III. Operation of Audit Firms

A. Operations Management System

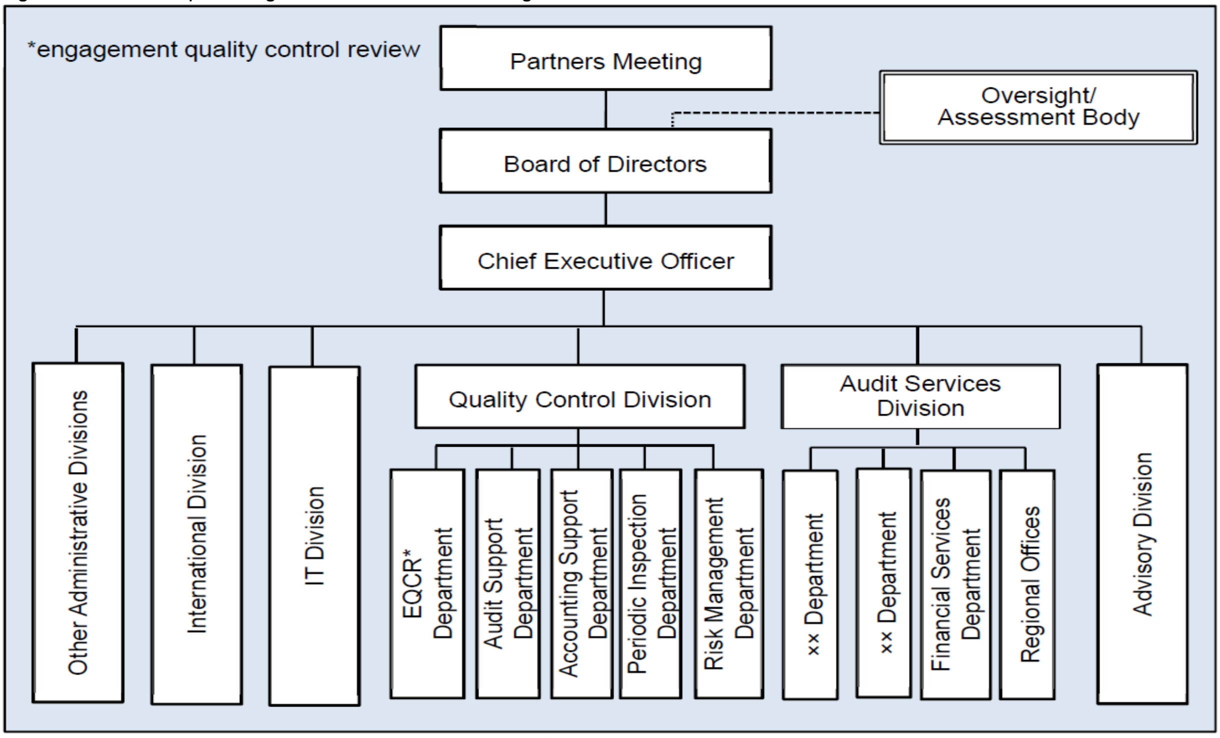
1. Organizational Structure of Audit Firms

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. Large-sized and mid-tier audit firms have structures more focused on functions than those seen at small and medium-sized audit firms (Figure III-1-1).

Large-sized audit firms have established sector-specific departments within the audit services division, for example, financial service division. This department might be referred to as the "Financial Services Division" and form part of the Audit Services Division.

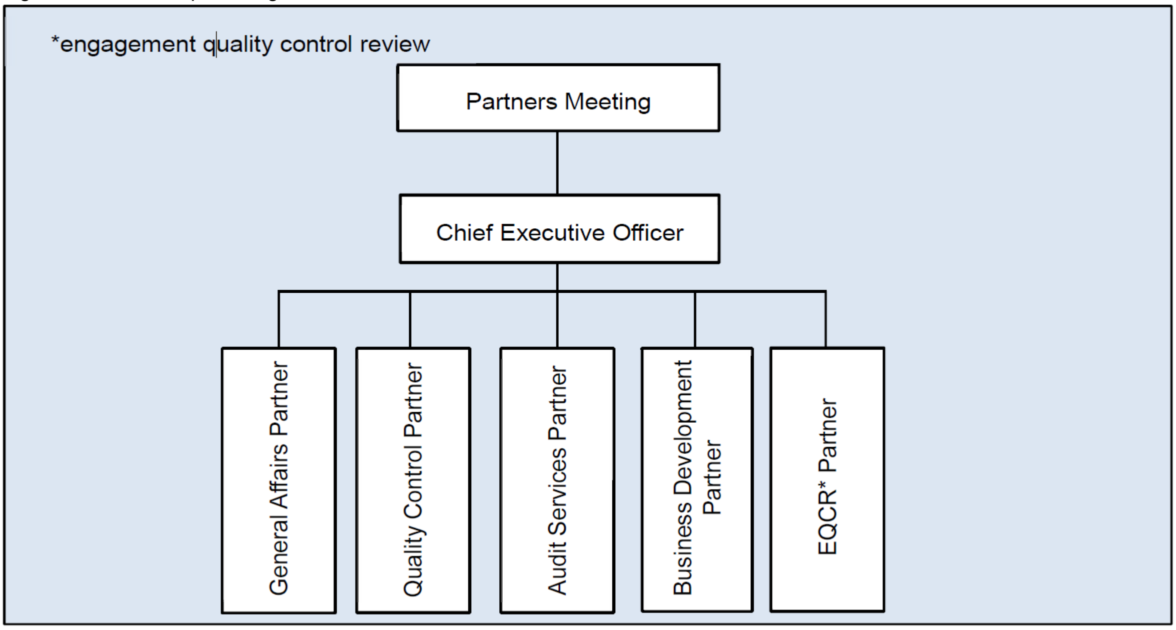
Figure III-1-1: Example of organizational structure at large-sized and mid-tier audit firms



(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 do not have siloed audit engagement division and their organizational decisions are made by partners meeting without the establishment of the board of directors or oversight/assessment body due to the human resource constraint. Similarly, they 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)

Large-sized audit firms strategically assign full-time staff members to sections divided in accordance with their operations and are promoting efforts to improve the quality of audits through the specialization and hierarchization of operations, such as transferring certain quality control functions to a section in charge of audit engagements. As a recent trend, principal responsibility for quality control is shifting from the quality control section at the headquarters to the audit services section, which is closer to audit site. There are cases in which the audit services section sets up a quality control committee to monitor auditing by the audit services section in cooperation with the quality control section at the headquarters and an independent monitoring section is established under an official concurrently in charge of the quality control and audit services sections to monitor the development of the quality control organization and the effectiveness of its operation.

At mid-tier audit firms, head-office functions are being strengthened through, for example, increases in the headcount of the head-office as a way of responding to rises in the number of audited companies. At some firms, however, the operations system has not been adequately modified to ensure that consistent quality is maintained as the business operations expand.

At small and medium-sized audit firms, staff members have dual caps of audit engagement as well as quality control. 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 the partners are also often allowed to engage in their side job such as operating their own accounting office and/or proportion of part-time staff are relatively high. Furthermore, at some small and medium-sized audit firms, quality control management is run by multiple audit departments independently, not by centralized 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	Approx. 170 to 600	Approx. 30 to less than 100	Up to approx. 40 (Note)
Number of full-time personnel	Approx. 2,800 to 6,600	Approx. 200 to over 800	Up to approx. 90 (Note)
Decision-making bodies	・The highest decision-making body is the partners meeting ・A board of directors and an executive committee are set up under the partners meeting	・The highest decision-making body is the partners meeting ・A board of directors is set up under the partners meeting	・Most decisions are made at the partners meeting ・Larger firms have a board of directors beneath the partners meeting
Oversight/assessment bodies	・A body is established to supervise/assess business execution bodies such as the board of directors ・Subcommittees is established for “nomination” (nominations of chief operating officers and other executives), “compensation” (evaluation of executives/partners, compensation decisions, etc.), and “audit” (accounting and audit areas other than accounting). A public interest subcommittee is also established to monitor business execution from a public-interest standpoint ・Third parties with independence (“independent third parties”) serve as members of oversight/ assessment bodies and subcommittees	・Oversight/assessment bodies are established but their powers are limited compared with those at large-sized audit firms ・Many firms do not establish subcommittees for nomination, compensation, and audit ・While audit firms use independent third persons as constituent members of oversight/assessment bodies, involvement by the independent third persons is limited to advice and suggestions to executive bodies at many audit firms.	・Many firms have systems of checks and balances between partners without establishing oversight/assessment bodies. ・Many firms do not appoint independent third parties
Design of business operation departments	・Multiple audit services departments are established, and firm-wide operation including regional offices is also conducted ・A department specializing in financial services is established ・Departments in charge of quality control, risk management are established	・Management of firms, including regional offices, in addition to the establishment of multiple audit engagement sections ・A department in charge of quality control are established	・Many firms appoint partners to handle the particular services without establishing particular departments ・Larger audit firms have set up organizations that resemble those of mid-tier audit firms
Number of offices	・There are many cases of setting up regional offices on a nationwide scale in addition to the three big cities (Tokyo’s 23 wards, Osaka City and Nagoya City).	・Besides the firm’s main office, there are often also offices in metropolises (Tokyo, Osaka and Nagoya)	・Many firms only have a main office
Design of quality control divisions	・A quality control division comprises various departments for functions such as revising and distributing audit manuals, providing advice on accounting procedures, IFRS and US accounting standards , and conducting engagement quality control reviews and periodic inspections in relation to its system of quality control ・A risk management department, which is responsible for monitoring of audit contracts, independence, and audit risks, is established ・Audit services departments also often have quality control functions	・Some of the departments under a quality control division ・Some also have a department for engagement quality control reviews	・Many firms appoint partners to handle both quality control and audit engagements without establishing quality control departments ・Some small firms’ representatives are also in charge of quality control

(Reference) Prepared by the CPAAOB from CPAAOB inspections, collected reports and operational reports in PY2020.
(Note) Excluding an audit firm having a wide gap between the number of partners and that of full-time staff members.

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 hamper 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.

<ins>Principle 1: The Role to Be Accomplished by an Audit Firm</ins>

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

<ins>Principle 2: Organizational structure (management functions)</ins>

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.

<ins>Principle 3: Organizational structure (oversight/assessment functions)</ins>

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.

<ins>Principle 4: Operation</ins>

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.

<ins>Principle 5: Ensuring transparency</ins>

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, 2022, all large-sized audit firms and mid-tier audit firms as well as nine small and medium-sized audit firms had announced adoption of the Audit Firm Governance Code[1].

When it comes to the status to adopt each principle of the Code from the viewpoint of the firms’ scalability, large-sized and mid-tier audit firms have adopted all the principles. Few small and medium-sized audit firms have adopted 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 examine the efforts that audit firms are making with respect to these two principles.

[1] Sources: a list of audit firms adopted “Principles for Effective Management of Audit Firms (The Audit Firm Governance Code)”, the FSA website

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

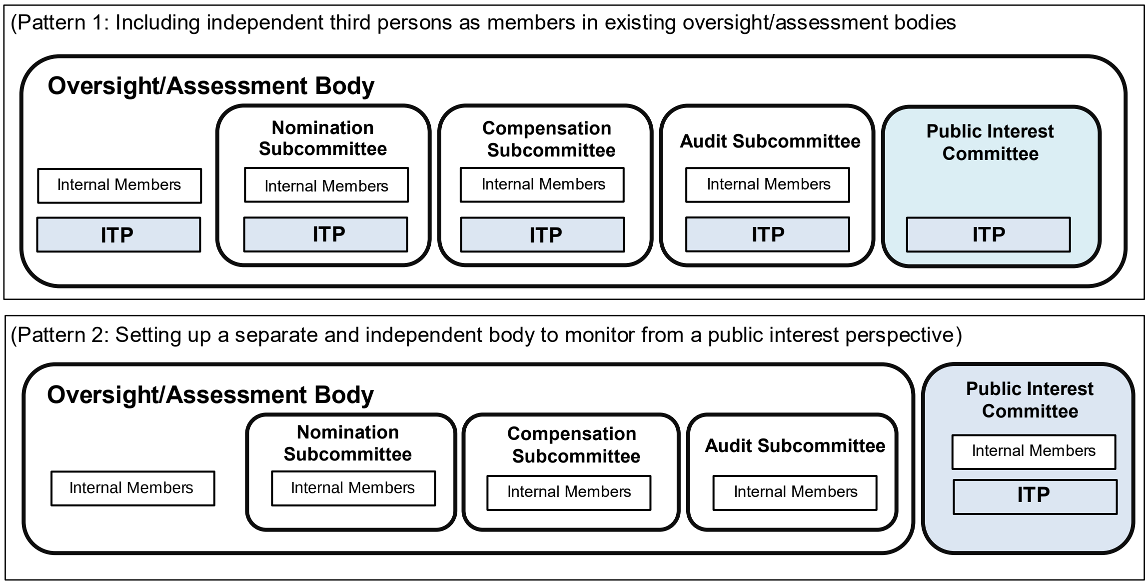
The publication of the Audit Firm Governance Code has prompted mid-tier audit firms to make efforts to establish independent bodies, such as public-interest committees that are comprised of independent third parties as oversight/assessment bodies. However, with the exception of some firms, they have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

Under the pattern in which independent third persons are included as constituent members of existing oversight/assessment bodies (Pattern 1 in Figure III-1-4), firms provide information to them and receive opinions from them through their participation in meetings of the oversight/assessment bodies. There are also efforts to improve the effective use of independent third persons by raising the ratio of outside members who are independent third persons in the oversight/assessment bodies and subcommittees.

On the other hand, where 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 receives 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 provide independent third persons with the information they need in a timely and appropriate manner so that effective discussions are conducted.

To provide independent third persons with necessary information 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 have taken such steps as establishing a secretariat to assist outside committee members, who are independent third persons.

(ii) Mid-tier audit firms

Many mid-tier audit firms have established independent bodies such as public interest committees constituting of independent third person . 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 determined the authority that allows independent third persons to obtain information proactively.

(iii) Small and medium-sized audit firms

Oversight/assessment bodies established in small and medium-sized audit firms often consist of in-house partners and independent third parties. In many cases, the audit firms provide information to independent third parties through the oversight/assessment bodies and exchange opinions at meetings of business execution bodies. The range of information provided to independent third parties and that of business execution bodies' meetings attended by independent third persons differ from audit firm to audit firm. The degree of utilization of knowledge of outside experts thus varies.

iii. Experience/expertise of independent third persons

When it comes to 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).

The number of independent third persons assigned is three or four at large-sized audit firms, one to three at mid-tier audit firms, and one at small and medium-sized audit firms. Some large-sized and mid-tier audit firms assign independent third persons to chair their oversight/assessment bodies and “nomination,” “compensation” and “audit” subcommittees in order to improve the effective use of them.

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	5	1	1	2	2
Small and medium-sized audit firms	–	3	2	–	–

(Reference) Prepared by the CPAAOB from CPAAPB inspections and reference material released by each audit firm in PY2021. The number is the total of independent third persons at firms grouped by scale. If more than one is assigned at a firm, the number is the total of them.

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 audit quality indicator (AQI) 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. Some firms gave accounts for measures to address key audit matters (KAMs) and COVID-19 infections, according to reports on the quality of audits, etc., issued in FY2020, and gave accounts for measures for disclosure of non-financial information and responses to new Quality Control Standards in FY2021.

(ii) Mid-tier audit firms

Mid-tier audit firms issued reports on the quality of audit, etc., mainly to explain their organizational structure and quality control, and they have posted them on their websites. The reports are more simplified in content than those released by large audit firms. They include reports omitting explanations of audit quality indexes, plans to develop human resources such as educational programs and training curriculums, and so forth, which are available in reports by large audit firms. Some firms released the assessment of current efforts to improve the quality of audits by constituent members, such as results of in-house questionnaires about quality control.

(iii) Small and medium-sized audit firms

Six out of nine 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 have conducted surveys and dialogues, related to the quality of audits, of chief financial officers (CFOs), auditors and others of audited companies. Recently, they have worked on securing dialogue with market participants and others on a broader basis through measures such as hosting sessions, in the presence of independent third persons, to exchange opinions with institutional investors and analysts.

(ii) Mid-tier audit firms

Some mid-tier audit firms appeared to conduct surveys, related to the quality of audits, of CFOs, auditors and others of audited companies. There are also cases in which firms make use of the meetings held for investors by the JICPA or exchanges instead of hosting sessions individually.

(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 and their responses are no more than exchanging information between engagement teams and the chief financial officers (CFOs), audit and supervisory board members etc. of audited companies.

The current Audit Firm Governance Code has not been reviewed since it was drawn up in March 2017 and is said to include principles and rules that do not fit in with the management of small and medium-sized audit firms. A report released by the Subcommittee on the Certified Public Accountant System of the Financial System Council in January 2022 said that it is plausible to require audit firms, which audit listed companies, to comply with the Audit Firm Governance Code as a form of discipline. But as the current code is formulated with the organizational management of large audit firms in mind, the report recommended that amendments to the code should be examined so as to equally contribute to the securement of quality in the auditing of listed companies by mid-tier audit firms and small and medium-sized audit firms and adopt principles for the effectiveness of audits in accordance with the scale and other factors of audit firms.

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 13).

Many mid-tier audit firms and small and medium-sized audit firms, meanwhile, find it difficult to recruit enough CPA examination passers and thus tend to have a larger portion of CPAs hired midcareer. The recruits are mainly CPAs who have left large-sized audit firms, and in this way they are endeavoring to secure the necessary headcount for audit engagements etc.

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

The number of partners and full-time staff members, analyzed on the basis of scale, has generally leveled off at large audit firms since FY2017 and has been on the rise at mid-tier audit firms during the same period. At small and medium-sized audit firms, it turned upward in FY2017 due in part to the establishment of new firms after showing a downward trend until FY2016.

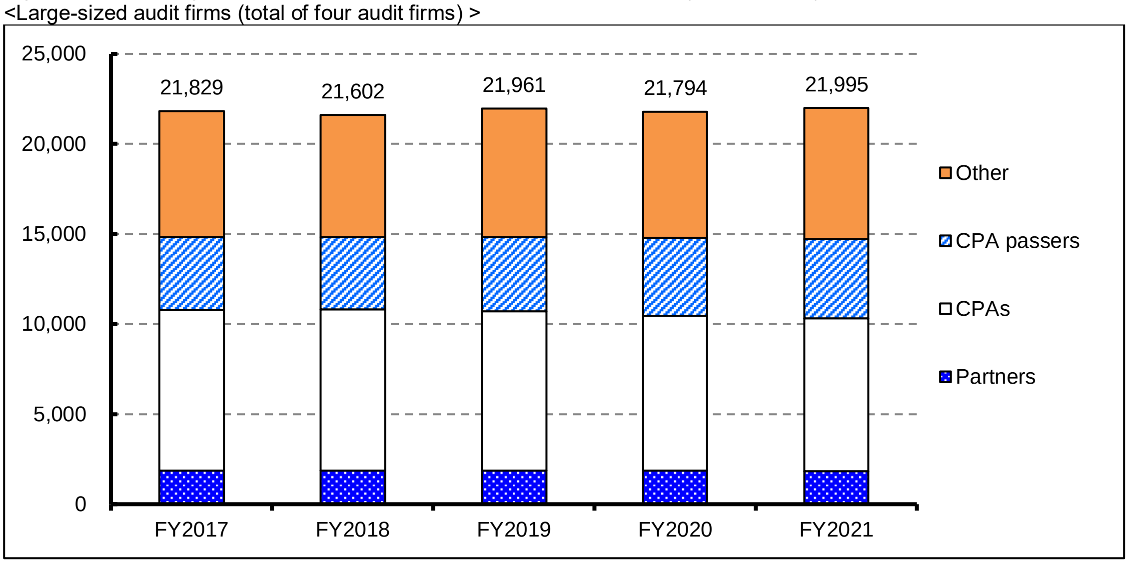
As far as the structure of manpower is concerned, the number of CPA examination passers, etc. turned to increase in or after FY2019 at all audit firms in disregard of scale. The number of staff members other than CPAs and CPA examination passers, has also been on the rise at all audit firms in recent years. According to the latest data, non-CPA staffs account for 33% of the total workforce at large-sized audit firms, 30% at mid-tier audit firms, and 27% at small and medium-sized audit firms. Compared with FY2017 (FY2016 in the case of small and medium-sized audit firms), the ratio rose sharply from 25% and 14% at mid-tier audit firms and small and medium-sized audit firms, respectively, and slightly from 32% at large-sized firms (see Figure III-1-6).

Audit firms have increased their staff members other than CPAs and CPA examination passers, to deal with the audited companies promoting IT, to improve operational efficiency, to address personnel shortages, and to facilitate CPAs to focus more on judgmental tasks, and so on. Among these personnel are IT experts who conduct IT audits with the use of technologies and support engagement teams in carrying out audit procedures using IT, and audit assistants who support engagement teams by sending/receiving balance confirmation letters, preparing various reports, and sorting data.

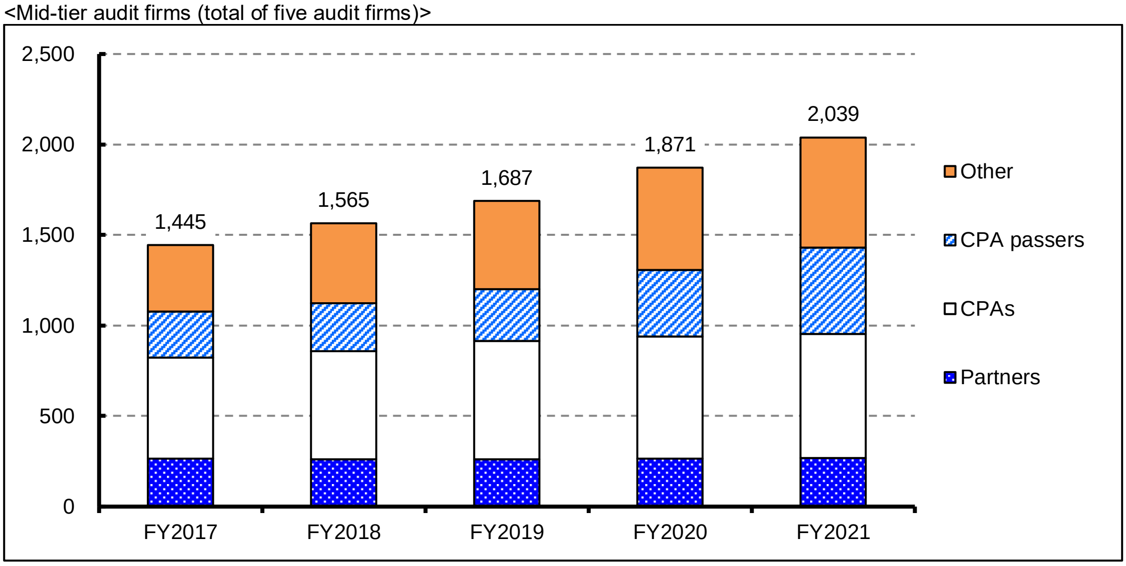
Some large-sized audit firms have improved their operations by establishing specialized organizations to centrally manage such things as audit assistants' work/procedures, skill development, and job allocations.

Figure III-1-6: Change in the number of partners and full-time personnel (unit: persons)

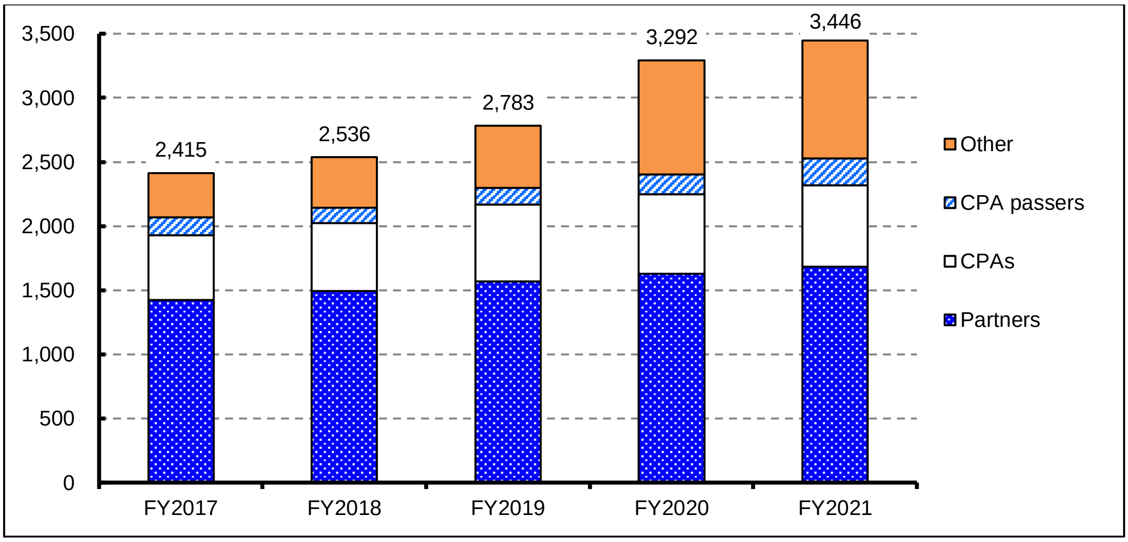
<Large-sized audit firms (total of four audit firms) >



<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 FY2020 have not yet been compiled. As a result, the figures for small and medium-sized audit firms only cover the period to up to FY2020.

(Note 2) The number of small and medium-sized audit firms varies from year to year, but 237 such firms are included in the figures for FY2020.

■ Promotion of remote work at audit firms ■

Amid the global spread of novel coronavirus infections since early in 2020, society-wide anti-infection efforts have been underway in Japan as in other countries.

Under the unavoidable behavioral restrictions as part of anti-coronavirus measures, the way of offering audit services has greatly changed. Audit firms have been promoting operations incorporating remote work on top of the conventional method of sending auditors to client companies.

Audit firms continued efforts, as mentioned in the chart below, in PY2021 to select optimum places of work based on purposes in order to simultaneously implement anti-coronavirus measures and high-quality audit services effectively and efficiently.

Place of work	Main purposes
Home	• Efforts for new ways of work • Anti-coronavirus measures, etc.
Audit firm	• Promotion of communication within the audit team • Human resources development through training and other programs, etc.
Audited companies	• Promotion of communication with audited companies • Reading of original texts and others, etc.

b. Side businesses by partners

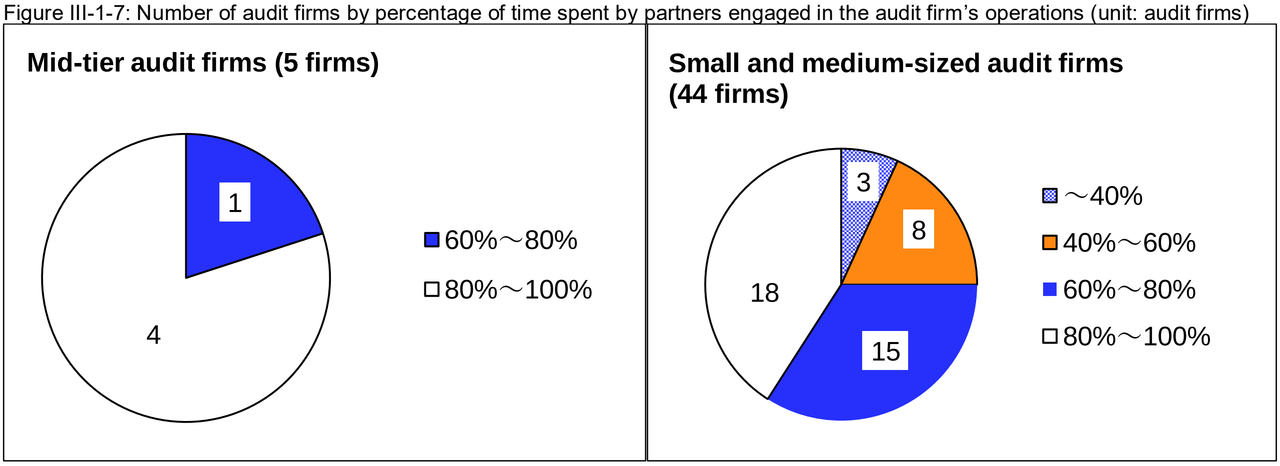
Large-sized audit firms do not permit dual work by partners at tax accountant offices or solo private accountant offices in principle.

While there are mid-tier audit firms that, like large-sized audit firms, do not permit dual work by partners, the ratio of those having dual work among all partners is about 60% at some of them.

Most small and medium-sized audit firms permit dual work as many partners are already operating a tax accountant office on their own when they joined them.

Figure III-1-7 shows ratios of hours spent on audit engagements by partners, including those engaging in dual work, at mid-tier audit firms and small and medium-sized audit firms as ascertained through inspections and collection of reports.

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 PY2021 the CPAAOB inspections and collection of reports

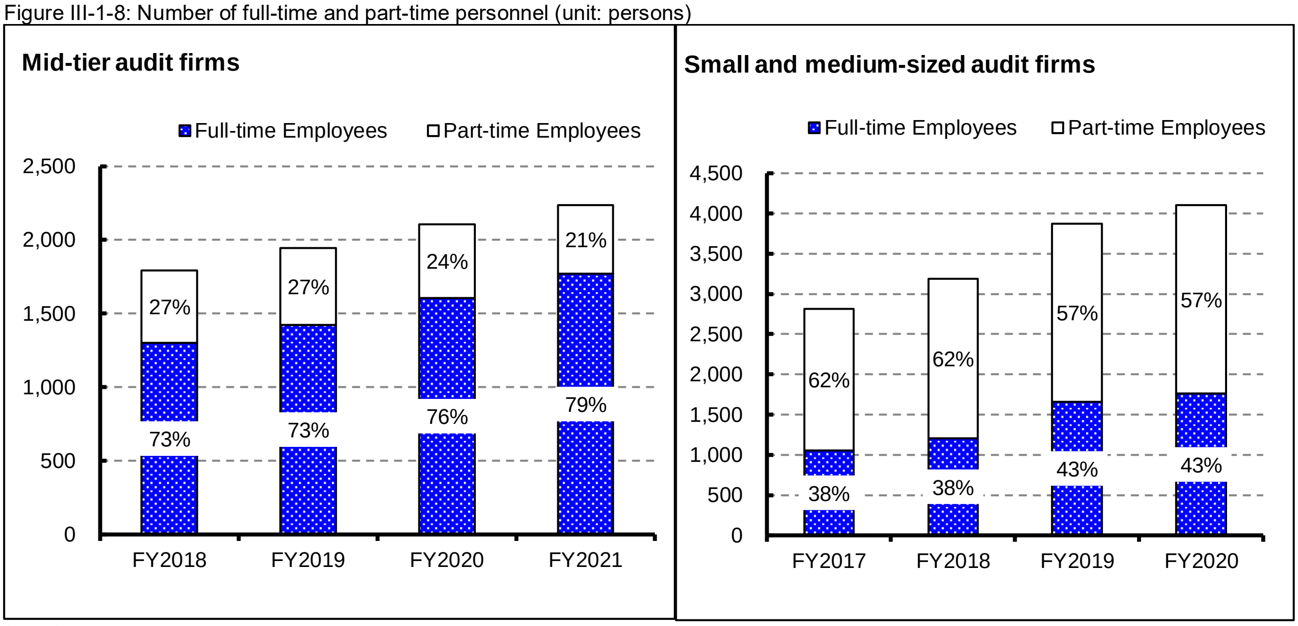
c. Part-time personnel

Part-time staff members account for an extremely low; around 3% to the total headcount at large audit firms.

While the ratio hovers at around 20% to 30% at mid-tier audit firms as a whole, it varies among them and stands close to 40% at some of them.

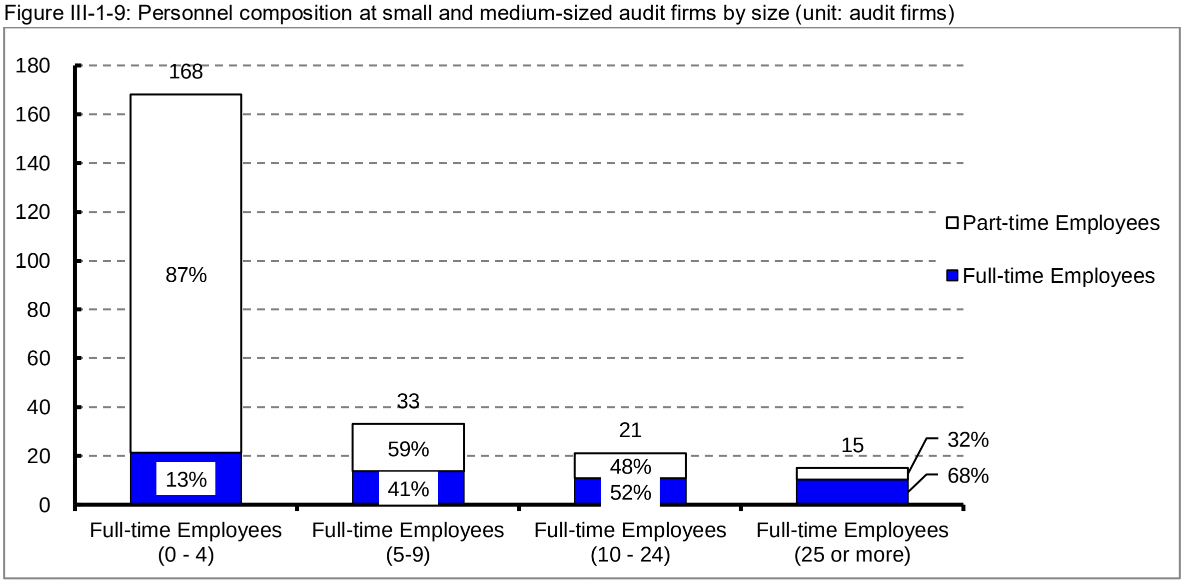
The ratio of part-time staff members stands at around 60% at small and medium-sized audit firms, some of which rely on them as the audit assistants needed for their operation (see Figure III-1-8). In particular, at audit firms with a full-time staff of four or less which occupies around 70% of small and medium-sized firms, the ratio of a part-time staff of which accounts for over 80% (see 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

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



(Note) The 237 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 FY2020, after which the number of fulltime 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[2], 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 including other monitoring activities.
This section elaborates the status of engagement teams.

An engagement team consists of an executive partner who takes primary responsibility, CPAs serving as audit assistants and other audit assistants. Other audit assistants include CPA exam passers and other audit assistants (staff members who are not qualified to be involved in the audit of financial statements by CPAs, etc.). If the business activities of an audited company are complicated and extensive in scale, IT, tax and other in-house experts join the team. As occasion demands, corporate value assessment and fraud experts of a group audit firm may also join the team. The general job classification-based formation of an engagement team (Note 1), formed by a large-sized audit firm to audit a big domestic listed company, is shown in Figure III-1-10.
Large-sized audit firms are implementing measures to reduce clerical work by CPAs at audit sites (where auditing services are actually performed), as mentioned in (5) organizational structure to support audit engagements. As a result, the number of members and job classification-based formation of engagement teams may change depending on the progress made in the measures.

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	One senior manager/ Manager	Senior manager/Manager	Management of engagement team, management of audits
Assistants to the engagement partners	One senior manager/ Manager	Senior manager/Manager	Management of foreign component audits
Assistants to the engagement partners	10 CPAs	Manager/Senior staff	Performance of audit procedures in significant audit areas
Assistants to the engagement partners	13 qualified assistants (CPA passers, etc.)	Staff	Performance of procedures for assessing the design and effectiveness of internal controls, performance of audit procedures other than important audit procedures
Assistants to the engagement partners	Four 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
Assistants to the engagement partners	Seven in-house experts (Note 2)	Partner, manager, senior staff, etc.	Assessment of IT control, verification of corporate tax, etc. treatment and of adequacy of retirement benefit obligations at audited companies

(Note 1) An example of an engagement team auditing a company having consolidated sales of approximately 1.6 trillion JPY that requires approximately 15,000 hours for audit engagements.
(Note 2) In-house experts are assigned to engagement teams as needed

2 An attitude with 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 key audit areas under the instruction and supervision of engagement partners. Inexperienced CPAs, CPA examination passers, etc. usually cover audit procedures for audit areas other than important audit areas. Audit assistants help with audit services by performing such administrative tasks as sending balance confirmation letters. As mentioned above, furthermore, there are cases such as large-sized audit firms consolidating services done by audit assistants at a separately established center for enabling CPAs to concentrate on work requiring their professional judgment by reducing their workload.
Although human resource for audit teams is limited, engagement teams at mid-tier audit firms have a structure of job demarcation in a merit-based manner as in the case of large-sized audit firms. Some mid-tier audit firms appear to step up the recruitment of audit assistants.
As human resources for audit teams at small and medium-sized audit firms is limited, some firms are unable to assign enough audit assistants to their teams. Compared with large-sized audit firms, therefore, the members with primary responsibility for auditing tend to play larger roles, such as needing to engage in audit procedures (Figure III-1-11).

< Structure of the engagement team in an audit of a financial institution >
To audit listed financial institutions subject to accounting and auditing procedures greatly different from those applicable to ordinary business enterprises, large-sized audit firms have set up mechanisms capable of performing an audit based on professional knowledge and experience, such as the establishment of financial business sections destined to audit the financial institutions. An engagement team to audit a listed financial institution involves knowledgeable members about the financial institution audit in such manners as forming a team mainly from a financial business section or deploying a primary responsible member from the section.

< Structure of the engagement team in an audit of an IPO >
No audit firm has an organization specializing in IPO audit, which is conducted by an existing audit section. To address risks inherent in IPOs (vulnerability of internal control, etc.), large-sized and mid-tier audit firms adopt such measures as primarily assigning workers well versed in IPO audit.
Many large-sized and mid-tier audit firms have established special organizations, such as an IPO support team to cope with requests for IPO-related services from companies aiming for IPOs or improve the quality of 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		・Setting material audit areas and assessing audit risks ・Reviewing audit procedures performed by assistants ・Communicating with management and the audit and supervisory boards	・Setting material audit areas and assessing audit risks ・Reviewing audit procedures performed by assistants ・Conducting audit procedures in material audit areas ・Communicating with management and the audit and supervisory boards	・Setting material audit areas, assessing audit risks, and drafting audit plans ・Reviewing audit procedures performed by assistants ・Conducting audit procedures (including material audit procedures) ・Communicating with management and the audit and supervisory boards
Assistants to the engagement partners	CPAs	・Draw up an audit plan ・Implement the audit procedure in key audit areas ・Review the audit procedure implemented by other audit assistants	・Draw up an audit plan ・Implement the audit procedure ・Inspect the audit procedure implemented by other audit assistants	・Implement the audit procedure (including data analysis and sending, collection and management of balance confirmation documents) ・Inspect the audit procedure implemented by other audit assistants
	CPA Passers, etc.	・Implement the audit procedures	・Conducting audit procedures	・Conducting audit procedures ・Not employed in most small audit firms
	Unqualified assistants	・Data processing, reconciliation of administrative vouchers, other tasks not requiring significant judgements ・Management of sending/ collection of balance confirmation letters, administration of audit documentation	・Data setting ・Administration of sending/ collection of balance confirmation letters, administration of audit documentation	・Not employed in most small audit firms

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

5. Organizational Structure for Supporting Audit Services

With audited companies becoming larger in scale and promoting the sophistication and internationalization of operations, audit firms need to not only provide expertise and develop IT-driven tools and systems but also support engagement teams through such means as setting up environments that contribute to efficient and effective implementation of operations.

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 support system

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: contract management, periodic review in relation to a system of quality control, accounting support, audit support, engagement quality control review, IT, international services, and risk management (Figure III-1-12). See "B. Engagement Quality Control Reviews" (page 71) and "C. Monitoring of Systems of Quality Control" (page 73) for information on engagement quality control reviews and periodic reviews. 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. Audit firms, especially large ones, are introducing, in addition to digitizing audit working papers, analytical tools to recognize unusual figures in journal entry data, AI-based tools to identify fraud risks, communications tools to facilitate the online exchange of information and reference material between audited companies and engagement teams, etc. (For progress in the digitization of auditing services, see 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 (page 69).

In addition, there is a case where large-sized audit firms establish organizations in charge of not only menial tasks, such as sending and collecting balance confirmation documents, checking the descriptions of securities reports, and entering and processing data for use by CPAs in audits but also confirmation work in certain audit services, such as management assessment procedure related to internal control, in order to enable CPAs and others to concentrate on tasks requiring their professional judgement. Organizations of such kind are located within an audit firm's existing office or newly established near Tokyo and regional cities. While their workload is done mainly by audit assistants at the organizations, audit firms carry out the provision of guidance and supervision in order to ensure a certain level of quality for the work, such as providing training programs for audit assistance and CPAs' check process for their works. With regard to the confirmation of balances, Audit Confirmation Center GK, jointly founded by large-sized audit firms in November 2018, has jointly developed a system to confirm receivables and obligations, provided an online platform related to the confirmation of balances, and is being entrusted with operations to send balance confirmation documents, etc. As such, large-sized audit firms, which are relatively stable financial-wise and have adequate human resources, are further reinforcing support in recent years to streamline operations by engagement teams through the development of various IT-based tools, division of clerical work and so forth.

Mid-tier audit firms have also quality control divisions, but they are smaller than those of large-sized audit firms. Furthermore, they are pushing ahead with the digitalization of audit working papers by, for example, adopting the audit-paper management systems used by their affiliated international network. There are many cases that small and medium-sized audit firms do not have a quality control section and instead appoint a person in charge of quality control or top management concurrently take charge of quality control. 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, mid-tier audit firms and small and medium-sized audit firms have the bottleneck in financial foundations and human resources compared with large-sized audit firms, which may make it difficult to take steps like large-sized audit firms. As a result, variation in the environment for audit engagement support appears to be further expanding 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	Contract management department	Approving acceptance and continuance of audit engagements
	Periodic inspection department	Ongoing monitoring and implementing periodic review in relation to a quality control system
	Accounting support department	Responding to technical inquiries concerning accounting standards, procedures, etc.
	Audit support department	Responding to technical inquiries concerning audit standards, manuals, and procedures
	Engagement quality control review department	Performing engagement quality control review as well as the higher-level reviews against material or high risk issues
IT division		Auditing IT areas of audited companies, supporting engagement teams with the use of IT audit tools
International division		Collecting/providing local information overseas and liaising with network firms, etc
Risk management division		Responding to inquiries concerning professional ethics and independence, collecting and analyzing risk information, supporting responses to risk of fraud, etc.

b. Management of risk information

Audit firms develop and maintain the firm-wide 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 through gathering information for past and current years and implementing continued monitoring and support to engagement teams
- Establishing a procedure to obtain internal or external expert advice when a situation which indicates material fraudulent misstatement or a suspicion of material misstatement caused by fraud is identified , Issuing instructions for the launch of higher-level review
- 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 in the risk of fraud or considering high-risk matters

6. Domestic Audit Firm Groups

a. Structure of domestic audit firm groups

Many large-sized and mid-tier audit firms have formed their own audit firm groups that use common brand of global networks they have joined. And within the group, audit firm and other entities cooperate with each other in providing services in Japan (hereinafter, such groups are referred to as "domestic audit firm groups"). Besides the audit firms, these groups generally include consulting companies, financial advisory companies that carry out financial due diligence and provide financial advice on M&A deals, tax accountant firms, and attorney firms ("group companies"). The average number of companies in a large-sized audit firm's group is around 15, while that in a mid-tier audit firm group is around four.

In terms of structure of a domestic group to which large-sized audit firms belong, there are many examples of firms setting up holding company like companies to manage a global brand and putting the group companies on par with the audit firm, but there are also audit firms directly investing in group companies (excluding entities of certified experts such as tax accountant firms or attorney firms, etc.) and making them subsidiaries.

Domestic groups to which large-sized audit firms belong generally establish 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

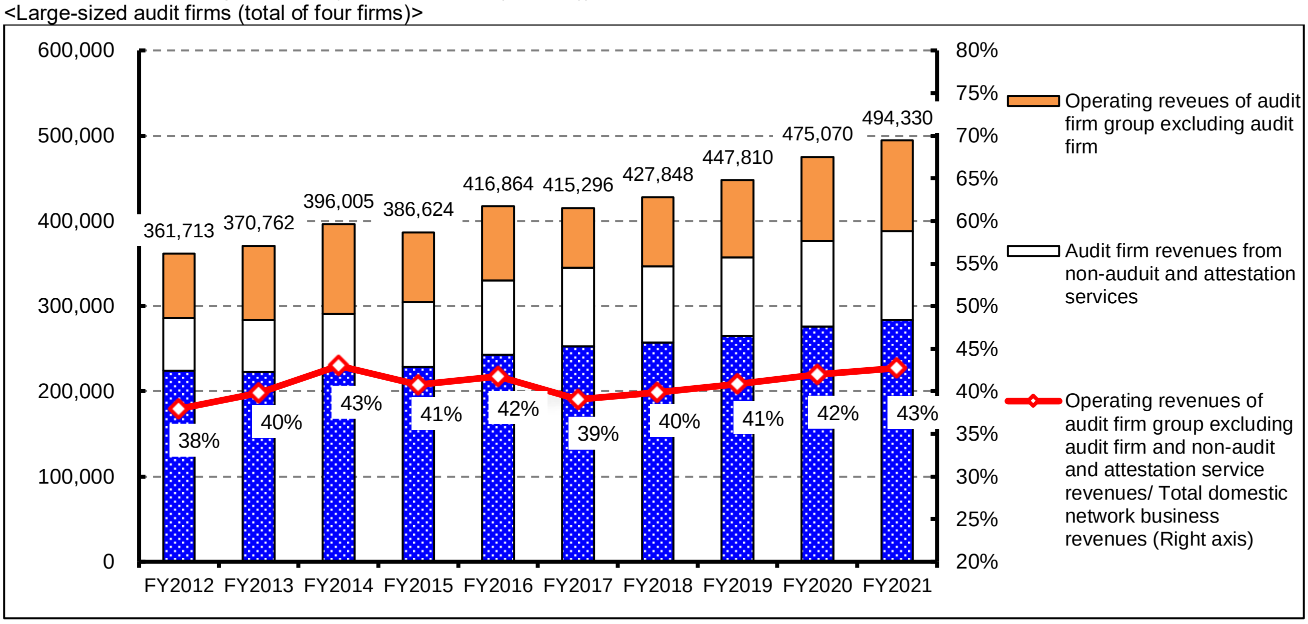
The ratio of non-audit and attestation revenue to operating revenue at groups consisting of audit firms and their subsidiaries, etc. ("audit firm groups")[3] had steadily risen to reach 43% in FY2014. The ratio once decreased to 39% as certain large-sized audit firms spun off non-audit and attestation services and subsidiaries from them, subsidiaries and so forth in FY2015 and FY2017, but it has been on an upward trend in recent years due to increases in revenue of group companies (Figure III-1-4). (For audit firms' operating revenue, 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 18).)

At mid-tier audit firm groups, the ratio of non-audit and attestation revenue has stayed lower than at large-sized audit firms, moving roughly in a range between 10% and 14% from FY2012 through FY2021. Group revenue structure of mid-tier audit firm groups is largely different from large-sized audit firms as audit and attestation revenue accounts for a large portion of total group revenue at the latter (Figure III-1-15).

Regarding small and medium-sized audit firms, few firms have group companies, which indicates that non-audit services seem to be provided by the audit firms.

[3] Some group companies that do not have capital relationship with an audit firm have operating revenue of several tens of billions yen.

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 of audit firm groups include revenues from companies that fall under subsidiaries, etc. of an audit firm within the group, in principle, as well as revenues from subsidiaries, etc. offering intra-group services.

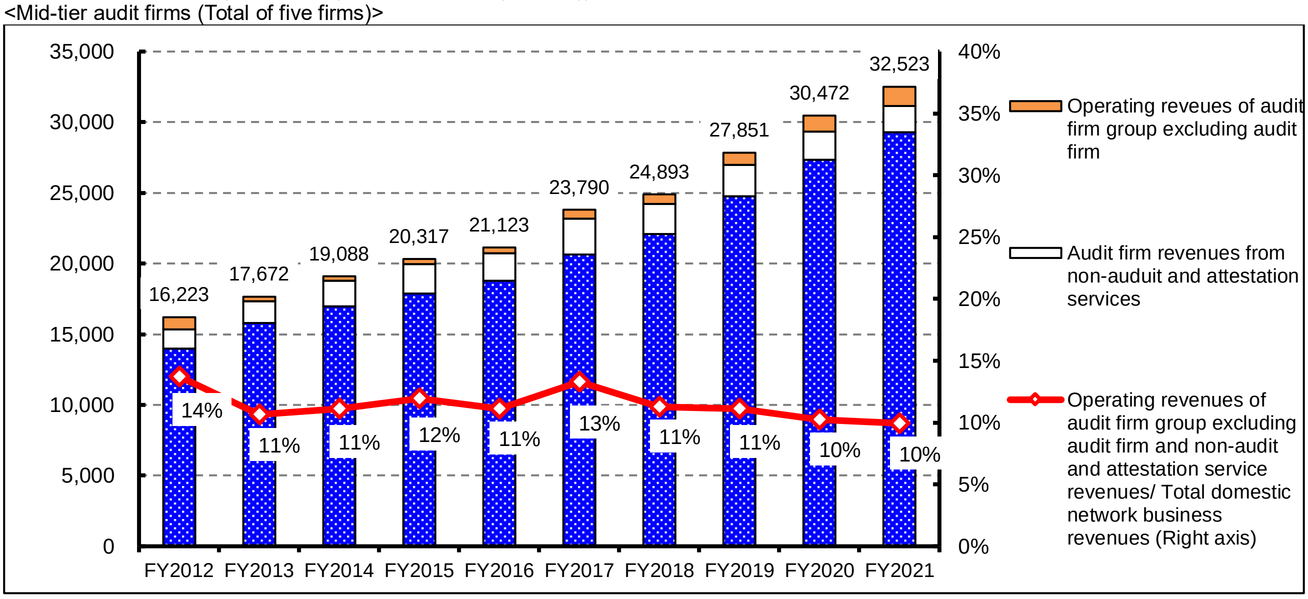
(Note 2) Non-audit and attestation service revenues are the total of the non-audit and attestation revenue of the audit firm and the revenues of the subsidiaries etc. of the audit firm.

(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 or subsidiaries that perform non-audit and attestation services

(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 groups include revenues from companies that fall under subsidiaries, etc. of an audit firm within the group, in principle.

(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 auditors 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 style

An engagement quality control review 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. For large-sized audit firms, the review is conducted with regard to the entirety of audit engagements, from planning to forming an audit opinion, throughout the period of the audit.

However, in the case of the concurring review partner style, the quality of the review is heavily influenced by the abilities of specific EQC reviewers. 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 style

The council style 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 the case with the concurring review partner style.

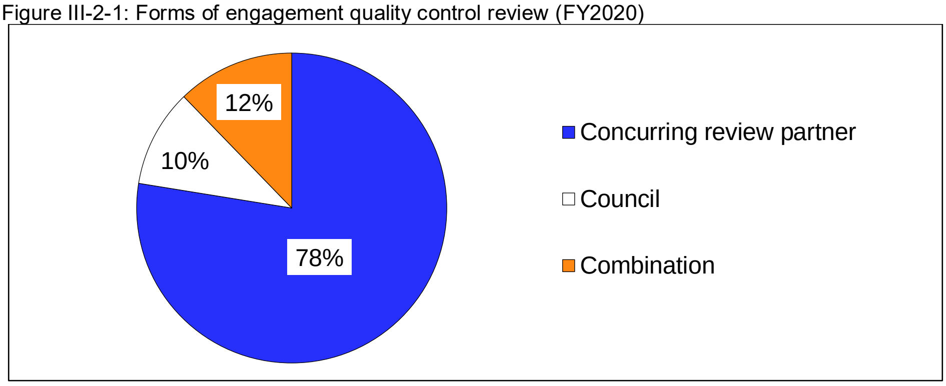
On the other hand, as the conclusions are those of the council and not the individual EQC reviewers, each of the reviewers - members of the council - may feel less of a sense of responsibility. Furthermore, as multiple reviewers examine a single issue, the total time required for the review is normally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

c. Combination style

The combination style can involve the concurring review partner style 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 style or the council style 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 (FY2020)



(Note) Aggregated the status of 247 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 style and the council style. 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 brought up before a review committee at headquarters. Furthermore, during reviews, some firms have reinforced independence from executive departments in the review division to ensure that decisions harmful to 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 style, though some perform engagement quality control reviews using the council style or the combination style.

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

The inspection section and others often monitor inspection results, etc. and time spent for inspection. In

addition, there are cases in which the inspection section and others use the ratio of time involving inspectors of audit services, executive partners, etc. as audit quality indexes.
There also are audit firms implementing programs to further improve audit functions, such as reinforcing the information sharing among inspectors, carrying out inspection-related compulsory training programs and increasing the number of workers primarily engaging in inspections.

C. Monitoring of Systems of Quality Control

Audit firms should take primary responsible for maintaining and improving audit quality, and in this sense, it is important for them to positively take the initiative in improving audit quality.
For this, it is important for audit firms to understand and continuously have remediation in place on audit engagements in a timely manner. The CPAAOB inspects the monitoring of audit firms' quality control systems.
Furthermore, when an audit firm is a member of the global networks, it is sometimes the case that the global network, with the aim of ensuring consistency of 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"). Given that large-sized audit firms have introduced the global review system into the quality control systems, the CPAAOB describes how those firms utilize global reviews in this section.

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 sizes 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, the results of the inspections and the identified deficiencies are shared for raising risk awareness to all partners and staff at each firm through in-house training, etc.
Moreover, the inspection results are usually reflected on performance evaluation of engagement partners at large-sized audit firms and some mid-tier audit firms to boost the effectiveness of audit quality improvements.

In recent years, some large audit firms have set up a section tasked with monitoring audit services to enhance the objectivity and effectiveness of monitoring in their quality control systems. They conduct periodic verification mainly by members of the section.

Figure III-3-1: Overview of the periodic inspections conducted in FY2021

	Large-sized audit firms	Mid-tier audit firms	Other
Number and method of selection of audit engagements to be inspected	Each engagement partner is mandatory inspected at least once every three years. Additional inspections may also be performed based on the scalability and complexity of audited companies.	Each engagement partner is mandatory inspected at least once every three years. Additional inspections may also be performed based on the scalability and complexity of audited companies.	Each engagement partner is mandatorily inspected at least once every three years.
Inspectors	Under the supervision of quality control, partners and assistants who are not involved in inspected audit engagements	Under the supervision of quality control, partners and assistants who are not involved in inspected audit engagements	Persons not involved in inspected audit services (including those outside an audit firm concerned) under the supervision of a partner in charge of quality control.
Number of inspectors	Between around 40 and 180	Between a few and around 20	Between one and around 15
Number of engagements handled by each inspector	One to two engagements	One to two engagements	One to five engagements
Inspection framework (procedures, assessment policy), tools to be used	Conducted under the Inspection framework and tools provided by the global network. Regarding responses to specifically Japanese auditing standards, many firms have partially tailored the global network's tools, such as adding items.	Conducted based on an inspection framework determined by the firm independently and tools.	Conducted based on each firm's own inspection framework. Many firms use "Checklist for Periodic Inspections" and "Audit Service Review Procedures" provided by JICPA as inspection tool.
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 them in evaluations of partners and staff.	Inspection results are shared within the firm.

(Note) The number of verifications per verifier was calculated by dividing the number of audits subjected to periodic verifications conducted in FY2021 by the number of verifiers involved.
(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 are focusing more on the implementation of high quality audit engagements. 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 comply with the manual. Large-sized audit firms and some mid-tier audit firms undergo a global review by the global network every year.

Global networks other than the Big Four sometimes require their member firms to comply with the audit manual provided by the global network to the same degree as that of the Big Four, but most of them operationalize more relaxed rules than the Big Four. Given that global networks do not necessarily require their member firms to conform to local or international auditing standards, there is a wide variation in the nature and frequency of global reviews (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 95).

While all large and mid-tier audit firms are subject to the global review, most small and medium-sized audit firms, belonging to the global networks, are not reviewed (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 global network reviewers.	In most cases, the global review is performed by global network reviewers.	In most cases, the global review is performed by reviewers appointed by the global network. Sometimes the results of self-inspections using a checklist for global reviews are reviewed.

(Note) Few small and medium-sized audit firms etc. are members of global networks.()
(Source) Prepared by the CPAAOB based on information obtained through the CPAAOB inspections or the collection of reports

3. Monitoring before expression of audit opinions

Monitoring is conducted prior to the expression of audit opinions especially by large audit firms as a measure to improve the quality of audits in recent years.

Monitoring before the expression of audit opinions is an operation assigned to a reviewer, designated by the quality control sector or audit services sector, to promptly find problems in quality control and prompt the audit team to take timely remedies.

Monitoring, furthermore, is often carried out in audit areas involving high risks, such as fraud or going concern, and those where deficiencies are continuously detected through external inspections and internal regular inspections, such as accounting estimates.

D. Education, Training and Evaluation of Audit Personnel

In order to maintain and improve audit quality, audit firms need to provide their audit personnel with opportunities to acquire necessary expertise and also need to evaluate them appropriately. It is particularly important to train and properly evaluate the audit personnel who can exercise the professional skepticism needed to detect accounting fraud. The CPAAOB monitors and inspects recruit, training, and assignment of, and evaluation/compensation, etc. for partners etc. of audit firms.

In this section we elaborate audit firms' human resource development, education, training, and evaluation of its audit personnel (including engagement partners with primary responsibility).

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 in quality control activities and advisory and other non-audit services
- Placing personnel overseas at network firms
- Seconding personnel to locations outside the audit firm (e.g., domestic group firms, JICPA and other relevant organizations, business companies, etc.)

In addition, programs aimed at retaining human resources have been introduced, such as the adoption of flexible working arrangements, review of personnel evaluation programs, including compensation, and provision of various career plans through counseling and of work opportunities matching career plans. Some audit firms provide on-the-job training for young staff members on a one-to-one basis. There also are firms where counseling sessions are held on a group basis, such as those involving staff members of the same generation, to attend to their motivation. Among other cases, a mentor system that enables workers to seek advice on their personal problems helps reduce the rates of turnover and absence from work, while the turnover rate is monitored as a audit quality index along with efforts to improve work environments for the enhancement of workers' interest in audit services.

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	・ Establishing a training section within the human resources department to design and operate training programs for each job classification and level of experience ・ Audit firms implement a series of training programs for updating accounting and auditing standards, utilization of monitoring tools, responses to fraud risks, results of periodic verifications, inspections by the CPAAOB, quality control reviews by the JICPA and so forth, professional ethics and independence, information security and auditing. ・ Conducting examinations to measure understanding of training ・ Audit firms provide support for acquiring language-related qualifications and implement language training programs at home and abroad (including online training) ・ 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
Small and medium-sized audit firms, partnerships and solo practitioners	・ 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 ・ Sharing results of periodic inspections, the CPAAOB inspections, and JICPA quality control reviews within firms

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 and having decided to adopt IFRS have now exceeded 250 in Japan, there has been an increasing number of partners and staff involved in audits of companies adopting 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	・ Introducing in-house IFRS certification, and providing periodic training on updates of the standards for certified personnel ・ Setting up sections within the firm specializing in the interpretation and specific application of IFRS, and distributing necessary guidelines within the firm, in addition to providing advice to and having consultations on specific issues with audit teams Audit firms dispatch personnel to the organizations within the networks they belong to that interpret the IFRS and examine the application policy of them. Or they hold periodic sessions to exchange views with the organizations concerned.

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 ongoing effort 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

Large-sized and mid-tier audit firms evaluate partners based on their contribution to audit quality and the management of the firms and the exploitation of new business. In particular, they have adopted evaluation methods placing emphasis on audit quality. For example, large-sized audit firms make assessment as mentioned 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 73) 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 required improvement. Some audit firms adjust partner compensation and assignment of audited companies 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 not often 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 a seven to 10 year and to partners, following a selection process, after a further seven to 10 year. As small and medium-sized audit firms rarely hire newly qualified CPAs, they often hire mid-career CPAs on the assumption that they are going to be promoted to partners. Many large-sized and mid-tier audit firms evaluate personnel based on their understanding of auditing standards related to audit quality, communications skills within an engagement team, management skills (including capacities for an international issue) and so forth. Although small and medium-sized audit firms evaluate personnel in a similar manner, many of them have not established a policy of recruit or promotion systems 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 reviews this matter through the monitoring activities, and endeavors to understand 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.

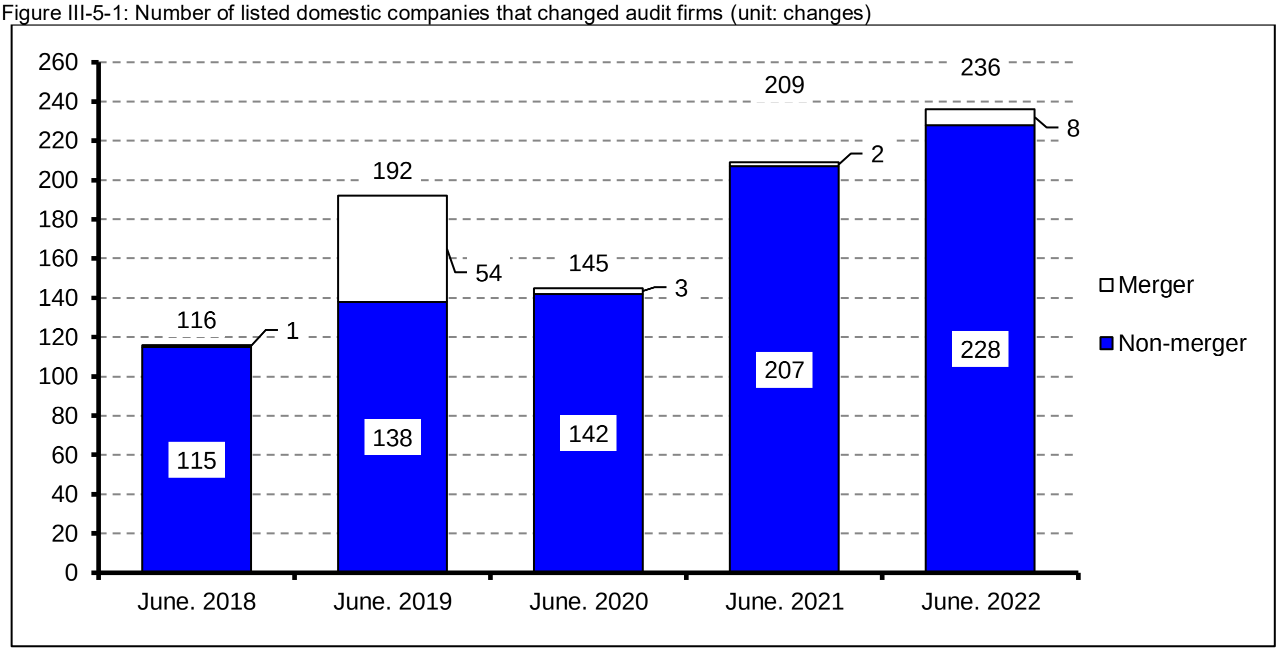
Large sized audit firms occasionally receive the proposal on audit engagement through providing non-audit and attestation services to companies other than audited companies and deepening the relationships with them. Still, on the occasion of changing an accounting auditor, an audited company often asks for audit proposals to multiple audit firms. In such a case, an audit firm often acts in an organized manner for accepting a new audit contract, such as involving a partner familiar with the industry.

In contrast, the conclusion of new audit contracts by mid-tier audit firms and small and medium-sized audit firms is being made through introduction by acquaintances of their partners or workers, etc., or by receiving inquiries via firms' websites or requests for audits from customers to which they provide non-audit and attestation services.

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.

There were 236 cases of changing auditors at domestic listed companies in the year to June 2022, the largest number over the last five years (Figure III-5-1). During that five-year period, changes in the year to June 2019, included many changes caused by mergers such as those between mid-tier audit firms. Excluding changes through mergers, the cases have been on the rise since the year to June, 2018.For information on mergers, see "I. Overview of the Audit Sector, B. Audit Firms, 4. Mergers of Audit Firms" (page 17).

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

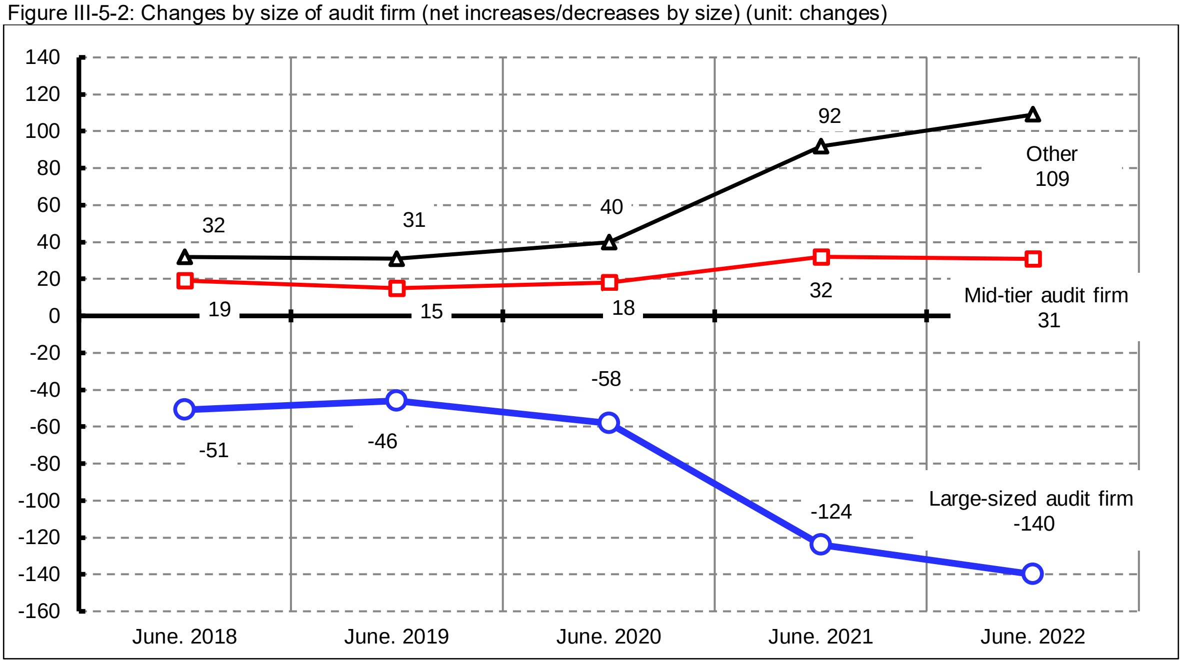


(Note) The figures above show the number of companies that had decided on an incoming auditor by the end of June of each period, based on timely disclosures of listed domestic companies.

As can be seen from changing auditors 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 2022 (Figures III-5-2 and III-5-3). This trend is likely in connection with business administration at large-sized audit firms related to the continuance of audit contracts. For information about business administration concerning continuance of audit contracts at large-sized audit firms, see "3. Reasons for Changes in Accounting Auditors as Identified Through Monitoring Activities" (page 83).

The above-mentioned shift from large audit firms to mid-tier as well as small and medium-sized audit firms indicates an increase in the role of small and medium-sized audit firms in auditing listed companies. But the recent inspection of small and medium-sized audit firms by the CPAAOB discovered inadequate systems to properly conduct audit services, making it imperative for them to maintain and improve their audit quality. As a result, the CPAAOB will put greater emphasis on the inspection of small and medium-size audit firms.

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 2021	June 2022	Increase/Decrease
Large-sized	→	Large-sized	19	19	0
	→	Mid-tier	42	45	3
	→	Other	87	97	10
Mid-tier	→	Large-sized	2	1	▲1
	→	Mid-tier	0	5	5
	→	Other	12	15	3
Other	→	Large-sized	3	1	▲2
	→	Mid-tier	4	2	▲2
	→	Other	40	51	11
Total			209	236	27

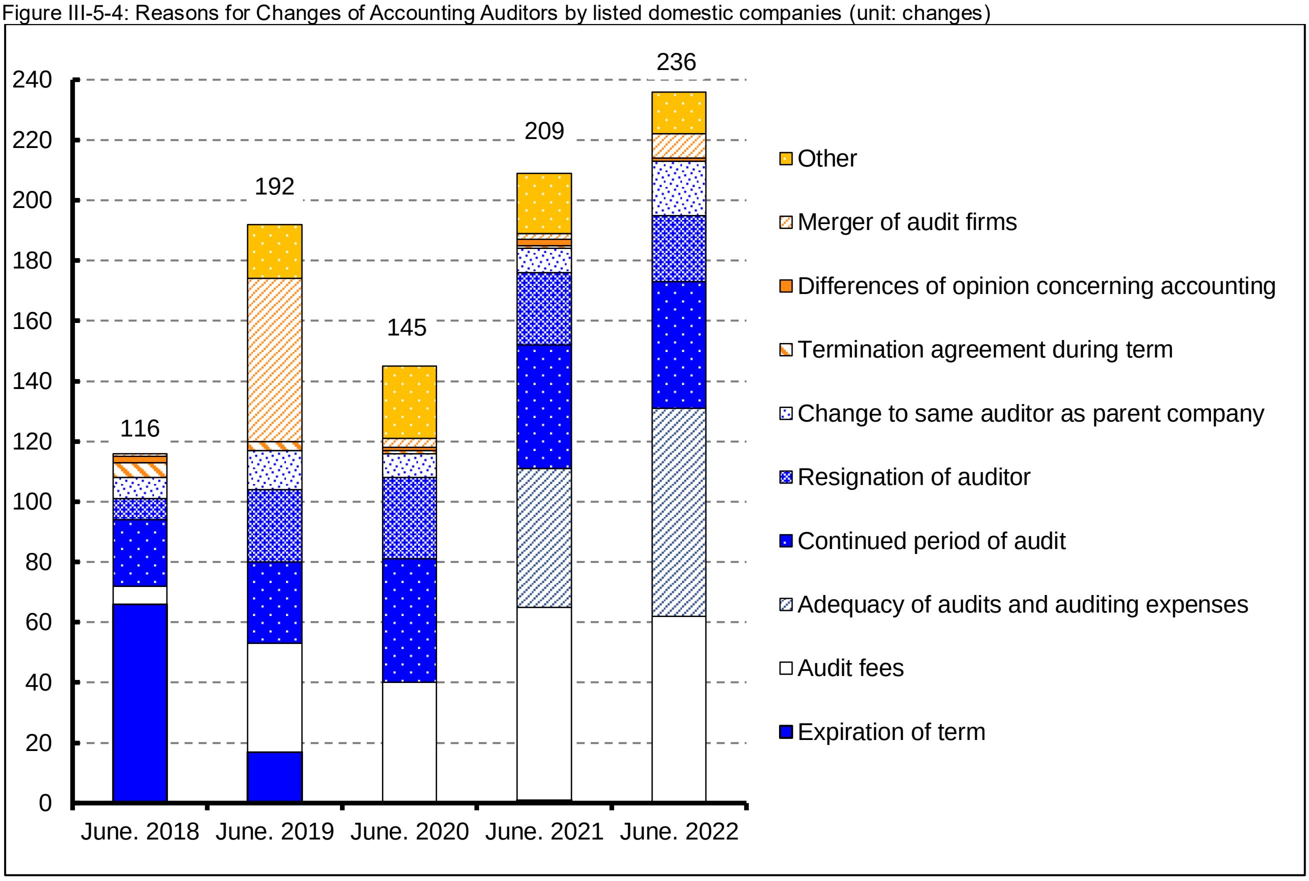
(Note 1) Aggregates of number of companies that had decided on an successor auditor by the end of June of each period, based on timely disclosures by listed domestic companies
(Note 2) "Other" in the figure refers to small and medium-sized audit firms, partnerships and solo practitioners.
(Note 3) Effects of mergers included those in two mergers involving small and medium-sized audit firms in the year to June 2021 and eight in the year to June 2022. As the mergers were made between firms of the same scale, they did not affect the figures in Figure III-5-2, which shows a net increase or decrease in the number of transfers categorized by scale.

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 shall disclose the change and reason for the change immediately (Article 402 of the Securities Listing Regulations, Tokyo Stock Exchange).

Under the regulations above, the most common reason for the changes was just described as "the expiration of the audit contract" in the disclosures and in many cases, any substantial reason have not being given in the disclosures made in the year to June 2018 (Figure III-5-4). After the year to June 2019, more companies gave the additional explanation in addition to expiration of the audit contract as the reason, and there was a sharp drop in the number of companies only giving expiration of the audit term as the reason. In the year to June 2022, there were many cases of proposed increase in audit fees and the prolongation of continuous audit term, and cases where companies opted for change after examining the audit services based on their scale and the adequacy of audit fees in comparison with other audit firms.

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



(Note 1) Complied by the CPAAOB based on timely disclosures by listed domestic companies choosing new auditors by the end of June each year.
(Note 2) In the case of two or more reasons disclosed, the classification was made based on principal reasons.
(Note 3) Prior to the year to June 2020, the "adequacy of audits and auditing fees" was included in "others." While there was no reference to it in the year to June 2018, it was mentioned in four cases in the year to June 2019 and eight in the year to June 2020.

2. Reasons for Change of Accounting Auditors during Fiscal Term

In the year to June 2022, in five cases, out of 236 cases, companies changed auditors in the middle of the fiscal year. Cancellation of contracts or resignation from the role due to improper accounting and other reasons at audited companies was the reason for many cases.

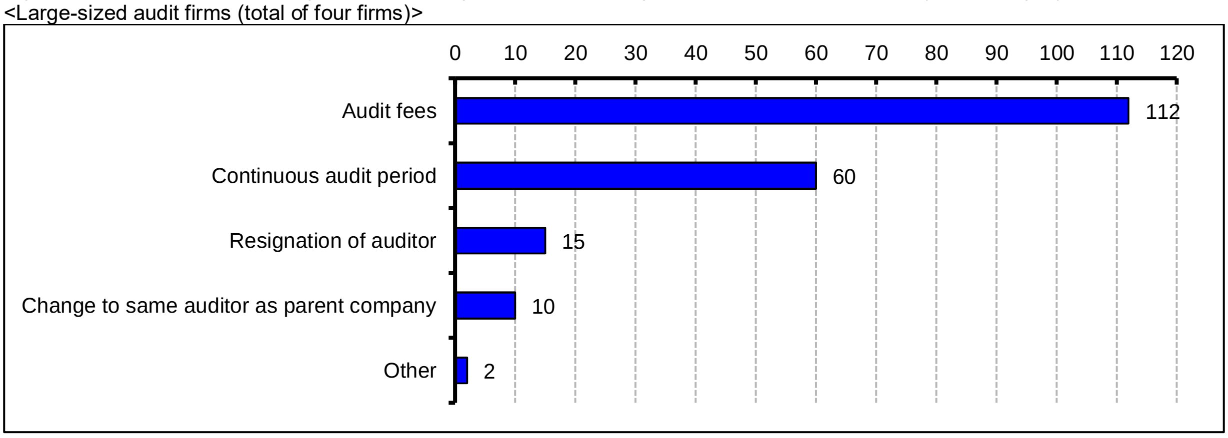
3. Reasons for Changes of Accounting Auditors as Identified Through Monitoring Activities

This section lays out reasons for changing accounting auditors ascertained through monitoring activities in PY2021 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 PY2021 and the number includes the previous year's figures 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, similar to 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 referred to 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 while 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 applicable to continuously serve as an auditor, 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)>

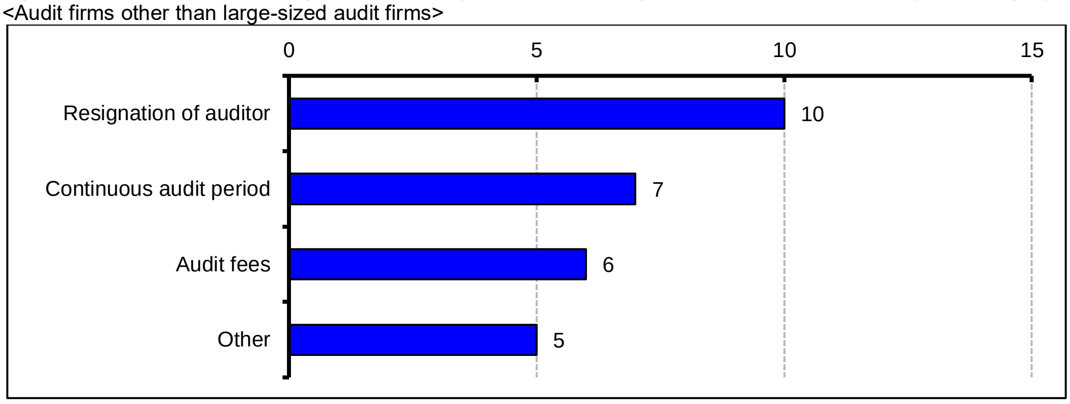


(Note 1) Based on data from 142 changes identified through inspections and report collection during PY2021
(Note 2) If there was more than one reason, that change is included in the figure for each reason (a cumulative total of 199)

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

"Resignation proposed by auditors, etc." formed the largest number of reasons for 22 cases of changing auditors (who replied as former auditors) identified through the inspection of mid-tier audit firms and small and medium-sized audit firms and the collection of reports from them. Conceivable factors behind the reason include the shortage of auditors, in addition to bleak audited companies' performance, detection of improper accounting operations, and increased audit risks accompanied by fragile accounting systems (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 22 changes for which the reason was identified through the inspection by the CPAAOB in PY2021 and reports collected from five mid-tier audit firms and 35 small and medium-sized audit firms, 9 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 24)

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.
On the other hand, the JICPA’s Code of Ethics states that an audit firm may quote whatever fee deemed appropriate based on the content and value of services, while the quotation of a low fee without due foundation may make it difficult to offer professional services of a certain level. Therefore, the code calls for examination of safeguards, such as those mentioned below, to ensure a certain level of audit quality.

a. To win audited companies’ understanding of the basis of audit fees and the contents and terms of services offered.
b. To assign an 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).

■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 as such R&D expenses are expected to increase, there is a movement to explore new methods of calculating audit fees estimates.

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 spend by a certain unit price (hereinafter referred to as the “charged rate”).
Fixed fees and hourly rates	Audit fees comprise two components: the fixed fee (a fixed amount) and the hourly rates (a variable amount). 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.

(Source) Prepared by the CPAAOB based on “Guidelines for the Calculation of Audit Fees” (October 2003), JICPA

According to the reports collected in PY2021, audit fee estimates are calculated as follows.

a. Large-sized audit firm

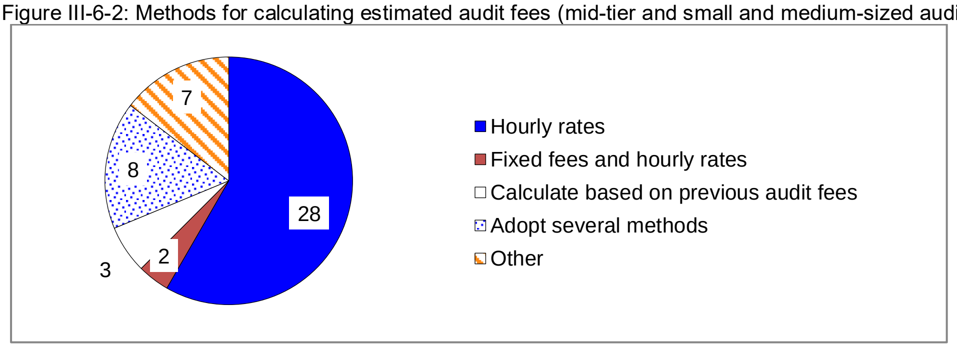
All large-sized audit firms state that they adopt the hourly rates approach for audit fee estimates. Hourly rates are set for each hierarchy level of employee, and the rate is determined while considering indirect costs associated with firm management and quality control such as the payrolls of administrative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

Many firms charge fees based on the hourly rates approach. There are also firms that combine basic and service execution fees, calculate fees on the basis of fees in the past, or use a number of 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 PY2020

Regarding the hourly rates approach, 70% 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	13	27%
Rates not set	35	73%
Total	48	100%

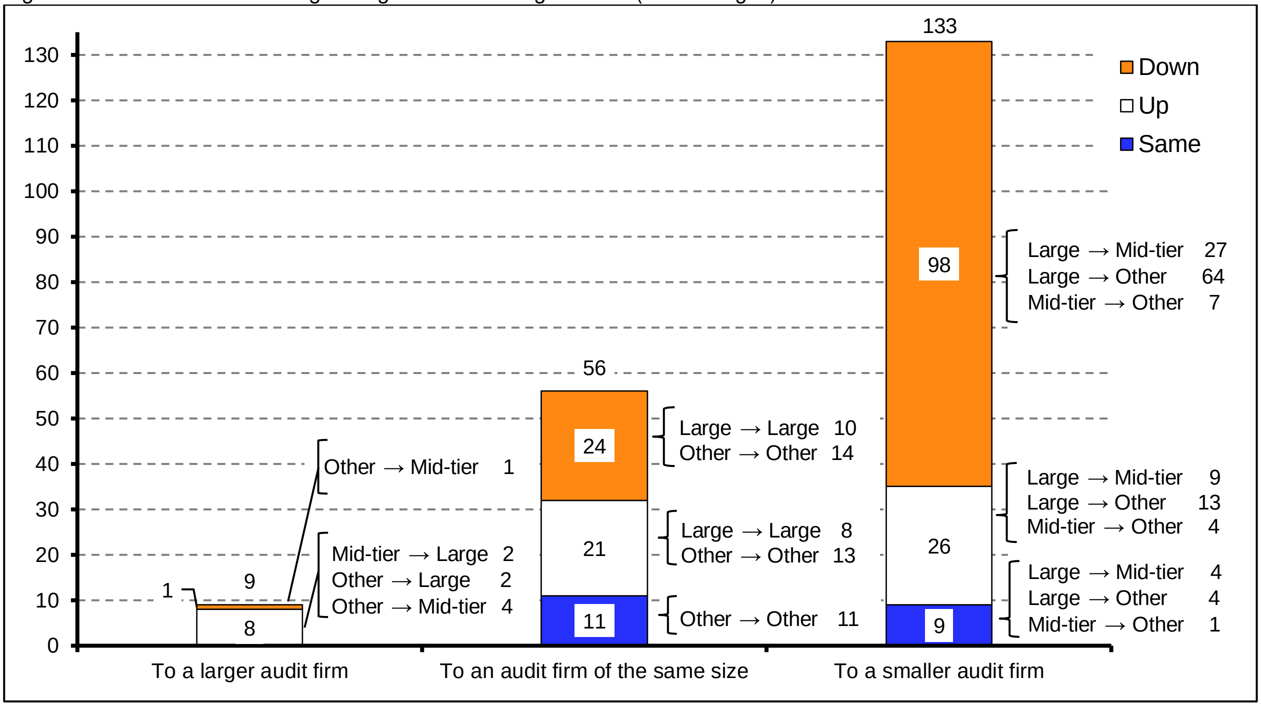
(Note) Aggregated from reports collected from mid-tier and small and medium-sized audit firms in PY2021

3. Audit Fees Before and After Changes in Accounting Auditors

As audit fees are often reviewed after changing auditors, the CPAAOB analyzed pre- and post-transfer fees, finding differences in the margin of rise or fall in them depending on the scale of new accounting auditors.

Audit fees often rise in changes to bigger audit firms. In moves from an office to another of the same scale, fees rose in about 40% transfers (21 of 56 cases) but dropped in some 40% (24 of 56 cases). In changes to a smaller firm, audit fees decreased in approximately 70% (98 of 133 cases). Changes from a large-sized audit firm to a small or medium-sized firm resulted in audit fee falls in some 80% (64 of 81 cases).

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



(Note 1) Tabulated timely disclosures of changes in accounting auditors by listed domestic companies (from July 2020 to June 2021) are included, provided that the audit fees before and after the changes were publicly disclosed

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

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

(Sources) Prepared by the CPAAOB based on timely disclosures of changes in accounting auditors and securities reports submitted by June 2022

4. Dependence of Fees (Safeguards)

When the audit fees of a specific audited company represent a certain rate to the total revenues[4] of the audit firm, etc.[5], there could be a case that audit firms are placed to be suffered with conflict of interests - unfavorable from the independence perspective - or unreasonable pressure from the audited companies due to the concern about losing the source of revenue.

The JICPA's "Guidelines on Independence" stipulates that where the audit fees from a particular listed

[4] Total of audit and attestation revenue and non-audit and attestation revenue (various advisory services, tax processing and so forth)

[5] Audit firms and business enterprises that control business enterprises and audit firms through their contracts, human relations and so forth.

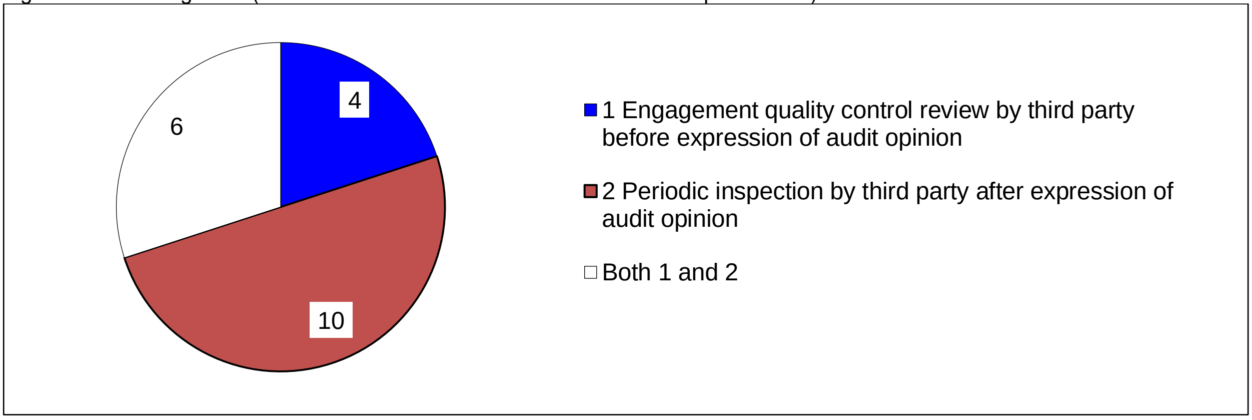
domestic company represent more than 15% of the audit firm's revenues for two consecutive years, the audit firm must examine which of the safeguards below would be appropriate:

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

With regard to the recent revision of the Code of Ethics of the International Ethics Standards Board for Accountants pertaining to fees, see IV. Responses to Changes in the Global Environment Surrounding Audits, E. Recent Trends with Accounting Audits, 1. Trends with International Standards on Auditing and Code of Ethics (page 104).

No large-sized and mid-tier audit firms breached the threshold (15%). Of 44 small and medium-sized audit firms traced through inspections and the collection of reports in PY2021, 16 small and medium-sized firms resorted to safeguards for 20 engagements.
Small and medium-sized audit firms addressed the question of safeguard through inspection, etc. before the expression of opinions by third-party CPAs, who are not members of the audit firm, internal periodic inspections after the expression of opinions and so forth (Figure III-6-5).

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



(Note) Tallied for 16 audit firms (20engagements) out of 44 audit firms that were inspected or from which reports were collected in PY2021.

■ Amendments to IESBA's (International Ethics Standards Board for Accountants) ethics code for audit fees ■

The IESBA released amendments to its ethics code for audit fees in April 2021, calling for appropriate management of reliance on audit fees from audited companies. When reliance on audit fees for audited companies, which are public interest entities, exceeds a set threshold level, reports to auditors and others, disclosure of the situation in question, a pre-audit review, a ban on the provision of audit services and so forth are required