

Concerning the Start of the Certified Public Accountants and Auditing Oversight Board

Chairman of the Certified Public Accountants and Auditing Oversight Board

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1. Introduction

Due to rapid and dramatic social changes since the end of the 20th century, existing systems and practices that used to maintain the order of society no longer match actual social conditions, thereby causing various social problems. Systems and practices corresponding to actual society have so far indeed been implemented, however they have not been necessarily sufficient, and new systems and practices have not yet taken root in the society either.

In the field of corporate accounting and audit as well, various issues have been raised by the discrepancy and mismatch between actual conditions and existing systems. For example, due to changes in the social economy, Certified Public Accountants (hereinafter referred as “CPAs”) are now required not only to perform financial audits (“audit services”), but also to provide advice and consulting services (“non-audit services”). As fees obtained from non-audit services have been increasing considerably, the ratio it accounts for in the audit firms’ revenue has also been increasing notably, causing audit firms to be no longer able to disregard non-audit services. On the other hand, inappropriate conditions can be seen from the provision of both audit services and non-audit services to the same company. Moreover, the increasing number of individual investors and the globalization of corporate activities generate a greater demand than ever before for appropriateness and reliability of financial information of corporations; as well as an unprecedented need for fairness, independence and reliability of auditing.

Due to long term and fixed auditing by the same CPA, auditors and audit clients have entered into a too-cozy relationship, and this has led to situations where the reliability of auditing has been compromised. Moreover, the growing globalization of the economy has raised various issues with respect to convergence of accounting and auditing standards etc. These situations demonstrate the fact that the CPA system (law) did not properly address actual situations and the needs of society.

The amendment of the Certified Public Accountants Law (“CPA Law”) in May 2003 intended to resolve this discrepancy between actual social conditions and existing systems, properly regulate accounting and auditing for companies and satisfy social needs.

2. Establishing the Certified Public Accountants and Auditing Oversight Board and its Role

On April 1, 2004, the Certified Public Accountants and Auditing Oversight Board (hereinafter referred to as the “CPAFOB”) was established. The amended CPA Law stipulates that the CPAFOB be established and it was inaugurated on April 1, 2004. The main difference in the operations of the CPAFOB compared to the previous CPA Examination and Investigation Board is that the CPAFOB has a new assignment of overseeing the quality control review conducted by the Japanese Institute of Certified Public Accountants (hereinafter referred to as the “JICPA”) with respect to audit services provided by CPAs and audit firms (hereinafter referred to as “audit firms”).

The CPAFOB, as a legally appointed administrative agency, oversees the JICPA’s quality control review with the objectives of making the self-regulatory system more effective, and appropriately enhancing and managing quality control of audit practices at audit firms.

I was appointed the chairman of the CPAFOB by the Prime Minister. Taking this opportunity, I would like to express my views on the mechanisms and characteristics of the oversight activities conducted by the CPAFOB and the future activities of the CPAFOB.

3. Mechanisms and Characteristics of the Oversight Activities by the CPAFOB

I sometimes hear that since I was once a commissioner as well as the president of the Board of Audit of Japan from 1997 to 2002, some people think that we will strictly check the audits of audit firms. And some people also ask me to do so with great severity. However, these opinions and requests do not necessarily express a correct understanding of the mechanisms and characteristics of oversight. Since I have taken the position of chairman, I have given many interviews to media representatives, where I have explained the roles of the CPAFOB as well as the mechanisms and characteristics of oversight so that people can understand them correctly.

It is true that there is strong demand to ensure fairness, independence and reliability of auditing worldwide due to the occurrence of cases in which the reliability of auditing by audit firms were questioned in recent years on a global mass scale. Considering such situations, several countries, including the US, have established public agencies or corresponding organizations to oversee audits. In Japan as well, responding to this development, the CPA Law was amended for the purpose of enhancing and strengthening the system of overseeing audit firms and the CPAAOB was established by reorganizing the CPA Examination and Investigation Board.

Although this amendment of the CPA Law aims at enhancing and strengthening oversight of audit firms, the CPAAOB itself is indeed not an agency that controls audit firms. The CPAAOB is an agency that oversees the quality control reviews conducted by the JICPA, and, as a result, if audit firms do not conform to regulations/laws or the quality control standard etc., or if some quality control reviews are not properly conducted by the JICPA, the CPAAOB will recommend the Commissioner of the Financial Service Agency to take administrative dispositions and other measures. In order to ensure the effectiveness of oversight, the CPAAOB can, if deemed necessary, conduct on-site inspections of the JICPA, audit firms, and audit clients etc. However, specific administrative measures are taken by the Commissioner of the Financial Service Agency based on recommendations by the CPAAOB.

As discussed above, the main duty of the CPAAOB is, through oversight, to ensure fairness, independence and reliability of auditing by audit firms, by making the JICPA's quality control review more proper and more effective. Therefore, if fairness, independence and reliability of auditing cannot be ensured with the quality control review by the self-regulating organization JICPA, the CPAAOB will then make recommendations to the Financial Service Agency, upon which the Financial Service Agency will take administrative dispositions and other measures.

4. Effectiveness of the Oversight System

With respect to this system which aims to ensure fairness, independence and reliability of auditing by audit firms through the quality control review by the JICPA and oversight by the CPAAOB, there may be doubts about the effectiveness of this oversight system and various

demands that the CPAAOB takes direct measures, i.e., imposes direct regulations on audit firms. However, from my experience involved in public accounting examination as a commissioner as well as the president of the Board of Audit of Japan, I consider this system to be an efficient and effective means of ensuring fairness, independence and reliability of auditing.

Many people may imagine that the examination at the Board of Audit of Japan, which checks the administration of the national budget, is a control type of examination, but this type of examination is already an out-of-date examination method in various advanced nations. In "financial audits" conducted by the Supreme Audit Institution (SAI) in the advanced nations of the world today, a risk-based approach is employed, and, at the same time, in "performance audits", an examination from the viewpoint of efficiency, economical efficiency and overall effectiveness is mainstream. I categorized these examination methods as risk management types and value added types, and have tried to promote them so that they can take root in Japan. In risk management type examination methods, the actual or potential occurrence of risks in targets is identified and the targets are proactively requested to manage risks so that they do not materialize. In value added type examination methods, targets are recommended to reduce costs and improve quality with regard to business operations. Especially for the former method, it is important to establish and enhance the target's internal control system to suppress the occurrence of risks. By doing so, risks can be prevented from materializing, and sound financial processing can be ensured. Thus, the examination of individual accounting transactions in "financial audits" is focused on a sample-based examination that confirms whether or not the internal control is actually functioning or the internal control system is appropriate, thereby ensuring the efficiency of the examination.

Oversight conducted by the CPAAOB, in the same way, does not intend to control, but aims to reinforce even further self-regulation conducted by the JICPA in order to ensure the quality (fairness, independence and reliability) of audit services by audit firms.

5. Importance of the JICPA's Role

If problems arise with the quality of audit services by audit firms, such problems are related to the effectiveness of JICPA's self-regulation, and the JICPA will be sought to enhance the quality control review system and ensure the effectiveness of the system in order to prevent such problems from arising in the future. In this sense, the JICPA's role in the quality control

review is considered to be extremely important.

It is not possible to judge uniformly whether control type regulation backed by government authority or self-regulation placing importance on autonomy is more effective in ensuring effectiveness. However, when thinking about the effectiveness of a system (law) in the field of law, it is more common to think in terms of both "effectiveness" and "appropriateness." "Effectiveness" deals with the degree to which laws are conformed to. "Appropriateness," on the other hand, is a measure of the value of laws, i.e., why a particular law has to be abided by. While "appropriateness" is not necessarily generated from "effectiveness," "effectiveness" may be generated from "appropriateness." In other words, although heteronomy (compulsion) may cause a situation in which laws are abided by, it is difficult to maintain the situation if this compulsion is lost; so it is necessary to maintain strict enforcement at all times. In contrast, once one accepts the values represented in the spirit of the law, autonomy fosters the observance of laws by one's own will, and the law abiding status can be maintained without strict enforcement. However, such autonomy is difficult to maintain without a strong will. That is why the proper combination of autonomy and heteronomy can realize optimal conditions for the effectiveness of systems (laws).

In order to ensure "effectiveness" based on "appropriateness" of the amended CPA Law, it is essential that the quality control review, which respects the autonomy of the JICPA, be conducted properly.

6. Conclusion

Ensuring fairness, independence and reliability of auditing will improve the reliability of financial information of corporations and thus the reliability of the economy of each country and the world, and thereby contribute to the enrichment of people's lives. This is exactly the purpose of the amended CPA Law. The oversight system of the CPAAOB established by the amended CPA Law represents the proper combination of autonomy and heteronomy, i.e., self-regulation by the JICPA and administrative measures by the Commissioner of the Financial Service Agency based on recommendations, when deemed necessary, by the CPAAOB. Realizing an optimal balance between autonomy and heteronomy depends on the future self-regulation of the JICPA and oversight activities by the CPAAOB.

The CPAAOB intends to conduct proper oversight from an administrative perspective and

will strive to realize the goals of the amended CPA Law while expecting the JICPA to make further efforts to improve the effectiveness of its quality control review.