

Provisional Translation

2018 Monitoring Report

Certified Public Accountants and Auditing Oversight Board
July 2018

Introduction

Since 2016, the Certified Public Accountants and Auditing Oversight Board (“CPAFOB”) has been annually releasing a Monitoring Report with the aim of providing readily comprehensible information on audit firms not only to auditors and accounting experts but also to market participants and general users. Turned into a publication of its own independent from the Case Report from Audit Firm Inspection Results, the 2017 Monitoring Report incorporated revisions such as the addition of data on the landscape of audit firms and audited companies and information obtained through the CPAFOB’s monitoring activities.

In the 2018 monitoring report, we made following revisions:

As with the 2017 edition, the report has been divided into three sections (I – III), but its structure has been revamped as follows.

Section I has been renamed “Overview of the Audit Sector”, and its content combines part of the 2017 edition’s Section I (“Overview of Quality Control at Audit Firms”) with Section II (“Overview of the Audit Sector”). The introductory overview of the audit sector at present provides readers with a good general perspective.

Section II has been renamed “Monitoring by the CPAFOB,” taking “CPAFOB’s Monitoring”, an item within Section I (“Overview of Quality Control at Audit Firms”) of the 2017 edition and making it its own section. This will complement the monitoring information posted and make it easier to understand the CPAFOB’s activities.

Section III (“Operation of Audit Firms”) focuses on updating the data from the 2017 edition. In view of the importance of the Audit Firm Governance Code and the use of IT and other current approaches being taken by audit firms, information on these have been added as new items.

To improve audit quality, the CPAFOB believes it is important for the audit & supervisory board as well as investors and other market participants to deepen understanding on accounting audits. We welcome your opinion and request for further enhancement of the content of the monitoring report.

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(Abbreviations)

Abbreviations used in this Report shall be defined as follows:

| | |
|----------------|---|
| CPAAOB | Certified Public Accountants and Auditing Oversight Board |
| FSA | Financial Services Agency |
| 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 Statement No. 1 |
| ASCS | Auditing Standards Committee Statements |

(Terms)

Terms used in this Report shall be defined as follows:

| | |
|------------------------|---|
| 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, and solo practitioners |
| Large-sized audit firm | Audit firms that have 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, Ernst & Young ShinNihon LLC, Deloitte Touche Tohmatsu LLC and PricewaterhouseCoopers Aarata LLC. |
| Second-tier audit firm | An audit firm whose business scale is second only to large-sized audit firms. In this report, this will refer to five audit firms: Gyosei & Co., BDO Sanyu & Co., Grant Thornton Taiyo |

LLC, Crowe Toyo & Co., and PricewaterhouseCoopers Kyoto.

(Note) Yusei Audit & Co. had been included among

second-tier audit firms until PY2017, but it merged with

Grant Thornton Taiyo LLC as of July 2, 2018. The data in

this Report distinguishes between Grant Thornton Taiyo

LLC and Yusei Audit & Co.

| | |
|--|---|
| Small and medium-sized audit firm | Audit firms other than large-sized and second-tier audit firms |
| Small and medium-sized audit firm, partnership and solo practitioner | Small and medium-sized audit firm including partnership and solo practitioner |
| Domestic listed company | Listed companies other than foreign companies |
| Audited company | Companies that undergo audits |
| Audit Firm Governance Code | "Principles for Organizational Operation of Audit firms" published by the FSA on March 31, 2017 |
| Big 4 global accounting firms | The global networks of the four largest accounting firms: Deloitte Touche Tohmatsu, Ernst & Young, KPMG, and PricewaterhouseCoopers |
| 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 |

(Sources)

Where sources are not indicated, the information has been prepared based on data on audit firms obtained by the CPAAOB in the course of its monitoring activities.

(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 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)

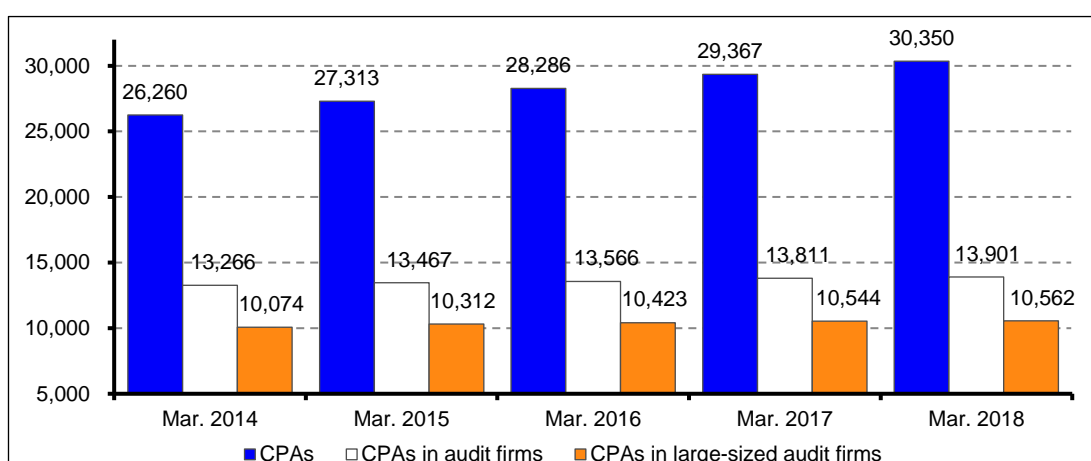
“A certified public accountant shall always maintain his/her dignity, endeavor to acquire knowledge and skills, and provide services with fairness and integrity from an independent standpoint.” (Article 1-2)

2. CPAs

A person wishing to become a CPA must pass the CPA examination, satisfy certain requirements (completing an internship and a professional accountancy education program, etc.), and be registered in the JICPA's list (Articles 3, 17, and 18 of the CPA Act).

The number of registered CPAs has been gradually increasing over the past few years. Although a growing number belong to audit firms, their proportion of the overall total of registered CPAs has dropped year by year from 50.5% at the end of March 2014 to 45.8% at the end of March 2018. Of the registered CPAs belonging to audit firms, 75.9% work at large-sized audit firms (Figure I-1-1).

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

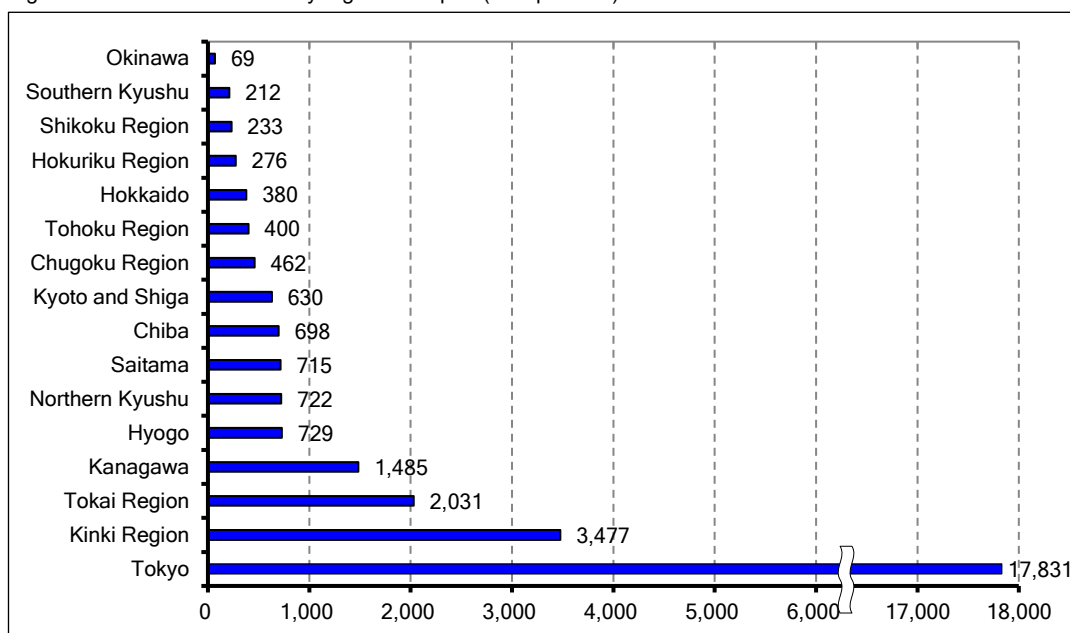


(Source) JICPA, CPAAOB (Note)

(Note) The number of persons belonging to large-sized audit firms has been collected from operational reports, etc., submitted by audit firms.

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 2018). Chapter membership among CPAs is concentrated in the Tokyo metropolitan area (Tokyo, Kanagawa, Saitama, Chiba), accounting for about 70% of the total (Figure I-1-2).

Figure I-1-2: Number of CPAs by regional chapter (unit: persons)

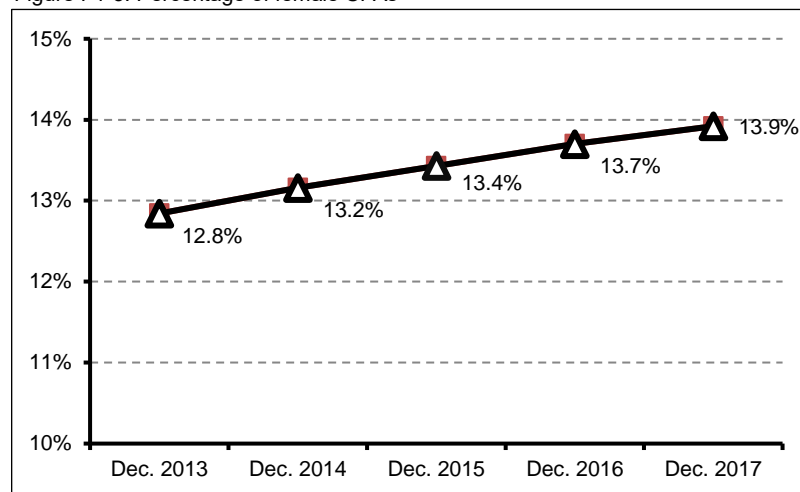


(Source) JICPA (as of end of March 2018)

3. Percentage of Female CPAs

There has been a gradual increase in the percentage of women among the total number of registered CPAs over the past recent years, but this figure is still short of 14%, lower than the percentages of female attorneys¹ (18.4%) and female tax accountants² (14.4%) (Figure I-1-3). Women comprise 40% of CPAs in the US³ and 35% in the UK⁴.

Figure I-1-3: Percentage of female CPAs



(Source) JICPA

¹ White Paper on Attorneys 2017

² Zenkoku Josei Zeirishi Renmei website (as of May 31, 2018)

³ AICPA "2017 Trend Report", US CPAs working at accounting firms in 2016

⁴ Financial Reporting Council, "Key Facts and Trends in the Accountancy Profession 2017" (the UK has multiple accounting associations, and this figure is the average for these associations)

B. Audit Firms

Audit firms, i.e., CPA firms engaged in providing audit and attestation services, numbered 2,021 at the end of March 2017, 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 law. When CPA audits were first introduced, the only statutory audits were FIEA audits, but thereafter educational corporation audits were introduced under the Act on Subsidies for Private Schools, and CPA audits under the Companies Act. There are now a multitude of statutory audits, including audits of labor unions, credit unions, social welfare corporations and medical corporations, etc. A more detailed explanation of audit and attestation services is provided on page 25 (“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 by a group of persons including five or more CPAs for the purpose of organizationally performing audit and attestation services. The audit firm system was created in 1966 since 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. Numerous incidents of fraudulent accounting were occurring at the time, bringing into question the *raison d'être* of CPAs. It was thus expected that conducting organizational audits would improve level of audit. The CPAAOB classifies audit firms by scale into large-sized audit firms, second-tier audit firms, and small to medium sized audit firms.

The 2,021 firms were classified as shown below (Figure I-2-1), and the CPAAOB mainly monitors those firms conducting FIEA audits (audits of domestic listed companies).

Figure I-2-1: Classifications of audit firms (as of March 31, 2017)

| Audit firm | Number of firms | Statutory audits | | | Voluntary audits |
|---|------------------------------------|----------------------|----------------------|-------|------------------|
| | | FIEA audits (Note 3) | Companies Act audits | Other | |
| Large-sized audit firms | 4 | ○ | ○ | ○ | ○ |
| Second-tier audit firms | 6 | ○ | ○ | ○ | ○ |
| Small and medium-sized audit firms, partnerships and solo practitioners | 2,011 | ○ (Note 4) | ○ | ○ | ○ |
| (Breakdown) | Small and medium-sized audit firms | (212) | | | |
| | Partnerships (Note1) | (48) | | | |
| | Solo practitioners (Note 1) | (1,751) | | | |

(Note 1) The number of audit firms as of FY 2016 (closing date between April 1, 2016 and March 31, 2017) listed in the audit summaries or audit implementation reports submitted to the JICPA in accordance with the Rules on Submission of Statutory Audit-related Documentation, etc.

(Note 2) The symbol “○” in the table indicates that these audits can be conducted.

(Note 3) Audit firms must register with the JICPA in order to audit domestic listed companies. For further information, see “JICPA’s Registration System for Listed Company Audit Firms” (page 29).

(Note 4) Stock exchanges require solo practitioners to undergo audit certification by two or more CPAs (Securities Listing Regulations).

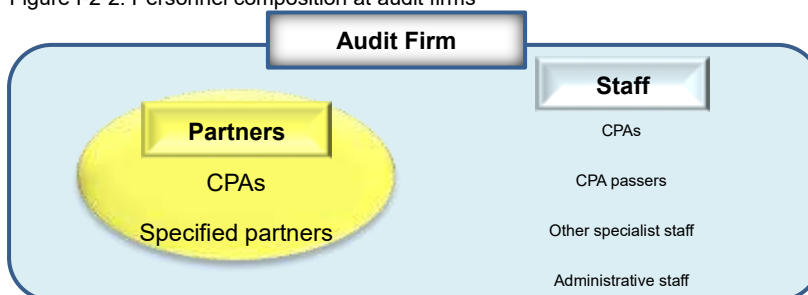
1. Organizational Structure of Audit Firms

Audit firms are established through investment by groups including five or more CPAs, and their defining characteristics are that the partners/investors 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, CPA passers, and other experts as staff.

A partner is required to have a wide range of knowledge including management, law, IT, pension mathematics to ensure appropriate operational management and to provide effective organizational audit services. Accordingly, the CPA act initially allowed that only CPAs were brought on as partners by audit firms. After 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. The FY2016 operational reports of large-sized audit firms indicate 125 specified partners among a total of 1,878 partners.

The personnel composition of an audit firm is outlined below (Figure I-2-2), and explained in more detail in “III. Operation of Audit Firms.”

Figure I-2-2: Personnel composition at audit firms



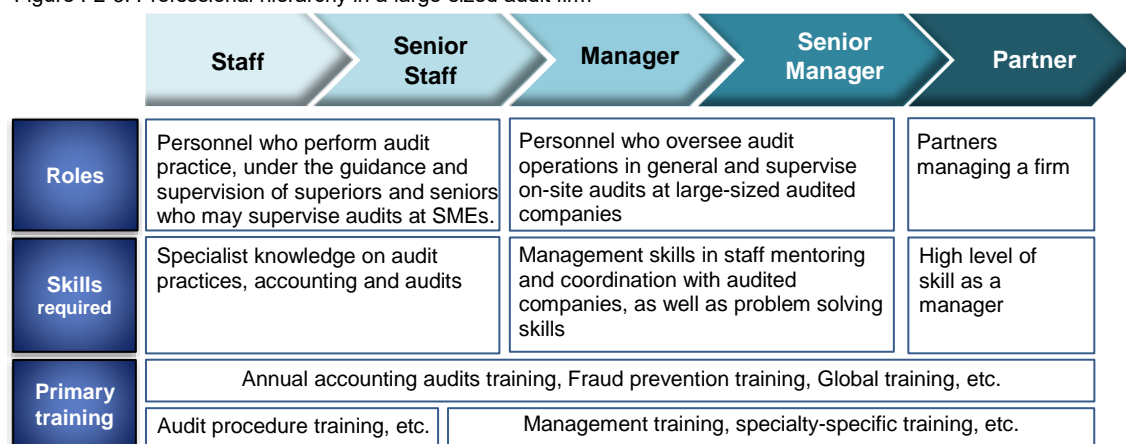
| | Large-sized audit firm | Second-tier audit firm | Small and medium-sized audit firm |
|-----------------|---------------------------|---------------------------|---|
| Partners | More than 100 | Up to 100 | Up to 30 |
| Full-time staff | More than 2,500 | Up to 600 | Up to 50 |

(Note) 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.

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 second-tier audit firms now frequently have more than 100 people. The difficulties that have surfaced in recent years with regard to ensuring audit quality can be attributed to audit firms' inability to fully cope with this expansion in scale and the rising complexity of organizational management. Therefore, the FSA formulated the Audit Firm Governance Code.

As audit firms grow in scale, they introduce job classification system defined by experience, abilities, etc. (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.

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



(Note) For details, see "III. Operation of Audit Firms, A. Operations Management Environment and Environment Developed under the Audit Firm Governance Code, 4. Organizational Structure for Providing Audit Services" (page 61) and "5. Organizational Structure for Supporting Audit Services" (page 64).

2. Development of Quality Control Structures by Audit Firms

To ensure audit quality, it is important that audit firms have their partners perform audit services properly, and develop/administer appropriate quality control structures.

Following revisions made in 2003, the CPA Act legally mandated that an audit firm shall develop the operation control structure in order to perform its services fairly and accurately, and the revisions made in 2007 clarified that the following must be included in the operation control structure (Article 34-13 (2) of the CPA Act):

- a. Measures for securing the fair execution of services
- b. Formulation and implementation of policy on service quality control
- c. Measures for eliminating the possibility of persons other than partners who are CPAs from having an inappropriate influence on the execution of audit and attestation services provided by partners who are CPAs

The 2007 revision of the CPA Act thus transformed the formulation and implementation of the service quality control policy into legal obligations for audit firms as part of their development of the operation control structure. Service quality control means to take the necessary measures for preventing the occurrence of a situation that would impair the appropriateness, fairness or credibility of services (Article 34-13 (3) of the CPA Act).

A Cabinet Office Ordinance (the Ordinance for Enforcement of the Certified Public Accountants Act) specifically stipulates the following regarding matters concerning the implementation of services (Article 26 of the Ordinance):

- a. Observance of professional ethics and securing of independence with regard to services
- b. Conclusion and renewal of contracts pertaining to services
- c. Employment, education, training, evaluation, and appointment of partners in charge of services and any other persons
- d. Implementation of services and reviews thereof (including the following matters)
 - Consultation of expert opinions (solicitation of opinions on specialist matters from persons having expert knowledge and experience with regard to the services)
 - Resolution of differences of opinion in audits (differences in determinations between the persons implementing the audit and attestation services or between such persons and persons engaging in a review of the audit and attestation services)
 - Reviews of audit and attestation services

The aforementioned regulations on service quality control have been consistent with the “Quality Control Standards for Audits” (2005), incorporating all six component elements of these quality control standards: a. responsibility for quality control, b. professional ethics and independence, c. conclusion and renewal of audit contracts, d. employment, education, training, evaluation and appointment of engagement teams, e. implementation of services, and f. monitoring of the system of quality control.

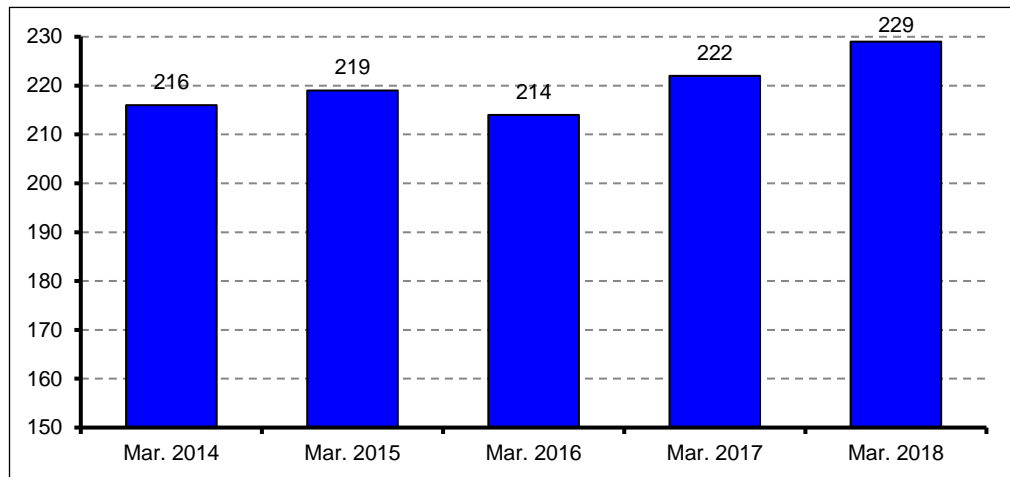
Furthermore, the “Quality Control Standards on Audits” were formulated for audit and attestation services, but the services requiring development of quality control as part of firm’s operation control structure are not limited to audit and attestation services but encompass all of audit firm’s operations. Consequently, audit firms need to comply with professional ethics in their services other than audit and attestation services as well.

3. Number of Audit firms

The number of audit firms has been in an uptrend since the end of March 2016.

Four firms were dissolved and 11 established in the period April 2017-March 2018, producing a net increase of seven firms (Figure I-2-4). See “4. Mergers” (page 21) for details on mergers.

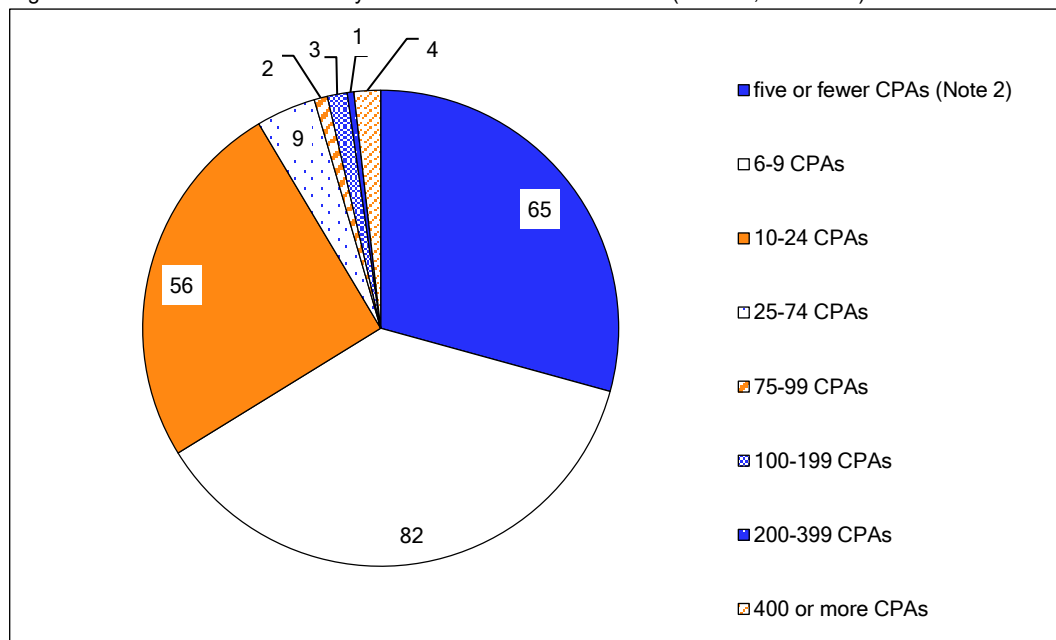
Figure I-2-4: Change in the number of audit firms (unit: firms)



(Source) JICPA

A look at the distribution by the number of full-time CPAs belonging to each audit firm reveals that firms with fewer than 25 CPAs make up 90% of the total (Figure I-2-5).

Figure I-2-5: Number of audit firms by scale in terms of full-time CPAs (FY2016; unit: firms)



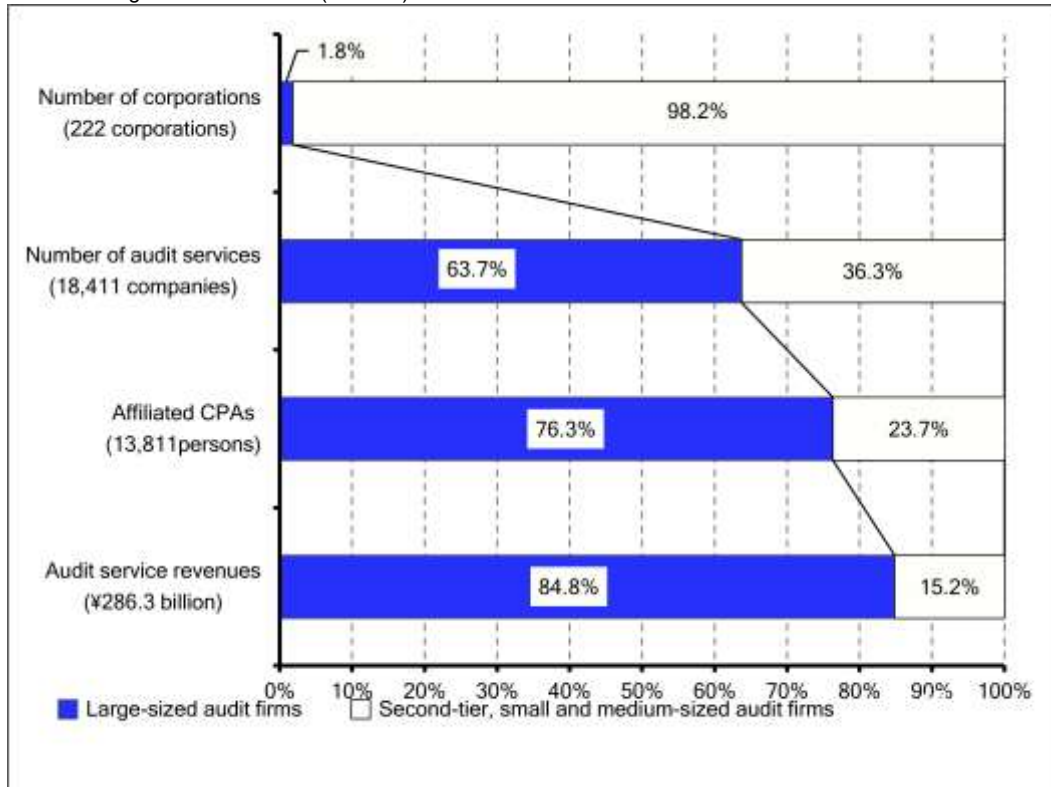
(Note 1) Data on 222 audit firms was collected from operational reports submitted by these firms in FY2016.

(Note 2) An audit firm whose CPA count drops to fewer than five should be dissolved, but only after the count has remained at this level for six months.

■ Concentration in Large-sized Audit Firms ■

A look at 222 audit firms at the end of FY2016 shows that audited companies, CPAs, revenues, etc., are concentrated in large-sized audit firms.

Share of large-sized audit firms (FY2016)



(Note 1) Data was collected from FY2016 JICPA's member information and operational reports submitted by audit firms

(Note 2) In FY2016, one firm changed its fiscal year-end from March to June, thus its FY2016 service revenue is not available. Instead, FY2015 data has been used for the number of audit and attestation services and operating revenue for this firm.

4. Mergers

There have been 11 mergers of audit firms since FY2013 (Figure I-2-6), carried out for such reasons as increasing scale to reinforce management infrastructure and aiming to expand operating territory.

Figure I-2-6: Audit firms involved in mergers from FY2013

| FY | Surviving firm | Disappearing firm |
|------|---|--|
| 2013 | Grant Thornton Taiyo ASG LLC (Grant Thornton Taiyo LLC) | Kasumigaseki Audit Corporation |
| 2014 | Gravitas Co. Osaka | Daido Audit Firm |
| | Osaka Audit Corporation (PKF Hibiki Audit Corporation) | Pegasus Audit Corporation, Shimbashi & Co. |
| | Gyosei & Co. | MEIWA Audit Corporation |
| | Seishin & Co. (SeishinShisei & Co.) | Keiwa Accounting Office |
| 2015 | Shisei Audit Corporation (SeishinShisei & Co.) | Seishin & Co. |
| | Meiji Audit Corporation. (ARK MEIJI AUDIT & Co.) | ARK & Co. |
| 2016 | ARK MEIJI AUDIT & Co. | Hijiribashi Audit Corporation |
| | Seiyo Audit Corporation | Kudan Audit Corporation |
| 2017 | (No mergers) | |
| 2018 | Grant Thornton Taiyo LLC | Yusei Audit & Co. |
| | Toho Audit Corporation | Aoyagi Accounting Office |

(Note) As of July 2, 2018, names in parentheses show the current name of the surviving firm.

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

The Collection of Reports indicates that approximately half of second-tier audit firms are considering mergers as a potential business strategy for the future.

According to the Collection of Reports for 43 small and medium-sized audit firms implemented in PY2017, only 5% of these firms were considering mergers, and these were all relatively larger firms.

5. Finance (Operating Revenue and Proportion of Audit and Non-audit Service Revenue)

In addition to audit services, audit firms offer non-audit services that include financial advisory services, such as IPO advisory services, IFRS and accounting change services, and organizational restructuring services including M&A.

a. Operating revenue

Operating revenues for large-sized and second-tier audit firms are in an uptrend, but those of small and medium-sized audit firms have been on the decline since FY2014. Second-tier and small and medium-sized audit firms have heavily depended on revenues from audit services which provide 90% of the operating revenues (Figure I-2-7).

b. Audit service revenue

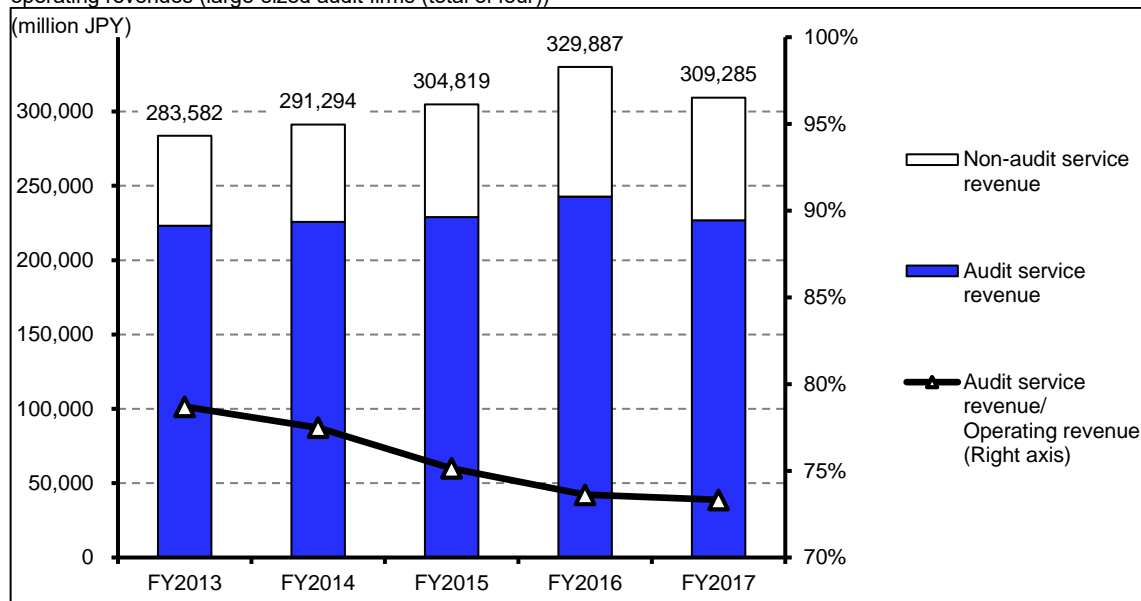
For one large-sized audit firm that changed their fiscal year-ends in FY 2017, the CPAAOB extrapolated its eight-month earnings report figure to twelve months and then externally confirmed operating revenue trends by component factor. It became apparent that audit service revenues were in an uptrend for large-sized and second-tier audit firms. For small and medium-sized audit firms, however, audit service revenues have continued downward since their peak in FY2012.

c. Non-audit service revenue

Non-audit service revenues of large-sized audit firms have continued to trend upward after modification in the same manner to audit service revenues as shown above. Because the rate of increase for audit service revenue is lower than that for non-audit service revenues, the proportion of audit service revenues to total operating revenues has been declining for the past few years.

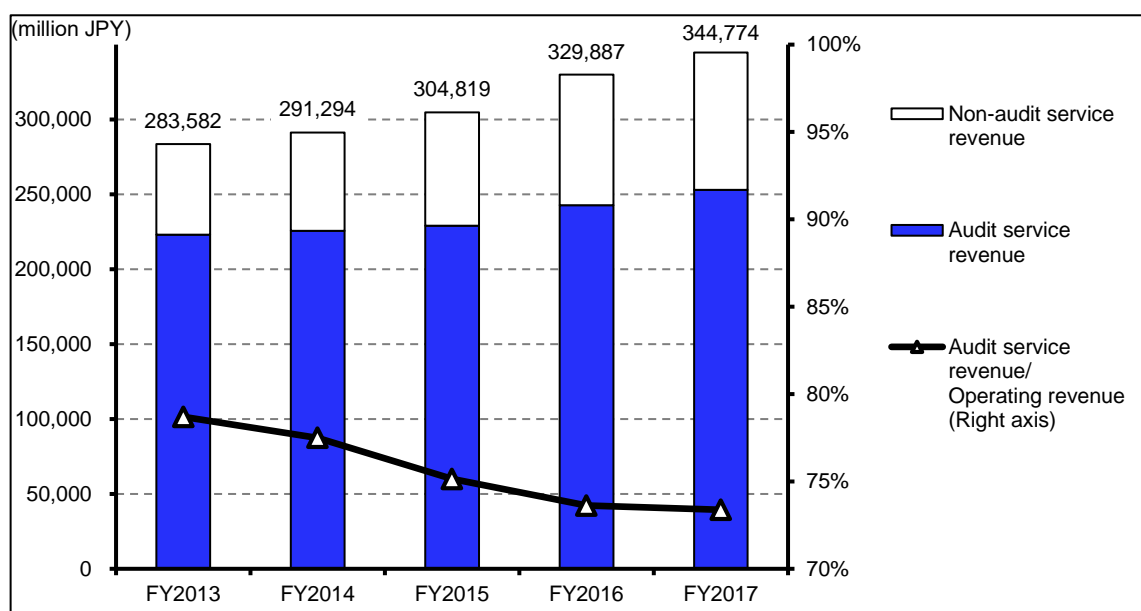
Revenue from non-audit services has been a gentle uptrend over the past few years while the revenue fluctuates.

Figure I-2-7: Operating revenues, breakdowns of operating revenues, and proportions of audit service revenues to total operating revenues (large-sized audit firms (total of four))

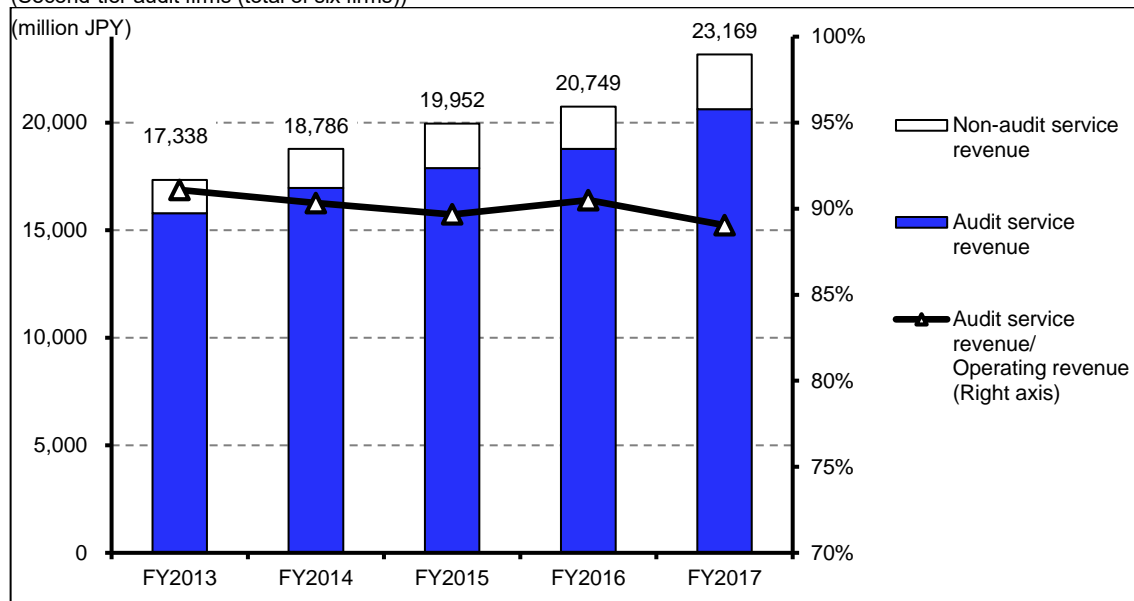


(Note) In FY2017, one audit firm changed its fiscal year-end, so calculations are based on eight-month figures.

(Reference) When extrapolating eight-month operating revenues to one-year periods (by multiplying figures by 12 months/8 months) for the audit firm that changed its fiscal year-end, the changes in revenues over time are estimated as follows:

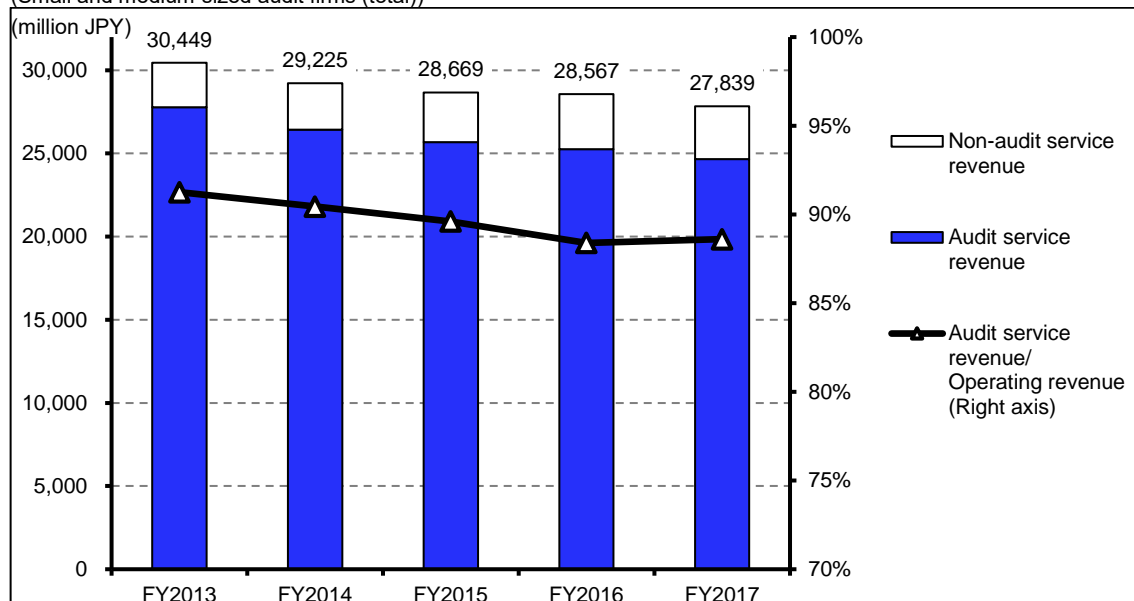


(Second-tier audit firms (total of six firms))



(Note) In FY2016 one audit firm changed its fiscal year-end, and the 15 months of operating revenue were posted to FY2017. For that reason, because the FY2016 operating revenues for this firm are not available, the data for FY2015 has been used.

(Small and medium-sized audit firms (total))



(Note) The operating revenues for audit firms in each fiscal year have been aggregated. Data was collected for large-sized and second-tier audit firms through FY2017, and for small and medium-sized audit firms through FY2016.

C. Audited Companies

Audit and attestation services differ by content and status due to statutory audits mandated by different regulations and to the impact of audited companies' business scale, etc.

1. Types of Audit and Attestation Services

As previously noted (see "B. Audit Firms" (page 13)), 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 voluntarily 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

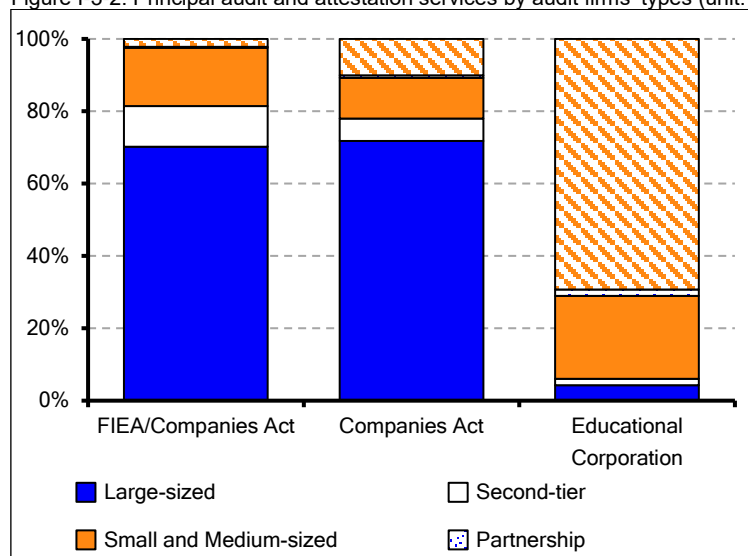
| Type | Statutory audits | | | | | | Non-statutory audits | Total |
|---------------------|---------------------|------|---------------|--------------------------------------|-----------------|-------|----------------------|--------|
| | FIEA /Companies Act | FIEA | Companies Act | Act on Subsidies for Private Schools | Labor Union Act | Other | | |
| Number of companies | 3,871 | 333 | 5,219 | 1,769 | 461 | 2,189 | 4,569 | 18,411 |
| Share (%) | 21.0 | 1.8 | 28.3 | 9.6 | 2.5 | 11.9 | 24.8 | 100 |

(Note 1) The number of audited companies has been aggregated from operational reports submitted by audit firms in FY2016.

(Note 2) In FY2016 one second-tier audit firm changed its fiscal year-end, and the number of audited companies for FY2016 for this firm is not available. Accordingly, FY2015 data has been used for the number of companies audited in FY2016 by this firm.

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 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)



| Type | FIEA/ Companies Act | Companies Act | Educational Corporation |
|------------------------|------------------------|---------------|----------------------------|
| Audit firms | 3,827 | 5,182 | 1,691 |
| Large-sized | 2,755 | 4,170 | 251 |
| Second-tier | 440 | 357 | 104 |
| Small and medium-sized | 632 | 655 | 1,336 |
| Partnerships | 9 | 39 | 102 |
| Solo practitioners | 87 | 586 | 4,048 |

(Note) Data was aggregated from audits conducted from the term ended April 2016 to the term ended March 2017. The figures do not match with the figures in Figure I-3-1 because the collection period is different
(Source) JICPA

2. Companies Audited under FIEA and Companies Act, and Listed audited companies

The CPAAOB analyzed audited companies that are subject to statutory audits under the FIEA and the Companies Act and listed audited companies that have a significant impact on capital markets (excluding foreign companies; the same applies this chapter).

- 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, second-tier audit firms have been gaining a slightly larger share each year since FY2013 (Figure I-3-4).

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

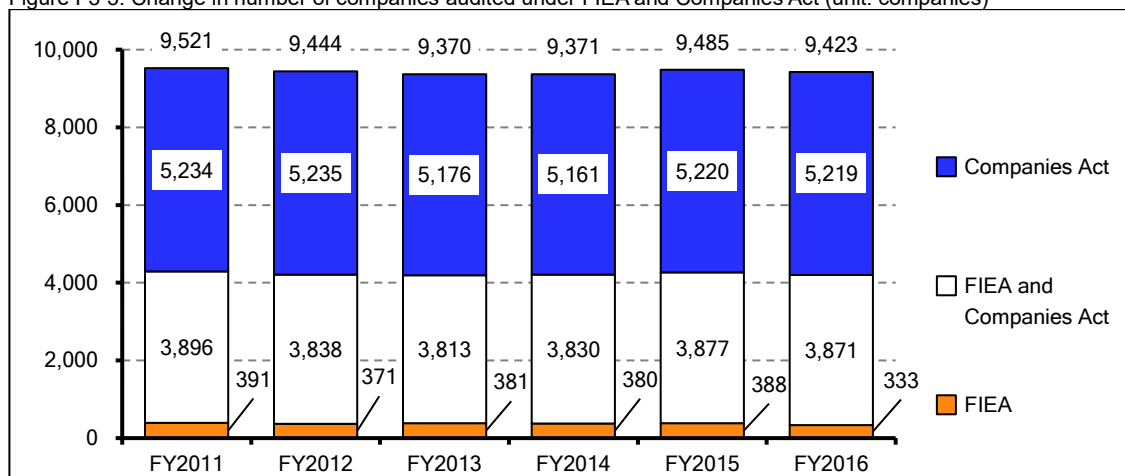
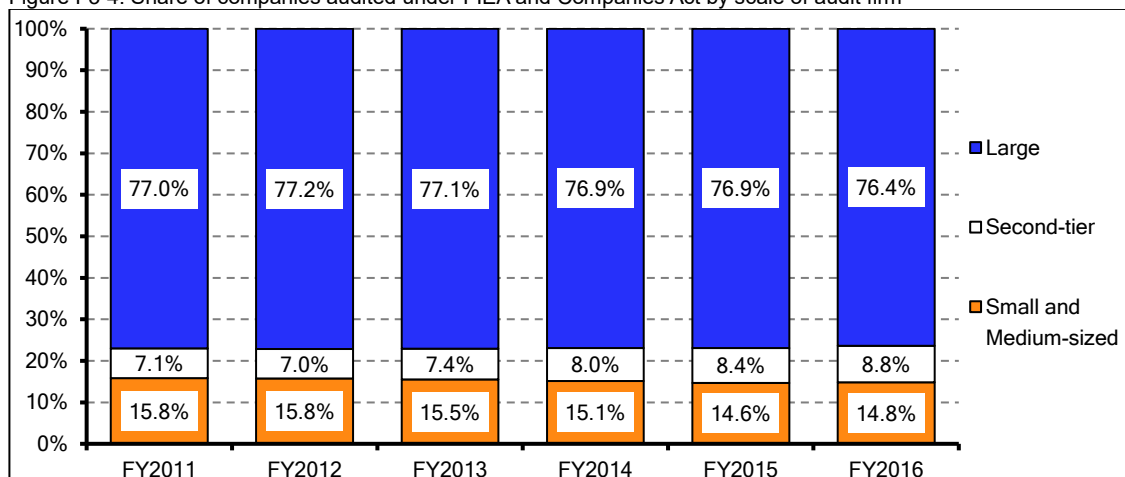


Figure I-3-4: Share of companies audited under FIEA and Companies Act by scale of audit firm



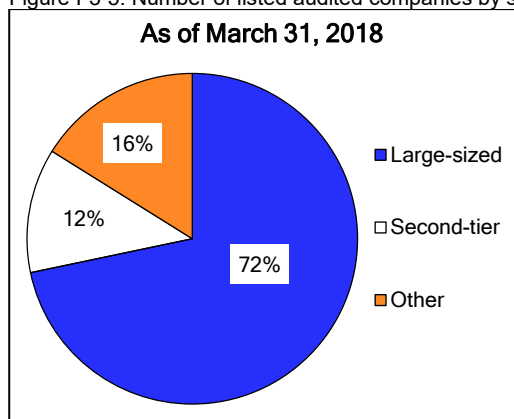
(Note 1) The number of audited companies, etc., of each audit firm for each fiscal year have been aggregated.

(Note 2) In FY2016 one second-tier audit firm changed its fiscal year-end, thus its FY2016 operating revenue is not available. Instead, FY2015 data has been used for this firm's FY2016 operating revenue.

b. Share of listed audited companies by scale of audit firm

Audits at about 70% of listed audited companies are conducted by large-sized audit firms. The larger the company, the greater its scale and complexity of its transactions, requires a large number of auditors. For that reason, in most of cases, large-sized audit firms carry out the audits for such companies, and large-sized audit firms account for 90% of audits on a total market value basis (Figures I-3-5 and I-3-6).

Figure I-3-5: Number of listed audited companies by scale of auditor (units for left-hand graph: companies)

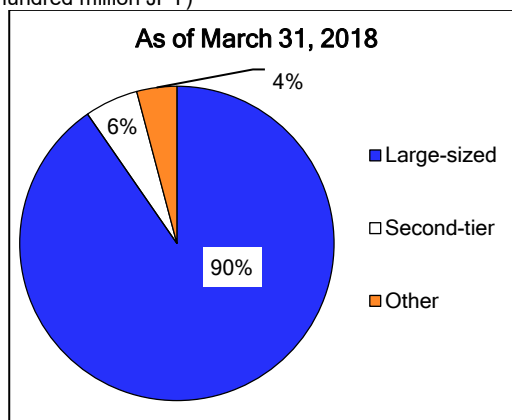


(Note) "Other" in the figure refers to small and medium-sized audit firms, partnerships and solo practitioners.

| | |
|---|--------------|
| Large-sized audit firms | 2,646 |
| Second-tier audit firms | 449 |
| Small and medium-sized audit firms, partnerships and solo practitioners | 595 |
| Total | 3,690 |

(Note) An audited company that has an audit conducted jointly by a large-sized audit firm and a small and medium-sized audit firm is regarded as having been conducted by the large-sized audit firm.

Figure I-3-6: Total market value of listed audited companies by scale of auditor (unit for right-hand graph: hundred million JPY)



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

| | |
|---|------------------|
| Large-sized audit firms | 6,101,451 |
| Second-tier audit firms | 371,724 |
| Small and medium-sized audit firms, partnerships and solo practitioners | 278,092 |
| Total | 6,751,267 |

(Note) An audited company that has an audit conducted jointly by a large-sized audit firm and a small and medium-sized audit firm is regarded as having been conducted by the large-sized audit firm.

c. Number of listed audited companies and total market value by fiscal year-end

About 70% of listed audited companies close their books at the end of March, and these companies account for about 80% of total market value. Consequently, audit operations are heavily concentrated in specific periods (Figures I-3-7 and I-3-8).

Figure I-3-7: Number of listed audited companies by fiscal year-end (unit for right-hand table: companies)

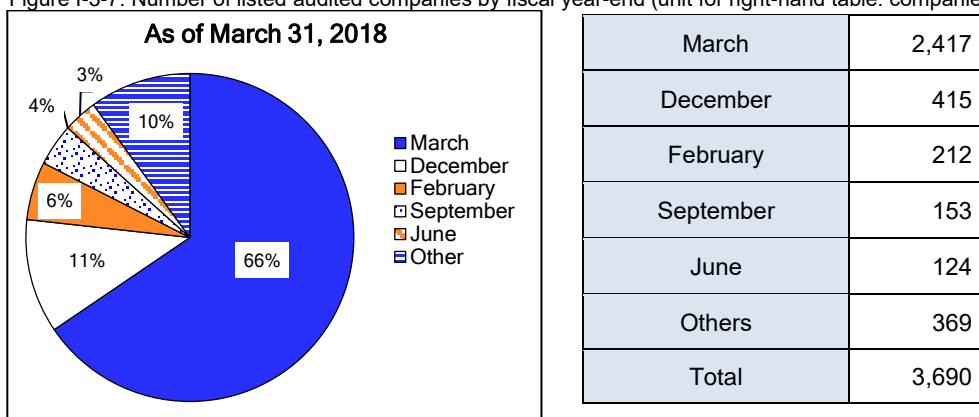
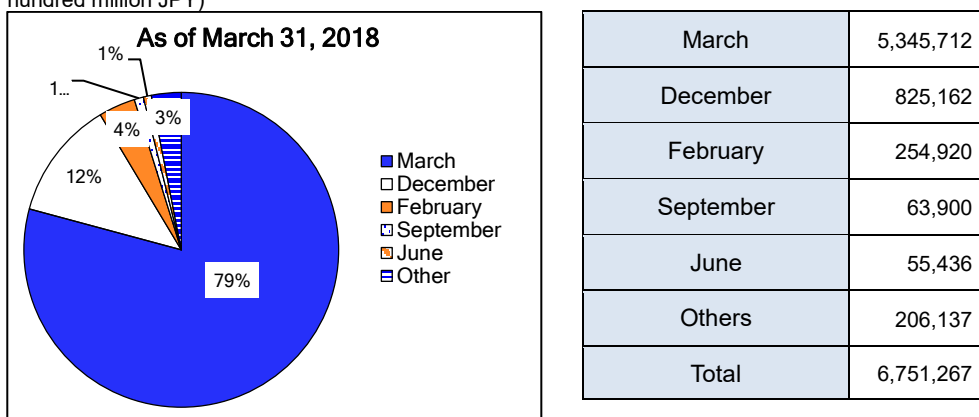


Figure I-3-8: Total market value of listed audited companies by fiscal year-end (units for right-hand table: hundred million JPY)



(Source) QUICK, stock exchanges (as of March 31, 2018)

■ JICPA's Registration System for Listed Company Audit Firms ■

The registration system for listed company audit firms requires firms that audit domestic listed companies to register with the JICPA. The names and addresses of registered audit firms, descriptions of their quality control systems, quality control reviews and other information are disclosed via the "list of registered firms" and the "List of associate registered firms" on the JICPA's website. There were 126 firms in the list of registered firms as of the end of May 2018,

The audit firms in the list of registered firms regularly undergo quality control reviews. If it is determined that the quality control level of the firms are not adequate enough to audit listed companies, the registration may be delisted.

Stock exchanges' Securities Listing Regulations also stipulate that the auditors of domestic listed companies must be audit firms registered on the list of registered firms or the List of associate registered firms.

3. Companies Adopting IFRS

The following figures show the listing markets for companies that have adopted IFRS and the scale of the auditors for these companies (Figures I-3-9 and I-3-10).

The majority of companies adopting and planning to adopt IFRS are listed on the First Section of the Tokyo Stock Exchange. Audit contracts are concentrated in large-sized audit firms which are able to collaborate with big 4 global networks because most of such companies do their businesses overseas.

Figure I-3-9: Companies adopting IFRS (unit: companies)

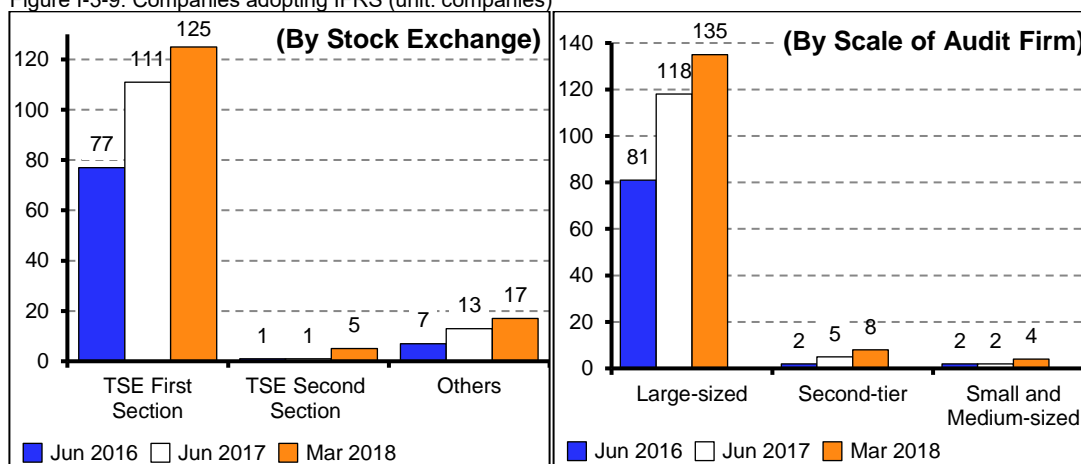
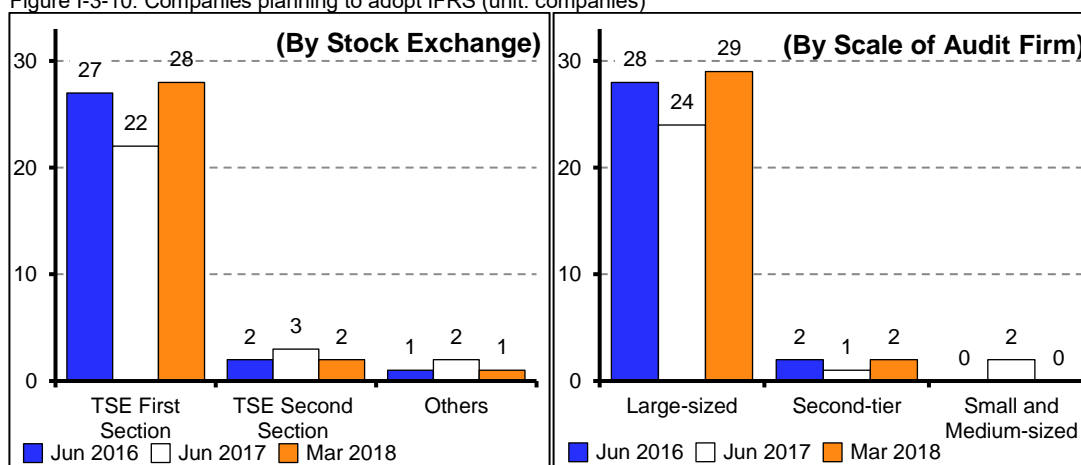


Figure I-3-10: Companies planning to adopt IFRS (unit: companies)



(Source) Stock Exchange

4. Audits of Initial Public Offerings

The number of IPOs (excluding listings on the Tokyo Pro Market) came to 90 at the end of December 2017, the second highest level in the past six years (Figure I-3-11).

Even though large-sized audit firms still possess the largest share, the number of new domestic listed companies for which small and medium-sized audit firms were responsible went from zero in the previous year to five companies at the end of December 2017 (Figure I-3-12). Breaking these down by the stock exchange market, each was listed on the Tokyo Stock Exchange's First Section, Second Section and Mothers, and two on JASDAQ.

Figure I-3-11: Number of newly listed domestic companies by stock exchange (unit: companies)

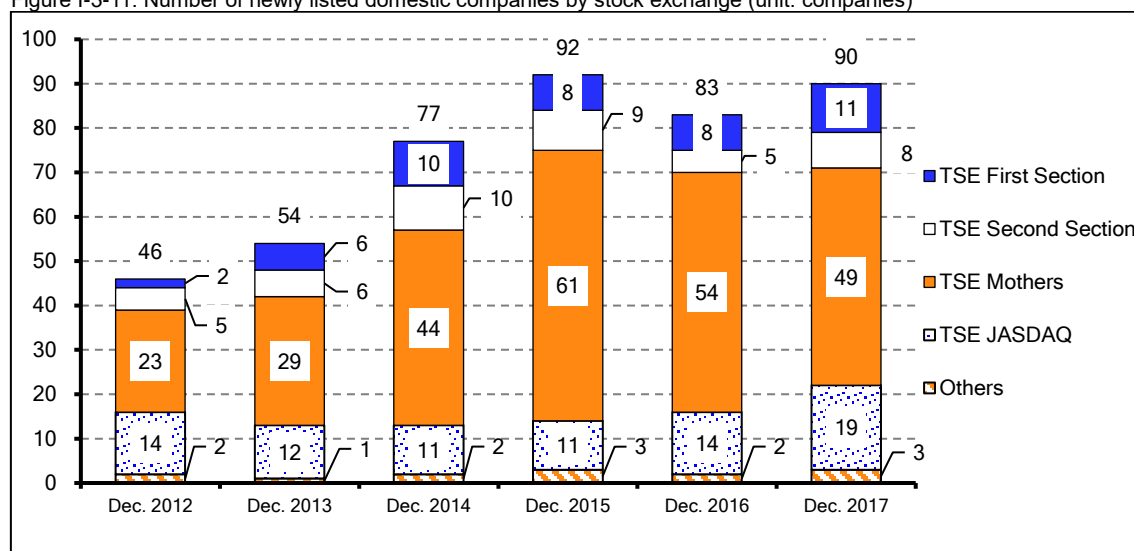
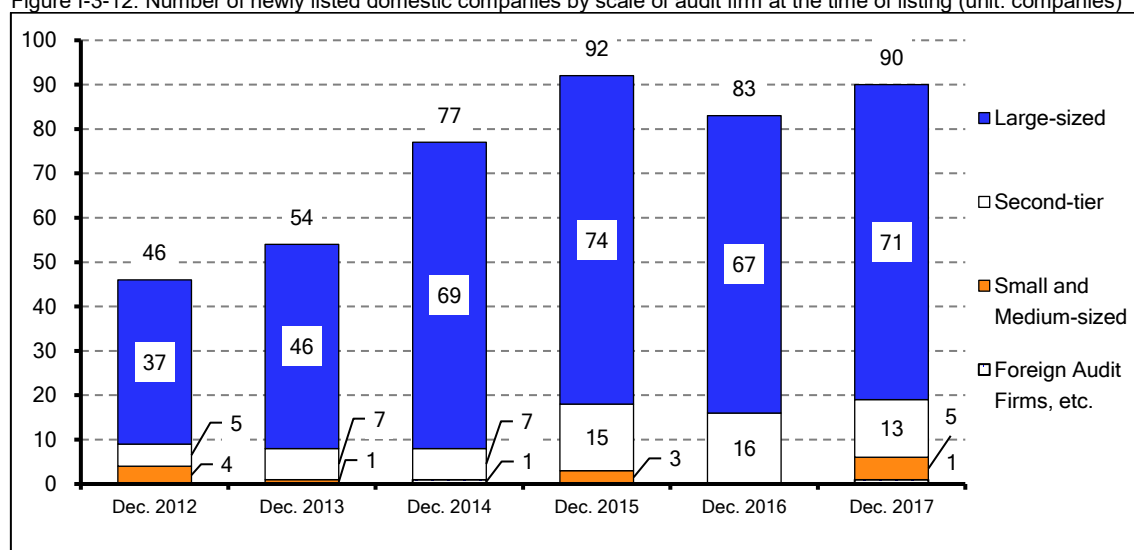


Figure I-3-12: Number of newly listed domestic companies by scale of audit firm at the time of listing (unit: companies)



(Source) Stock exchanges

II. CPAAOB's Monitoring

II. CPAAOB's Monitoring

A. Overview of System

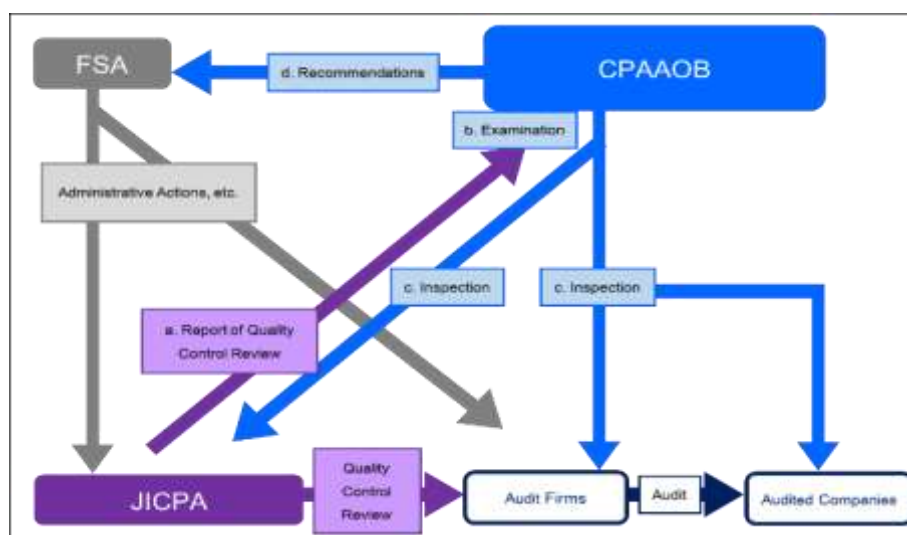
1. Legal Position of CPAAOB Examination and Inspection

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 of the Act for Establishment of the Financial Services Agency. The CPAAOB strives to enhance the trust of investors in capital markets by improving the quality of audits and ensuring their reliability through examinations/inspections of audit firms.

Figure II-1-1 illustrates the relationship between CPAAOB examinations and inspections on the one hand, and the JICPA's quality control reviews and the FSA's administrative actions on the other.

Based on the JICPA's 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 audit firms, the JICPA, 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: Overview of CPAAOB examinations and inspections



⁵ This body comprises a chairman and up to nine members with an understanding and insight of CPAs, and appointed by the Prime Minister with the consent of both houses of the Diet.

The CPAAOB encourages audit firms to take voluntary actions to ensure/improve audit quality by conducting both on-site monitoring (inspections) and off-site monitoring (information collection via submitted reports, information exchanges, and other non-inspection activities).

The CPAAOB conducts monitoring accordance with the Basic Policy for Monitoring Audit Firms that sets out monitoring perspectives and targets, as well as the Basic Plan for Monitoring Audit Firms for each program year formulated in line with the Basic Policy⁶. The Monitoring and Inspection Office, responsible for monitoring at the CPAAOB, has a regular staff of 42 as of the end of FY2017, 33 of whom are inspectors. For further details on inspections (the number of inspectors per inspection, the inspection period, etc.), see “B. State of Examination, Collection of Reports and Inspection, 3. Inspection” (page 44).

2. Report of JICPA Quality Control Review

The JICPA is the only 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 provides members with guidance, liaison and supervision and performs administrative tasks pertaining to CPA registration.

The quality control reviews⁷ are conducted by the JICPA to maintain/improve suitable qualitative standards for audit services and to maintain/ensure public trust in audits. More specifically, the JICPA reviews the quality control of audits conducted by audit firms, reports its findings to the audit firms and, when necessary, recommends improvements and monitors these improvements.

The quality control review system was put in place by the JICPA in FY1999 as self-regulations, and in 2003 it was stipulated by the CPA Act that the JICPA is to conduct reviews and report its findings of these reviews to the CPAAOB.

The JICPA regularly submits to the CPAAOB monthly and annual reports prepared in accordance with the Cabinet Office Ordinance on the Japanese Institute of Certified Public Accountants, and provides quality control review reports as needed. The specific information reported is as follows:

⁶ The Basic Policy for Monitoring Audit Firms and the Basic Plan for Monitoring Audit Firms are published on the CPAAOB website.

⁷ For details concerning quality control reviews, see the JICPA website and the annual report from the Quality Control Committee.

- a. Plans for conducting reviews
- b. Details on any deficiencies discovered during reviews and the audit firms' perspectives on these
- 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 (warnings, severe warnings, recommendation to withdraw from audit engagements)
- e. "Improvement Plan" prepared by the audit firm and submitted to the JICPA

Quality control reviews evaluate whether the systems of quality control (all policies and procedures for quality control pertaining to audits, including quality control procedures for audit services) established by audit firms have been suitably and sufficiently developed in compliance with the quality control standards set forth in QCSCS, ASCS, etc. (i.e., the development of systems of quality control), and whether these systems of quality control are operating effectively (i.e., the operation of systems of quality control) and ascertain their operational status through sampling survey methods.

Quality control reviews comprise ordinary reviews, which are conducted regularly or on an ad hoc basis covering the status of quality control on a firm-wide basis, and extraordinary reviews, which are conducted whenever a situation has arisen that threatens public confidence in audits covering quality control in relation to the specific areas of activity or specific audit services of audit firms.

In FY2017, there were a total of 40 reviewers who conducted ordinary reviews of 96 audit firms.

3. Examination

The CPAAOB receives quality control review reports from the JICPA, and then reviews these reports to determine appropriateness of these quality control reviews and audit services performed by reviewed audit firms.

More specifically, the CPAAOB confirms the implementation of quality control reviews and guidance to audit firms on necessary improvement measures, and analyses the findings of quality control reviews (to determine any qualifications applicable to the conclusions of the quality control reviews, the nature of any deficiencies discovered in the quality control reviews) as well as details of improvement plans submitted by audit firms to the JICPA.

In addition to considering the need for conducting on-site inspections in light of these analysis results, the CPAAOB engages in exchanges of opinions with the JICPA.

When conducting examinations, the CPAAOB also utilizes information obtained from relevant organizations such as the FSA, the JIPCA, stock exchanges, the Japan Audit & Supervisory Board Members Association.

4. Collection of Reports

The CPAAOB collects reports from the JICPA and audit firms when it deems this necessary in the course of conducting the examinations in 3. above. It also collects reports from audit firms in a timely manner to encourage the adoption of appropriate audit quality control in audit firms (a. and b. below) and to efficiently monitor this quality control (c. below).

When collecting these reports, the CPAAOB also holds face-to-face meetings as needed for effective monitoring.

a. Collection of reports for priority monitoring tailored to the scale of audit firms

This primarily entails requesting reports from small to medium-sized audit firms to verify the development of systems of quality control, the representatives' management policies, earnings/financial structures and organizations/human resources, and considering conducting inspections if serious deficiencies are suspected.

b. Collection of reports after the CPAAOB inspection

This entails ascertaining the status of subsequent efforts taken by the audit firm to address deficiencies identified in the inspection, and verifying the audit firm's quality control improvements.

c. Collection of reports for continuous assessment of quantitative/qualitative information on business management (governance) environment and operations management environment

This primarily entails requesting reports from large-sized audit firms, analyzing the information obtained and utilizing it to support effective/efficient inspections, make comparative analyses of such firms, understand cross-sectional issues, etc.

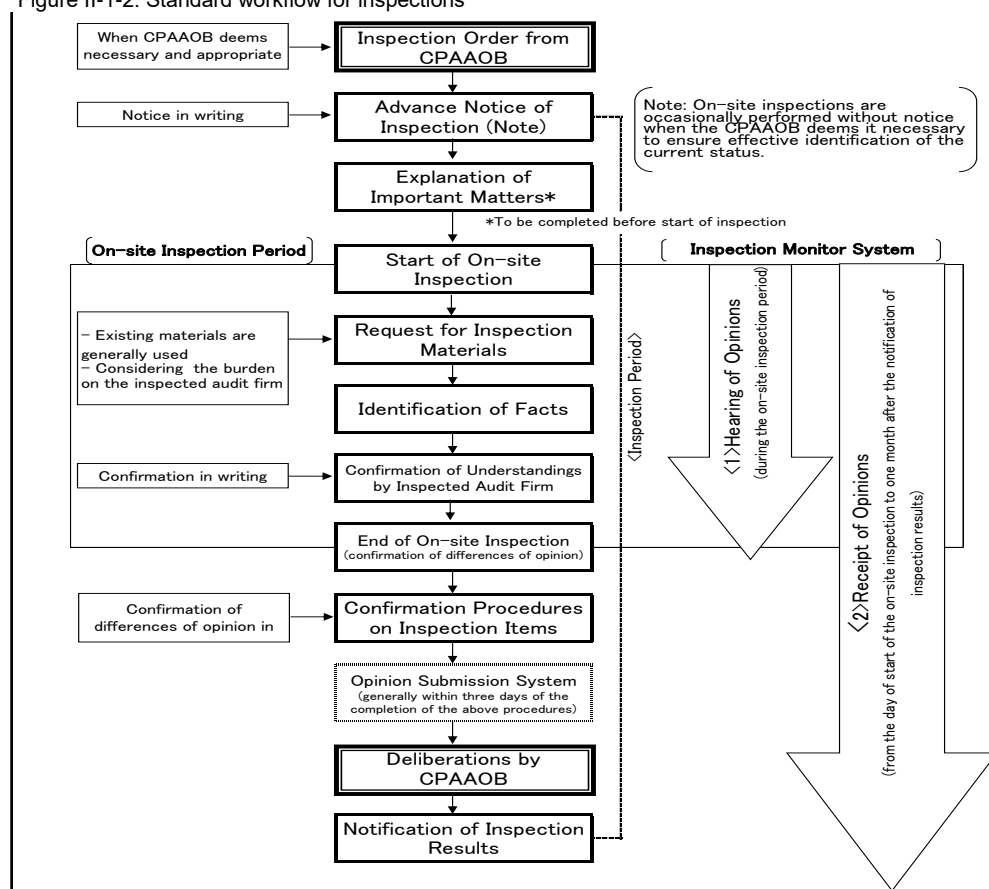
5. Inspection

When deemed necessary and appropriate for the public interest or the protection of investors as the result of 3. or 4. above, the CPAAOB will inspect audit firms and relevant places (audited companies, etc.). The CPAAOB will also conduct inspections of the JICPA when deemed necessary and appropriate to ensure proper administration by the JICPA.

The basic scope of CPAAOB inspections, the procedures for inspections, and the handling of inspection findings are stipulated in the “Basic Guidelines on Inspections Conducted by the Certified Public Accountants and Auditing Oversight Board” (April 2015; hereinafter, “Basic Guidelines”).

The standard workflow for inspections of audit firms conducted in accordance with the Basic Guidelines is depicted below (Figure II-1-2).

Figure II-1-2: Standard workflow for inspections



a. Inspection order from the CPAAOB

The CPAAOB issues an order to inspectors to inspect an audit firm.

b. Explanation of important matters

Before the on-site inspection, the inspectors explain to the responsible person at the audit firm the authority for and purpose of the inspection, the inspection methods, an overview of the inspection monitor system and the opinion submission system, and other necessary matters.

c. On-site inspection

Generally, the inspectors visit the audit firm and inspect its audit engagements and quality control environment. The audit engagements inspected are selected based on the size of the audit firm, the key points of the basic inspection plan, 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 staffs.

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

d. Confirmation procedures on inspection items and opinion submission system

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 where differences of opinion exist (the confirmation procedures on inspection items).

If there are differences of opinion, the audit firm may submit its opinion in writing, usually within a three-day period from the day on which the procedures for confirmation of inspection items were completed (opinion submission system).

e. Inspection monitor system

The CPAAOB asks the audit firm to submit its opinion concerning inspection methods, etc. for ascertaining the quality of CPAAOB inspections and helping to ensure that inspections are conducted properly and efficiently.

6. Notification of Inspection Results

a. Inspection results notification

The responsible person at the audit firm is notified of the results of the inspection in writing (inspection results notification).

The current inspection results notifications contain the information shown in Figure II-1-3⁸.

Figure II-1-3: Items included in inspection results notification

1. Key points
2. Inspection viewpoints
3. Deficiencies in measures 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. Deficiencies in the conduct of audit services (audit engagements)

The “Key points” section provides an overall rating and an overview of deficiencies within the operations management environment, the quality control environment and audit engagements.

b. Overall rating

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-1-4.

Figure II-1-4: Example of key points

1. Key points
As a result of our inspection of your audit firm, we discovered within the scope of our inspection the following issues relating to the operation of your firm.
(1) Operations management environment
...(presents problems with its governance and operation of services)
(2) Quality control environment
...(presents deficiencies in the system of quality control)
(3) audit engagements
...(presents deficiencies in audit services)

⁸ Overall ratings will not be given for ad hoc inspections or follow-up inspections of large-sized audit firms, and the inspection results notifications in those cases will differ from the ones of regular inspections.

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 improve understanding of the level of quality control among the audit & supervisory boards⁹ to whom the inspection results notification is provided.

The overall rating takes the form of one of the following five grades, and is based on the assessment results of audit firm's operations management environment, quality control environment, and audit engagements:

1. "Generally satisfactory"
Given when operation of services is deemed to be satisfactory, e.g., there are almost no deficiencies in the quality control environment or audit engagements.
2. "Satisfactory with minor deficiencies"
Given when there are issues needing to be fixed, but operation of services is deemed to be satisfactory on the whole, e.g., there are no material weaknesses but there are some deficiencies in the operations management environment, the quality control environment, or audit engagements.
3. "Unsatisfactory"
Given when operation of services is deemed to be unsatisfactory, e.g., there are material weaknesses in the operations management environment, the quality control environment, or audit engagements that need to be fixed.
4. "Unsatisfactory and in need of immediate remediation"
Given when operation of services is deemed to be unsatisfactory and in need of immediate remediation.
5. "Extremely unsatisfactory"
Material deficiencies with the quality control environment and audit engagements were identified and voluntary remediation cannot be expected to be implemented by the audit firm.

The CPAAOB will make recommendations to the FSA Commissioner regarding audit firms rated 5.

For further details on overall ratings in inspections begun in PYs 2016 and 2017, see "B.

⁹ An audit & supervisory board performs audits and oversight of director's compliance with regal and regulatory requirements and auditor's activities and independence. Their role is similar to the one of audit committee in the US.

State of Examination, Collection of Reports and Inspection, 3. Inspection c. Overall ratings (page 47).

c. Handling of inspection results

Inspected audit firms must obtain prior consent from the CPAAOB to disclose the inspection results to a third party¹⁰.

However, the inspected audit firm may disclose the results without the prior consent of the CPAAOB in the following cases:

- i. When submitting them to the JICPA in accordance with provisions concerning the handling of inspection results notifications that are prescribed in the rules of the JICPA Quality Control Committee.
- ii. When the inspected audit firm disseminates the following information in writing to the audit & supervisory board of audited companies¹¹
 - Whether there were any findings concerning the establishment and operation of the audit firm's quality control system, and if there were, a summary thereof
 - In cases where audited companies were subject to inspection, whether there were any findings with respect to the audited companies, and if there were, the details thereof

This approach is designed to improve the effectiveness of the JICPA's quality control reviews and to encourage the audit & supervisory board and directors of audited companies to utilize the inspection results and to pursue greater collaboration with audit firms. With this in mind, the CPAAOB asks audit firms to deliver to the audit & supervisory board, etc. as is the content of the "Key points" section in the inspection results notification.

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

¹¹ The ASCS requires audit firms to convey in writing to the audit & supervisory board the details of inspection results notifications and the measures for improvements (ASCS 260, No. 15-2, A22-3).

B. State of Examination, Collection of Reports and Inspection

1. Examination

The CPAAOB examined the quality control reviews conducted in FY2017 by the JICPA in PY2017 and an overview of the examination is given below.

a. FY2017 quality control reviews

As of June 4, 2018, quality control reviews had been completed for 95 of the 96 firms subjected to quality control reviews, of which 87 audit firms received unqualified conclusions, seven qualified conclusions and one an adverse conclusion. Ninety firms (including the seven audit firms with qualified conclusions and the one audit firm with an adverse conclusion) also received recommendations for improvements (Figure II-2-1).

Figure II-2-1: FY2017 quality control reviews (unit: audit firms)

| Classification | Reviewed parties | Conclusion | | | Recommendations for improvement | |
|----------------|------------------|------------------------|----------------------|--------------------|---------------------------------|----|
| | | Unqualified conclusion | Qualified conclusion | Adverse conclusion | Yes | No |
| Audit firms | 72 | 66 | 4 | 1 | 66 | 5 |
| CPAs | 24 | 21 | 3 | 0 | 24 | 0 |
| Total | 96 | 87 | 7 | 1 | 90 | 5 |

(Note 1) Four partnerships are included among the 72 audit firms

(Note 2) Qualified conclusions are given when material deficiencies have been discovered, and there is some concern about serious compliance violations of audit standards, etc.

(Note 3) Adverse conclusions are given when material deficiencies have been discovered, there is significant concern about serious compliance violations of audit standards, etc., and there are extremely serious compliance violations in audit engagements.

(Note 4) Audit firms receiving unqualified conclusions may nonetheless be given recommendations for improvement when specific areas requiring improvement are discovered.

(Note 5) Of the 96 firms reviewed, one firm was still under review as of June 4, 2018 and data on its conclusion and recommendations for improvement are not included in this table.

b. Analysis of FY2017 quality control reviews

The following verifications/analyses were conducted on quality control review reports from the JICPA to determine whether quality control reviews are being suitably conducted:

- Verification of policies governing FY2017 quality control reviews, confirmation of efforts toward improvement, and verification of improvements being made to review operations
- Analyses of any adverse or qualified conclusions given for quality control reviews, and of the details of deficiencies pointed out in quality control reviews
- Verification that the JICPA is encouraging audit firms to make effective

improvements by analyzing the details of deficiencies noted in the quality control reviews and the guidance provided for improvements

These verifications/analyses made it clear that qualitative improvements are pursued with respect to quality control reviews:

- In implementing FY2017 quality control reviews, there were a greater number of cases than the previous fiscal year in which the number of review days and the number of reviewers had been flexibly set in line with the current level of quality control at audit firms, and cases in which review periods had been extended in response to issues uncovered during the review.
- The JICPA reviewers have come to point out not only deficiencies in documenting but also linking those to deficiencies in quality control environment. They have also noted that these deficiencies were caused by improper audit procedures.

2. Collection of Reports

- a. Collection of reports for prioritized inspections tailored to the characteristics of audit firms

In PY2017, the CPAAOB collected reports from 51 audit firms: four second-tier audit firms, 47 small and medium-sized audit firms. The reports were on audit firms' management policies, earnings/financial structures, organizations/human resources, training, global networks, etc., group audits. Those firms were selected from among firms subjected to FY2016 quality control reviews in consideration of the seriousness of deficiencies pointed out in their reviews, etc.

- b. Collection of reports after inspection

In PY2017, the CPAAOB collected reports from three small and medium-sized audit firms inspected in PY2016 to confirm progress in improvements on deficiencies noted during the inspections.

- c. Collection of reports to ensure ongoing access to quantitative/qualitative information on business management (governance) environment and operations management environment

In PY2017, the CPAAOB collected reports from all large-sized audit firms on their operations management environment, their governance, their domestic group structure, their collaboration with global networks and other aspects of their business management environment and their quality control environment such as their risk information management. These are conducted in July 2017.

3. Inspection

a. State of implementation of inspections

The CPAAOB conducts inspections in different cycles depending on the size of the audit firm. Details of the inspections conducted during the past five years are presented below (Figures II-2-2 and II-2-3).

The CPAAOB conducts regular inspections of large-sized audit firms once every two years and, since PY2016, has run follow-up inspections designed to verify improvements in the program year following the regular inspection.

Inspections of second-tier audit firms are generally conducted once every three years.

Inspections of small and medium-sized audit firms are conducted as necessary, in consideration of deficiencies pointed out in quality control reviews. The higher number of inspections conducted in FY2013 and FY2014 include ad hoc inspections of limited scope.

Figure II-2-2: State of implementation of inspections in the past five years (based on commencement of inspections) (unit: audit firms)

| Fiscal/PY | 2013 | 2014 | 2015 | 2016 (Notes 1,2) | 2017 (Note 2) |
|---|------|------|------|---------------------|------------------|
| Large-sized audit firms | 2 | 2 | 2 | 4 (2) | 4 (2) |
| Second-tier audit firms | 2 | 1 | 1 | 2 | 2 |
| Small and medium-sized audit firms, partnerships and solo practitioners | 9 | 11 | 6 | 5 | 3 |
| Foreign audit firms (Note 3) | 0 | 1 | 0 | 1 | 0 |
| Total | 13 | 15 | 9 | 12 (2) | 9 (2) |

(Note 1) The data collection period was changed to the program year from July 2016. The number of inspections conducted between April and June 2016 is also included in PY2016 because it was a transitional year.

(Note 2) Figures in parentheses are the number of follow-up inspections.

(Note 3) See "III. Operation of Audit Firms, I. Foreign Audit firms." (page 98) for information on foreign audit firms.

Figure II-2-3: Number of inspectors, inspection periods and number of audit engagements

| | Large-sized audit firms | Second-tier audit firms | Small and medium-sized audit firms |
|---|-------------------------|-------------------------|------------------------------------|
| Number of inspections | 9 | 8 | 22 |
| Average number of inspectors | 9.1 | 6.8 | 4.7 |
| Average inspection period (calendar days) | 152.1 | 112.0 | 98.5 |
| Average number of inspected audit engagements (companies) | 8.1 | 5.3 | 2.9 |

(Note 1) Covers inspections conducted during the five-year period from FY2013 to PY2017, excluding follow-up inspections and inspections resulted in recommendations for administrative measures to the FSA Commissioner

(Note 2) Inspections began on the inspection date (in the case of inspections with advance notice; 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 began) and ended on the date on which notification of the inspection results was issued.

b. Deficiencies

i. Characteristics of deficiencies identified through inspections of quality control environment

The results of inspections at large-sized audit firms from PY2016 show that, although these firms are making efforts organizationally to improve quality control by strengthening collaboration between quality control divisions and audit services divisions, there are still cases in which insufficient effort has been made to ascertain and address risk identification to engagement teams such as involvement of engagement partners.

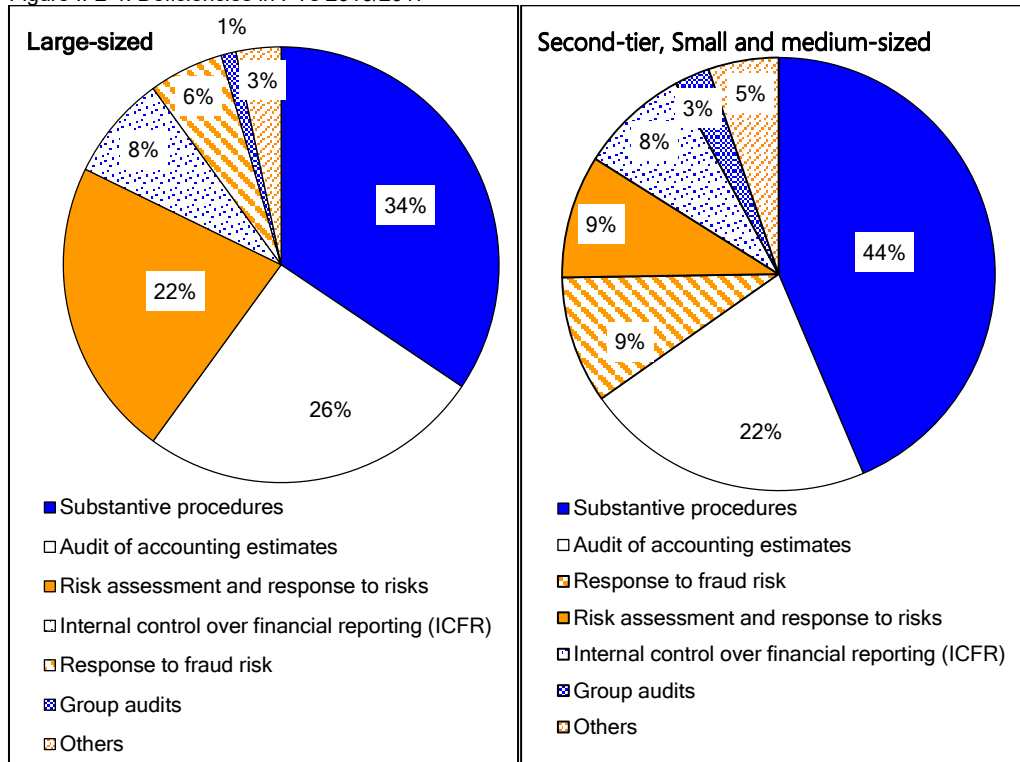
While second-tier audit firms have developed quality control structure firm-wide, there have been cases in which sufficient administration and control have not been exercised because of the limited number of partners responsible for quality control.

At some small and medium-sized audit firms, there were cases in which priority had been given to expanding the scope and scale of business over constructing appropriate quality control environments, as well as cases in which representatives and quality control managers did not accord adequate importance to quality control.

ii. Characteristics of deficiencies identified through inspections of audit engagements

Deficiencies identified through inspections of audit engagements in PYs 2016 and 2017 can be classified in line with the ASCS structure as follows (Figure II-2-4).

Figure II-2-4: Deficiencies in PYs 2016/2017



(Note) Classifications of deficiencies noted at four large-sized audit firms, four second-tier audit firms, nine small and medium-sized audit firms (including one audit firm whose inspection started in FY2015 and for which the inspection results notification was issued in PY2016).

At large-sized audit firms, deficiencies regarding audits of substantive procedures and accounting estimates accounted for 60% of the total, followed by deficiencies regarding risk assessments and responses to risk occurred at audit planning, at 20%.

At second-tier and small and medium-sized audit firms, half of deficiencies were found in substantive procedures and, when combined with deficiencies pertaining to audits of accounting estimates, it amount to 70% of all deficiencies. These firms also had far more deficiencies regarding responses to the risk of fraud than did large-sized audit firms.

The CPAAOB encourages inspected audit firms to take their initiatives in improving their operation through its examinations, by analyzing the causes of the deficiencies identified in the inspections and sharing these through dialogue with the inspected audit firms. See the Case Report from Audit Firm Inspection Results for examples of deficiencies identified during the inspections and their causes.

c. Overall ratings

The overall ratings in regular inspections begun in PYs 2016 and 2017 are shown below (Figure II-2-5).

No audit firms qualified as “Generally satisfactory”, the highest rating in the overall rating scheme, so quality control at all audit firms was rated as “Satisfactory with minor deficiencies” or lower.

Many small and medium-sized audit firms had overall ratings lower than those of large-sized and second-tier audit firms. This is because the CPAAOB inspected the small and medium-sized audit firms whose quality control environments needed urgent confirmation. It was apparent at small and medium-sized audit firms with low overall ratings that there was insufficient awareness of the recent environmental changes pertaining to auditing and accounting as well as inadequate understanding of the quality control levels required by the current audit standards

Figure II-2-5: Overall ratings for inspections in PYs 2016/2017 (based on commencement of inspections) (unit: audit firms)

| Overall rating | Large-sized and second-tier audit firms | Small and medium-sized audit firms, partnerships and solo practitioners |
|---|---|---|
| Generally satisfactory | - | - |
| Satisfactory with minor deficiencies | 6 | 3 |
| Unsatisfactory | 2 | 2 |
| Unsatisfactory and in need of immediate remediation | - | 1 |
| Extremely unsatisfactory | - | 2 |

III . Operation of Audit Firms

III . Operation of Audit Firms

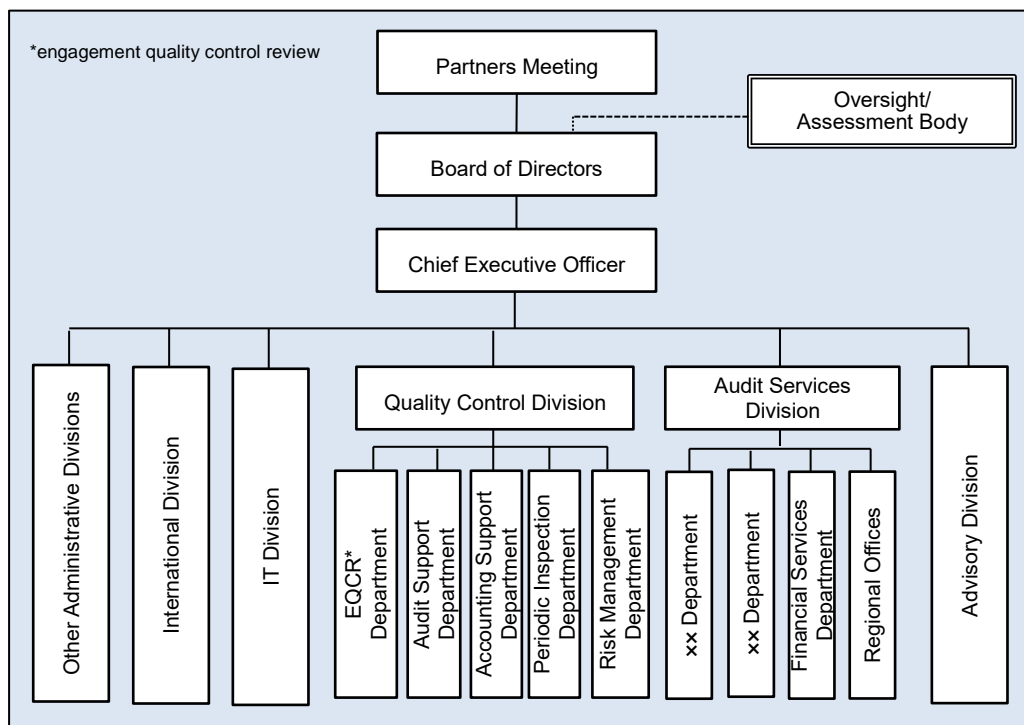
A. Operations Management Environment and Environment Developed under the Audit Firm Governance Code

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.

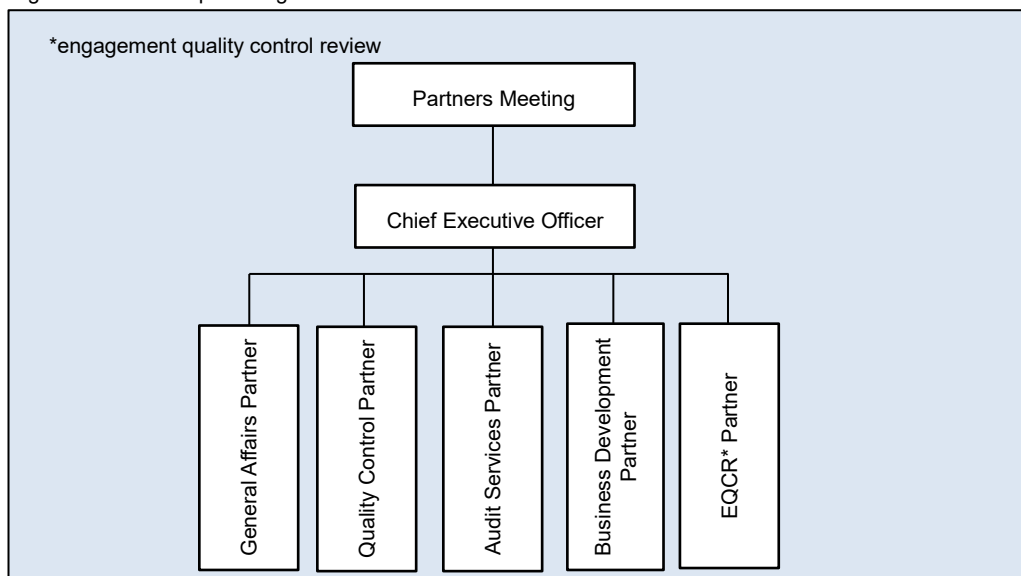
Large-sized and second-tier audit firms have a board of directors under the partners meeting, the highest decision-making body composed by all partners, to make important decisions and administer corporate operations. There is also an oversight/assessment body to oversee and assess the effectiveness 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. The structures of large audit firms are more organized than those seen at small and medium-sized audit firms (Figure III-1-1).

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



Small and medium-sized audit firms, on the other hand, have smaller workforces, so in many cases the partners meeting also handles day-to-day decision making and the audit services division is not subdivided. Quality control tends to be handled by a particular partner, rather than a department being established for that purpose, and the system is thus dependent more on individual expertise than that of large-sized audit firms (Figure III-1-2).

Figure III-1-2: Example of organizational structure at small and medium-sized audit firms



Since the publication of the Audit Firm Governance Code, all large-sized and second-tier audit firms as well as eight small and medium-sized audit firms have announced their adoption of the Code as of the end of June, 2018¹². Efforts have been made at large-sized audit firms to bolster pre-existing oversight/assessment bodies by incorporating public benefit perspective and third-party knowledge. Second-tier audit firms have set up new oversight/assessment bodies that include independent third persons among their members prompted by the release of the Audit Firm Governance Code. See 2. below (“Audit Firm’s Response to the Audit Firm Governance Code”; page 53) for details of specific efforts being made at large-sized and second-tier audit firms.

¹² JICPA website (as of the end of June, 2018)

The characteristics of each type of audit firm identified through inspections are as follows (Figure III-1-3).

Figure III-1-3: Characteristics of each type of audit firm

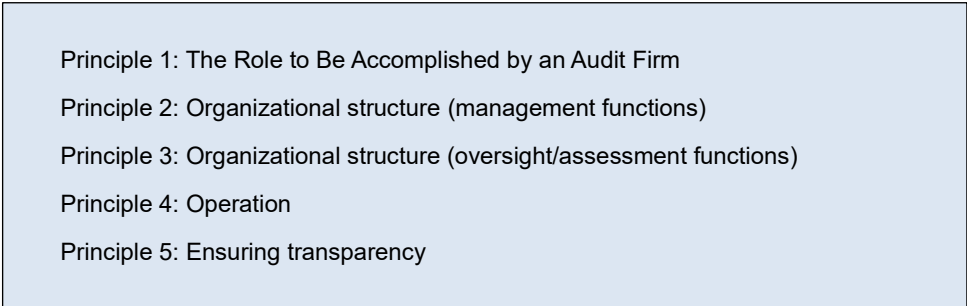
| | Large-sized audit firm | Second-tier audit firm | Small and medium-sized audit firms |
|--|---|---|--|
| Number of partners | Between 100 and 600(+) | Between 20 and 100 | Fewer than 30 |
| Number of full-time personnel | Approx. 2,500 to 6,200 | Approx. 100 to 600 | Up to 50 |
| Decision-making 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"> • Subcommittees have been established for "nomination" (nominations of chief operating officers and other executives), "compensation" (evaluation of executives/partners, compensation decisions, etc.), and "audit" (accounting and areas other than accounting,) • Separate independent bodies may also be established for monitoring purposes from the perspective of public interests | <ul style="list-style-type: none"> • In addition to internal auditors or monitoring committees, independent bodies comprising independent third persons are separately established | <ul style="list-style-type: none"> • Many firms have systems of checks and balances between partners without establishing oversight/assessment bodies. • Some firms set up oversight/assessment bodies |
| 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"> • Multiple audit services departments are established • 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 second-tier audit firms |
| Number of offices | <ul style="list-style-type: none"> • There are offices in three metropolises (Tokyo, Osaka and Nagoya) and often also local offices throughout Japan | <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 |

| | Large-sized audit firm | Second-tier audit firm | Small and medium-sized audit firms |
|-------------------------------------|--|--|---|
| 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"> • A quality control division comprises similar departments to those found at large-sized audit firms • Some firms also have a department for engagement quality control reviews | <ul style="list-style-type: none"> • Many firms appoint partners to handle quality control without establishing quality control departments • Some firm's representatives are also in charge of quality control |

2. Audit Firm's Response to the Audit Firm Governance Code

The Audit Firm Governance Code states principles for effective management of audit firms. The code is primarily intended for large-sized audit firms with many partners and staff that conduct audits of major listed companies. The code allows audit firms to adopt it on a comply-and-explain basis. It is more important that large-sized audit firms and other audit firms put the five principles into practice in ways suited to their own distinct circumstances than to simply follow them superficially.

Figure III-1-4: Five principles of the Audit Firm Governance Code

- 
- Principle 1: The Role to Be Accomplished by an Audit Firm
 - Principle 2: Organizational structure (management functions)
 - Principle 3: Organizational structure (oversight/assessment functions)
 - Principle 4: Operation
 - Principle 5: Ensuring transparency

Major efforts done by large-sized audit firms in relation to the Audit Firm Governance Code were: a. utilization of the knowledge and experience of independent third persons in oversight/assessment functions (relating to Principle 3), and b. dialogue with stakeholders in the capital market for the further improvements in their audit qualities (relating to Principle 5). Below is an analysis of the efforts.

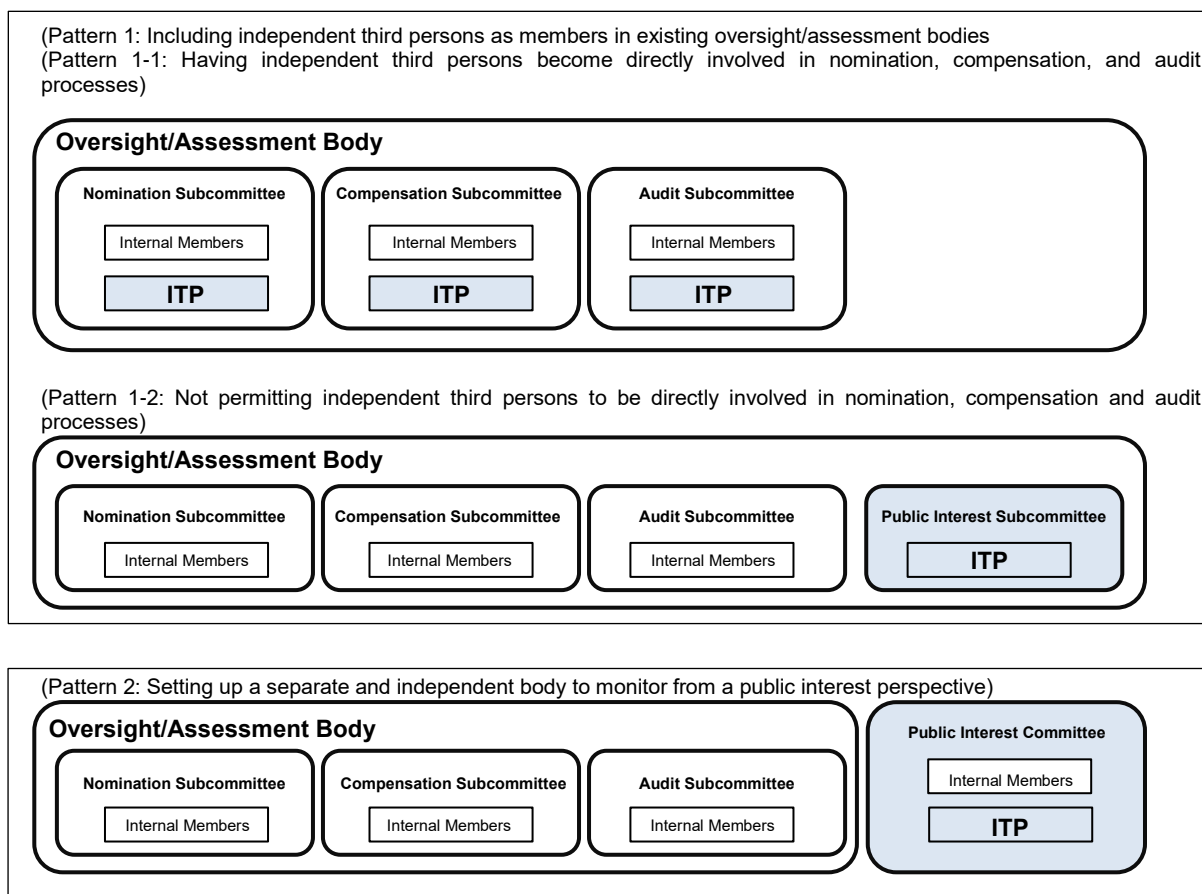
- a. Efforts to utilize the knowledge and experience of independent third persons in oversight/assessment functions
 - i. Strengthening oversight/assessment functions at large-sized audit firms

In striving to incorporate a public interest perspective and the knowledge of independent third persons in strengthening their oversight/assessment bodies, large-sized audit firms who have adopted the Audit Firm Governance Code have embraced 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 to monitor affairs from a public interest perspective (Pattern 2).

Pattern 1 can be further subdivided into a pattern of directly involving independent third persons as outside members in the processes pursued by nomination,

compensation, and audit subcommittees (Pattern 1-1) and a pattern of setting up independent subcommittees comprising outside members not directly involved in these processes (Pattern 1-2) (Figure III-1-5).

Figure III-1-5: Strengthening oversight/assessment functions at large-sized audit firms (ITP in this figure means independent third persons)



- ii. Efforts to utilize the knowledge and experience of independent third persons at 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 with sufficient information of audit firms such as key decisions and business operations. It is also important to seek comments of these independent third persons timely.

When following the pattern of including independent third persons as members in an existing oversight/assessment body (Pattern 1 in Figure III-1-5 above), independent third persons attend meetings held by the oversight/assessment body to acquiring information and to advising audit firms. On the other hand, when following the pattern

of separately setting up independent bodies (Pattern 2 in Figure III-1-5 above), they make comments based on information provided by oversight/assessment bodies. In addition, they exchange information periodically with chairpersons of audit firms. In this case, the independent third persons might have limited access to information, which is important or necessary from the perspective of the audit firm's personnel.

iii. Experience/expertise of independent third persons

When including independent third persons among the members of oversight/assessment bodies, it is necessary to appoint persons with the expected knowledge and experience based on the scale of audit firm, its governance structure and organizational issues. Large-sized and second-tier audit firms tend to appoint people with managerial experience at general business companies (Figure III-1-6).

Figure III-1-6: Experience/expertise of independent third persons (unit: persons)

| | Former senior management | Academic | Attorneys and legal experts | Former ministry/agency officials | Other |
|-------------------------|--------------------------|----------|-----------------------------|----------------------------------|-------|
| Large-sized audit firms | 7 | 1 | 1 | 3 | 1 |
| Second-tier audit firms | 4 | 1 | 2 | 2 | 2 |

(Note) Prepared by the CPAAOB using PY2017 inspections and publicly available materials from audit firms

b. Dialogue with stakeholders in the capital market for the further improvements in their audit qualities

i. Efforts at large-sized audit firms

Large-sized audit firms have heretofore had persons not on engagement teams conducting audit quality surveys and have created opportunities for dialogue with chief financial officers (CFOs), the audit & supervisory board of audited companies. With the release of the Audit Firm Governance Code, these firms have also begun holding meetings with institutional investors and analysts to exchange information and arranging other opportunities to speak with a broader range of capital market participants.

ii. Efforts at second-tier audit firms

Second-tier audit firms have not been holding their own meetings to exchange information, but some have considered joining in round-table discussions for investors hosted by the JICPA and stock exchanges.

3. Human Resources of Audit Firms

a. Partners and full-time personnel

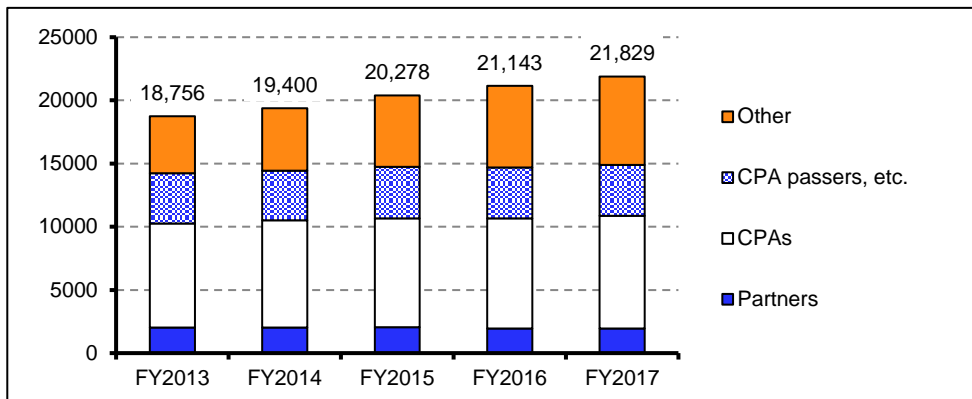
A look at changes in the number of partners and full-time personnel at different types of audit firms reveal that staffing levels at large-sized and second-tier audit firms have been on the rise since FY2014, but in a downtrend at small and medium-sized audit firms.

Looking at the composition of personnel, large-sized and second-tier audit firms have been increasing their non-CPA personnel (excluding CPA passer). The percentages of non-CPA personnel in firms' workforces in FY2017 were 32% at large-sized audit firms and 25% at second-tier audit firms, higher than their respective FY2013 figures of 24% and 20%. At small and medium-sized audit firms, on the other hand, there is a big fall in the number of CPA passers and other personnel (Figure III-1-7).

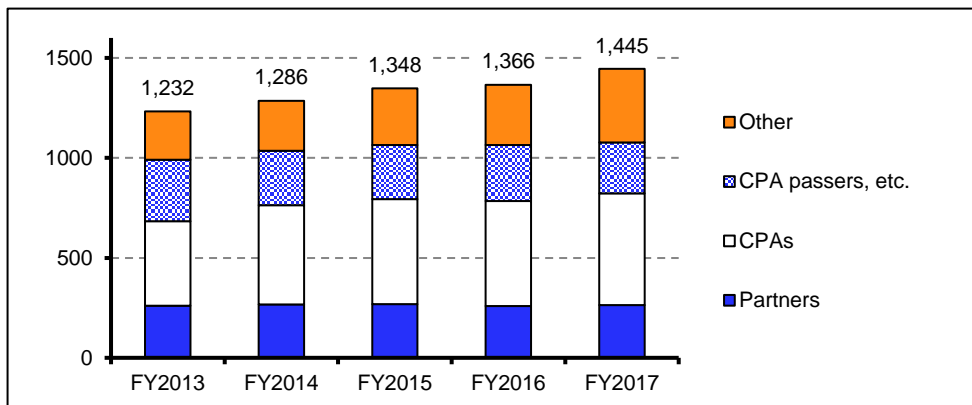
Large-sized and second-tier audit firms have increased their non-CPA personnel to deal with the growing use of IT at audited companies, improve operational efficiency, alleviate personnel shortages, and allow CPAs to focus more on assessment. Among these personnel are IT experts who conduct IT audits of audited companies and who use IT to support engagement teams in carrying out audit procedures, and unqualified assistants who assist 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 specialist organizations to centrally manage such things as unqualified assistants' work/procedures, skill development, and job allocations.

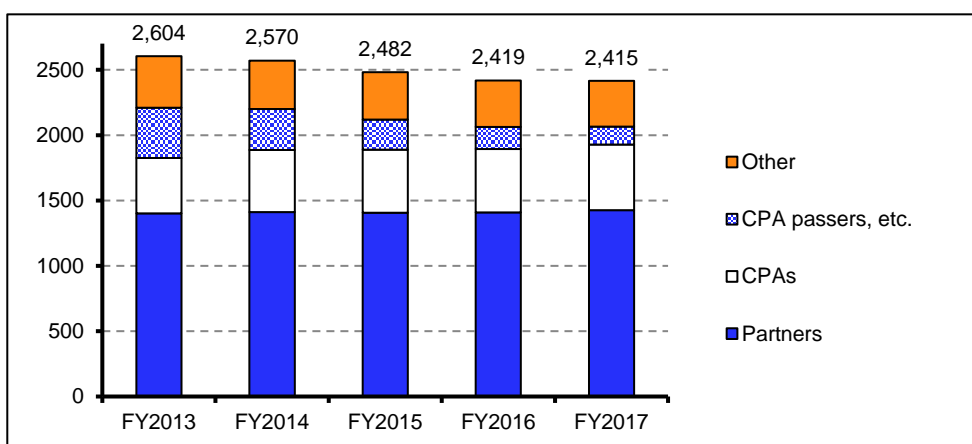
Figure III-1-7: Change in the number of partners and full-time personnel (unit: persons)
 <Large-sized audit firms (total of four audit firms)>



<Second-tier audit firms (total of six audit firms)>



<Small and medium-sized audit firms (total)>



(Note) The data are aggregates of personnel based on audit firm's operational reports. The figures for large-sized and second-tier audit firms are available up to FY2017, and those for small and medium-sized audit firms up to FY2016

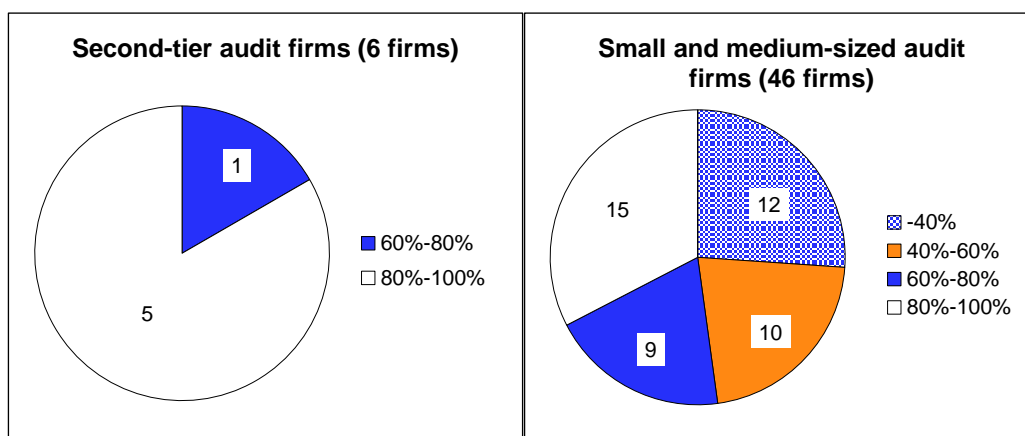
b. Side businesses by partners

Large-sized audit firms generally do not allow partners to run tax accountant offices or other solo practitioners.

Most second-tier audit firms generally do not permit partners to run side businesses as well. However, there is a firm where more than 90% of partners run side businesses.

At small and medium-sized audit firms, many of the partners were already running their own tax accountant offices when they joined the audit firm, so the vast majority of small and medium-sized audit firms permit partners to run side businesses (Figure III-1-8). In the relatively larger firms, the percentage of partners running side businesses is relatively lower.

Figure III-1-8: Number of audit firms by percentage of time spent by partners engaged in the audit firm's operations (unit: audit firms)



(Note) Prepared by the CPAAOB based on partner's declarations collected in PY2017 inspections and collection of reports

c. Part-time personnel

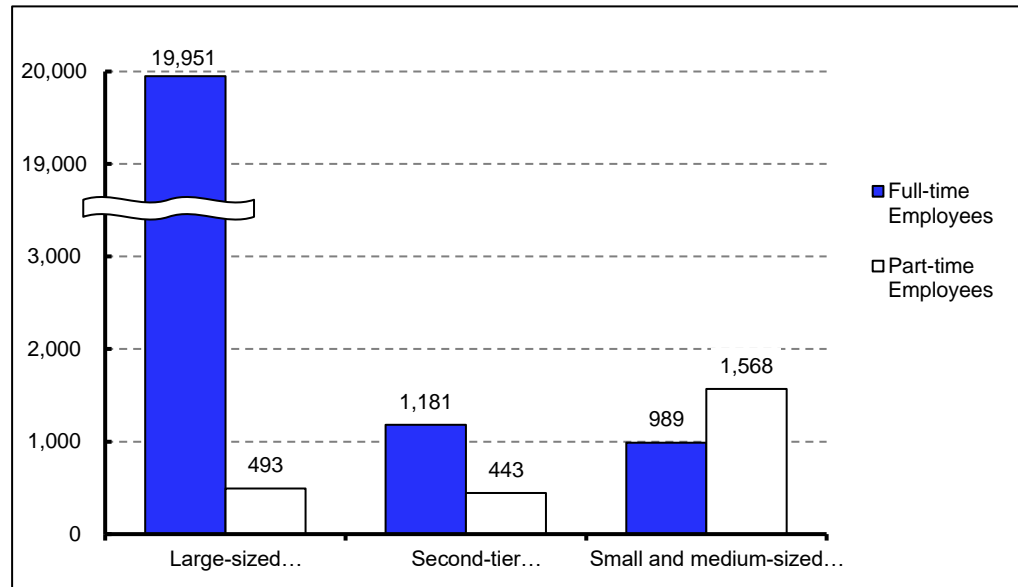
At large-sized audit firms, the percentage of part-time personnel among the workforce is extremely low.

At second-tier audit firms, part-time personnel make up less than 30% of the total workforces at all six audit firms. However, the percentage of each firm is varied and some firms have more than 60% part-time staff.

The percentage of part-time personnel at small and medium-sized audit firms is greater than 60% across the 208 audit firms as a whole, with much depending on part-time

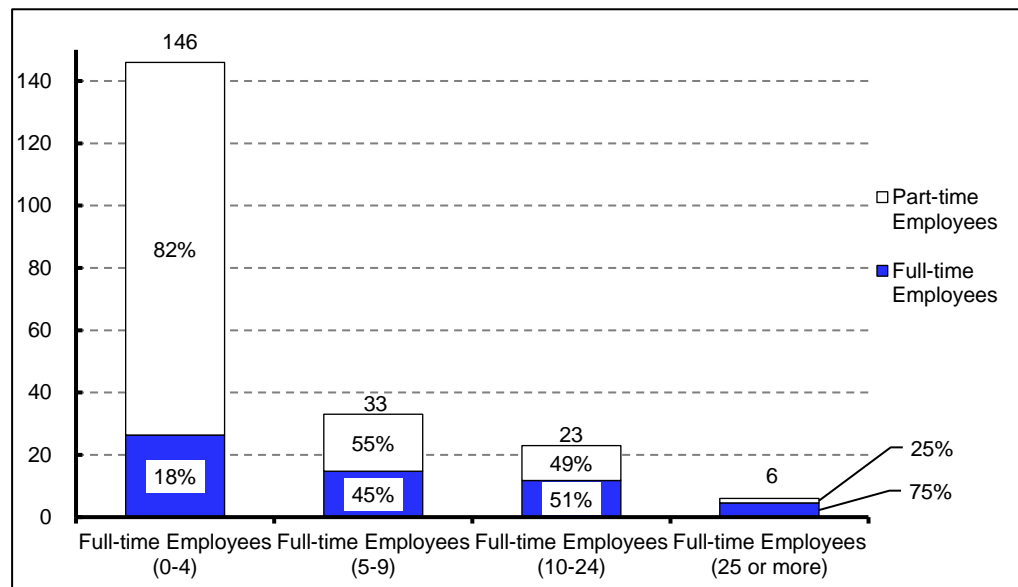
personnel to serve as assistants to engagement partners (Figure III-1-9). In particular, audit firms with four or fewer full-time personnel – accounting for 70% of all small and medium-sized audit firms – have more than 80% part-time personnel (Figure III-1-10).

Figure III-1-9: Number of full-time and part-time personnel (unit: persons)



(Note) The data aggregated for large-sized and second-tier audit firms is from FY2017 and that for small and medium-sized audit firms from FY2016.

Figure III-1-10: Personnel composition at small and medium-sized audit firms by size (unit: audit firms)



(Note) The 208 audit firms were classified by the number of full-time personnel based on the operational reports submitted by the audit firms, after which the number of employees was totaled and the composition ratios of full-time and part-time personnel calculated.

■ Efforts toward Work Style Reform ■

As shrinking Japan's labor force and growing needs for a diverse workforce, many companies have been pursuing work style reforms to improve their productivities. These companies have also been to offer workers a selection of work style options suited to their circumstances in the face of issues such as expanding employment opportunities and creating an environment in which employees can fully leverage their motivation and skills.

Personnel shortages and overwork have become problems for audit firms, too, and large-sized audit firms in particular have been making work style reform efforts to overcome these problems and ensure sufficient time for CPAs for consideration and assessment.

<Examples of work style reform efforts at large-sized audit firms >

- ◆ Timely monitoring of overtime record and schedule and considering a solution for reducing or eliminating overtime
- ◆ Limiting access time to networks, including electronic audit documentation
- ◆ Expanding work-from-home opportunities
- ◆ Introducing flextime and short-time work system
- ◆ Encouraging to take paid holidays
- ◆ Further improving audit quality/efficiency by facilitating communication with engagement teams and Quality Control division.
- ◆ Disseminating messages from top executives to raise awareness among partners and personnel

4. Organizational Structure for Providing Audit Services

An audit engagement team, as an audit service provider, is required to exercise professional skepticism¹³, carry out appropriate risk assessments 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 conduct of audit services through other monitoring activities.

This section will analyze engagement teams identified through monitoring activities.

Engagement teams ordinarily comprise engagement partners who control audits, CPAs and other personnel who assist the engagement partners. The other personnel include CPA passers and unqualified assistants (personnel without CPA-related qualifications). In addition, when the business activities of the audited companies are complex or large in scale, in-house experts (IT experts, tax experts, etc.) may be added to the engagement teams. An example of the roles by position on an engagement team at a large-sized audit firm is shown in Figure III-1-11.

Figure III-1-11: Example of the 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 | CPA A | Manager | Management of engagement team, management of financial statement audits |
| | CPA B | Manager | Management of internal control audit services |
| | CPA C | Manager | Management of foreign component audits |
| | 29 other CPAs | Senior staff | Performance of audit procedures in significant audit areas |
| | 31 qualified assistants (CPA passers, etc.) | Staff | Performance of procedures for assessing the design and effectiveness of internal controls, performance of general audit procedures |
| | Seven unqualified assistants | Assistant | Data analysis, reconciliation of administrative vouchers, other tasks not requiring significant decisions, sending/receiving of balance confirmation letters, administration of engagement documentation |
| | 14 in-house experts (Note 2) | Partner, manager, senior staff, etc. | Assessment of IT controls at audited companies, verifications of corporate tax and indirect tax processing, verifications of real estate appraisals |

¹³ An attitude includes a questioning mind, being alert to conditions which may indicate possible misstatement due to error or fraud, and a critical assessment of audit evidence.

(Note 1) Prepared by the CPAAOB based on an example of an engagement team auditing a company having consolidated sales of approximately 1.5 trillion JPY that requires approximately 18,000 hours of audit time.
(Note 2) In-house experts will be assigned to engagement teams as needed

While more than 70% of companies with consolidated sales of over 500 billion JPY used teams with three or more engagement partners, the majority of companies with consolidated sales of 500 billion JPY or less used teams with two engagement partners upon aggregating the number of personnel on the engagement teams of 4,096 companies from their FY2017 annual reports. Meanwhile, the number of assistants to engagement partners tended to increase the higher the sales of the audited companies.

The general features of the composition of engagement teams identified through inspections were as follows.

At large-sized audit firms, experienced CPAs audit high risk areas under the guidance and supervision of engagement partners. CPA passers usually cover low-risk audit areas. Unqualified assistants assist with audit services by performing such administrative tasks as sending balance confirmation letters.

On the other hand, at second-tier and small and medium-sized audit firms, the engagement partners tend to face a heavier workload than their counterparts at large-sized audit firms because limited workforce requires them to implement audit procedures, etc. (Figure III-1-12).

Figure III-1-12: Typical engagement team composition and main roles of team members

| | | Large-sized audit firms | Second-tier audit firms | Small and medium-sized audit firms |
|---------------------------------------|------------------------|--|--|--|
| Engagement partners | | <ul style="list-style-type: none"> • Setting of significant audit areas and assessment of risks • Review of audit procedures performed by assistants • Communication with management and the audit & supervisory boards | <ul style="list-style-type: none"> • Setting of significant audit areas and assessment of risks • Review of audit procedures performed by assistants • Performance of audit procedures in significant audit areas • Communication with management and the audit & supervisory boards | <ul style="list-style-type: none"> • Setting of significant audit areas, assessment of audit risk, and drafting of audit plans • Review of audit procedures performed by assistants • Performance of audit procedures • Communication with management and the audit & supervisory boards |
| Assistants to the engagement partners | CPAs | <ul style="list-style-type: none"> • Drafting of audit plans • Performance of audit procedures in significant audit areas • Review of audit procedures performed by other assistants | <ul style="list-style-type: none"> • Drafting of audit plans • Performance of audit procedures • Review of audit procedures performed by other assistants | <ul style="list-style-type: none"> • Performance of audit procedures • Review of audit procedures performed by other assistants |
| | CPA Passers | <ul style="list-style-type: none"> • Performance of audit procedures | <ul style="list-style-type: none"> • Performance of audit procedures | <ul style="list-style-type: none"> • Performance of audit procedures • Not employed in most small audit firms |
| | Unqualified assistants | <ul style="list-style-type: none"> • Data analysis • Dispatch/collection of balance confirmation letters, administration of audit documentation | <ul style="list-style-type: none"> • Data analysis • Dispatch/collection of balance confirmation letters, administration of audit documentation | <ul style="list-style-type: none"> • Not employed in most small audit firms |

5. Organizational Structure for Supporting Audit Services

With audited companies becoming larger and more internationalized, it is essential that audit firms provide expertise and otherwise support engagement teams to ensure appropriate audits.

Accordingly, the CPAAOB's 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 environment for supporting audit services identified through our monitoring. We will also provide some examples, mainly from large-sized audit firms, of environments for identifying audit risk.

a. Overview of environment for support

To ensure appropriate services, large-sized audit firms have established various departments: risk management, periodic inspection in relation to a system of quality control, accounting support, audit support, engagement quality control reviews, IT, and international services (Figure III-1-13). See "E. Engagement Quality Control Reviews" (page 84) and "F. Monitoring of Systems of Quality Control" (page 85) for information on engagement quality control reviews and periodic inspections.

There are more than 100 full-time professionals on average at the quality control divisions of large-sized audit firms according to our collection of reports and on-site inspections. These professionals work with personnel in charge of quality control in the audit services division.

Many second-tier audit firms also have quality control divisions, but their structure is smaller than those of large-sized audit firms. Small and medium-sized audit firms, on the other hand, sometimes do not have a quality control division. Instead, they have a person in charge of quality control, and sometimes this person is the firm's representative.

Figure III-1-13: Example of a support system at a large-sized audit firm

| Support departments | | Roles |
|--------------------------|--|---|
| Quality control division | Risk management department | Ensuring independence, approving acceptance of and withdrawal from audit engagements, responding to risk of fraud, etc. |
| | Periodic inspection department | Ongoing monitoring and implementing periodic inspection in relation to a system of quality control |
| | Accounting support department | Responding with expert advice to inquiries concerning accounting standards, procedures, etc. |
| | Audit support department | Responding with expert advice to inquiries concerning audit standards, manuals, and procedures |
| | Engagement quality control review department | Performing engagement quality control review as well as the higher-level reviews about important or risky issues |
| IT division | | Conducting IT audits for audited companies, supporting engagement teams through IT audit tools |
| International division | | Collecting/providing local information overseas, supporting collaboration with network firms, etc. |

b. Management of risk information

Audit firms develop and maintain the cross-organizational 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-1-14).

Figure III-1-14: 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 and implementing continued monitoring and support to engagement teams by gathering information • Maintaining a system for accessing expertise inside and outside of the audit firm and performing a high-level engagement quality control review when there are circumstances that indicate the possibility of a material misstatement due to fraud or suspicion of a material misstatement due to fraud • 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 when addressing the risk of fraud or considering high-risk matters |
|---|

6. Audit Firm Groups

a. Group structure

Many large-sized and second-tier audit firms have formed their own audit firm groups that use a common brand and cooperate with each other in providing services. Besides the audit firms, these groups generally include consulting companies that carry out financial due diligence¹⁴, corporate value assessment, fraud investigations, etc., advisory companies that provide financial advice on M&A deals, and tax accountant firms. Data made publicly available by audit firms show that the average number of companies in a large-sized audit firm's group is 13, while that in a second-tier audit firm group is six.

In terms of group structure, 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 tax accountant and attorney firms) and making them subsidiaries.

Groups are generally administered by 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

A look at the changes in the proportion of total operating revenues¹⁵ generated by group companies other than the audit firms reveals that, in large-sized audit firm groups, the operating revenues of group firms increased substantially through FY2016, propelling an uptrend in the share of these operating revenues within operating revenues for the group as a whole. One firm's group changed its fiscal year-end in FY2017, making it difficult to draw simple comparisons, but the proportion of operating revenues coming from group companies within those for the entire group has turned downward, now sitting at about 30%. A similar trend can be seen in the proportion of revenues from non-audit services to the group's overall operating revenues (group company revenues as well as non-audit service revenues at audit firms), which was less than 50% in FY2017.

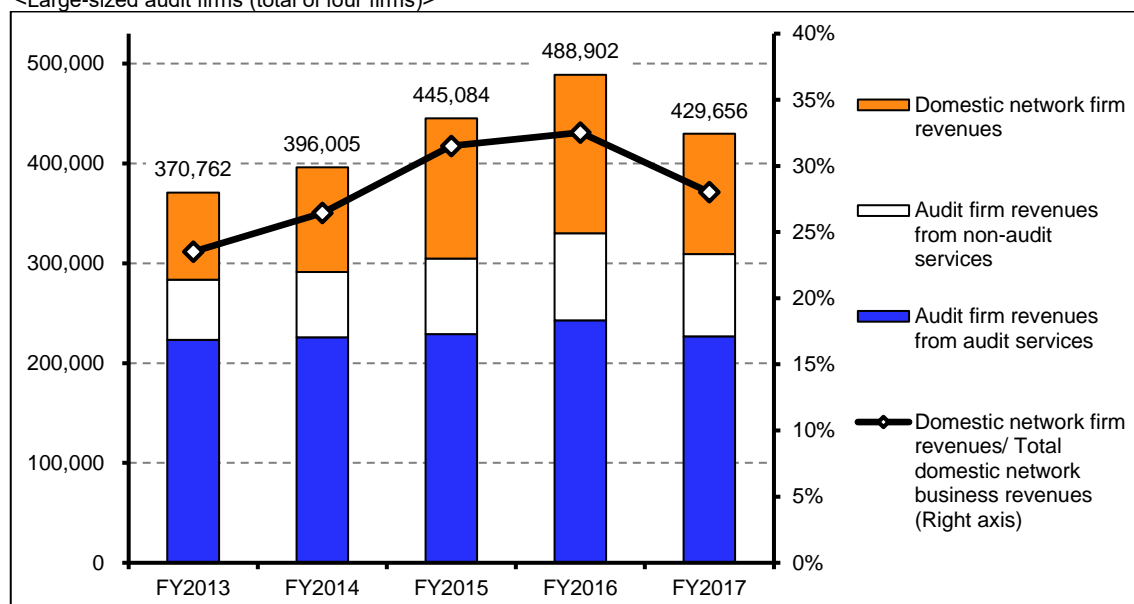
At second-tier audit firms, on the other hand, revenues from group companies other than the audit firm's account for a small percentage of total operating revenue, and the

¹⁴ Asset investigations of companies are considered for acquisition, etc.

¹⁵ Excludes the operating revenues of tax accountant and attorney firms

amount has not changed much. Group earnings structures thus differ greatly from those of large-sized audit firms (Figure III-1-15).

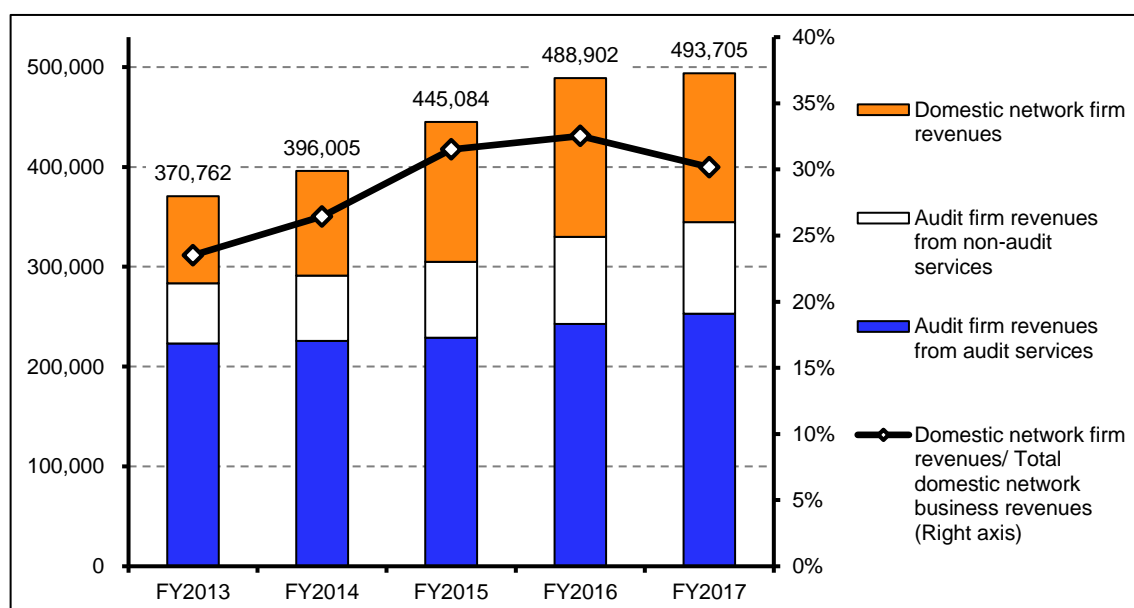
Figure III-1-15: Changes in audit firm group operating revenues and group firms' share of these operating revenues (unit: million JPY (left axis))
<Large-sized audit firms (total of four firms)>



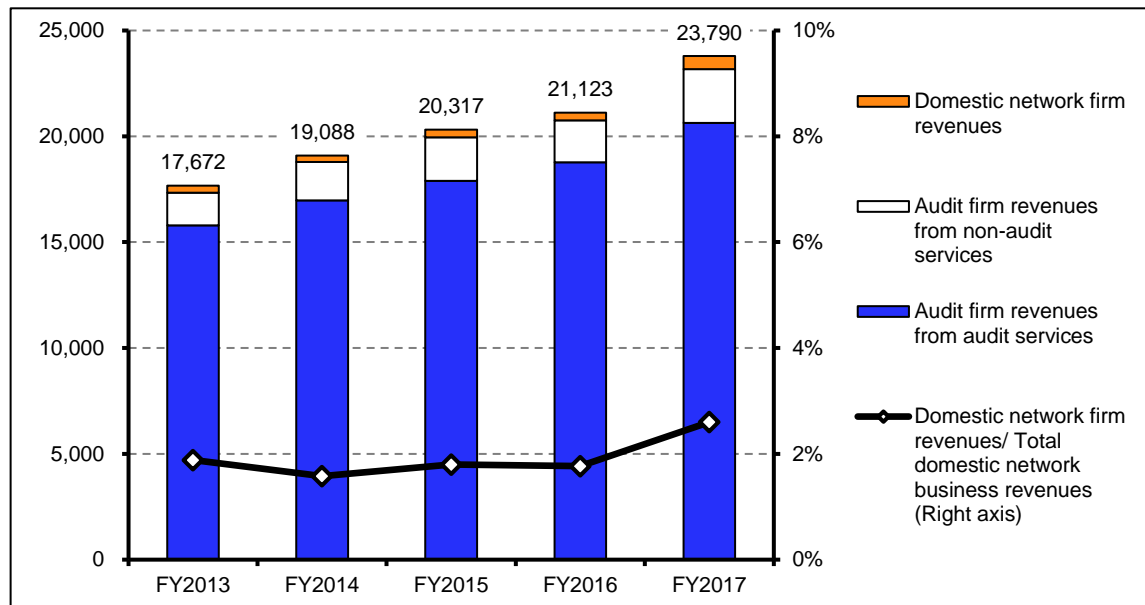
(Note 1) Group operating revenues do not include operating revenues from tax accountant and attorney firms

(Note 2) 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.

(Reference) If the eight months of operating revenues for the audit firm group that changed its fiscal year-end are extrapolated at the same level to a full year (i.e., multiplied by 12 months/8months), the estimated change over time is shown below.



(Second-tier audit firms) (Total of six firms)



(Note) Operating revenues are the sum for the audit firm groups for the above fiscal years.

B. Education, Training and Evaluation of Engagement Teams

In order to maintain and improve audit quality, audit firms need to provide their engagement teams with opportunities to acquire necessary expertise and also need to evaluate them appropriately. It is particularly important to cultivate and evaluate members of the engagement teams who can exercise the proper professional skepticism needed to identify accounting fraud. The CPAAOB monitors and inspects firm management, especially focusing on hiring, training, assignment, evaluation and compensation.

In this section we will describe audit firms' human resource development, education, training, and evaluation of its engagement teams (including engagement partners), which we have studied through our monitoring activities.

1. Human Resource Development

To deal with changes to the auditing environment and the deepening complexity of audit methodologies, large-sized and second-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-2-1).

Figure III-2-1: Examples of career opportunities at large-sized and second-tier audit firms

- Carrying out work rotations and inter-organizational transfers (inclusive of regional offices)
- Involving personnel in advisory and other non-audit services and quality control activities
- Posting personnel at network firms
- Seconding personnel to locations outside the audit firm (e.g., domestic group firms, JICPA and other relevant organizations, other companies, etc.)

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 (28)).

To meet this requirement, audit firms have developed structures for educating and training their engagement teams in proportion to their size (Figure III-2-2).

Figure III-2-2: Examples of systems for education/training

| | |
|---|---|
| Large-sized and second-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 position and level of experience • Implementing a series of training courses that include updates of foreign and domestic accounting and auditing standards, the use of audit tools, responding risk of fraud, the results of periodic inspections, the CPAAOB inspections and the JICPA reviews • Conducting examinations to measure understanding of training • Offering aid for obtaining language qualifications and providing foreign language training inside and outside Japan |
| 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 DVDs in most firms • Sharing results of periodic inspections, CPAAOB inspections, and JICPA reviews within firms |

Large-sized and second-tier audit firms have education and training sections. In addition, large-sized audit firms have developed training programs based on job position and experience in conjunction with their global audit networks.

On the other hand, some small and medium-sized audit firms have difficulties in providing training programs that are suitable to personnel's experience and capability and their audited companies due to a lack of human resources capable of providing their own educational and training programs. Therefore, they just have personnel watch DVDs supplied by the JICPA.

(Education and training needed for IFRS adoption)

As the number of companies adopting IFRS have now exceeded 150 in Japan¹⁶, there has been an increasing number of partners and staff involved in audits of audited companies that apply IFRS, especially at large-sized audit firms. For that reason, the CPAAOB monitors the training structures relating to IFRS (Figure III-2-3).

¹⁶ Sources: Stock exchanges (as of June 30, 2018)

Figure III-2-3: Examples of education/training related to IFRS

| | |
|--|---|
| <p>Large-sized and second-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 · Dispatching personnel to, or exchanging information with, the organization responsible for interpreting IFRS and formulating policies for the application |
|--|---|

■ Example of Education/Training of Professional Staff ■

Although it had been noted in past quality control reviews that partners and staff lack adequate knowledge of audit procedures, a small and medium-sized audit firm did not develop education/training environments to improve audit quality. The audit firm had previously planned/conducted its own training, but in recent years only checked whether its CPAs received required training for maintaining the CPA certifications (Continuing Professional Education (CPE)). The partner in charge of quality control and other partners unable to spare the time for quality control because they devoted all their time to new audit engagements.

3. Evaluation of Engagement Team Members

The appropriate performance evaluation of engagement team members is notably important for improving audit quality at audit firms. The QCSCS stipulate 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 A24).

a. Evaluation of partners

Performance evaluation of partners is conducted based on audit quality, contribution to audit firm operations, and the number of new engagements obtained. In recent years, there has been a shift in emphasis in performance evaluation procedures, particularly at large-sized audit firms, in favor of audit quality control. For example, large-sized audit firms perform their evaluations as shown in Figure III-2-4.

Figure III-2-4: Examples of evaluations of partners at large-sized audit firms

- Partners are usually evaluated in various areas, including team management and 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 communication with executives of audited companies.
- Skills and performance evaluations are conducted and “quality control” and “expertise/skills” are given considerable weight in skills evaluations.
- Assessments made during periodic inspections in relation to firm’s system of quality control (see “F. Monitoring of Systems of Quality Control, 1. Periodic Inspections” (page 85) for details) 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 necessary action, such as setting goals for addressing areas that need improvement. Some audit firms adjust partner compensation and assignment of audits based on evaluation. The firms occasionally restrict partners’ involvement in audit engagements when evaluation results are extremely poor.

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 second-tier audit firms generally promote new hires to managers after approximately 10 years and to partners after a further seven to 10 years. Small and medium-sized audit firms, however, rarely hire new graduates, and sometimes they hire mid-career CPAs based on the assumption that they will be promoted to partners.

Most large-sized and second-tier audit firms evaluate personnel based on factors such as audit quality, understanding of auditing standards and communication within engagement teams. Small and medium-sized audit firms conduct similar evaluations, but have often not established a policy of giving promotions to partner or other job positions based on evaluation results.

■ Example of Partner Evaluations ■

When appointing engagement partners, a second-tier audit firm did not evaluate candidates’ competence and skills in performing their professional responsibilities as engagement partners. The audit firm executive preparing the proposal presumed that an examination of the partner’s execution of routine duties essentially constituted the evaluation needed for appointment as engagement partners. Members of the partners meeting did not find any problems with the approach taken by the audit firm executive when they approved the proposal.

C. Acceptance of New Audit Engagements and Changes of Auditors

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 has also collected information and conducted examinations on this matter through our monitoring activities, which include inspections.

The differences among large-sized and second-tier audit firms as well as small and medium-sized audit firms in the process of the acceptance of new audit engagements are described below.

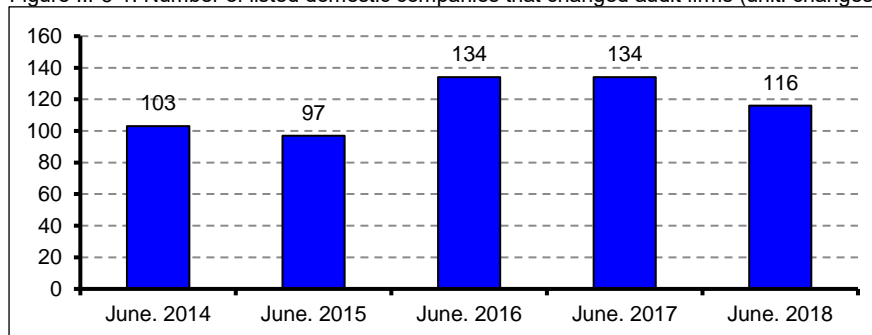
Because large-sized audit firms also provide non-audit services to companies other than their audited companies, they receive requests to audit these companies by deepening their relationships with the companies through the provision of non-audit services. In other case, audited companies ask audit firms to submit proposals and hold a competition when making new audit engagements. In such cases, audit firms take organizational efforts, for example, partners who are familiar with the sector in which potential clients operate are assigned to work on the proposals.

The most common reason for accepting new audit engagements at second-tier and small and medium-sized audit firms are an introduction from its partner's acquaintance. It seems that second-tier and small and medium-sized audit firms tend to accept audit engagements through the personal connections of partners.

The section below analyzes the acceptance of new audit engagements and changes in auditors, and the connection between details ascertained through monitoring activities and publicly available information.

The number of listed domestic companies that changed their audit firm was 116 as of the end of June 2018, fewer than the numbers at the end of June 2016 and June 2017 but more than at the end of June 2015 (Figure III-3-1).

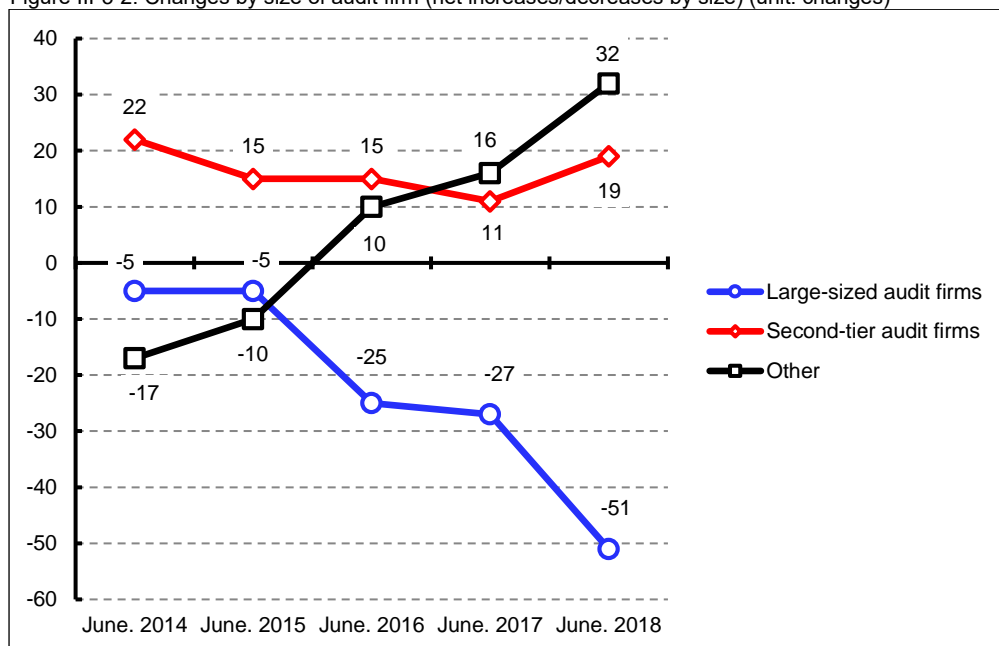
Figure III-3-1: Number of listed domestic companies that changed audit firms (unit: changes)



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

Examining these changes by audit firm size highlights the trend of changing from large-sized audit firms to second-tier or small and medium-sized audit firms at the end of June 2018 (Figures III-3-2 and III-3-3).

Figure III-3-2: Changes by size of audit firm (net increases/decreases by size) (unit: changes)



(Note 1) Net increases/decreases in the number of changes

(Note 2) "Other" in the figure refers to small and medium-sized audit firms, partnerships and solo practitioners.

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

| From/to | June 2017 | June 2018 | Increase/decrease |
|---------------------------|-----------|-----------|-------------------|
| Large-sized → Large-sized | 27 | 27 | 0 |
| → Second-tier | 16 | 23 | 7 |
| → Other | 23 | 29 | 6 |
| Second-tier → Large-sized | 4 | 1 | ▲3 |
| → Second-tier | 5 | 1 | ▲4 |
| → Other | 7 | 6 | ▲1 |
| Other → Large-sized | 8 | 0 | ▲8 |
| → Second-tier | 6 | 3 | ▲3 |
| → Other | 38 | 26 | ▲12 |
| Total | 134 | 116 | ▲18 |

(Note 1) Aggregates based on timely disclosures by listed domestic companies

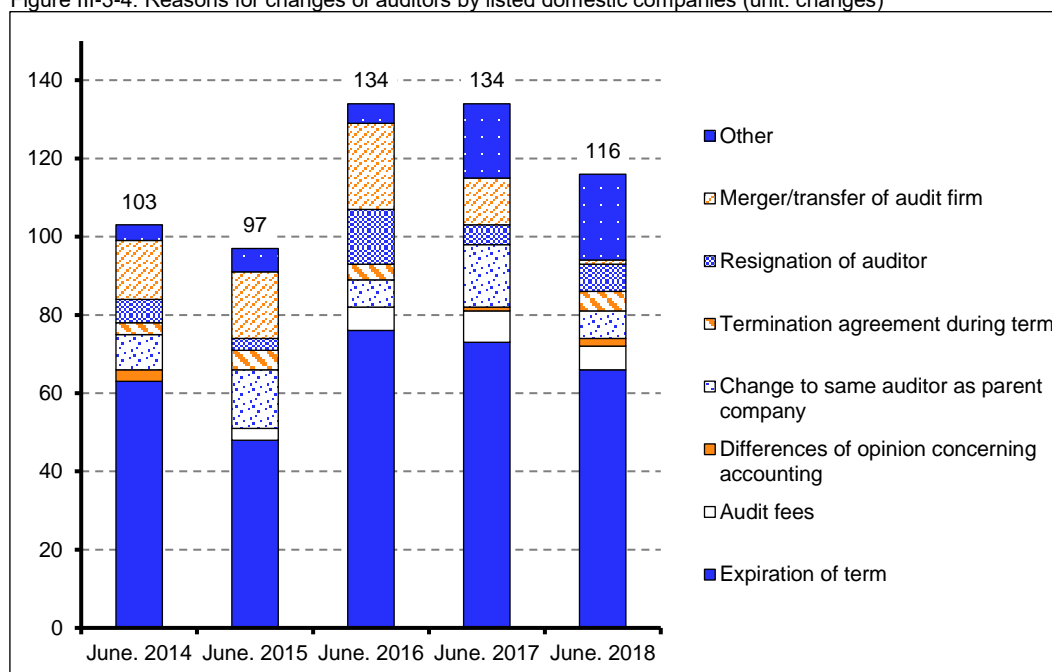
(Note 2) "Other" in the figure refers to small and medium-sized audit firms, partnerships and solo practitioners.

1. Reasons for Change of Auditor Given in Timely Disclosures by Audited Companies

When a listed domestic company has changed its auditors, the company must disclose the change and reason for the change immediately (Article 402 of the Securities Listing Regulations, Tokyo Stock Exchange).

The most common reason for the changes was the expiration of the audit term, with substantial reasons not being given in many cases, according to disclosures made during the past five years (Figure III-3-4).

Figure III-3-4: Reasons for changes of auditors by listed domestic companies (unit: changes)



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

2. Reasons for Change of Auditor during Fiscal Term

There were 15 instances of auditors being changed during the fiscal term within a total of 116 changes in total at the end of June 2018 (Figure III-3-5).

Figure III-3-5: Reasons for change of auditor during fiscal term (unit: changes)

| Reason for change | Changes |
|---|---------|
| Request for cancellation/resignation by audit firm due to accounting frauds by audited companies | 6 |
| Request for cancellation by audited company due to differences of opinion concerning accounting with audit firm | 3 |
| Dissolution of audit firm | 3 |
| Change by subsidiary to same auditor as parent company | 1 |
| Failure reaching agreement on audit fees | 1 |
| Other | 1 |

3. Reasons for Changes in Auditors as Identified Through Monitoring Activities

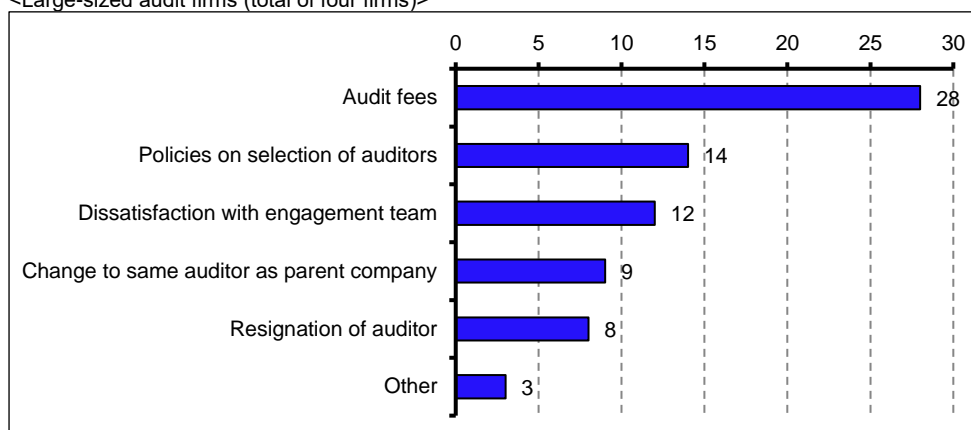
This section discusses reasons for changing auditors ascertained through monitoring activities in PY2017. The number of changes obtained through the CPAAOB monitoring does not match the number obtained through company disclosure for the following reasons: inspections were not conducted and reports were not collected from all audit firms in PY2017 and the number includes the previous year's due to the timing of inspections and collection of reports.

a. Large-sized audit firms

Predecessor auditors at large-sized audit firms pointed to audit fees as the primary reason for the changes, as was the case the previous year, according to the results of inspections and the collection of reports. Next came policies on the selection of auditors. The companies mentioning this reason changed their auditors due to lengthening of audit engagements and needs for new perspectives.

Similar to the previous year, dissatisfaction with the engagement team was also frequently cited as a reason. Details of the reason were: the predecessor auditor's response to fraud and prior period adjustment, inflexibility of the engagement team, a rise in audit workload, and involvement of inexperienced staff in substantive audit procedures (Figure III-3-6).

Figure III-3-6: Reasons for changes in auditors according to the predecessor auditors (unit: changes)
<Large-sized audit firms (total of four firms)>



(Note 1) Based on data from 51 changes identified through inspections and report collection during PY2017

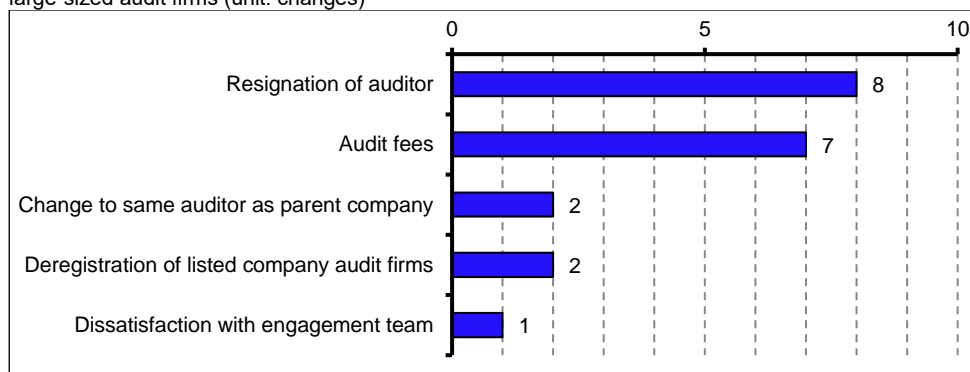
(Note 2) If there was more than one reason, that change is included in the figure for each reason (a cumulative total of 74)

b. Second-tier and small and medium-sized audit firms

The primary reason of changes was resignation of an auditor, where the auditor did not renew the audit agreement, according to 16 changes aggregated by the results of inspections and the collection of reports between July 2016 and June 2017. It cites heightened audit risks from the expansion of audited companies' business, changes in shareholders, or the exposure of fraud. In addition, changes in auditors stemming from audit fees increased vis-à-vis the monitoring results from the previous year (Figure III-3-7).

When the eight changes prompted by the resignation of the auditor were cross-checked against the reasons given in company disclosure, it was found that expiration of term was the reason given in seven of the company disclosure.

Figure III-3-7: Reasons for changes in auditors according to the predecessor auditor at audit firms other than large-sized audit firms (unit: changes)



(Note 1) Based on data from 16 changes for which the reason was identified in reports collected from six second-tier audit firms and 43 small and medium-sized audit firms and four solo practitioners

(Note 2) If there was more than one reason, that change is included in the figure for each reason (a cumulative total of 20)

- c. Analysis of reasons given in disclosures by audited companies and reasons identified through monitoring activities

Amongst above mentioned 94 reasons, 80 was expiration of term in the disclosures made by audited companies. Below figure reveals that gaps between the reasons disclosed by the companies and those identified through monitoring activities (Figure III-3-8).

Figure III-3-8: Breakdown of changes due to "expiration of term" (unit: changes)

| Reasons for change identified through monitoring | Changes |
|--|---------|
| Audit fees | 34 |
| Resignation of auditor | 14 |
| Policies on selection of auditors | 14 |
| Dissatisfaction with engagement team | 12 |
| Change to same auditor as parent company | 2 |
| Other | 4 |
| Total | 80 |

D. 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 when determining them.

On the other hand, the JICPA's Code of Ethics states that an audit firm may quote whatever fee deemed to be appropriate. There may be a self-interest threat to professional competence and due care is created if the fee quoted is so low that it may be difficult to perform the engagement in accordance with applicable technical and professional standards. Therefore, the Code also stipulates that safeguards should be considered and applied as necessary to eliminate or reduce such threat to an acceptable level for ensuring a certain level of audit quality.

- a. Making the client aware of the terms of the engagement and, in particular, the basis on which fees are charged and which services are covered by the quoted fee
- b. Assigning appropriate time and qualified staff to the task

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-4-1).

Figure III-4-1: Methods for calculating estimated audit fees

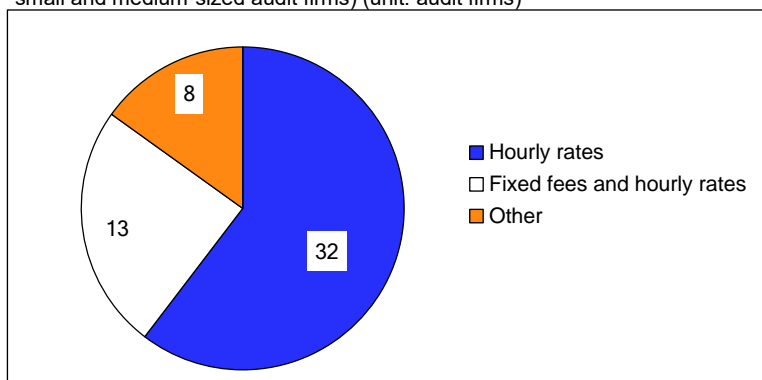
| Method | Method for calculating estimated audit fees |
|-----------------------------|--|
| Hourly rates | Audit fees are calculated by multiplying the number of hours an audit team will spend by a certain unit price (hereinafter referred to as the "charged rate"). |
| Fixed fees and hourly rates | <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) "Guidelines for the Calculation of Audit Fees", JICPA

The collected reports indicate that all large-sized audit firms employ the hourly rate approach for audit fee estimates.

Similarly, most second-tier and small and medium-sized audit firms also take the hourly rate approach, but some use the fixed fees and hourly rate approach. Several firms charge the same fees as the predecessor auditor or as they charged in previous years, or utilize multiple calculation methods (Figure III-4-2).

Figure III-4-2: Methods for calculating estimated audit fees (second-tier and small and medium-sized audit firms) (unit: audit firms)



(Note) Aggregated from 53 reports collected from second-tier and small and medium-sized audit firms in PY2017

There are two ways of determining the charged rate: one is the rate charged by job position and the other is single rate.

Some large-sized audit firms set rates by job position, by the degree of difficulty of audit services, and by each audit service provided. One-quarter of second-tier and small and medium-sized audit firms have set rates corresponding to job position or professional responsibility, while the majority of the remaining firms have set single rates irrespective of job position (Figure III-4-3).

Figure III-4-3: Setting of rates corresponding to job position (second-tier and small and medium-sized audit firms)

| Settings | Number of audit firms | Percentage |
|---------------|-----------------------|------------|
| Rates set | 13 | 25% |
| Rates not set | 40 | 75% |
| Total | 53 | 100% |

(Note) Aggregated from 53 reports collected from second-tier and small and medium-sized audit firms in PY2017

At large-sized audit firms, 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. Investment in information systems is on the rise, prompted by advances in R&D on audit methodologies utilizing IT.

3. Audit Fees Before and After Changes in Auditors

According to “Auditors of Listed Companies and Audit Fees - 2018” published by the JICPA, the average audit fees paid by the listed domestic companies that were covered by the report declined between fiscal years 2008 and 2012 but have been on the increase since fiscal year 2013.

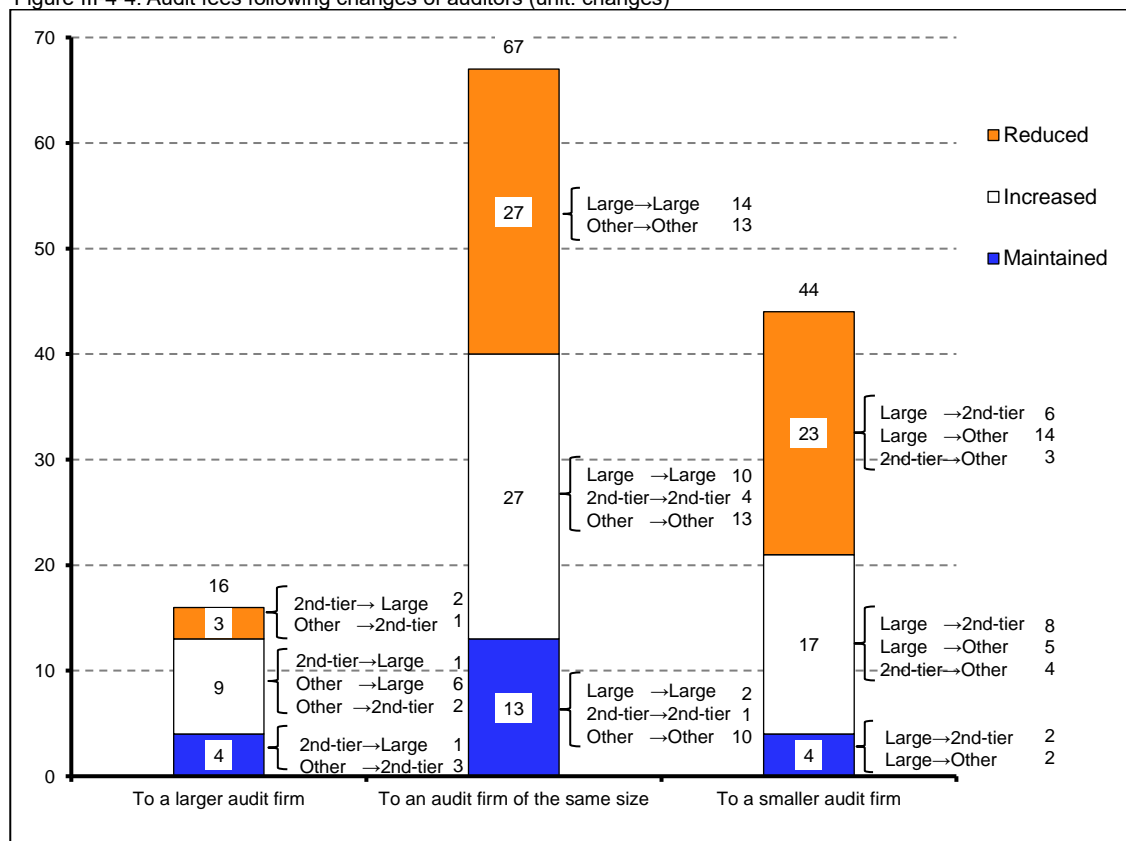
As audit fees are often revised when auditors are changed, the CPAAOB analyzed audit fees before and after changes in auditors. We found that the change in audit fees varies depending on the size of the incoming audit firms.

When switching to a larger audit firm, the audit fees often remain the same or increase.

When switching to an audit firm of similar size, audit fees are reduced in around 40 percent of cases, but in the case of switches between large-sized audit firms, most of the switches (14 out of 26) saw a drop in audit fees, and this trend has been continuing since 2016.

When switching to a smaller audit firm, the audit fees fell in over 50% of the cases (Figure III-4-4).

Figure III-4-4: Audit fees following changes of auditors (unit: changes)



(Note 1) Based on changes in auditors between July 2016 and June 2017 where the audit fees before and after the changes were publicly disclosed

(Note 2) Breakdowns of these changes are shown in the graph.

(Note 3) "Other" in the figure refers to small and medium-sized audit firms, partnerships and solo practitioners.

(Sources) Timely disclosures of changes in auditors and annual securities reports

4. Dependence on Fees (Safeguards)

An audit firm may, out of fear of losing an audit engagement, be impeded its independence by its self-interest or become susceptible to unreasonable pressure due to the audit firm's dependence from its audited company when the revenues from the audited company reach a certain percentage of the audit firm's¹⁷ total revenues¹⁸.

The JICPA's "Guidelines on Independence" stipulate that if an audit firm has been dependent on an audit fee from a particular listed domestic company for more than 15 percent of its revenues for two straight terms, it must examine whether it would be prudent to institute one of the following safeguards:

- a. Before expressing its audit opinion for the second or subsequent years, requesting a CPA that is not a member of the audit firm to conduct an engagement quality control review of the audit
- b. Between expressing its audit opinion for the second or subsequent years and before expressing its audit opinion for the next fiscal year, requesting a CPA that is not a member of the audit firm to conduct the periodic inspection in relation to system of quality control, or ask the JICPA to conduct a quality control review of the audit

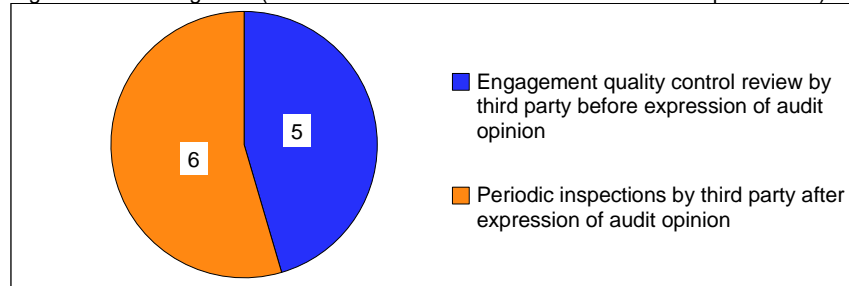
Large-sized audit firms did not have any cases requiring safeguards. One second-tier audit firm (1 engagement), six small and medium-sized audit firms (10 engagements), and one solo practitioner (1 engagement) imposed safeguards due to high dependence on particular engagements among the 53 audit firms that were subject to inspections or collection of reports in PY2017.

The second-tier audit firm mentioned above accepted an engagement quality control review by a third-party CPA before the expression of an audit opinion. The small and medium-sized audit firms and a solo practitioner, meanwhile, responded by undergoing the periodic inspections or engagement quality control reviews before the expression of an audit opinion by a third-party CPA (Figure III-4-5).

¹⁷ Refers to the audit firm, business entities controlled by the audit firm via agreements, personal relations, etc., and business entities that control the audit firm

¹⁸ Total audit and non-audit service revenues (from advisory services, tax-related services, etc.)

Figure III-4-5: Safeguards (small and medium-sized audit firms and a solo practitioner)



(Note) Data aggregated from 47 reports collected from small and medium-sized audit firms, partnerships and solo practitioners in PY2017

■ Example of Safeguards ■

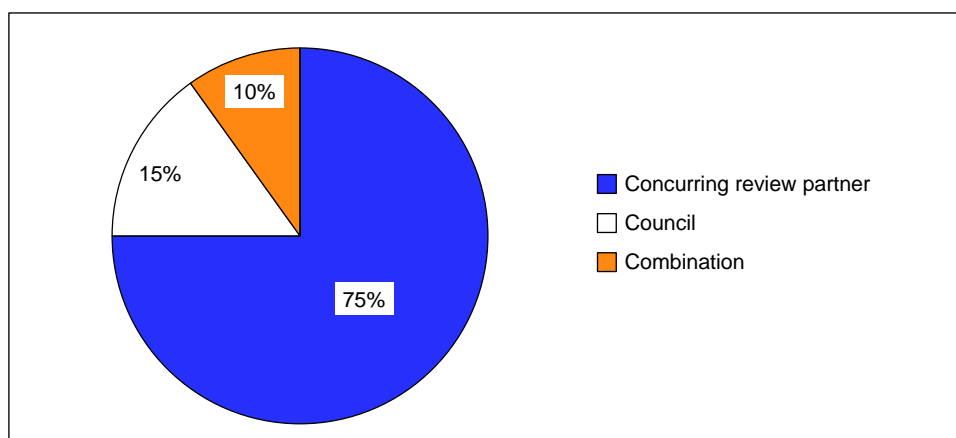
One small and medium-sized audit firm assigned a third-party CPA responsibility for safeguards even though the CPA had not performed audit services for a long period of time.

E. Engagement Quality Control Reviews

The “IV. Reporting Standards – Basic Principles” in auditing standards require that an engagement quality control review be performed with respect to the expression of an audit opinion, and the review can be regarded as the last bastion of an appropriate audit opinion. Performing an appropriate engagement quality control review has a significant impact on audit quality as it concerns the objective assessment of an audit opinion and material judgments made by an engagement team.

There are three main forms of engagement quality control reviews adopted by audit firms: a. the concurring review partner form (a review is performed by a partner other than the engagement partner), b. the council form (an engagement quality control review is performed under the council system), and c. the combination form (an engagement quality control review is performed by a concurring review partner, and certain significant matters in expressing audit opinions, which are clarified in advance, are discussed and reviewed at the council if the matters arise). The forms of engagement quality control review are shown below (Figure III-5)

Figure III-5: Forms of engagement quality control review (FY2016)



(Note) Aggregated the status of 214 audit firms from operational reports submitted by the audit firms

Most large-sized and second-tier audit firms conduct engagement quality control reviews using the combination form. Around 70 percent of small and medium-sized audit firms, however, employ the concurring review partner form, though some perform engagement quality control reviews using the council form or the combination form.

■ Cases Pertaining to Engagement Quality Control Reviews ■

The use of methods or ratios different from those established in the audit firm's guidelines to decide on audit materiality requires approval from the reviewer or the review council but, during inspections of several second-tier audit firms, it was discovered that the reviewer and/or the review council had given approval despite the audit firm not providing a reasonable explanation.

F. Monitoring of Systems of Quality Control

Audit firms are responsible for maintaining and improving audit quality, and it is important that they take the initiative in improving audit quality

Therefore, it is important for audit firms to understand and improve the quality control level of audit engagements. The CPAAOB inspects the monitoring of audit firms' systems of quality control.

Furthermore, audit firms, particularly large-sized ones, have undergone reviews from the global networks to which they belong as part of their monitoring in relation to quality control in recent years. In this section, The CPAAOB also analyzes how those firms utilize global reviews.

1. Periodic Inspections

Once an audit has concluded, the audit firm must conduct procedures to ascertain whether an engagement team performed audits in accordance with the system of quality control 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 (QCSCS (47)).

Although the periodic inspections are being conducted at all audit firms, factors such as the number of inspections, the number of people involved and tools used differ depending on the size of the firm (Figure III-6-1).

Furthermore, regardless of their size, at all firms the results of the inspections and details of the identified deficiencies are shared and warned to all partners and staff at each firm through in-house training, etc.

Moreover, the inspection results are usually reflected on evaluation of engagement partners at large-sized audit firms to boost the effectiveness of audit quality improvements.

Figure III-6-1: Overview of the periodic inspections conducted in FY2017

| | Large-sized audit firms | Second-tier audit firms | Other |
|---|--|--|---|
| Number and method of selection of audit engagements to be inspected | Each engagement partner is subject to an inspection at least once every three years. Additional inspections may also be performed based on the size and complexity of audited companies. | Each engagement partner is subject to an inspection at least once every three years. Additional inspections may also be performed based on the size and complexity of audited companies. | Each engagement partner is subject to an inspection at least once every three years. |
| Inspectors | The partner in charge of quality control and other partners and assistants who are not involved in inspected audit engagements (sometimes a dedicated team is established) | The partner in charge of quality control and other partners and assistants who are not involved in inspected audit engagements; third-party CPAs inspect engagements to which safeguards due to a high dependence on particular engagements have been applied. | The partner in charge of quality control and/or partners and staff appointed by him/her; third-party CPAs inspect engagements to which safeguards due to a high dependence on particular engagements have been applied. |
| Number of inspectors | Between around 40 and 210 | From a few to around 20 | A few |
| Number of engagements handled by each inspector | Typically around three to five engagements, but some firms have each inspector handle around 20 engagements. | From a few to a dozen or so | A few |
| Inspection tools | Tools provided by the global network to which the firm belongs or tools developed in-house are used. | Typically tools developed in-house are used. | "Checklist for Periodic Inspections" and "Audit Service Review Procedures" provided by JICPA are used. |
| Use of inspection results | Inspection results are shared within the firm and reflected in evaluations of partners and staff. | At some firms, inspection results are shared within the firm and reflected in evaluations of partners and staff. | Inspection results are shared within the firm. |

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

■ Cases Pertaining to Periodic Inspections ■

There were some large-sized audit firms that, in addition to periodic inspections, select audit services with high audit risk and inspect audit working papers throughout the audit procedures, and then endeavor to make timely improvements of any deficiencies identified in the audit procedures.

2. Utilization of Global Reviews

Most global networks assign reviewers to their member audit firms to perform global reviews aimed at confirming that local audit services are being conducted in accordance with the network's policy.

Whether or not global reviews are performed generally depends on using the global network's audit manual. Whereas all large-sized and second-tier audit firms have global reviews, most of the small and medium-sized audit firms that are members of global audit networks (22 firms) do not undergo these reviews (Figure III-6-2).

Figure III-6-2: Overview of global reviews

| | Large-sized audit firms | Second-tier audit firms | Other |
|-----------------------------|--|---|---|
| Subject to global reviews | Yes (reviewed) | Yes (reviewed) | Most of them are not reviewed |
| Frequency of global reviews | Every year | Every year to once every four years | Typically once every three years |
| Method for global reviews | In some cases the global review is performed as a direct investigation, while in others the results of the periodic inspections done by the firms are reviewed indirectly. | In most cases the global review is performed as a direct investigation. | In most cases the global review is performed as a direct investigation. |

(Note 1) Few small and medium-sized audit firms etc. are members of global networks. See "H. Responses to Overseas Expansion of Companies 2. Ties with Global Networks (page 94)".

(Note 2) "Other" in the figure refers to small and medium-sized audit firms, partnerships and solo practitioners.

G. Usage of Technology in Audit and Cybersecurity Efforts

1. Audit Methods Employing IT

With IT becoming more widespread and sophisticated, audited companies are increasingly digitizing accounting books and transaction documents including estimates, statements of delivery, etc. heretofore recorded on paper. Listed domestic companies have been introducing operational systems, such as ERP systems, designed to centrally manage corporate activities ranging from production and sales activities (material procurement, manufacturing, sales, and inventory control) to management activities (personnel, salaries, finance, and accounting), and thus relying more and more on information technology. The growing volume of electronic data at audited companies has made audit firms aware of the need to incorporate further audit methods employing IT beyond data analysis using computer-assisted audit techniques (CAAT) that they already utilize.

The leading efforts in this regard are being made by large-sized audit firms auditing numerous listed domestic companies, and their efforts will thus be the primary focus of this section.

Large-sized audit firms are members of the global networks Deloitte Touche Tohmatsu, Ernst & Young, KPMG and PricewaterhouseCoopers (the Big 4 global networks; see “H. Responses to Overseas Expansion of Companies, 2. Ties with Global Networks (page 94) for further details), and they use the audit tools of the global networks to which they belong. These global networks provide integrated R&D and operation that make efficient use of IT investment, and feedback from audit firms on troubles in audit tools allows the network to improve security and refine functions.

In addition to the above, some audit firms have introduced audit tools researched and developed on their own that help enhance the efficiency of their audit services and complement the audit tools of the global networks to which they belong.

IT experts, namely data scientists and AI experts, have been increasingly called upon to research, develop and operate audit tools. Certain large-sized audit firms have even created an in-house certification as well as organizations that encourage the use of audit tools.

As described above, various efforts made by global networks and large-sized audit firms accompany an increase in IT investment.

Second-tier audit firms are also introducing the audit tools provided by global networks.

Furthermore, some of these firms have been pursuing R&D for AI and dedicated audit tools but, despite active use of IT, large-sized audit firms' efforts are advanced in terms of investment amounts, audit tool functions, etc.

As shown in Figure III-7, many audit tools allow an auditor: to improve the efficiency and accuracy of standard audit procedures in audits; to conduct in-depth audit procedures by moving from sampling to testing complete data sets; and to perform real-time audits. Improvements in analytics capabilities are enabling auditors to concentrate their efforts towards dedicating audit procedures requiring sophisticated discernment, such as those aimed at uncovering fraud.

Figure III-7: Utilization of IT in audit operations at large-sized audit firms

| Status | Description |
|--|---|
| Installed | <ul style="list-style-type: none">• Electronic audit documentation system (preparation of audit documentation and audit progress management)• File exchange system (used for exchanging data with audited companies)• Journal analysis tools (analysis of transaction details (journals) and detection of abnormalities)• Evidence reconciliation tool (precise methods for cross-checking data from outside with all sales data at audited companies) |
| Planned to install/ introduced at some firms | <ul style="list-style-type: none">• RPA (automation of data input and processing)• Fraud forecasting (systems for forecasting future fraudulent accounting from past financial information, etc.)• Debt/credit balance confirmation system (automation of the external confirmation of the existence/accuracy of transactions) |
| Under development | <ul style="list-style-type: none">• AI (fraud forecasting using non-financial information)• Drones (improved efficiency when attending a physical inventory count) |

■ Efforts to Promote Use of IT across the Audit Industry ■

In May 2018, a large-sized audit firm announced that it would be jointly developing a debt/credit balance confirmation system for confirming online the transactions of audited companies. This joint development of an audit system represents a first for the audit industry.

Transactions are presently being confirmed exclusively by mail, but the introduction of this system will streamline the balance confirmation by eliminating the mailing process and reducing the risk of misdirected mail. Audited companies and their business partners are currently required to fill out different forms for different audit firms, but a planned consolidation of entry formats should make processing more efficient.

Audit firms are thus engaged in both R&D on audit tools within the global networks to which they belong and in cooperation between domestic audit firms, all with the aim of improving the efficiency of IT investment.

2. Cybersecurity Efforts

As mentioned earlier, large-sized audit firms in particular are utilizing audit tools and exchanging data with audited companies via e-mail and file exchange systems. Growing use has been made of these approaches 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. Cybersecurity issues constitute management risks for audit firms and, with the increasing use of IT, cybersecurity will need to be steadily bolstered.

Accordingly, the CPAAOB has been carrying out the following.

a. Monitoring of audit firms

The CPAAOB checks audit firms' cybersecurity measures through periodic collection of reports, interviews and meetings. These approaches have enabled us to identify the following efforts common to large-sized audit firms:

- Formulating basic information security policies and promoting information protection inclusive of cybersecurity across the global network as a whole
- Setting up organizations responsible for cybersecurity (CSIRT¹⁹) and, as necessary, recruiting experts from inside and outside the audit firm

¹⁹ CSIRT (Computer Security Incident Response Team) is the collective term for the organizations responsible for dealing with incidents pertaining to computer security.

- Identifying the data held by the audit firm, rating its importance, and developing regulations for data use as well as contingency plans for information security incidents and cyberattacks
- Undergoing reviews by the global network to externally confirm the effectiveness of the audit firm's information security environment, making improvements in the environment, collecting information on cyberattacks and information security countermeasures, and utilizing this information to develop and improve the information security environment

b. International efforts for cybersecurity issues

The International Forum of Independent Audit Regulators (IFIAR²⁰) comprising audit regulatory authorities from Japan and other countries continually holds dialogues with the Big 6 global networks²¹ and, with regard to cybersecurity, they also exchange information on the assignment of experts and other aspects concerning the development and operation of a secure environment.

■ Adverse Effects on Audit Firms Overseas Attributable to Cyberattacks ■

In September 2017, a global network announced that a part of audited companies' data had been leaked as a consequence of a cyberattack. According to its press release, the hackers had gained unauthorized access through an e-mail platform.

This global network organized a cybersecurity response team to investigate the incident. This team reviewed logs to determine the scope of the cyberattack's impact and have scrutinized all data impacted.

Other steps reportedly taken to prevent recurrences and to enhance security include imposing stricter control on access authorization and introducing a multi-factor authentication system (a system requiring multiple passwords to log in).

²⁰ International Forum of Independent Audit Regulators (IFIAR): an international institution established in 2006 comprising independent audit regulatory authorities that carry out inspections of audit firms. Its aim is to improve audit quality globally through cooperation/collaboration between authorities. Its membership as of June 30, 2018 was 52 countries/regions, including Japan.

²¹ Refers to the Big 4 global networks plus BDO and Grant Thornton

H. Responses to Overseas Expansion of Companies

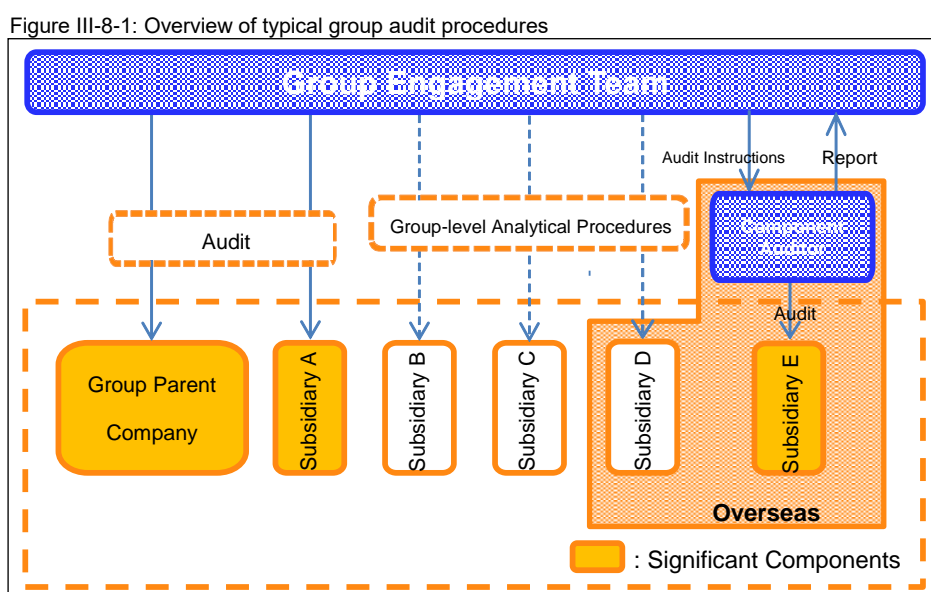
1. Group Audits

In recent years, more and more companies have been operating their businesses for and in overseas, and have been pursuing M&A. In association with internationalized business, material accounting frauds have arisen at foreign subsidiaries under circumstances that companies face, such as establishing governance of foreign subsidiaries, considering complex transactions and responding to differences in accounting standards. The importance of group audits has been growing, and the CPAAOB has also focused on group audits as a key area for its inspections. In this section, we will provide an overview of group audits and describe the audit procedures that they involve.

a. Overview of Group audits

When the auditor of a parent company (group engagement team) performs an audit and attestation of the consolidated financial statements, the audit covers not only the parent company but also its subsidiaries and affiliates. Subsidiaries and affiliates are classified as either “significant components” or “components that are not significant components” depending on factors such as their financial importance and significance of risks that requiring special consideration. Group engagement teams determine the audit procedures that shall be performed for each category of component (ASCS 600 (8), (23), (25), (27)).

The following figure illustrates typical group audit procedures (Figure III-8-1):



b. Determination of Significant Components

When determining the significant 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 due to fraud or error, and must focus in particular on the risks of material misstatements resulting from fraud.

If a component is deemed to be financially important, or it is deemed that a component contains significant risks in relation to the group financial statements, the group engagement team needs to identify the component as a significant component and prepare the audit plan based on this risk assessment.

c. Audit Procedures for Significant Components

The group engagement team needs to conduct audit procedures for significant components. However, the general approach is to ask a local auditor (the component auditor) to perform the audit procedure when the group engagement team faces certain restrictions on conducting the audit procedures, such as a significant component being located overseas. In such cases, they need to provide the local auditor of the significant component with audit instructions covering the work to be performed, the use to be made of that work, and the form and content of the component auditor's communication with the group engagement team (ASCS 600 (39)).

The approaches to group audit procedures taken by audit firms of different sizes are as follows (Figure III-8-2).

Figure III-8-2: Approach to group audit procedures taken by audit firms of different sizes

| | Large-sized audit firms | Second-tier audit firms | Other |
|--------------------|---|--|--|
| Group audit manual | Sharing a group audit manual with the global network | Sharing a group audit manual with the global audit network or preparing their own | Typically not sharing a group audit manual with the global network |
| Audit instructions | Sharing a template for audit instructions with the global network | Sharing a template for audit instructions with the global network or preparing their own | Typically preparing their own templates for audit instructions or using templates provided by large-sized audit firms if alliances established |

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

■ Cases Pertaining to Group Audits ■

There are some global networks that give group engagement teams at their network firms a say in appointing/dismissing engagement partners at overseas components to make group audits more effective.

d. Communication with component auditors

In the case that there is no effective communication between group engagement teams and component auditors, there is the risk that the group engagement team will not be able to obtain sufficient and appropriate audit evidence to serve as the foundation for an audit opinion regarding group financial statements.

For that reason, not only the receipt in writing of audit instructions and audit finding reports, the group engagement team also carries out teleconferencing and visits to the component auditor. Large-sized audit firms communicate with their component auditors for several times each year by visiting and telephoning. In contrast, some small and medium-sized audit firms, etc. visit their component auditors only every other year.

For facilitating smooth communication with component auditors, , large-sized audit firms and some second-tier audit firms have set up an international operations support desks within the audit firms and dispatching Japanese representatives to key locations. They also have provided local information to group engagement teams.

■ Examples of Efforts in Group Audits ■

Some large-sized audit firms centrally manage the progress of component auditor's work and directly examine audit working papers by using shared electronic audit working paper systems within the global network and group engagement teams.

2. Ties with Global Networks

Large-sized audit firms, second-tier audit firms, and some small and medium-sized audit firms belong to global audit networks. This makes it easier for them to perform audits of audited companies with overseas operations and enables them to share know-how such as audit manuals.

a. Membership of global networks

While all large-sized and second-tier audit firms belong to global networks, only some small and medium-sized audit firms do (Figures III-8-3 and III-8-4).

Figure III-8-3: Number of audit firms belonging to global networks (FY2016) (unit: audit firms)²²

| | |
|------------------------------------|----|
| Large-sized audit firms | 4 |
| Second-tier audit firms | 6 |
| Small and medium-sized audit firms | 22 |
| Total | 32 |

Figure III-8-4: List of global networks to which large-sized and second-tier audit firms belong

| Audit firm | Global network |
|-----------------------------------|--|
| KPMG AZSA LLC | KPMG International Cooperative (KPMG) |
| Ernst & Young ShinNihon LLC | Ernst & Young Global Limited (EY) |
| Deloitte Touche Tohmatsu LLC | Deloitte Touche Tohmatsu Limited (DTT) |
| PricewaterhouseCoopers Aarata LLC | PricewaterhouseCoopers International Limited (PwC) |
| GYOSEI & CO. | NEXIA International Limited (NEXIA) |
| BDO Sanyu & Co. | BDO International Limited (BDO) |
| Grant Thornton Taiyo LLC | Grant Thornton International Limited (GT) |
| BDO Toyo & Co. | Crowe Global |
| PricewaterhouseCoopers Kyoto | PricewaterhouseCoopers International Limited (PwC) |

(Source) Based on data from publicly disclosed materials from each audit firm (as of July 2, 2018)

(Note) YUSEI Audit & Co. merged with Grant Thornton Taiyo LLC and was eliminated on July 2, 2018; it is thus not included in this figure.

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-8-5), with the scale of the Big 4 global networks being particularly prominent.

²² Among small and medium-sized audit firms, the firms that have concluded cooperative relations (alliances) with overseas audit firms are included.

Figure III-8-5: Operating revenues of global networks (unit: billion USD)

| | DTT | PwC | EY | KPMG | BDO | GT |
|--|---------------|---------------|---------------|---------------|--------------|--------------|
| Operating revenues | 38.8 | 37.7 | 31.4 | 26.4 | 8.1 | 5.0 |
| Audit services (Share of operating revenues) | 9.4 (24%) | 16.0 (42%) | 11.6 (37%) | 10.4 (39%) | 3.6 (44%) | 2.1 (41%) |
| Tax services (Share of operating revenues) | 7.3 (19%) | 9.5 (25%) | 8.2 (26%) | 5.8 (22%) | 1.8 (22%) | 1.0 (21%) |
| Advisory services (Share of operating revenues) | 22.2 (57%) | 12.3 (33%) | 11.6 (37%) | 10.2 (39%) | 2.8 (34%) | 1.9 (38%) |

(Sources) Based on data from publicly disclosed materials from each global network (2017 accounting year)

b. Relationships with global networks

Network firms comprising global networks are responsible for a range of areas including quality control and are able to use the networks' logos and brand, introduce business to each other, and share know-how. The nature and degree of these responsibilities vary depending on the scale of the global network. In general, the larger the global audit network, the more influence it can exert on its members.

Each of the large-sized audit firms belongs to one of the Big 4 accounting 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 operation of the networks. For example, their CEOs are members of important network committees

Large-sized audit firms have also received audit manuals and tools from the networks, and they carry out audits in accordance with the audit manuals that are based on the networks' standards. Moreover, they have adopted standards and procedures determined by the networks for engagement quality control reviews, independence, and other quality controls.

Large-sized audit firms also regularly undergo global reviews conducted by the networks in order to maintain audit quality, particularly for audit engagements, at the level required by the networks. Some firms regard the global reviews as all or part of their periodic inspection in relation to firm's system of quality control (See "F. Monitoring of Systems of Quality Control, 2. Utilization of Global Reviews" (page 87) for details.).

All second-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 getting referral of audit engagements from network firms in other countries, but not receiving audit manuals. Although all second-tier audit firms undergo global reviews, there are big differences in terms of the frequency and content of the reviews.

The networks to which small and medium-sized audit firms belong only allow them to use their logos and brand and to be introduced to audit engagements in network firms' countries. Some of the small and medium-sized audit firms do not receive audit manuals or undergo global reviews.

I. Foreign Audit Firms

1. System for Foreign Audit Firms

Financial statements, which shall be submitted under the provisions of the FIEA by an issuer company of listed securities, must generally require an audit certification by a CPA or audit firm that has no special interest in the issuer company (Article 193-2 of the FIEA).

If the issuer company is a foreign company, the financial statements generally undergo audit certification by a CPA or audit firm in the home country. Therefore, to avoid duplicate audits, an exception is granted in cases where the issuer company has received an audit certification deemed to be equivalent to that prescribed under the FIEA because it was issued by a party equivalent to a Japanese CPA or audit firm. In such cases, the issuer company does not need to receive an audit certification 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 that audit the financial statements of foreign companies, etc., that are subject to FIEA disclosure rules to register with the FSA Commissioner.

Audit firms that have submitted this registration 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 FSA.

The CPAAOB generally collects reports from foreign audit firms once every three years, most recently having collected from 72 foreign audit firms in 27 countries/regions in FY2015 and conducting inspection of a foreign audit firm in May 2017, based on the findings from analyses of the reports collected.

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 III-9-1). Foreign audit firm registrations are published and updated as “Registered Foreign Audit Firms” on the FSA website.

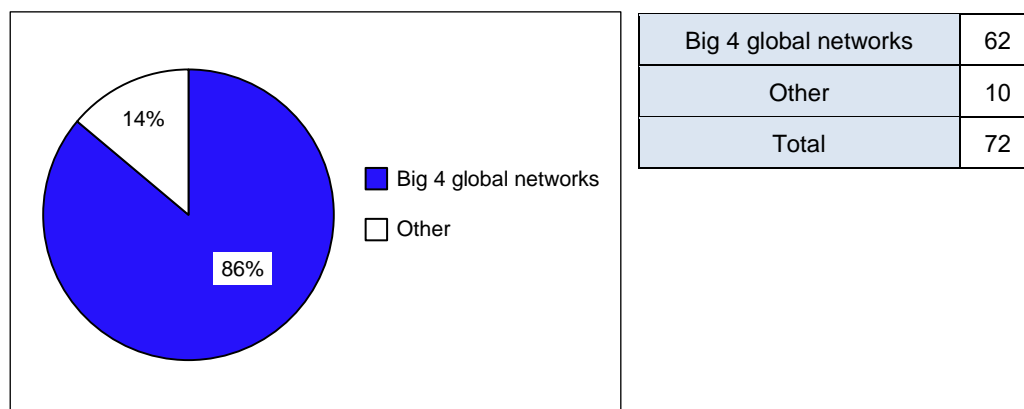
Figure III-9-1: Number of registered foreign audit firms, etc. (as of March 31, 2018)

| | Number of countries/regions | Number of audit firms, etc. |
|-----------------------|-----------------------------|-----------------------------|
| Europe | 15 | 44 |
| Asia-Pacific | 10 | 27 |
| North America | 2 | 9 |
| Central/South America | 3 | 9 |
| Middle East | 1 | 2 |
| Total | 31 | 91 |

Among the foreign audit firms from which reports have been collected by the CPAAOB, around 90 percent are affiliated with one of the Big 4 global accounting firms.

Those foreign audit firms belonging to the Big 4 global networks receive periodic global reviews, and are expected to maintain the level of audit quality demanded by the networks. On the other hand, not many foreign audit firms that are affiliated with a global audit network other than the Big 4 are subject to periodic global reviews. Their activities mainly focus on the exchange of information among network firms (Figure III-9-2).

Figure III-9-2: Affiliation with global networks (unit in table at right: audit firms, as of September 1, 2015)

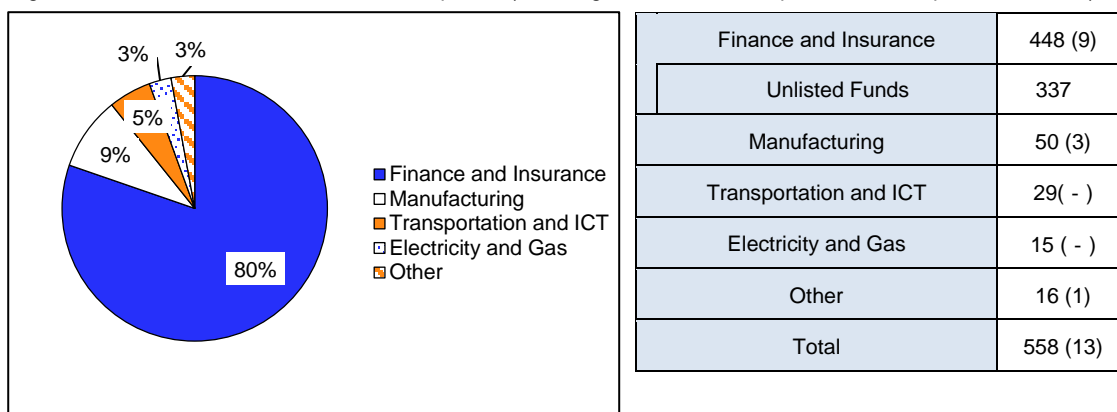


3. Audited Companies

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

Regarding the industries of companies audited by foreign audit firms from which we have collected reports, 80 percent are classified as finance or insurance, and most of these are unlisted funds (Figure III-9-3).

Figure III-9-3: Business sector of audited companies (unit in right-hand table: companies; as of September 1, 2015)



(Note) Figures in parentheses are the number of companies (including funds) listed in Japan.

(Reference materials)

The following websites are useful for obtaining reference data.

CPAAOB website

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

FSA website

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

JICPA website

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

Japan Exchange Group website

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

Basic Policy for Monitoring Audit Firms

<https://www.fsa.go.jp/cpaaob/english/shinsakensa/kouhyou/20161221-1.html>

Basic Plan for Monitoring Audit Firms (PY2018)

<https://www.fsa.go.jp/cpaaob/english/oversight/20181126/20181126.html>

Case Report from Audit Firm Inspection Results

<https://www.fsa.go.jp/cpaaob/shinsakensa/kouhyou/20180731/20180731-2.html> (Japanese)

English version is planned to be published in 2019.

JICPA 2018 Annual Report

http://www.hp.jicpa.or.jp/english/news/files/annualreport_2018.pdf

On the Disclosure of Inspection Results, etc., to Third Parties

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

The following is a useful reference on the 2007 revision of the CPA Act:

Ikeda Yuichi, Mitsui Hidenori, eds., "The New CPA/Audit Firm Audit System - Ensuring Fair Financial/Capital Markets" (Dai-Ichi Hoki Co., Ltd., 2009)



Certified Public Accountants and
Auditing Oversight Board

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