

Responses Expected of Audit Firms

1. Ensuring the Reliability of Audits

In recent years, the powers of Audit and Supervisory Board Members, Audit and Supervisory Boards, Audit Committee Members, and Audit Committees (hereinafter referred to as "company auditors, etc.") have been strengthened, corporate governance codes are introduced, and these developments have helped enhance corporate governance environments. However, incidents of fraud continue to occur both in Japan and overseas and a number of listed companies have announced inappropriate accounting practices and other misconduct through the timely disclosure procedure.

Under these circumstances, efforts have been continuously made to improve the quality of audits and ensure their reliability. For example, audit standards concerning "Key Audit Considerations (KAM)" and "Other Content" in audit reports have been revised, the Quality Control Standards on Audits have been revised to introduce a quality control system based on a risk-based approach, and ethical rules have been revised to strengthen independence concerning remuneration, etc. For accounting auditors of listed companies, mid-tier audit firms and small and medium-sized audit firms are continuing to replace large-sized audit firms. Mid-tier audit firms and small and medium-sized audit firms are playing a greater role as auditors of listed companies, and are urgently required to improve audit quality. It is therefore necessary for each audit firm to continue to verify its individual audit engagements and quality control systems with reference to the deficiencies and their causes described in this Case Report.

In doing so, audit firms should be mindful of striving in practice to ensure and improve the quality of their audits, considering not only whether individual audit engagements and quality control system formally comply with audit standards but also whether they are applying appropriate professional skepticism to identify fraudulent accounting and whether they are focusing at all times on audited companies' business risks to assess and address risk of material misstatement.

If deficiencies are identified in individual audit engagements or quality control systems, the audit firm should not only remedy the deficiencies but also analyze the root causes before making improvements.

This Case Report also includes examples of "observed effective efforts" by audit firms that might serve as guides for improvement, and we ask that you find these informative.

2. Organized Responses

The chief executive officer (CEO) of an audit firm, such as the chief director, and the person in charge of quality control (PICOQC) are required to exercise leadership in the design and operation of a system of quality control. However, the improvement of the quality control systems should not only be an issue for the CEO and PICOQC, but rather a firm responsibility to be fulfilled voluntarily by the partners and employees of an audit firm. It is important, through such organized improvements, to foster a climate that emphasizes audit quality.

With regard to the organizational operation of audit firms, in light of the "Principles for the Organizational Operation of Audit Firms" (Audit Firm Governance Code) (formulated in March 2017), large-sized audit firms and others are working to further establish and strengthen governance environments to ensure and improve audit quality. Amid this situation, the Audit Firm Governance Code was revised in March 2023 to require effective disciplines suited to the size and characteristics of audit firms. The CPAAOB will continue to verify whether the governance environments established and strengthened by each audit firm are effective.

3. Accurately Discerning Deficiencies and Analyzing Causes

One prerequisite for appropriately analyzing root causes is accurately identifying back ground of deficiencies and precisely discerning their essential causes. If these essential causes cannot be precisely discerned, then the root causes cannot be suitably analyzed and the measures responding to root cause will also be unsuitable. For example, we should bear in mind that when appropriate audit work papers on significant matters during the audit has not been prepared, the issue in the vast majority of cases is not simply a lack of documentation but a failure to perform the audit procedures to obtain sufficient and appropriate audit evidence. If the prepared audit documentation does not satisfy the requirements stipulated in Auditing Standards Statement No. 230, paragraph 7, it is necessary to carefully discern whether this is due to the necessary audit procedures not having been implemented without playing it down as simply an issue of documentation. If the necessary audit procedures have not been carried out, the reasons for this must be further analyzed and efforts must be made to improve. To ensure that necessary audit procedures are implemented, the skills of the engagement team must be enhanced through classroom education/training and superiors need to commit to providing guidance on a day-to-day basis to the members of engagement team through supervising the audit practices, reviewing audit work papers, performing engagement quality reviews and conducting periodic inspection, etc.

4. Responding to Issues According to Firm Size

There is wide variation in the sizes of audit firms, with some having just a few personnel while others have headcounts that run into the thousands. There are also differences in operations management system. Because of these factors, it is important to continuously check whether the quality control system established by the audit firm is appropriate in view of the size of the firm and the operations management system.

The following characteristics have been identified as issues relating to the size of the audit firm, so each audit firm should refer to them and take appropriate action based on their size.

[Large-sized audit firms]

We can see that large-sized audit firms are working in an organized manner on improvements for ensuring higher quality, such as rebuilding their governance environments through, for example, the utilization of knowledge of outside third parties, strengthening of collaboration between different levels within the firm

(management, quality control division, audit divisions, engagement teams), and appropriate human resource development and personnel management and evaluation.

On the other hand, due to the large size of the organization, communication among layers of official positions and between departments is not always smooth, and it remains difficult to disseminate organizational measures throughout to all departments and offices. As one of such measures, in recent years there has been a trends to establish a quality control system not only at the head office but also at business units closer to the audit frontline. Such efforts are considered to be effective to some extent, but it is necessary to ensure that the head office quality control unit accurately and continuously identifies the characteristics of operations in each business unit and ensures the effectiveness of efforts in each business unit.

[Mid-tier audit firms]

Mid-tier audit firms have been improving their organizational structures for ensuring systematic actions with regard to quality system, but their headquarter organizations are still weaker than large-sized audit firms. In addition, the quality control system of some firms is inadequate as a result of limited manpower assigned to quality control and also insufficient awareness of CEOs and PICOQCs concerning quality control. Another issue is that at firms expanding their operations, the competency and capability are not enough to serve new audit contracts in a timely manner. In addition, business administration at each firm is characterized by the reliance on a large number of part-time professional staff and audit support staff for audit engagements and by quality control issues at certain district offices.

Moreover, while Mid-tier audit firms are required to improve their ability to perform audits for large-sized listed companies, they have problems in that they have yet to sufficiently develop a system for securing human resources and offering organizational support to engagement team or a system for international services, such as for effectively utilizing their overseas business alliance.

[Small and medium-sized audit firms]

As a result of lack of awareness of the importance of quality control among the CEOs and PICOQCs, small and medium-sized audit firms fail to proactively address matters of quality control. In addition, they lack the resources for developing quality control systems. Because of these, while they are addressing deficiencies identified in external inspections in their efforts for improving audit quality, this remedial action is often superficial, being based on treating the symptoms rather than tackling the root causes. Some audit firms are also not making an effort on a day-to-day basis to improve audit quality and only followed the previous audit procedures on the grounds that no major issue had occurred in the past.

Some small and medium-sized audit firms prioritize expanding their operations and have concluded new contracts in the belief that risks of new audit contracts (hereinafter, "contract risks," including risks for renewing contracts) had been appropriately assessed even though due consideration had not been given to fraud risks of listed companies with high audit risk. As a result, instances of inadequate and inappropriate risk assessment procedure and further audit procedures in audit services are found.