

2023 Monitoring Report Key Points

July 2023

Certified Public Accountants and
Auditing Oversight Board



Purpose of Publication

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

Composition

- The Report comprises the following four sectors (I - IV).

I. Overview of the Audit Sector

Provides an overview of the audit sector as a whole through presenting the developments of the number of CPAs, audit firms, and audited companies etc.

II. Monitoring by the CPAAOB

Provides a whole picture of the CPAAOB's monitoring including inspections

III. Operation of Audit Firms

Describes the operation of audit firms including their structure, progress of digitalization, address to group audits, change of auditors, and increase or decrease of audit fees caused by auditor change

IV. Responses to the Changes in the Global Environment Surrounding Audits

Describes the development of systems based on the changes in the environment surrounding audit

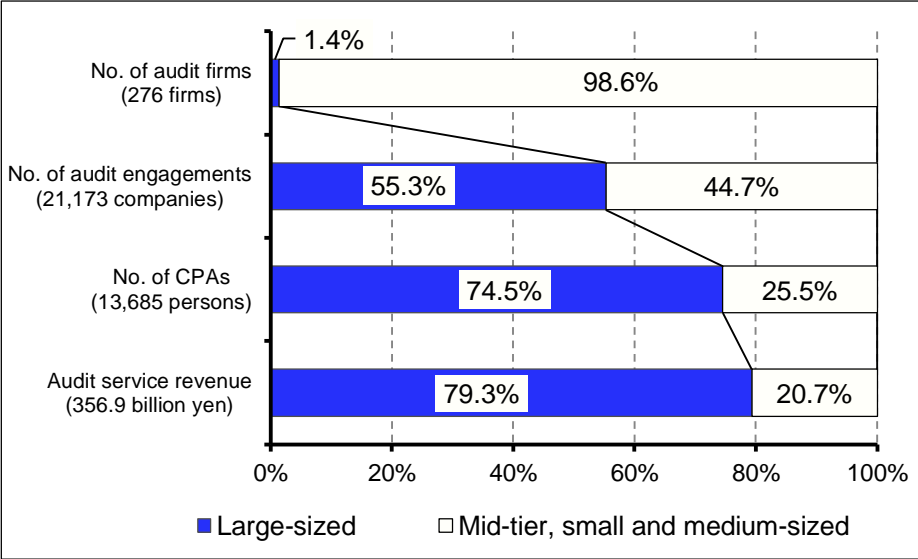
※We also present subjects which draw reader's interest as "column".

Concentration of audit engagements at large-sized audit firms

Refer to P23-24

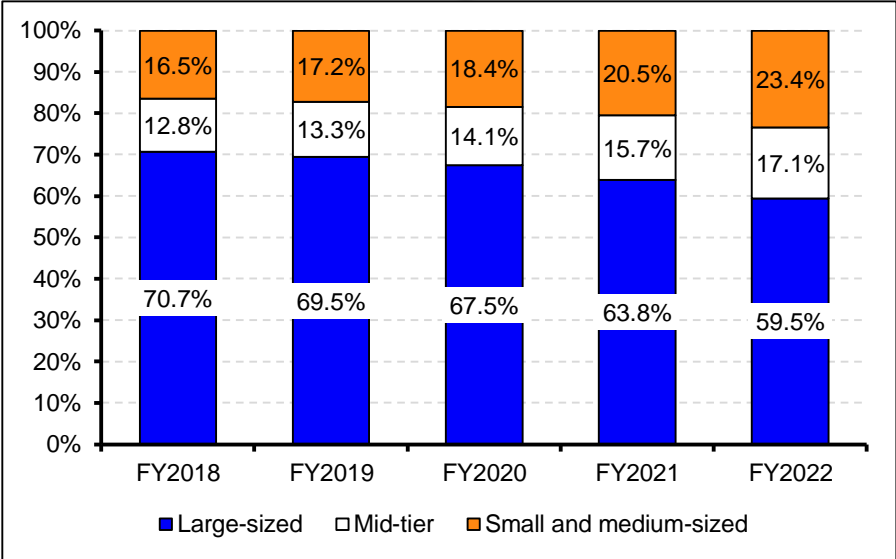
- Approximately 79% of audit service revenue is marked by large-sized audit firms.
- In recent years, the ratio of large-sized audit firms has been on a downward trend in the number of audit engagements, audit service revenue.
- The same oligopolistic tendency is also seen in the United states and the UK.

Market share by type of audit firm(FY2021)



(Note) Compiled based on FY2021 JICPA member data and operational reports submitted by audit firms

Number of listed domestic companies by scale of accounting auditor



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

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

	Japan	United States	UK
Big Four global networks' share	96%	99%	92%

(Note) Shares were calculated based on the numbers of companies included in the following stock indexes:
 Japan: Nikkei225
 United States: S&P500
 UK: FTSE350

Refer to P80

Quality Control System

- 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.
- The “Standard on Quality Control for Audits” were formulated for audit and attestation services in 2005, but the services requiring development of quality control are not limited to audit and attestation services but encompass all of audit firm’s operations.
- In November 2021, the “Standard on Quality Control for Audits” was revised.

Concept of the revised Standard Quality Control for Audits

- While the former Standards on Quality Control required to develop determinate policies and procedures uniformly ,the revised Standards introduces risk-based approach requiring audit firms that
 - they should set their own quality objectives
 - distinguish quality risks that hinder the achievement of such quality goals and asses them
 - determine policies or procedures for dealing with those assessed quality risks and implement them
 - make improvements based on the root cause of defects, if any

Components of the revised Standard Quality Control for Audits

- 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 implementation of services
- e. Resources for operational management of the audit firm
- f. Information and communication
- g. Monitoring of the quality control system and improvement process
- h. Succession among audit firms

Starting period where revised Standards are applied

- Large audit firms(Note): The revised Standards are applied to audits of financial statements for business year or accounting period on or after July 1, 2023.

(Note) Audit firms that provided audit and attestation services to more than 100 listed companies, etc. in the most recent fiscal year (See Article 24 of the Ordinance for Enforcement of the CPA Act)

- Audit firms other than large audit firms : The revised Standards are applied to audits of financial statements for business year or accounting period on or after July 1, 2024.

Ongoing progress at large-sized audit firms and mid-tier audit firms

- In collaboration with global networks, large-sized and mid-tier audit firms are moving forward with responses to the Revised Standards in parallel with responses to ISQM1 that began to be applied from December 2022.
- They have completed the development of components of quality control systems based on quality goals and quality risks set by global networks. They also added evaluation items according to the Revised Standards' own requirements and are dry-running towards the application of the Revised Standards.
- Large-sized audit firms are considering measures to ensure that the quality control system continues to permeate the workplace and does not lose substance.

Ongoing progress at small and mid-sized audit firms

- Approximately 90% of these firms started consideration of applying the Revised Standards collecting information provided by the JICPA's training program or publicly available information.
- Approximately 10% of these firms have not started making concrete preparations.

Monitoring of Systems of Quality Control

Refer to P90~92

Periodic Inspections

- Once an audit has completed, the audit firm conducts procedures to ascertain whether an engagement team performed audit in accordance with the quality control system prescribed by the audit firm (Periodic inspections of audit services). This inspection must be performed for at least one of the audits that each engagement partner has conducted during a certain period (e.g. three years).
- Factors such as the number of inspections, inspectors involved, and tools differ depending on the size of the firm. (For example, the number of inspectors involved is as follows. Large-sized audit firms: Between around 40 and 240, Mid-tier audit firms: Between a few and around 50, Other: Between one and around 15)
- Regardless of their size, the results and the identified deficiencies are shared for raising risk awareness to all partners and staff through in-house training, etc.

Utilization of Global Networks

- The Big Four global networks require network firms in each country to comply with a detailed audit manual provided by them and conduct global reviews to confirm whether network firms comply with the manual. Large-audit firms and some mid-tier audit firms undergo global review every year.
- Other than Big Four, global networks operationalize relaxed rules for complying with the audit manual provided by global network. There is a wide variation in the nature and frequency of global reviews.

Monitoring before expression of audit opinions

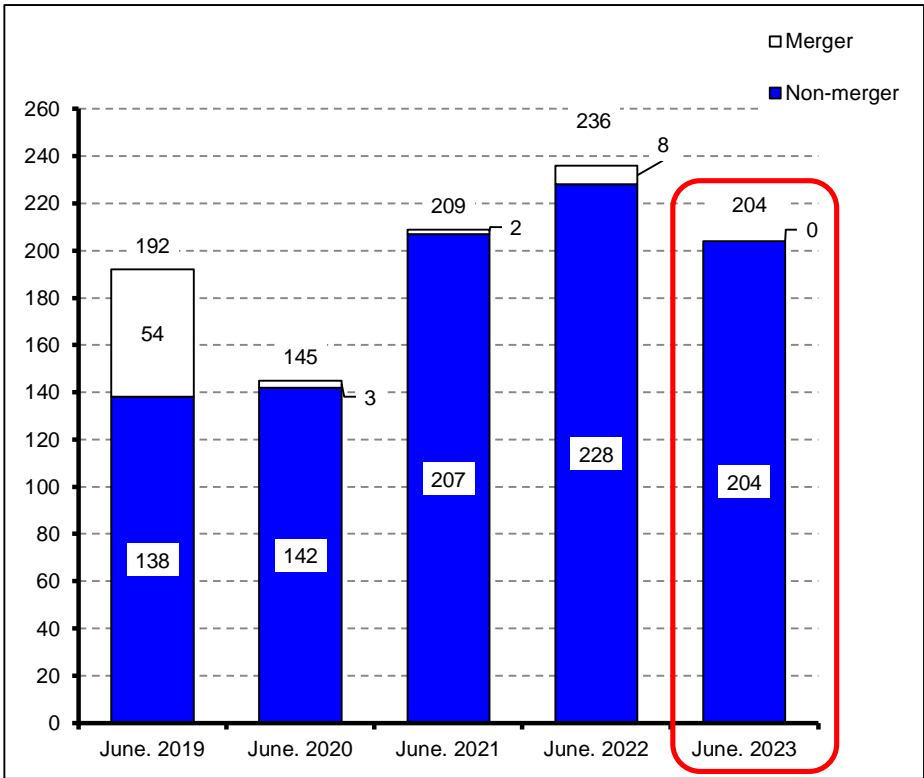
- In recent years, large-sized audit firms especially conduct this monitoring to improve the quality of audits.
- This monitoring targets ongoing audit engagements to promptly find problems and prompt the engagement team to take timely remedies.
- It is often carried out in audit areas involving high risks, such as fraud.

Changes of accounting auditors (1/2)

Refer to P97-98

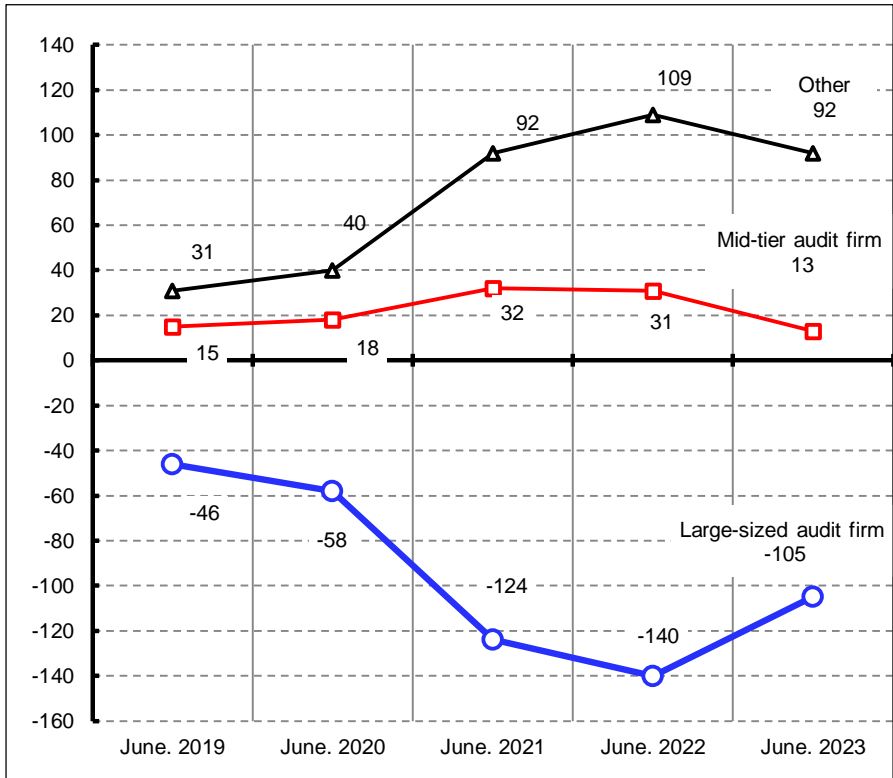
- The number of changes is 204. Even if changes due to merger are excluded, the number of changes remains in high level.
- Breaking things down by size of audit firm reveals an ongoing shift from large-sized audit firms.

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



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

Changes by size of audit firm (unit: companies)



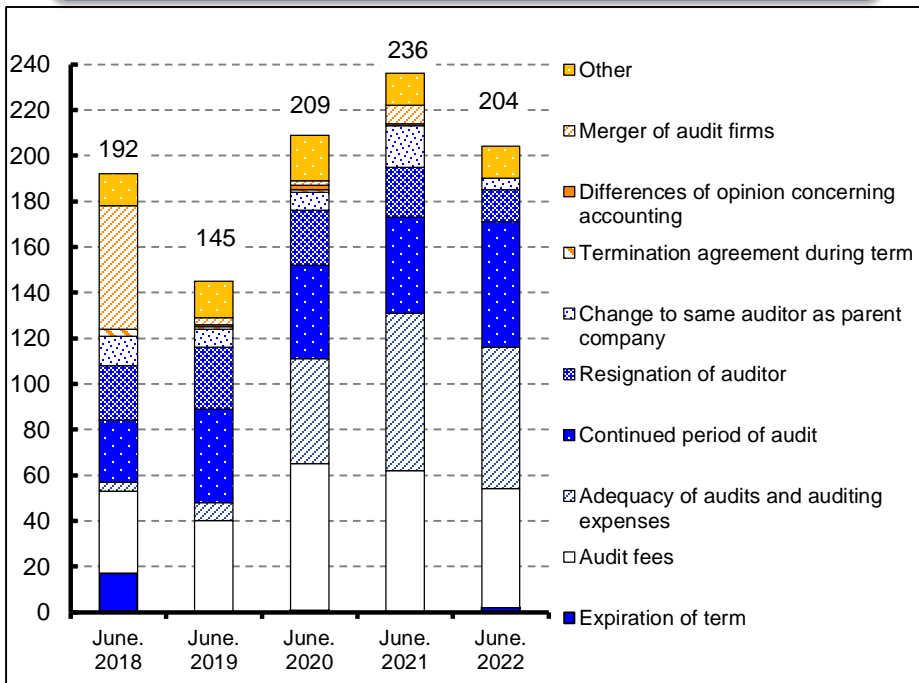
(Note) Net increases/decreases in the number of changes

Changes of accounting auditors (2/2)

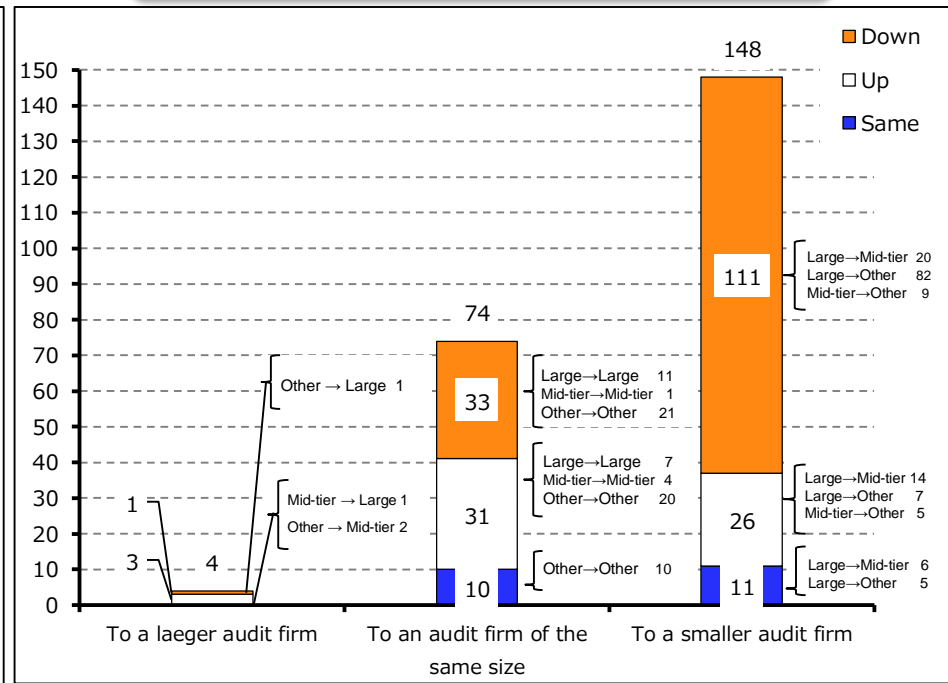
Refer to P99-100, P103-104

- Cases in changes of accounting auditors solely based on expiration of term have decreased sharply since June 2019.
- In the year ending June 30, 2023, there are many cases in which audit fee hike proposal and prolongation of continuous audit terms are cited as reason. Additionally, in many cases, companies cited that consideration of the audit service suited for their business scale and adequacy of audit fees through comparison with other audit firms resulted in changes of auditors.
- Regarding audit fees before and after changes, approximately 80% of changes to a smaller audit firms resulted in lower fees. Among these, changes from a large-sized audit firm to a small and medium-sized audit firm, partnership, or solo practitioner saw fees drop in approximately 90% of changes.

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



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



(Note1) Complied 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.

(Note3) Prior to the year to June 2020, the "adequacy of audits and auditing expenses" was included in "others". While there was no reference to it in the year 2018, it was mentioned in four cases in the year end to June 2019 and eight in the year June 2020.

(Note1) Based on changes in accounting auditors between July 2022 and June 2023 where the audit fees before and after the changes were publicly disclosed.

(Note2) Prepared by the CPAAOB based on timely disclosures of changes in accounting auditors and security reports submitted by June 2023

(Note3) Breakdowns of these changes are shown in the graph.

Side businesses by partners, Part-time personnel

Refer to P65-66

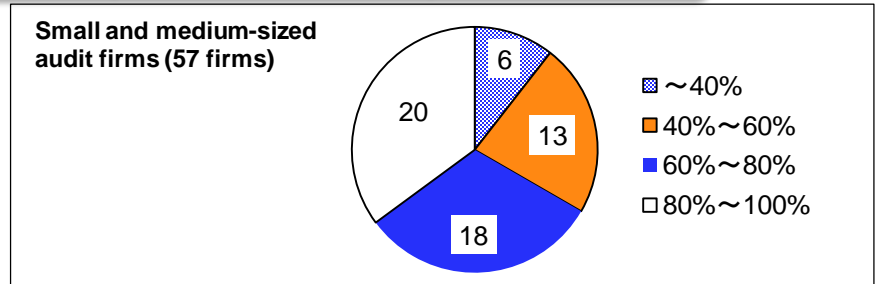
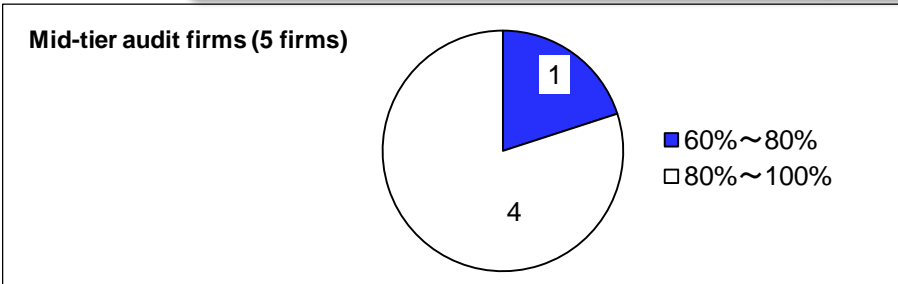
Side businesses by partners

- Large-sized audit firms do not permit dual work by partners at tax accountant offices or solo private accountant offices in principle.
- Other than Large-sized audit firms, permission of dual work by partners varies by firm.

Part-time Personnel

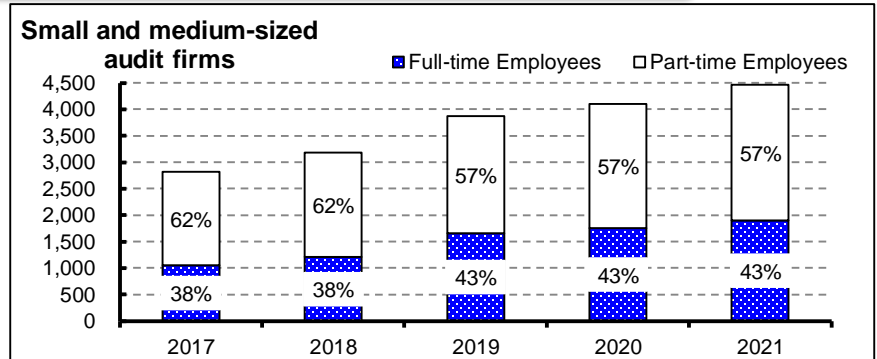
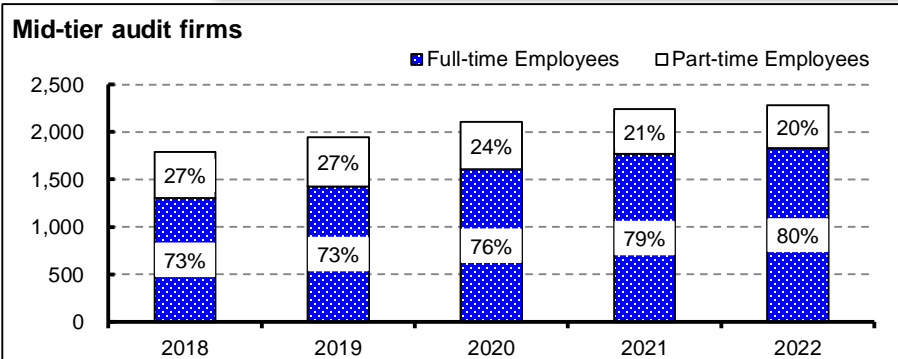
- Part-time staff account for around 60% at small and medium-sized audit firms. Some of such firms rely on part-time staff as audit assistants needed for their operation.

Number of audit firms by percentage of time spent by partners engaged in the audit firm's operations (unit: audit times)



(Note) Prepared by the CPAAOB based on partner's declarations collected through the CPAAOB inspections and collection of reports in PY2022.

Number of full-time and part-time personnel (unit: persons)



(Note) The data is based on operational reports submitted by audit firms.

Audit Firm Governance Code

- The Audit Firm Governance Code was formulated in March 2017, and subsequently revised in March 2023 with the aim of accompanying acceptance of small and medium-sized audit firms. This was in response to a series of government ordinances accompanying revisions to the CPA act, which mandated audit firms that audit listed companies to establish a framework for conducting operations in line with the Audit Governance Code and requiring enhanced information disclosure.
- 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 reasons for not implementing the principles).

Key Points of the revision of the Audit Firm Governance Code

Revision to cover all audit firms that audit listed companies	The preamble states that, instead of being formulated with large-sized audit firms in mind, the Code was formulated with the organizational operation of audit firm that audit listed companies in mind and that partnerships and solo practitioners are also subject to the Code.
Revisions to accommodate acceptance by small and medium-sized audit firms	Principle 2 states that when a management institution is not established, effective management functions should be ensured. Principle 3 states that when a supervisory/assessment organization is not established, functions that support supervisory/assessment functions and management functions should be ensured, and knowledge of independent third parties should be ingeniously utilized.
Revisions to enhance information disclosure	Principle 5 states that the explanation should be made from viewpoints of quality control, governance, IT/digital, human resources, finance, and international matters, taking account each audit firm’s size and characteristics.
Revisions to enhance disclosure on the global network	Principle 1 states that when an audit firm is a member of a global network, the relationship and positioning with the global network that the audit firm keeps in mind should be clarified. Principle 5 states that the significance and purpose of joining a global network, and risks and mitigation measures that affect ensuring and continuously improving audit quality should be explained.

(Reference)5 principles in the Audit Firm Governance Code

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

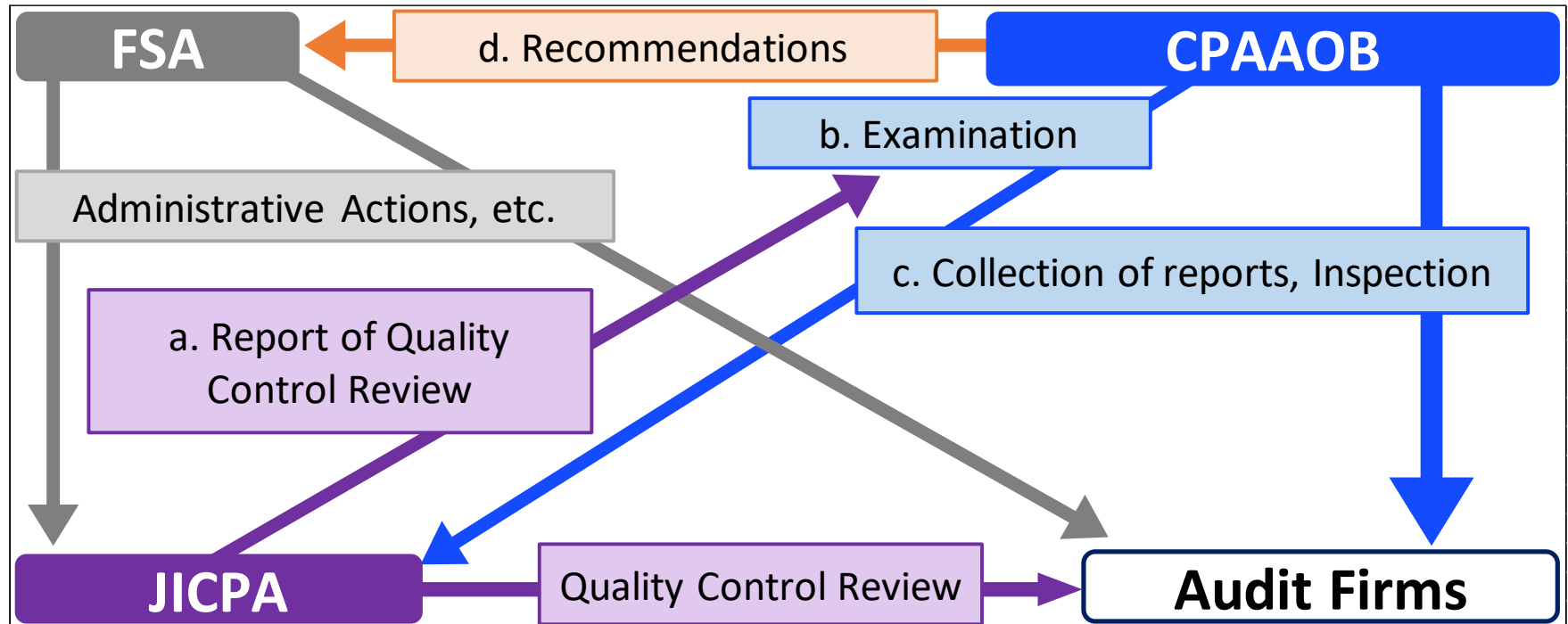
An audit firm should develop an operational structure to effectively manage its operations. An audit firm should also strengthen the people retention and development and proactively engage in a dialogue and discussion within the firm and with audited companies about the possible enhancement of audit 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.

Overview of the CPAAOB Monitoring

- Based on the JICPA quality control 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 and conduct 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.)



Basic Policy and Basic Plan for Monitoring Audit Firms

- The CPAAOB articulates its objectives and approach for monitoring in its Basic Policy for Monitoring Audit Firms each term of office for its Chairman and Commissioners (three years) . The Basic Policy for Monitoring Audit Firms for the CPAAOB's 7th Term (April 2022-March 2025) was published on May 20, 2022.
- Based on the objectives and approach for monitoring articulated in the above Basic Policy, the CPAAOB formulates the Basic Plan for Monitoring Audit Firms each program year. The Basic Plan for Monitoring Audit Firms for Program Year 2023 , which shows monitoring priorities in PY 2023, is published on July 14, 2023.

Key points of the Basic Plan for Monitoring Audit Firms for PY 2023

- **Large-sized audit firms**
 - ✓ Regular inspections and follow-up inspections are conducted alternately each year in principle.
 - ✓ In follow-up inspections, the CPAAOB mainly verifies the status of improvement measures for issues pointed out in regular inspections rather than examine individual audit engagements. In certain cases, the CPAAOB verifies the status of improvement through collecting reports instead of conducting follow-up inspection.
- **Mid-tier audit firms**
 - ✓ The CPAAOB modifies the frequency of inspection from once every three years to once every two years.
- **Small and medium-sized audit firms**
 - ✓ The CPAAOB considers the necessity of inspection based on the results of the JICPA's quality control review, operation control system of audit firms, and degree of audit risk brought by listed audited companies.
 - ✓ In light of the growing role of small and medium-sized audit firms as auditors of listed companies, the CPAAOB places greater emphasis on inspections of such audit firms.

Situation with overall ratings

Refer to P42-46

Overall Ratings

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

Overall rating description	Details	Large-sized audit firms	Mid-tier audit firms	Small and medium-sized audit firms
Generally Satisfactory (rating: 1)	Given when operation of services is deemed to be satisfactory	-	-	-
Satisfactory with minor deficiencies (rating:2)	Given when there are issues needing to be fixed, but operation of services is deemed to be satisfactory as a whole	4	-	3
Unsatisfactory (rating: 3)	Given when operation of services is deemed to be unsatisfactory	-	4	6
Unsatisfactory and in need of immediate remediation (rating: 4)	Given when operation of services is deemed to be unsatisfactory and in need of immediate remediation	-	1	8
Extremely unsatisfactory (rating: 5)	Material deficiencies with the quality control and audit engagements were identified and voluntary remediation cannot be expected to be implemented by the audit firm (recommendation is made to the FSA Commissioner)	-	-	10

(Note1) The above figures are tabulated based on inspections that terminated from PY2016 to PY2022.

(Note2) Regular inspections take place once every two years in the case of large sized audit firms, once every three years in the case of mid-tier audit firms, and as necessary in the cases of small and medium sized audit firms, partnerships, and solo practitioners.

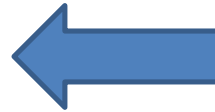
(Note3) For audit firms that underwent regular inspections multiple times during the relevant period, results of the latest inspection are tabulated.

Changes in the environment surrounding audits by small and medium-sized audit firms

- In recent years, as the large number of companies change their accounting auditors from large-sized audit firms to mid-tier/small and medium-sized audit firms, the role of small and medium-sized audit firms as auditors of listed companies is growing.
- Based on the above, the legal registration system for auditors of listed companies was introduced.

Auditors of listed companies

- develop the system of operational management
- develop the system of disclosing information (e.g. the status of complying with Audit Firm Governance Code)



“Confirmation of eligibility” by the JICPA

- utilize quality control review
- newly established Quality Control Oversight Board conducts screening of registrations

- As well as conducting “Confirmation of eligibility”, the JICPA supports small and medium-sized audit firms for enhancement of their disclosure of the six business fundamentals (quality control, organization and governance, human resources, IT/digital, finance, and international matters).

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

- Led by the Practices Policy Committee for Small and Medium-Sized Audit Firms and the Small and Medium-sized Audit Firms Liaison Council, the JICPA takes efforts as below.
 - Publication of guidance for revised Quality Control Standards
 - Opinion exchange meeting with capital market participants
 - Interactive training for small and medium-sized audit firms
 - Former reviewers of the JICPA's quality control review serve as lecturers, and opinions and information are shared through Q&As and discussions.
 - Support for digitalization of small and medium-sized audit firms
 - Identify the state of IT infrastructure development and the use of IT-based audit methods, develop a shared IT infrastructure environment (a platform of electronic audit documentation system), and establish network among IT personnel at small and medium-sized audit firms.

Response by the CPAAOB

- The revised Quality Control Standards states 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 7th Term.