



# 2020 Monitoring Report

Certified Public Accountants and Auditing Oversight Board  
July 2020

## **Introduction**

The Certified Public Accountants and Auditing Oversight Board (hereafter “CPAAOB”) conducts examinations and inspections etc. (monitoring) of audit firms from the viewpoint of safeguarding the public interest and protecting investors, in order to improve the quality and ensure the reliability of audits performed by certified public accountants (CPAs).

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

Since CPAAOB launched publishing this sort of report under the title “Monitoring Report” in July 2016, we have updated the data about audit firms and audited companies, and also made revisions, such as adding the latest information obtained through the CPAAOB’s monitoring activities.

We have compiled and publish herein the 2020 Monitoring Report, which describes matters such as the results of the CPAAOB monitoring activities in PY 2019.

Main revisions for the 2020 edition:

### **I. Overview of the Audit Sector**

In addition to updating the data, we have added information about the CPA examinations, and regarding the circumstances of audited companies etc. we have encompassed new columns about the landscape of audits of financial institutions and IPO support services.

### **II. The CPAAOB monitoring**

In addition to updating monitoring-related data, we have elaborated the Basic Plan for Monitoring Audit Firms in Program Year 2020.

### **III. Operation of Audit Firms**

In addition to updating the data, we have enhanced descriptions of organizational structures for supporting audit engagement and also added a column describing actual examples of the establishment of organizations for the centralized operation of audit-related clerical tasks.

### **IV. Responses to Changes in the Global Environment Surrounding Audit**

In light of recent changes in the environment surrounding audit, we have enhanced descriptions of the use of IT in audits and of cooperation with the global networks. Furthermore, as it is a recent development affecting accounting audits, we have described responses to the spread of new coronavirus disease (COVID-19), recent

developments relating to auditing standards and material reports that have been published.

To improve audit quality, the CPAAOB believes it is important to draw the interest in and awareness on accounting audits of the audit and supervisory board members etc. as well as investors and other market participants. 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
JICPA	Japanese Institute of Certified Public Accountants
Stock exchange	Financial instruments exchange
CPA Act	Certified Public Accountants Act
FIEA	Financial Instruments and Exchange Act
QCSCS	Quality Control Standards Commission Statements No.1
ASCS	Auditing Standards Committee Statements

## (Terms)

Terms used in this Report shall be defined as follows:

Monitoring	Collectively refers to on-site monitoring and off-site monitoring. On-site monitoring refers to inspections, while off-site monitoring refers to activities other than inspections, which include the gathering of information through the collection of reports concerning and the conduct of interviews with audit firms, through information exchanges and cooperation with relevant parties.
Fiscal year (FY)	The year starting in April and ending in March of the following year, unless otherwise stated
Program year (PY)	The year starting in July and ending in June of the following year
Audit firm	Audit firms, partnerships (persons providing audit and attestation services jointly with other CPAs), and solo practitioners
Large-sized audit firm	An audit firm that has more than approximately 100 domestic listed audited companies and whose full-time staff performing actual audit duties total at least 1,000. In this report, they specifically refer to KPMG Azsa LLC, Deloitte Touche Tohmatsu LLC, Ernst & Young ShinNihon LLC, and PricewaterhouseCoopers Aarata LLC.

Mid-tier audit firm	An audit firm whose business scale is second only to large-sized audit firms. In this report, this will refer to five audit firms: Gyosei & Co., BDO Sanyu & Co., Grant Thornton Taiyo LLC, Crowe Toyo & Co., and PricewaterhouseCoopers Kyoto.
Small and medium-sized audit firm	An audit firm other than large-sized and mid-tier audit firms
Foreign audit firm	An audit firm that is based on a foreign country but provides audit and attestation services for financial documents etc. that are disclosed domestically within Japan
Accounting auditor	A CPA or audit firm
Domestic listed company	Listed companies other than foreign companies. Note that listed companies refers to companies that are listed on a financial instruments exchanges (“exchange”).
Listed financial institution	Among domestic listed companies, refers to securities companies and insurance companies.
Audited company	Companies that undergo audits
Audit engagement	Audit and attestation services carried out by an audit firm for an individual audited company
Business report	A document submitted by an audit firm to the FSA each program year that contains the audit firm’s financial statements and an overview of its operations
Audit Firm Governance Code	“Principles for Organizational Operation of Audit firms” published by the FSA on March 31, 2017
Big Four global accounting firms	The global networks of the four largest accounting firms: Deloitte Touche Tohmatsu, Ernst & Young, KPMG, and PricewaterhouseCoopers
Big Six global accounting firms	The global networks of the Big Four accounting firms, BDO and Grant Thornton



Network firm	An accounting firm belonging to the same global accounting firms
IFRS	International Financial Reporting Standards; accounting standards established by the International Accounting Standards Board (IASB) that have been adopted by many countries/regions
KAM	Key Audit Matters: It has become obligatory to describe them in audit reports pursuant to the Financial Instruments and Exchange Act (FIEA).

(Sources)

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

(Timing and timeframe of data collection)

To reflect the most up-to-date information, the timing and timeframe of data collection are not uniform; the timing and timeframe of data collection are listed in the notes inside or underneath each figure. Component ratios have been rounded down to the nearest whole number, and may not add up evenly to 100.

# I. Overview of the Audit Sector

## **I. Overview of the Audit Sector**

### **A. CPAs**

#### **1. Introduction of the CPA system**

A certified public accountant system was introduced in Japan in 1948. The Securities and Exchange Act was promulgated in 1947, requiring companies that issue or solicit investment in shares, corporate bonds or other securities to submit reports. The issuer 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)

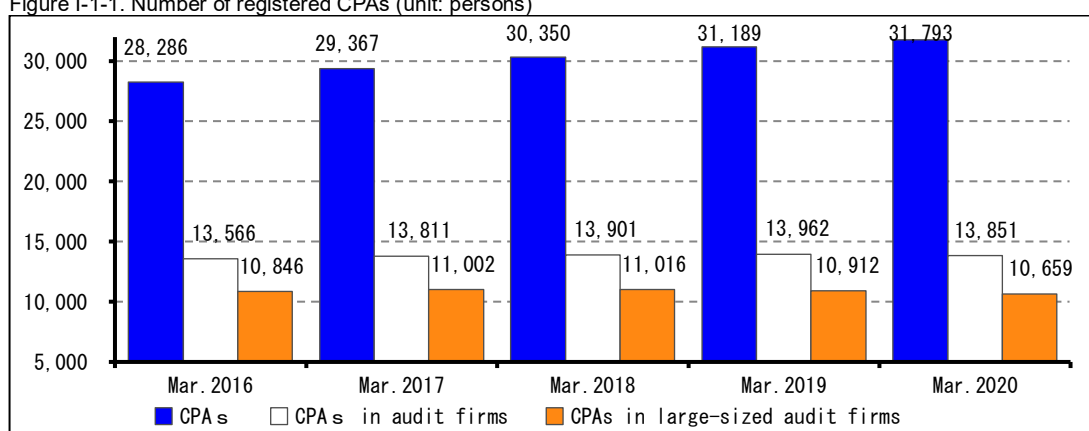
#### **2. CPAs**

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 list of the Japanese Association of Certified Public Accountants (“JICPA”) (Articles 3, 17, and 18 of the CPA Act).

The number of registered CPAs has been gradually increasing over the past few years. However, the number of the registered CPAs belonging to audit firms has stayed flat and their proportion of the overall total of registered CPAs has dropped year by year from 48.0% at the end of March 2016 to 43.6% at the end of March 2020. Of the registered CPAs belonging to audit firms, around 80% work at large-sized audit firms (Figure I-1-1).

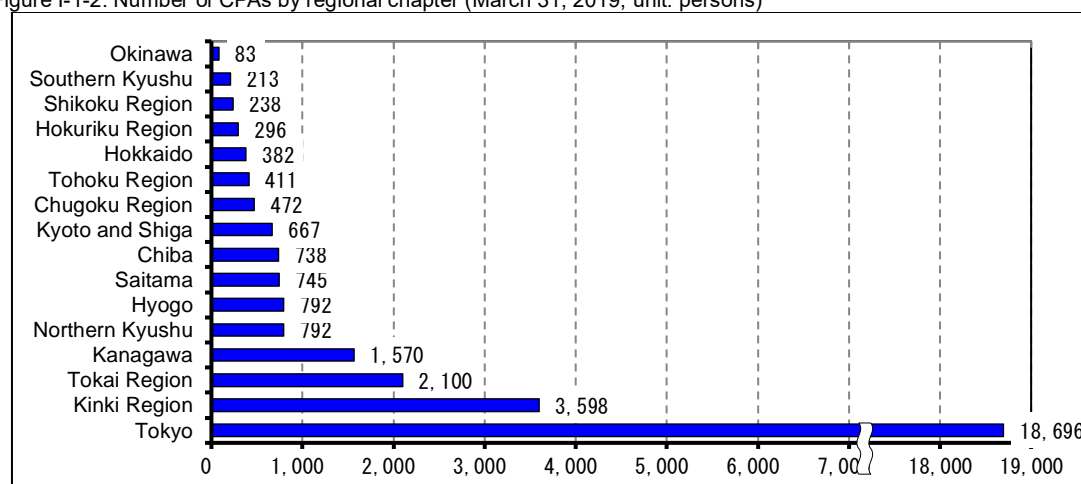
Figure I-1-1. Number of registered CPAs (unit: persons)



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

CPAs must be members of the JICPA (Article 46-2 of the CPA Act) and must belong to a regional chapter, i.e., one of the JICPA branches established across Japan (16 regional chapters as of March 31, 2020). Around 70% of CPAs are based in the Tokyo metropolitan area (Tokyo, Kanagawa, Saitama, Chiba) (Figure I-1-2).

Figure I-1-2: Number of CPAs by regional chapter (March 31, 2019; unit: persons)

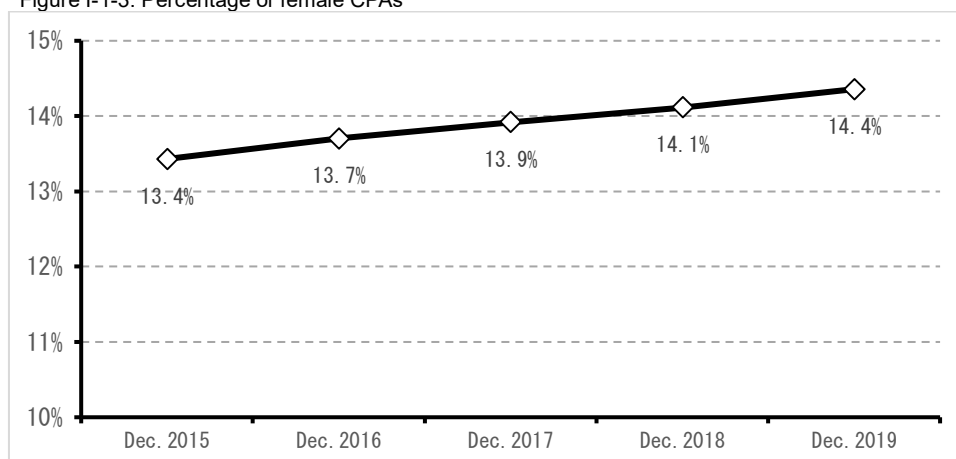


(Source) Prepared by the CPAAOB based on data (e.g. survey of numbers of members) from the JICPA

### 3. Percentage of Female CPAs

The percentage of women among the total number of registered CPAs is gradually increasing (Figure I-1-3), and at the end of 2019 the figure topped 14.4%, which is the same as the level for female tax accountants<sup>1</sup>. On the other hand, it is still lower than the percentages of female attorneys<sup>2</sup> and female CPAs in the UK and US<sup>3</sup>.

Figure I-1-3: Percentage of female CPAs



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

#### ■ Efforts by the CPAAOB to expand the number of female examinees ■

At lectures for young people such as high-school and university students (including students of women's universities), female inspectors of the CPAAOB who possess the CPA qualification talk the advantages of obtaining the qualification and pursuing a career as a CPA, and this serves to raise the interest in the qualification among female students.

Furthermore, a pamphlet published annually by the CPAAOB features messages from female CPAs about their job satisfaction and their career plans, which is also aimed at expanding the number of females taking the exam. Over the past few years the number of females applying for and passing the exam has been increasing, and 23.6% of those who passed the 2019 CPA exam were female (20.0% in 2018).

In the 2019 CPA exam, the percentage of women who passed was 10.3%, more or less the same as the 10.8% figure for men.

### 4. Age Structure of Persons who Passed the CPA exam

Breaking down the age structure of persons who passed the CPA examinations, we see that the largest age group is 20-24 years. People in this group accounted for 57.5% of

<sup>1</sup> According to a survey of female participation in policy making conducted by the Cabinet Office's Gender Equality Bureau, the percentage of females is 14.9%.

<sup>2</sup> According to the White Paper on Attorneys 2018, the percentage of females is 18.8%.

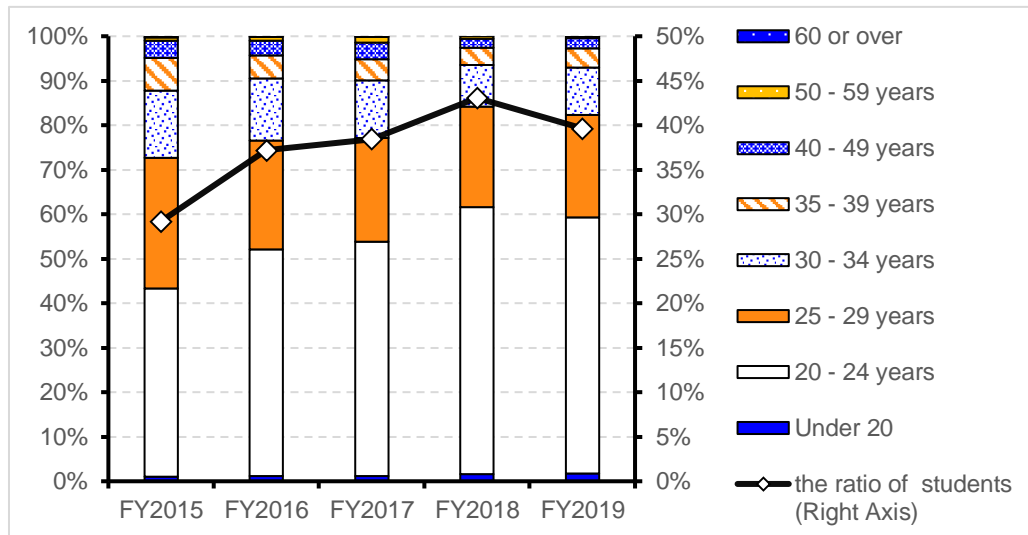
<sup>3</sup> The percentage of female CPAs in the U.S. and the U.K. is as follows:

U.S.: According to a survey of employment at accounting firms in 2018 conducted by the AICPA and included in its "2019 Trend Report," the percentage of females is 42%.

U.K.: According to the Financial Reporting Council's "Key Facts and Trends in the Accountancy Profession 2019," there are several CPA institutes in the U.K., and the average female membership for them is 37%.

those who passed it in 2019. As for occupation, the ratio of students (excluding persons enrolled in courses at vocational schools etc.) is the highest. Among them, the proportion enrolled in universities (including junior colleges) was 39.6% in the 2019 examinations (Figure I-1-4).

Figure I-1-4: Age structure of persons who passed the CPA exam



(Source) Prepared by the CPAAOB based on data from the CPAAOB survey of persons who passed the CPA exam

## **B. Audit Firms**

Audit firms, i.e., CPA firms engaged in providing audit and attestation services, numbered 2,114 at the end of March 2019, but they vary by service and business format.

Audit and attestation services cover both statutory audits and non-statutory audits. Statutory audits are CPA audits required by the law. When CPA audits were first introduced, the only statutory audits were FIEA audits, but thereafter CPA audits under the Companies Act were introduced, and then educational corporation audits under the Act on Subsidies for Private Schools. There are now a multitude of statutory audits, including audits of labor unions, credit unions, 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 pursuant to the CPA Act for the purpose of organizationally performing audit and attestation services. When the audit firm system was forged in 1966, the tasks involved in audit and attestation services had increased in volume and complexity as corporations subsequently grew larger in scale and management became more multifaceted. Numerous incidents of fraudulent accounting were occurring at the time, bringing into question the *raison d’être* of CPAs. The system of audit firms was therefore introduced to improve audit quality for promoting the conduct of organizational audits.

The CPAAOB classifies audit firms by scale into large-sized audit firms, mid-tier audit firms, and small and medium-sized audit firms. The firms were classified as shown below based on their size and the audit services they provide (Figure I-2-1), and the CPAAOB mainly monitors those audit firms conducting FIEA audits of domestic listed companies.



Figure I-2-1: Classifications of audit firms (as of March 31, 2019)

Audit firm	Number of firms	Statutory audits			Non-statutory audits
		FIEA audits (Note 4)	Companies Act audits	Other	
Large-sized audit firms	4	○	○	○	○
Mid-tier audit firms	5	○	○	○	○
Small and medium-sized audit firms	2,105	○ (Note 4)	○	○	○
(Breakdown)	Small and medium-sized audit firms	(227)			
	Partnerships (Note1)	(49)			
	Solo practitioners (Note 1)	(1,829)			

(Note 1) The number of audit firms as of FY 2018 (closing date between April 1, 2018 and March 31, 2019) listed in copies of 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 in the above figure 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 the column “JICPA’s Registration System for Listed Company Audit Firms” (page 30).

(Note 4) For solo practitioners to provide audit and attestation services to listed companies, the CPA Act and exchanges require two or more CPAs to provide audit attestation (Securities Listing Regulations).

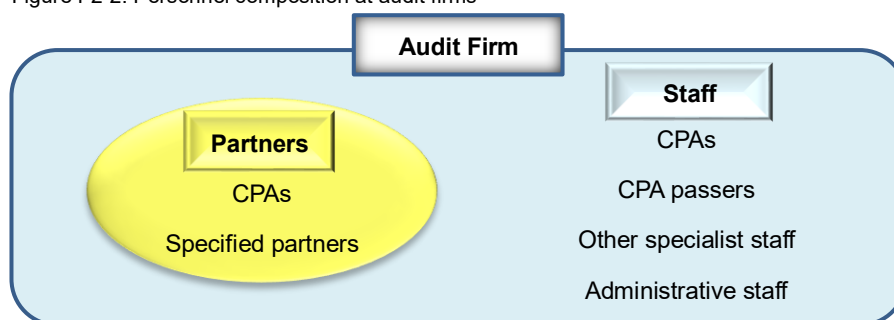
## 1. Organizational Structure of Audit Firms

Audit firms are established through investment by groups including five or more CPAs, and their defining characteristics are that the persons who invested (partners) are directly engaged in management and that they ensure organizational discipline via mutual monitoring. Some audit firms comprise only partners, but those of a certain scale ordinarily employ CPAs (CPAs who have not invested in order to become partners of the audit firm), CPA passers (persons who have passed the CPA exam but have not been registered as CPAs after undergoing practical training and providing assistance with audit work), and other experts as staff.

In the past, partners of audit firms were limited to CPAs, but in today’s more sophisticated economy and society, a partner is required to have a wide range of knowledge including management, law, IT, pension mathematics to ensure appropriate operational management of the audit firm and to provide effective organizational audit services. Accordingly, as a result of legal revisions in 2007, a “specified partner system” allowed non-CPAs to be partners at an audit firm. However, CPAs must comprise at least 75% of the audit firm’s partners if specified partners join the firm. In FY2019 large-sized audit firms had 126 specified partners among a total of 1,862 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 A. Operations Management System 3. Human Resources of Audit Firms.” (page 78).

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



	Large-sized audit firm	Mid-tier audit firm	Small and medium-sized audit firm
Partners	More than 100 up to approx. 600	Approx. 30 up to 100	Up to approx. 50
Full-time staff	Approx. 3,100 up to approx. 6,400	Approx. 150 up to 700	Up to approx. 80

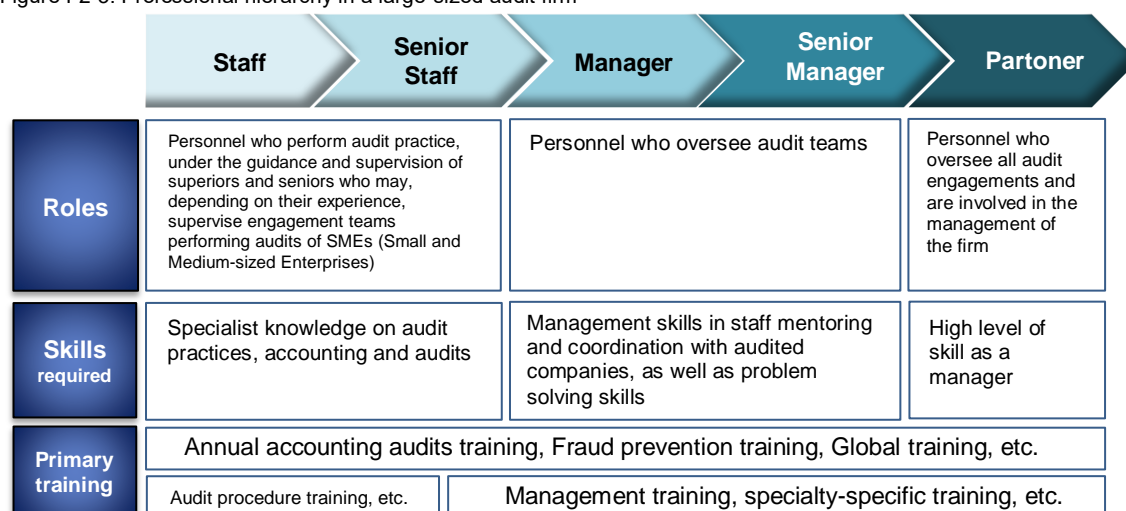
(Source) Prepared by the CPAAOB with reference to page 55 of "New CPA/Audit firm Audit System - Ensuring Fair Financial/Capital Markets" (Dai-ichi Hoki Co., Ltd., 2009), Yuichi Ikeda and Hidenori Mitsui, ed.

In response to the increasing complexity and internationalization of corporate activities at domestic listed companies, especially major ones, audit firms grow bigger. The large-sized audit firms responsible for the majority of audits of major listed companies have workforces exceeding several thousand people; even mid-tier audit firms now frequently have more than 150 people.

As audit firms grow in scale, they introduce job classification system defined by abilities, experience, etc. for effective management of organization. (Figure I-2-3). It is standard practice for personnel to move up the ranks from staff and senior staff to manager, senior manager and, if selected, to partner.

The expanding size of audit firms and the increasing complexity of their organizational administration has made the difficulty of ensuring audit quality even more apparent. In response to this situation, Principles for Effective Management of Audit Firms (the Audit Firm Governance Code) were formulated in March 2017, and are now being adopted, particularly by large-sized audit firms and mid-tier audit firms.

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



(Note) For details, see "III. Operation of Audit Firms, A. Operations Management System, 4. Organizational Structure for Providing Audit Services" (page 82) and "5. Organizational Structure for Supporting Audit Services" (page 85).

## 2. Development of Quality Control Structures by Audit Firms

To ensure audit quality, it is important that audit firms develop/administer appropriate quality control structures to serve as a foundation for having their partners perform audit services properly.

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 is 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 deteriorate 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

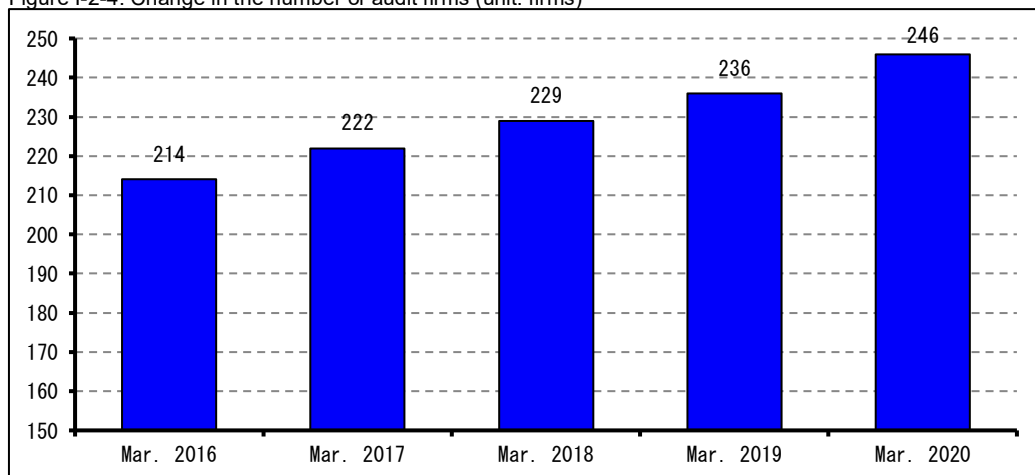
The aforementioned regulations on service quality control have been consistent with the “Quality Control Standards for Audits” (2005), which were established by the Business Accounting Council, and incorporate all six component elements of these quality control standards: a. responsibility for quality 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 increasing in recent years. As of March 31, 2020, there were 246 firms, and three firms disappeared as a result of dissolution or merger and 13 were established in the period April 2019-March 2020, producing a net increase of 10 firms (Figure I-2-4) year on year. See “4. Mergers of Audit Firms” (page 21) for details on mergers from FY2015 onwards.

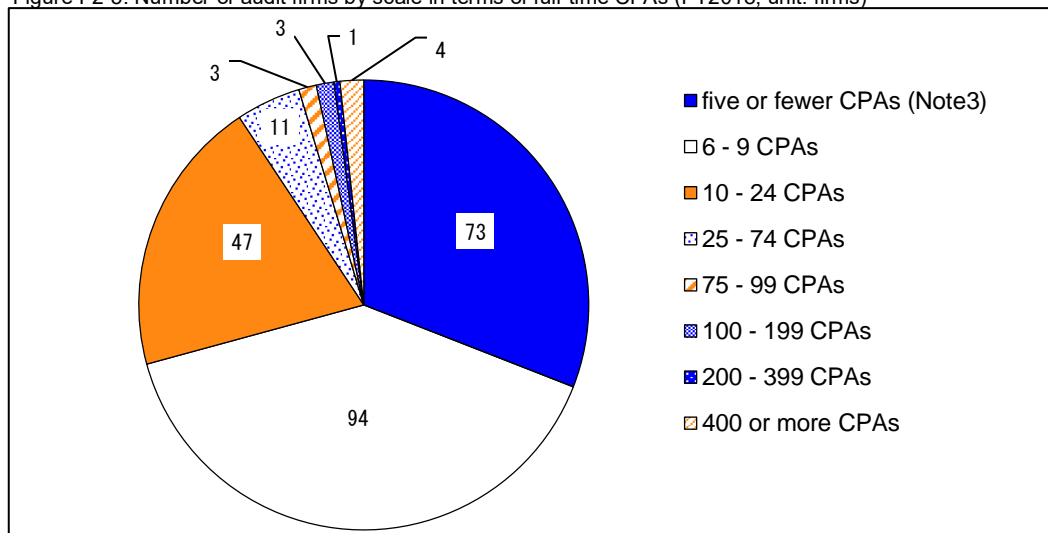
Figure I-2-4: Change in the number of audit firms (unit: firms)



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

Classification 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 (FY2018; unit: firms)



(Note 1) The number of full-time CPAs is the total of partners who are CPAs and full-time staff who are CPAs.

(Note 2) Data on 236 audit firms was collected from operational reports submitted by these firms in FY2018.

(Note 3) An audit firm where the number of partners who are CPAs drops to four or fewer should be dissolved, but six months is granted as suspended term as stipulated in the CPA Act.

## 4. Mergers of Audit Firms

There have been 7 mergers of audit firms since FY2015 (Figure I-2-6), with the main reasons for the mergers being increasing scale to reinforce management infrastructure and aiming to expand operating territory.

Figure I-2-6: Audit firms involved in mergers from FY2015 (March 31, 2020)

FY	Surviving firm	Disappearing firm
2015	Shisei Audit Corporation (Moore Shisei & Co.)	Seisin & 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
2019	Sohken Audit Corporation (Sohken Nichiei Audit Corporation)	Nichiei Audit Corporation

(Note) Names in parentheses show the name of the surviving firm as of March 31, 2020.

The merger of Ark & Co. and Kinki Daiichi & Co. was announced on October 29, 2019, but because the merger date was July 1, 2020, it is not included in the above table.

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

The Collection of Reports from mid-tier audit firms (five firms) for PY2019 indicates that more than half of mid-tier audit firms are considering mergers as a potential business strategy for the future.

According to the Collection of Reports for small and medium-sized audit firms (covered 31 firms) implemented in the same program year, approximately 30% of them are either considering a specific merger or would do so if they could find a good merger party.

## **5. Financial Condition (Operating Revenue, Proportion of Audit and Attestation Services and Non-audit and Attestation Services)**

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

Operating revenues during the five years until FY2019 (FY2018 in the case of small and medium-sized audit firms) reveals that those for large-sized and mid-tier audit firms are in an uptrend, while the operating revenues of small and medium-sized audit firms declined between FY2015 and FY2016 before turning upwards in FY2017.

Looking at revenue from audit and attestation services as a proportion of operating revenues shows that the figure is between 70% and 80% for large-sized audit firms. At mid-tier and small and medium-sized audit firms it is higher, with audit and attestation services providing approximately 90% of the operating revenues (Figure I-2-7). For the operating revenues of audit firm groups, see “III. Operation of Audit Firms, A. Operations Management System, 6. Audit Firm Groups” (page 88).

Characteristics of audit firms based on size are as follows:

### **a. Large-sized audit firms**

Audit service and attestation revenue as a proportion of operating revenues has ranged between 70% and 80% at three of the four firms, but at the remaining firm it has hovered at around 50%.

Large-sized audit firms operate based on the view that performing non-audit services provides opportunities to acquire a wide variety of business experiences to foster staff, obtaining a broad range of experiences and knowledge serves to improve audit quality, and a policy of also carrying out non-audit service is effective for attracting talent.

### **b. Mid-tier audit firms**

Audit and attestation service revenue has been rising at all the firms, and has accounted for between 80% to more than 90% of operating revenues. There is wide variation in revenues among mid-tier audit firms, and this variation is likely to change as a result of future developments such as mergers.

Mid-tier audit firms are aiming to expand the non-audit services they perform, as specifically, performing non-audit services provides opportunities to acquire a wide variety of business experiences to foster staff, obtaining a broad range of experiences

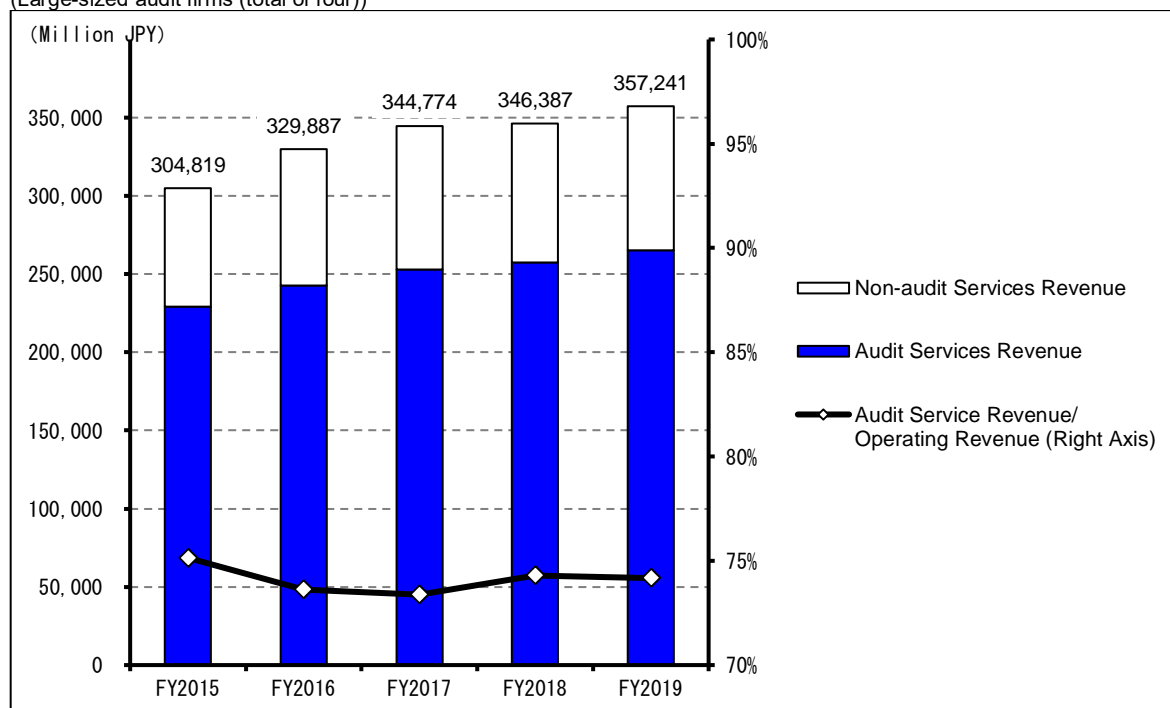
and knowledge serves to improve audit quality, and a policy of also carrying out non-audit services is effective for attracting talent. However, due to reasons such as limitations in terms of headcount, Mid-tier audit firms find themselves not to be placed to rapidly expand a proportion of operating revenues is not increasing rapidly.

#### c. Small and medium-sized audit firms

The operating revenues of small and medium-sized audit firms are low on the whole, but mergers among some of the largest firms in the category are resulting in an expansion in their business.

Figure I-2-7: Operating revenues, breakdowns of operating revenues, and proportions of audit and attestation service revenues to total operating revenues

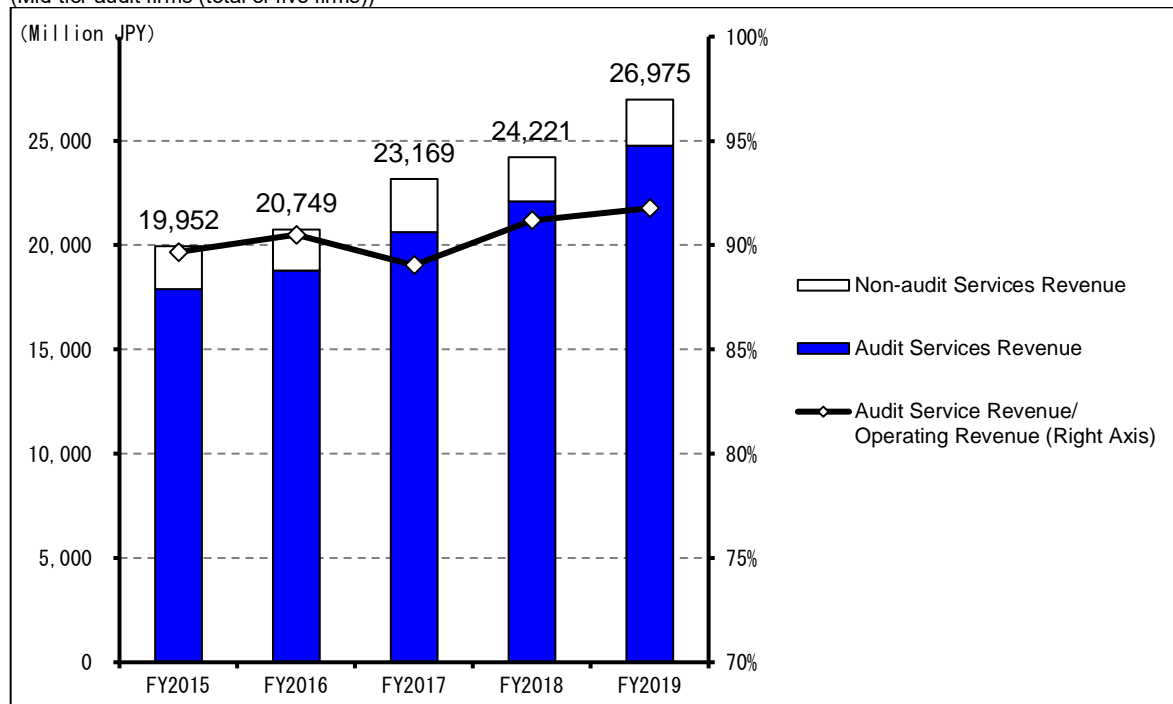
(Large-sized audit firms (total of four))



(Note) In FY2017, one audit firm changed its fiscal year-end, so calculations are based on eight-month figures. As a result, FY2017 operating revenues are calculated by extrapolating eight-month operating revenues to one-year periods (by multiplying figures by 12 months/8 months) for the audit firm that changed its fiscal year-end.

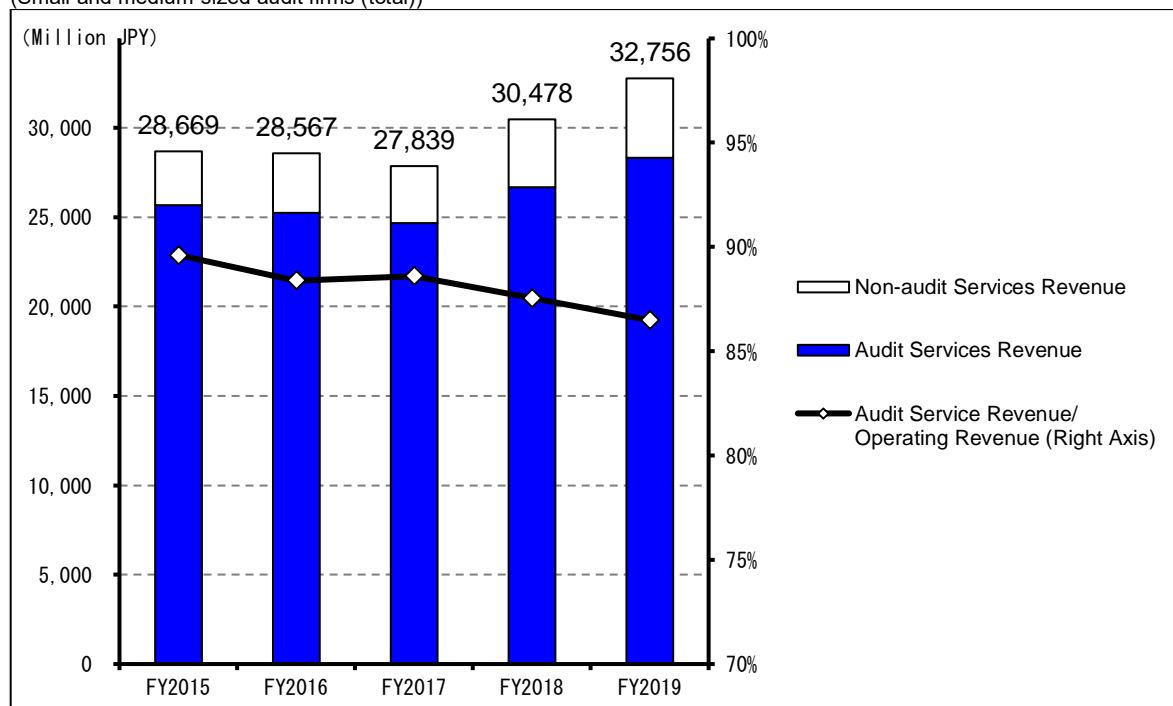


(Mid-tier audit firms (total of five firms))



(Note) In FY2016 one firm changed its fiscal year-end, closed its books after a 15-month fiscal year, and did not submit its report within the program year. As a result, when aggregating the figures, FY2015 data was used for the FY2016 operating revenues for this firm. Operating revenues for FY2017 represent 15 months' worth of operating revenues.

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



(Note) The book-closing months of small and medium-sized audit firms vary widely, so figures for FY2019 have not been compiled. As a result, the figures of small and medium-sized audit firms only cover the period to up to FY2018. The number of small and medium-sized audit firms varies from year to year, but 221 such firms are included in the figures for FY2018.

(Source) Prepared by the CPAAOB based on operational reports submitted by audit firms

## C. Audited Companies

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

### 1. Types of Audit and Attestation Services

As previously noted (see "B. Audit Firms" (page 15)), audit and attestation services include statutory audits, which are based on such laws as the FIEA, the Companies Act, the Act on Subsidies for Private Schools, and the Labor Union Act and non-statutory audits whose objectives and content are decided by the parties involved. The types of audit and attestation services provided by audit firms are shown below (Figure I-3-1).

Figure I-3-1: Types of audit and attestation services

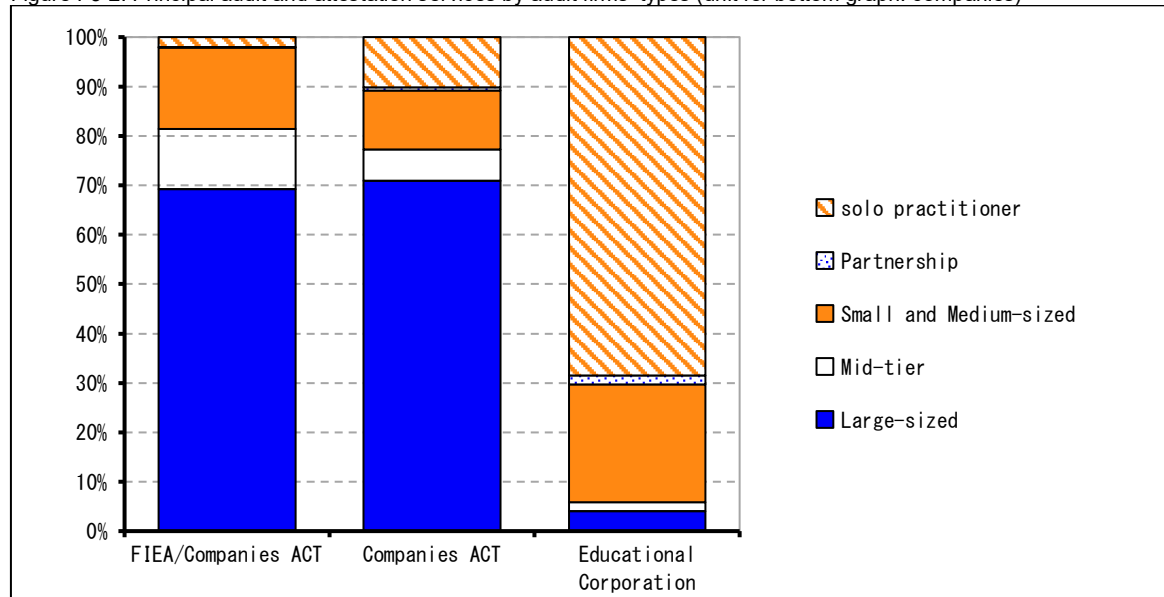
Type	Statutory audits						Non-statutory audits	Total
	FIEA / Companies Act	FIEA	Companies Act	Act on Subsidies for Private Schools	Labor Union Act	Other		
Number of companies	3,963	342	5,302	1,705	436	2,628	5,054	19,430
Percentage	20.4	1.8	27.3	8.8	2.2	13.5	26.0	100.0

(Note 1) The number of audited companies has been aggregated from operational reports submitted by audit firms in FY2018.

(Note 2) "FIEA/Companies Act" denotes operations where audit and attestation under both the FIEA and Companies Act are required, while "FIEA" and "Companies Act" denote operations where audit and attestation under the respective act only is required.

Audit firms, partnerships and solo practitioners are the entities that provide audit and attestation services. Looking at the entities providing audit and attestation services, about 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 for bottom graph: companies)



Type	FIEA/ Companies Act	Companies Act	Educational Corporation
Audit firms	3,887	5,264	1,599
(Large-sized)	(2,744)	(4,188)	(219)
(Mid-tier)	(479)	(369)	(95)
(Small and medium-sized)	(654)	(707)	(1,285)
Partnership	7	39	100
Solo practitioners	78	600	3,695

(Note) Data was aggregated from audits conducted from the term ended April 2018 to the term ended March 2019. The figures do not match with the figures in Figure I-3-1 because the collection period is different

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

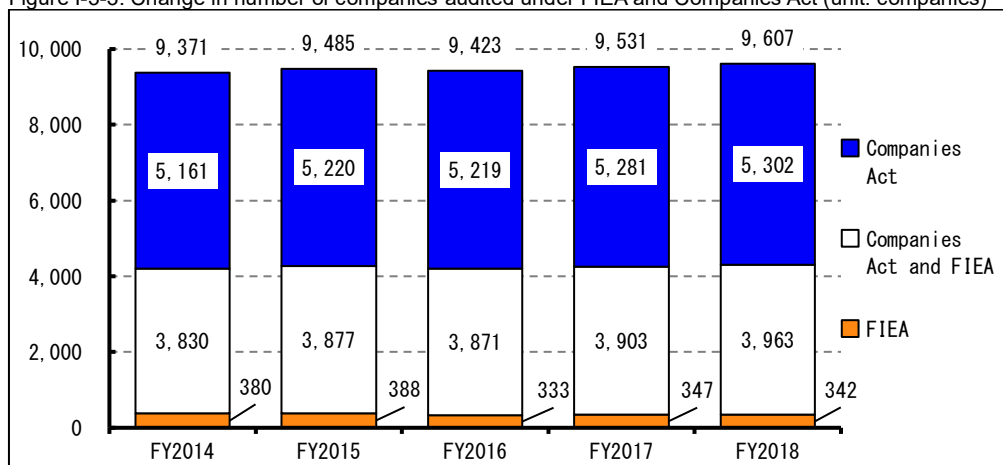
## 2. FIEA and Companies Act Audits

The results of analysis of audited companies etc. and listed companies that are subject to statutory audits under the FIEA and the Companies Act are as follows:

- a. Number of companies audited under the FIEA and the Companies Act and share by scale of audit firm

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

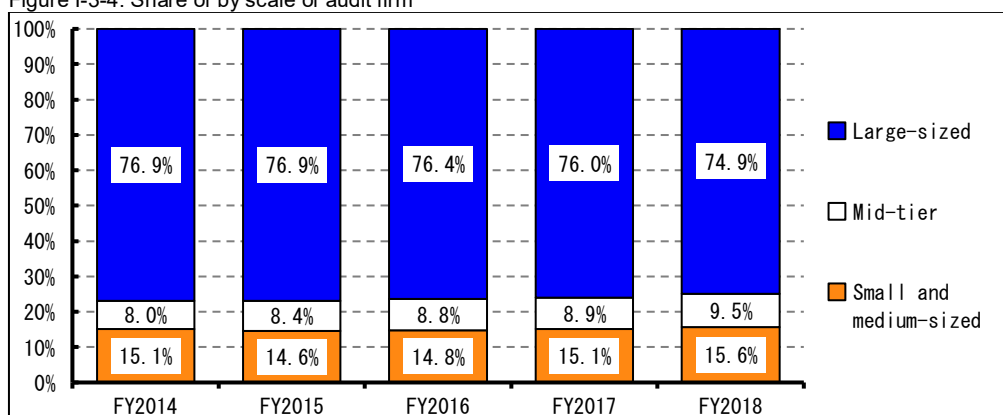
Figure I-3-3: Change in number of companies audited under FIEA and Companies Act (unit: companies)



(Note 1) The number of audited companies is compiled based on operational reports submitted by audit firms.

(Note 2) Figures for mid-tier audit firms that changed their closing month in FY2016 are compiled using FY2015 data as the number of audited firm for FY2016 is unknown.

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



(Note 1) The number of audited companies is compiled based on operational reports submitted by audit firms.

(Note 2) Figures for mid-tier audit firms that changed their closing month in FY2016 are compiled using FY2015 data as the number of audited firm for FY2016 is unknown.

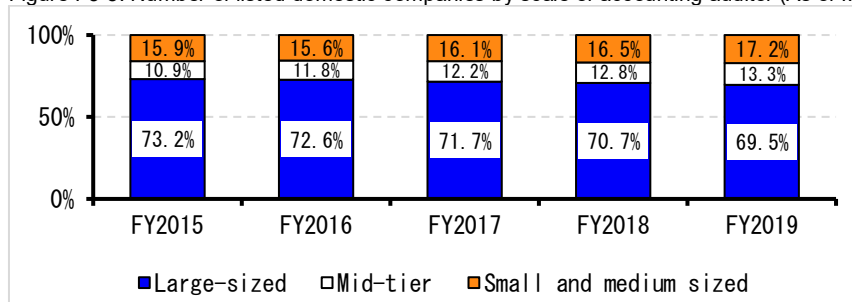
b. Share of listed domestic companies by scale of audit firm

Audits at about 70% of listed domestic companies are conducted by large-sized audit firms, but in terms of market capitalization, large-sized audit firms have a 90% share and this has been the case for many years. This is because listed domestic companies with large market capitalizations conduct operations on a large scale, their operations are complex, and many of their operations are international. As a result, their audits require a large number of audit personnel and various specialist capabilities, which likely makes it difficult for firms other than large-sized audit firms to handle their audits (Figures I-3-5 and I-3-6).

At the end of FY2019, there were 3,784 domestic listed companies, and 2,630 of them were audited by large-sized audit firms, 504 of them were audited by mid-tier audit firms, and 650 were audited by small and medium-sized audit firms. Meanwhile, the market capitalization of domestic listed companies was 557,053.8 billion yen, of which large-sized audit firms handled 505,035.2 billion yen, mid-tier audit firms handled 30,925.9 billion yen, and small and medium-sized audit firms handled 21,092.7 billion yen.

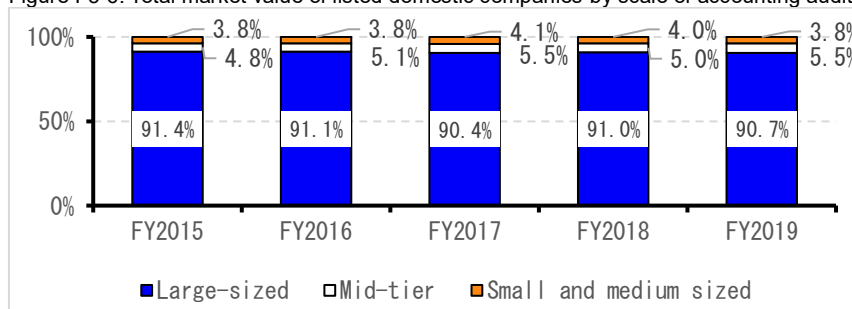
Among the top 20 companies in terms of market capitalization at the end of FY2019 (accounting for 25% of total market capitalization), 18 companies were audited by large-sized audit firms.

Figure I-3-5: Number of listed domestic companies by scale of accounting auditor (As of March 31, 2020)



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

Figure I-3-6: Total market value of listed domestic companies by scale of accounting auditor (March 31, 2020)

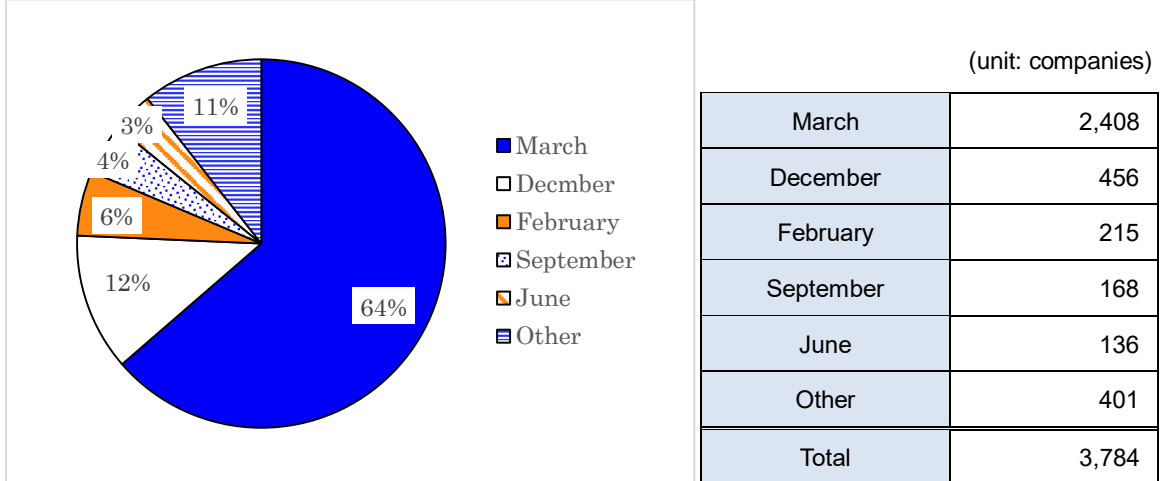


(Source) Prepared by the CPAAOB based on data from Quick and exchanges

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

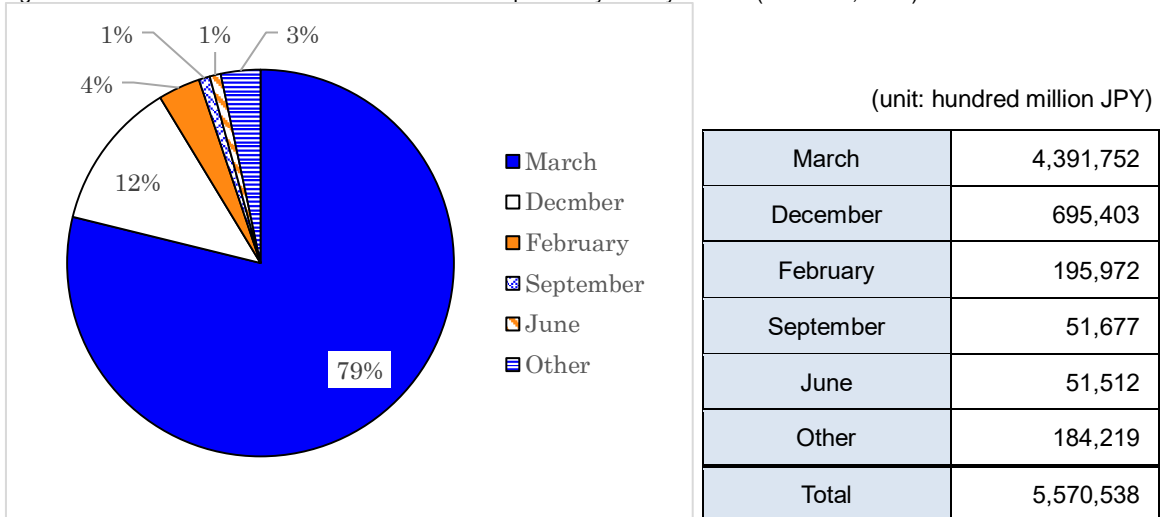
A look at when listed domestic companies close their books reveals that 64% do so at the end of March, and that they account for 79% of the total market capitalization, which explains why audit operations are heavily concentrated in specific periods (Figures I-3-7 and I-3-8).

Figure I-3-7: Number of listed domestic companies by fiscal year-end (March 31, 2020)



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

Figure I-3-8: Total market value of listed domestic companies by fiscal year-end (March 31, 2020)



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

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

With the aim of strengthening the quality control structures of audit firms that audit listed companies, which have a major impact on society, and securing the trust of the capital markets in financial statement audits, the JICPA introduced a registration for listed company audit firms on April 1, 2017. The system requires firms that audit domestic listed companies to register with the JICPA as "listed company audit firms." 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 120 firms in the list of registered firms as of the end of June 2020,

The list of registered firms includes audit firms whose registration has been approved based on the results of quality control reviews. The list of associate registered firms, meanwhile, includes audit firms who have applied for registration, but whose registration is currently under review because, for example, the quality control review has not been completed. Each of the lists can be viewed on the JICPA's website.

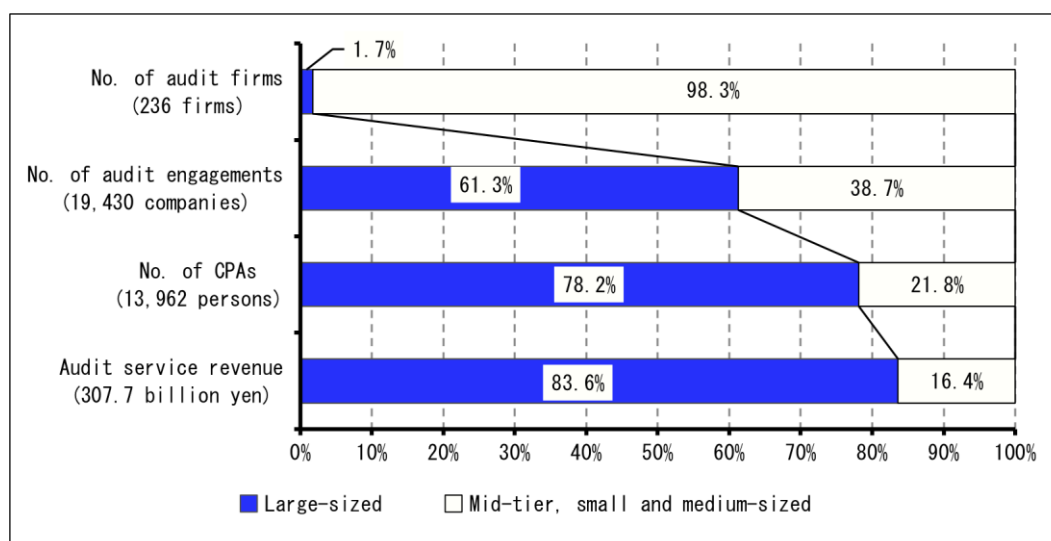
The audit firms in the list of registered firms regularly undergo quality control reviews, and based on the results of these reviews, such as action as removing them from the list may be taken.

Stock exchanges' securities listing regulations etc. also stipulate that the accounting auditors of listed domestic companies must be audit firms registered on the list of registered firms or the list of associate registered firms.

### ■Concentration at Large-sized Audit Firms■

Among the 236 audit firms as of the end of FY2018, large-sized audit firms accounting for a large proportion of the number of audit and attestation engagements, the number of CPAs, and audit and attestation service revenue.

<Share by category of audit firm (FY2018)>



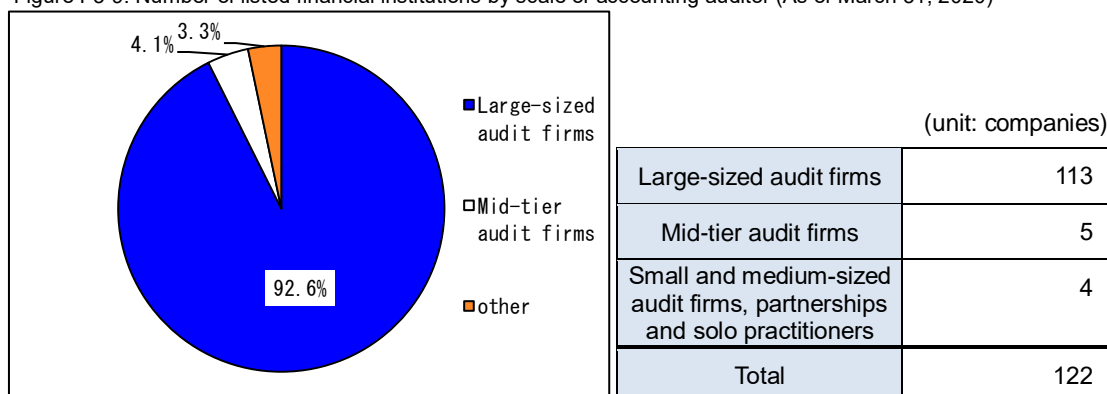
(Note 1) Compiled based on FY2018 JICPA member data and operational reports submitted by audit firms

### 3. Audits of Financial Institutions

92% of listed financial institutions (122 companies) were audited by large-sized audit firms, and in terms of market capitalization, large-sized audit firms handled 99%. So compared with all domestic listed companies, large-sized audit firms' share presented a further increase (Figures I-3-9 and I-3-10). For information about domestic listed firms as a whole, see 2. FIEA and Companies Act Audits (page 27).

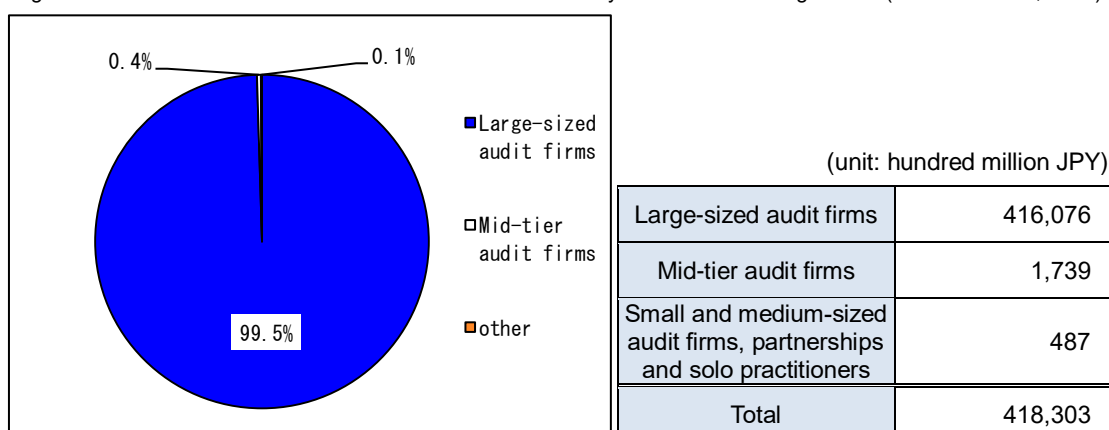
Large-sized audit firms are pursuing initiatives to enable them to cope with accounting and audit practices that are designed to the listed financial institutions. These include establishing organizational and audit structures specifically for the financial sector and providing education/training to audit practitioners.

Figure I-3-9: Number of listed financial institutions by scale of accounting auditor (As of March 31, 2020)



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

Figure I-3-10: Total market value of listed financial institutions by scale of accounting auditor (As of March 31, 2020)



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

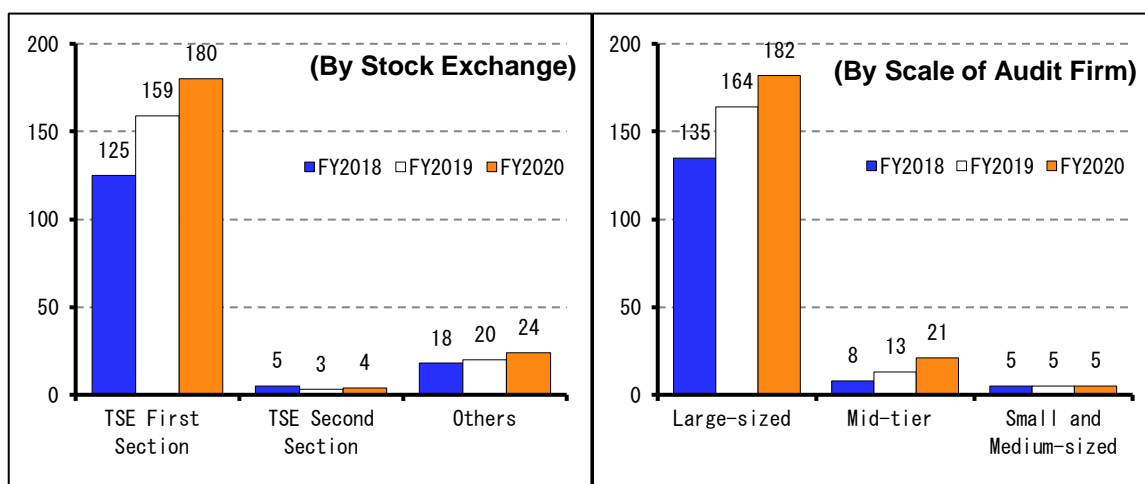


## 4. Companies Adopting IFRS

The following figures show the listing markets for companies that have adopted IFRS and the scale of the accounting auditors for these companies (Figures I-3-11).

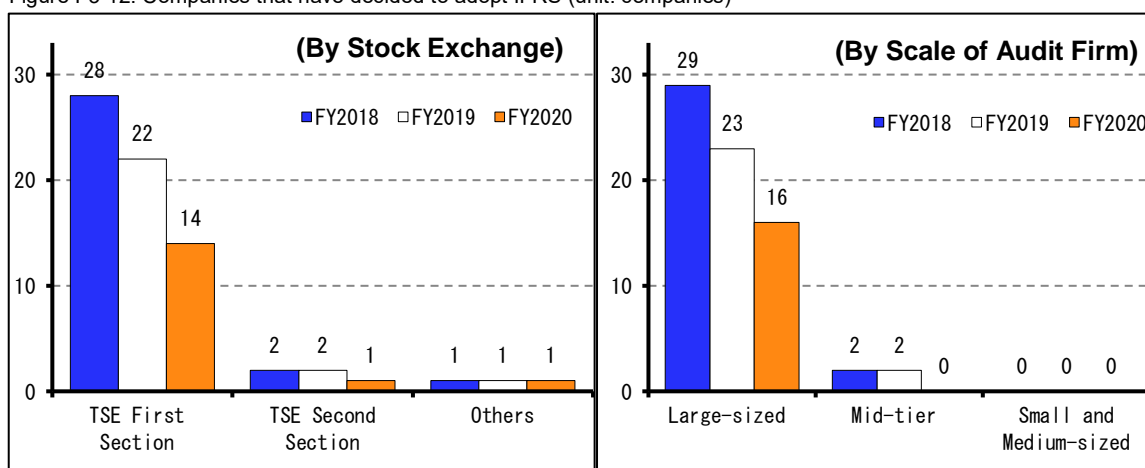
The majority of companies that have adopted IFRS are listed on the First Section of the Tokyo Stock Exchange, and many of them operate internationally. Audit contracts are concentrated in large-sized audit firms which are able to collaborate with Big Four global networks. A similar situation is seen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

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



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

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



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

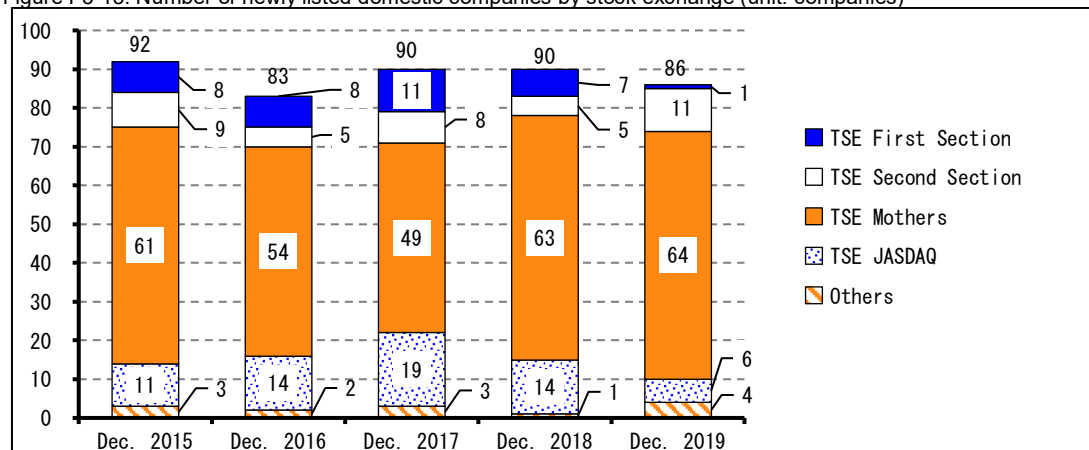
## 5. Audits of Initial Public Offerings

The number of IPOs (excluding listings on the Tokyo Pro Market) came to 86 at the end of December 2019, which is slightly down but more or less the same level as the previous year. Listings on the Tokyo Stock Exchange Mothers market were particularly numerous (Figure I-3-13).

A look at shares by size of audit firm reveals that large-sized audit firms still possess a large share (Figure I-3-14). However, the shares held by each of the large-sized audit firms have changed, which likely reflects changes in the business administration policies and IPO operations of each firm. For information about the policies, organizational structures, etc. of audit firms regarding the acceptance of IPO audit engagements, see III. Operation of Audit Firms, A. Operations Management Environment, 1. Organizational Structure of Audit Firms (page 67).

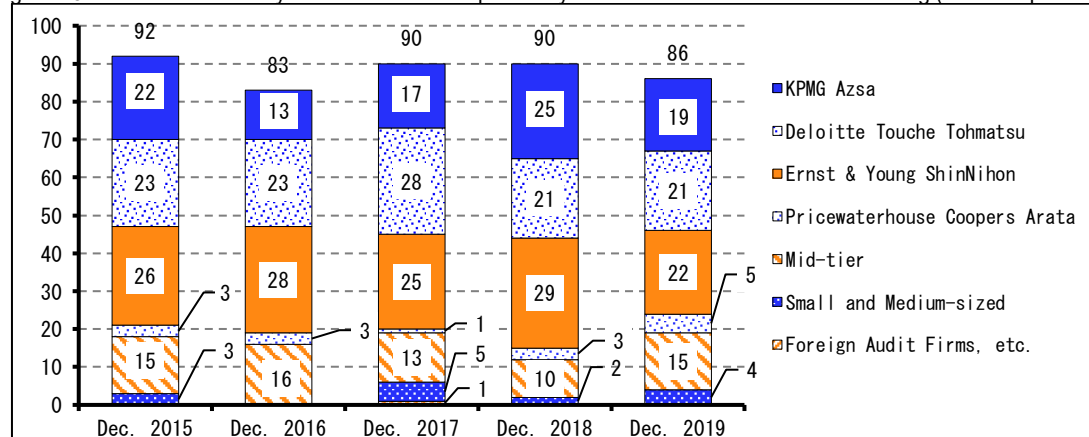
Note that the share of large audit firms was 78% in the year to December 2019.

Figure I-3-13: Number of newly listed domestic companies by stock exchange (unit: companies)



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

Figure I-3-14: Number of newly listed domestic companies by scale of audit firm at the time of listing (unit: companies)

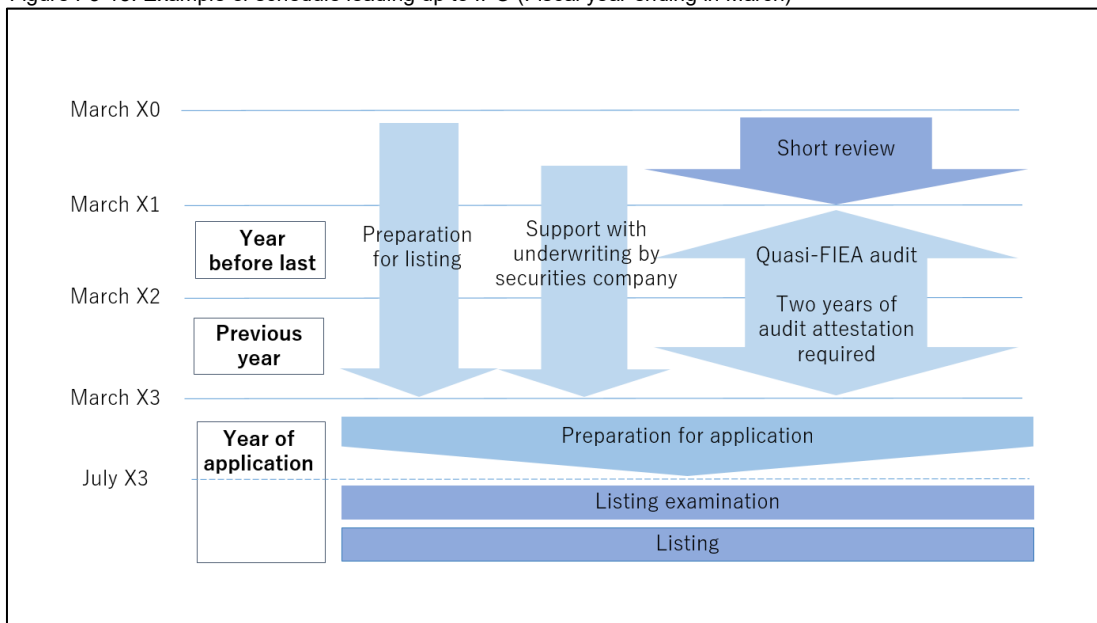


(Source) Prepared by the CPAAOB based on data from exchanges

Most audit firms regard the acceptance of IPO audit engagements as part of their mission of audit firms, since assisting with IPOs enables companies to grow and contributes to socioeconomic development.

However, IPO audits often entail a relatively high level of audit risk, e.g. vulnerability in the internal management structure of the audited company. As a result, before accepting IPO audit engagements, many audit firms follow their policies to conduct more rigorous risk assessments than normal.

Figure I-3-15: Example of schedule leading up to IPO (Fiscal year ending in March)



(Source) Prepared by the CPAAOB

### ■ IPO support services ■

Stock exchange rules stipulate that for listing, a company needs to have its financial statements audited for the two years prior to the year in which it will be listed (application year), with the type of audit being equivalent to that prescribed in Article 192-2, paragraph of the FIEA (below, "quasi-FIEA audit" ). Furthermore, before concluding a quasi-FIEA audit contract, a short review is conducted so as to identify and resolve issues ahead of listing. This is the typical workflow when preparing for listing. Companies often ask CPAs and audit firms for support with conducting the short review and resolving issues, and CPAs and audit firms accept these engagements as non-audit work. The IPO-related support services that CPAs and audit firms provide as non-audit work include the following:

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

## II. The CPAAOB monitoring

## **II. The CPAAOB monitoring**

### **A. Overview of System and Situation with Implementation**

#### **1. Legal Position of the CPAAOB**

The CPAAOB is an administrative body<sup>4</sup> 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. It comprises a chairperson and a maximum of nine members (who serve three-year terms). Although the members are part time, one full-time member can be appointed.

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

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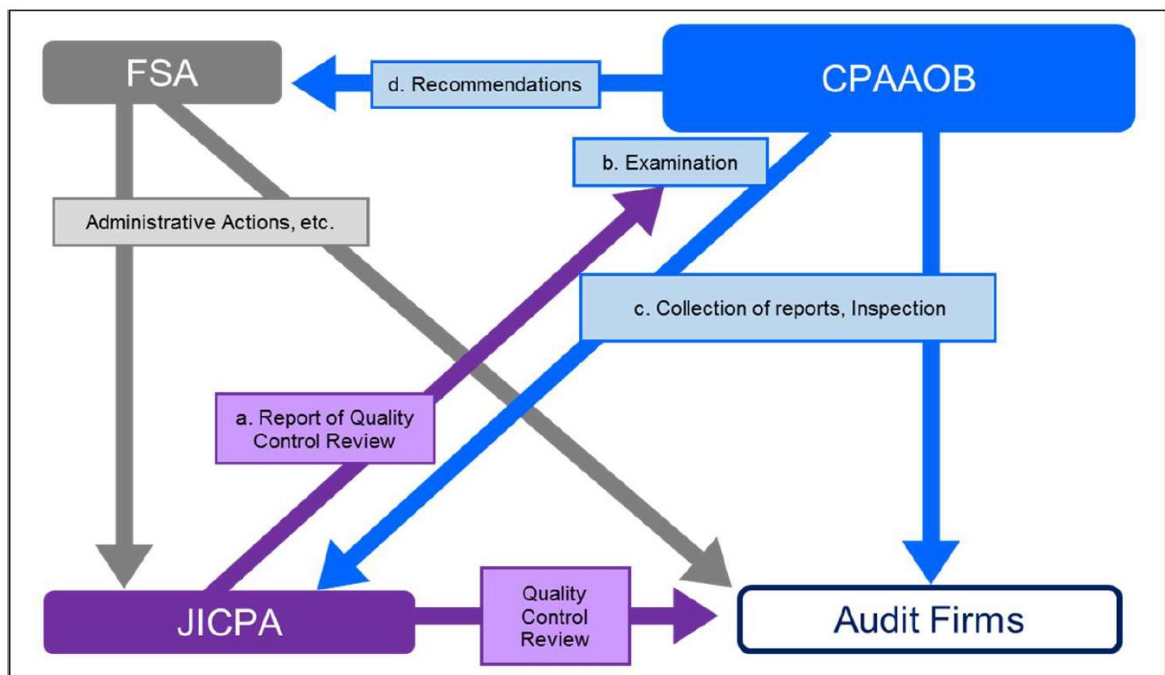
<sup>4</sup> Appointed by the Prime Minister with the consent of both houses of the Diet from persons with an understanding of and insight concerning matters relating to CPAs.

## 2. Overview of Examinations, Collection of Reports, and Inspections by the CPAAOB

Figure II-1-1 shows the relationship between examinations, collection of reports, and inspections by the CPAAOB on the one hand, and the JICPA quality control reviews, the FSA's administrative actions, etc. on the other.

Based on the JICPA quality control review reports (a), the CPAAOB assesses whether the JICPA has carried out the quality control reviews properly and whether the audit firms have properly performed its audit services (b), and collects reports from the JICPA, audit firms, etc. and conducts on-site inspections when deemed necessary (c). If it finds it to be necessary as results of inspections, the CPAAOB recommends administrative actions or other measures to the FSA Commissioner (d).

Figure II-1-1: Scheme for examinations, collection of reports, and inspections by the CPAAOB



### 3. 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 the registration of CPAs and specified partners. The quality control reviews are conducted by the JICPA to maintain/improve suitable qualitative standards for audit services and to ensure public trust in audits. More specifically, the JICPA reviews the administration of audit engagements conducted by audit firms, reports its findings to the audit firms and, when necessary, recommends improvements and monitors these improvements<sup>5</sup>.

Quality control reviews were introduced by the JICPA in FY1999 as self-regulations, and in 2003 a revision to the CPA Act made it mandatory for the JICPA to conduct reviews of the administration of audit and attestation services by audit firms and report its findings of these reviews to the CPAAOB.

The JICPA regularly submits to the CPAAOB monthly and annual reports and provides quality control review reports as needed. The specific information reported is as follows:

- 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. "Remediation plan" prepared by the audit firm and submitted to the JICPA

Quality control reviews evaluate the audit firms' systems of quality control. They involve confirming that quality controls have been established and conducting sampling to confirm that they are being implemented. Specifically, they confirm whether the audit firms' systems of quality control (all policies and procedures for quality control pertaining to audit, including quality control procedures for audit engagements) have been suitably and sufficiently developed in compliance with quality control standards<sup>6</sup>, and whether these systems of quality control are operating effectively.

Quality control reviews comprise ordinary reviews, which are conducted regularly or on

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<sup>5</sup> For details concerning quality control reviews, see the JICPA website and the annual report from the Quality Control Committee.

<sup>6</sup> Refers to Quality Control Standards for Audit, Quality Control Standards Commission Statement No. 1 ("QCSCS"), and Auditing Standards Committee Statements "ASCS").

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 FY2019, there were a total of 40 reviewers (as of August 1, 2019) who conducted ordinary reviews of 84 audit firms.



## 4. Examination

### a. Overview

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 nature of the quality control reviews conducted and guidance to audit firms on necessary remediation measures, and analyses the findings of quality control reviews as well as details of remediation plans submitted by audit firms to the JICPA. In addition to considering the need for conducting on-site inspections and collecting reports in light of these analysis results, the CPAAOB engages in exchanges of opinions with the JICPA concerning matters such as the effectiveness of quality control reviews. When conducting examinations, the CPAAOB also utilizes information obtained from the relevant FSA departments, relevant organizations, etc.

### b. State of implementation of examination and review results

The CPAAOB examined the quality control reviews conducted in FY2019 by the JICPA in PY2019 and an overview of the examination is given below.

#### i. FY2019 quality control reviews

As of June 30, 2020, quality control reviews had resulted in conclusions being approved for 82 of the 84 firms subjected to quality control reviews, of which 6 audit firms received qualified conclusions, 76 unqualified conclusions, so no audit firms received negative or disclaimer of conclusions, 77 firms (including the 6 audit firms with qualified conclusions) also received recommendations for improvements (Figure II-1-2).

Figure II-1-2: FY2019 quality control reviews (unit: audit firms)

Classification	Reviewed parties	Conclusion			Recommendations for improvement	
		Unqualified conclusion	Qualified conclusion	Adverse conclusion	Yes	No
Audit firms	57	54	1	0	51	4
Partnerships	1	1	0	0	0	1
Solo practitioners	26	21	5	0	26	0
Total	84	76	6	0	77	5

(Note 1) Qualified conclusions are given when material deficiencies have been discovered, and there is some concern about serious compliance violations of audit standards, etc.

(Note 2) 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 3) Audit firms receiving unqualified conclusions may nonetheless be given recommendations for improvement when specific areas requiring improvement are discovered.

(Note 4) Of the 84 firms reviewed, the review conclusions for two firms had still not been determined as of June 30, 2020 so data on conclusion and recommendations for improvement with respect to these firms are not included in this table.

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

## ii. Examination of FY2019 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 FY2019 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

The above results of examinations made it clear that qualitative improvements are pursued with respect to FY2019 quality control reviews:

- To strengthen the risk-based approach, review plans were formulated after taking into account the results of past quality control reviews of the audit firms and risk assessments performed at each stage of the audit engagements covered by the review. Furthermore, steps were taken such as extending the review period in light of risk information that came to light after the commencement of the review.

- To ensure that issues pointed out with specific audit engagements are not cast aside as marginal documentation problems (presentation errors in audit papers), and that issues can be pointed out based on the bedrock of the deficiencies, review procedures have been revised, training has been provided to reviewers, and so on. As a result, a proportion of documentation issues pointed out continues to decline.

Regarding issues pointed out in quality control reviews, there has been an increase in issues relating to the performance of journal tests, which are required to mitigate the risk of management overriding internal controls. As a result, a rise has been seen in issues relating to mitigating the risk of material misstatement, including fraud.

## 5. Collection of Reports

### a. Overview

The CPAAOB may collect reports from the JICPA or audit firms when it deems this necessary. With limited inspection resources at its disposal, it is important for the CPAAOB to make effective use of the collection of reports so as to encourage audit quality to be ensured and improved at all audit firms in Japan. Based on this point of view, we collect reports from audit firms as follows after taking into account the sizes of firms, their operations management environments, the results of the CPAAOB inspections and quality control reviews, and so on.

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

In the case of large-sized audit firms and mid-tier audit firms, we periodically analyze quantitative and qualitative information concerning their business management (governance) environments and operations management system so as to contribute to making inspections more effective. We also find out about the adoption of IT and cybersecurity measures in connection with audit engagements. In addition, we employ the information obtained from through the collection of reports to perform comparative analysis of audit firms, identify sector-wide issues, etc.

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

In the case of small and medium-sized audit firm, partnership and solo practitioner, we select firms from which to collect reports based on the results of quality control reviews. We then gather and analyse information about measures taken to address issues pointed out during quality control reviews, their operations management system, their quality control system, and so on. Furthermore, because the influence of top management is especially strong at small and medium-sized audit firm, partnership and solo practitioner, we find out about the current level of audit quality and top management's attitudes toward audit quality, and conduct interviews with them as necessary.

#### iii. Collection of reports from small and medium-sized audit firm, partnership and solo practitioner (follow-up after notification of inspection results)

In the case of problems that small and medium-sized audit firm, partnership and solo practitioner have been notified of in the form of inspection results, once a certain period of time has passed since the notification of the inspection results, we follow

up by finding out about the action that has been taken, and if necessary, encourage the audit firm concerned to make independent improvements through interviews, etc.

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

If, as a result of an inspection, the overall rating of the firm's business administration is that it is "unsatisfactory and in need of immediate remediation," we collect reports at the time of the notification of the inspection results, and encourage the firm to make improvements promptly (for information about overall ratings, see "7. Notification of Inspection Results" (page 53)).

b. Implementation

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

In PY2019, the CPAAOB collected reports from all large-sized audit firms and mid-tier audit firms in order to find out about their business management (governance) environments, operations management system, etc.

Furthermore, we analyzed information obtained through the collection of reports to ensure that inspections would be conducted effectively and efficiently. Within the information, we also conducted firm-wide factfinding of business management (governance) environments and operations management environments at large-sized audit firms and mid-tier audit firms.

ii. Collection of reports from small and medium-sized audit firms

In PY2019 we collected reports from 31 small and medium-sized audit firms that we had selected after taking into account the results of quality control reviews, which we received mainly from firms that had been subject to such reviews in FY2018. We collected reports on improvement recommendations made in the reviews, management policy, the organization, human resources, and training systems (including their implementation) of the audit firms, matters relating to the global networks, the conduct of group audits, and so on.

Among the small and medium-sized audit firms from which reports were collected, we also conducted face-to-face interviews with representatives of 10 of them (firms where material deficiencies or auditing standards violations had been identified, firms where the number of improvement recommendations etc. was higher than average, firms that need to consider matters such as audit risks relating to audited companies, etc.).

During these interviews, our aim was to encourage the firms to establish proper audit quality controls. We conveyed the problems as we saw them, and focused on asking

questions about the firms' quality control systems (including their responses to review results), the management policy of the representatives, organization, human resources, and so on.

As a result of the interviews, we had concerns, which are described below, about the operations management environments at certain audit firms, and resolved to treat them as important reference information during future examinations, inspections, etc.

- A top of audit firm believes that it is achieving a reasonable level of quality control despite moving to expand its business. However, with the number of audit engagements increasing recently, it is hiring part-time staff (CPAs) in an effort to keep up with the higher workload, but at the same time are reducing the number of partners tasked with quality control.
- Both the number of audit engagements and partners continues to decline, and the firm has been looking for a merger to ensure that it can stay in business, but has so far not completed any merger. The ages of partners are increasing, but action is not being taken to maintain/improve quality control.
- Despite a lot of issues being pointed out during quality control reviews, the top of audit firm believed that it would be possible to address the deficiencies solely by replacing the engagement partner. The top therefore did not have a sufficient understanding of the importance of undertaking root cause analysis.

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

In PY2019, among small and medium-sized audit firms that had been notified of inspection results by the CPAAOB in past fiscal years, the CPAAOB collected reports from two audit firms for which about one year had passed since the notification in order to confirm the improvements that had been made to address issues pointed out during the inspection.

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

In PY2019, we continued to receive improvement reports at the same as issuing inspection results notifications two audit firms which, as a result of inspections, had received an overall rating with regard to business administration of “unsatisfactory and in need of immediate remediation.”

The audit firms included ones where numerous deficiencies in audits of large listed domestic companies had been identified, ones where the establishment and

administration of headquarters organizations were inadequate, and ones where procedures for accepting audit engagements from high-risk listed domestic companies were inappropriate.

## 6. Inspections

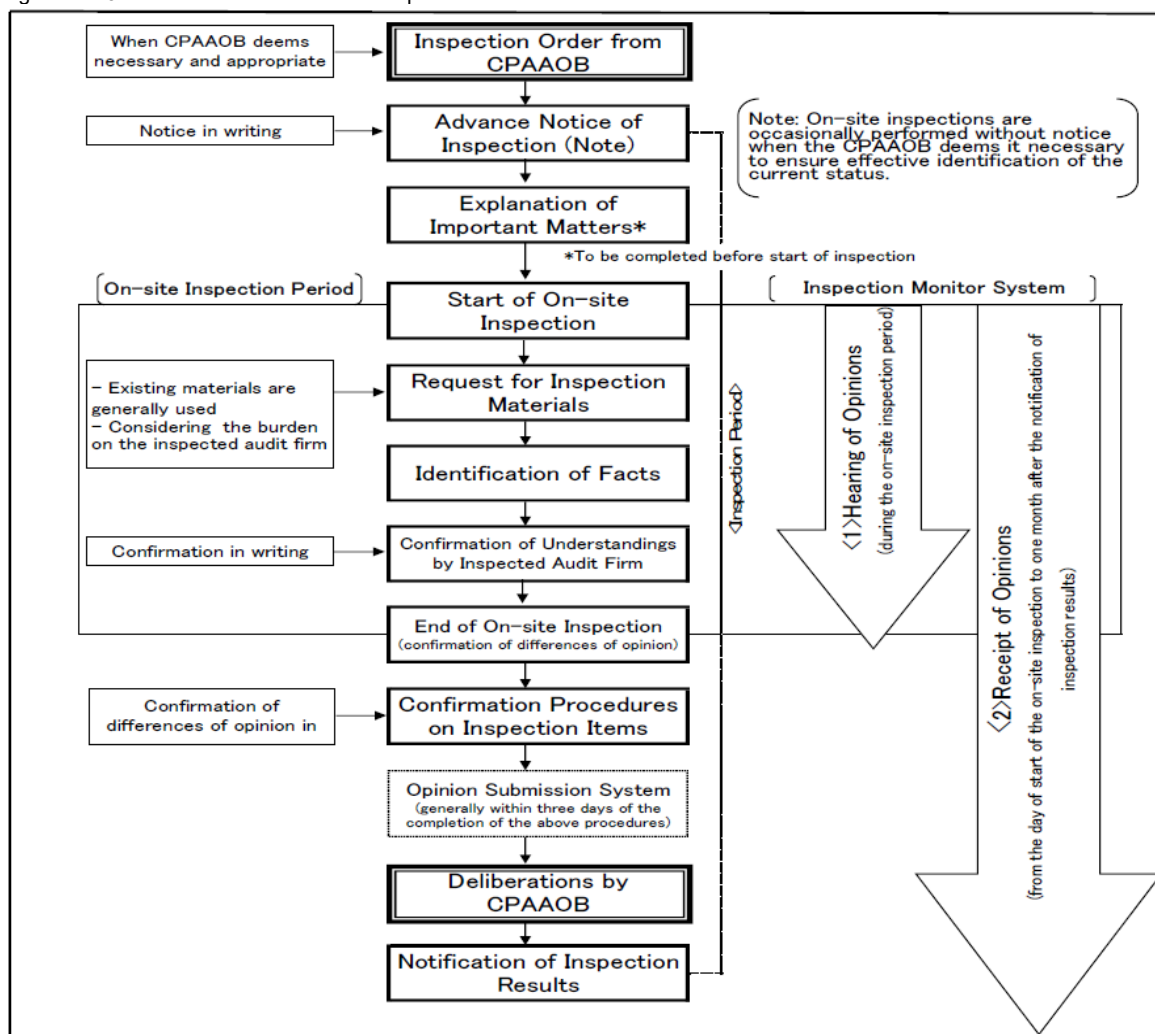
### a. Overview

When deemed necessary and appropriate for the public interest or the protection of investors as the result of 4. or 5. above, the CPAAOB will inspect audit firms (Article 49-3-2 of the CPA Act). Furthermore, when deemed necessary for ensuring the proper administration of the JICPA, the CPAAOB will also inspect the JICPA (Article 46-12-1 of the CPA Act).

Basic matters concerning the CPAAOB's inspections, procedures for conducting inspections, the handling of inspection results, etc. are prescribed in the "Basic Guidelines on Inspections Conducted by the Certified Public Accountants and Auditing Oversight Board" (last revised in April 2015).

The standard workflow for inspections of audit firms conducted in accordance with the Basic Guidelines is depicted below (Figure II-1-3).

Figure II-1-3: The standard workflow for inspections





The following is an explanation of the main components of the standard workflow:

i. Inspection order from the CPAAOB

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

ii. Explanation of important matters

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

iii. On-site inspection

Generally, the inspectors visit the audit firm and inspect its operations management environment, quality control environment, and audit engagements. The audit engagements inspected are selected based on the size of the audit firm, the key points of the basic plan on monitoring, and the audited company's audit risks.

Inspectors examine whether the audit firm's procedures on quality control comply with regulations, auditing standards and quality control policies established by the audit firm through the inspection of books, records and other materials and interviews of the audit firm's executives and 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.

iv. Confirmation procedures on inspection items

After the on-site inspection, the CPAAOB communicates to the audit firm any problems discovered during the inspection, solicits the views of the audit firm on these problems, and confirms with the audit firm matters whether there are any differences of opinion between the CPAAOB and audit firms.

v. Opinion submission system

If there is a chasm of opinion, the audit firm may submit its opinion to Secretary-General of Executive Bureau in writing, usually within a three-day period (excluding weekends and public holidays) from the day on which the procedures for confirmation of inspection items were completed. Furthermore, if it receives a request from the audit firm to extend the submission period, the CPAAOB will consider extending the submission period by up to two days.

If an opinion has been submitted, the head of the CPAAOB Executive Bureau Planning, Management and CPA Examination Office or the head of the Planning, Management and CPA Examination Office will review the opinion submitted and investigate the facts, prepare the results of their review, and submit them to the CPAAOB.

Review results approved by the CPAAOB will be conveyed to the audit firm via the Planning, Management and CPA Examination Office.

vi. Inspection monitor system

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

Inspection monitoring is performed by “asking for opinions” and “receiving opinions, and the head of the Planning, Management, and CPA Examination Office may take such action as giving instructions to inspectors.

b. State of implementation of inspections

i. Recent conduct of inspections

The frequency of inspections differs depending on the size of the audit firm.

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

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

Inspections of small and medium-sized audit firms are conducted as necessary, in light of deficiencies pointed out in quality control reviews.

Details of the inspections conducted during the past five years are presented below (Figures II-1-4 and II-1-5).

Figure II-1-4: State of implementation of inspections in the past five years  
(based on commencement of inspections)

(unit: audit firms)

Fiscal/PY	2015	2016 (Notes 1, 2)	2017 (Note 2)	2018 (Note 2)	2019 (Note 2)
Large-sized audit firms	2	4(2)	4(2)	4(2)	4(2)
Mid-tier audit firms	1	2	2	1	2
Small and medium-sized audit firms, partnerships and solo practitioners	6	5	3	5(1)	3
Foreign audit firms, etc. (Note 3)	0	1	0	0	1
Total	9	12(2)	9(2)	10(3)	10(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 "B. Foreign Audit Firms." (page 59) for information on foreign audit firms etc.

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

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

	Large-sized audit firms	Mid-tier audit firms	Small and medium- sized audit firms
Number of inspections	8	7	15
Average number of inspectors	9.1	6.7	5.1
Average inspection period (calendar days)	143.3	132.0	112.7
Average number of inspected audit engagements (companies)	6.8	5.3	3.1

(Note 1) Covers inspections conducted during the five-year period from FY2015 to PY2019, excluding inspections for foreign audit firms, etc., ad hoc inspections, follow-up inspections, inspections resulted in submission of opinions, and inspections resulted in recommendations for administrative measures to the FSA Commissioner, as they go through procedures different from those for regular inspections.

(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 (calendar day basis).

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

## ii. Deficiencies

### a. Characteristics of deficiencies identified through inspections of quality control environment

Results of the CPAAOB inspections from PY2017 are as follows.

Large-sized audit firms tend to be shifting responsibility for quality control from headoffice quality control departments to business units, which are closer to the audit frontline, and that this has proved somewhat effective. However, inadequate cooperation between the quality control department and business units is an issue (for information on the organization of large-sized audit firms, see "III Operation of Audit Firms, A. Operations Management Environment, 1. Organizational Structure of Audit Firms" (page 67).

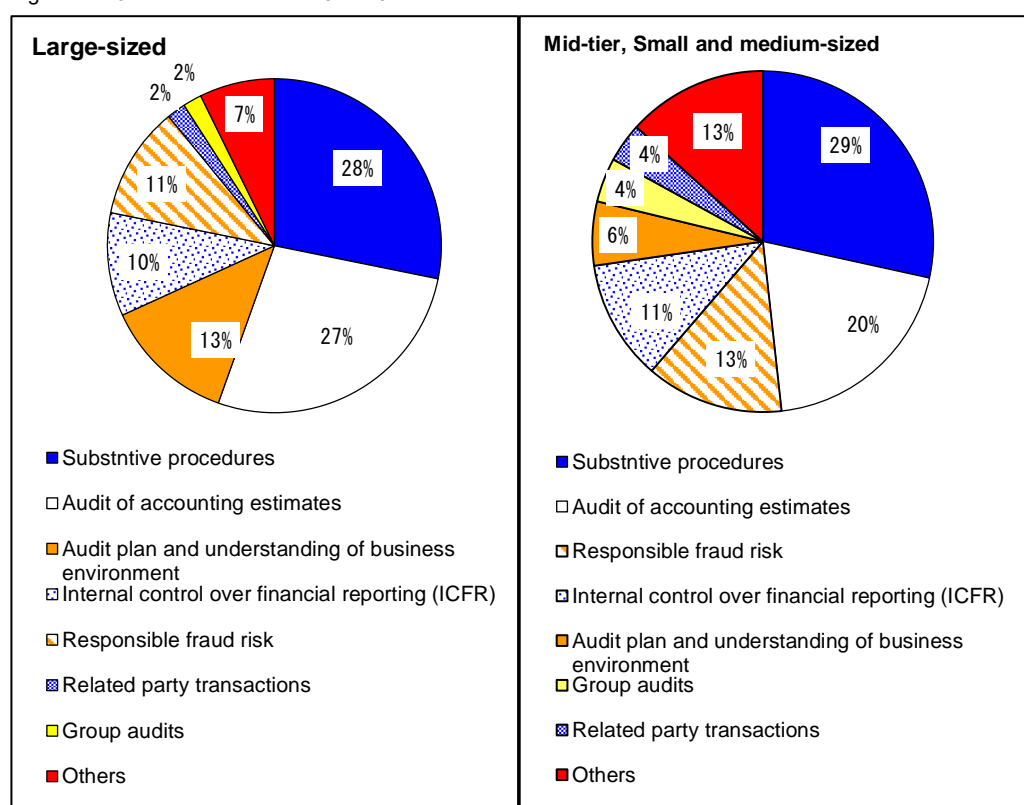
While mid-tier audit firms have developed quality control structure firm-wide,

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. Furthermore, their executives, including top management, have insufficient awareness of the importance of ensuring and improving quality control.

As for small and medium-sized audit firms, some of the larger ones have failed to establish operations management environments or quality control environments that are sufficient to cope with their business expansion. Furthermore, at some firms the environment for conducting proper audits of high-risk listed companies is inadequate.

- b. Characteristics of deficiencies identified through inspections of audit engagements
- Deficiencies identified through inspections of audit engagements from PY2017 to PY2019 can be classified in line with the ASCS structure as follows (Figure II-1-6).

Figure II-1-6: Deficiencies in PY2017-19



(Note) Classifications of deficiencies noted at five large-sized audit firms (total), five mid-tier audit firms, and 10 small and medium-sized audit firms

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

Regardless of the size of the audit firm, deficiencies in substantive procedures (audit procedures such as analytical verification procedures and detailed tests that are conducted with regard to transaction types, account balances, and footnotes to tackle the risk of material misstatements) were the most common. However, during the past three program years, such deficiencies have been falling as a proportion of the total. In contrast, deficiencies relating to the audit of accounting estimates continue to account for a large share, and the proportion of deficiencies that relate to understanding of audit plans and corporate environments or responding to fraud risk is on the rise. We therefore perform inspections with a focus on the investigation of these sorts of deficiencies.

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 detailed information about examples of deficiencies identified during the inspections and their causes.

## 7. 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-1-7<sup>7</sup>.

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

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

### b. “Key points” section

Among the sections included in an inspection results notification, the “Key points” section provides information about those deficiencies identified during the CPAAOB inspections that are regarded as significant. It comprises three subsections (operations management environment, the quality control environment and audit engagements) and confers an overall rating based on the situation with each.

The overall rating of the operation of services at the inspected audit firm is presented at the beginning of the “Key points” section of the inspection results notification, as shown in Figure II-1-8.

Figure II-1-8: Example of key points

5. Key points  
As a result of our inspection of your audit firm, we discovered within the scope of our inspection the following unsatisfactory results 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)

<sup>7</sup> Overall ratings will not be given for ad hoc inspections or follow-up inspections of large-sized audit firms as the inspection results notifications in those cases 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 ensure proper understanding of their level of quality control among audit and supervisory board members etc. of audited companies, to whom the inspection results notification is provided.

c. Overall rating grades

The overall rating takes the form of one of the following five grades, and is based on the assessment results of audit firm's operations management environment, quality control environment, and audit engagements. Figure II-1-8 provides examples of minor deficiencies warranting an overall rating of "satisfactory with minor deficiencies."

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 and audit engagements.

2. "Satisfactory with minor deficiencies"

Given when there are problems needing to be fixed, but operation of services is deemed to be satisfactory on the whole, e.g., there are no significant deficiencies 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 significant deficiencies 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.

Note that in the case of audit firms rated as "Unsatisfactory and in need of immediate

remediation,” we collect reports at the time of the notification of the inspection results, and encourage the firm to make improvements promptly (for more details, see “5. Collection of Reports” (page 43)). Furthermore, in the case of audit firms rated as “Extremely unsatisfactory,” we make recommendations concerning administrative actions and other measures to the FSA Commissioner.

d. Distribution of overall ratings

The distribution of overall ratings for regular inspections that were commenced and completed between PY2017 and PY2019 is shown below (Figure II-1-9).

No audit firms qualified as “Generally satisfactory”, the highest rating in the overall rating scheme, so based on the assessment of the results of the operations management environment, quality control, and audit engagements, all audit firms were qualified as “Satisfactory with minor deficiencies” or lower.

Many small and medium-sized audit firms, partnerships and solo practitioners had overall ratings lower than those of large-sized and mid-tier audit firms. This is because the CPAAOB mainly inspected the small and medium-sized audit firms, partnerships and solo practitioners whose quality control environments needed urgent confirmation. It was apparent at small and medium-sized audit firms, partnerships and solo practitioners with low overall ratings that there was insufficient awareness among the top management of the firms concerning quality control, and that partners and staff lacked an understanding of the recent environmental changes pertaining to accounting and auditing and of the quality control levels required by the current audit standards.

Figure II-1-9: Overall ratings for inspections in PYs 2016/2019 (based on commencement of inspections)  
(unit: audit firms)

Overall rating	Large-sized and mid-tier audit firms	Small and medium-sized audit firms, partnerships and solo practitioners
Generally satisfactory	-	-
Satisfactory with minor deficiencies	9	3
Unsatisfactory	5	4
Unsatisfactory and in need of immediate remediation	-	3
Extremely unsatisfactory	-	4

(Note) Totals for audit firms subject to regular inspections that were commenced and completed between PY2016 and PY2019



- e. Communication of “key points” to audit and supervisory board members etc. of all audited companies<sup>8</sup>

Audit firms are required to communicate the “key points” in their inspection results notifications and the action they are taking in response to them to audit and supervisory board members etc. of all audited companies<sup>8</sup>.

In addition, audit firms must communicate to the audit and supervisory board members etc. of audited companies whose engagements were selected as inspection scopes about inspection details of deficiencies and the action the audit firms are taking in response.

Furthermore, with the aim of accurately conveying inspection results to audit firms, since inspections that began in PY2016, the CPAAOB has asked audit firms to relay the “key points” to audit and supervisory board members etc. of audited companies.

Moreover, for the purpose of enabling audit and supervisory board members etc. of audited companies to compare inspection results with those for other audited firms and better understand the business administration levels of audit firms, we have published the distribution of overall ratings in d. above since the 2019 Monitoring Report.

- f. Handling of inspection results

Inspected audit firms must obtain prior consent from the CPAAOB to disclose the inspection results to a third party<sup>9</sup>.

However, the inspected audit firms may disclose the results without the prior consent of the CPAAOB in the case of e. above and 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 and supervisory board members etc. of audited companies
  - 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

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<sup>8</sup> The ASCS requires audit firms to convey in writing to the audit and supervisory board members etc. the details of inspection results notifications and the measures for improvements (ASCS 260, No. 16, A31-2).

<sup>9</sup> Details on disclosing inspection results to third parties are listed on the CPAAOB website.

This approach is designed to improve the effectiveness of the JICPA quality control reviews and to encourage audit and supervisory board members etc. of audited companies to utilize the inspection results and to pursue greater collaboration with audit firms.

In recent years, there have been cases of audit firms asking the CPAAOB to approve in advance the disclosure of inspection results etc. in response to requests from directors etc. of audited companies and potential audited companies (e.g. companies that are considering which accounting auditor to appoint).

We hope that not only audit and supervisory board members etc. of audited companies but also the directors etc. of audited companies and potential audited companies make use of the CPAAOB inspection results etc. in order to confirm the establishment and implementation of quality control systems by accounting auditors.

## **B. 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 attestation by a Japanese CPA or audit firm. However, if the issuer company is a foreign company, the financial statements generally undergo audit attestation 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 attestation deemed to be equivalent to that prescribed under the FIEA.

With the aim of further enhancing the soundness of Japan's capital markets, the CPA Act was amended in 2007 to require foreign CPAs and audit firms that audit the financial statements of foreign companies, etc., that are subject to FIEA disclosure rules to submit the notification to the FSA Commissioner.

Audit firms that have submitted it 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.

Based on the "Approach to Inspections and Supervision of Foreign Audit Firms (published on September 14, 2009), the CPAAOB generally collects reports from foreign audit firms once every three years, most recently having collected from 79 foreign audit firms in 29 countries/regions in PY2018. The CPAAOB also conducted an inspection of one foreign audit firm each in 2014, 2017 and 2019.

## 2. Foreign Audit Firms

Regarding the locations of foreign audit firms that have registered with the FSA, the largest number are based in Europe, with the second largest number being headquartered in the Asia-Pacific region (Figure II-2-1). The top countries/regions are France, with eight firms, the Cayman Islands, with seven firms, and the U.S. and Hong Kong, with six firms each. Foreign audit firm registrations are published and updated as “Registered Foreign Audit Firms” on the FSA website.

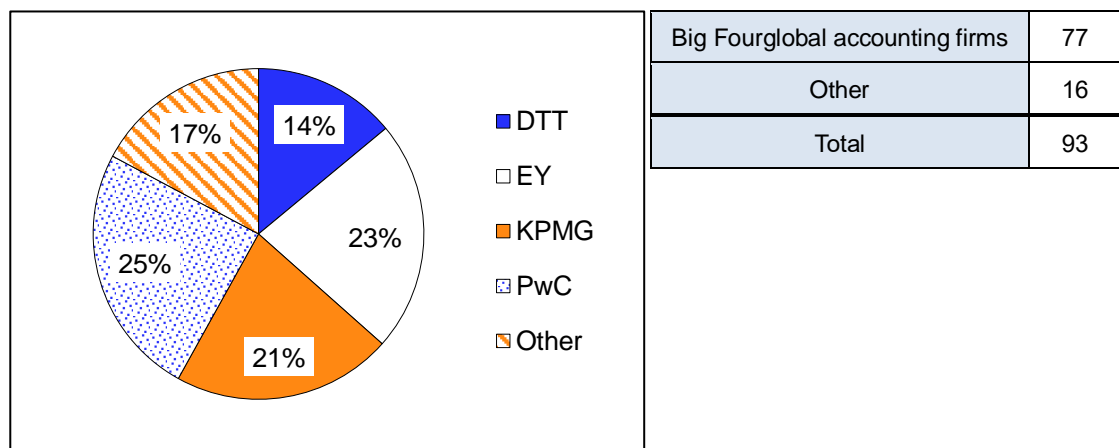
Figure II-2-1: Number of registered foreign audit firms, etc. (as of March 31, 2020)

	Number of countries/regions	Number of audit firms, etc.
Europe	15	47
Asia-Pacific	10	28
North America	2	9
Central/South America	2	8
Middle East	1	1
Total	30	93

(Source) Prepared by the CPAAOB based on information from the FSA website

Among the foreign audit firms from which reports have been collected by the CPAAOB, around 80% is affiliated with one of the Big Four global accounting firms (Figure II-2-2).

Figure II-2-2: Affiliation to the global networks (as of March 31, 2020, unit in right-hand table: Firms)



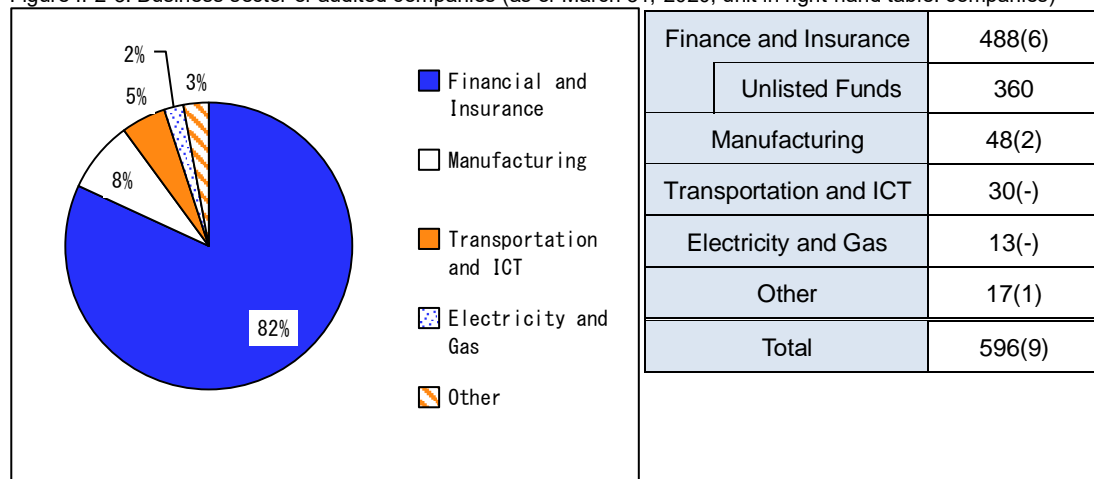
(Note) Compiled based on 79 reports collected from foreign audit firms in PY2019

### 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, but also bonds issued by foreign companies, beneficiary certificates issued by foreign investment trusts, and foreign investment securities. Among foreign companies currently subject to disclosure rules, most are unlisted funds (foreign investment trusts and foreign investment securities).

Regarding the business sectors of companies audited by foreign audit firms from which we have collected reports, 80% are classified as finance and insurance, and most of these are unlisted funds (Figure II-2-3).

Figure II-2-3: Business sector of audited companies (as of March 31, 2020; unit in right-hand table: companies)



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

(Source) Prepared by the CPAAOB based on information on the FSA website

## **C. The CPAAOB monitoring Perspectives, Objectives etc. (Basic Policy and Basic Plan)**

During the 15 years since its establishment in April 2004, the CPAAOB has endeavored to raise the level of trust that investors place in the capital markets based on its mission to enhance the fairness and transparency of Japanese capital markets by raising the quality and ensuring the reliability of audits by CPAs.

As part of these efforts, the CPAAOB formulates a Basic Policy for Monitoring Audit Firms each cycle (three years) and a Basic Plan for Monitoring Audit Firms, which is based on the Basic Policy, each program year. In this way, the CPAAOB articulates the perspectives and objectives of monitoring, priorities for each program year, and so on.

### **1. Basic Policy for Monitoring Audit Firms**

The entire text of the Basic Policy for Monitoring Audit Firms for the CPAAOB's 6th Cycle (April 2019 – March 2022) is presented on the CPAAOB's website, but monitoring perspectives, objectives, etc. are summarized below:

#### **[Monitoring Perspectives]**

The CPAAOB always acts in the public interest from the standpoint of citizens and takes full advantage of its powers to conduct effective monitoring based on the sizes of audit firms, their operations management environments, and the degree of risk of audited companies.

Through monitoring, we aim to ensure the reliability of audits in the capital markets by continuously encouraging audit firms to independently ensure and improve audit quality. Moreover, we share useful information obtained through monitoring with relevant parties such as relevant FSA departments and the JICPA, and also proactively provide information to the general public.

In addition, we will be cooperating and sharing information with the International Forum of Independent Audit Regulators (IFIAR) and foreign audit regulatory authorities, and will, as necessary, reflect international discussions concerning the accounting audits that we have learned about through this cooperation, as well as developments with the global networks, in the monitoring conducted by the CPAAOB.

#### **[Objectives of Monitoring and Basic Approach to Achieving Them]**

The main focus of monitoring performed by the CPAAOB is not on whether specific audit opinions are appropriate, but rather, is aimed at encouraging improvements in the effectiveness of quality control reviews performed by the JICPA, and ensuring that audit

engagements, including audit quality control conducted by audit firms and foreign audit firms , are performed appropriately.

To achieve such objectives, the CPAAOB performs monitoring as follows:

- Given that the entities responsible for ensuring proper business administration are audit firms, we conduct effective monitoring that encourages them to act independently.
- We conduct monitoring that emphasizes whether the quality control environments established by audit firms for the purpose of ensuring and improving audit quality are effective. For example, we verify that they not only adhering to audit standards formally, but also demonstrating the kind of professional skepticism needed to identify accounting fraud, and examine whether audit firms are always keeping an eye on business risks and assessing audit-related risks.
- We conduct ongoing monitoring of whether business management environments established based on the Audit Firm Governance Code are contributing to ensuring proper business administration at the audit firms concerned.

## 2. Basic Plan for Monitoring Audit Firms in Program Year 2020

The entire text of the Basic Plan for Monitoring Audit Firms in Program Year 2020 (July 2020 – June 2021) is presented on the CPAAOB's website.

When conducting monitoring in PY 2020, we will gauge the impact of COVID-19, and behave in a flexible manner by altering the nature of monitoring in response to the circumstances of audit firms subject to monitoring with consideration for the status of COVID-19 infections and the burden on audit firms.

Furthermore, in light of the fact that new ways of working are being proactively adopted, we will use the spread of COVID-19 as an opportunity to review monitoring methods to ensure that monitoring of audit firms by the CPAAOB is efficient and effective for both sides. Monitoring priorities etc. are described below:

### [Basic Plan Pertaining to Off-site Monitoring]

#### a. Collection of reports

In the case of large-sized and mid-tier audit firms, we continuously demand, through the collection of reports, qualitative and quantitative information required for the investigation of business management (governance) and operations management environments established in response to the Audit Firm Governance Code, as well as for investigation of audit methods including the utilization of IT, cybersecurity measures, steps taken to ensure compliance with laws and regulations such as the Act on Prevention of Transfer of Criminal Proceeds, etc. We also conduct fact-finding concerning the audit, review environments, etc. for listed financial institutions, the audit of which requires advanced specialist knowledge of and an understanding of IT.

In the case of small and medium-sized audit firms, partnerships and solo practitioners, we collect reports whenever it is appropriate to do so based on the results of JICPA quality control reviews, with an aim to encourage the audit firms to ensure proper audit quality management.

#### b. Examination of JICPA quality control reviews and cooperation with the JICPA

In the case of issues etc. concerning the effectiveness of quality control reviews identified through monitoring of audit firms, the CPAAOB shares the issues with the JICPA, and through ongoing consultations between the CPAAOB and JICPA reviewers, urges action to be taken to enhance the effectiveness of quality control reviews. Regarding connectiveness between the CPAAOB and the JICPA, we will be engaging in more specific and substantial discussions, as this is vital for ensuring and improving audit quality cross-sector wise.



c. Collection and analysis of information regarding audit firms

The CPAAOB engages in periodic dialog with executives, including top management, of large-sized and mid-tier audit firms in order to find out about the latest developments with the operations management environments at audit firms and problems facing audit firms and the audit sector. Executives, including top management, have a big influence on the organizational culture of their audit firms, so we will continue to engage in dialog with them and endeavor to make our discussions more in-depth. When doing this, we aim to grasp such matters as what the firm is doing to introduce KAM.

Through exchanges of views, cooperation, etc., we will also enhance information sharing with relevant bodies such as FSA departments, the JICPA, financial instruments exchanges, and the Japan Audit & Supervisory Board Members Association, as well as with international audit regulatory bodies, foreign audit regulators, and the global networks of audit firms. Furthermore, we will endeavor to upgrade our capabilities for collecting and analyzing data, information, etc. in accordance with the risks facing audit firms.

[Basic Inspection Plan]

a. Large-sized audit firms

We generally inspect large-sized audit firms every year (with regular inspections and follow-up inspections being conducted in alternate years). When conducting follow-up inspections, we give consideration to the burden on the audit firm and endeavor to ensure that the inspection is performed efficiently and effectively, with a focus on verifying remedy measures taken to address issues pointed out during regular inspections. There are 10 priority inspection points, and the main ones are as follows:

- We will investigate the attitudes and actions of executives with respect to quality control as well as their impact on the operations management environment and quality management environment of the audit firm
- With regard to environments (particularly supervision and evaluation bodies) established or reinforced based on the Audit Firm Governance Code, we will verify their effectiveness from the standpoint of whether they are contributing to ensuring and improving quality control at audit firms
- We will investigate the appropriateness of procedures for concluding new audit contracts (particularly ones with large listed companies or other listed companies considered to be high risk) and, the background to the conclusion of contracts the impact that the audit execution structures established in conjunction with the

conclusion of new audit contracts with large listed companies have on the audit quality within the audit firm as a whole

- We will investigate the situation with regard to the assessment of internal controls of companies, including those operating overseas, and the situation with regard to group audits that encompass overseas subsidiaries
- We will examine the status of education/training and human resource development for audit assistants, IT specialists, etc.
- We will examine efforts to enhance disclosure information concerning accounting audits, such as KAM

b. Mid-tier audit firms

We generally conduct inspections of mid-tier audit firms once every three years. There are 11 priority inspection points, and more or less the same as for large-sized audit firms, but the following are characteristic of mid-tier audit firms:

- With regard to audit firms that are expanding the range of business they conduct as a result of mergers etc., we will investigate the business management environment and operations management environment to examine, for example, organizational unity

c. Small and medium-sized audit firms, partnerships and solo practitioners

In the case of small and medium-sized audit firms, partnerships and solo practitioners, when selecting firms to be inspected, we will take into account such factors as JICPA quality control review results, the degree of risk pertaining to audited companies, and consider whether the quality control system of the audit firm needs to be confirmed immediately. Among the eleven priority inspection points, those characteristic of small and medium-sized audit firms are as follows:

- We will investigate the operations management environment, including the attitudes and involvement of top management and partners as well as organizational unity
- We will investigate audit resources by, for example, ascertaining whether personnel possess sufficient and appropriate experience and capabilities to cope with risks pertaining to audited companies
- We will investigate, in particular, audit procedures and fraud risks assessments relating to revenue recognition and accounting estimates from the standpoint of whether professional skepticism is being demonstrated

### III. Operation of Audit Firms

### III. Operation of Audit Firms

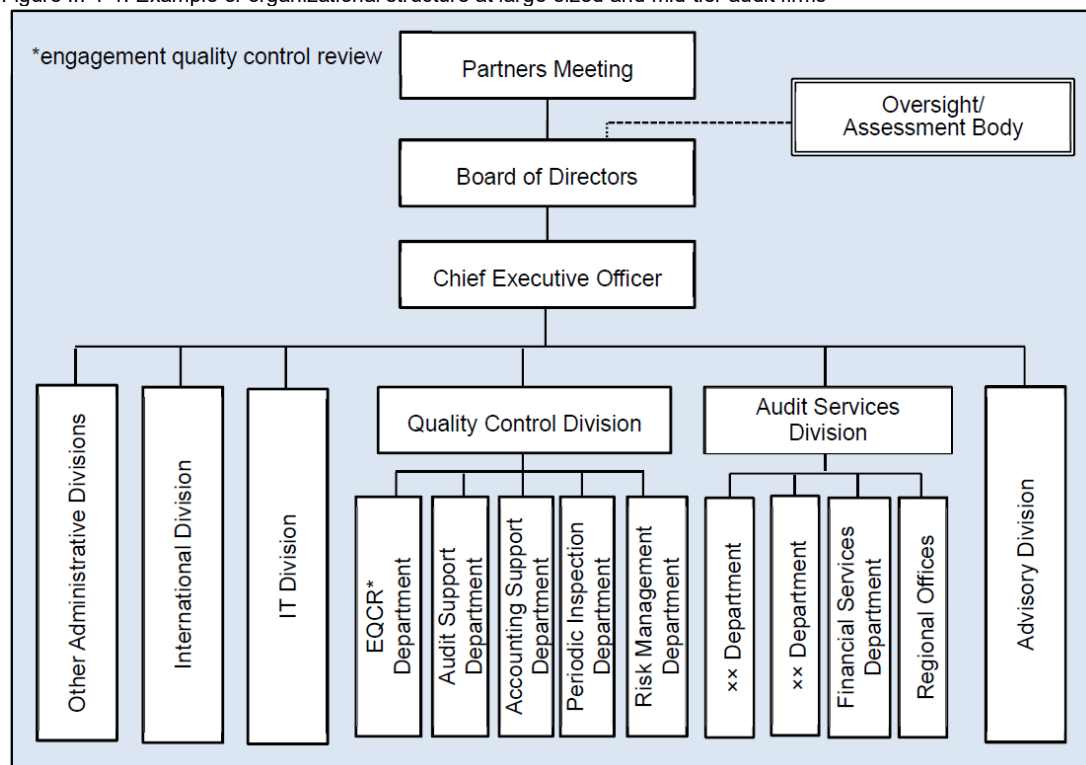
#### A. Operations Management Environment

##### 1. Organizational Structure of Audit Firms

The characteristics of the organizational structure of each type of audit firm, as categorized by size, are shown below.

Large-sized and mid-tier audit firms have a board of directors 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 well-organized than those seen at small and medium-sized audit firms (Figure III-1-1). Large-sized audit firms have established sector-specific departments for conducting audits of listed financial institutions, for example. This department might be referred to as the "Financial Services Division" and form part of the Audit Services Division.

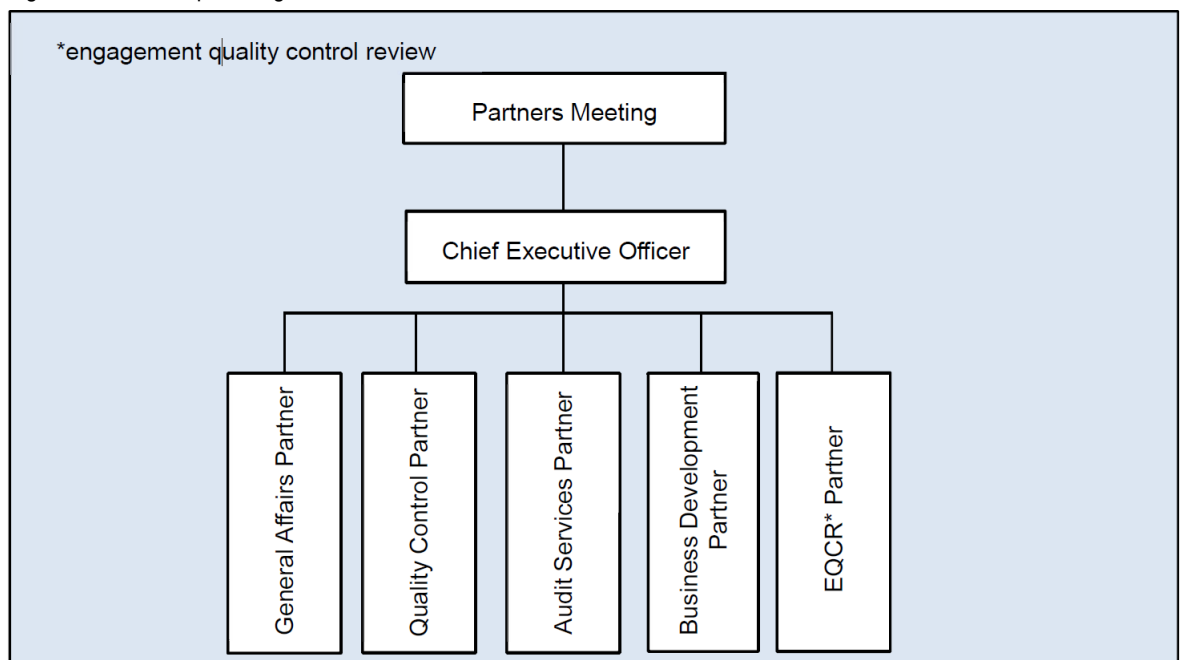
Figure III-1-1: Example of organizational structure at large-sized and mid-tier audit firms



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

On the other hand, the majority of small and medium-sized audit firms manage quality control by assigning a person in charge instead of establishing a department for the purpose. However, with this management, the level of quality control depends on the ability and involvement time of the person in charge, and knowledge and experience are less likely to be accumulated in the organization in the audit firm. Therefore, the quality management system of small and medium-sized audit firms are weaker than that of major audit firms (Figure III-1-2).

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



Characteristics of organizational structure based on audit firm size are as follows: (Figure III-1-3)

At large-sized audit firms, full-time staffs are strategically assigned to organizations that have specific roles based on the tasks they perform, and large-sized audit firms make efforts to improve quality control through specializing and stratifying organizations. For example, certain quality control functions may be entrusted to the departments that conduct audit engagements. Recently, firms tend to be shifting function of quality control from head-office quality control departments to operating departments, which are closer to the audit frontline, and that this has proved effective to some extent. However, inadequate cooperation between the quality control departments and operating departments has appeared to be as an issue.

At mid-tier audit firms, head-office functions are being strengthened through, for example, increases in the number of head-office personnel as a way of responding to rises in the

number of audited companies. At some firms, however, the operations environment has not been adequately modified to ensure that a uniform level of quality is maintained as the firm expands.

At small and medium-sized audit firms, quality control is generally handled by an individual who also works on audit engagements. However there are some cases that partners and full-time staff sometimes do not devote adequate time to quality control, due to the situation where partners are also often allowed to run their side job, proportion of part-time staff tends to be high. We find that some small and medium-sized audit firms manage quality control through multiple audit departments, not by firm-wide quality control system.

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

	Large-sized audit firm	Mid-tier audit firm	Small and medium-sized audit firms
Number of partners	Between 100 and 600	Approx. 30 to 100	Up to approx. 50
Number of full-time personnel	Approx. 3,100 to 6,400	Approx. 150 to 700	Up to approx. 80
Decision-making bodies	<ul style="list-style-type: none"> <li>The highest decision-making body is the partners meeting</li> <li>A board of directors and an executive committee are set up under the partners meeting</li> </ul>	<ul style="list-style-type: none"> <li>The highest decision-making body is the partners meeting</li> <li>A board of directors is set up under the partners meeting</li> </ul>	<ul style="list-style-type: none"> <li>Most decisions are made at the partners meeting</li> <li>Larger firms have a board of directors beneath the partners meeting</li> </ul>
Oversight/assessment bodies	<ul style="list-style-type: none"> <li>A body has been established to supervise/ assess business execution bodies such as the board of directors</li> <li>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). A public interest committee has also been established to monitor business execution from a public-interest standpoint</li> <li>Third parties with independence ("independent third parties") serve as members of oversight/ assessment bodies and subcommittees</li> </ul>	<ul style="list-style-type: none"> <li>Oversight/assessment bodies are established but their powers are limited compared with those at large-sized audit firms</li> <li>Many firms have not established subcommittees for nomination, compensation, and audit</li> <li>At many firms, involvement by independent third parties is limited to providing advice/recommendations to business execution bodies</li> </ul>	<ul style="list-style-type: none"> <li>Many firms have systems of checks and balances between partners without establishing oversight/assessment bodies.</li> <li>Many firms have not appointed independent third parties</li> </ul>
Design of business operation departments	<ul style="list-style-type: none"> <li>Multiple audit services departments are established, and firmwide operation including regional offices is also conducted</li> <li>A department specializing in financial services is established</li> <li>Departments in charge of quality control, risk management are established</li> </ul>	<ul style="list-style-type: none"> <li>Multiple audit services departments are established</li> <li>A department in charge of quality control are established</li> </ul>	<ul style="list-style-type: none"> <li>Many firms appoint partners to handle the particular services without establishing particular departments</li> <li>Larger audit firms have set up organizations that resemble those of mid-tier audit firms</li> </ul>
Number of offices	<ul style="list-style-type: none"> <li>There are offices in three metropolises (Tokyo, Osaka and Nagoya) and often also local offices throughout Japan</li> </ul>	<ul style="list-style-type: none"> <li>Besides the firm's main office, there are often also offices in metropolises (Tokyo, Osaka and Nagoya)</li> </ul>	<ul style="list-style-type: none"> <li>Many firms only have a main office</li> </ul>
Design of quality control divisions	<ul style="list-style-type: none"> <li>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</li> <li>A risk management department, which is responsible for monitoring of audit contracts, independence, and audit risks, is established</li> <li>Audit services departments also often have quality control functions</li> </ul>	<ul style="list-style-type: none"> <li>A quality control division includes some of the departments found at large-sized audit firms</li> <li>Some also have a department for engagement quality control reviews</li> </ul>	<ul style="list-style-type: none"> <li>Many firms appoint partners to handle both quality control and audit engagements without establishing quality control departments</li> <li>Some small firms' representatives are also in charge of quality control</li> </ul>

(Source) Prepared by the CPAAOB based on inspections conducted and reports collected during PY2019

## 2. Efforts in Response to 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, but there is nothing to stop other audit firms applying the code voluntarily. The code allows audit firms to adopt it on a comply-or-explain basis. It is important that large-sized audit firms and other audit firms put the five principles into practice in ways suited to their own distinct circumstances in order to implement it and achieve effective organizational administration.

### Principle 1: The Role to Be Accomplished by an Audit Firm

An audit firm has the public interest role to ensure the credibility of corporate financial information through the audits, seek to protect stakeholders such as participants in the capital market and thereby contribute to the sound development of the national economy. In order to accomplish this role, the audit firm should encourage its members to have frank and openminded dialogue, enhance mutual development, promote their full competence, and continuously enhance the audit quality on a firm-wide basis.

### Principle 2: Organizational structure (management functions)

An audit firm should have effective management in order to develop its organizational operations as a whole for the continuous enhancement of the audit quality.

### Principle 3: Organizational structure (oversight/assessment functions)

An audit firm should have a function to oversee and assess the effectiveness of its management from the independent viewpoint and thereby support to enhance the effectiveness of the management.

### Principle 4: Operation

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

### Principle 5: Ensuring transparency

An audit firm should ensure full transparency to allow stakeholders in the capital market to appropriately assess its audit quality, by explaining the status of the Code's implementation. The audit firm should also effectively utilize the internal and external assessment of its efforts for improvement in its management and operations.

As of July 1, 2020, all large-sized audit firms and mid-tier audit firms as well as eight small and medium-sized audit firms had announced adoption of the Audit Firm Governance Code<sup>10</sup>.

<sup>10</sup> Sources: a list of audit firms adopted "Principles for Effective Management of Audit Firms (The Audit Firm Governance Code)", the FSA website



Regarding the each principle of the Audit Firm Governance Code, application of them by firms varies based on the size of the firm. Large-sized audit firms and mid-tier audit firms are applying all the principles. Few small and medium-sized audit firms are applying all of the principles, with oversight/assessment functions within organizational structure (Principle 3) and ensuring transparency (Principle 5) often not being adopted, in particular. As described above, because of the situation where there is size-based variation in the application of oversight/assessment functions within organizational structure (Principle 3) and ensuring transparency (Principle 5), we will examine the efforts that audit firms are making with respect to these two principles.

a. Oversight/assessment functions within organizational structure (Principle 3)

i. Strengthening oversight/assessment functions through the utilization of independent third parties

(i) Large-sized audit firms

Large-sized audit firms are taking steps to incorporate a public interest perspective and the knowledge of independent third persons in order to strengthen their oversight/assessment bodies. As methods of achieving this, two patterns have been observed: A pattern of including independent third persons as outside committee members in existing oversight/assessment bodies (Pattern 1) and a pattern of setting up separate and independent bodies such as a public interest committee (Pattern 2) (Figure III-1-4).

Pattern 1: independent third persons are directly involved as outside members in the processes pursued by nomination, compensation, and audit subcommittees.

Pattern 2: independent third persons are not directly involved in these processes by setting up separate and independent bodies such as a public interest committee comprising outside members.

Note that all large-sized audit firms state whether independent third parties are involved in each of the processes of “nomination,” “compensation,” and “audit” in the reports etc. concerning audit quality that they publish annually.

(ii) Mid-tier audit firms

The publication of the Audit Firm Governance Code has prompted mid-tier audit firms to make efforts to establish independent bodies, such as public-interest committees that are comprised of independent third parties, as oversight/assessment bodies. However, with the exception of some firms, they

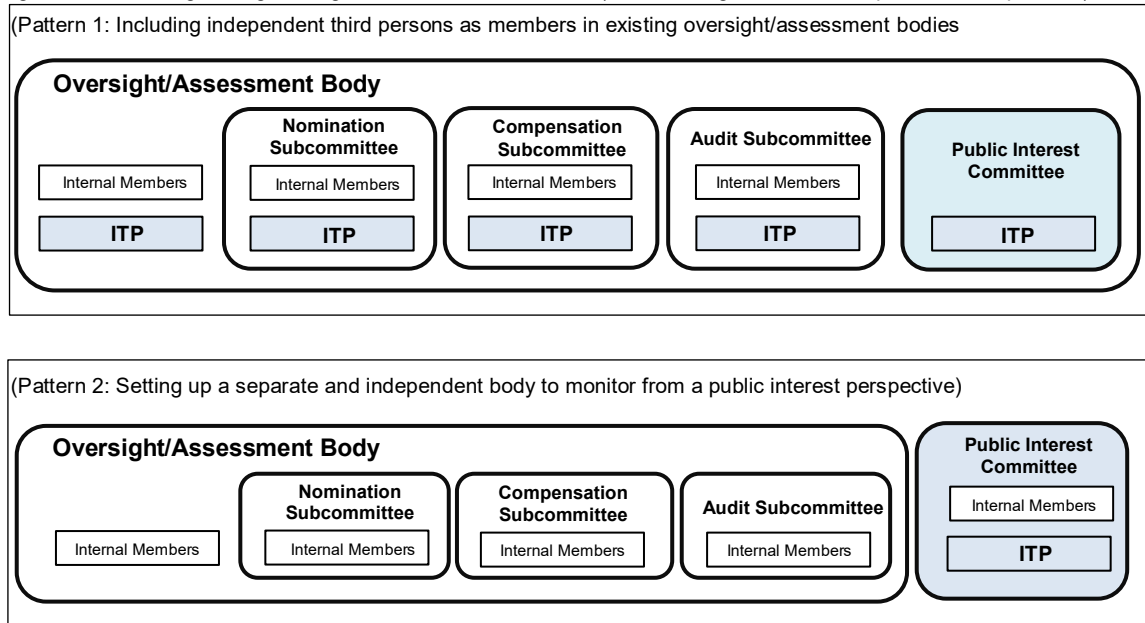
have not established subcommittees for “nomination,” “compensation,” and “audit,” so involvement by independent third parties in nomination, compensation, and audit processes is more limited than at large-sized audit firms. There are also firms that have not clarified the selection methods, term, and powers of independent third parties.

(iii) Small and medium-sized audit firms

Five out of eight small and medium-sized audit firms have not established oversight/assessment bodies on the grounds that they are small and partners are therefore able to check each other’s activities. At some of the firms that have not established oversight/assessment bodies, however, independent third parties take part in meetings relating to business administration.

Note that many audit firms do not clearly define specific procedures for each process of “nomination”, “remuneration”, and “audit”.

Figure III-1-4: Strengthening oversight/assessment functions at (ITP in this figure means independent third persons)



ii. Efforts to utilize the knowledge and experience of independent third persons

(i) Large-sized audit firms

In seeking to incorporate a public interest perspective and the knowledge and experience of independent third persons listed in a. above, it is important to provide independent third persons in a timely and appropriate manner with necessary information about audit firms such as organizational administration, nomination and dismissal in members of executive bodies, and matters

concerning assessment and compensation. It is also important to seek comments of these independent third persons timely.

When following the pattern of including independent third persons as members in an existing oversight/assessment body (Pattern 1 in Figure III-1-4 above), independent third persons attend meetings of the oversight/assessment body to acquire information and to advise audit firms. There are also examples of firms seeking to enhance effectiveness by increasing the proportion of outside members of oversight/assessment bodies and other sub-committees.

On the other hand, when the independent organizations are set up separately (Pattern 2 in Chart III-1-4 above), the audit firm provides information to independent third parties through internal committees, etc., and acquires opinions from independent third parties, and has opportunities to exchange opinions regularly with the CEO. In Pattern 2, since independent third persons are members of bodies that are independent of existing oversight/assessment bodies, it is particularly important to ensure that effective discussions are conducted by providing independent third persons with the information they need in a timely and appropriate manner. Therefore, as a means of providing independent third persons with the information they need in a timely and appropriate manner, some firms confer independent third persons the right to attend meetings of executive bodies, including those of group firms, and the power to demand information. Other firms, meanwhile, have taken such steps as establishing a secretariat to assist outside committee members.

#### (ii) Mid-tier audit firms

Many mid-tier audit firms have established independent bodies such as publicinterest committees, with independent third persons constituting the membership of these bodies. However, unless the independent third persons are provided with the information they need in a timely and appropriate manner, there are potential risks that the oversight/assessment bodies will not function adequately. With regard to this point, some firms are endeavoring to ensure that required information is provided, for example, conferring on independent third persons the right to attend meetings of executive bodies and the right to demand information. Nevertheless, some firms have not conferred independent third persons the authority to obtain information.

#### iii. Experience/expertise of independent third persons

When including independent third persons among the members of

oversight/assessment bodies, it is necessary to assign persons with the expected knowledge and experience based on the size of audit firm, its governance structure and organizational issues. Furthermore, consideration needs to be given not only to independence from the audit firm, but also independence from companies that the firm audits.

Large-sized and mid-tier audit firms tend to assign people with managerial experience at general business companies, while small and medium-sized audit firms prefer academics or attorneys (Figure III-1-5).

Regarding the number of independent third persons assigned, at large-sized audit firms it is three or four, at mid-tier audit firms it is between one and three, and at small and medium-sized audit firms it is one. Furthermore, at some large-sized audit firms and mid-tier audit firms, independent third persons are assigned as the chairs of oversight/assessment bodies and nomination, compensation, and audit subcommittees, which makes the bodies more effective.

Figure III-1-5: Experience/expertise of independent third persons (unit: persons)

	Former senior management	Academic expert	Attorneys and legal experts	Former ministry/agency officials	Other
Large-sized audit firms	10	1	1	1	-
Mid-tier audit firms	4	1	1	2	2
Small- and medium-sized audit firms	-	3	1	-	-

(Note) Prepared by the CPAAOB using PY2018 the CPAAOB inspections and publicly available materials from audit firms

#### b. Ensuring transparency (Principle 5)

##### i. Explanations of application of each of the principles of the Audit Firm Governance Code and efforts to improve audit quality

###### (i) Large-sized audit firms

Large-sized audit firms issue annual reports etc. concerning their audit quality and disclose them on their websites. These reports etc. describe how they are applying each of the principles of the Audit Corporate Governance Code and the action they are taking to improve audit quality. The reports etc. include detailed information about their organizational structure, quality controls, human resources development, global networks they belong to, and so on. In recent years, they devote considerable space to explanations of work style reform and effective utilization of IT. Some firms also report the results of action taken to address issues identified the previous year and issues to be tackled in the following year, while others disclose attendance by independent third persons at executive meetings etc.

(ii) Mid-tier audit firms

Mid-tier audit firms issue reports etc. concerning audit quality and disclose them on their websites. These reports etc. consist mainly of explanations of their organizational structure and quality controls. The information contained to reports etc. concerning audit quality tends to be briefer than that contained in the reports etc. from large-sized audit firms, and in some cases there are inadequate explanations of methods of selecting members of executive bodies, the establishment of structures for conveying the approach of executive bodies etc. to the audit frontline, and the systematic development of human resources. However, there are also firms that publish an internal assessments in an effort to improve audit quality. These include the results of questionnaire surveys of members concerning audit quality.

(iii) Small and medium-sized audit firms

Four out of eight of the firms that have declared adoption of the Audit Firm Governance Code publish reports etc. concerning audit quality. Those that do not publish reports etc. concerning audit quality merely provide brief descriptions on their websites of their application of the Audit Firm Governance Code. Reports etc. concerning audit quality and explanations on websites tend to contain fewer items and more concise than those of mid-tier audit firms, and they sometimes include no specific description of organizational structure.

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

(i) Large-sized audit firms

Large-sized audit firms heretofore have made some efforts to conduct audit quality surveys by persons out of engagement teams and to secure opportunities for dialogue and other forms of interaction with chief financial officers (CFOs) and the audit and supervisory board of audited companies. With the release of the Audit Firm Governance Code, these firms are also holding meetings, which are also attended by independent third persons, with institutional investors and analysts to exchange information and arranging other opportunities to speak with a broader range of capital market participants.

(ii) Mid-tier audit firms

Mid-tier audit firms have not only been holding their own meetings to exchange information, but some have been joining in round-table discussions for investors

hosted by the JICPA and stock exchanges.

(iii) Small and medium-sized audit firms

Most of the small and medium-sized audit firms that have declared adoption of the Audit Firm Governance Code do no more than having engagement teams exchange information with the chief financial officers (CFOs), audit and supervisory board members etc. of audited companies.

■ Exchange of Opinions with Capital Market Participants at Forum

In June 2019, Nikkei, Inc. hosted (with the JICPA as co-sponsor) a global accounting/audit forum on the theme of “Prospects for and Issues with AI Utilization in Business/Audit. The forum was attended by representatives of large-sized audit firms, AI experts from nonfinancial companies, etc. There were panel discussions on the topics of “current and future prospects for AI utilization by corporate businesses,” “AI-driven initiatives at audit firms,” and “issues for AI-driven business/audit and skills that will be needed in the future.” It therefore served as an opportunity for audit firms to exchange views with capital market participants and others.

### 3. Human Resources of Audit Firms

#### a. Partners and full-time personnel

At most large-sized audit firms, most CPA exam passers being hired immediately after they have passed the essay exam while only a small proportion of CPAs (including persons who have passed the CPA exam) are recruited mid-career. In general, the CPA exam passers hired become CPAs at the audit firm concerned, and some of them are internally selected for promotion to managerial positions. Furthermore, some of them are later promoted to partner (for details, see “I. Overview of the Audit Sector, B. Audit Firms, 1. Organizational Structure of Audit Firms” (page 16).

Many mid-tier audit firms and small and medium-sized audit firms, meanwhile, find it difficult to recruit CPA passers, and tend instead to recruit a large proportion of their CPAs mid-career. The recruits are mainly CPAs who have left large-sized audit firms, and in this way they are endeavoring to secure the human resources they need for audit engagements etc.

In many cases, such CPAs who have left large-sized audit firms establish a new audit firm.

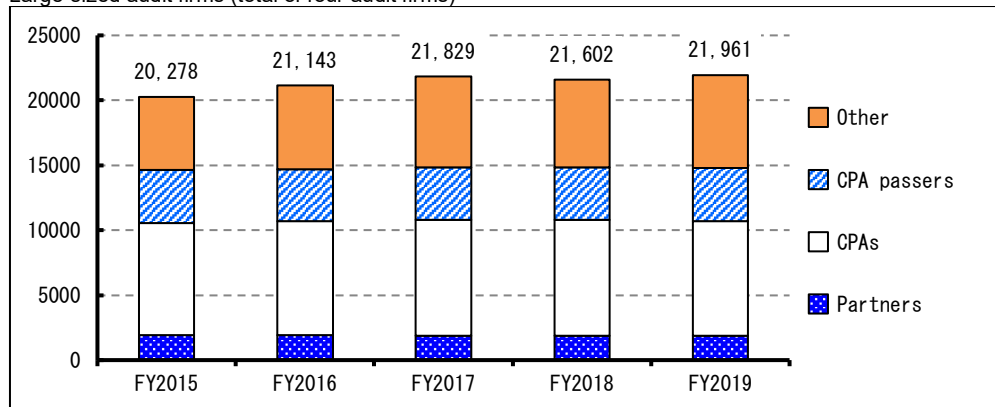
A look at changes in the number of partners and full-time personnel at different types of audit firms reveal that staffing levels at large-sized and mid-tier audit firms have been on the rise since FY2016. At small and medium-sized audit firms, meanwhile, they were in a downward trend until FY2016, but turned upwards since FY2017 as the establishment of new audit firm.

Looking at the composition of personnel, the number of CPA exam passers etc. has remained steady at large-sized and mid-tier audit firms, but has declined at small and medium-sized audit firms. Non-CPA personnel (excluding CPA exam passers), meanwhile, have been increasing in numbers in recent years at audit firms of all sizes. According to the most recent data, the percentages of non-CPA personnel in firms' workforces were 33% at large-sized audit firms, 29% at mid-tier audit firms, and 17% at small and medium-sized audit firms, higher than their respective FY2015 figures of 28%, 21%, and 15% (Figure III-1-6).

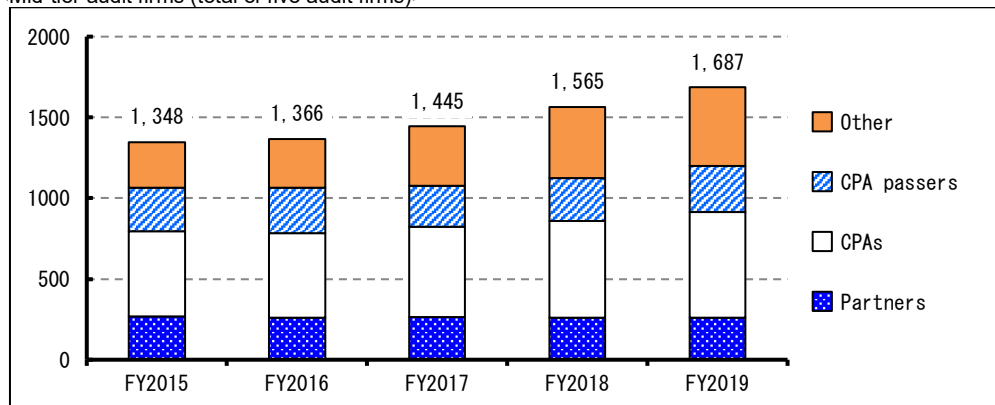
Audit firms have increased their non-CPA personnel to deal with the audited companies promoting IT, to improve operational efficiency, to address personnel shortages, and to facilitate CPAs to focus more on judgemental tasks, and so on. Among these personnel are IT experts who conduct IT audits of audited companies and who use technologies 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.

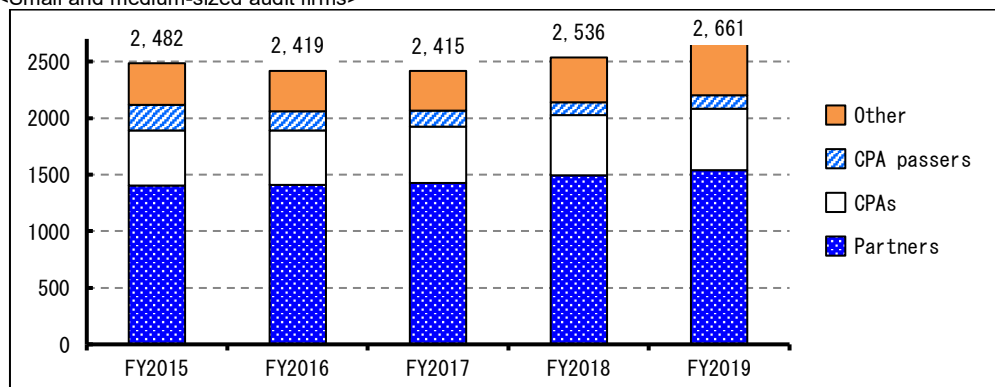
Figure III-1-6: Change in the number of partners and full-time personnel (unit: persons)  
<Large-sized audit firms (total of four audit firms) >



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



<Small and medium-sized audit firms >



(Note 1) The data are aggregates of personnel for each fiscal year based on audit firm's operational reports. The book-closing months of small and medium-sized audit firms vary widely, so figures for FY2019 have not yet been compiled. As a result, the figures for small and medium-sized audit firms only cover the period to up to FY2018.

(Note 2) The number of small and medium-sized audit firms varies from year to year, but 221 such firms are included in the figures for FY2018.



## ■Initiatives for Work-style Reform■

With declining the population of people of productive age and diversifying work-style needs, efforts are underway throughout society to transform work styles so as to create a society in which workers can choose from diverse ways of working to suit their personal circumstances in order to raise productivity, expand employment opportunities, and establish an environment in which people can fulfill their ambitions and leverage their abilities to the full. Audit firms, particularly large-sized ones, are also tackling work-style reform as a means of eliminating problems such as personnel shortages and overwork and securing sufficient time for CPAs to concentrate to consider and make decisions.

〈Examples of work-style reform initiatives at large-sized audit firms〉

- Timely monitoring of past actual overtime and expected future overtime as well as systematic consideration of ways of eliminating overtime
- Restrictions on access to networks (including electronic audit documentation system) at weekends and late at night
- Increases in audit assessment personnel and reductions in working hours per person through adoption of IT
- Introduction of flexible working hours and multi-track promotion systems, expansion of application of remote working, and encouragement to take paid leave
- Establishment of internal daycare facilities and assistance with using babysitters
- Messages from top management aimed at changing attitudes among staff, and labor management training for managers

### b. Side businesses by partners

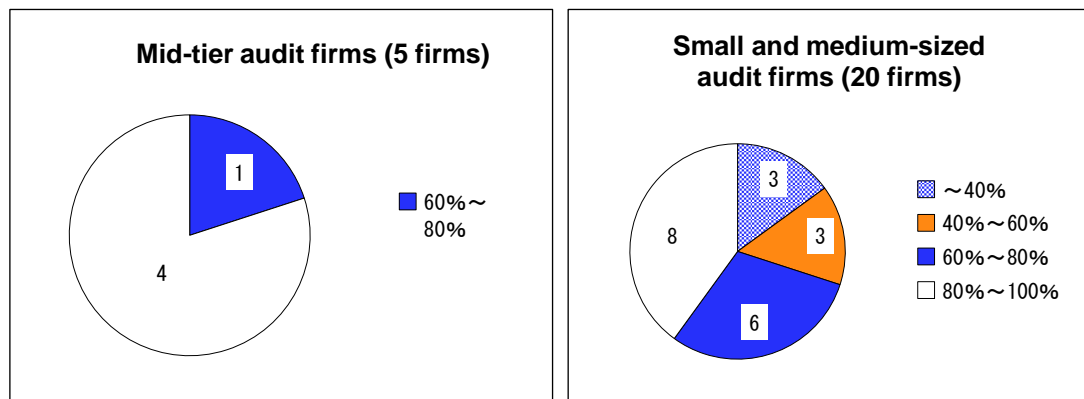
Large-sized audit firms generally do not allow partners to run tax accountant offices or other solo practitioners.

Most mid-tier audit firms do not permit partners to run side businesses as well.

However, there is a firm where more than 50% 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 mediumsized audit firms permit partners to run side businesses (Figure III-1-7).

Figure III-1-7: Number of audit firms by percentage of time spent by partners engaged in the audit firm's operations (unit: audit firms)



(Source) Prepared by the CPAAOB based on partner's declarations collected in PY2018 the CPAAOB inspections and collection of reports

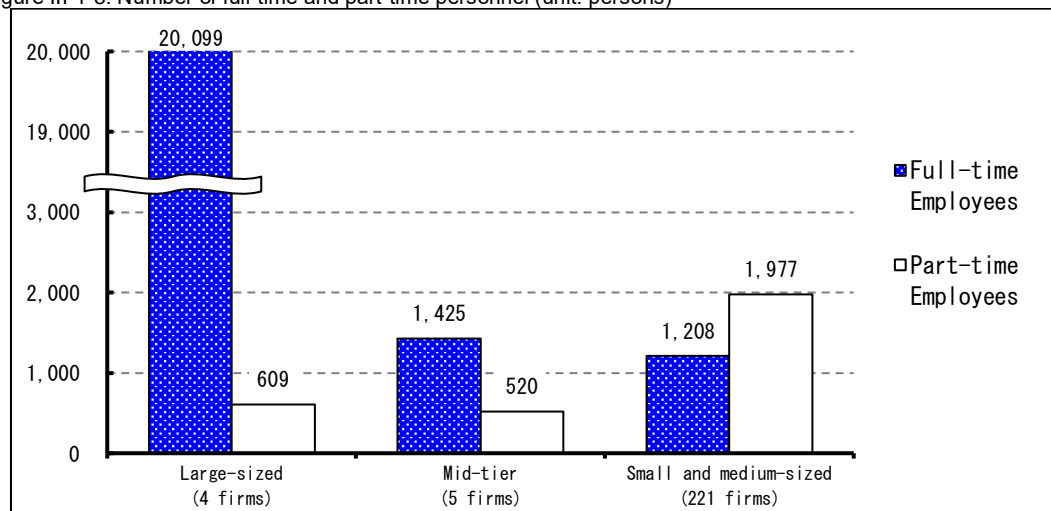
### c. Part-time personnel

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

At mid-tier audit firms, part-time personnel make up less than 30% of the total workforces at all five audit firms. However, the percentage of each firm is varied and some firms have more than 50% part-time staff.

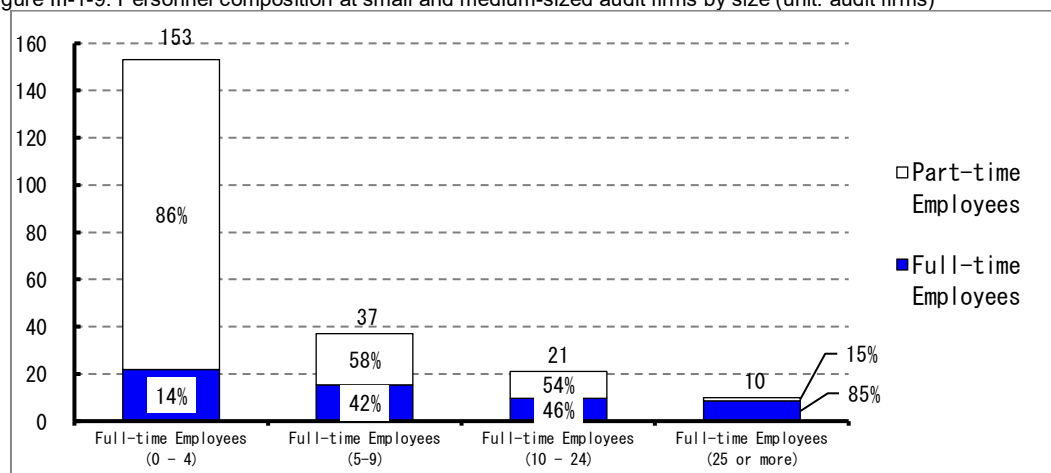
The percentage of part-time personnel at small and medium-sized audit firms is greater than 60% across the 221 audit firms as a whole, with much depending on part-time personnel to serve as assistants to engagement partners (Figure III-1-8). In particular, audit firms with four or fewer full-time personnel – accounting for 70% of all small and medium-sized audit firms – have more than 80% part-time personnel (Figure III-1-9).

Figure III-1-8: Number of full-time and part-time personnel (unit: persons)



(Note) The data is based on operational reports submitted by audit firms, and aggregated for large-sized and mid-tier audit firms is from reports for FY2019 and that for small and medium-sized audit firms from reports for FY2018.

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



(Note) The 212 audit firms were classified by the number of full-time personnel based on the operational reports submitted by small and medium-sized audit firms in FY2017, after which the number of full-time and part-time employees was totaled and the composition ratios of full-time and part-time personnel calculated.

## 4. Organizational Structure for Providing Audit Services

An audit engagement team, as an audit service provider, is required to exercise professional skepticism<sup>11</sup>, carry out appropriate risk assessments and risk-response procedures and perform proper audit procedures for improving audit quality. The CPAAOB endeavors to understand the engagement team's status through its inspections of audit engagements, and to ascertain the conduct of audit services through other monitoring activities.

This section will analyze engagement teams.

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 (staff who do not possess the CPA qualification or other qualification related to financial statement audits.). 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. A typical composition by layer of an engagement team (Note 1) for a large domestic listed company at a large-sized audit firm is shown in Figure III-1-10. Large-sized audit firms are taking steps to reduce routine work for CPAs on the frontline, and if progress with such measures is made, it is possible that the headcounts and hierarchical compositions of audit teams will change in the future as described in 5. Organizational Structure for Supporting Audit Services (page 85).

Figure III-1-10: Example of the composition and main roles of engagement team members at a large-sized audit firm

		Position	Principal roles
Three engagement partners		Partner	Control of audit services, communication with the senior management of the audited company
Assistants to the engagement partners	CPAA	Senior manager/ Manager	Management of engagement team, management of financial statement audits
	CPA B	Senior manager/ Manager	Management of internal control audit services
	CPA C	Senior manager/ 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.)	Senior staff	Performance of procedures for assessing the design and effectiveness of internal controls, performance of audit procedures other than important audit procedures
	Seven unqualified assistants	Assistant	Data processing, reconciliation of administrative vouchers, other tasks not requiring significant decisions, management of sending/ collection 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 processing of corporate tax etc., verifications of real estate appraisals

(Note 1) 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

<sup>11</sup> 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.

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

At large-sized audit firms, experienced CPAs exert audit procedures for important audit areas under the guidance and supervision of engagement partners. Inexperienced CPAs, CPA passers, etc. usually cover audit procedures for audit areas other than important audit areas. Unqualified assistants assist with audit services by performing such administrative tasks as sending balance confirmation letters. Furthermore, a large-sized audit firm is taking steps to allow CPAs to focus on tasks that require expert decisions by easing the workload of CPAs. For example, tasks performed by audit assistants have been centralized at a newly-established center (see the column “Example of Establishment of Organization for Performing Clerical Work Relating to Audits” (page 87)). With regard to audits of listed financial institutions, which differ greatly from those of typical nonfinancial companies due to the nature of the sector and the accounting/audit methods applied, large-sized audit firms have been putting together mechanisms for enabling audits based on specialist knowledge and experience to be performed. An example of this is the establishment of financial services departments to conduct audits of financial institutions. In addition, when putting together audit teams to work on audits of listed financial institutions, efforts are being made to involve personnel with knowledge concerning the audit of financial institutions. For example, efforts are being made to ensure that personnel from the financial services department comprise the bulk of the team, to appoint personnel from the financial services department as engagement partners, and so on.

Mid-tier audit firms have limited audit team personnel, but the composition of the teams is similar to that at large-sized audit firms, with work normally allocated based on the competencies of the team members. Furthermore, some mid-tier audit firms are stepping up their recruitment of audit assistants.

In addition, at small and medium-sized audit firms it is sometimes difficult to assign assistants to engagement partners due to the limited workforce. For this reason, the engagement partners tend to face a heavier workload than their counterparts at large-sized audit firms because they are also performing audit procedures by themselves. (Figure III-1-11).

No audit firm has established an organization that specializes in the conduct of IPO audits. Rather, a regular audit division performs IPO audits. However, large-sized audit and mid-tier audit firms are responding by, for example, prioritizing the assignment of personnel with a wealth of experience of IPO audits, so as to properly cope with the unique risks involved with IPO audits (e.g. vulnerability of internal controls).

Furthermore, several large-sized audit and mid-tier audit firms have set up special organizations such as IPO support teams to serve as contact points for companies that

are preparing for IPOs and wish to seek help with IPO-related tasks from audit firms ahead of their IPOs. The objective of audit firms in establishing these special organizations is to enable personnel with expert knowledge and experience of assisting with IPOs to get involved prior to the IPO audit.

Figure III-1-11: Typical engagement team composition and main roles of team members

		Large-sized audit firms	Mid-tier audit firms	Small and medium-sized audit firms
Engagement partners		<ul style="list-style-type: none"> <li>Setting of significant audit areas and assessment of risks</li> <li>Review of audit procedures performed by assistants</li> <li>Communication with management and the audit and supervisory boards</li> </ul>	<ul style="list-style-type: none"> <li>Setting of significant audit areas and assessment of risks</li> <li>Review of audit procedures performed by assistants</li> <li>Performance of audit procedures in significant audit areas</li> <li>Communication with management and the audit and supervisory boards</li> </ul>	<ul style="list-style-type: none"> <li>Setting of significant audit areas, assessment of audit risk, and drafting of audit plans</li> <li>Review of audit procedures performed by assistants</li> <li>Performance of audit procedures (including important audit procedures)</li> <li>Communication with management and the audit and supervisory boards</li> </ul>
Assistants to the engagement partners	CPAs	<ul style="list-style-type: none"> <li>Drafting of audit plans</li> <li>Performance of audit procedures in significant audit areas</li> <li>Review of audit procedures performed by other assistants</li> </ul>	<ul style="list-style-type: none"> <li>Drafting of audit plans</li> <li>Performance of audit procedures</li> <li>Review of audit procedures performed by other assistants</li> </ul>	<ul style="list-style-type: none"> <li>Performance of audit procedures (including data analysis, operation of sending/collection of balance confirmation letters, administration of engagement documentation)</li> <li>Review of audit procedures performed by other assistants</li> </ul>
	CPA Passers, etc.	<ul style="list-style-type: none"> <li>Performance of audit procedures</li> </ul>	<ul style="list-style-type: none"> <li>Performance of audit procedures</li> </ul>	<ul style="list-style-type: none"> <li>Performance of audit procedures</li> <li>Not employed in most small audit firms</li> </ul>
	Unqualified assistants	<ul style="list-style-type: none"> <li>Data processing</li> <li>Operation of sending/collection of balance confirmation letters, administration of audit documentation</li> </ul>	<ul style="list-style-type: none"> <li>Data processing</li> <li>Operation of sending/collection of balance confirmation letters, administration of audit documentation</li> </ul>	<ul style="list-style-type: none"> <li>Not employed in most small audit firms</li> </ul>

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

## 5. Organizational Structure for Supporting Audit Services

With audited companies becoming larger and more internationalized, and their operations becoming more complex, it is essential that audit firms not only provide expertise and develop IT-driven tools and systems, but also improve business efficiency, establish environments that contribute to effective audit implementation, and otherwise support engagement teams to ensure appropriate audits.

Accordingly, the CPAAOB monitoring focuses not only on audit engagements, but also on whether audit firms take measures to ensure the appropriateness of audit services (the environment for supporting audit services) tailored to the firm's scale and characteristics. This section provides an overview of the environment for supporting audit services. We will also provide some examples, mainly from large-sized audit firms, of environments for identifying audit risk and efforts to promote the development of IT-driven tools and systems and separate a clerical tasks.

### a. Overview of environment for support

To ensure appropriate services, large-sized audit firms have assigned an average of over 100 full-time personnel to their quality control divisions, and have established various departments: 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-1-12). See "B. Engagement Quality Control Reviews" (page 91) and "C. Monitoring of Systems of Quality Control" (page 94) for information on engagement quality control reviews and periodic inspections. A number of large-sized audit firms are strengthening quality control functions within their audit operation divisions, and are taking steps to gather information on the firm's quality control in a timely manner and to provide support to engagement teams. Furthermore, all largesized audit firms have already digitized their audit documentations, and some are developing analytical tools for identifying abnormal figures in journal data, tools for identifying fraud risk, and communication tools for facilitating the smooth online exchange of information and materials between audit teams and audited companies.

Also, some audit firms have established an organization that centrally handles work such as sending out balance confirmation letters and putting together organizations for performing clerical tasks such as entering/processing data (see the column "Example of Establishment of Organization for Performing Clerical Work Relating to Audits" (page 87). Furthermore, with regard to confirming balances, in November 2018 large audit firms established Balance Gateway (Audit Confirmation Center GK), which has begun jointly developing a system for confirming receivable/payable balances, providing a platform for

performing balance confirmations online, and undertaking the sending of balance confirmation letters.

As such, at large-sized audit firms, which have a relatively stable financial foundation and boast diverse human resources, to support for improving the work efficiency of engagement teams, such as by developing various IT-driven tools and separating the performance of clerical tasks.

Mid-tier audit firms also have quality control divisions, but they are smaller than those of large-sized audit firms. Furthermore, they are pushing ahead with the digitalization of audit papers by, for example, adopting the audit-paper management systems used by overseas firms they are affiliated with. 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 (PICOQC), and sometimes this person is the firm's head. Note that most small and medium-sized audit firms have not digitalized audit papers, and instead are producing audit papers using, for example, widely-available software.

While large-sized audit firms are taking steps for engagement teams, the fragile financial foundations of mid-tier audit firms and small and medium-sized audit firms compared with large-sized audit firms, their financial foundation is weak, and they have a constraint of human resources, which seem to be making it difficult to strengthen support in the same way as large-sized audit firms. As a result, variation in the environment for audit engagement support appears to be increasing among large-sized audit firms, mid-tier audit firms, and small and medium-sized audit firms.

Figure III-1-12: 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-1-13).

Figure III-1-13: Examples of management of risk information at large-sized audit firms

### [Actions taken by risk management department]

- 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

### [Actions taken by engagement teams]

- 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

## Example of Establishment of Organization for Performing Clerical Work Relating to Audits

Some large-sized audit firms have established organizations to focus on those aspects of audit engagements that constitute clerical tasks, so as to enable CPAs etc. to concentrate on work that involves decision making. In some cases, the operations performed by such organizations have been expanded to include not only routine tasks such as sending/receiving balance confirmation letters, checking disclosures such as securities reports, and entering/processing data used by CPAs during accounting audits, but also checking tasks that form part of audit engagements, such as procedures for assessing the implementation of internal controls. Regarding the locations of these organizations, in some cases they are installed at existing firm sites, while in others they are established in new locations in the Tokyo suburbs or in provincial cities. At organizations like these, operations are performed by audit assistants, but there is guidance and supervision to ensure a consistent level of audit quality. For example, CPAs etc. might check the work of the audit assistants.



## 6. Audit Firm Groups

### a. Group structure

Many large-sized and mid-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 diligence, advisory companies that provide financial advice on M&A deals, and tax accountant firms. The average number of companies in a large-sized audit firm's group is 13, while that in a mid-tier audit firm group is three.

In terms of group structure, there are many examples of firms setting up holding companylike 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

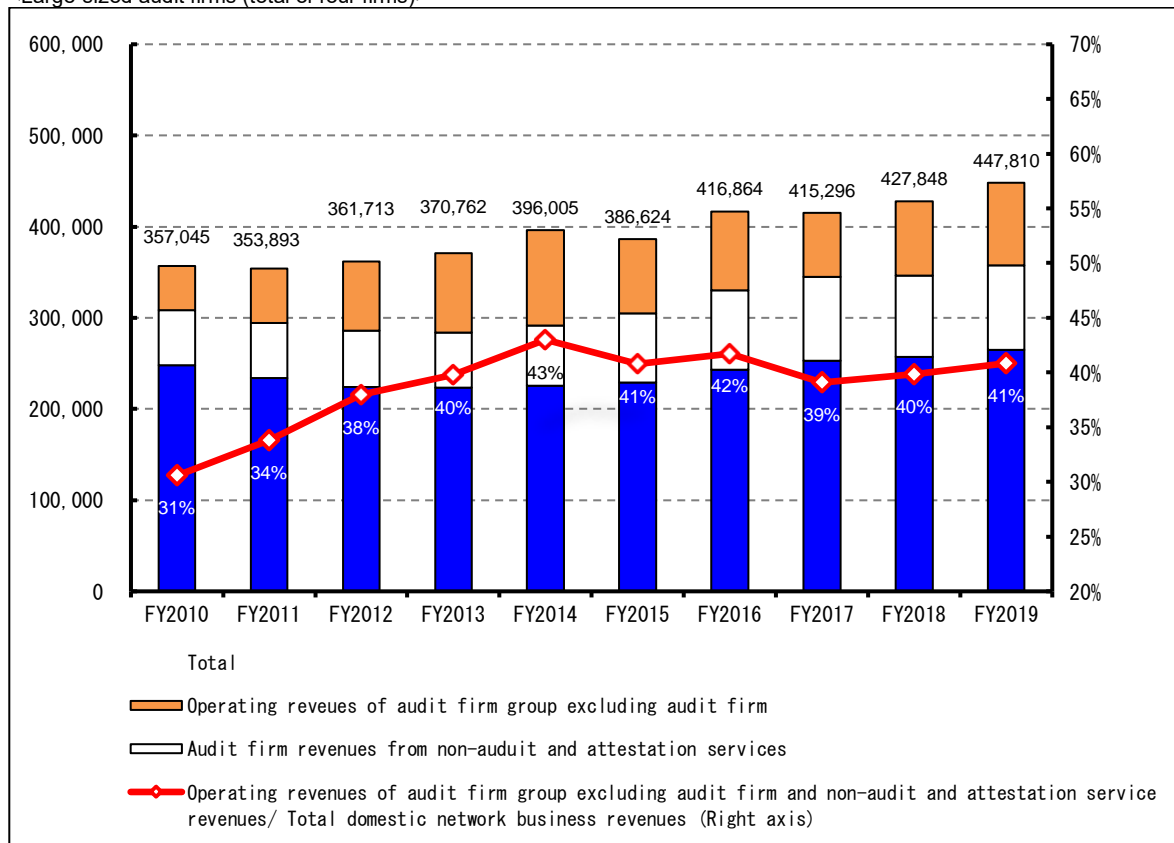
The changes in the proportion of operating revenues (among group firms, excluding revenues from firms other than subsidiaries etc.) accounted for by non-audit and attestation service revenue reveals that, in large-sized audit firm groups, it rose steadily between FY2010 and FY2014 from 31% to 43%, but in recent years has remained flat at around 40% as a result of certain large-sized audit firms spinning off businesses that perform non-audit and attestation services or subsidiaries from the audit firm or its subsidiaries etc. in FY2015 and FY2017 (Figure III-1-14). For the operating revenues of audit firms, see "I. Overview of the Audit Sector, B. Audit Firms, 5. Financial Condition (Operating Revenue, Proportion of Audit and Attestation Services and Non-audit and Attestation Services)" (page 22).

At mid-tier audit firm groups, on the other hand, the proportion of total operating revenues accounted for by non-audit and attestation service revenue reveals rise from 11% to around 14% between FY2010 and FY2018, meaning that it remains at a lower level of the proportion than at large-sized audit firm groups. A major difference between the group revenue structures of mid-tier audit firm groups and large-sized audit firm groups is that the proportion of total operating revenue accounted for by audit and attestation service revenue is higher in mid-tier audit firm groups, and this gap has been widening further in recent years (Figure III-1-15).

Regarding small and medium-sized audit firms, few firms have group companies other

than tax accountant firms or other tax-related firms, which indicates that non-audit services seem to be provided by the firms themselves.

Figure III-1-14: Changes in operating revenues of audit firm group excluding audit firm and non-audit and attestation service revenues' share of these operating revenues (unit: million JPY (left axis))  
<Large-sized audit firms (total of four firms)>



(Note 1) Operating revenues for audit firm groups exclude revenues from firms other than subsidiaries etc. that are group companies.

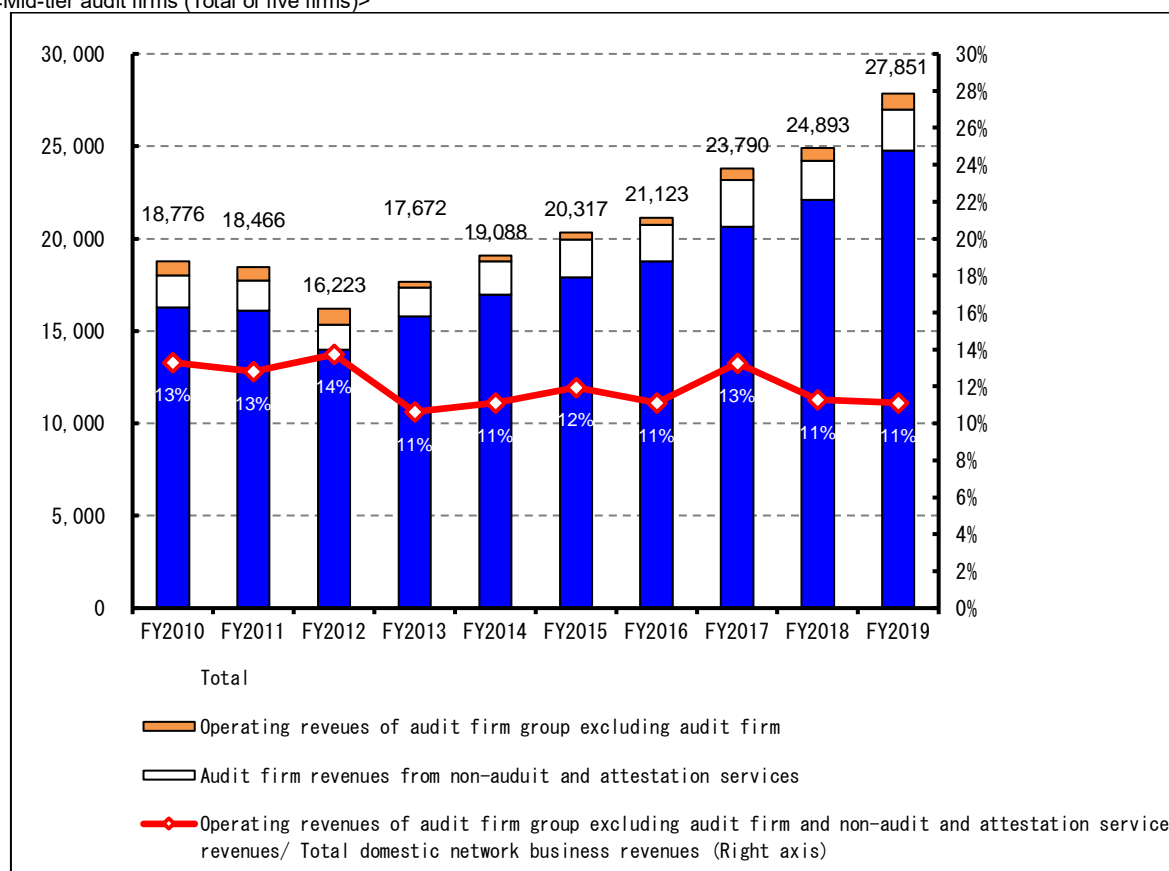
(Note 2) Non-audit and attestation service revenues are the total of the non-audit and attestation revenue of the audit firm and the revenues of the subsidiaries etc. of the audit firm.

(Note 3) One audit firm group changed its fiscal year-end in FY2017, so the FY2017 operating revenues for that audit firm group covers an eight-month period. As a result, FY2017 operating revenues are calculated by extrapolating eight-month operating revenues to one-year periods (by multiplying figures by 12 months/8 months) for the audit firm group that changed its fiscal year-end.

(Note 4) In FY2015 and FY2017, certain large-sized audit firms spun off businesses that perform non-audit and attestation services or subsidiaries from the audit firm or its subsidiaries etc.

(Source) Prepared by the CPAAOB based on operational reports submitted by audit firms

Figure III-1-15: Changes in operating revenues of audit firm group excluding audit firm and non-audit and attestation service revenues' share of these operating revenues (unit: million JPY (left axis))  
<Mid-tier audit firms (Total of five firms)>



(Note 1) Operating revenues of audit firm group excluding audit firm and domestic network firm revenues do not include operating revenues from tax accountant and attorney firms

(Note 2) Non-audit and attestation service revenues are the total of audit firm revenues from non-audit services and domestic network firm revenues

(Note 3) One audit firm group changed its fiscal year-end in FY2016, and it did not submit its report within the program year, so the FY2016 operating revenues for that audit firm group covers a fifteen-month period. As a result, when aggregating the figure, FY2015 data was used for the FY2016 operating revenues for the audit firm group. Operating revenues for FY2017 represent 15 month worth of operating revenues.

(Source) Prepared by the CPAAOB based on operational reports submitted by audit firms

## B. Engagement Quality Control Reviews

The “IV. Reporting Standards 1. General Principles” in Auditing Standards require auditor to be undertaken a review prior to the expression of the audit opinion in order to confirm that their opinion has been formulated appropriately in accordance with audit standards generally accepted as fair and reasonable. The review is therefore the final safeguard for ensuring the appropriate audit opinion. In the assessment, how objectively the audit team conducts the audit procedure, makes the material decision, and assesses the audit opinion etc. is to have substantial impact on the audit quality.

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 by a council), and c. the combination form (both the concurring review partner form and council form are adopted).

### a. Concurring review partner form

An engagement quality control review conducted based on the concurring review partner form normally involves the engagement quality control (EQC) reviewer, who is appointed for each audit engagement, performing the entire review from the audit planning stage to the expression of the audit opinion. This means that a deeper review can be possible. For example, efforts are made to accumulate information on the audited company and the engagement team, and throughout the period of the audit, the review examines whether the engagement team is responding appropriately to changes in the circumstances of the audited company.

However, in the case of the concurring review partner form, the quality of the review is heavily influenced by the abilities of specific EQC reviewer. At some small and medium-sized audit firms, the review of all audit engagements is handled by a specific reviewer, and in such cases the quality of review for the audit firm as a whole is affected by the abilities of this specific reviewer.

### b. Council form

The council form encompasses not only cases where engagement quality control reviews are conducted by a single council, but also cases where there are multiple levels of councils. In the case of the multi-level councils, important matters etc. involved in the expression of the audit opinion are determined in advance, with a high-level council undertaking the review of these matters. There are also cases where specialist councils are established, covering such areas as finance, non-profit, and internal

controls.

Since reviews conducted based on the council form involve collaboration among multiple EQC reviewers, they allow for more multi-faceted investigations than is the case with the concurring review partner form.

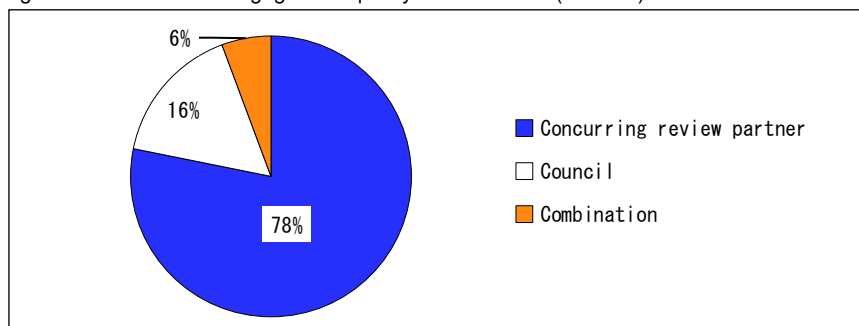
On the other hand, as the conclusions are those of the council and not the individual EQC reviewers, each of the reviewers who make up the council may feel less of a sense of responsibility. Furthermore, as multiple reviewers examine a single issue, the total time required for the review is normally longer than with the concurring review partner form.

c. Combination form

The combination form can involve the concurring review partner form being adopted, with important matters etc. involved in the expression of the audit opinion being determined in advance and a council undertaking the review of these matters. It can also involve deciding whether to use the concurring review partner form or the council form for each audit engagement after considering the risks etc. relating to the engagement.

The forms of engagement quality control review are shown below (Figure III-2-1)

Figure III-2-1: Forms of engagement quality control review (FY2018)



(Note) Aggregated the status of 228 audit firms based on operational reports submitted by the audit firms

Many large-sized audit and mid-tier audit firms have adopted both the concurring review partner method and the council method. For example, a reviewer conducts reviews of risk assessments performed by the audit team, the appropriateness of risk-response procedures, etc., while material matters for investigation are put before a review committee at headquarters. Furthermore, a during reviews, some firms have reinforced independence from executive departments in the review division to ensure that decisions that go against the public interest are not made, while others consult with bodies etc. featuring third parties

in the case of important matters that would likely have a substantial social impact.

Note that large-sized audit firms, when reviewing audits of listed financial institutions, are taking steps such as establishing a council for dealing exclusively with finance-related issues, and having this council deliberate with regard to the review.

Around 80% of small and medium-sized audit firms, however, employ the concurring review partner form, though some perform engagement quality control reviews using the council form or the combination form.

Regarding the appointment of reviewers, many firms select them among personnel persons who meet previously-defined eligibility requirements for reviewers in terms of knowledge, experience, competence, position, etc., and are appointed by the review division or the quality control division in light of the circumstances of audit firms. At some firms, however, the audit operations department etc. picks candidates who are then approved by the review division, the board of directors of the firm, etc.

In many cases, the review division etc. conducts monitoring of review results etc., and there are also firms where the review division etc. has reviewers submit information concerning audit risk and analyse it. Furthermore, while the review division etc. often monitors the time that reviewers spend reviewing, at some firms, the review department etc. measures the proportion of time that reviewers, executive partners, etc. spend on each audit engagement as an audit quality indicator (AQI).

Some firms are also moving to further enhance review functions by, for example, stepping up information provision to reviewers, providing the required training to conduct reviews, and increasing the number of personnel who perform review work exclusively.

## **C. 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 continuously improve the quality control level of audit engagements in a timely manner. The CPAAOB inspects the monitoring of audit firms' systems of quality control.

Furthermore, when an audit firm is a member of one of the global networks, it is sometimes the case that the global network, with an eye to ensuring consistency high audit quality at network firms across countries, demands that network firms conduct domestic audit engagements in line with the global network policy, and that network firms verify that the global network policy is being followed (referred to below as "global reviews"). In this section, the CPAAOB describes how those firms utilize global reviews.

### **1. Periodic Inspections**

Once an audit has completed, the audit firm is required to conduct procedures to ascertain whether an engagement team performed audits in accordance with the system of quality control prescribed by the audit firm (periodic inspections of audit services). This inspection must be performed for at least one of the audits that each engagement partner has conducted during a certain period (e.g. three years) (QCSCS (47), A61).

Although the periodic inspections are being conducted at all audit firms, factors such as the number of inspections, the number of inspector involved and tools used differ depending on the size of the firm. Audit firms belonging to the Big Four global networks, in particular, are asked to perform periodic inspections based on the network's periodic inspection framework and verification tools (Figure III-3-1).

Furthermore, regardless of their size, 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 inhouse training, etc.

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

### ■ Cases Pertaining to Periodic Inspection ■

In recent years, some large-sized audit firms, with the aim of enhancing objectivity and effectiveness in quality control system surveillance, have established dedicated departments for monitoring audit engagements, and the members of these departments play a central role in periodic inspections. Furthermore, at some large-sized audit firms, in addition to conducting periodic inspections, the quality control division performs centralized monitoring of ongoing individual audit engagements, with the principle aim of monitoring progress. Specifically, the quality control division gathers information using electronic surveillance tools, and performs centralized monitoring of whether there are any serious delays with respect to the key milestones between the formulation of the audit plan for an individual audit engagement and the completion of the year-end audit.

Figure III-3-1: Overview of the periodic inspections conducted in FY2019

	Large-sized audit firms	Mid-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	The partner in charge of quality control and other partners and assistants who are not involved in inspected audit engagements	The partner in charge of quality control and/or partners and staff appointed by him/her
Number of inspectors	Between around 40 and 180	Between a few and around 20	Between one and around 20
Number of engagements handled by each inspector	One to three engagements	One to two engagements	One to five engagements
Inspection framework (procedures, assessment policy), tools to be used	Inspection framework and tools provided by the global network to which the firm belongs are used. Regarding demands specific to Japanese auditing standards, many firms have partially modified the global network's tools, such as by adding items.	Conducted based on an inspection framework determined by the firm independently and tools.	Conducted based on an inspection framework determined by the firm independently. "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.	Inspection results are shared within the firm. Some firms reflected in evaluations of partners and staff.	Inspection results are shared within the firm.

(Note) The "number of engagements handled by each inspector" is the average number of inspections per person, calculated by dividing the number of audit engagements subject to regular inspections in FY2018 by the number of inspectors.

(Source) Prepared by the CPAAOB based on information obtained through the CPAAOB inspections or the collection of reports



## 2. Utilization of Global Reviews

The Big Four global networks, in particular, are increasingly interested in whether audit engagements are being conducted with high quality. For this reason, they require network firms in each country to comply with a detailed audit manual provided by the global network, and conduct global reviews to confirm whether network firms are comply with the manual. Large-sized audit firms and some mid-tier audit firms undergo a global review by the Big Four Global Network every year.

Global networks other than the Big Four sometimes require complying with the audit manual provided by the global network to the same degree that the Big Four do, but most of them are more relaxed about this than the Big Four. If compliance with the manual provided by the global network is not required, there is wide variation in the nature and frequency of global reviews. For example, the reviews might look at whether audit engagements conducted by the network firm are in accordance with the auditing standards of the country concerned or with international auditing standards (for information on ties with global networks, see “IV. Responses to Changes in the Global Environment Surrounding Audit, B. Responses to Overseas Expansion of Companies, 2. Ties with Global Networks, b. Relationships with global networks” (page 127).

Whereas all large-sized and mid-tier audit firms have global reviews, most of the small and medium-sized audit firms, partnerships and solo practitioners that are members of global audit networks do not undergo these reviews (Figure III-3-2).

Figure III-3-2: Overview of global reviews

	Large-sized audit firms	Mid-tier audit firm	Other
Whether global reviews are performed	All firms are reviewed	All firms are reviewed	Only some firms are reviewed
Frequency of global reviews	Every year	Every year to once every four years	Typically once every three years
Global reviewers	In most cases the global review is performed by a global network reviewer.	In most cases the global review is performed by a global network reviewer.	In most cases the global review is performed by a reviewer appointed by the global network. Sometimes the results of self-inspections using a checklist for global reviews are examined.

(Note) Few small and medium-sized audit firms etc. are members of global networks. See “IV. Responses to Changes in the Global Environment Surrounding Audit, B. Responses to Overseas Expansion of Companies 2. Ties with Global Networks (page 127)”.

(Source) Prepared by the CPAAOB based on information obtained through the CPAAOB inspections or the collection of reports

## D. 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 train and properly evaluate members of the engagement teams who can exercise the professional skepticism needed to identify accounting fraud. The CPAAOB monitors and inspects hiring, training, assignment, evaluation/compensation, etc.

In this section we will describe audit firms' human resource development, education, training, and evaluation of its engagement teams (including engagement partners).

### 1. Human Resource Development

To deal with changes to the auditing environment and the deepening complexity of audit methodologies, large-sized and mid-tier audit firms have been developing medium to long-term policies for developing human resources and offering education and training, in the context of which they have also provided personnel with a variety of career opportunities (Figure III-4-1).

Figure III-4-1: Examples of career opportunities at large-sized and mid-tier audit firms

- Carrying out work rotations and inter-organizational transfers (inclusive of regional offices)
- Involving personnel in advisory and other non-audit services and quality control activities
- Posting personnel overseas 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-4-2).

Figure III-4-2: Examples of systems for education/training

Large-sized and mid-tier audit firms	<ul style="list-style-type: none"> <li>• Establishing a training section within the human resources department to design and operate training programs for each job classification and level of experience</li> <li>• 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's inspections and the JICPA quality control reviews</li> <li>• Conducting examinations to measure understanding of training</li> <li>• Offering aid for obtaining language qualifications and providing foreign language training inside and outside Japan</li> <li>• In addition to the above, periodic training on issues specific to financial institutions is provided to personnel working on the audits of listed financial institutions. Briefings on the latest industry trends are also organized</li> </ul>
Small and medium-sized audit firms, partnerships and solo practitioners	<ul style="list-style-type: none"> <li>• Providing opportunities to attend training sessions held at the JICPA headquarters or regional chapters, or to study by watching JICPA training DVDs in most audit firms</li> <li>• Sharing results of periodic inspections, the CPAAOB inspections, and JICPA quality control reviews within firms</li> </ul>

Large-sized and mid-tier audit firms have education and training sections, and they have developed training programs based on job classification and experience in conjunction with their global audit networks. Furthermore, by deploying e-learning systems, they enable individuals to access to education and training based on their learning level at times and locations that are convenient for them.

Even among small and medium-sized audit firms, partnerships and solo practitioners, some of the comparatively larger ones have introduced level-based training systems and e-learning systems, while others are providing opportunities for education and training by covering the cost of tuition fees for external training programs. On the other hand, many small and medium-sized audit firms, partnerships and solo practitioners have difficulties in providing training programs that are suitable to personnel's experience and capability and situation in their audited companies. Specifically, due to a lack of human resources

capable of providing their own educational and training programs, many firms are only confirming that their partners and staff are undergoing the Continuing Professional Education provided institutionally by JICPA (i.e. whether they have obtained the required number of credits) or just having personnel watch DVDs supplied by the JICPA.

(Education and training needed for IFRS adoption)

As the number of companies adopting IFRS have now exceeded 200 in Japan, 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, with key examples shown below (Figure III-4-3).

Figure III-4-3: Examples of education/training related to IFRS

Large-sized and mid-tier audit firms	<ul style="list-style-type: none"> <li>• Introducing in-house IFRS certification, and providing periodic training on updates of the standards for certified personnel</li> <li>• Setting up sections within the firm specializing in the interpretation and specific application of IFRS, and distributing necessary guidelines within the firm</li> <li>• Dispatching personnel to, or exchanging information with, the organization responsible for interpreting IFRS and formulating policies for the application</li> </ul>
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### 3. Evaluation of Engagement Team Members

The appropriate performance evaluation of engagement team members demonstrates that the audit firm is committed to audit quality, and ensuring that it is ongoing is particularly important for fostering the organizational culture that forms the foundation of audit quality. The QCSCS stipulate, for example, that performance evaluation, compensation and promotion procedures give due recognition and reward to the development and maintenance of competence and commitment to ethical principles (including independence) (QCSCS (28), A24).

#### a. Evaluation of partners

At large-sized audit firms and mid-tier audit firms, performance evaluation of partners is conducted based on audit quality, contribution to audit firm operations, and the number of new engagements accepted. In recent years, the audit firms, mainly large-sized ones, have been adopting performance evaluation procedures that place particular emphasis on audit quality. For example, large-sized audit firms perform their evaluations as shown in Figure III-4-4.

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

- Partners are usually evaluated in various areas, including team management and a business development based on "Performance Evaluation Rules." In the case of partners who provide audit services, there is an emphasis on quality control.
- Partners are evaluated with an emphasis on audit quality, including global capabilities
- Skills and performance evaluations are conducted and quality control as well as ethics/compliance are given considerable weight in skills evaluations.
- Assessments made during periodic inspections in relation to firm's system of quality control (see "C. Monitoring of System of Quality Control, 1, Periodic Inspections" (page 94) for details) as well as the results of quality control reviews etc. are reflected in the performance evaluations of engagement partners.

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

Many small and medium-sized audit firms, partnerships and solo practitioners, however, do not conduct periodic evaluations of partners, and even when they do, they have often not articulated policies and procedures for the evaluations.

b. Evaluation of staff

Audit firms evaluate personnel in accordance with their evaluation standards and determine promotions based on the results of the evaluations.

Large-sized and mid-tier audit firms generally promote to managers after approximately 10 years and to partners, following a selection process, after a further seven to 10 years. Small and medium-sized audit firms, partnerships and solo practitioners, 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 mid-tier audit firms evaluate personnel based on factors such as understanding of auditing standards relating to audit quality and communication within engagement teams. Small and medium-sized audit firms, partnerships and solo practitioners conduct similar evaluations, but have often not established a policy of giving promotions to partner or other job classifications based on evaluation results.

## **E. Acceptance of New Audit Engagements and Changes of Accounting Auditors**

Since the acceptance of new audit engagements has a significant impact not only on the quality level of audit engagements but also on an audit firm's operation, the CPAAOB also conducts examinations on this matter through our monitoring activities, and endeavors to find out the reasons for changes in accounting auditors and the impact of the acceptance of the new audit engagements on quality control at the audit firm as a whole.

Characteristics of large-sized and mid-tier audit firms as well as small and medium-sized audit firms, partnerships and solo practitioners in the process of the acceptance of new audit engagements are described below.

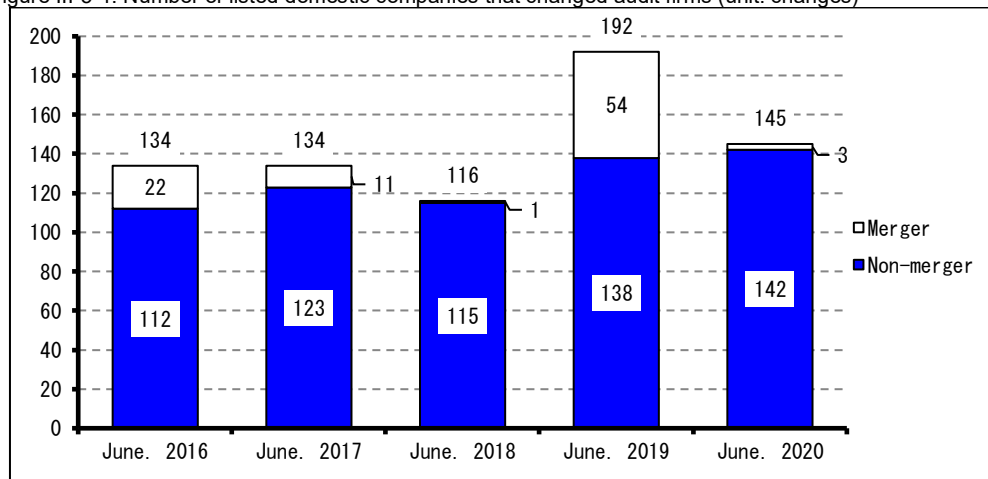
As large-sized audit firms also provide non-audit and attestation services to companies other than their audited companies, they receive an offer to audit these companies by deepening their relationships with the companies through the provision of non-audit and attestation services. In other case, companies ask several audit firms to make proposals when accepting new audit engagements. In such cases, audit firms take organizational efforts to make new engagements with such companies by assigning partners who are familiar with the sector in which the potential clients operate are to work on the proposals.

At mid-tier audit firms, small and medium-sized audit firms, partnerships and solo practitioners, an introduction from partner's acquaintance is the most common reason for accepting new audit engagements. It seems that mid-tier and small and medium-sized audit firms tend to accept an offer through the personal connections of partners.

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

The number of listed domestic companies that changed their audit firm was 145 in the year to June 2020 (July 2019 – June 2020), the highest level seen in the past five years (Figure III-5-1). This figure for the year to June 2019 included in some years, there are numerous changes as a result of merger, but even if this effect is excluded, the figure is still the highest since the year to June 2015. For information on mergers, see "I. Overview of the Audit Sector, B. Audit Firms, 4. Mergers of Audit Firms" (page 21).

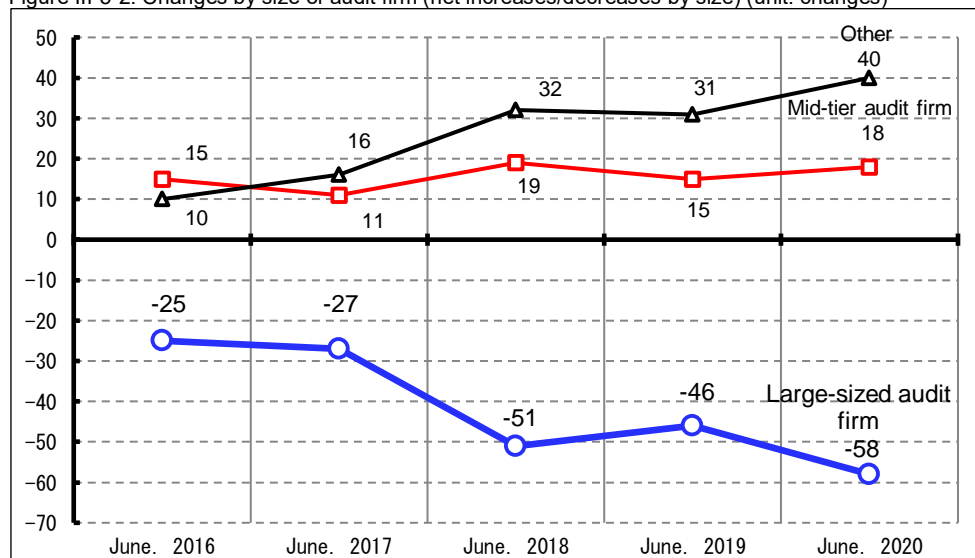
Figure III-5-1: Number of listed domestic companies that changed audit firms (unit: changes)



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

Examining these changes by audit firm size reveals that the trend of changing from large-sized audit firms to mid-tier audit firms or small and medium-sized audit firms, partnerships and solo practitioners continued into the year to June 2020 (Figures III-5-2 and III-5-3). This trend is likely related to business administration in connection with the continuance of audit contracts with large-sized audit firms. For information about business administration in connection with continuance of audit contracts at large-sized audit firms, see “3. Reasons for Changes in Accounting Auditors as Identified Through Monitoring Activities” (page 107).”

Figure III-5-2: 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) Aggregates of number of companies that had decided on an incoming auditor by the end of June of each period, based on timely disclosures by listed domestic companies



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

From/To		June 2019	June 2020	Increase/Decrease
Large-sized	→ Large-sized	25	28	3
	→ Mid-tier	29	24	▲5
	→ Other	27	38	11
Mid-tier	→ Large-sized	5	1	▲4
	→ Mid-tier	54	0	▲54
	→ Other	12	8	▲4
Other	→ Large-sized	5	3	▲2
	→ Mid-tier	3	3	0
	→ Other	32	40	8
Total		192	145	▲47

(Note 1) Aggregates of number of companies that had decided on an incoming auditor by the end of June of each period, based on timely disclosures by listed domestic companies

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

(Note 3) The 52 cases of Mid-tier → Mid-tier and two case of Other → Other in the year to June 2019, the three cases of Other → Other in the year to June 2020 were affected by merger. These mergers were between firms of similar sizes, so they do not affect Figure III-5-2, which shows the net increase/decrease in changes by size of audit firm.

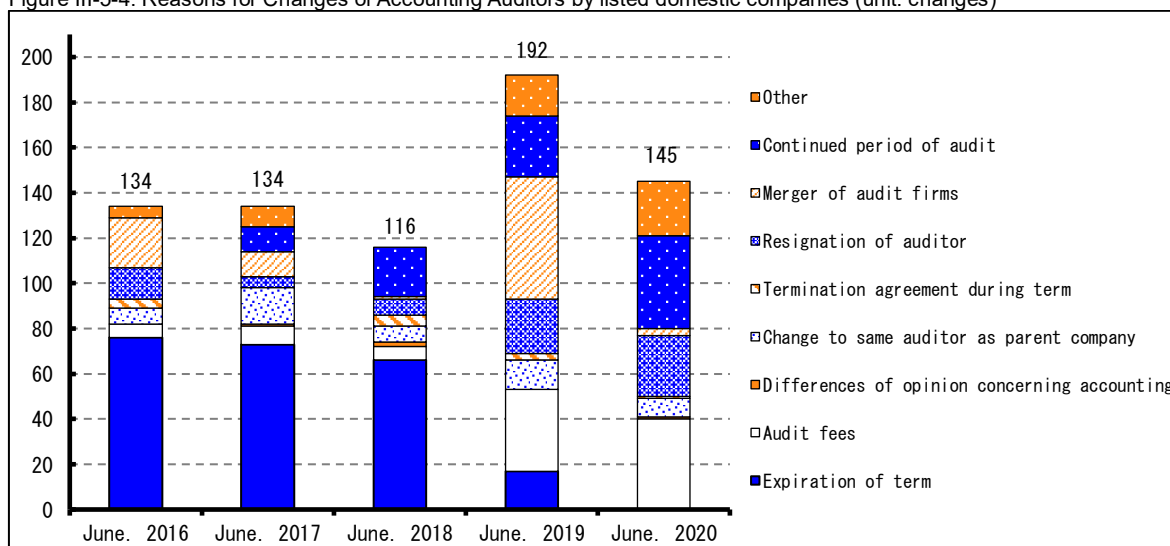
## 1. Reasons for Change of Accounting Auditors Given in Timely Disclosures by Audited Companies

When a listed domestic company changes its accounting auditors, the company 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 just described as “the expiration of the audit term” in the disclosures though any substantial reason have not being given in many cases according to disclosures made in the period until June 2018 (Figure III-5-4). After June 2019, the number of companies giving the expiration of the audit term as the reason with some sort of additional information related to the reason increased, and there was a sharp drop in the number of companies only giving expiration of the audit term as the reason.

Regarding the background to this, it was likely influenced by a report (Improving the Provision of Information Concerning Accounting Audits) published on January 22, 2019 by the Advisory Council on Enhancement of Auditing Information Provision as well as the updated version of the Tokyo Stock Exchange’s Guidebook for Timely Disclosure of Corporate Information, which state that substantial reasons for changing accounting auditors should be disclosed.

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



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

## **2. Reasons for Change of Accounting Auditors during Fiscal Term**

There were nine cases of accounting auditors being changed during the year to June 2020 within a total of 145 changes in total.

Reasons for change of accounting auditors amidst fiscal term are request for cancellation/resignation by audited company due to inappropriate accounting etc. by the audited company, request for resignation by audit firm after consideration of audit firm's human resources and mutually-agreed cancellation due to gaps of opinion concerning accounting treatment.

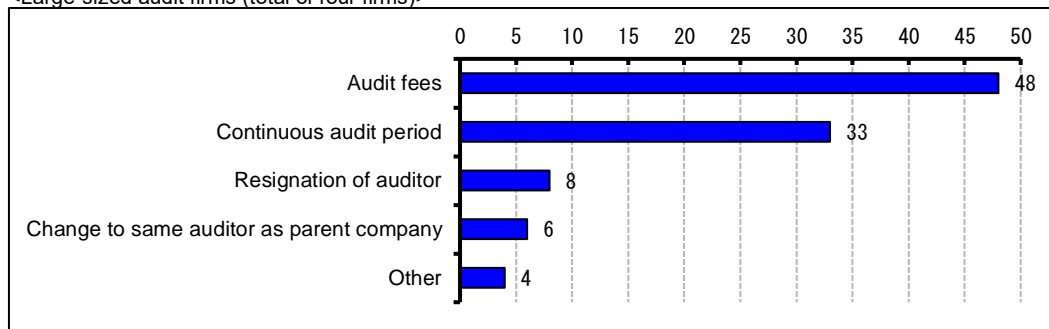
## **3. Reasons for Changes of Accounting Auditors as Identified Through Monitoring Activities**

This section discusses reasons for changing accounting auditors ascertained through monitoring activities in PY2019 rather than through timely disclosure by audited companies. The number of changes obtained through the CPAAOB monitoring does not match the number obtained through company disclosure for the following reasons: inspections were not conducted and reports were not collected from all audit firms in PY2019 and the number includes the previous year's due to the timing of inspections and collection of reports.

### **a. Large-sized audit firms**

Predecessor accounting auditors at large-sized audit firms pointed to audit fees as the primary reason for the changes, as was the case the previous year, according to the results of inspections and the collection of reports. Next came "continuous audit period," of which there were many instances. (Figure III-5-5). In many cases, both "audit fees" and "continuous audit period" are pointed as the reason for the changes. This is likely due to large-sized audit firms administering business through the analysis of audit engagements or the firm-wide basis. Specifically, audited companies consider changes in accounting auditors after taking into account the "continuous audit period," "audit fees, etc.," when considering whether to renew audit contracts, the firms look at whether the level of audit risk is commensurate with the audit fees, whether the audit risk is at a level that can continue to be tolerated, whether the personnel required for the audit engagement can be secured, and so on.

Figure III-5-5: Reasons for changes in accounting auditors according to the predecessor auditors (unit: changes)  
<Large-sized audit firms (total of four firms)>



(Note 1) Based on data from 77 changes identified through inspections and report collection during PY2019

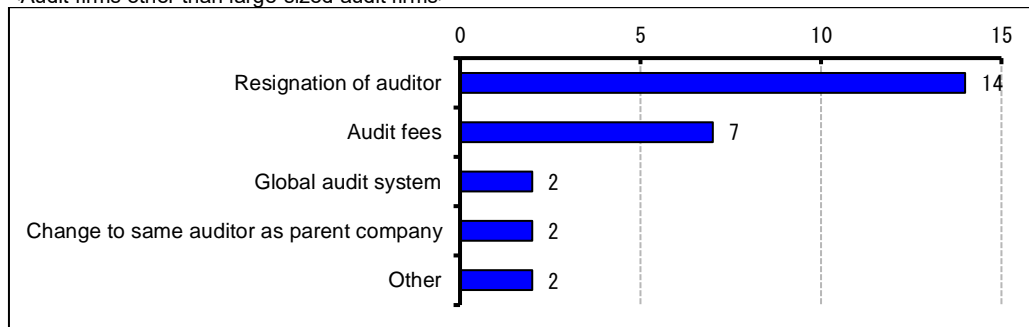
(Note 2) If there was more than one reason, that change is included in the figure for each reason (a cumulative total of 99)

b. Mid-tier audit firms and small and medium-sized audit firms, partnerships and solo practitioners

The primary reason for changes was resignation of an auditor, where the auditor did not renew the audit agreement, according to 24 changes aggregated by the results of inspections and the collection of reports to mid-tier audit firms and small and medium-sized audit firms, partnerships and solo practitioners.

Many cited heightened audit risks from changes in the audited companies' business or deterioration in its performance, changes in shareholders, or vulnerabilities in its accounting structure (Figure III-5-6).

Figure III-5-6: Reasons for changes in accounting auditors according to the predecessor auditor (unit: changes)  
<Audit firms other than large-sized audit firms>



(Note 1) Based on data from 24 changes for which the reason was identified in reports collected from five mid-tier audit firms and 20 small and medium-sized audit firms, two partnerships, and nine 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 27)

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

Amongst the 126 reasons mentioned in a. and b. above, eight were expiration of term in timely disclosures made by audited companies, but five cases of audit fees and three cases of resignation of accounting auditor etc. were identified through monitoring activities.

## **F. Audit Fees**

### **1. Rules on Audit Fees**

Audit fees are determined through negotiations between auditors and audited companies. The JICPA has set guidelines for the calculation of audit fees to serve as a reference 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-6-1).

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

Methods	Methods for calculating estimated audit fees
Hourly rates	Audit fees are calculated by multiplying the number of hours an audit team 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) Prepared by the CPAAOB based on "Guidelines for the Calculation of Audit Fees" (October 2003), JICPA

### ■ New Methods of Calculating Audit Fee Estimates ■

With the development of IT, some audit firms are conducting R&D on audit techniques. At present, audit fees tend to be calculated based on the hours audit team members directly spend on the audit engagement, but because such R&D expenses are expected to increase, there is movement to explore new methods of calculating audit fees estimates.

According to the reports collected in PY2019, audit fee estimates are calculated as follows.

#### a. Large-sized audit firm

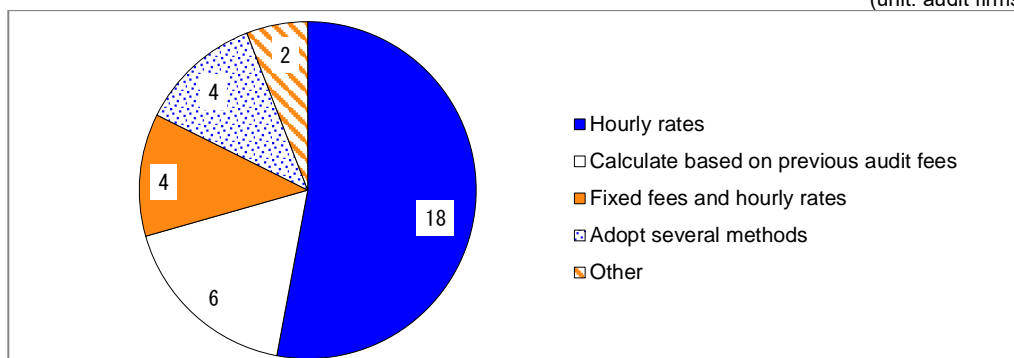
All large-sized audit firms state that they adopt the hourly rates approach for audit fee estimates. Hourly rates are set for each hierarchy level of employee, and the rate is determined while considering indirect costs associated with firm management and quality control such as the payrolls of administrative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

Some large-sized audit firms charge a wide variety of rates, taking into account not only job classification but also the complexity of the audit engagement and each audit service provided.

- b. Mid-tier audit firms and small and medium-sized audit firms, partnerships and solo practitioners

Most mid-tier audit firms and small and medium-sized audit firms, partnerships and solo practitioners also adopt the hourly rates approach, but some charge the same fees as the predecessor auditor or as they charged in previous years. Several firms adopt the fixed fees and hourly rates approach, or utilize multiple calculation methods (Figure III-6-2).

Figure III-6-2: Methods for calculating estimated audit fees (mid-tier and small and medium-sized audit firms)  
(unit: audit firms)



(Note) Aggregated from reports collected from mid-tier and small and medium-sized audit firms in PY2019

Regarding the hourly rates approach, 60% of mid-tier audit firms and small and medium-sized audit firms, partnerships and solo practitioners do not set charged rates by job classification (Figure III-6-3).

Figure III-6-3: Setting of rates corresponding to job classification (mid-tier and small and medium-sized audit firms)

Settings	Number of audit firms	Percentage
Rates set	14	41%
Rates not set	20	59%
合計	34	100%

(Note) Aggregated from reports collected from mid-tier and small and medium-sized audit firms in PY2019

### **3. Audit Fees Before and After Changes in Accounting Auditors**

According to “Auditors of Listed Companies and Audit Fees - 2020” 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.

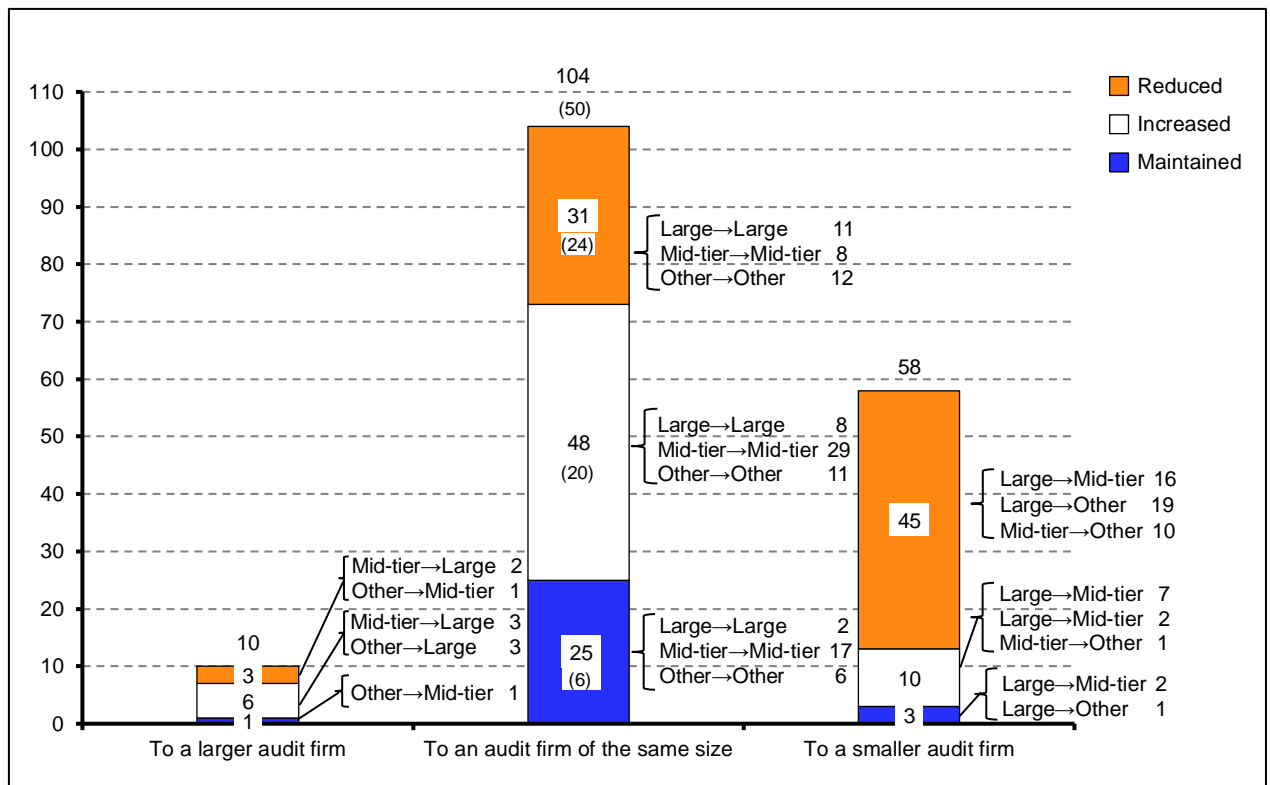
As audit fees are often revised when accounting auditors are changed, the CPAAOB analysed audit fees before and after changes in auditors. We found that the change in audit fees varies depending on the size of the successor accounting auditors.

When switching to a larger audit firm, the audit fees either remain the same or increase. When switching to an audit firm of similar size, audit fees are increased in approximately 50% of cases (48 out of 104). However, in the year to June 2019, there were numerous changes as a result of mergers among mid-tier audit firms and small and medium-sized audit firms, and if these changes due to merger are excluded, audit fees declined in approximately 50% of cases (24 out of 50).

When switching to a smaller audit firm, the audit fees decreased in over 80% of all cases (45 out of 58), and in more than 80% of cases of switching from a large-sized audit firm to a small and medium-sized audit firms, partnerships and solo practitioners (19 out of 22) (Figure III-6-4).



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



(Note 1) Based on changes in accounting auditors between July 2019 and June 2020 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.

(Note 4) Figures in parentheses exclude the 54 cases that were due to mergers among mid-tier audit firms and small and medium-sized audit firms in the year to June 2019.

(Sources) Prepared by the CPAAOB based on timely disclosures of changes in accounting auditors securities reports submitted by June 2020

#### 4. Dependence of Fees (Safeguards)

When the total fees from an audited company represent a large portion of the total fees of the audit firm's total revenues, the dependence on that audited company and concern about losing the audited company creates a self-interest or intimidation threat.

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

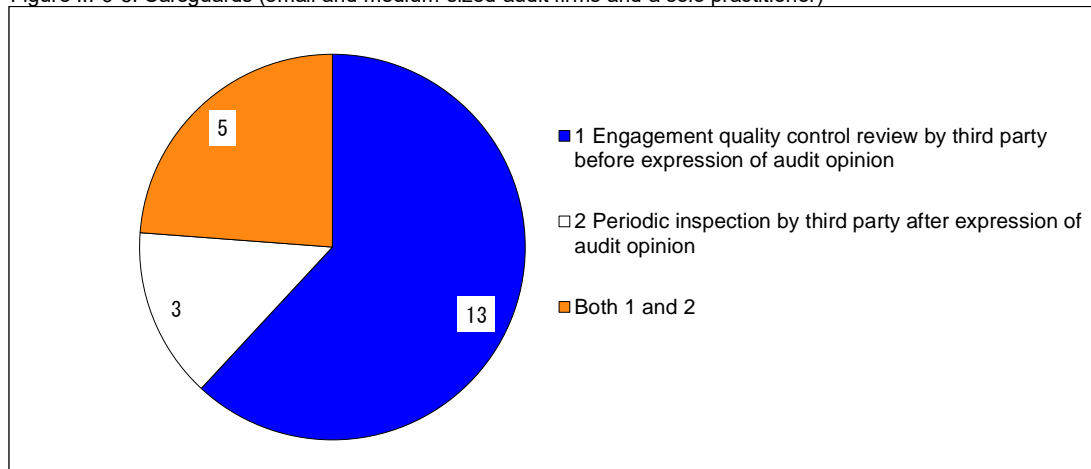
- a. Prior to the issuance of the audit opinion on the second year's financial statements, a professional accountant, who is not a member of the audit firm performs an engagement quality control review of that engagement
- b. After the audit opinion on the second year's financial statements has been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

For a discussion of fee dependence in recent years by the International Ethics Board of Accountants (IESBA), see IV. Responses to Changes in the Global Environment Surrounding Audits, C. Recent Trends with Auditing, 2. Trends with International Standards on Auditing and Code of Ethics (page 132).

Large-sized audit firms did not have any cases requiring safeguards. One mid-tier audit firm (3 engagement) and 10 small and medium-sized audit firms, partnerships, and solo practitioners (21 engagements) applied safeguards due to high dependence on particular engagements among the 38 audit firms that were subject to inspections or collection of reports in PY2019.

The mid-tier audit firm mentioned above applied an engagement quality control review by a professional accountant, who is not a member of the firm prior the issuance of the audit opinion. The small and medium-sized audit firms, partnerships, and solo practitioner, meanwhile, applied periodic inspections, engagement quality control reviews before the issuance of an audit opinion, etc. by a third-party CPA (Figure III-6-5)

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



(Note) Data aggregated from 31 reports collected from small and medium-sized audit firms, partnerships and solo practitioners in PY2019

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

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

### **A. Usage of Technology in Audit and Cybersecurity Efforts**

#### **1. Progress with the Adoption of IT in Audit Engagements**

In recent years, the use of IT in audit engagements, including AI utilization, by audit firms, mainly large-sized audit firms and mid-tier audit firms, has been increasing significantly. This is likely due to audited companies are rapidly digitizing their accounting records, transaction records, etc. As a result of the spread of information technology in the society, and in conjunction with this, audit firms also need, as “workstyle reforms” are introduced, to complete audit engagements more efficiently and effectively. This is affecting the nature of audits, and large-sized and mid-tier audit firms are moving proactively, either jointly with their global networks or independently, to deploy or develop IT-driven audit techniques. Here we explain how audit firms are responding to changes at audited companies by changing their audit techniques, with our main focus being on developments in the last few years.

It is also possible that the spread of COVID-19 will serve as a trigger for the faster adoption of IT in audit engagements.

##### **a. From sample-testing to testing all items in a population**

When performing audit procedures, if transaction records such as receipt/shipping vouchers etc. are stored in paper format, it is difficult to confirm the consistency of all this documentary evidence with accounting records. Therefore, some of the documentary evidence and accounting records are selected as a sample and compared with each other (sampling).

On the other hand, if the originals of such documentary evidence are stored electronically, audit tools can be employed to confirm the consistency of all this documentary evidence with accounting records, so some firms, mainly large-sized audit firms have begun to incorporate this method of testing of all items in a population into their audit engagements.

Furthermore, it is gradually becoming technically feasible to use AI to identify unusual transactions from all transactions are in the process of introducing techniques.

##### **b. Task automation (RPA<sup>12</sup>) and centralization**

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<sup>12</sup> Stands for “Robotic Process Automation,” and involves the use of technology such as artificial intelligence to make office work more efficient or to automate it entirely. It is achieved using software robots that can operate software etc. in the same way as humans. Also referred to as “digital labor” or “virtual knowledge workers.”

When performing audit procedures, it has been typical for CPAs themselves to aggregate figures from transaction records stored in paper or electronic form, but routine tasks such as data processing, aggregation, etc. progress is being made with automation of the processing and import of data by analytical tools and the automation of audit procedures through the use of analytical tools.

c. Unification of audit tools

Audit firms that are members of the global networks use audit tools provided by the global networks to which they belong (see “B. Responses to Overseas Expansion of Companies, 2. Ties with Global Networks” (page 126) for further details). Collected R&D and IT operation of the network firms promote efficiency of IT investment, and feedback from network firms on troubles in audit tools or requests for improvement offers the advantage of allowing the network to improve security and refine functions of audit tools.

However, there are also cases of Japanese audit firms independently developing/deploying analytical tools and implementing them as models for predicting accounting fraud.

d. Broader risk analysis sophistication

In the past, audit firms performed risk analysis that involved the measurement of indications of fraudulent accounting etc. in audited companies' financial information. Recently, however, mainly large-sized audit firms have been developing tools that predict future fraud using nonfinancial information, so it has made it possible to make audit judgements based on more sophisticated analysis. By also employing the results of analysis of non-financial information such as rumors about audited companies, it is expected to become possible to analyze a broader range of risks.

e. From ex post facto audit to real-time audit

At present, most audit work are centered on the period after the date of the financial statements, but with the aim of creating a more comfortable working environment by avoiding concentration of audit work in busy periods, and making audits more sensitive to risks and more likely to uncover fraud at an early stage, audit firms are exploring the possible introduction of audit techniques that allow the day-to-day analysis of transactions etc. conducted by audited companies (real-time audit).

a., b., and c. above are fields in which progress is being made with deployment in large-sized audit firms, while d. and e. are areas that are expected to be applied in the future. The introduction of these advanced audit techniques requires that originals of transaction

records etc. of audited companies be in electronic form. The handover of this data also requires the consent of the audited company concerned. In other words, it requires the understanding and cooperation of audited companies. As a result, progress is gradual.

Figure IV-1 presents information on the adoption of the audit tools etc. discussed above based on the size of the audit firm. It shows that large-sized audit firms, which audit numerous large companies, which possess vast amounts of data, are taking the lead in the adoption of audit tools etc.

Small and medium-sized audit firms, partnerships and solo practitioners, on the other hand, are making scarcely any progress with the use of audit tools. This is because they are small, and have little need for audit tools that offer massive processing capabilities.

Furthermore, to achieve this sort of progress in the adoption of IT, IT specialists are essential, and among large-sized audit firms in particular, some are actively hiring such human resources and designating them as specified partners under the CPA Act.

Figure IV-1: Utilization of IT in audit operations at large-sized audit firms and mid-tier audit firms

Status	Large-sized audit firms	Mid-tier audit firms
Installed	<ul style="list-style-type: none"> <li>• Electronic audit documentation system (audit paper preparation and audit progress management)</li> <li>• Journal analysis tools (analysis of transaction details (journals) and detection of abnormalities)</li> <li>• Evidence reconciliation tools (precise methods for cross-checking data from outside with all sales data at audited companies)</li> <li>• File exchange system (used for exchanging data with audited companies)</li> <li>• RPA (automation of data input and processing)</li> <li>• Debt/credit balance confirmation system (automation of the external confirmation of the existence/accuracy of transactions)</li> </ul>	<ul style="list-style-type: none"> <li>• Electronic audit documentation system (audit paper preparation and audit progress management)</li> <li>• Journal analysis tools (analysis of transaction details (journals) and detection of abnormalities)</li> </ul>
Being installed/ introduced at some firms	<ul style="list-style-type: none"> <li>• AI (prediction of future fraud based on abnormal transactions using past financial information etc.)</li> <li>• Audit databases (putting knowledge etc. from inside the firm into a database to create a system for sharing it)</li> </ul>	<ul style="list-style-type: none"> <li>• Evidence reconciliation tools</li> <li>• File sharing systems</li> <li>• RPA</li> </ul>
Under development	<ul style="list-style-type: none"> <li>• AI (fraud forecasting using non-financial information)</li> <li>• Drones (improved efficiency when attending physical inventory count)</li> <li>• Utilization of blockchains</li> </ul>	<ul style="list-style-type: none"> <li>• AI (fraud forecasting using past financial information etc.)</li> </ul>

(Source) Prepared by the CPAAOB based on information obtained through the collection of reports, etc.

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

In November 2019, large-sized audit firms jointly established Audit Confirmation Center GK, a company set up to put together a system for confirming transactions by audited companies online. This joint development of an audit system represents a first for the audit industry.

Transactions have hitherto been confirmed by mail, so by making confirmation possible online, IT investment beyond a sole global network is being made more efficient and clerical processes are being centralized. For example, entry formats are being consolidated to ease the burden on audited companies and respondents.



## 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. Because the leakage of information about audited companies, in particular, causes severe damage to the trust placed in the audit firm concerned, it will be important to steadily bolster cybersecurity.

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 dialog. These approaches have enabled us to identify the following efforts common to large-sized audit firms:

- Establishing basic information security policies and promoting information protection inclusive of cybersecurity across the global network as a whole
- Setting up organizations responsible for cybersecurity (CSIRT<sup>13</sup>) and, as necessary, recruiting experts from inside and outside the audit firm
- 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

Mid-tier audit firms are also taking similar steps to large-sized audit firms, but at some of them it is unclear whether they have established an environment capable of promptly

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<sup>13</sup> CSIRT (Computer Security Incident Response Team) is the collective term for the organizations responsible for dealing with incidents pertaining to computer security.

and properly responding in the case of damage resulting from a cyberattack. The reasons for this include less involvement by the global network than is the case at large-sized audit firms and incompatibility of rules on information security etc. with actual circumstances.

b. International efforts for cybersecurity issues

The International Forum of Independent Audit Regulators (for information about IFIAR, see the Column “International Forum of Independent Audit Regulators (IFIAR)” (page 129) comprises audit regulatory authorities from Japan and other countries, and continually holds dialogues with the Big Six global accounting firms 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.

■Participation by Audit Firms in Cybersecurity Exercises■

With the aim of further improving the ability of the financial sector as a whole to respond to cyber-incidents, the FSA has conducted cybersecurity exercises (Delta Wall) on three occasions since FY2016. In the autumn of 2019, audit firms took part for the first time in the cybersecurity exercises which were held for the fourth time.

During the exercise, the participants were placed amid imaginary scenarios such as their firm’s website being subject to a DDoS attack or them being subject to a targeted email attack. After asking top management to also get involved, they confirmed response preparedness and procedures relating to information sharing both inside and outside the organization in the event of an incident.

The FSA provided feedback not only to participating audit firms but also the sector as a whole in the form of analysis of general trends etc. identified from the results of the exercise, so that it could serve as a reference for improving preparedness within audit firms and raising awareness of cybersecurity.

## **B. 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 involving overseas firms. In association with internationalized business, numerous cases of serious accounting fraud 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 audit firms have also been stepping up action. In this section, we will provide an overview of group audits and describe the audit procedures that they involve.

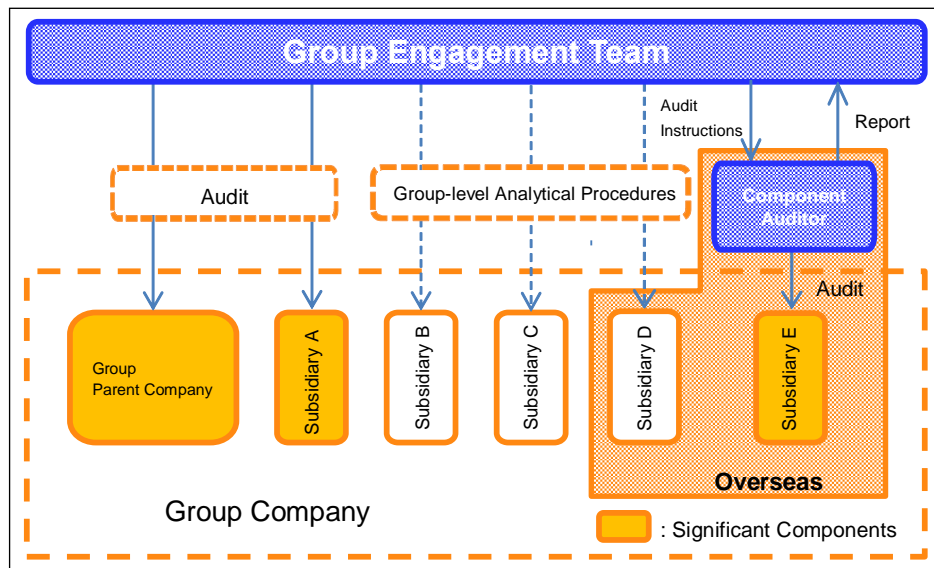
#### **a. Overview of Group audits**

When the auditor of a parent company (group engagement team) performs an audit and attestation of the group financial statements, the audit covers not only the parent company but also its subsidiaries and affiliates (companies etc. that constitute units that prepare financial information for inclusion in the group financial statements are referred to as “components”). A manufacturing company that operates internationally, for example, will have numerous subsidiaries overseas (local units) as it will establish manufacturing subsidiaries in countries with lower labor costs, establish local sales subsidiaries to serve overseas markets, and so on.

Components such as subsidiaries 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 requiring special consideration, and 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 IV-2-1):

Figure IV-2-1: Overview of typical group audit procedures



#### 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. In recent years there have been cases of fraud etc. discovered at foreign subsidiaries that would affect group financial statements. It has therefore become important to perform risk assessments based on an adequate understanding of the environment of companies. Possible steps could include establishing a department at head office tasked with managing foreign subsidiaries, creating a group management environment for performing internal audits of foreign subsidiaries, and internal controls at foreign subsidiaries.

If a component is deemed to be financially important, or it is deemed that a component could contain significant risks in relation to the group financial statements, the group engagement team needs to identify the component as a significant component.

#### 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)).

#### ■ Case of Use of IT in Group Audits ■

At some large-sized audit firms, common electronic audit documentation systems are being used within the global network, and group engagement teams are performing centralized management of engagements by auditors of overseas components as well as directly reviewing audit documentation.

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

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

	Large-sized audit firms	Mid-tier audit firms	Other
Group audit manual	Incorporating the global network's group audit manual into the firm's audit manual	Many firms are incorporating the global network's group audit manual into the firm's audit manual, but some have produced their own	Many firms have produced their own group audit manual
Audit instructions	Using the global network's template for audit instructions	Many firms are using the global network's template for audit instructions, but some have produced their own	Many firms have produced their own template for audit instructions, but some are using a template provided by the global network

(Note) Regarding "Other" in the figure, of the 31 firms from which reports were collected in PY2019, information is presented for 11 firms conducting audit engagements for which group audit is required. Among these, just four firms are affiliated with a global network and using a group audit manual or audit instructions provided by the global network.

(Source) Prepared by the CPAAOB based on information obtained through the CPAAOB inspections or the collection of reports

#### d. Communication with component auditors

If effective dialogue between the group engagement team and the component auditors does not exist, there is a risk that the group engagement team may not obtain sufficient appropriate audit evidence on which to base the group audit opinion.

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, partnerships and solo practitioners visit their component auditors only every other year.

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

#### ■Cases Concerning Appointment of Component Engagement Partner■

Some global networks are making group audit more effective by giving the audit firm to which the group engagement team belongs certain rights to express their views concerning engagement partners for overseas components. For example, they can demand that the person appointes have experience of auditing the sector concerned.

## 2. Ties with Global Networks

Large-sized audit firms, second-tier audit firms, and some small and medium-sized audit firms, partnerships, and solo practitioners have concluded member firm contracts etc. and belong to global audit networks. This makes it easier for them to perform audits of audited companies with overseas operations and enables them to utilize know-how such as audit manuals.

### a. Membership of global networks

All large-sized and mid-tier audit firms as well as some small and medium-sized audit firms, partnerships, and solo practitioners that need to audit the overseas operations of audited companies belong to global networks, and are moving forward with the establishment of structures for group audit (Figures IV-2-3 and IV-2-4). Note, however, that not all small and medium-sized audit firms, partnerships, and solo practitioners that need to conduct group audits belong to global networks (for details, see “1. Group Audits, c. Audit Procedures for Significant Components” (page 123).

Figure IV-2-3: Number of audit firms belonging to global networks<sup>14</sup> (FY2019) (unit: audit firms)

Large-sized audit firms	4
Mid-tier audit firms	5
Small and medium-sized audit firms	22
Total	31

(Source) Prepared by the CPAAOB based on operational reports

Figure IV-2-4: List of global networks to which large-sized and mid-tier audit firms belong

Audit firm	Global network
KPMG AZSA LLC	KPMG International Cooperative (KPMG)
Deloitte Touche Tohmatsu LLC	Deloitte Touche Tohmatsu Limited (DTT)
Ernst & Young ShinNihon LLC	Ernst & Young Global Limited (EY)
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)
Crowe Toyo & Co.	Crowe Global
PricewaterhouseCoopers Kyoto	PricewaterhouseCoopers International Limited (PwC)

(Source) Prepared by the CPAAOB based on data from publicly disclosed materials from each audit firm (as of June 7, 2020)

<sup>14</sup> Among small and medium-sized audit firms, the firms that have concluded cooperative relations (alliances) with overseas audit firms are included.

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 IV-2-5). The scale of the Big Four global networks is particularly prominent.

Figure IV-2-5: Operating revenues of global networks (unit: billion USD)

	DTT	PwC	EY	KPMG	BDO	GT
Operating revenues	462	424	364	298	90	57
Audit services (Share of operating revenues)	102 (22%)	173 (41%)	126 (35%)	112 (38%)	40 (45%)	23 (40%)
Tax-related services (Share of operating revenues)	83 (18%)	107 (25%)	95 (26%)	66 (22%)	19 (21%)	13 (23%)
Advisory services (Share of operating revenues)	277 (60%)	144 (34%)	143 (39%)	120 (40%)	31 (34%)	21 (37%)

(Source) Prepared by the CPAAOB based on data from publicly disclosed materials from each global network (2019 accounting year). However, for BDO only, operating revenues for FY2018 are presented.

In Japan, the Big Four global networks<sup>15</sup> share of audit services is so oligopolistic that together they audit 96% of the 225 companies that comprise the Nikkei Stock Average (Nikkei 225). Overseas, they account for even larger shares of audit services, auditing 99% of the 500 companies comprising the S&P 500 index in the U.S. and 97% of the 350 companies with the largest market capitalizations on the London Stock Exchange (FTSE 350 index), meaning that the situation in these countries is the same as in Japan (Figure IV-2-6).

Figure IV-2-6: Big Four global networks' share of audit services for important listed companies in Japan, the U.S., and the U.K.

	Japan	US	UK
Big Four global networks' share (based on number of companies)	96%	99%	97%

(Sources) Japan: Compiled by the CPAAOB from QUICK and exchange data (as of March 31, 2020)

U.S.: Compiled by the CPAAOB from Bloomberg data (as of March 31, 2020)

U.K.: "DEVELOPMENTS IN AUDIT 2019, NOVEMBER 2019," Financial Reporting Council

#### 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.

<sup>15</sup> Refers to large-sized audit firms and PwC Kyoto, which is a mid-tier audit firm.



i. Large-sized audit firms

Each of the large-sized audit firms belongs to one of the Big Four 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 and PICOQCs express the views from Japan as members of important network committees, while outside members of oversight/assessment bodies at large-sized audit firms take part in global meetings.

They 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. They have adopted standards and procedures determined by the networks for engagement quality control reviews, independence, and other quality controls as well.

In addition to receiving manuals and tools from the networks, some large-sized audit firms dispatch the PICOQC etc. from the audit firm's head office to the network and are able to ensure that the views from Japan are directly reflected in the initiatives being pursued at the network level, such as the revision of audit manuals and the development of electronic audit tools.

They also regularly undergo global reviews conducted by the networks in order to confirm that audit quality, particularly for audit engagements, is being maintained at the level required by the networks (see "III. Operation of Audit Firms, C. Monitoring of Systems of Quality Control, 2. Utilization of Global Reviews" (page 96) for details.).

Furthermore, in conjunction with business expansion in recent years in the Asia-Pacific region, and most notably Japan and China, there are moves to oversee/manage each region separately, and Japanese large-sized audit firms that are members of global networks tend to play a central role in the Asia-Pacific region, such as by participating as board members for organizations established in the Asia-Pacific region.

ii. Mid-tier audit firms

All mid-tier audit firms are affiliated with global audit networks. However, the extent of their ties differs depending on size of the networks. Some have formed alliances that are at the same level of those of the large-sized audit firms, while others maintain moderate ties, only having the right to use the networks' logos and brand and 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.

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

The networks to which small and medium-sized audit firms, partnerships and solo practitioners 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, partnerships and solo practitioners do not receive audit manuals or undergo global reviews.

■International Forum of Independent Audit Regulators (IFIAR) ■

The International Forum of Independent Audit Regulators (IFIAR) is 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 March 31, 2019 was 55 countries/regions). In April 2017 the IFIAR secretariat was established in Tokyo, marking the first time an international financial organization has been headquartered in Japan.

Japan has been a member and served on the board of IFIAR ever since it was established. The CPAAOB chairman, inspectors, etc. participate actively in various meetings, and endeavor to build and strengthen cooperation with the authorities of other countries. Furthermore, by engaging in dialog with executives, including the CEOs, of the Big Six global accounting firms, we are endeavoring to improve audit quality globally.

## **C. Recent Trends with Auditing**

Some of the recent trends shaping accounting audits are described below.

### **1. Impact of and Response to Spread of COVID-19**

The rapid spread of COVID-19 from around March 2020 has had a huge impact on corporate bookclosings, audits, etc.

Particularly at those at companies that closed their books in March, i.e. were approaching the ends of their fiscal years, there was a risk that bookclosing procedures would be delayed, that it would be impossible to make forward-looking earnings forecasts, and so on. There was also a risk that wide-ranging limitations on what could be accomplished with regard to audits, e.g. observing inventory being counted, confirming balances, and auditing overseas group companies, could result in delays in the completion of audit engagements and affect audit opinions.

In response to these circumstances, from March 2020 onwards, the JICPA came out with a list of important points to keep in mind in connection with COVID-19 when conducting audits, while the FSA extended deadlines for submission of securities reports and other filings. The Ministry of Justice, meanwhile, issued guidance on the scheduling of annual shareholders meetings, while the Accounting Standards Board of Japan (ASBJ) published its views on the impact of COVID-19 on accounting estimates.

Furthermore, regarding bookclosing, audits, etc. for companies that close their books in March, the Liaison Council Concerning Handling of Corporate Bookclosing, Audit, etc. in View of the Impact of Novel Coronavirus Disease” was established to facilitate the sharing of understanding of and responses to the current situation among relevant parties.

Audit firms have also been taking action. In light of the risk of infection with COVID-19, while the government’s state of emergency was in force, firms switched to teleworking, with their staff generally working at home. As for audit procedures, meanwhile, audit firms have been following alternative procedures designed based on the aforementioned important points highlighted by the JICPA. And as for quality control procedures such as examinations and reviews, some audit firms have been conducting them in a non-face-to-face manner, via videoconferencing systems, for example.

Large-sized audit firms, in particular, have been moving forward in recent years with the utilization of IT in audit, but given the recent spread of the COVID-19, audited companies are digitalizing required documents such as contracts and invoices before submitting them to the audit firm. And to support that, some audit firms have been loaning the companies multifunction devices that they have developed. Large-sized audit firms and

second-tier audit firms have continued with teleworking to some extent even after the lifting of the state of emergency, and it is likely that the use of IT in audit engagements, and especially so-called “remote audits,” which are audit engagements that do not involve visits to audited companies, will further accelerate.

For more information about IT initiatives, see IV. Changes in Environment Surrounding Audit, A. Usage of IT in Audits and Cybersecurity Methods (pages 116-121).

With respect to the impact of COVID-19 on audit engagements, the responses of audit firms, etc., the CPAAOB, for its part, is committed to conducting monitoring in light of actual facts and circumstances.

## **2. Trends with International Standards on Auditing and Code of Ethics**

In the tide of globalization, revision of the International Standards on Auditing and Code of Ethics, which are formulated by the International Federation of Accountants (IFAC), an organization comprising the accounting bodies of each country, also affects auditing standards and ethical standards in Japan.

Among the major recent revisions to the International Standards on Auditing (ISA) established by the IFAC's International Auditing and Assurance Standards Board (IAASB) are the revision to Quality Control for an Audit of Financial Statements (ISA220), a standard relating to audit quality, and Quality Control for Firms That Perform Audits and Reviews of Financial Statements, and Other Assurance and Related Services Engagements (ISQC1) being revised as International Standard on Quality Management 1 (ISQM1, Quality Management at Firm Level) and International Standard on Quality Management 2 (ISQM2, Engagement Quality Reviews), established as an independent standard concerning quality reviews of individual audit engagements. Exposure drafts of these revisions were published in February 2019, before finalized during 2020. Discussions are ongoing with a view to application from December 2022.

Furthermore, revisions to the Code of Ethics formulated by IFAC's International Ethics Standards Board for Accountants (IESBA) are also being considered. They relate to "non-assurance services," "fees," "objectivity of reviewers," etc., and an exposure draft for each of revisions was published in January 2020. Among them, that relating to "fees" involves a strengthening of independence rules. Specifically, in the case of audit clients that are public interest entities (PIEs), a requirement to cease to act as auditor if fee dependency on the audit client continues beyond a specified period would be introduced.

### 3. Enhancing the transparency of audit reports (introduction of KAM)

With the aim of improving the provision of information concerning accounting audits, in September 2017 the Business Accounting Council began studying ways of making audit reports more transparent. Later, in July 2018, it revised auditing standards to require inclusion in audit reports of not only the audit opinion concerning the adequacy of the financial statements, but also Key Audit Matters (KAM).

- Accounting auditors must consider, out of the matters discussed with the audit and supervisory board member etc. during the audit, the following matters:
  - Matters for which significant risks have been identified or matters deemed to be at high risk of material misstatement
  - Degree of the accounting auditor's judgement concerning matters involving important judgements by the company's management, including matters for which a high degree of uncertainty has been identified with respect to estimates
  - Impact on the audit of important events or transactions that occurred during the fiscal year concerned
- These must then be narrowed down to matters that the auditor, as a professional expert, deems to be of particular importance to determine the KAM. A section for the KAM must be provided in the audit report, and it must contain the following matters
  - Details of the KAM
  - If there is a disclosure in the relevant financial statements, refer to said disclosure
  - Reasons why the accounting auditor believed that the matters were of particular importance in the audit of the financial statements for the fiscal year concerned and deemed them to be KAM
  - The accounting auditor's response during the audit

Regarding the presentation of KAM, application under the FIEA begins with accounts for the year to March 2021, but early application from the year to March 2020 is also permissible. With an eye to early application of KAM, audit firms are busy providing explanations to and discussing the matter with audited companies, selecting, drafting, and editing KAM, training their staff, and so on. As of June 2020, 45 firms have committed to early application of KAM from the year to March 2020. Firms had been watching what other firms were doing, and the spread of COVID-19 also had an impact.

#### **4. Expansion of Disclosure of Descriptive Information**

In response to the publication of the Report by the Working Group on Corporate Disclosure compiled in June 2018, in January 2019 the Cabinet Office Ordinance on the Disclosure of Corporate Affairs, etc. was revised, and as a result, companies are required (effective from the year to March 2020) to provide more substantial disclosures in their securities reports with respect to descriptive information such as “management policy, operating environment, issues to be tackled, etc.,” “risks to business etc.,” and “analysis by management of financial condition, operating performance, and cash flow position.” At the same time, with the aim of encouraging companies to take action to expand their disclosures, and not just following the rules formally, principles-based guidance in the form of “Principles Concerning Disclosure of Descriptive Information” have been published. Furthermore, with a view to disseminating good examples of disclosure to the audit sector, a “Compendium of Examples of Disclosure of Descriptive Information” was published in March 2019. Both these documents are updated in due course. While not subject to audit, descriptive information provides explanations of assessments concerning the company’s medium- to long-term vision, outlook, and performance so that financial information, which is subject to audit, can be better understood. It is essential information for making investment decisions, and its disclosure therefore needs to be expanded. Recently, the ESG (Environmental, Social, and Corporate Governance) perspective has become necessary to ensure the sustainable growth of companies, and the number of institutional investors that place importance on ESG information has been increasing. In light of this, more and more companies are including ESG information in descriptive information such as “risks to business etc.,” or even going as far as publishing “integrated reports,” which are voluntary disclosure documents that contain more of this sort of information.

## 5. Rotation system for audit firms

In Europe, a so-called rotation system<sup>16</sup> for audit firms was introduced in June 2016 as a means of ensuring the independence of audit firms.

We conducted a survey of trends in the Japanese audit market and the situation in Europe since the system was introduced in order to identify the advantages and disadvantages of introducing a similar system in Japan. We then published a preliminary report of our findings in July 2017, a secondary report in October 2019.

Following a fact-finding survey of partner rotation etc., the second report reveals that there have been cases where, for example, a person who audited a company for a long period in a non-partner role, i.e. as an assistant, continued to do so after making partner. In such cases, they have been involved in the audit of the same company for fairly long period of time in total. Furthermore, fact-finding concerning the rotation of audit firms showed that to ensure the smooth rotation of audit firms, it is important to allow sufficient time for preparations and the establishment of internal structures. However, the audit market is oligopolistic, and available options are limited, so the view was expressed that this will be an outstanding issue when considering the enhancement of the system.

And in response to the publication of the second report, in February 2020 the JICPA chairman sent out a memorandum stating that not only engagement partners, but also audit assistants would be rotated under a JICPA self-regulatory system of “team member rotation,” effective from program years beginning on or after April 1, 2021.

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<sup>16</sup> A system whereby companies are obligated to change the audit firm that conducts their audits at fixed intervals



## **6. Report from the Liaison Council on the Appointment of Audit Firms for Initial Public Offering (IPO) Audits**

As an issue concerning the selection of audit firms for IPOs, it has been pointed out that the number of companies seeking for IPOs is on the increase, but there is a supply-and-demand imbalance between such companies and audit firms, so some companies cannot receive the audits they require. For more information about IPOs, see I. Overview of the Audit Sector, C. Audited Companies, 5. Audits of Initial Public Offerings (page 33).

On the other hand, if audit engagements are accepted even though the necessary personnel, audit hours, etc. cannot be secured, audit quality will be declined, and trust in audits per se will be harmed. This is unacceptable, as audit quality must be ensured.

Conscious of these sorts of problems, in December 2019 the FSA established the Liaison Council on the Appointment of Audit Firms for Initial Public Offering (IPO) Audits, with the aim of promoting liaison among relevant parties concerning the selection etc. of audit firms for IPOs. The Council then published a report in March 2020. The report presents actions expected of each relevant party, namely audit firms, the JICPA, securities companies, venture capital providers, securities exchanges, etc. to enable large-sized audit firms to continue to perform a vital function in IPO audits as the creators of an environment for delivering high-quality audits for companies wishing to complete IPOs. The actions suggested include reviewing organizational structures and the allocation of personnel, the establishment/clarification of consultation desks, and so on.

## **(Reference materials)**

CPAAOB website  
<https://www.fsa.go.jp/cpaaob/>

FSA website  
<https://www.fsa.go.jp/>

JICPA website  
<https://jicpa.or.jp/>

Japan Exchange Group website  
<https://www.jpx.co.jp/>

Basic Policy for Monitoring Audit Firms  
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Basic Plan for Monitoring Audit Firms (PY2020)  
<https://www.fsa.go.jp/cpaaob/shinsakensa/kihonkeikaku/20200714/20200714-1.html>

Case Report from Audit Firm Inspection Results  
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<https://www.fsa.go.jp/cpaaob/shinsakensa/kouhyou/20150611.html>

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