# I. Operations Management System
# (Root Cause Analysis)

## 1. Operations Management System and Root Cause Analysis

### (1) Necessity of Root Cause Analysis

With regard to audit firms that the CPAAOB conducted inspections of, it has been recognized that when a deficiency was detected in a review conducted by the JICPA in accordance with Article 46-9-2 of the Certified Public Accountants Act (below, “the Act”) and Article 77 of the JICPA Rules (below, “QC review”) or periodic inspection, not a few audit firms only took superficial improvement measures, without fully identifying the causes.

Deficiencies identified in inspections are detected within the scope of investigations. It is likely that the audit firms have other undetected deficiencies arising from the same root causes. Moreover, even if the measures are implemented only to address the superficial causes of the deficiencies, they may be effective temporarily, and similar deficiencies may occur again. Therefore, improvement measures developed only to cope with the superficial causes, without any root cause analysis, would not be effective or sufficient for improving the quality control system of the entire firms, and would not lead to fundamental improvement; therefore, the quality of the audits by the audit firms would not be improved.

On the contrary, taking symptom-treating perfunctory measures such as simply adding checklist items in response to individual deficiencies, for example, would lead to an increase in unnecessary and ineffective workload for professional staff to respond to the checklist and often prevent them from implementing an effective and efficient audit engagements.

Thus, audit firms shall understand importance of root cause analysis of deficiencies in order to substantively improve quality control.

In recent years, with regard to deficiencies relating to individual audit engagements identified through external inspections, etc. and periodic inspections, large-sized audit firms not only specify the factors of deficiencies in audit procedures and audit evidence make them well known, but also incorporate action to analyze their root causes into their quality control system.

For example, the quality control department etc. acts voluntarily to conduct interviews with and questionnaire surveys of the audit team in which deficiencies were identified in order to find out the details of the essential causes of the deficiencies, after which the department analyzes whether these direct causes were the result of the firm’s operations management system or quality control system, and then reflects its findings in the improvements to be made.

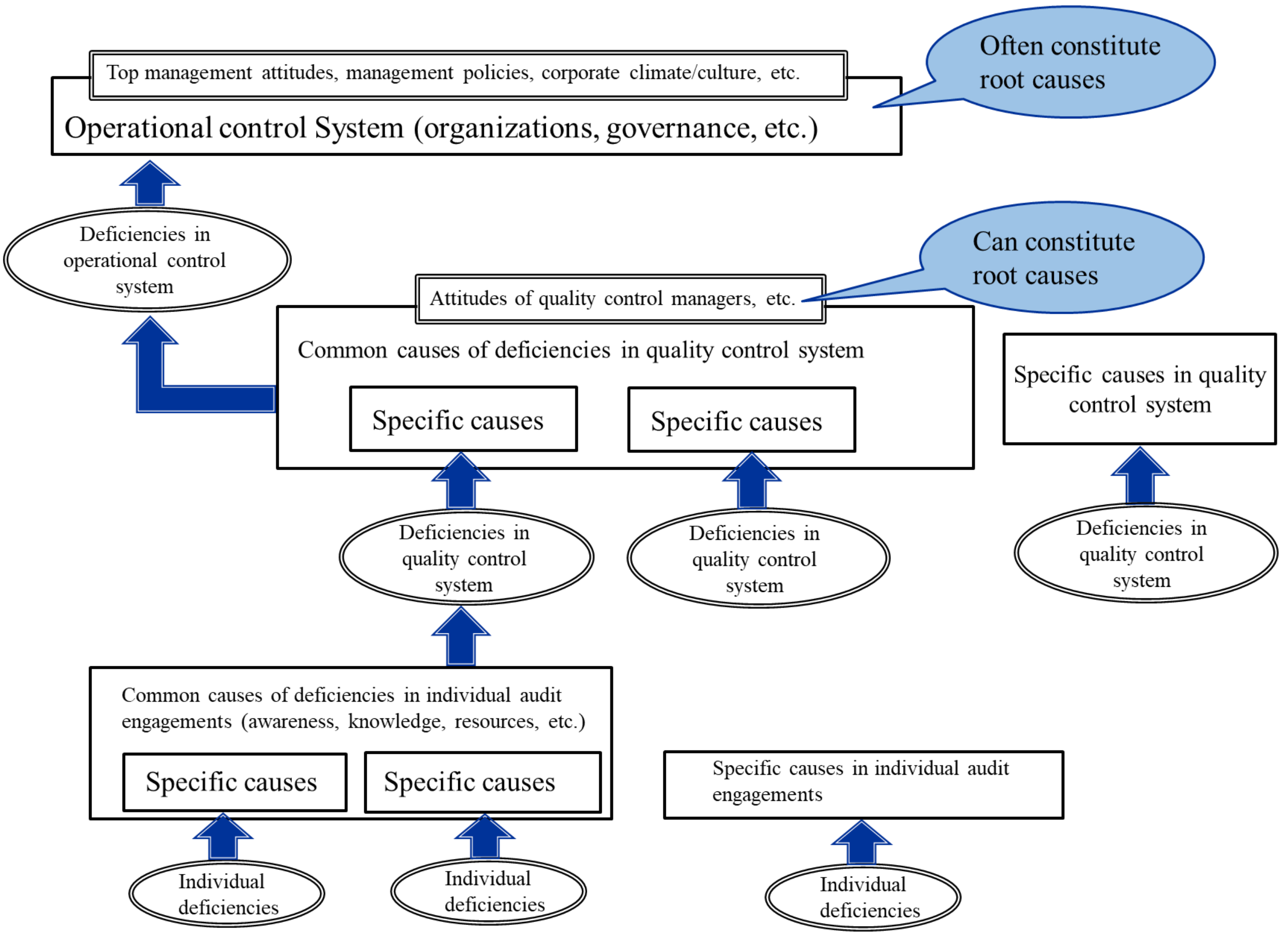
### (2) Root Cause Analysis

When conducting root cause analysis, it is first and foremost important to accurately identify the essential causes of deficiencies. Rather than ascribing the direct causes merely to the knowledge, attitudes, or experiences of individual personnel involved, it is essential to identify the direct causes after sufficiently understanding engagement team's circumstances and the business conditions of audited companies, among other factors, and conduct a further analysis to explore the root causes in light of the identified causes.

Direct causes include "specific causes," which are identified with regard to individual deficiencies, and "common causes," which are common to multiple deficiencies. Further examining the underlying causes of common causes often helps to identify the root causes.

In the past inspections, the root causes were frequently related to the operations management system as manifested in the attitudes and policies of top management, the governance environment and the organizational climate. Accordingly, attention must be paid to the effectiveness of the operations management system. At times, the attitude of PICOQC or some other aspect of the quality control system constitutes the root causes (see [Figure 1]).

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




The following are examples of root cause analysis in which the CPAAOB analyzed the direct causes of deficiencies, investigated the root causes and discovered the root causes within the operations management and quality control systems.

**[Large-sized audit firms]**

**[Case 1]**

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

The causes of these deficiencies included the fact that in an audit area etc. in which the engagement partner deemed the risk to be relatively low, based on their understanding of the business environment and past audit experience, the engagement partner was not aware of the need to carry out an in-depth audit response in accordance with the assessed risks. The causes also included the fact that assistants to engagement partner lacked commitment to critically considering the explanation provided by the audited company and to in-depth consideration of fraud risks.

In light of this situation, further investigations into the root cause determined that the root cause lay in the fact that the audit firm had not adequately ensured penetration of efforts to appropriately implement audit consideration and responses in areas other than those thought to have particularly high risk of material misstatement.

**[Case 2]**

NEW

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

The direct causes of these deficiencies were as follows: engagement partners and assistants to engagement partners did not sufficiently critically review management's assertions concerning the timeliness of accounting treatment for accounting estimates; and engagement partners and assistants to engagement partners did not sufficiently recognize the need to examine whether audit procedures suited to the level of risk were being performed in areas where the risk of material misstatement was deemed to be relatively low. Furthermore, there were common causes for deficiencies in the quality control environment: the Quality Control Headquarters, which led audit quality improvement measures, did not clearly indicate the scope and level of procedures to be performed to the quality control partners of each audit division, who were responsible for implementing remedial measures, when providing systematic support to engagement teams facing risks, and the Quality Control Headquarters did not sufficiently confirm whether improvement effects were being achieved on the audit frontline.

Further considerations into the root cause discovered that the root cause lay in the quality control environment. Specifically, **the management executives did not sufficiently recognize the need to confirm whether the QC Headquarters and the firm implementing the remedial measures were cooperating closely to ensure that the measures were being implemented in line with their original intent and purpose and that remediations were being made on the audit frontline**.

**[Case 3]**

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

The direct causes of those deficiencies included the assumption among engagement partners and their assistants that it was sufficient to examine material audit matters, such as accounting estimates, based only on the understanding of nature of audited companies' business and past business performance trends and that it was not necessary to examine quantitative supporting data. There were also common causes related to the deficiencies in the quality control system at individual divisions and departments of the headquarters involved in quality control, including: a lack of efforts to ensure that the level of audit procedures required by the current audit standards are penetrated throughout the firm; and a lack of efforts to encourage engagement partners to be proactively involved in the audit engagements that they are in charge of.

Further analysis of the root causes ascribed the above deficiencies to the quality control system. For example, the audit firm assumed that appropriately identifying material risks faced by audited companies and repeatedly communicating the importance of conducting risk-focused audits to engagement teams would be sufficient to improve audit quality. As a result, adequate verification was not conducted as to the extent to which quality control measures had taken hold and how effective they were.

**[Mid-tier audit firms]**

**[Case 1]**

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

The causes of those deficiencies included a lack of awareness of following the previous year in the audit and a lack of professional skepticism in terms of willingness to critically assess relevant assertions. There was a common cause of the deficiencies in the quality control system, which was a lack of awareness on the part of the PICOQC that the inadequate staffing and level of involvement of the quality control division meant it could not identify and remediate deficiencies.

In light of this situation, further investigations into the root cause determined that it lay in the operations management system. More specifically, with operations expanding, the chief executive officer (CEO) was unaware that the headquarter organization was unable to consider the adequacy of personnel allocation and lacked awareness of the need to personally verify the adequacy and effectiveness of the quality control system. For example, the CEO thought that the enhancement of the headquarter organization's functions and improvement of the quality control system would be carried out appropriately if left up to the people in charge at headquarters.

Another root cause, also lying in the operations management system, was determined to be the failure of the CEO and the people in charge at headquarters to develop an adequate environment for verifying the status of efforts to ensure quality control measures take hold in audit fieldwork and their effectiveness, even though engagement partners lacked sufficient awareness of their own responsibility for the audit engagement and its performance and the skill level of audit teams as a whole had not been raised to an adequate degree.

**[Case 2]**

Multiple significant deficiencies with some individual audit engagements subject to inspections were identified at an audit firm. These concerned, for example, substantive procedures for revenue and procedures for responding to fraud risk. Many of these deficiencies were identified frequently at a specific regional office.

The common cause for these deficiencies in individual audit engagements turned out to be that the engagement partners had not effectively reviewed audit work papers, instead followed same audit procedures from the past years because no major issues had arisen in audit engagements theretofore.

The common cause for these deficiencies in individual audit engagements lay in the quality control system in that the CEO had believed having a mechanism in place to convey decisions made by the head office to regional offices was in and of itself sufficient and he had no intent of revising the practice of regional offices administering these decisions independently, and in that the CEO and the PICOQC followed past practices because no major issues had arisen theretofore in key matters noted with regard to business administration and quality control at the audit firm by outside organizations.

Further investigations into the root cause determined that it lay in the operations management system. More specifically, the audit firm had undergone repeated mergers but the headquarters organization remained fragile and the regional offices established by separate entities were permitted to run their businesses in their own ways, with hardly any exchanges of personnel taking place.

**[Case 3]**

At the audit firm, multiple deficiencies were identified with regard to all individual audit engagements subject to inspection. Many significant deficiencies, including significant ones, were identified in individual audit engagements at particular regional offices.

Those deficiencies in the individual audit engagements had common causes, including a lack of understanding among engagement partners and their assistants of the level of audit procedures required by the current audit standards, including lack of professional skepticism with regard to response to fraud risks and accounting estimates; and lack of awareness of the need to review risk assessment and risk-related audit procedures every fiscal year due to the assumption that merely following the audit procedures performed in the previous fiscal year would be sufficient. The deficiencies in the individual audit engagements at particular regional offices also had a common cause, which was lack of awareness among some engagement partners of the need to give instructions to and supervise engagement teams and of the need to conduct in-depth review due to the assumption that audit procedures were being properly performed by other engagement partners concurrently serving as the chief auditors.

The common causes of those deficiencies in the individual audit engagements are ascribable to the quality control system. For example, the PICOQC lacked awareness of the need to emphasize the need for cooperation between the quality control and audit divisions under the belief that the audit division should play the leading role in ensuring that improvement measures take hold in audit fieldwork. The common cause of the deficiencies in the individual audit engagements at particular regional offices are also ascribable to the quality control system. Specifically, there was lack of awareness on the part of the manager in charge of the audit division about the need for support from the audit division due to the assumption that engagement teams could be appropriately organized if engagement partners were appropriately assigned.

Further analysis of the root causes ascribed the above deficiencies to the operations management system. For example, in some cases, the CEO, when planning and implementing measures to improve audit quality, refrained from exercising strong leadership and placed emphasis on the independence of the quality control and audit divisions. As a result, there was lack of awareness of the need to quickly make improvements. Furthermore, the executive management team also respected the independence of the quality control and audit divisions and lacked awareness about the need for strong cooperation between those two divisions. In other examples, although the executive management team was aware of audit quality issued at some regional offices, it assumed that the regional offices would be able to make improvements on their own. As a result, there was lack of awareness of the need to actively support the regional offices.

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

**[Case 1]**

NEW

Deficiencies were identified in the quality control environment at this audit firm, and numerous significant deficiencies were also identified in individual audit engagements subject to inspection.

The common causes of the deficiencies in individual audit engagements included: engagement partners and assistants to engagement partners did not sufficiently understand the level of procedures required under current audit standards, such as assessment and response to fraud risks and audit of accounting estimates; engagement partners did not perform in-depth reviews of audit documentation because they had too much trust in assistants to engagement partners and therefore believed that they were performing their duties appropriately; and the common causes of the deficiencies in the quality control environment were as follows: the CEO and the PICOQC did not perform a root cause analysis of deficiencies identified in quality control reviews and daily monitoring activities (including periodic inspections) in order to prevent similar deficiencies from occurring; they lacked awareness of the need to implement remedial measures; and they did not recognize that assistants to engagement partners lacked understanding of the level of procedures required under current audit standards.

Further consideration into the root cause discovered that the root cause lay in the operations management environment. Specifically, **the CEO and the PICOQC did not recognize the need to maintain and improve audit quality because they assumed that there were no audit quality issues based on the fact that no major deficiencies had been identified in past quality control reviews. They also did not demonstrate leadership in improving audit quality because they assumed that merely establishing a quality control environment as a formality would lead to improvements in audit quality**.

**[Case 2]**

Deficiencies were identified in the quality control system at this audit firm, and numerous significant deficiencies were also discovered with individual audit engagements.

The deficiencies in the individual audit engagements were due to a common cause of the engagement teams not sufficiently understanding the levels required by auditing standards pertaining to fraud risks and group audits. The common cause of the deficiencies in individual audit engagements lay in the quality control system in that the PICOQC did not sufficiently understand the level of quality control system demanded by the quality control standards and thus was not aware of the need to establish and administer a suitable quality control system, while the CEO believed that that the audit procedures to be implemented would be of a sufficient level if audit documentation systems, templates, etc., were suitably established and that issues could be addressed to a certain degree using quality control methods similar to those employed before the merger even though the office had expanded in scale because of the merger.

Further analysis of the root causes discovered that they lay in the operations management system. Specifically, they found that the CEO had not sufficiently understood the appropriate levels demanded of operations management and quality control systems in keeping with the office's expanded post-merger scale and that he lacked awareness of the need to rapidly institute organizational improvements in the operations management and quality control systems.

**[Case 3]**

Although the audit firm is small, its audit division has comprised two departments since its foundation, with audit engagements and financial and personnel affairs of each department independently managed. This has resulted in the development of an organizational culture that gives precedence to the independence of each department. Furthermore, only engagement partners work on a full-time basis, while all staff are certified public accountants and substantially all work part-time.

Under these circumstances, at the audit firm, multiple deficiencies, including significant ones, were identified with regard to the quality control system. In addition, many deficiencies, including significant ones, were identified with regard to individual audit engagements subject to inspection. The deficiencies in the individual audit engagements had common causes, including: a lack of understanding among engagement partners and staff of the level of audits required by the audit standards; a lack of professional skepticism, such as willingness to critically assess relevant assertions; lack of sense of belonging to the firm and of awareness of the need to maintain and improve the quality level of audits among part-time staff. The common causes of the deficiencies in the individual audit engagements are ascribable to the quality control system. For example, the CEO and the PICOQC did not sufficiently understand the depth and methods of analysis of causes necessary for preventing deficiencies similar to the ones detected in the QC review, etc. and placed too much trust in engagement partners and staff had sufficient capabilities given their extensive practical experiences.

Further analysis of root causes ascribed the above deficiencies to the operations management system. For example, the CEO and the PICOQC were not aware of a lack of understanding among all audit team members, including themselves, of the purposes of the current audit standards and of the levels of quality control and audit procedures required by the standards. In other example cases, the CEO and PICOQC assumed that there was no issue with the current organizational structure that had been maintained since the firm's foundation, since no serious deficiencies had been detected in past QC reviews, etc. As a result, they were not aware of the need to achieve integrated operations management, including integrating the two departments, or the need to develop an organized audit operational system, including employing more full-time staff.

As mentioned above, many of the root causes of deficiencies are ascribable to the operations management and quality control systems, and it is important to improve those environments in order to fundamentally remediate deficiencies.

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

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

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

To remediate deficiencies, it will be necessary for audit firms to tackle fundamental issues that affect the firm as a whole, such as issues relating to its operations management system and to ensure and improve audit quality with reference to these examples.

**[Large-sized audit firms]**

While large-sized audit firms have established quality control system, there are issues with the effectiveness of their operation.

Since large-sized audit firms have several thousands of employees, they usually have multiple audit divisions, consisting of several hundreds of staff managed by a division manager, etc., and multiple offices, including some regional offices.

Under such circumstances, in order to improve the quality control level across the entire organization, it is necessary not only for firms to design the organization and procedures of a quality control system, but also for the management, including the CEO, to demonstrate strong leadership, and for each division to instill the improvement measures into the engagement teams. At large-sized audit firms, however, deficiencies such as lack of leadership, including with respect to the management's awareness of quality control, and issues with initiatives by divisions etc.

In recent years, large-sized audit firms, in a bid to address these deficiencies, have, under the leadership of the management, been taking steps to improve audit quality, with the measures being implemented by PICOQCs, quality control departments, etc. Furthermore, to ensure that these quality improvement initiatives are implemented on a sustained basis, they tend to be shifting responsibility for quality control from head-office quality control departments to divisions etc., which are closer to the audit frontline. As a result, divisions etc. are playing a greater role in voluntarily improving audit quality and penetrating a quality-oriented mindset among engagement team members.

However, as the management and the quality control departments, etc. give precedence to the independence of each business division with regard to efforts to improve audit quality, they are leaving those efforts entirely in the hands of individual business divisions or neglecting to ensure sufficient communication with the divisions. As a result, issues occurred, including an insufficient understanding of the actual situation of each business division and an inadequate verification as to whether improvement measures are being appropriately implemented. Therefore, the management and quality control departments etc. need to appropriately identify the efforts being made in each business division and sufficiently examine the extent to which improvement measures have taken hold and how effective they are.

The following are specific examples of root causes of deficiencies at large-sized audit firms identified so far through the CPAAOB's inspections:

- The executive management team thought that the engagement partners would appropriately fulfill their own roles if the executive management team conveyed to the engagement partners the importance of being proactively involved in the audit engagements that they are in charge of and adjusted the operational workload of engagement partners. In addition, the executive management team thought thorough adherence to in-depth audit consideration and responses in particularly important areas would mean that audit teams would also respond appropriately in accordance with the degree of risk in other areas. Accordingly, the executive management team was unable to adequately confirm that measures to increase the sufficient and appropriate involvement of engagement partners in audit engagement that they are in charge of and improve audit quality among audit teams had taken hold. (With regard to root cause analysis regarding this example, also refer to [Large-sized audit firms] [Case 1] on p. 9)

- NEW **The management executives were not sufficiently aware of the need to check whether the Quality Control Headquarters, which was leading the remedial measures based on the results of the root cause analysis on the deficiencies identified in the previous CPAAOB inspection, and the partners in charge of quality control at the Audit Division were closely cooperating with each other in order to ensure that the remedial measures were implemented in line with their original intent and purpose and that the remediation made at the audit site were effective**. As a result, the partners in charge of quality control at the Quality Control Headquarters and the partners in charge of quality control at the Audit Division were not sufficiently cooperating with each other, so the penetration and effectiveness of the quality control remedial measures could not be sufficiently verified.– (With regard to root cause analysis regarding this example, also refer to [Large-sized audit firms] [Case 2] on p. 10).
- The management executives believed that, by repeatedly communicating the importance of appropriately identifying material risks at audited companies and conducting risk-focused audits through messaging and training, the engagement team would appropriately understand the level of audit procedures required under the current audit standards and respond to them. Moreover, it assumed that communicating to engagement partners the importance of proactive involvement in the audit engagements that they are in charge of would induce them to appropriately perform their role. As a result, adequate verification was not conducted as to the extent to which quality control measures had taken hold and how effective they were. (With regard to root cause analysis regarding this example, also refer to [Large-sized audit firms] [Case 3] on p. 10).
- NEW The management executives and the Quality Control Headquarters **believed that, if measures and monitoring were implemented to conduct specific and in-depth examinations of fraud techniques, etc. at each stage of sales transactions, measures to improve audit quality, including responses to fraud risk relating to revenue recognition, would permeate the audit frontline, and audit quality above a certain level would be secured for all engagement teams.** Therefore, they could not sufficiently verify the penetration and effectiveness of quality control measures.
- NEW The management executives and the Quality Control Headquarters **believed that all engagement partners and assistants to engagement partners had a full understanding of the significance and importance of the CPA registration system, and that they appropriately confirmed and aggregated CPA qualifications and the number of CPAs and engagement hours for each qualification when listing CPA qualifications and the number of CPAs and engagement hours for each qualification in materials submitted outside the firm**.

**[Mid-tier audit firms]**

Mid-tier audit firms are proceeding with the development of the quality control system. However, generally speaking, the headquarters functions have not been sufficiently strengthened. Furthermore, top managements' awareness about quality control has not kept up with the pace of the firms' expanded operations. In addition, some firms are heavily dependent on part-time staff in the performance of audit engagements, while others are facing audit quality issues at particular regional offices. On the other hand, founding history, operations management systems and size of operations are different firm by firm, so the root causes of issues differ from firm to firm.
As a result, each firm needs to analyze root causes and accelerate effective improvements in considerations with trends of its own operations, their operations management system, and so on.

The following are specific examples of root causes of deficiencies at Mid-tier audit firms identified so far through the CPAAOB's inspections:

- With operations expanding, the CEO was unaware that the headquarter organization was unable to consider the adequacy of personnel allocation and lacked awareness of the need to verify the adequacy and effectiveness of the quality control system. For example, the CEO thought that the enhancement of the headquarter organization's functions and improvement of the quality control system would be carried out appropriately if left up to the right people in charge at headquarters. Moreover, the CEO and the people in charge at headquarters failed to develop an adequate system for verifying the status of efforts to ensure quality control measures take hold in audit fieldwork and their effectiveness, even though engagement partners lacked sufficient awareness of their own responsibility for carrying out operations and the skill level of audit teams as a whole had not been raised to an adequate degree. (With regard to root cause analysis regarding this example, also refer to [Mid-tier audit firms] [Case 1] on p. 11)
- Operations are performed independently at each regional office. Specifically, matters such as the organization of engagement teams, the determination of partners' compensation, periodic inspections, and engagement quality control reviews are determined and implemented under an independent operations management system at each regional office. Furthermore, exchange of partners and staff among different regional offices has been hardly made. Given this situation, the CEO recognizes the need for integrated business administration within the firm, and is taking steps to achieve this, such as strengthening headquarters functions. However, because the role of headquarters is not clearly prescribed in organizational rules etc., and there are no full-timers assigned to headquarters, the functions of headquarters has not been effective, so the steps being taken are inadequate to ensure integrated business administration. (With regard to root cause analysis regarding this example, also refer to [Mid-tier audit firms] [Case 2] on p.11)

- The CEO placed emphasis on the need to foster personnel responsible for maintaining and improving audit quality when planning and implementing measures to improve audit quality. Moreover, since becoming the representative of the audit firm, the CEO had refrained from exercising overly strong leadership and placed emphasis on the independence of activities of the quality control and audit divisions. As a result, there was a lack of awareness of the need to accelerate the improvements of quality management system.
  The executive management team assumed that cooperation between the quality control division and audit divisions would be ensured by sorting out and sharing issues through discussions at executive management meetings. Thus, the executive management and respected the independence of each division, in order to take steps to improve audit quality. As a result, there was lack of awareness of the need for strong cooperation between these two divisions. Furthermore, although the executive management team was aware of audit quality issues at some particular regional offices, it assumed that the regional offices would be able to make improvements on their own. As a result, there was a lack of awareness of the need to actively support regional offices, for example by allocating the human resources necessary for making improvements. (With regard to root cause analysis regarding this example, also refer to [Mid-tier audit firms] [Case 3] on p.12)
- NEW The members of the Management Committee were convinced that the human and time resource issues had been resolved through such measures as changing the allocation of audit engagements to personnel, introducing monitoring of the percentage of engagement partners involved, and increasing the number of assistants to engagement partners. As a result, the PICOQC and the head of the audit business unit **did not recognize the need to verify the sufficiency of human and time resources for each audit engagement based on an accurate understanding of the situation on the audit frontline**.
- NEW The members of the Management Committee and the PICOQC were not aware that the attitude of carefully examining whether or not there were fraud risks to be identified when performing individual audit engagements, the attitude of critically examining material assumptions, etc. adopted by management, and the attitude of the EQC reviewer and the monitoring partner, etc. to objectively evaluate the views of the engagement team had not improved since the previous CPAAOB inspection. **They were convinced that implementation of remedial measures in response to the results of the previous CPAAOB inspection would improve and enhance quality control at the firm as a whole, and lacked awareness of the need to understand and verify their effectiveness in detail**.

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

Small and medium-sized audit firms come in various sizes and have different founding history, and levels of establishment and implementation of quality control system also differ from firm to firm. However, their organizations are relatively small, and they all face the difficulty of providing audit teams with organizational support in areas such as quality control. A key characteristic of the firm, therefore, is that business administration and quality control levels, in many cases, are highly dependent on the abilities of personnel that belong to the audit firm, including the CEOs, and the relationship between the personnel and the firm.

Because of this, low awareness of and involvement in quality control by the CEOs often affect the culture of quality control throughout the audit firms, so it is important for the CEOs to demonstrate leadership in quality control. One characteristic trend identified in recent inspections is that the CEOs and the PICOQCs were "not aware of a lack of understanding among all audit team members, including themselves, of the current audit standards and the levels of quality control and audit procedures required by the standards." Another is that the CEOs and the PICOQCs "did not sufficiently understand the depth and methods of analysis of causes necessary for preventing deficiencies similar to the ones detected in the QC reviews, etc."

The root causes of deficiencies identified in the CPAAOB's inspections of small and medium-sized audit firms can be broadly categorized into the following three types:

・Cases related to a lack of awareness about quality control among CEOs and PICOQCs.
・Cases ascribable to changes in audit firms' management environment, such as mergers etc.
・Cases ascribable to audit firms' organizational climate

**(1) Cases related to a lack of awareness about quality control among CEOs and PICOQCs**

NEW

- The CEO and the PICOQC **did not conduct a fundamental analysis of the causes of deficiencies based on the recognition that the deficiencies identified in past quality control reviews did not include significant matters. Instead, they were convinced that if internal rules and checklists for remedial measures were prepared and the contents of these checklists were communicated through training programs and general meetings, audit engagements would be conducted in accordance with these rules, and audit quality would improve accordingly**.
  Furthermore, the CEO and the PICOQC **did not exercise leadership in improving audit quality**. For example, they did not recognize the need to verify the implementation of remedial measures implemented by persons in charge of EQC reviews and periodic inspections. In addition, engagement partners did not recognize the need to confirm the implementation of remedial measures on the audit frontline on their own responsibility. **As a result, awareness of maintaining and improving audit quality throughout the firm was weak**.
  Furthermore, the CEO and PICOQC did not recognize that professional staff, including themselves, lacked an understanding of the level of procedures required by the current audit standards. (With regard to root cause analysis regarding this example, also refer to [Small and medium-sized audit firms] [Case 1] on p.12)
- The CEO lacked awareness to design, implement and maintain of quality control systems that emphasize audit quality. For example, when evaluating partners, the CEO did not put more emphasis

on the quality of audit engagements for which partners were responsible for an engagement partners than the number of companies for which partners were responsible as engagement partners or engagement quality control reviewers (EQCRs) were responsible or the number of companies newly accepted new audit contracts which partners got.

- NEW Each partner, including the CEO, did not take a stance of critically examining the quality of individual audit engagements performed by other partners, and thus lacked awareness of the need to improve and enhance audit quality at the firm as a whole. As a result, **when reviewing audit documentation, examining audit engagements, conducting periodic inspections, and implementing remedial measures for issues pointed out in quality control reviews, they did not adequately fulfill their responsibilities and roles as partners for improving and enhancing audit quality at the firm as a whole**.
- The CEO gave top priority to releasing unqualified opinions until the filing due dates of the audit reports and did not exercise due care as a professional specialist. He also did not recognize the need to fulfill the roles and responsibilities as an audit firm expected by society in providing assurance to the reliability of financial statements. Other engagement partners, including the PICOQC, shared the CEO's thoughts and failed to check other engagement partners, including the CEO.
- NEW Under these circumstances, each partner, including the CEO, **did not proactively engage in audit engagements when performing individual audit engagements, and professional staff, including the CEO, did not recognize the lack of understanding of audit standards and the level of procedures required under current audit standards**. As a result, there was a lack of awareness of the importance of audit quality.
- The CEO did not appropriately evaluate the quality of individual audit engagements and the professional skills of professional staff, even though the most recent quality control review had identified relevant significant deficiencies. He had partners with insufficient understanding and knowledge of the quality levels required under current audit standards serve as engagement partners or engagement quality control reviewers (EQCRs) of listed companies for many years, and had not established an effective quality control system.
- NEW The CEO and the PICOQC **were convinced that an understanding of the level of procedures required by the current audit standards was sufficiently widespread within the firm through the hiring of CPAs who had worked at large-sized audit firms and through the training that the audit firm required them to attend**. Furthermore, **the PICOQC believed that partners and employees would appropriately use tools for improving audit quality,** such as forms for audit documentation and "self-inspection checklists," **as long as these tools were provided, and that there was no need to directly check the use of these tools**. As a result, the PICOQC did not take an attitude toward maintaining and improving audit quality.
- The PICOQC is replaced every two years, but the current PICOQC believes that his main role is to continue conducting periodic inspections, as his/her predecessor did. He/she therefore lacks awareness of the need to proactively get involved in quality control as a whole. Because of this,

he/she is not properly fulfilling his/her role of managing quality control. For example, he/she is not providing adequate instructions to staff involved in quality control. Furthermore, even though the CEO has been aware of this situation with quality control, he/she has not attempted to establish a more effective quality control system.

**(2) Cases ascribable to changes in audit firms' management environment, such as mergers etc.**

- The CEO did not sufficiently understand the required levels of the operations management system and quality control system suited to the audit firm's expanded size after the merger and assumed that post-merger quality control at the audit firm could be handled to a certain degree using the management methods employed before the merger. Accordingly, the CEO lacked awareness of the need to take prompt action to develop organized operations management system and quality control system. (With regard to root cause analysis regarding this example, also refer to [Small and medium-sized audit firms] [Case 2] on p.13)
- The audit firm had gone through a merger in recent years, but despite the need to implement integrated corporate management in respect of such matters as personnel evaluations, compensation, and the organization of engagement teams, the CEO was not aware of the importance of completing this process without delay.
- As the audit firm increased its audit engagements of listed and other companies, the audit engagement risk had been rising. However, the CEO failed to exercise leadership as a quality control manager in developing a quality control system, as indicated by a lack of commitment to conduct appropriate risk assessment of continuous and newly contracted audited companies.
- The number of audit engagements had increased every fiscal year and new audit contracts had recently been concluded with high-risk listed companies. However, only a small number of partners are serving as full-time audit team members, and the audit firm was dependent on part-time staff as assistants to engagement partners. As a result, the partners were preoccupied with the audit engagements that they are in charge of and failed to sufficiently involve themselves in quality control operation.

**(3) Cases ascribable to audit firms' organizational climate**

- Although the audit firm is small, its audit division has comprised two departments since its foundation, with audit engagements and financial and personnel affairs of each department independently managed. This has resulted in the development of an organizational culture that gives precedence to the independence of each department. Furthermore, only engagement partners work on a full-time basis, while all staff are certified public accountants and substantially all work part-time.

  Under these circumstances, the CEO and the PICOQC were not aware of a lack of understanding among all audit team members, including themselves, of the purposes of the current audit standards and the levels of quality control and audit procedures required by the current audit standards.

Moreover, they assumed that there was no issue with the current organizational structure that had been maintained since the firm's foundation, since no serious deficiencies had been detected in past QC reviews, etc. As a result, they were not aware of the need to achieve integrated operations management, including integrating the two departments within the audit division, or the need to develop an organized operations management system, including employing more full-time staff. (With regard to root cause analysis regarding this example, also refer to [Small and medium-sized audit firms] [Case 3] on p.13)

- The audit firm was pursuing operational improvements after being issued with a Business Improvement Order (improvement of operations management system) by the FSA and receiving recommendations for improvements several times in QC reviews.
  Amid this situation, each partner at the audit firm had been engaged in non-audit services at their own private firms, etc. to a considerable degree and generally lacked awareness of the maintenance and improvement of audit quality at the firm. Accordingly, they were not aware of the aforementioned order or recommendations for improvements being problems relating to the fundamentals of operations management. Moreover, the CEO and PICOQC lacked the awareness to develop an environment that would enable the quality control system to function effectively. For example, they did not demonstrate leadership in respect of improving audit quality. Furthermore, each partner at the firm lacked awareness of their position as partners in regard to operations management. For example, they were not aware of the need to monitor the state of quality improvements in individual audit engagements in which they were not involved. Thus, an organizational culture conducive to the maintenance and improvement of audit quality, in which partners keep each other in check, had not been fostered at the audit firm and it did not have system in which audits could be carried out systematically.
- The CEO thought that as long as the CEO, the person responsible for EQCR, and the PICOQC considered important matters for discussion, there was no need to share information with other partners. As such, the CEO did not strive to foster an organizational culture conducive to the maintenance and improvement of audit quality based on collaborative efforts by the all partners, including them, and thus did not develop system in which audits could be carried out organizationally.
- Partners at the audit firm had spent many years working on audit engagements for a particular listed audited company. Amid this situation, they demonstrated a lack of commitment to carefully discerning audit risk in light of such matters as the nature of audited company and its environment.
- The audit firm, which comprises a small number of partners and their assistants who have little experience of audit engagement at other audit firms, has maintained the management environment that has continued since its foundation. For many years, the firm has mainly audited several listed companies, and as a result, the ratio of fees received from those audited listed companies to the firm's overall revenue (fee dependency) is high.

Under these circumstances, the CEO, who concurrently serves as PICOQC, had placed top priority on maintaining the relationships with audited companies that had continued since before the firm's foundation and assumed that there was no issue with the performed audits and the firm's management because no changes had been made to the composition of audited companies. In addition, the CEO/PICOQC was not aware of the need to place emphasis on audit quality and the required qualifications for certified public accountants, such as professional ethics and independence. He was also not aware of the need to develop organized operations management and quality control systems. Moreover, as the autocratic management of the firm by the CEO/PICOQC had become entrenched, other partners were not aware of the need to perform their duties.

- The audit firm comprises two audit departments, and each department's audit engagements, and financial and personnel affairs are managed independently by the representative partner, head of each department. The organizational climate, which prioritizes independence of each audit department, has been fostered, such that the representative partner of each audit department is in effect appointed by the previous representative partner. The audit firm has designated the CEO as the person with the ultimate responsibility for quality control, but the CEO has not set forth a policy for achieving integrated quality control or demonstrated sufficient leadership in establishing an effective headquarters organization.
- The audit firm was established by partners who were colleagues at a large-sized audit firm. As the audit firm is comprised of a small number of partners, the CEO and PICOQC have a grasp of the capabilities of individual partners and are assuming that the partners are exercising their capabilities. In addition, since no significant deficiency has been pointed out to the audit firm in quality control reviews so far conducted, perception of the CEO and PICOQC is that the necessary minimum quality control system appropriate to the size of the audit firm has been developed. Accordingly, they were not sufficiently aware of the need to develop an organized quality control system.
- NEW The partners and employees of the audit firm were extremely lacking in awareness of the importance of integrity and trustworthiness as professionals. As a result, **the audit firm conducted inappropriate response in all individual audit engagements subject to inspection by the CPAAOB. The partners and employees thus lacked awareness of the need to perform their duties in compliance with laws and regulations, ethical rules, internal rules, etc. As a result, the CEO was unable to develop an organizational culture that emphasizes compliance with professional ethics**.

## 2. Response to the Audit Firm Governance Code

In light of the socio-economic conditions surrounding accounting audits, the Act for Partial Amendment of the Certified Public Accountants Act and the Financial Instruments and Exchange Act was enacted and promulgated in May 2022. The act introduced a registration system for audit firms that audit listed companies in order to ensure the reliability of accounting audits and to contribute to the further demonstration and improvement of the capabilities of CPAs. The related government orders were promulgated in January 2023 and came into effect in April of the same year. As a result, audit firms that audit listed companies are obliged to establish a framework for conducting operations in accordance with the Audit Firm Governance Code and a framework for conducting enhanced information disclosure.

The Audit Firm Governance Code was established in 2017. Based on the above laws and regulations, the Expert Review Committee on the Audit Firm Governance Code held discussions and revised the Audit Firm Governance Code in March 2023 to require effective disciplines suited to the scales and natures of audit firms. The purpose of the revision was to: (I) encourage small and medium-sized audit firms that conduct audits of listed companies to make arrangements suited to their acceptance of the code and disclose information to the public; and (ii) enhance disclosure in response to the globalization of audit firms.

The Audit Firm Governance Code has been formulated with organizational business administration in mind at audit firms that conduct audits of listed companies, etc., but it does not preclude other audit firms from voluntarily applying it. On this basis, each audit firm is required to take an autonomous approach based on its size and characteristics to implement the Audit Firm Governance Code and achieve effective organizational management.

In addition, we have published information about responses based on the size of audit firms in the form of the "2023 Monitoring Report". Please also refer to this report.

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

The Business Accounting Council of Japan published an opinion letter on the revision of quality control standards for audits ("Quality Control Standards") (November 16, 2024). The opinion letter included the introduction of a quality management system (a management method in which audit firms: (I) set quality objectives; (ii) identify and assess quality risks that hinder the achievement of quality objectives; (iii) define and implement policies or procedures to address the assessed quality risks; and (iv) make remediations based on root cause analysis if there are deficiencies), based on the revisions of international quality control standards such as "International Quality Management Standard 1" (Quality Management at Audit Firms - ISQM1), "International Quality Management Standard 2" (ISQM2), and "Quality Control for Financial Statement Audits" (ISA220). The revised quality control standards are required to be implemented from the audits of financial statements for fiscal years or accounting periods starting on or after July 1, 2023 (for audit firms other than large-scale audit firms under the Certified Public Accountants Act, for fiscal years or accounting periods starting on or after July 1, 2021).

In February 2023, the JICPA published Quality Control Standards Statement No. 1, Practical Guidance No. 3 (Q & A on Quality Control at Audit Firms and Audit Engagements, and Reviews of Audit Engagements) and Quality Control Standards Statement No. 1, Practical Guidance No. 4 (Tools for

Quality Control at Audit Firms) as practical guidelines necessary for applying the revised quality control standards.

In addition, we have published information about responses based on the size of audit firms in the form of the "2023 Monitoring Report". Please also refer to this report.