auditing standards and ethics standards. Recent major revisions to the International Standards on Auditing (ISA) issued by the IAASB include the release of an Exposure Draft revising "Fraud" (ISA240) in February 2024. This Exposure Draft requires auditors to communicate with management and those with governance responsibilities regarding fraud, and to identify matters that they consider to be of particular importance in the audit of the current year's financial statements as Key Audit Matters. Comments on this Exposure Draft are due by June 2024. The revision of "Going Concern" (ISA570), which sets a 12-month period for management's assessment on going concern from the date of financial statement approval, is scheduled to be finalized in December 2024 after the public comment period ends in August 2023.

Recent developments in the IESBA Code of Ethics include the publication in January 2024 of Exposure Drafts of the "Proposed International Ethics Standards for Sustainability Assurance (Including international Independence Standards) (IESSA) and Other Revisions to the Code Relying to Sustainability Assurance and Reporting" and the "Using the Work of an External Expert".

The former sets out the revisions to establish a new part (Part 5) that regulates the independence and ethics of the practitioners, including those who are not professional accountants, who perform sustainability assurance engagements that meet certain criteria,. The latter provides guidelines for evaluating competence, capability, and objectivity when using a person with expertise other than that of a professional accountant or sustainability assurance practitioners. IESBA expects to finalize both drafts in December 2024.

2. Revision of the Code of Ethics by JICPA

Referring to revisions made to the IESBA Code of Ethics, the JICPA amended its Code of Ethics in July 2022. Major additions and modifications to individual rules include matters related to compensation and non-assurance activities.

Regarding compensation, audit firms are required to disclose information related to audit fees (audit fees and non-audit fees) when the client of an audit engagement is a business entity with a high degree of social impact ("PIE"). Also, as a safeguard for cases where the firm's fee dependence on PIEs exceeds or is likely to exceed 15% for two consecutive years, pre-audit opinion review is now required, and disclosure of fee dependency becomes mandatory. In addition, in cases where the firm's fee dependence on PIEs continues to exceed or is likely to exceed 15% for five consecutive years, the firm is required to resign after the fifth annual opinion.

For non-assurance engagements, if the client of the audit engagement is a PIE, the audit firm or

¹⁹ An organization created to replace the International Federation of Accountants (IFAC) and bring under its umbrella the IAASB and IESBA, in the interest that standard-setters should be independent of professional accountants

network firm must not provide non-assurance engagements that could be subject to self-review as a disincentive.

The Cabinet Office Ordinance on Audit Certification of Financial Statements, etc. ("Audit Certification Ordinance") was also revised to require audit firms to add matters concerning the fees that CPAs or audit firms (including those who belong to the same network as these firms) receive from audited companies (including consolidated subsidiaries and non-consolidated subsidiaries) as descriptions in audit reports.

3. Other Trends in Financial Reporting Systems

a Abolition of quarterly disclosure system

The quarterly reporting system was legislated in June 2006. However, in recent years, economic and social conditions have changed significantly, and the demand for reviewing framework of company's information disclosure is observed. Under these circumstances, the importance of non-financial information related to medium- to long-term corporate value has increased in corporate disclosure. On the other hand, it is pointed out that there are overlaps between quarterly reports based on the FIEA (Quarterly Securities Report) and those based on exchange rules (Quarterly Earnings Report (Tanshin)), and such reports should be reviewed from the viewpoint of cost reduction and efficiency. In light of this, on November 20, 2023, the "Act for Partial Amendment of the Financial Instruments and Exchange Act, etc." was enacted to abolish the quarterly report system and uniformly require companies submitting securities reports to submit semiannual reports.

In November 2023, based on the council of experts, the Tokyo Stock Exchange (TSE) formulated the "Practical Policy Concerning the Revision of the Quarterly Disclosure System" and revised the Securities Listing Regulations in March 2024, making reviews of the first and third quarters by an auditor mandatory only in the following cases.

- 1) A listed company receives a result other than an unqualified opinion in an audit report of their latest Annual Securities Report, Semiannual Securities Report or Quarterly Earnings Report (only if a review has been conducted)
- 2) A listed company receives a result other than an unqualified opinion in an Internal Control Audit Report of the latest Annual Securities Report
- 3) A listed company has significant deficiencies in internal controls that should be disclosed in their latest Internal Control Report
- 4) A listed company does not submit the latest Annual Securities Report or Semiannual Securities Report by the initial deadline
- 5) The Semiannual Securities Report for the current term is amended and a review report is attached to the amended financial statements

* 1) and 3) are also applicable to cases where the most recent Annual Securities Report, Semiannual Securities Report, Quarterly Earnings Report (only in receiving a review) or

Internal Control Report is amended, and the amendment report meets the conditions.

** Except where it is clear that the reliability of financial statements is not in question regarding 4) and 5).

In addition, the Business Accounting Council has released "Written Opinion of the proposals to revise the quarterly review standards to the interim review standards". This revision changes the name of the quarterly review standards to the interim review standards, as it is common to all interim reviews conducted by auditors who audit annual financial statements, including reviews on quarterly earnings reports (kessan tanshin), in addition to reviews on interim financial statements under the revised FIEA. And it also introduces a form of conclusion regarding compliance in addition to the form of conclusion regarding fair disclosure stipulated in the current quarterly review standards.

The differences between the conclusion regarding fair disclosure and the conclusion regarding compliance are described in the Secretariat's materials of the Corporate Accounting Committee of the Business Accounting Council at its 55th meeting held on December 14, 2023.

Both the "Conclusion regarding fair disclosure" and the "Conclusion regarding compliance" require an assessment of whether the accounting policies used by management are in accordance with accounting principles generally accepted in Japan and applied on a consistent basis, whether the choice and application of policies fairly reflects the reality of accounting events and transactions, and whether the interim financial statements are in accordance with accounting principles.

In addition, "conclusions regarding fair disclosure" involves an assessment from a step away point of view whether the financial statements as a whole are appropriately presented for the users of interim financial statements to understand the financial position and results of operations.

JICPA has published the following practical guidelines for the review of interim financial statements and related matters that require understanding.

- Interim Review Standards Statement No. 1, "Review of Interim Financial Statements Conducted by an Independent Auditor": an amendment to the existing Quarterly Review Standards Report No. 1, "Quarterly Review", responding to the reviews of interim financial statements under the FIEA.
- Interim Review Standards Statement No. 2, "Review of Interim Financial Statements Conducted by the Independent Auditor", responding to interim reviews other than interim reviews under the FIEA conducted by annual auditors.
- Revision of the Practical Guidelines for Assurance Engagements 2400, "Review of Financial Statements": responding to interim reviews other than FIEA reviews conducted by auditors other than annual auditors.
- Interim Review Standards Statement No. 2 - Practical Guidance No. 1 "Q & A Regarding

Interim reviews of Quarterly Financial Statements, etc. Prescribed by the Securities Listing Regulations of the Tokyo Stock Exchange (Practical Guidance)"

Major audit firms noted that when they do not conduct voluntary reviews, they will perform procedures as part of their annual audits, but in doing so, they will be careful not to mislead the audited company into believing that they are providing any assurance on the quarterly financial statements. CPAAOB will review the implementation status of voluntary reviews, etc., and the practical impact and issues related to the impact of the abolition of the quarterly report system on audit work, including audit firms other than major audit firms.

b Internal Control Reporting System

There have been some cases in which material deficiencies that should be disclosed outside the scope of management's assessment of internal controls have become clear, and in which sufficient reasons were not disclosed when the evaluation of the effectiveness of internal controls was corrected. There are concerns about the effectiveness of the internal control reporting system, such as whether management has not appropriately considered the importance of the impact on the reliability of financial reporting when examining the scope of evaluation of internal controls.

Against this background, the Business Accounting Council published "Revision of Standards and Practice Standards for Management Assessment and Audit concerning Internal Control Over Financial Reporting (Council Opinion)" in April 2023.

As for the main points of revision, for example, regarding the evaluation and reporting of internal controls over financial reporting, the revised Standard indicates that the following indicators should not be automatically applied when management determines the scope of assessment of internal controls: "approximately 2/3 of sales, etc." and "three accounts of sales, accounts receivable, and inventories," which are exemplified; it is appropriate to describe in the internal control report the reasons for judgment regarding the scope of assessment of internal controls by management; and regarding the audit of internal controls over financial reporting, the revised Standard indicates that it is important to utilize audit evidence obtained in the process of auditing financial statements and to have appropriate discussions with management in order to conduct an effective internal control audit.

In light of the above revisions, the "Cabinet Office Ordinance Partially Amending the Cabinet Office Ordinance on the System for Ensuring the Appropriateness of Documents on Financial Calculation and Other Information" was published in June 2023. The ordinance adds new matters to be included in the internal control report, etc. In July 2023, the JICPA amended Internal Control over Financial Reporting Auditing Standards Statement No. 1 "Auditing of Internal Controls over Financial Reporting."

The following issues were raised during deliberations by the Internal Control Standard Committee and will be addressed as medium to long-term issues.

- The treatment of non-financial information such as sustainability in the internal control reporting system should be considered based on domestic and overseas discussions.
- Whether or not to adopt direct reporting should be discussed in light of the nature of internal control audits.
- With regard to enhancing the disclosure of the internal control audit report, whether or not to adopt, for example, "Key Audit Matters" related to internal controls should be considered in light of progress in disclosure in the internal control report.
- The audit of the corrected internal control report is currently not required. However, the way how the auditor is involved should be considered.
- Administrative monetary penalty and penal provisions should be reviewed in order to clarify the responsibility of management and to deal with management override of internal controls.
- Alignment between the FIEA and the Companies act, such as stipulating obligations to build internal control in Companies Act, is necessary. In the future, stipulations regarding internal control of the Companies Act and the FIEA should be integrated so that comprehensive judgments can be made covering the four objectives of internal controls.
- In the written confirmation by the company representative concerning the appropriateness of the content of the securities report, it may be appropriate to consider enhancing the content of statements related to internal controls.
- If the FIEA aims to promote extraordinary disclosure instead of periodic disclosure, we should be conscious of internal control even for extraordinary reports.

C. Trends in Sustainability Disclosure and Assurance

1. Trends in Sustainability Disclosure

a Expansion of non-financial information disclosure

In recent years, emphasis has been placed on sustainability in corporate management and investors' investment decisions, and non-financial information related to medium - to long-term corporate value has become increasingly important. Non-financial information is expected to contribute not only to corporate management and investment decisions, but also to direct capital toward companies that are actively engaged in addressing social issues related to climate, nature, human rights and the exclusion of marginalized groups, thus embedding such efforts in society in terms of the financial system. On January 31, 2023, the FSA announced revisions to the Cabinet Office Ordinance on Disclosure of Corporate Affairs, etc., which result in the following new disclosures and enhanced disclosures regarding corporate information prior to the "Status of Accounting" in securities reports and registration statements for the fiscal years ending on or after March 31, 2023.

- A new section titled "Views and Initiatives on Sustainability" has been added to the "Description of Businesses" section. Companies should describe their operations in

accordance with four components consistent with international frameworks: "Governance," "Risk Management," "Strategy," and "Indicators and Targets."

- As human capital disclosure, the company shall describe the policy on human resource development including ensuring diversity of human resources, the policy on the internal environment, and the details of indicators related to such policy in "Strategy" and "Indicators and Targets" in the "Description Column" of Sustainability Information. These descriptions are required regardless of their materiality.
- In the "Status of Corporate Governance, etc." section, companies are required to describe the activities of the Board of Directors, the Nomination Committee, the Compensation Committee, etc. (frequency of meetings, specific matters to be discussed, attendance), the effectiveness of internal audits (dual reporting: a system whereby the Internal Audit Department reports directly to the Board of Directors and the Audit and Supervisory Board Members, as well as to the CEO), and an outline of business alliances with companies issuing cross-shareholdings.

Non-financial disclosures are being established and expanded in other countries as well. For example, in the United States, on March 6, 2024, the U.S. Securities and Exchange Commission (SEC) issued the final rule requiring climate-related disclosures for all domestic and foreign SEC-registered companies.²⁰ SEC-registered companies shall disclose the following in their annual reports and registration statements.

[Other than financial statements]

In line with concepts similar to the four components of the TCFD (Task Force on Climate-related Financial Disclosures) recommendations ("Governance", "Risk Management", "Strategy", and "Indicators and Targets"), disclose the followings:

- Any oversight by the board of directors of climate-related risks and any role by management in assessing and managing the material climate-related risks,
- The actual and potential material impacts of any identified climate-related risks on the strategy, business model, and outlook,
- Disclosures regarding activities to mitigate or adapt to a material climate-related risk including the use of transition plans, scenario analysis, or internal carbon prices,
- If greenhouse gas (GHG) emissions are material, information about Scope 1²¹ emissions and/or Scope 2 emissions (Scope 3 is not required), etc.

[Financial Statements]

- The capitalized costs, expenditures expensed, and losses incurred etc., as a result of severe weather events and other natural conditions, disclosed in a note.

²⁰ Since the publication of the rule, several U.S. energy companies and business associations have filed lawsuits, and on April 4, the SEC decided to suspend enforcement of the rule.

²¹ Scope 1 refers to direct emissions by the business itself; Scope 2 refers to indirect emissions from the use of electricity, heat and steam supplied by other companies; and Scope 3 refers to indirect emissions other than Scope 1 and Scope 2 (emissions by other companies related to the business' activities).

With respect to the above information, large accelerated filers (companies that meet the requirements for market capitalization of \$700 million or more, etc.) will be phased in beginning in 2025, accelerated filers (companies that meet the requirements for market capitalization of \$75 million to \$700 million, etc.) will be phased in beginning in 2026, smaller reporting companies (companies that meet the requirements for market capitalization of less than \$250 million, etc.) will be phased in beginning in 2027, and emerging growth companies (companies that meet the requirements for market capitalization of less than \$1,235 million, etc.) and non-accelerated filers (companies that do not meet the requirements for large accelerated filers or accelerated filers) will be phased in beginning in 2027.

In the EU, the CSRD (Corporate Sustainability Reporting Directive) requires the preparation and disclosure of sustainability reports not only for large companies and listed small and medium-sized companies, but also for subsidiaries of non-EU companies located in the EU and foreign parent companies of subsidiaries and branches located in the EU (subject to size criteria). The contents of the sustainability report are as follows.

i. General Information

- Governance, strategy and business model, value chain, and stakeholder engagement
- Due diligence process, description of sustainability-related management and internal control systems, etc.

ii. Environmental information

- Climate change
- Pollution, etc.

iii. Social information

- Own employees
- Employees in the value chain, etc.

(iv) Governance information

- Business Activities

Double materiality²² is required in the sustainability reports.

As in the US, the start date for preparation and disclosure is set after 2024 in a phased manner depending on whether the company is listed or unlisted and on the size of the company.

b Consideration of sustainability disclosure standards

The mainstream of sustainability disclosure has been conducted voluntarily such as integrated reports; however, disclosure standards that stipulate specific disclosure content has been discussed in Japan and other countries.

Internationally, the International Sustainability Standards Board (ISSB) finalized Standard S1 (IFRS S1 General Requirements for Disclosure of Sustainability-related Financial Information)

²² Examining material issues not only from the impact of the environment and society on the company, but also from the impact of the company's activities on the environment and society. Considering material issues solely from the impact of the environment and society on the company is called single materiality.

and Standard S2 (IFRS S2 Climate-related Disclosures) in June 2023. These standards are to be applied from financial years beginning on or after January 2024. Each country is developing its own standards that are comparable to the standards published by the ISSB.

In April 2024, the ISSB also tentatively agreed to initiate a new research and standard-setting work on a research project on disclosure of risks and opportunities related to “biodiversity, ecosystems and ecosystem services” and “human capital,” based on the results of a public consultation on future priorities. The ISSB will develop a two-year work plan, starting in 2024, that includes work on the above two topics.

In Japan, on March 29, 2024, the Sustainability Standards Board of Japan (SSBJ) issued the Universal Sustainability Disclosure Standard Exposure Draft “Application of the Sustainability Disclosure Standards”, the Theme-based Sustainability Disclosure Standard Exposure Draft No. 1 “General Disclosures”, and the Theme-based Sustainability Disclosure Standard Exposure Draft No. 2 “Climate-related Disclosures.” The “Application of the Sustainability Disclosure Standards” describes the part of ISSB's S1 standard that defines fundamental matters such as the reporting period and timing of reporting. The “General Disclosures” and “Climate-related Disclosures” describe the matters to be disclosed regarding sustainability-related risks and opportunities (core contents) in ISSB Standards S1 and S2, respectively. The “Climate-related Disclosures” covers the disclosure of climate-related risks and opportunities, and the “General Disclosures” covers the disclosure of risks and opportunities for sustainability-related topics in general. The SSBJ has set July 31, 2024 as the deadline for comments on the three exposure drafts, with the goal of releasing finalized standards by March 31, 2025 at the latest.

These standards are intended to start with those companies focused on constructive dialogue with global investors (companies listed on the Prime Market or part thereof), as indicated at the 52nd General Meeting of the FSA Financial System Council held in February 19, 2024. In response to the Minister of State for Financial Services' consultation on February 19, 2024 (“Consideration on Sustainability Information Disclosure and Assurance”), the Working Group on Disclosure and Assurance of Sustainability-related Financial Information of the Financial System Council was established and held its first meeting on March 26, 2024.

2. Trends in Assurance on Sustainability Disclosures

It is also useful for investors and other stakeholders to set standards for the disclosure of sustainability information so that disclosure of each company has a certain degree of consistency, and increase the reliability of information through assurance by a third party. In recent years, with the background of increasing interest in a sustainable society, financing that proclaims sustainability, such as ESG investment, has increased, while society is paying attention to information dissemination that may cause mislead among stakeholders, such as greenwashing.

Regarding third party assurance on sustainability information, the US SEC has published a draft regulation mandating climate-related disclosures, under which limited guarantees on GHG emissions

for Scope1 and Scope2 are required from fiscal year 2029 for large accelerated filers and from fiscal year 2031 for accelerated filers, and shift to reasonable assurance after two years for large accelerated filers is planned.

In Europe, listed companies subject to Non-Financial Reporting Directive (NFRD) are scheduled to introduce a limited assurance in fiscal year 2024, other large companies in fiscal year 2025, and listed small and medium-sized companies (excluding micro-companies) in fiscal year 2026, along with reporting based on the CSRD, and to shift to reasonable assurance in the future. Non-EU companies, such as foreign parent companies of subsidiaries and branches located in the EU, are also scheduled to introduce limited assurance from fiscal year 2028 and shift to reasonable assurance in the future.

Standards for assurance are also being developed to ensure the quality of assurance. In August 2023, IAASB issued the Exposure Draft of International Sustainability Assurance Standard 5000 (ISSA5000), General Requirements for Sustainability Assurance Engagements. While this Exposure Draft is intended for all assurance providers, including non-professional accountants, it assumes that members of the engagement team and EQC reviewers will apply IESBA standards or at least equivalent or higher requirements for assurance engagements, and that the professional staff will be members of the audit firm applying ISQM1 or at least equivalent or higher requirements. The Exposure Draft also sets out requirements and application guidance for each component of the process, from the acceptance and continuance of service contracts to the preparation of assurance reports. IAASB stated that it would finalize ISSA 5000 in September 2024. Also, in January 2024, IESBA published the public comment for the Exposure Drafts “Proposed International Ethics Standards for Sustainability Assurance (Including International Independence Standards) and Other Revisions to the Code Relating to Sustainability Assurance and Reporting” and “Using the Work of an External Expert” which are scheduled for finalizing in December 2024. For more information, see ["B. Recent Trends with Auditing, 1. Trends in International Auditing Standards and Ethical Standards"](#).

In Japan, the Working Group on Sustainability Information Disclosure and Assurance, which was established under the Financial System Council, held its first meeting on March 26, 2024, and started discussions.

With regard to assurance of sustainability information, investors have expressed their desire to ensure the reliability of sustainability information. Audit firms with experience in assurance in accounting audits have responded as follows.

At large-sized audit firms, the audit firm itself or a group company of the audit firm provides advisory services related to sustainability information. In addition, the audit firm provides assurance engagement on sustainability information as an accredited assurance body of the Japanese Association of Assurance Organizations for Sustainability Information.²³ In addition, a department has been established to promote the sustainability information assurance engagements, which promotes

²³ The Japanese Association of Assurance Organizations for Sustainability Information is a general incorporated association. Its predecessor was the Japan Environmental Information Review Association, which was established in 2005 for the purpose of ensuring the reliability of reviews of environmental reports, etc. and contributing to the improvement of reliability of environmental reports, etc. by realizing efficient and effective reviews. The association has six accredited review organizations.

collaboration between audit-related departments and non-financial information specialists, and also allows audit staff to accumulate practical experience by engaging in the assurance of sustainability information.

Furthermore, those firms have developed a system of assurance procedures in collaboration with global network, formulated rules for quality control, and put in place quality control systems including EQC reviews. Human resources development for sustainability assurance engagements at large-sized audit firms is also relatively well developed in Japan, with systematic mandatory training programs through learning and practical work. Some firms established a sustainability disclosure assurance certification system.

Mid-tier audit firms recognize that assurance of sustainability information is a role that they should fulfill and it is a growth opportunity, so they have set up project teams to gather information and provide training within the firm. This includes gathering information on overseas trends in collaboration with global network. Some mid-tier audit firms have started gathering information through practical operations by having an advisory firm within the group start a service to support disclosure of sustainability information, etc. On the other hand, mid-tier audit firms indicate that they plan to improve quality control systems such as EQC reviews going forward.

No small and medium-sized audit firms have been observed to have started developing quality control systems or human resource capacity for sustainability information assurance. Of the 53 small and medium-sized audit firms that collected reports in the current year, all of the firms that responded that they were "interested in assurance engagements related to non-financial information, and are making specific consideration within the firm such as gathering information," stated that they are gathering information through training courses organized by the JICPA and global network.

In addition, around 80% of firms responded that they were "interested in assurance engagements on non-financial information but did not consider it specifically," or "not interested in assurance engagements on non-financial information, or do not intend to respond (even if consulted)." Of these, around 30% noted a lack of management resources. Since the reasons for responses are optional, it is possible that more audit firms are actually unable to engage in sustainability assurance engagements due to constraints on management resources.

■ Reasonable and limited assurance engagements for sustainability information ■

Third party assurance of sustainability information, which is introduced in the United States and Europe, starts with limited assurance and then shifts to reasonable assurance after several years. The Exposure Draft of ISSA5000 (General Requirements for Sustainability Assurance Engagements) ("Exposure Draft") defines reasonable assurance and limited assurance as follows:

Reasonable assurance engagement – An assurance engagement in which the practitioner reduces engagement risk to an acceptably low level in the circumstances of the engagement as the basis for the practitioner's conclusion (omitting the rest).

Limited assurance engagement – An assurance engagement in which the practitioner reduces engagement risk to a level that is acceptable in the circumstances of the engagement but where that risk is greater than for a reasonable assurance engagement as the basis for expressing a conclusion. (ellipsis) The nature, timing and extent of procedures performed in a limited assurance engagement is limited compared with that necessary in a reasonable assurance engagement but is planned to obtain a level of assurance that is, in the practitioner's professional judgment, meaningful. To be meaningful, the level of assurance obtained by the practitioner is likely to enhance the intended users' confidence about the sustainability information to a degree that is clearly more than inconsequential.

As described above, the level of assurance provided through reasonable assurance engagements is higher than that provided through limited assurance engagements. A report published by the International Organization of Securities Commissions (IOSCO) in March 2023 reported that investors expect reasonable assurance engagements in the long term, although limited assurance engagements may be a realistic goal in the short term. On the other hand, in Japan, there are challenges for both information providers and assurance providers in the transition to reasonable assurance engagements.

Reasonable assurance engagements are based on the premise that processes for gathering information to be assured and internal controls are appropriately established and operated. ISSA5000 requires that a practitioner of reasonable assurance understands components of the internal control system, including information system and communication as well as control activities. The "Report on the Effective Collection and Strategic Use of Sustainability-related Data ("Interim Report")" published by the Ministry of Economy, Trade and Industry in July 2023 lists various issues regarding the development and operation of internal controls of information preparers, including the difficulty of collecting data from consolidated subsidiaries (including overseas bases) and their value chain, inadequate business processes, and lack of human resources. The Interim Report also points out that while there are multiple media for disclosing sustainability information and multiple divisions in charge within the company, the coordination between the divisions in charge should be strengthened.

Among the challenges for assurance providers, the Interim Report points to the need to expand human resources, including highly specialized experts in individual topics such as climate change and biodiversity, as well as experts in assurance services in general. It also states that it is important for assurance providers to fully understand the IT systems, internal controls, and governance used in the process of generating sustainability-related information.

The Interim Report notes that sustainability-related information includes different types of information and that the level of assurance demanded by information users varies depending on the type of information. In addition, due to the large amount of forward-looking and qualitative information contained in sustainability information, its materiality needs to be fully discussed. Moreover, the nature of such information may make it difficult to obtain objective evidence. The Interim Report also states that the level of assurance and the timing of the introduction of limited assurance and reasonable assurance should be discussed carefully in light of these characteristics.

■ Knowledge required for sustainability information assurance ■

The “JICPA Syllabus for Sustainability Capacity Building” (“syllabus”), published by JICPA in April 2024, lists the following knowledge and competencies required for all CPAs.

- Gain a comprehensive understanding of sustainability issues and their impact on society and economy
- Understand the basic framework of the relationship between sustainability and corporate management/corporate value
- Have the capacity to engage in high-level, constructive dialogue with senior management and others on key sustainability trends and their impact on the industry and the company.
- Possess the necessary knowledge of sustainability-related disclosure requirements (systems and standards)
- Understand the significance and the framework of assurance engagement

The syllabus also describes the following roles and competences required of core sustainability assurance professionals (CPAs who play a central role in performing assurance engagements)

Role	Competences
<ul style="list-style-type: none"> • Performing risk assessment of assurance engagements for sustainability information • Developing the plan (schedule, procedures) for implementation of assurance engagements • Communicating with Board of Directors and Audit and Supervisory Board • Communicating with the engagement team • Evaluating the results of the implementation • Forming assurance opinion (conclusions) 	<ul style="list-style-type: none"> • Comprehensive knowledge on sustainability • An understanding of corporate management and corporate governance • An understanding of the material sustainability-related risks and opportunities associated with the assured company • An understanding of disclosure system and preparation standards • An understanding of disclosure processes and internal controls • An understanding of the interrelationships with financial reporting and financial statement audits • Advanced and expert knowledge and experience in the assurance engagements • An understanding of the professional ethics and independence required of persons engaged in assurance engagements

The syllabus is intended to serve as a compass for CPAs to gain an overall picture of the topics to be studied in acquiring such knowledge, skills, and expertise, and as a guide for training providers in planning and delivering training programs. The syllabus is divided into basic/common and advanced sections. The basic/common section is intended for all CPAs, while the advanced section is intended primarily for core personnel in assurance engagements.

	Basic/Common Section	Advanced Section
1. Overview of sustainability	Ba1: Sustainability in general and the expected role of CPA	
2. Sustainability and corporate management/governance	Ba2: Reflecting sustainability in governance, strategy, and risk management	Ad2: Sustainable finance
3. Information Disclosure	Ba3-1: Sustainability disclosure and integrated reporting (Overview) Ba3-2: Climate change (Overview) Ba3-3: Human capital and human rights (Overview)	Ad3-1: Sustainability disclosure and integrated reporting (Details) Ad3-2: Climate change (Details) Ad3-3: Biodiversity, ecosystems, and ecosystem services (Details) Ad3-4: Human capital (Details) Ad3-5: Human rights (Detail) Ad3-6: Other sustainability topics (Details)
	Se3: Key Topics by industry	
4. Assurance	Ba4: Ensuring reliability of sustainability information	Ad4-1-1: Professional ethics and independence Ad4-1-2: Quality control and related systems

	and assurance (Overview)	<p>Ad4-2-1: Sustainability assurance practice standards and practical issues- (1) Basic framework and sustainability assurance standards for assurance engagements</p> <p>Ad4-2-2: Sustainability assurance practice standards and practical issues- (2) Acceptance of assurance engagement and planning</p> <p>Ad4-2-3: Sustainability assurance engagement standards and practical issues- (3) Risk procedures/responding to the risk of material misstatement</p> <p>Ad4-2-4: Sustainability assurance standards and practical issues- (4) Opinion and assurance reporting</p> <p>Ad4-2-5: Sustainability assurance engagement standards and practical issues- (5) Coordination of financial statement audits and assurance engagements on sustainability information</p> <p>Ad4-3: Further point of issue in sustainability assurance engagements</p> <p>Ad4-4-1: Practical topics by theme- Assurance of GHG information</p> <p>Ad4-4-2: Practical topics by theme- Assurance on human capital and human rights information</p>
--	--------------------------	--

In Japan, there is currently no requirement to pass an examination in order to engage in sustainability assurance. However, there is a movement overseas, such as the EU CSRD, to require companies to pass an exam to be recognized as having sustainability expertise. In the United States, the Fundamentals of Sustainability Accounting (FSA) Credential, administered by the Sustainability Accounting Standards Board (SASB), is an example of a sustainability-related exam. This is open to non-US citizens and is administered in two levels: Level 1 (basic) and Level 2 (advanced).

(Reference materials)

1. Links to monitoring-related documents

Basic Policy for Monitoring Audit Firms

<https://www.fsa.go.jp/cpaaob/english/oversight/20220706/20220706.html>

Basic Plan for Monitoring of Audit Firms (Program Year 2023)

<https://www.fsa.go.jp/cpaaob/english/oversight/20240405/20240405.html>

Basic Guidelines for Inspections

<https://www.fsa.go.jp/cpaaob/shinsakensa/kihonkeikaku/20240626-1/20240626-1.html>

List of Recommendations

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

Framework for Inspection/Supervision of Foreign Audit Firms, etc.

<https://www.fsa.go.jp/cpaaob/english/shinsakensa/kouhyou/20090914.html>

Basic Guidelines on Information Requirements and Inspection on Foreign Audit Firms etc.

<https://www.fsa.go.jp/cpaaob/english/oversight/20220401-3/20220401-3.html>

Basic Plan for Monitoring of Audit Firms (Program Year 2024)

<https://www.fsa.go.jp/cpaaob/shinsakensa/kihonkeikaku/20240719/20240719.html>

Case Report of Audit Firm Inspection Results (Program Year 2024)

<https://www.fsa.go.jp/cpaaob/shinsakensa/kouhyou/20240719/20240719-2.html>

Annual Report of the CPAAOB

<https://www.fsa.go.jp/cpaaob/shinsakai/reports/05/gaiyou/gaiyou.html>

Self-regulation Report 2024 -Quality Control Review System- (JICPA)

<https://jicpa.or.jp/english/what-we-do/qc/#qualityControl3>

Disclosure of inspection results, etc. to third parties

<https://www.fsa.go.jp/cpaaob/shinsakensa/kouhyou/20150611.html>

2. Links to related organizations

Certified Public Accountants and Auditing Oversight Board website

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

Financial Services Agency website

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

The Japanese Institute of Certified Public Accountants

<https://jicpa.or.jp/english/>

Japan Exchange Group website

<https://www.jpx.co.jp/english/>

International Forum of Audit Regulators (IFIAR) website

<https://www.ifiar.org>

International Federation of Accountants (IFAC) website

<https://www.ifac.org>

International Auditing and Assurance Standards Board (IAASB) website

<https://www.iaasb.org>

International Ethics Standards Board for Accountants (IESBA) website

<https://www.ethicsboard.org>

International Sustainability Standards Board (ISSB) website

<https://www.ifrs.org/groups/international-sustainability-standards-board/>

International Organization of Securities Commissions (IOSCO) website (press release related to sustainability guarantees)

<https://www.iosco.org/news/pdf/IOSCONEWS686.pdf>



**Certified Public Accountants
and Auditing Oversight Board**

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