

IV. Responses to Changes in the Global Environment Surrounding Audits

A. Usage of Technology in Audit and Cybersecurity Efforts

1. Progress with the Adoption of IT in Audit Engagements

In recent years, the use of IT in audit engagements, including AI, by audit firms, mainly large-sized audit firms and mid-tier audit firms, has been increasing significantly. This is partly because audited companies are rapidly digitizing their accounting records, transaction records, etc. with the society digitalized, and in conjunction with this, audit firms also need, as “workstyle reforms” are introduced, to perform audit engagements more efficiently and effectively. This is affecting the nature of audits, and large-sized and mid-tier audit firms are moving proactively, either jointly with their global networks or independently, to deploy or develop IT-driven audits.

Here we elaborate audit firms’ strategies at present; how audit firms are developing their audits. Potentially, the spread of COVID-19 may serve as a trigger for the further adoption of IT in audit engagements.

a. Unification of audit tools

Audit firms that are members of the global networks use audit tools provided by the global networks (see "B. Responses to Overseas Expansion of Companies, 2. Ties with Global Networks" (page 95) for further details). Audit tools in question not only have the function of preparing and storing working papers but also include audit support tool functions, such as those for safe transfer of data and materials to and from audited companies, and timely tracing of progress in auditing, including work by the team of auditing subsidiaries.

Collected R&D and IT operation of the global networks promotes the efficiency of IT investment, and feedback from their member firms on remedies or requests of audit tools may be beneficial to the global networks enabling to improve security and refine functions of the audit tools.

However, there are also cases of Japanese audit firms independently developing/deploying analytical tools and implementing them as forecasting system on accounting fraud.

b. Task automation (RPA¹)

While certified public accountants have heretofore conducted standardized work for the implementation of audit procedures, such as processing and collection of data, by themselves, the introduction of audit support tools has advanced in recent years. The tools in question include a one-stop function from the extraction to analysis of data. With the function, the automatization of work, such as processing data and drafting working papers, is making headway. For example, it has become possible to automatically extract information needed for analytical work from data, collected in a lump from an audited company’s core operation system, and produce findings inside an audit support tool.

¹ RPA is short for robotic processing automation and represents efforts to streamline and automatize office work by means of artificial intelligence and other technologies. It is realized by software robotics that operates software and other programs like humans. It is also called "digital labor" and "virtual knowledge worker."

c. Sophistication and expansion of data analytics

Amid the increasing introduction of audit support tools, the improvement of their functions has made it possible to multilaterally analyze all accounting data of an audited company. Findings by a broad-ranged analysis, many of which are currently used to assess risks at the time of working out an audit plan, are expected to be used in the entire auditing process through the formation of audit opinions.

In the past, audit firms performed risk analysis that involved the measurement of indications of fraudulent accounting etc. in audited companies' financial information. Recently, however, the advancement of AI development has been facilitating the development and introduction of tools to predict future fraud using non-financial information and means to detect abnormal transactions that may lead to fraudulent accounting from among large amounts of accounting records, which enables audit judgements to be made based on more sophisticated analysis. Accordingly, integrating the results of analysis of non-financial information such as reputation about audited companies, audit firms are expected to be able to analyze a broader range of risks.

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

At present, most audit work are centered on the period after the date of the fiscal year end, but with the aim of setting up a more comfortable working environment by leveling audit work throughout a period, and making audits more sensitive to risks and more likely to uncover frauds at an early stage, by the use of the aforementioned IT tools, audit firms are exploring the applicability of audit techniques for the day-to-day analysis of transactions etc. (real-time audit).

a., b., and c. above are fields in which progress is being made with deployment in large-sized audit firms, while d. is an area expected to be applied in the future. The introduction of these advanced audit techniques requires that originals of transaction records etc. of audited companies are kept in electronic form, and the handover of the data also requires the consent of the audited company concerned. Additionally, time is required for data cleansing to enable utilization of data for RPA and data analytics. Due to these problems, progress is gradual. Regarding c. above, although the accuracy of fraud detection tools is becoming better than before, individual audit firms are developing tools that can detect abnormal transactions with higher fraud risks and fraud employing more complicated means.

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

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

As the improvement of IT skills on the part of partners and full-time staff, who actually operate auditing tools, is indispensable to promote the use of IT, audit firms, especially large-sized ones, are nurturing

IT experts through the introduction of auditing tools and training about data analyses. At the same time, they are recruiting experienced IT engineers from outside in order to develop their IT systems earlier.

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

Status	Large-sized audit firms	Mid-tier audit firms
Installed	<ul style="list-style-type: none"> ▪ Electronic audit documentation system (audit paper preparation and audit procedure management) ▪ Journal analysis tools (analysis of transaction details (journals) and detection of abnormal transactions) ▪ Evidence reconciliation tools (precise methods for cross-checking data from outside with all sales data at audited companies) ▪ File exchange system (used for exchanging data with audited companies) ▪ RPA (automation of data input and manipulation) ▪ Debt/credit balance confirmation system (automation of the external confirmation of the existence/accuracy of transactions) 	<ul style="list-style-type: none"> ▪ Electronic audit documentation system (audit paper preparation and audit progress management) ▪ Journal analysis tools (analysis of transaction details (journals) and detection of abnormalities)
Being installed/ introduced at some firms	<ul style="list-style-type: none"> ▪ AI (fraud forecasting abnormal transactions using past financial information) ▪ Audit databases (storing knowhow etc. on an in-house database to disseminate it) 	<ul style="list-style-type: none"> ▪ Evidence reconciliation tools ▪ File sharing systems
Under development	<ul style="list-style-type: none"> ▪ AI (fraud forecasting using non-financial information) ▪ Drones (improved efficiency in physical inventory count) ▪ Utilization of blockchains ▪ Text analysis (digitalization and analysis on documents) 	<ul style="list-style-type: none"> ▪ AI (fraud forecasting abnormal transactions using past financial information)

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

■ Effective audit using AI ■

Some large audit firms are increasing the use of AI in auditing work. Specifically, AI analyzes listed companies' trends of fraud in the past from their security reports, improper accounting data and others. They maintain that the practice can effectively detect signs of fraud at audited companies' subsidiaries and on a per account basis and automatize 30% to 40% of entire auditing work, especially financial data analysis and confirmation of documents.

With the introduction of AI, audit practitioners are expected to concentrate more strongly on tasks requiring experience, such as those involving fraud risks and accounting estimates.

■ Introduction of electronic audit documentation by small and medium-sized audit firms ■

In March 2021, a mid-tier audit firm, two small and medium-sized audit firms and a general business company founded and began operating the Audit Digital & Innovation Consortium (ADIC) to provide small and medium-sized audit firms with a common IT infrastructure for the safe use of the electronic audit documentation system (for the electronic and integrated management of audit papers, audit firms are obligated to prepare and store them in order).

The three audit firms have already adopted the shared IT infrastructure and are operating it on a scale of more than 500 users. In the future, they plan to create a knowledge network as a small and medium-sized audit firms' community and carry out a project that will contribute to the digital transformation of audits, including audit tools other than the electronic audit documentation system.

2. Cybersecurity Efforts

As mentioned earlier, large-sized audit firms in particular are embedding audit tools and exchanging data with audited companies via e-mail and file exchange systems. These use cases have been permeating as data volume has risen and transaction data has become more digitized.

At the same time, the risks posed by information leaks due to cyberattacks and other factors have risen, as seen in the damage inflicted by cyberattacks on audit firms overseas. Now that the information leaks in audited companies, in particular, cause serious damage to the audit firm's trust, bolstering cybersecurity steadily is a must.

Accordingly, the CPAAOB has been focusing on the following.

[Monitoring of audit firms]

- The CPAAOB reviews audit firms' cybersecurity measures through periodic collection of reports, hearings and dialog. These approaches have enabled us to identify the following efforts common to large-sized audit firms and some of mid-tier audit firms: Establishing basic information security policies and promoting information protection inclusive of cybersecurity across the global network as a whole
- Setting up organizations responsible for cybersecurity (CSIRT²) and, as necessary, recruiting experts in-outside the audit firm
- Identifying the data held by the audit firm, rating the materiality, and developing policies for data use as well as contingency plans for information security incidents and cyberattacks
- Undergoing reviews by the global network to confirm the effectiveness of the audit firm's information security system, making improvements in the system, collecting information on cyberattacks and information security countermeasures, and utilizing this information to develop and improve the information security system.

■ Participation by Audit Firms in Cybersecurity Exercises ■

To further improve the entire financial industry's ability to deal with incidents, the FSA has been conducting cross-industry cybersecurity drills (Delta Wall) since FY2016. Audit firms have kept participating in the drills since 2019, including the sixth exercise held in October 2021.

The drills confirmed initial responses to an incident, technological responses such as an investigation into the attack, information linkage, continuation of business and other issues. To enable the management and many sections concerned (systems, public relations, business and others) to take part, the drills were held in the form of participation from their workplaces.

Analytical results of general trends and so forth, found by the drills, were fed back to not only participant audit firms but also the entire auditing industry for enhancing readiness and awareness for dealing with cybersecurity at audit firms.

² CSIRT (Computer Security Incident Response Team) is the collective term for the organizations responsible for dealing with incidents pertaining to computer security.

■ Expanded use and risks of cloud services ■

The use of cloud-based online storage services is increasing these days as business enterprises have improved developed telework environments. To expand technology-based services, audit firms are also increasing investment in the IT field, including cloud technology.

But there are risks in services via cloud technology. In a 2021 report on data leaks and breaches, major American telecommunication company Verizon said the problem most frequently occurred through servers. With regard to risks concerning accompanied by the use of cloud services, the JICPA stressed the importance of understanding recognizing service providers' internal control on the risk of inappropriate access.

As the personal information protection law was amended in April 2022 to toughen control on the storage of data overseas and other matters of concern, personal information needs to be treated more strictly.

B. Responses to Overseas Expansion of Companies

1. Group Audits

Many listed companies are operating in other countries by establishing subsidiaries and other entities, while M&As targeting overseas businesses are on the rise in recent years. For this, companies are necessitated to address many issues, such as establishing a system to manage overseas subsidiaries, examining complicated economic transactions, and dealing with different accounting standards. At present, serious accounting fraud incidents often come out at overseas subsidiaries. With the importance of group audits growing under the circumstances, audit firms are strengthening measures to address them. A brief overview of group audits and auditing procedures follow:

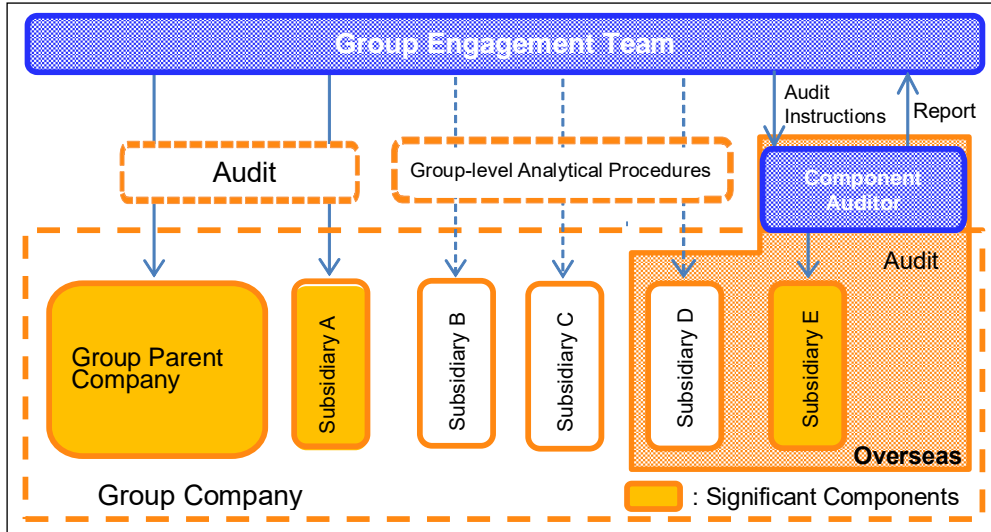
a. Overview of Group audits

When auditors at a parent company (hereinafter referred to as "group audit team") perform an audit of group financial statements for certification, the work covers the parent as well as consolidated subsidiaries and head offices and branches, etc. (each company and other entity that serves as a unit for preparation of financial information included in group financial statements is called a "component unit"). For example, an internationally operating manufacturer has many component units (subsidiaries) not only in Japan but also overseas, such as subsidiaries set up in countries with reasonable labor force and sales subsidiaries.

Components such as subsidiaries are classified as either "material components" or "non-material components" depending on factors such as their financial importance and existence of risks requiring special consideration, and group engagement teams determine the proportional audit procedures that shall be performed according to the classification of each component (ASCS 600 (8), (23), (25), (27)).

The following figure illustrates overview of typical group audit procedures (Figure IV-2-1):

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



b. Determination of Material Components

When determining the material components, the group engagement team is required to identify and assess the risks of material misstatement through obtaining an understanding of the entity and its environment (ASCS 600 (16)). During this process, the key members of the group engagement team need to discuss the possibility of there being a material misstatement in the financial statements of the group caused by fraud or error, and must focus in particular on the risks of material misstatements resulting from fraud.

In recent years, there have been many cases of fraud etc. discovered at overseas subsidiaries that would seriously affect group financial statements. It has therefore become more important to perform risk assessments based on an adequate understanding of the group management system such as establishing a department at a head office tasked with managing foreign subsidiaries or performing internal audits to foreign subsidiaries and group environment including internal control of overseas subsidiaries.

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

c. Audit Procedures for Material Components

A group audit team decides which kinds of audit work should be performed for component units' financial information. As for material components that may involve risks requiring special consideration concerning group financial statements, one or more of audits described below must be performed : audit on component units' financial information based on the overall materiality of component unit , audit on the balances of one or more special accounts related to risks requiring special consideration about group financial statements, audit on kinds of transactions or disclosure and others, and special audit procedures related to risks requiring special consideration about group financial statements (ASCS 600 (26)).

The approaches to group audit procedures taken by audit firms of different sizes are as follows

(Figure IV-2-2).

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

	Large-sized audit firms	Mid-tier audit firms	Other
Group audit manual	Incorporating the global network's group audit manual into the firm's audit manual	Many firms incorporated the global network's group audit manual into the firm's audit manual, but some prepared their own	Many firms prepared their own group audit manual
Audit instructions	Using the global network's template for audit instructions	Many firms used the global network's template for audit instructions, but some prepared own templates	Many firms prepared their own templates for audit instructions, but some used templates provided by the global network

(Note) Regarding "Other" in the figure, of the 43 firms from which reports were collected in PY2021, information is presented for 23 firms conducting audit engagements for which group audit is required in cases where there is any component overseas. Among these, just two firms are affiliated with their global networks and using the group audit manual or audit instructions provided by the global networks.

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

d. Communication with component auditors

If effective dialogue between the group engagement team and the component auditors does not exist, there is a risk that the group engagement team may not obtain sufficient and appropriate audit evidence on which to base the group audit opinion (ASCS 600 (39)).

The group audit team therefore not only sent and received audit instructions and reports on the audit results and grasped the situation by phone or e-mail, etc., but also visited auditors of component units, among other practices. The physical visit, however, went unfeasible due to COVID-19, the group audit team is maintaining communication via alternative means, such as online meetings. Still, there are cases in which the team is unable to receive reports on the results from auditors at component units in a timely manner due to lockdowns and other restrictions in countries where they are located. Ordinarily, large-sized audit firms and some mid-tier audit firms provide support for their group audit teams, such as facilitating communication between them and auditors at component units and providing local information by establishing international business support sections inside their organizations and dispatching Japanese representatives to their main overseas business outlets. The pandemic has increased the importance of such practices.

2. Ties with Global Networks

Large-sized audit firms, mid-tier audit firms, and some small and medium-sized audit firms, partnerships, and solo practitioners contracted the member firm agreement and belong to global networks in order to facilitate audits of audited companies exploring overseas operations by leveraging the global network's know-how such as audit manuals.

a. Membership of global networks

All large-sized and mid-tier audit firms as well as some small and medium-sized audit firms, partnerships, and solo practitioners that need to audit the overseas operations of audited companies belong to global networks, and are moving forward with the establishment of structures for group audit (Figures IV-2-3 and IV-2-4). Note, however, that not all small and

medium-sized audit firms, partnerships, and solo practitioners that are expected to conduct group audits belong to global networks (for details, see “1. Group Audits, c. Audit Procedures for Material Components” (page 94).

Figure IV-2-3: Number of audit firms belonging to global networks³ (FY2021) (unit: audit firms)

Large-sized audit firms	4
Mid-tier audit firms	5
Small and medium-sized audit firms	23
Total	32

(Source) Prepared by the CPAAOB based on operational reports

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

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

(Source) Prepared by the CPAAOB based on data from publicly disclosed materials from each audit firm (as of July 1, 2022)

The operating revenues of global networks comprise revenues from audit services, tax related services and advisory services, and a breakdown of the top-ranking global networks in terms of operating revenues is shown below (Figure IV-2-5). The scale of the Big Four global networks is particularly prominent.

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

	DTT	PwC	EY	KPMG	BDO	GT
Operating revenues	502	451	399	321	118	66
Audit services (Share of operating revenues)	105 (21%)	171 (38%)	136 (34%)	114 (36%)	50 (42%)	28 (43%)
Tax-related services (Share of operating revenues)	89 (18%)	110 (24%)	105 (26%)	70 (22%)	26 (22%)	14 (21%)
Advisory services (Share of operating revenues)	308 (61%)	170 (38%)	158 (40%)	137 (42%)	42 (36%)	24 (36%)

(Source) Prepared by the CPAAOB based on data from publicly disclosed materials from each global network (2021 accounting year).

In Japan, the Big Four global networks' share of audit services is 97% of the 225 companies that

³ Among small and medium-sized audit firms, the firms that have concluded cooperative relations (alliances) with overseas audit firms are included.

comprise the Nikkei Stock Average (Nikkei 225). Overseas, they account for even larger shares of audit services as shown below for the 500 companies comprising the S&P 500 index in the U.S. and the 350 companies with the largest market capitalizations on the London Stock Exchange (FTSE 350 index), meaning that the situation in these countries is the same as in Japan (Figure IV-2-6)

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

	Japan	US	UK
Big Four global networks' share (based on number of companies)	97%	99%	93%

(Sources) Japan: Compiled by the CPAAFOB from QUICK and exchange data (as of March 31, 2022)

U.S.: Compiled by the CPAAFOB from Bloomberg data (as of March 31, 2022)

U.K.: "Key Facts and Trends in the Accountancy Profession, July 2021," Financial Reporting Council

b. Relationships with global networks

Network firms comprising global networks are responsible for a range of areas including quality control instead of enabling to use the networks' logos and brand, to share mutual business and know-how. The nature and degree of these responsibilities vary depending on the scale of the global network. In general, the larger global audit network would be more impactful on its member firms.

i. Large-sized audit firms

Each of the large-sized audit firms belongs to one of the Big Four audit firms (Deloitte Touche Tohmatsu, Ernst & Young, KPMG, and PricewaterhouseCoopers) and has established close relationships with them. Specifically, they not only have the right to use the networks' logos and brand, but are also involved in the operation performed by the networks. For example, their CEOs and PICOQCs opine from the perspective of Japan as members of high level network committees, while members of oversight/assessment bodies at large-sized audit firms take part in global meetings.

Embedding audit manuals and tools prepared by the networks, and the large-sized audit firms perform audits in accordance with them subject to the networks' standards. When it comes to other quality control issues including quality control reviews, independence, they have adopted the standards and the procedures prepared by the networks.

Some large-sized audit firms, in addition to using the network's manuals and tools, dispatch the personnel like PICOQC etc. to the global firm in order to directly reflect the views of Japan in the initiatives taken at the network level, such as the revision of audit manuals and the development of audit tools.

They also regularly undergo global reviews conducted by the networks in order to confirm that audit quality, particularly for audit engagements, is secured at the level required by the networks (see "III. Operation of Audit Firms, C. Monitoring of Systems of Quality Control, 2. Utilization of Global Reviews" (page 74) for details.).

Furthermore, in conjunction with business expansion in recent years in the Asia-Pacific region

and, most notably, in Japan and China, some firms have appetite to manage member firms on a regional basis, while large Japanese audit firms, which are members of the global networks, tend to play a central role by participating as board members in organizations established in the Asia Pacific region.

ii. Mid-tier audit firms

All mid-tier audit firms are affiliated with global audit networks. However, the extent of their ties differs depending on size of the networks. Some have formed alliances that are at the same level of those of the large-sized audit firms, while others maintain moderate ties, only having the right to use the networks' logos and brand and getting referral of audit engagements from network firms in other countries, but not implementing audit manuals. Although all mid-tier audit firms undergo global reviews, there are substantial differences in terms of the frequency and the review area.

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

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

■ International Forum of Independent Audit Regulators (IFIAR) ■

Established in 2006, the International Forum of Independent Audit Regulators (IFIAR) is an international organization comprising independent audit regulators that conduct inspections and other tasks on audit firms to improve the audit quality globally through cooperation and collaboration between authorities concerned. (As of June 2022, it had members from 54 countries and jurisdictions, including Japan.) The IFIAR opened an office in Tokyo in April 2017 and became the first international financial organ with an outlet of its headquarters in Japan. In April 2021, a deputy commissioner in the Strategy Development Management Bureau of the FSA who was concurrently serving as the director of the Office of Japanese Delegation for IFIAR was elected vice chair of the IFIAR.

Japan is a founding member of the IFIAR and a member of its board. While the chairperson of the CPAAOB as well as inspectors and others have actively participated in various meetings of the IFIAR to establish and strengthen cooperative relations with regulators of other countries, Japan has been striving to improve the audit quality globally through participation in activities by the IFIAR, such as dialogues with leaders of the six large global networks. Now that an FSA official, as mentioned above, has assumed the post of vice chair of the IFIAR since April 2021, Japan is further strengthening its support for the IFIAR to contribute to the role of leading the overall management of the organ as a member of its management team.

■ Effects of international situation on auditing ■

The international situation, including the recent Ukrainian problem and lockdowns in Shanghai, is exerting considerable effects on not only business activities by globally operating companies but also auditors' work, such as the withdrawal of four large global networks from Russia. The JICPA has taken countermeasures, including the release in April 2022 of "Audit Considerations for the Fiscal Year Ended March 31, 2022 (Summary) (Regarding audit responses in light of the current international situation surrounding Ukraine)" as a digest of matters of concern pertaining to "Consideration of whether or not the risk assessment needs to be revised based on the situation" " and so forth under the current international situation.

In addition, the IFIAR has posted a consolidated version of Russia-related guidance issued by member audit regulators, auditors organizations, and so forth on its website (<https://www.ifiar.org/members/ukraine-russia/>).

C. Effects of and Responses to the COVID-19

The spread of COVID-19 infections, which started in around March 2020 and still continues, is affecting account settlements, audits, and so forth.

In April 2020, following the spread of COVID-19 infections, the Accounting Standards Board of Japan (ASBJ) announced the consideration in accounting estimates as a summary of the Discussion (supplemented in May 2020 and updated in February 2021), and the JICPA announced a series of "Audit Consideration related to COVID-19," involving such issues as attendance at inventory count, confirmation of outstanding balances, reliability of audit evidence, group audits, accounting estimates, assumptions related to going concerns, terms for extraordinary losses, self-assessment and impairment and allowances by financial institutions, and acquisition of management representation letters.

Based on the summary of the Discussion announced by the ASBJ, the FSA additionally released a written request in May 2020 to express its strong expectation that concrete and enhanced disclosure on the impact of COVID-19 infections would be made as financial and non-financial information in security reports. The FSA also released the "Q&A on the Disclosure of Narrative Information Regarding the Impact of COVID-19 Infection - Key Points for Better Disclosure for Investors" to encourage the promotion of efforts to enhance the disclosure of information.

Looking back on efforts made by members of the liaison council pertaining to responses to financial reporting and audits based on the effects of COVID-19, the "Our Responses to Financial reporting and audit of listed companies in consideration to the Impact of the COVID-19 Infection (Main Points)" was released under its name in July 2020.

For PY2021, furthermore, the FSA released the "Notice regarding the deadline for submission of annual securities and other reports in connection with COVID-19 infection" .In addition, the JICPA announced the following points of attention in auditing for members in consideration of an increase in remote auditing work environments for auditors due to the adoption of remote work by audited companies:

- Confirmation by means of e-mail
- Remote observation of inventory taking

- Authenticity of evidence converted into PDF format
- In case of restrictions on visiting inspection of components and others
- Remote meeting and use of remote meeting tools

In its "Notice regarding the implementation of review of securities reports" released in April 2021, the FSA designated the review of COVID-19 infection-related nonfinancial information ("business policies and strategies, etc.," "business risks" and "analysis by the management of financial conditions, operating results and the cash flow status") and financial information ("notes based on accounting standards pertaining to the disclosure of accounting estimates" and "additional information") as a key theme. As prospects for the impact of the COVID-19 disease, etc. may differ between companies, the appropriateness of them is not subject to the review. On the assumption that prospects differ between companies, therefore, the review will examine whether information is disclosed in a manner to enable investors and others to fully understand companies' specific conditions and ways of thinking.

The CPAAOB understands the effects of COVID-19 infections on audit firms through dialogues with and the collection of reports from them.

Specifically, auditing methods, such as the observation of inventory taking and confirmation of outstanding balances, and the management of audit firms are reviewed based on advances in the introduction of IT at audited companies and the effects of COVID-19 infections.

Regarding responses to workers' physical attendance, large-sized and mid-tier audit firms adopt a hybrid system combining remote work and office work, while limiting the attendance rate of workers. In the meantime, some small and medium-sized audit firms have developed a remote work environment but leave each audit team to decide whether to come to the office or not.

From the perspective of responses in audit procedures, communications in group audits are made mainly through the use of remote conference systems, and there were also cases where the number of audit team members who visit audited companies is limited depending on workers' physical attendance at audited companies.

For alleviating workers' mental burden, some audit firms recommend providing an opportunity for communication other than through a remote conference system, such as by setting office days for each of the audit teams, mainly for young workers with less experience in audit practices.

Partially triggered by the spread of COVID-19, the CPAAOB presented the "Consideration of Monitoring Methods" in the Basic Plan for Monitoring Audit Firms and so forth in PY2021.

In PY2021 as well, the CPAAOB reviewed its monitoring method by taking into account the audit document digitization and so forth at audit firms to further improve the efficiency and effectiveness of monitoring through such means as expanding the coverage of remote inspection.

The CPAAOB's office was used as the principal venue for remote inspections, where inspectors conducted inspections using online methods, reviewing digitalized audit work papers and other documents submitted from audit firms or through audit firms' electronic audit work papers systems. For interviews with members of audit firms, efforts to reduce face-to-face conversation and moving of staff

members were made by the active use of online conference systems, while maintaining face-to-face meeting to some extent in consideration of the effectiveness of interviews.

D. Treatment of key audit matters

From the perspective of enhancing the transparency of and the provision of information pertaining to audits conducted under the Financial Instruments and Exchange Act, entries of "key audit matters" (KAMs) in audit reports come to be required, starting with accounting audits for the fiscal year ending March 31, 2021.

1. Processes and key points for deciding on and reporting KAMs

- a. Auditors take into consideration the following matters out of those they discussed with audit and supervisory board members and others in the process of auditing and decide the matters to which they paid special attention:
 - Matters in which risks requiring special consideration were identified or which were deemed to have a high risk of material misstatements
 - Degree of judgement by auditors about matters involving material judgment by management, including matters in which high uncertainty of estimate is identified
 - Effects on audits from material matters or transactions taking place in the relevant year
- b. Out of the matters to which they paid special attention, auditors as professionals narrow down especially important matters, decide them as KAMs, and mention the following in a section set for them in audit reports.
 - Content of KAMs
 - Reference to disclosure in related financial statements where applicable
 - Reasons why auditors considered the matter especially important in the audit of financial statements in current fiscal year and determined it as KAMs.
 - Auditor's responses in audit

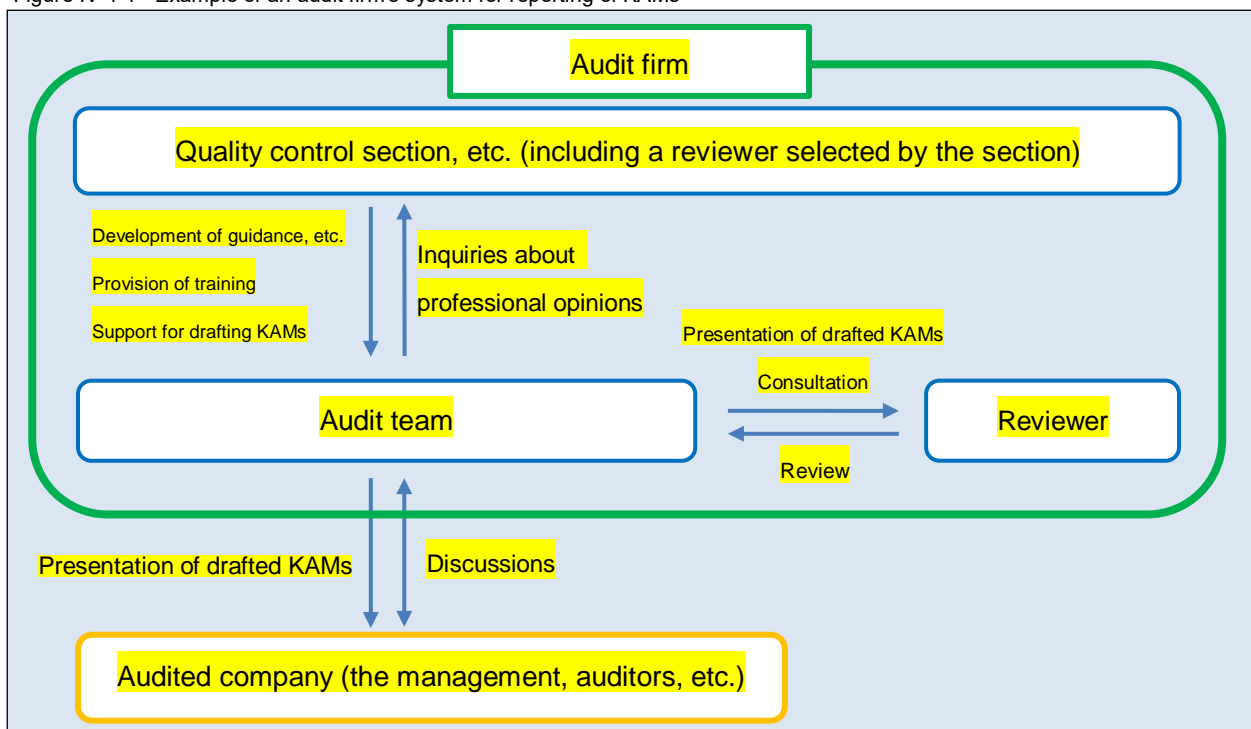
2. Responses by audit firms

Recent monitoring found the following responses by large-sized and mid-tier audit firms upon mandatory application of KAMs. Centered on large-sized audit firms, some audit firms have developed a system for KAMs, including communications with audited companies (Figure IV-4-1).

- a. Development of guidance for preparation of KAMs
 - Preparation and dissemination of guidance and descriptive examples with which audit teams comply when preparing KAMs

- b. Provision of training
 - Training to provide explanation of good examples on KAMs based on analyses of actual application cases
 - Training to provide explanation of points of attention concerning the notes in financial statements and narrative information accompanied by the introduction of KAMs
 - Training with a workshop format adopted, wherein audit teams actually draft KAMs
 - Training to provide explanation of points to note in drafting KAMs
- c. Quality control section's support for audit team
 - Clarification of the specific content of communication and schedule to achieve in-depth communication throughout the year with the management, audit and supervisory board members and others of an audited company
 - Monitoring and follow-up of audit teams' handling of KAMs
 - Review by a reviewer selected by the quality control section of KAMs drafted by audit teams
 - Holding of consulting sessions regarding KAMs on a regular basis
- d. Reviews and inquiries of professional opinions
 - Request for conference-format reviews by the headquarters in specific cases, such as treating the non-disclosure of KAMs and assumption related to a going concern as KAMs
 - Request for inquiries about professional opinions regarding entries of KAMs in cases falling under specific cases defined by revised policies for inquiries about professional opinions

Figure IV-4-1 <Example of an audit firm's system for reporting of KAMs>



3. Analyses of KAMs reported in the first year of mandatory application and recommendations

Handling of KAMs in the year ending March 31, 2021 has been analyzed by the FSA and other related organizations, and they made recommendations (Figure IV-4-2).

Figure IV-4-2 < Analyses of KAMs reported in the first year of mandatory application >

Organizations that published their analyses, timing of publication, published documents, and web links
<p>Japanese Institute of Certified Public Accountants (October 2021)</p> <p>Report on analysis of KAMs reported in the first year of mandatory application (the year to March 2021)</p> <p>Aggregate results of the questionnaire survey with members in the first year of mandatory application of KAMs</p> <p>https://jicpa.or.jp/specialized_field/20211029fgf.html (Available in Japanese)</p>
<p>Japan Audit & Supervisory Board Members Association (December 2021)</p> <p>Involvement of auditors, etc. in the process of consideration in the first year of mandatory application of KAMs</p> <p>https://www.kansa.or.jp/support/library/post-2551/ (Available in Japanese)</p>
<p>Securities Analysts Association of Japan (February 2022)</p> <p>Good examples of KAMs helpful for securities analysts</p> <p>https://www.saa.or.jp/standards/account/questionnaire/index.html (Available in Japanese)</p>
<p>Financial Services Agency (March 2022)</p> <p>Characteristic examples of KAMs and points to note in making entries</p> <p>https://www.fsa.go.jp/news/r3/sonota/20220304-2/20220304-2.html (Available in Japanese)</p>

In the analyses above, recommendations for the second year are also made based on actual entries of reported KAMs. Major recommendations are as follows.

- Stylization and uniformity of contents of KAMs should be avoided. It is not preferable to merely follow entries in the previous year or use similar entries across audit firms. It is important to describe situations unique to each company concretely.
- It is important to devise subtitles, make annotations with numbers, ascertain potential impact, and consider the influence to be caused by putting KAMs into the accounting standard and assumptions.
- If selecting the same items in KAMs as in the previous year, it is preferable to describe why these items continue to be important in the relevant year and how they have changed from the previous year, thereby supplementing the content or deepening explanations of the report in the previous year.
- If omitting any items in KAMs that were entered in the previous year, it is very important to enter the reason therefor from the perspective of user convenience.

E. Recent Trends with Auditing

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

1. Trends with International Standards on Auditing and Code of Ethics

The development of international auditing standards and ethics standards is underway at the International Auditing and Assurance Standards Board (IAASB) and the International Ethics Standards Board for Accountants (IESBA) established in the International Federation of Accountants (IFAC) comprising of professional accountancy associations around the world. As recent major changes in the International Standards on Auditing (ISA) set out by the IAASB, "Quality Management for an Audit of Financial Statement" (ISA220) was revised, while ISQC1 (Quality Control for Firms that Perform Audits and Reviews of Financial Statements, and Other Assurance and Related Services Engagements) was revised to International Standard on Quality Management 1 (ISQM1; Quality Management for Firms that Perform Audits or Reviews of Financial Statements, or Other Assurance or Related Services Engagements) and International Standard on Quality Management 2 (ISQM2; Engagement Quality Reviews) - standalone standard in review for engagement. The revisions were finalized in December 2020. ISQM1 is scheduled to come into effect on December 15, 2022, and ISQM2 and ISA220 are due to take effect for audits in a given business year from that date onward (voluntary early application is possible).

As recent amendments on the IESBA's ethics code in compliance with ISQM2, Objectivity of an Engagement Quality Reviewer and Other Appropriate Reviewers was added in January 2021. In April of the same year, furthermore, the revision concerning non-assurance services banning on providing non-assurance services to audited companies was published for the sake of reinforcing the independence of auditors, as well as the revision concerning fee-related provisions was published for the sake of enhancing the independence of auditors and the transparency of audit fee-related information. The revision concerning the ratio of audit fees from a public interest entity to the total fees of the audit firm (so-called fee dependency) requires the firm to step down as the auditor if the fee dependency remains high amount for more than a specific period.

The IESBA also published the amendment of the IESBA Code of Ethics, "Definitions of Listed Entity and Public Interest Entity in the Code," in April 2022. Accordingly, each jurisdiction is required to review the definition of PIE, in light of their individual circumstances, starting from audits for the business year that starts on December 15, 2024, onward (voluntary early application is possible).

2. Trends in domestic auditing standards and code of ethics

Based on recent revisions to the international quality control standards, the Business Accounting Council published the Written Opinion on the Revision of the Quality Control Standards for Audit in November 2021. Then, in June 2022, Quality Control Standards Commission Statements No.1 titled "Quality Control at Audit Firms," Quality Control Standards Commission Statements No.2 titled

"Review for Auditing," and Auditing Standards Committee Statements 220 titled "Quality Control in Auditing" were revised.

With regard to the code of ethics, the JICPA is reviewing its code of ethics by reference to the IESBA Code of Ethics, and published a draft on revision of JICPA's ethical rules in November 2021. The revised ethical regulations in question embrace the reinforcement of fee-related independence, including the degree of dependence on fees, based on the revised international code of ethics, and the JICPA is concurrently reviewing the Practice Guidance as well.

3. Expansion of Disclosure of Descriptive Information

In January 2019, the Cabinet Office Order on Disclosure of Corporate Affairs was amended, and as a result, companies came to be required to provide more substantial disclosures in their annual securities reports with respect to descriptive information such as "management policy, management environment, pressing issues to address, etc.," "risks to business etc.," and "management analysis of financial positions, operating results and cash flow." In addition, the principles-based guidance, "Principles regarding the Disclosure of Narrative Information," was released to encourage companies to upgrade disclosed information beyond boilerplate compliance with the regulations. In March 2019, furthermore, "Best Practices for the Disclosure of Narrative Information" was published to make favorable cases of disclosure by some companies practiced widely. The list of good examples has been updated in due course. From December 2021 to March 2022, favorable cases of disclosure of information on business status and sustainability-related information, in which social interest is increasing in recent years, were compiled, and were published and updated as "Best Practices for the Disclosure of Narrative Information 2021."

Although narrative information is not subject to auditing, it elaborates a company's business strategies and risk information needed to better understand its financial information that is subject to auditing. There are calls for upgrading the disclosure of narrative information as it is considered necessary for making investment judgments. With the demand rising for upgrading the disclosure of non-financial information as well, auditors' procedures about descriptions other than audited financial statements and audit reports have been clarified. In addition, the Auditing Standards Committee's Statement 720 has been revised to require the inclusion of necessary descriptions in audit reports (to be applicable from audits for business years that end on or after March 31, 2022).

4. Efforts to address disclosure of sustainability

These days, Efforts to deal with medium and long term sustainability are advanced with social interest growing in ESG. For example, the Corporate Governance Code, revised in June 2021, calls for listed companies to proactively tackle tasks related to medium and long term sustainability (including ESG elements) in order to enhance their corporate values on long-sighted basis. In addition, the Stewardship Code, revised in March 2020, has added the need for taking sustainability into consideration.

To achieve carbon neutrality by 2050, furthermore, it is important that financial institutions as well as financial and capital markets fulfill their functions appropriately. In this context, the FSA established the Expert Panel on Sustainable Finance in December 2020 to discuss challenges and necessary measures. Based on proposals in a report of the Expert Panel released in June 2021, the FSA compiled the basic idea and ways to have dialogues with financial institutions, and published the Supervisory Guidance on Climate-related Risk Management and Client Engagement (draft) in April 2022.

Internationally, in November 2021, the International Financial Reporting Standards Foundation, principal organizer of the International Financial Reporting Standards (IFRS), established the International Sustainability Standards Board (ISSB) to work out standards for the disclosure of internationally consistent and comparable information on sustainability. In March 2022, the ISSB published a draft of the General Requirements for Disclosure of Sustainability-related Financial Information and Climate-related Disclosures Standards, and is planning to undergo public consultation procedures (seeking public comments for a period of 120 days until July 29) and finalize the standards by the end of 2022. In Europe, the European Commission published a draft of the Corporate Sustainability Reporting Directive (CSRD) in April 2021 and plans to expand the coverage of companies that are required to disclose sustainability-related information and introduce detailed requirements and assurance of reporting. In the United States as well, the Securities and Exchange Commission (SEC) published draft regulations to make climate-related information disclosure mandatory in March 2022 and underwent public consultation procedures (seeking public comments until June 17, 2022).

The International Auditing and Assurance Standards Board (IAASB) and the International Ethics Standards Board for Accountants (IESBA) commenced deliberations on frameworks for the assurance and ethics regarding international sustainability reporting. The issue of the assurance and ethics is also deliberated by the Task Force on Sustainable Finance of the International Organization of Securities Commissions (IOSCO).

Domestically, the FSA and other government ministries and agencies concerned have been supporting financial institutions and business corporations voluntarily promoting disclosures in line with the proposals of the Task Force on Climate-related Financial Disclosures (TCFD). To upgrade the disclosure of climate-related information while ensuring the autonomy and flexibility of private companies, the Corporate Governance Code, revised in June 2021, stipulates that companies listed on the Tokyo Stock Exchange's Prime Market, new market segment which commenced operation in April 2022, should promote efforts to improve the quality and quantity of disclosures based on the TCFD's proposals or equivalent international frameworks.

Domestic related parties are collaboratively responding to the initiatives of the IFRS Foundation, and the Sustainability Standards Board of Japan (SSBJ) was newly established under the Financial Accounting Standards Foundation on July 1, 2022, for the purpose of presenting opinions regarding the standards being worked out by the ISSB and developing domestic standards based on the former.

5. Partial amendment of the Certified Public Accountants Act and the Financial Instruments and Exchange Act

In November 2021, based on recent environmental changes surrounding auditing, the Advisory Council on the Systems of Accounting and Auditing of the FSA published a summary of discussions whose key points are arrangements for ensuring confidence in auditing, improving the capacity and capabilities of certified public accountants and achieving high-quality accounting audits. Based on this summary of discussions, the Financial System Council's Subcommittee on Certified Public Accountant System had discussions on the certified public accountants system, including an institutional framework to require a high degree of discipline in audits of listed companies. In January 2022, the Subcommittee compiled the Report of the Financial System Council's Subcommittee on Certified Public Accountant System – For Ensuring the Quality of Audits of Listed Companies and Having Certified Public Accountants Exert Their Capabilities.

Based on the aforementioned report, the FSA submitted a draft of the Act Partially Amending the Certified Public Accountants Act and the Financial Instruments and Exchange Act to the 208th ordinary session of the Diet, with the aim of ensuring the reliability of auditing and encouraging certified public accountants to exert and enhance their capabilities, thereby further enhancing the reliability of corporate financial documents. The following are incorporated in the draft Act:

- Introduction of a registration system for audits of listed companies, etc.
- Review of restrictions on audit firm partners' services based on their marital status
- Review of qualification requirements for certified public accountants
- Review of the authority to conduct on-site inspections of the Certified Public Accountants and Auditing Oversight Board

The draft Act was enacted on May 11, 2022.

The FSA plans to amend relevant government Orders, etc. for the enforcement of the amended Acts.