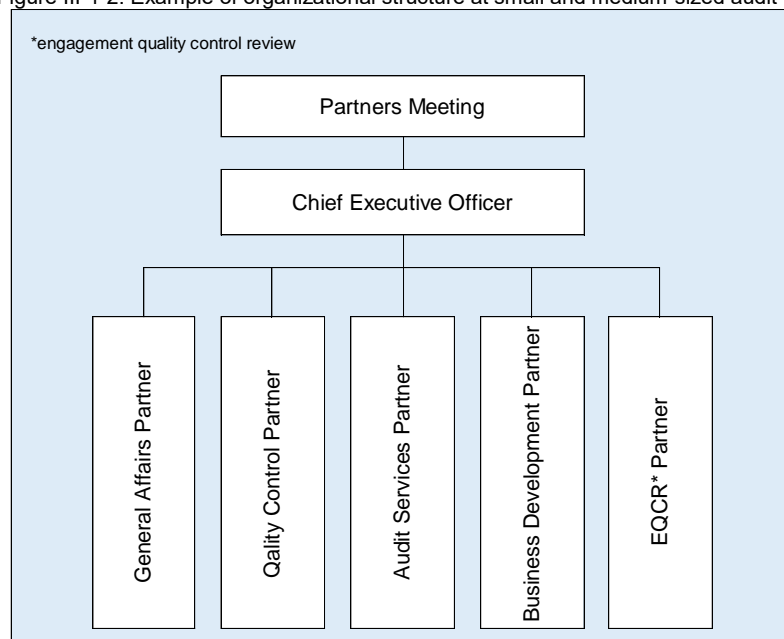


### III. Operation of Audit Firms



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 systems 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 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.

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. 190 to 580	Approx. 40 to less than 90	Up to approx. 40 (Note)
Number of full-time personnel	Approx. 2,800 to 7,300	Approx. 200 to over 900	Up to approx. 100 (Note)
Decision-making bodies	<ul style="list-style-type: none"> <li>• The highest decision-making body is the partners meeting</li> <li>• A board of directors and an executive committee are set up under the partners meeting</li> </ul>	<ul style="list-style-type: none"> <li>• The highest decision-making body is the partners meeting</li> <li>• A board of directors is set up under the partners meeting</li> </ul>	<ul style="list-style-type: none"> <li>• Most decisions are made at the partners meeting</li> <li>• Larger firms have a board of directors beneath the partners meeting</li> </ul>
Oversight/assessment bodies	<ul style="list-style-type: none"> <li>• A body is established to supervise/assess business execution bodies such as the board of directors and management committee</li> <li>• 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</li> <li>• Third parties with independence ("independent third parties") serve as members of oversight/assessment bodies and subcommittees</li> </ul>	<ul style="list-style-type: none"> <li>• Oversight/assessment bodies are established but their powers are limited compared with those at large-sized audit firms</li> <li>• Many firms do not establish subcommittees for nomination, compensation, and audit</li> <li>• While audit firms use independent third persons as constituent members of oversight/assessment bodies, there are some situations where the involvement of the independent third persons is limited to advice and suggestions to executive bodies.</li> </ul>	<ul style="list-style-type: none"> <li>• Many firms have systems of checks and balances between partners without establishing oversight/assessment bodies.</li> <li>• Many firms do not appoint independent third parties</li> </ul>
Design of business operation departments	<ul style="list-style-type: none"> <li>• Multiple audit services departments are established, and firm-wide operation including regional offices is also conducted</li> <li>• A department specializing in financial services is established</li> <li>• Departments in charge of quality control, risk management are established</li> </ul>	<ul style="list-style-type: none"> <li>• Management of firms, including regional offices, in addition to the establishment of multiple audit engagement sections</li> <li>• A department in charge of quality control are established</li> </ul>	<ul style="list-style-type: none"> <li>• Many firms appoint partners to handle the particular services without establishing particular departments</li> <li>• Larger audit firms have set up organizations that resemble those of mid-tier audit firms</li> </ul>
Number of offices	<ul style="list-style-type: none"> <li>• There are 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).</li> </ul>	<ul style="list-style-type: none"> <li>• Besides the firm's main office, there are often also offices in metropolises (Tokyo, Osaka and Nagoya)</li> </ul>	<ul style="list-style-type: none"> <li>• Many firms only have a main office</li> </ul>
Design of quality control divisions	<ul style="list-style-type: none"> <li>• A quality control division comprises various departments for functions such as revising and distributing audit manuals, providing advice on accounting procedures, IFRS and US accounting standards, and conducting engagement quality control reviews and periodic inspections in relation to its system of quality control</li> <li>• A risk management department, which is responsible for monitoring of audit contracts, independence, and audit risks, is established</li> <li>• Audit services departments also often have quality control functions</li> </ul>	<ul style="list-style-type: none"> <li>• Under the quality control division, a department in charge of risk management, accounting consultations, engagement quality control reviews and periodic inspections is generally established.</li> </ul>	<ul style="list-style-type: none"> <li>• Many firms appoint partners to handle both quality control and audit engagements without establishing quality control departments</li> <li>• In some small firms, CEO is also in charge of quality control</li> </ul>

(Reference) Prepared by the CPAAOB from CPAAOB inspections, collected reports and operational reports in PY2023.

(Note) Excluding an audit firm whose number of partners and full-time staff members is much higher than others.

## 2. Efforts in Response to Audit Firm Governance Code

The Audit Firm Governance Code was formulated in March 2017, and subsequently in response to a series of government ordinances (published in January 2023 and put into effect in April) accompanying revisions to the CPA act (May 2022), which mandated audit firms that audit listed companies to establish a framework for conducting operations in line with the Code and requiring enhanced information disclosure. In line with these developments, the Code was revised in March 2023 with the aim of accompanying acceptance of small and medium-sized audit firms. The obligation to establish a system in line with the Code was effective from the beginning of the first accounting period of the audited company that began on or after July 1, 2024 (for large-sized audit firms, from July 1, 2023). The Audit Firm Governance Code has been formulated with the organizational management of audit firms that audit listed companies in mind. It is expected that the Code will be applied in a “comply or explain” manner (either implement the principles or explain the reasons for not implementing the principles). Audit firms are required that they put the five principles into practice in ways suited to their own distinct circumstances in order to implement it and achieve effective organizational administration.

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

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

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

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

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

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

### Principle 4: Operation

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

### Principle 5: Ensuring transparency

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

As of March 31, 2024, all large-sized audit firms and mid-tier audit firms as well as 12 small and medium-sized audit firms had announced adoption of the Audit Firm Governance Code<sup>1</sup>.

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. Some small and medium-sized audit firms do not adopt all of the principles, with oversight/assessment functions within

<sup>1</sup> Sources: JICPA's website "List of efforts regarding effective organizational operation in audit firms"

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.

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, but they oversee and assess the process by receiving reports from internal members of the independent bodies such as a public interest committee.

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.

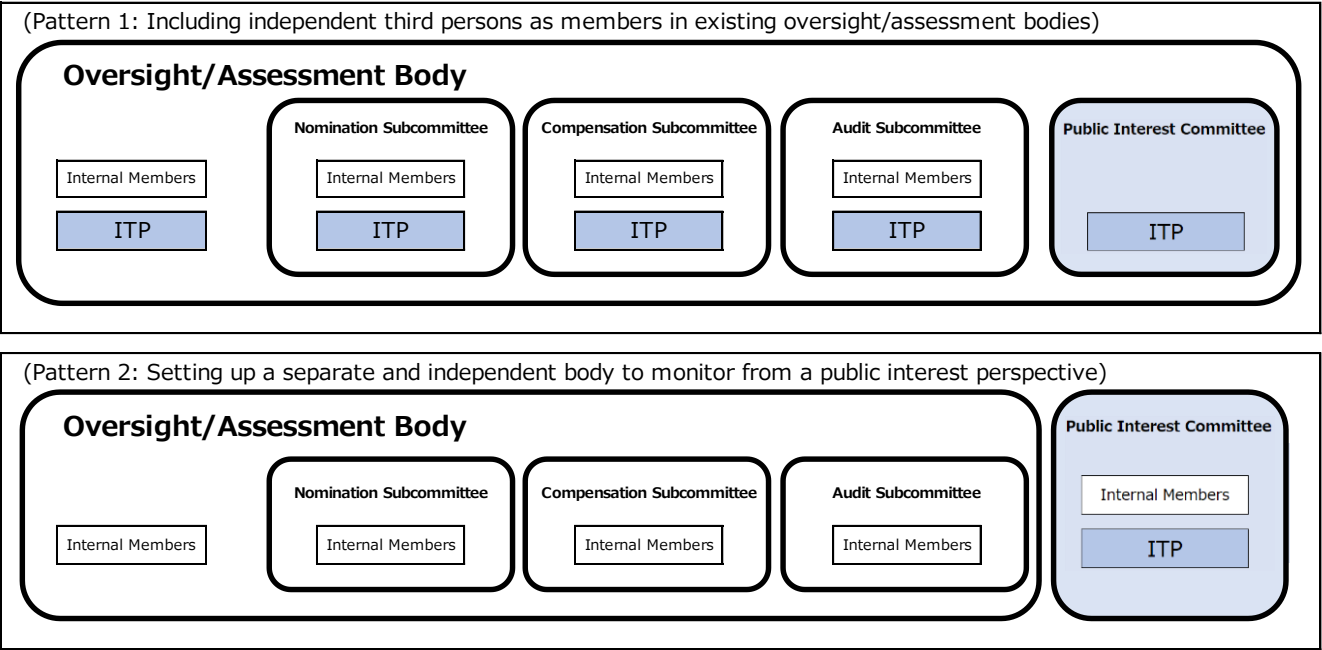
(iii) Small and medium-sized audit firms

Six out of 12 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. Also, there is a case where an audit firm

published continuous consideration of the necessity of independent third parties' involvement from the perspective of their contribution to public interest.

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 few 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 firm to firm. The degree of utilization of knowledge of outside experts also 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 (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 generally 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	2	1	—
Mid-tier audit firms	3	1	1	2	2
Small and medium-sized audit firms	2	3	1	—	1

(Reference) Prepared by the CPAAOB from CPAAPB inspections and reference material released by each audit firm in PY2023.  
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 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, relationship with global networks that they belong to, and so on. In recent years, they devote considerable space to explanations of compliance with the new quality control standards, in addition to audit quality indicator (AQI), effective use of technology in auditing, and response to non-financial disclosures. Some firms also report the results of action taken to address issues identified the previous year and issues to be tackled in the following year, while others disclose attendance by independent third persons at executive meetings etc.

(ii) Mid-tier audit firms

Mid-tier audit firms 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 AQIs, plans for human resource development such as educational programs and training curriculums, etc., which are available in the reports of large audit firms. Some firms explain their measures for effective use of technology in auditing, response to non-financial disclosures, and the explanations of compliance with the new quality control standards. Also, some firms released the assessment of current efforts to improve the audit quality by constituent members, such as the results of in-house questionnaires about quality control.

(iii) Small and medium-sized audit firms

Nine out of 12 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 enforcement of relevant government orders in conjunction with the revision of the CPA act, made it obligatory for audit firms that audit listed companies to have systems in place to conduct operations in line with the Audit Governance Code and systems that require substantial information disclosure. As a result, many small and medium-sized audit firms that had not adopted the Audit Firm Governance Code in the past are now required to deal with the Code. Audit Firms are required to autonomously implement the Audit Firm Governance Code and realize effective organizational management taking into account their own size and characteristics. And the JICPA is expected to leverage its knowledge and experience obtained from self-regulation to provide sufficient guidance and supervision as a professional organization.

## ■ Disclosure of Audit Quality Indicators (AQI) ■

There is no established definition of audit quality, and it is difficult to measure directly.

For this reason, some large-sized audit firms, mid-tier audit firms, and small and medium-sized audit firms set up AQI, which quantifies their efforts and results of audit quality improvement according to each firm's situation, and are trying to understand the audit quality status through continuous monitoring of AQIs. The AQI at the audit firm level is also disclosed to the public through annual audit quality reports issued by audit firms, mainly large-sized and mid-tier audit firms.

When we compared the AQI statements in the most recent audit quality reports from large-sized audit firms and mid-tier audit firms, we found the following points. It should be noted that the AQIs are selected by audit firms to show a balanced picture of audit quality improvement based on their own circumstances, it is not possible to determine that there is an AQI deficiency just because an audit firm that does not report the AQI reported by other audit firms.

### (Large-sized Audit Firms)

- AQIs related to IT (e.g., investment amount, tools adoption rate, etc.) are listed, given that all firms are promoting the use of IT and service delivery centers in their audits.
- In addition to IT-related AQIs, other AQIs commonly published are: AQIs related to internal quality control inspections (e.g. number of significant deficiencies identified in periodic inspections), average training hours of partners and staff, AQIs related to responses to globalization (e.g. % of staff with overseas work experience), and AQIs related to diversity (e.g. % of female staff).
- In addition to the above, many firms have posted AQI related to quality control systems (e.g., number of personnel engaged in quality control activities), AQI related to independence (e.g., results of internal inspection), results of inspections by external organizations, etc.

### (Mid-tier Audit Firms)

- Commonly listed AQIs are related to personnel structure and quality control system (e.g. number of personnel), independence (e.g. response rate of independence confirmation forms, number of violations identified), and internal inspection (e.g. number of significant findings).
- Some firms also list AQIs related to the use of IT

AQIs are expected to promote constructive dialogue between audit firms and audit clients and other stakeholders as a common language, and to strengthen audit firms' PDCA cycle regarding audit quality. Audit firms are requested to continuously review the selection of AQI and the way of disclosure so that they can have constructive dialogues with stakeholders.

Figure: AQI in reports on audit quality by audit firms

	Large-sized audit firms	Mid-tier audit firms
AQIs common to all firms	<ul style="list-style-type: none"> <li>• AQI on the use of IT and service delivery centers for audits - Investment amount, tool adoption rate, percentage of audit staff using delivery centers, etc.</li> <li>• AQI on internal inspection of quality control - Coverage of periodic inspection, results of periodic inspections, etc.</li> <li>• AQI on training - Average hours of training</li> <li>• AQI on globalization - % and No. of staff with overseas working experience, No. of staff with globalization process experience, etc.</li> <li>• AQI on diversity and inclusion - % of female employees (all employees, by job level)</li> </ul>	<ul style="list-style-type: none"> <li>• Personnel Composition – No. of staff by job level</li> <li>• AQI on quality control system – No. of personnel and % of total staff engaged in quality control, etc.</li> <li>• AQI on independence - Response rate for written confirmation, No. of violations identified</li> <li>• AQI on internal inspection - Inspection results (No. of significant findings, etc.)</li> </ul>

	Large-sized audit firms	Mid-tier audit firms
AQIs common to several firms	<ul style="list-style-type: none"> <li>• Average annual working hours of auditors</li> <li>• Awareness Survey - % of company employees who are aware that the communication from top management includes the message that audit quality is a top priority, etc.</li> <li>• % of employees taking paid leave, maternity leave, etc.</li> </ul>	<ul style="list-style-type: none"> <li>• Feedback from audited companies - Questionnaires to CEOs, CFOs, auditors (satisfaction with services), etc.</li> <li>• AQI on training - Training hours per staff, attendance rate of mandatory training, and average number of credits earned, etc.</li> <li>• AQI on globalization – No. of staff with overseas working experience</li> <li>• Results of inspections by external organizations - Administrative action by the FSA, significant deficiencies identified in the JICPA quality control review, etc.</li> </ul>
AQIs found in only one firm	<ul style="list-style-type: none"> <li>• AQI on sustainability assurance – No. of staff responsible for assurance on reporting, No. of responsible staff in-charge and No. of annual assurance reports issued</li> <li>• No. of audit staff changes – No. of transfers per year</li> <li>• Personnel composition</li> <li>• Average hours involved in audit engagements of listed companies (by job level)</li> </ul>	<ul style="list-style-type: none"> <li>• AQI on the use of IT - Investment amount, tool adoption rate, percentage of investment to operating revenues</li> <li>• Acceptance and renewal of audit engagements – No. of listed audited companies</li> <li>• Restatement of financial statements accompanied by re-issuance of audit reports, etc.</li> </ul>

### 3. Human Resources of Audit Firms

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

In most large-sized audit firms, most CPA exam passers are hired immediately after passing the essay exam, while only a small proportion of CPAs and CPA exam passers 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”](#)).

Many mid-tier audit firms and small and medium-sized audit firms, meanwhile, find it difficult to recruit enough CPA exam 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 these firms are endeavoring to secure the necessary headcount for audit engagements etc. In many cases, new audit firms are also established by CPAs who have left from large-sized audit firms.

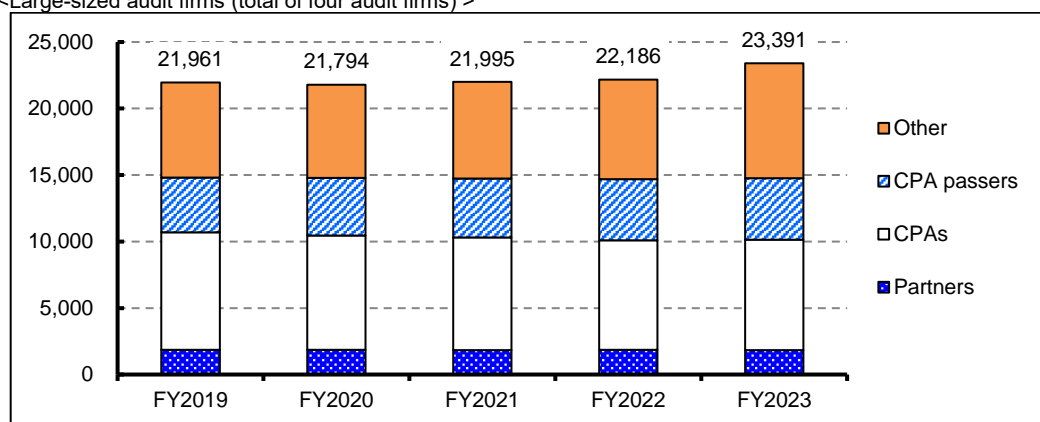
The number of partners and full-time staff members, analyzed by scale, has generally leveled off at large audit firms since FY2019, but increased in FY2023. For mid-tier audit firms, there has been increasing trend since FY2019, and the same increasing trend has been observed for small and medium-sized audit firms since FY2018, partly due to the establishment of new firms. As far as the structure of manpower is concerned, the number of CPA exam passers, etc. tends

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 37% of the total workforce at large-sized audit firms, 33% at mid-tier audit firms, and 26% at small and medium-sized audit firms. Compared to FY2019 (FY2018 for small and medium-sized audit firms), the ratio increased for both large-sized audit firms (24%) and mid-tier audit firms (30%), while the ratio remained for small and medium-sized audit firms (26%) (see Figure III-1-6).

Audit firms have increased their staff members other than CPAs and CPA exam 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 tasks requiring professional judgements, 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.

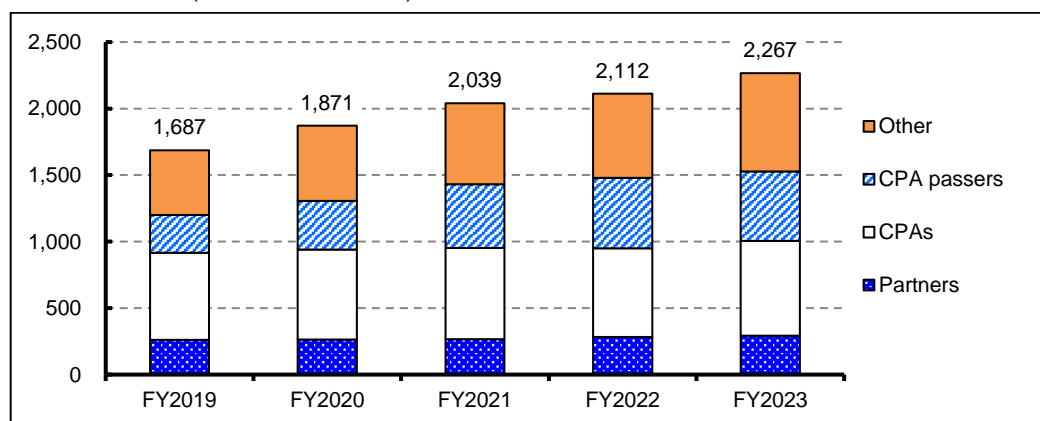
Some large-sized audit firms have improved their operations by establishing specialized organizations to centrally manage such as the work/procedures of audit assistants, skill development, and job allocations.

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) >



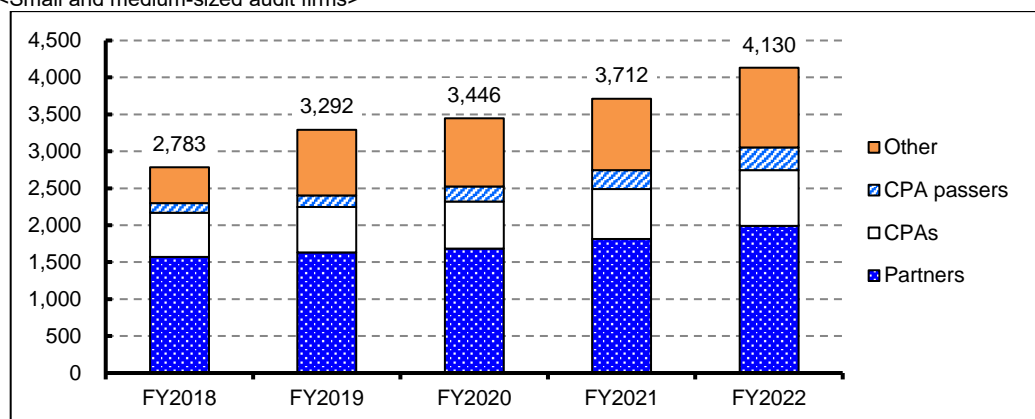
(Note) The number of PwC Kyoto in FY2023 is included in the mid-tier audit firms.

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



(Note) The number of PwC Kyoto in FY2023 is included in the mid-tier audit firms.

<Small and medium-sized audit firms>



(Note1) 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 FY2023 have not yet been compiled. As a result, the figures for small and medium-sized audit firms only cover the period to up to FY2022.

(Note2) The number of small and medium-sized audit firms varies from year to year, but 271 such firms are included in the figures for FY2022.

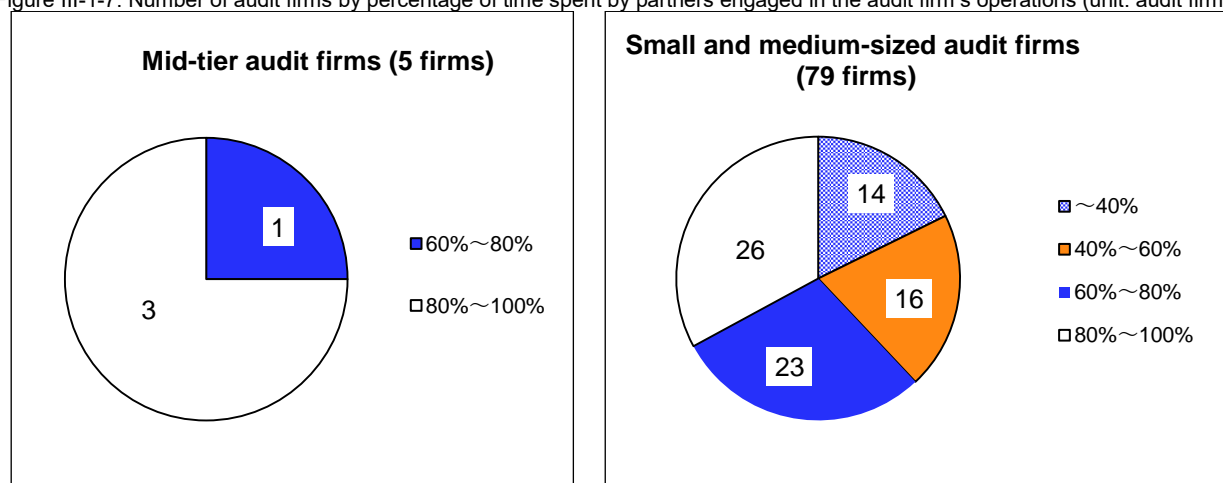
#### b. Side businesses by partners

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 50% 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 through the inspections and collection of reports in PY2023.

#### c. Part-time personnel

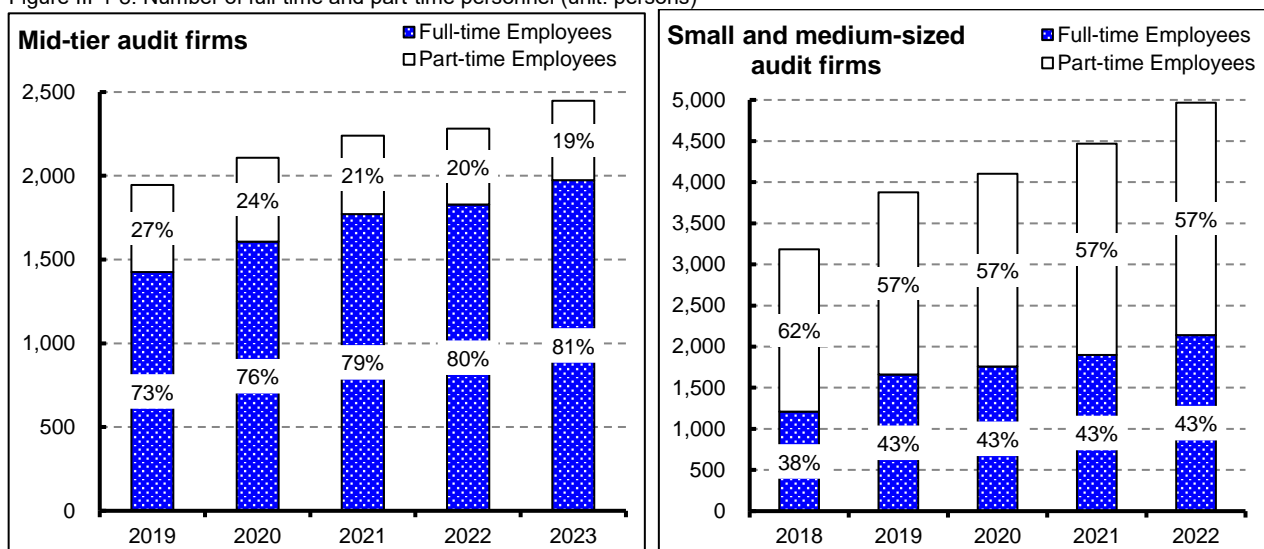
Part-time staff members account for an extremely low; around 3% to the total headcount at large

audit firms.

The ratio of part-time staff to total staff at small- and medium-sized audit firms has been on a decreasing trend, and in the last three years, the ratio has remained at around 20% in total for each firm, but there are differences among the firms.

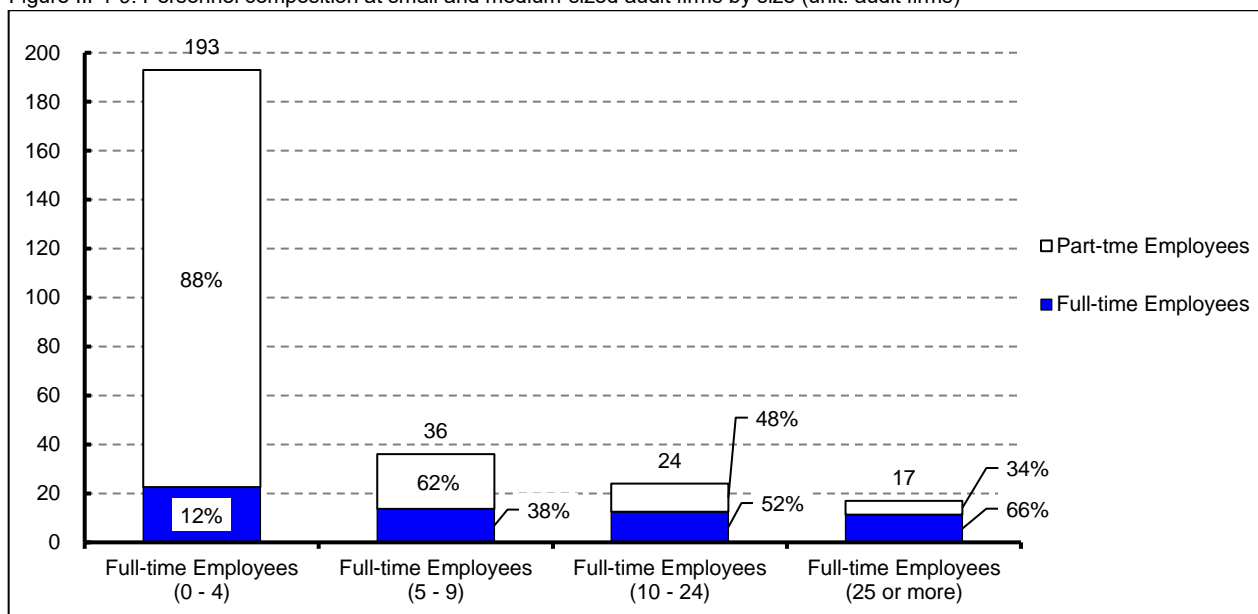
The ratio of part-time staff members has been slightly below 60% at small and medium-sized audit firms, indicating that they rely mainly on the audit assistants who are certified public accountants to support their operation (see Figure III-1-8). In particular, at audit firms with a full-time staff of 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 90% (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. The number of PwC Kyoto in FY2023 is included in the mid-tier audit firms

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



(Note) The 271 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 FY2022, after which the number of employees was totaled and the composition ratios of full-time and part-time personnel calculated.

## 4. Organizational Structure for Providing Audit Services

An audit engagement team, as an audit service provider, is required to exercise professional skepticism<sup>2</sup>, carry out appropriate risk assessments and risk-response procedures and perform proper audit procedures for improving audit quality. The CPAAOB endeavors to understand the engagement team's status through its inspections of audit engagements, and to ascertain the status of the conduct of audit services through 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 for Supporting Audit Services. 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
	One senior manager/Manager	Senior manager/Manager	Management of foreign component audits
	10 CPAs	Manager/Senior staff	Performance of audit procedures in significant audit areas
	13 qualified assistants (CPA exam passers, etc.)	Staff	Performance of audit procedures other than important audit procedures
	Four unqualified assistants	Assistant	Data processing, reconciliation of administrative vouchers, other tasks not requiring significant judgements, management of sending/ collection of balance confirmation letters, administration of engagement documentation
	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

(Note1) 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.

(Note2) In-house experts are assigned to engagement teams as needed

<sup>2</sup> 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.

Small and medium-sized audit firms often have audit assistants on a part-time basis due to limited human resources for audit teams, although in some firms it is difficult 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, for example, the audit manager needs 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 to 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		<ul style="list-style-type: none"> <li>• Setting material audit areas and assessing audit risks</li> <li>• Reviewing audit procedures performed by assistants</li> <li>• Communicating with management and the audit and supervisory boards</li> </ul>	<ul style="list-style-type: none"> <li>• Setting material audit areas and assessing audit risks</li> <li>• Reviewing audit procedures performed by assistants</li> <li>• Conducting audit procedures in material audit areas</li> <li>• Communicating with management and the audit and supervisory boards</li> </ul>	<ul style="list-style-type: none"> <li>• Setting material audit areas, assessing audit risks, and drafting audit plans</li> <li>• Reviewing audit procedures performed by assistants</li> <li>• Conducting audit procedures (including material audit procedures)</li> <li>• Communicating with management and the audit and supervisory boards</li> </ul>
Assistants to the engagement partners	CPAs (Note)	<ul style="list-style-type: none"> <li>• Drafting audit plans</li> <li>• Conducting audit procedures in material audit areas</li> <li>• Reviewing audit procedures performed by other audit assistants</li> </ul>	<ul style="list-style-type: none"> <li>• Drafting audit plans</li> <li>• Conducting audit procedures (including material audit procedures)</li> <li>• Reviewing audit procedures performed by other audit assistants</li> </ul>	<ul style="list-style-type: none"> <li>• Conducting audit procedures (including data analysis and sending, collection and management of balance confirmation documents)</li> <li>• Reviewing audit procedures performed by other audit assistants</li> </ul>
	CPA exam Passers, etc.	<ul style="list-style-type: none"> <li>• Conducting audit procedures other than material audit procedures</li> </ul>	<ul style="list-style-type: none"> <li>• Conducting audit procedures other than material audit procedures</li> </ul>	<ul style="list-style-type: none"> <li>• Conducting audit procedures other than material audit procedures</li> <li>• Not employed in most of smaller firms</li> </ul>
	Unqualified assistants	<ul style="list-style-type: none"> <li>• Data processing, reconciliation of administrative vouchers, other tasks not requiring significant judgements</li> <li>• Administration of sending/ collection of balance confirmation letters, administration of audit documentation</li> </ul>	<ul style="list-style-type: none"> <li>• Data processing, reconciliation of administrative vouchers, other tasks not requiring significant judgements</li> <li>• Administration of sending/ collection of balance confirmation letters, administration of audit documentation</li> </ul>	<ul style="list-style-type: none"> <li>• Not employed in most of firms</li> </ul>

(Note) CPAs at small and medium-sized audit firms are often part-time.

(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 system for supporting audit services. We will also provide some examples, mainly from large-sized audit firms, of systems 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](#)" and "[C. Monitoring of Systems of Quality Control](#)" 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, have introduced, in addition to digitizing audit working papers, analytical tools to recognize unusual figures in journal entry data, 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 "[6. Usage of Technology in Audit and Cybersecurity Efforts, a. Progress with the Adoption of IT in Audit Engagements](#)").

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 CEOs 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.

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

<p>[Actions taken by risk management department]</p> <ul style="list-style-type: none"> <li>• Developing a database of past fraud cases and sharing that information within the audit firm</li> <li>• Selecting high-risk audit engagements through gathering information for past and current years and implementing continued monitoring and support to engagement teams</li> <li>• 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</li> <li>• Organizing a team of experts for investigating fraud within an audit firm or its group companies</li> <li>• Establishing and operating a desk for receiving reports from whistleblowers inside or outside the audit firm</li> </ul> <p>[Actions taken by engagement teams]</p> <ul style="list-style-type: none"> <li>• Addressing the risk of fraud through the use of data analysis tools</li> <li>• 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</li> </ul>
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## 6. Usage of Technology in Audit and Cybersecurity Efforts

a. 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.

#### i. Unification of audit tools

Audit firms that are members of the global networks use audit tools provided by the global networks (for more details, see [“7. Responses to Overseas Expansion of Companies b. Ties with Global Networks”](#)). 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.

Unified 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.

#### ii. Task automation (RPA<sup>3</sup>)

While certified public accountants have conventionally 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.

#### iii. 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

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<sup>3</sup> 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."

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.

iv. 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).

i., ii., and iii. above are fields in which progress is being made with deployment in large-sized audit firms, while iv. 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 iii. 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 III-1-14 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.

On the other hand, with regard to the use of audit tools by small and medium-sized audit firms, according to the responses received from 53 small and medium-sized audit firms in this year, 10 firms have already implemented electronic audit documentation, and 28 firms have started to consider the possibility of implementing such tools. In addition, 12 firms replied that they had already introduced journal analysis tools (analysis of transaction details (journal entries) and detection of abnormal journal entries), indicating that small and medium-sized audit firms are also making use of IT in auditing, although not to the same extent as large and medium-sized audit firms.

As the improvement of IT skills on the part of partners and 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 III-1-14: Utilization of IT in audit operations at large-sized audit firms and mid-tier audit firms

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

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

### ■ Effective audit using AI ■

Currently, there is a move towards the introduction of AI into accounting audits, mainly with large-sized audit firms seeking to improve the efficiency and sophistication of audit work, mainly in areas such as financial data analysis and document verification, by having AI learn the know-how of auditors or by using generative AI.

As specific use case, chatbots are used to respond to queries on accounting and auditing standards, internal audit manuals, etc. AI analyses the financial statements and journal entries of audited companies using data from securities reports and past inappropriate accounting, and presents the audit team with accounts showing signs of fraud and abnormal journal entries. For another case, tools have been introduced that combine large-scale language models with accountants' know-how to quickly and comprehensively extract the necessary sections for auditing from contracts and other specialized documents without omission.

On the other hand, the American Institute of Certified Public Accountants (AICPA) and others have pointed out the following issues regarding the use of AI:

- Accuracy, timeliness and comprehensiveness of data: The accuracy and timeliness of input data is impaired, or the scope of input data is restricted, resulting in erroneous outputs.
- Black-boxing decision-making processes: In the case of deep learning, multiple decision-making processes exist over many layers, and even within a single layer, multiple processes exist in parallel, making it difficult to explain the decision-making process on which the output is based.
- Algorithm bias: Any bias in the algorithm or training data will produce biased outputs.
- Data confidentiality: If AI is used outside the firm or AI is trained using data obtained from an external internet environment, confidential information inside the firm may be leaked or external confidential information may be unintentionally stolen.

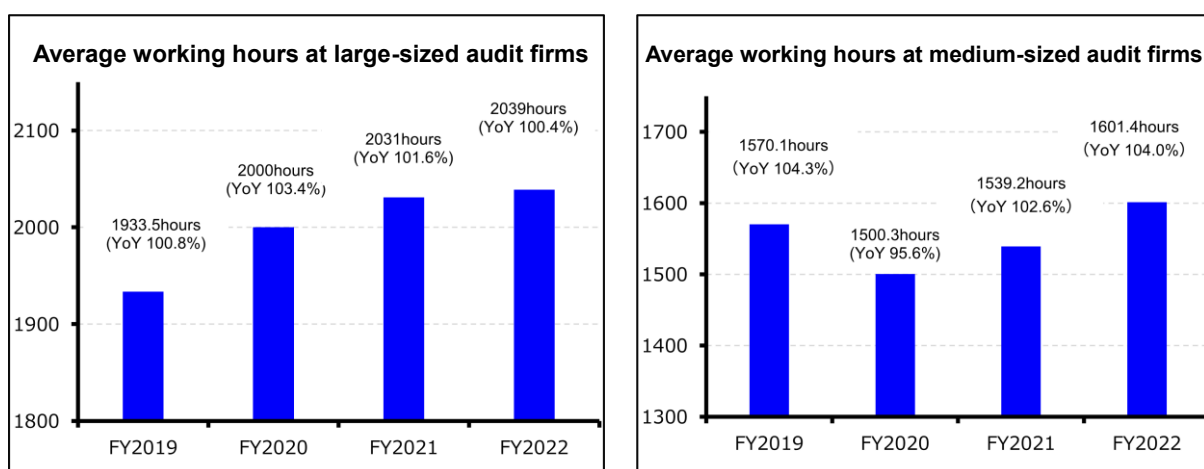
Audit firms that increase their use of AI are required to establish internal controls to address the above issues. In addition, accountants in such audit firms need to have a certain level of knowledge about data science and machine learning so that they do not rely on the output of AI.

## ■ Average working hours at large-sized and mid-tier audit firms ■

Some audit firms state the average annual working hours of partners, staff, etc. in their audit quality reports. The following table shows the average annual working hours and the average year-on-year rate of change for which we were able to confirm the information provided in the audit quality reports of large-sized audit firms and mid-tier audit firms over the last four years.

Although the average working hours of large-sized audit firms are longer than those of mid-tier audit firms, the rate of change from the previous year was lower for large-sized audit firms than for mid-tier audit firms, with the exception of FY2020.

Although this is a comparison of simple averages and is not a detailed analysis, it is possible that in addition to the transfer of audit services from large-sized audit firms to mid-tier audit firms and small and medium-sized audit firms, the introduction of IT tools in audit services and the transfer of operations to service delivery centers, which large-sized audit firms are actively promoting, are having an effect.



Going forward, it is possible that average annual working hours will decrease as the burden of data transfer associated with the initial introduction of IT tools is eliminated and engagement teams become more adept at using IT tools and service delivery centers. In addition, the introduction of AI-based tools may further enhance effectiveness.

### b. 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 it 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 (CSIRT<sup>4</sup>) 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.

While it is generally believed that cyber-attacks are targeted at areas where security is weak, there are some cases among small and medium audit firms where the rules and regulations regarding information security, etc., do not match the actual situation. We collected reports from 53 small and medium audit firms in this year, and in the responses on cybersecurity initiatives, some firms did not mention the introduction of anti-virus software, while less than half of the firms mentioned the initiatives such as the acquiring and analyzing communication logs, updating of operating systems, and establishing incident reporting procedures.

#### ■ CPA and Anti-Money Laundering and Countering the Financing Terrorism (AML/CFT) ■

Legal and accounting experts have a high level of expertise in law and accounting, etc., and have high social credibility. Therefore, transactions conducted through their duties and related operations can be abused as a means of money laundering and terrorist financing. The Financial Action Task Force (FATF)'s Fourth Mutual Assessment Report on Japan, published in August 2021, identifies Japan as a "Priority Follow-up Country" with inadequate measures against money laundering and terrorist financing. The FATF pointed out that Designated Non-Financial Businesses and Professions (DNFBPs), including CPAs, "have a low level of understanding of money laundering, terrorist financing risks, and AML / CFT requirements" and "Lawyers, judicial scriveners, administrative scriveners, tax accountants, and CPAs are not required to submit a suspicious transaction report. This severely compromises effectiveness."

The "Act for Partial Revision of the Act on Special Measures Concerning the Freezing of Property of International Terrorists and Other Measures Implemented by Japan in Response to United Nations Security Council Resolution 1267 and Other Resolutions, etc., in Response to International Traffic in Illicit Funds and Other Transactions" ("Revised Act") enacted on December 2, 2022, newly established the following provisions for legal/accounting experts.

- The purpose of the transaction and the beneficial owner of the corporation are added to the items to be confirmed in certain transactions (Financial consultation business for the sale and purchase of residential land and buildings, management and disposal of property, etc.) conducted by CPAs, etc.
- CPAs have been added to the list of entities subject to the suspicious transaction report (STR) obligation.

<sup>4</sup> CSIRT (Computer Security Incident Response Team) is the collective term for the organizations responsible for dealing with incidents pertaining to computer security.

Based on the Revised Act, the FSA published in December 2023 a partially amended draft of "Points of Attention Regarding the Act on Prevention of Transfer of Criminal Proceeds" and "Guidelines for Anti-Money Laundering and Combating the Financing of Terrorism for Certified Public Accountants and Audit Firms," which have been applied since April 2024.

## 7. Responses to Overseas Expansion of Companies

### a. Group audits

Many listed companies are operating in other countries by establishing subsidiaries and other entities, while M&A 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: Although the revised ASCS 600 "Special Consideration for Group Audits" was published in January 2023, its application begins with audits of financial statements for fiscal years beginning on or after April 1, 2024. Therefore, the descriptions in "a. Group Audits" are based on the pre-revision ASCS 600 "Group Audits."

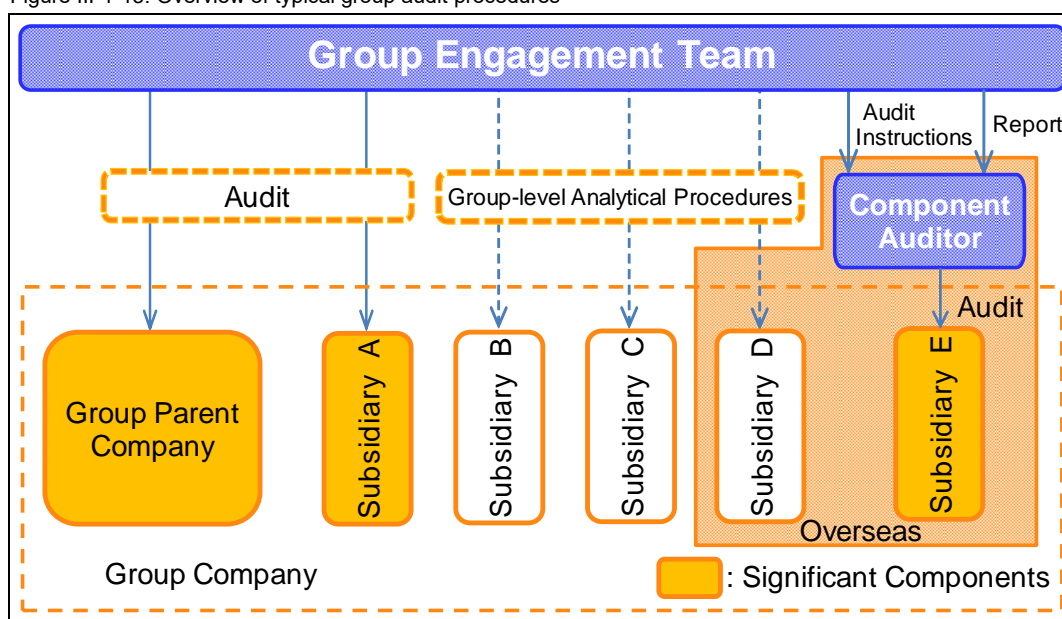
#### i. Overview of group audits

When auditors at a parent company ("group audit team") perform an audit attestation of group financial statements, 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), (26), (27)).

The following figure illustrates overview of typical group audit procedures (Figure III-1-15):

Figure III-1-15: Overview of typical group audit procedures



## ii. 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.

## iii. 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 III-1-16).

Figure III-1-16: 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 (Note1)	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.

(Note1) Documentation used by the group audit team to communicate its requirements to the component auditors.

(Note2) Regarding "Other" in the figure, of the 77 firms from which reports were collected in PY2023, information is presented for 28 firms conducting audit engagements for which group audit is required in cases where there is any component overseas. Among these, only four 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

#### iv. 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 communicate by visiting component auditors and online meetings. 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.

#### b. 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.

##### i. 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 III-1-17 and III-1-18). However, 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 [“7. Responses to Overseas Expansion of](#)

[Companies](#)”).

Figure III-1-17: Number of audit firms belonging to global networks<sup>5</sup> (FY2023) (unit: audit firms)

Large-sized audit firms	4
Mid-tier audit firms	4
Small and medium-sized audit firms	17
Total	25

(Note) PwC Kyoto merged with PwC Arata on December 1, 2023, and it is not included in the mid-tier audit firms as of July 1, 2024.  
(Source) Prepared by the CPAAOB based on operational reports

Figure III-1-18: List of global networks to which large-sized and mid-tier audit firms belong

Audit firm	Global network
KPMG AZSA LLC	KPMG International Limited (KPMG)
Deloitte Touche Tohmatsu LLC	Deloitte Touche Tohmatsu Limited (DTT)
Ernst & Young ShinNihon LLC	Ernst & Young Global Limited (EY)
PricewaterhouseCoopers Japan LLC	PricewaterhouseCoopers International Limited (PwC) (Note)
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

(Note) PwC Arata and PwC Kyoto merged on December 1, 2023 to form PwC Japan.  
(Source) Prepared by the CPAAOB based on data from publicly disclosed materials from each audit firm (as of July 1, 2024)

The operating revenues of global networks comprise revenues from audit services, tax related services and advisory services, and a breakdown of the top-ranking global networks in terms of operating revenues is shown below (Figure III-1-19). The scale of the Big Four global networks is particularly prominent.

Figure III-1-19: Operating revenues of global networks (unit: billion USD)

	DTT	PwC	EY	KPMG	BDO	GT
Operating revenues	649	530	493	364	141	75
Audit services (Share of operating revenues)	123 (19%)	187 (35%)	150 (30%)	126 (35%)	59 (42%)	32 (43%)
Tax-related services (Share of operating revenues)	103 (16%)	117 (22%)	120 (24%)	79 (22%)	32 (23%)	16 (21%)
Advisory services (Share of operating revenues)	423 (65%)	226 (43%)	223 (45%)	159 (44%)	49 (35%)	27 (36%)

(Source) Prepared by the CPAAOB based on data from publicly disclosed materials of each global network (2023 accounting year).

<sup>5</sup> Among small and medium-sized audit firms, the firms that have concluded cooperative relations (alliances) with overseas audit firms are included.

In Japan, the Big Four global networks' share of audit services is 97% of the 225 companies that 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 III-1-20)

Figure III-1-20: 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%	91%

(Sources) Japan: Compiled by the CPAAOB from QUICK and exchange data (as of March 31, 2024)

U.S.: Compiled by the CPAAOB from Bloomberg data (as of April 18, 2024)

U.K.: "Key Facts and Trends in the Accountancy Profession, August 2023," Financial Reporting Council

## ii. Relationships with global networks

Network firms comprising global networks are responsible for a range of areas including quality control in exchange for 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 the Person In Charge Of Quality Control (PICOQC) opine from the perspective of Japan as members of high level network committees, while members of oversight/assessment bodies take part in global meetings.

Embedding audit manuals and tools prepared by the networks, the large-sized audit firms perform audits in accordance with them subject to the networks' standards. AS of 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 (for details, see "[C. Monitoring of Systems of Quality Control, 2. Utilization of Global Reviews](#)").

Furthermore, some firms have an appetite to manage member firms on a regional basis. In the Asia-Pacific region, large Japanese audit firms tend to play a central role by participating as board members in organizations.

(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 receiving referral of audit engagements from network firms in other countries, but are not provided with audit manuals and other information or undergo global reviews.

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

Among small and medium-sized audit firms, partnerships and solo practitioners, some firms only use the global network logos and brand and receive referrals for audit engagements where the network firm belongs, and are not provided with audit manuals or subjected to global reviews.

■ International Forum of Independent Audit Regulators (IFIAR) ■

Established in 2006, the 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 March 2024, it had members from 56 countries and jurisdictions, including Japan.) In April 2017, the Secretariat of IFIAR was established in Tokyo, becoming the first headquarters of international organization in Japan.

Secretary General of the CPAAOB and the Deputy Commissioner of Strategy Development and Management Bureau of the FSA has been serving as the Chair of IFIAR since April 2023. This is the first appointment of a Chair from Asia since IFIAR was established in 2006.

In April 2024, the 24<sup>th</sup> IFIAR Plenary Meeting was hosted by the FSA and CPAAOB in Osaka. The IFIAR Plenary Meeting is an annual gathering of IFIAR members and stakeholders. This year's meeting was attended by more than 170 participants, including audit oversight bodies from 48 jurisdictions, CEOs of the six major audit firm networks, and other stakeholders.

The meeting covered topics of increasing importance in the audit industry in recent years, including audit firm governance, sustainability assurance, and the use of technology in auditing. This was the third time for Japan to host this conference, and the first time for IFIAR to hold a conference outside of Tokyo. Many attendees spoke highly of Japan's hospitality culture, not only for the content of the conference, but also for the smooth preparation and progress of the conference and the attention to detail during the conference.

## 8. Treatment of Key Audit Matters

From the perspective of enhancing the transparency and the provision of information pertaining to audits conducted under the FIEA, entries of "Key Audit Matters" (KAMs) in audit reports came to be required, starting with accounting audits for the fiscal year ending March 31, 2021.

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

i. 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

ii. 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 notes 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

b. Responses by audit firms

Recent monitoring found the following responses by large-sized and mid-tier audit firms. Some audit firms have developed a system for KAMs, including communications with audited companies (Figure III-1-21).

i. Development of guidance for preparation of KAMs

- Preparation and dissemination of guidance and descriptive examples with which audit teams comply when preparing KAMs

ii. Provision of training

- Training to provide explanation of good examples on KAMs based on analyses of actual application cases
- Training with a workshop format adopted, wherein audit teams actually draft KAMs
- Training to provide explanation of points to note in drafting KAMs

iii. Quality control section's support for audit team

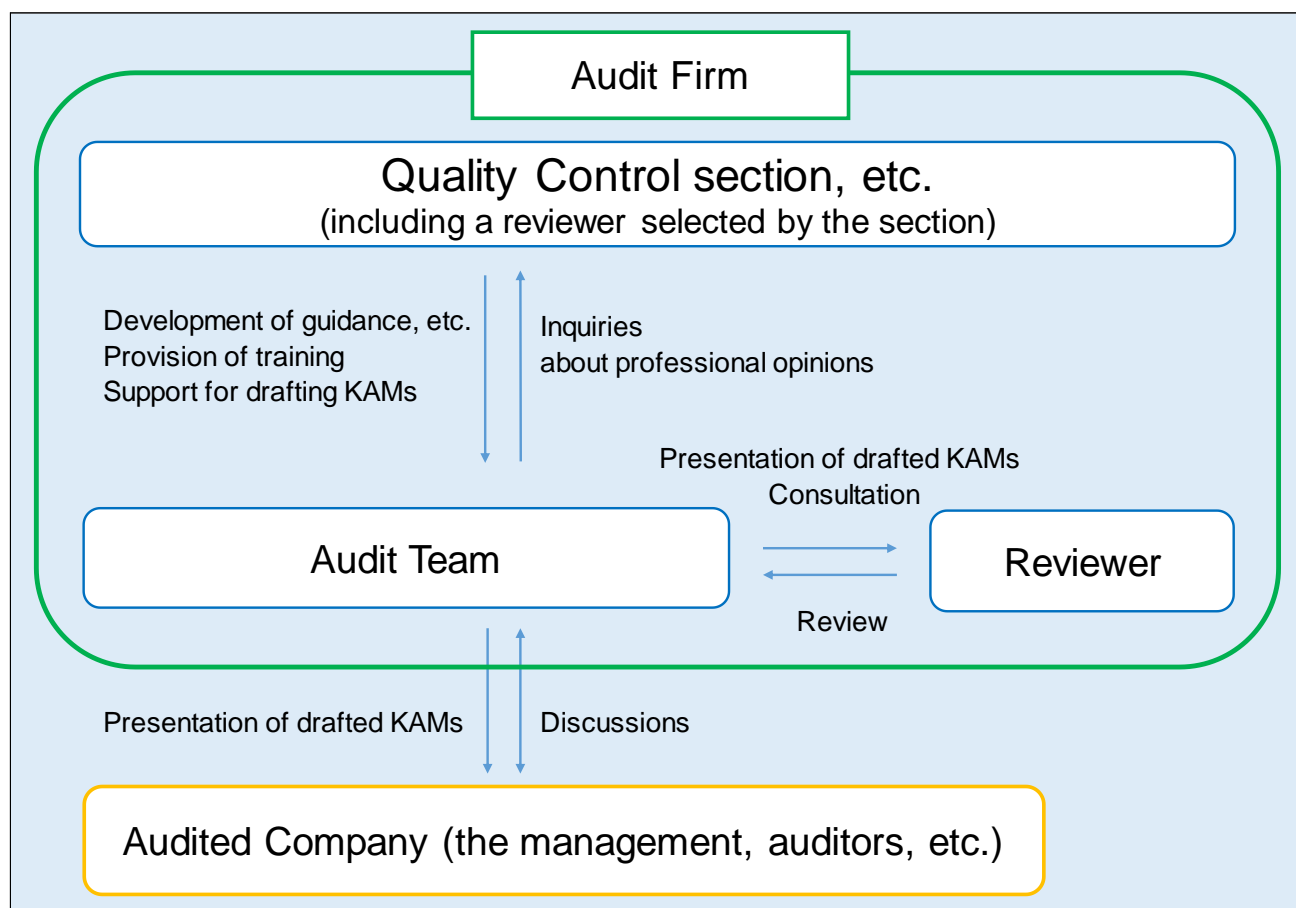
- Clarification of the specific content of communication and schedule to achieve in-depth communication throughout the year with the management, audit and supervisory board members and others of an audited company
- Monitoring and follow-up of audit teams' handling of KAMs
- Review of KAMs drafted by audit teams by a reviewer selected by the quality control section



iv. Reviews and inquiries of professional opinions

- Request for conference-format reviews by the headquarters and inquiries about professional opinions in specific cases, such as treating the non-disclosure of KAMs or assumption related to a going concern as KAMs

Figure III-1-21: Example of an audit firm's system for reporting of KAMs



c. Analyses of KAMs and recommendations

Regarding the KAMs in the year ending March 31, 2023, the FSA and other related organizations have released documents and other information (Figure III-1-22).

Figure III-1-22: Publication related to KAMs

Organizations that published their analyses, timing of publication, published documents, and web links
<p>Japanese Institute of Certified Public Accountants (April 2023)</p> <p>Auditing Standards Statements 701, Public knowledge document No.2, "Public knowledge document on the third year application of Key Audit Matters (KAMs)" <a href="https://jicpa.or.jp/specialized_field/20230403ffh.html">https://jicpa.or.jp/specialized_field/20230403ffh.html</a></p> <ul style="list-style-type: none"> <li>Summarizes points to keep in mind from the viewpoint of preventing boiler-plate and improving the usefulness of KAM.</li> </ul>
<p>Securities Analysts Association of Japan (February 2024)</p> <p>Good examples of KAMs helpful for securities analysts 2023 <a href="https://www.saa.or.jp/account/account/pdf/Kam20240213.pdf">https://www.saa.or.jp/account/account/pdf/Kam20240213.pdf</a></p> <ul style="list-style-type: none"> <li>In cooperation with the JICPA, the report introduces 23 'Excellent KAMs' and two 'Special KAMs' as good examples of KAMs, and describes the points that were evaluated and the comments of the analysts in charge.</li> <li>This is the third and final release of this kind, following the first two in February 2007 and in February 2023.</li> </ul>

Financial Services Agency (June 2023)

Efforts to establish and permeate the practice of Key Audit Matters (KAMs) <https://www.fsa.go.jp/news/r4/sonota/20230630-9/20230630-9.html>

- Summarizes the major efforts to made date to establish and permeate the KAM in practice.
- Although "Study Group on KAM" or "Characteristic Examples and Key Points of Key Audit Considerations (KAM)" are not planned to be held after FY 2023, the efforts to further improve KAM practices will be continued through follow-up of KAM publication and collaboration with relevant organizations.

The KAM is expected to promote constructive dialogue between auditors and stakeholders, but it also raises concerns such as boiler-plate and polarization of good and bad cases. The CPAAOB will examine the decision-making process on KAMs, the descriptions of audit responses, and the implementation status regarding audit responses based on the Basic Plan for Monitoring Audit Firms.

## 9. 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 ("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").

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")<sup>6</sup> had once decreased to 39% as certain large-sized audit firms spun off non-audit and attestation services and subsidiaries from their group in FY2015 and FY2017. However, it has been on an upward trend in recent years due to increases in revenue of group companies (Figure III-1-23). For audit firms' operating revenue, see "[I. Overview of the Audit Sector, B. Audit Firms, 5. Financial Condition \(Operating Revenue, Proportion of Audit and Attestation Services and Non-audit and Attestation Services\)](#)".

At mid-tier audit firm groups, the ratio of non-audit and attestation revenue has stayed lower

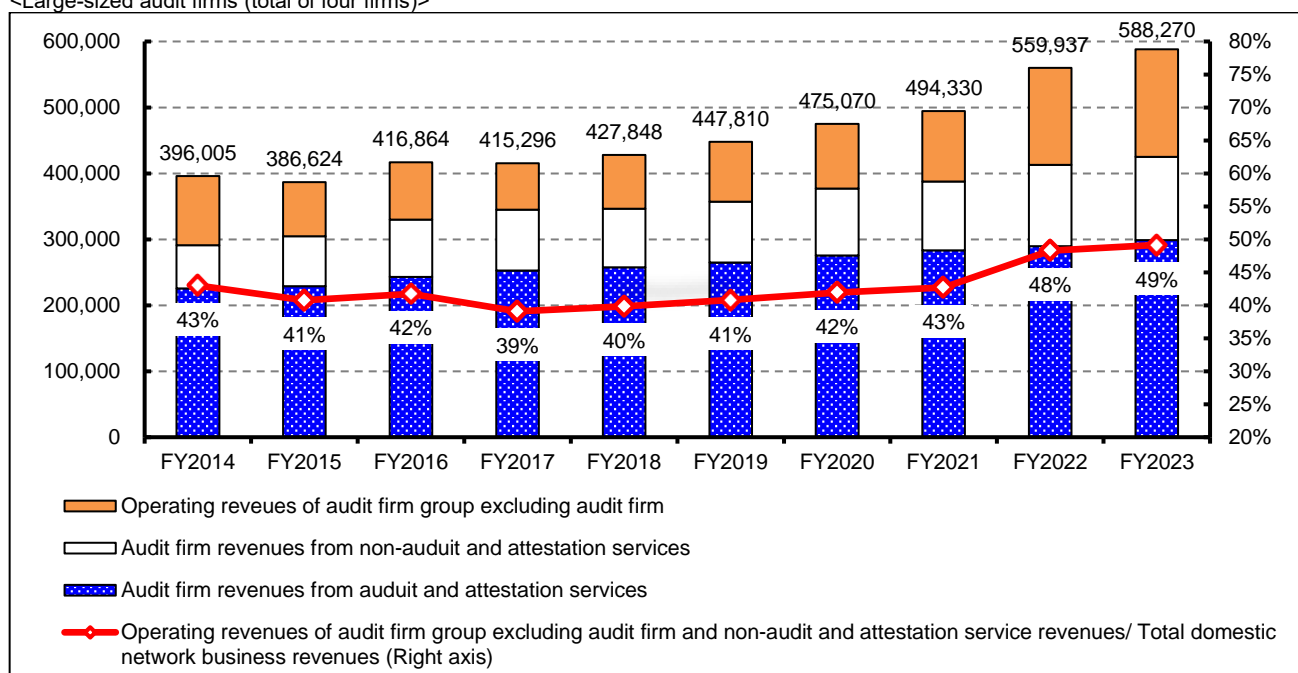
<sup>6</sup> Some group companies that do not have capital relationship with an audit firm have operating revenue of over 100 billion yen.

than at large-sized audit firms, moving roughly in a range between 10% and 13% from FY2014 through FY2023. 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-1-24).

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.

Figure III-1-23: 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)>



(Note1) 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.

(Note2) 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.

(Note3) 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.

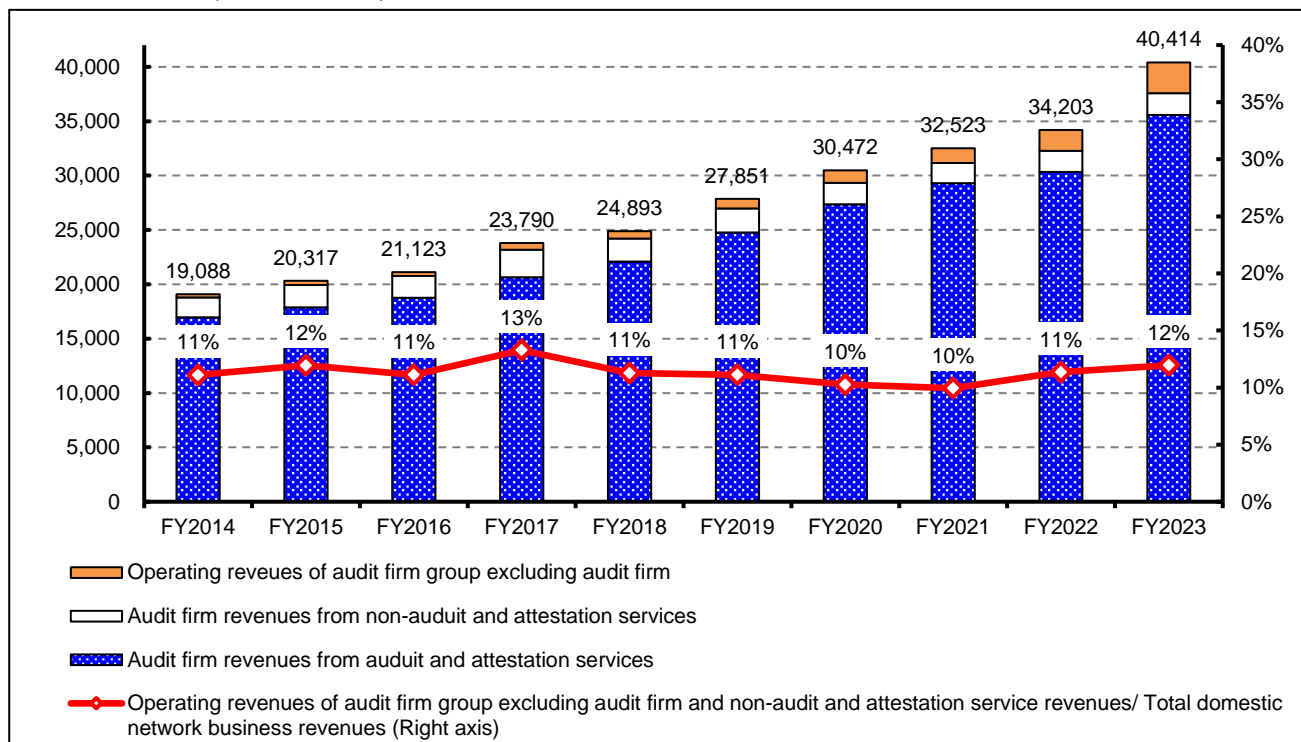
(Note4) In FY2015 and FY2017, certain large-sized audit firms spun off businesses or subsidiaries that perform non-audit and attestation services

(Note5) As the operational reports, including those for fiscal year 2023, were prepared before the establishment of PwC Japan, the figures include the revenues of PwC Aarata for large-sized audit firms and PwC Kyoto for mid-tier audit firms.

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

Figure III-1-24: 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)>



(Note1) Operating revenues of audit firm groups include revenues from companies that fall under subsidiaries, etc. of an audit firm within the group, in principle.

(Note2) Non-audit and attestation service revenues are the total of audit firm revenues from non-audit services and domestic network firm revenues

(Note3) 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.

(Note4) As the operational reports, including those for fiscal year 2023, were prepared before the establishment of PwC Japan, the figures include the revenues of PwC Aarata for large-sized audit firms and PwC Kyoto for mid-tier audit firms.

(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. When evaluating the audit procedure implemented by the audit team, material judgement in audit process and audit opinion, objectivity of quality control review has significant impact on the audit quality.

There are three main styles of engagement quality control reviews adopted by audit firms: a. the concurring review partner style (a review is performed by a partner other than the engagement partner), b. the council style (an engagement quality control review is performed by a council), and c. the combination style (both the concurring review partner style and council style 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.

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 covers 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.

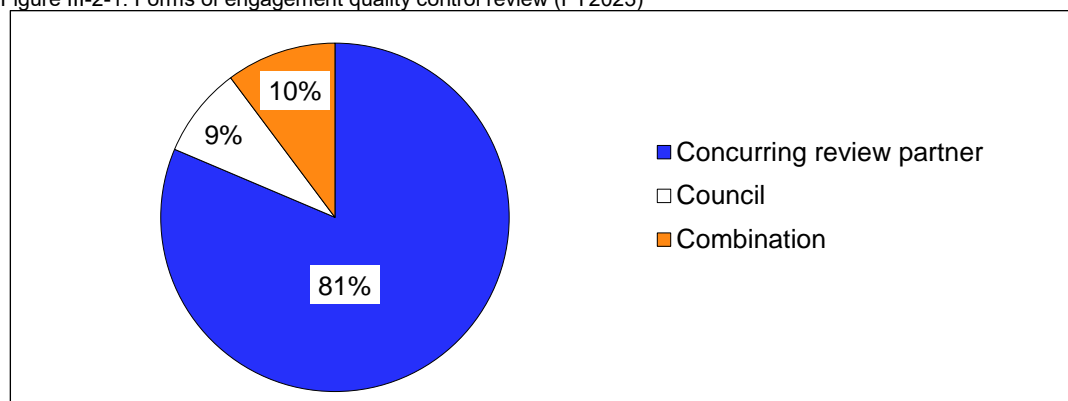
Since reviews of the council style involves the collaboration of several EQC reviewers, it allows for more multi-faceted reviews than the concurring review partner style.

### c. Combination style

Under the combination style, the concurring review partner style is used in some cases, while the council style is used when the matter involved in expressing audit opinion falls under predetermined criteria. In another case, either the concurring review partner style or the council style is used, depending on the risk of each audit 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 (FY2023)



(Note1) Aggregated the status of 274 audit firms based on operational reports submitted by the audit firms

(Note2) As fiscal year-end varies widely among small and medium-size audit firms, their results in FY2023 have yet to be tallied. This report therefore covers their results through FY2022 (from April 2022 through March 2023).

(Note3) The business report is prepared for the financial year before the establishment of PwC Japan and PwC Arata and PwC Kyoto are counted as separate entities.

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 at a review committee at headquarters. Furthermore, during reviews, some firms consult with bodies etc. featuring third parties in the case of important matters that would likely have a substantial social impact to ensure that decisions harmful to the public interest are not made.

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.

In large-sized and mid-tier audit firms, the review division and others often monitor the review results, etc. and the time spent by reviewers.

There also are audit firms implementing programs to further improve review functions, such as reinforcing the information shared among reviewers, carrying out review-related compulsory training programs and conducting quality control reviews by reviewers belonging to quality control division at headquarters in higher risk audit engagements compared to ordinary engagements.

## **C. Monitoring of Systems of Quality Control**

Audit firms are 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 the levels of quality control in audit engagements in a timely manner and continuously have remediation in place. 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 (hereinafter referred to as "global reviews"). Given that large-sized and mid-tier 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 (hereinafter referred to as "periodic inspections"). 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 (amended in February 2019) (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.

Large-sized and mid-tier 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 inspection 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 to four 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 approximately once every three years.
Inspectors	Under the supervision of quality control partner, partners and assistants who are not involved in inspected audit engagements  (Inspection team is mainly composed of staff belonging monitoring division.)	Under the supervision of quality control partner, 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 50 and 200	Between a few and around 20	Between one and around 20
Number of engagements handled by each inspector	One to two engagements	One to two engagements	One to six 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.	Some firms conduct under the inspection framework provided by the global network, while others conduct based on each firm's own inspection framework 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 tools.
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.

(Note1) The number of engagements per inspector was calculated by dividing the number of audits subjected to periodic inspections conducted in FY2023 by the number of inspectors involved.

(Note2) The business report is prepared for the financial year before the establishment of PwC Japan and PwC Arata and PwC Kyoto are counted as separate entities.

(Note3) As fiscal year-end varies widely among small and medium-size audit firms, their results in FY2023 have yet to be tallied. This report therefore covers their results through FY2022 (from April 2022 through March 2023).

(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 the detailed quality control provisions and audit manuals provided by the global network, and conduct global reviews to confirm whether network firms comply with those provisions and manual in periodic inspections and individual audit work.

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 [“III. Operation of Audit Firms, A. Operations Management System, 7. Responses to Overseas Expansion of Companies, b. Ties with Global Networks, ii. Relationships with global networks”](#).

While all large-sized audit firms are subject to the global review, some mid-tier audit firms are not. Few of the small and medium-sized audit firms that are part of the global networks are 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	Some firms are not 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 including remote work and flextime, 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 an 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 (amended in February 2019) (28)).

To meet this requirement, audit firms have developed structures for educating and training their engagement teams in proportion to their size (Figure III-4-2).

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

Large-sized and mid-tier audit firms	<ul style="list-style-type: none"> <li>• Establishing a training section within the human resources department to design and operate training programs for each job classification and level of experience</li> <li>• Audit firms implement a series of training programs for updating accounting and auditing standards, utilization of monitoring tools including data analysis tool, responses to fraud risks, key points by industrial sector, attendance to particular issues related to IPO audit, results of periodic inspections, inspections by the CPAAOB, quality control reviews by the JICPA and so forth, professional ethics and independence, information security and auditing.</li> <li>• Conducting examinations to measure understanding of training</li> <li>• Audit firms provide support for acquiring language-related qualifications and implement language training programs at home and abroad (including online training)</li> <li>• In addition to the above, periodic training on issues specific to financial institutions is provided to personnel working on the audits of listed financial institutions. Briefings on the latest industry trends are also organized</li> </ul>
Small and medium-sized audit firms, partnerships and solo practitioners	<ul style="list-style-type: none"> <li>• Providing opportunities to attend training sessions held at the JICPA headquarters or regional chapters, or to study by watching JICPA training e-learning in most audit firms</li> <li>• Sharing results of periodic inspections, the CPAAOB inspections, and JICPA quality control reviews within firms</li> </ul>

Large-sized and mid-tier audit firms have education and training sections, and they have developed training programs based on job classification and experience in conjunction with their global audit networks. Furthermore, by deploying e-learning systems, they enable individuals to access to education and training based on their learning level at times and locations that are convenient for them. Even among small and medium-sized audit firms, partnerships and solo practitioners, some of the comparatively larger ones have introduced level-based training systems and e-learning systems, while others are providing opportunities for education and training by covering the cost of tuition fees for external training programs. On the other hand, many small and medium-sized audit firms, partnerships and solo practitioners have difficulties in providing training programs that are suitable to auditors' experience and capability and situation in their audited companies. Thus, many firms are only confirming that their partners and staff are undergoing the Continuing Professional Development provided institutionally by JICPA (i.e. whether they have obtained the required number of credits).

(Education and training needed for IFRS adoption)

As the number of companies adopting and having decided to adopt IFRS in Japan has now exceeded 280, large-sized audit firms in particular are working to develop partners and staff involved in audits of companies adopting IFRS. 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

<p>Large-sized and mid-tier audit firms</p>	<ul style="list-style-type: none"> <li>• Introducing in-house IFRS certification, and providing periodic training on updates of the standards for certified personnel</li> <li>• Setting up sections within the firm specializing in the interpretation and specific application of IFRS, and distributing necessary guidelines within the firm, in addition to providing advice to and having consultations on specific issues with audit teams</li> </ul> <p>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.</p>
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### 3. Evaluation of Engagement Team Members

The appropriate performance evaluation of engagement team members demonstrates that the audit firm is committed to audit quality, and 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 (amended in February 2019) (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

<ul style="list-style-type: none"> <li>• 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.</li> <li>• Partners are evaluated with an emphasis on audit quality, including global capabilities</li> <li>• Skills and performance evaluations are conducted and quality control as well as ethics/compliance are given considerable weight in skills evaluations.</li> <li>• Assessments made during periodic inspections in relation to firm's system of quality control (for details, see "<a href="#">C. Monitoring of System of Quality Control, 1. Periodic Inspections</a>") as well as the results of quality control reviews etc. are reflected in the performance evaluations of engagement partners.</li> </ul>
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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.

Some 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.

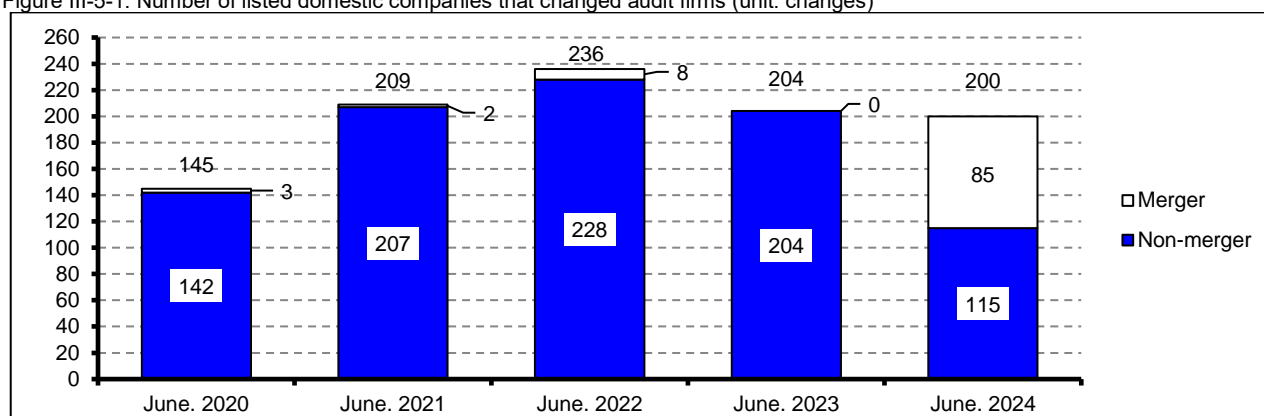
Large-sized and mid-tier audit firms establish rough standard of promotion by employees' seniorities. They generally promote to managers after approximately a seven to 10 year and to partners, following a selection process. As small and medium-sized audit firms rarely hire newly qualified CPAs, they 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, some 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. 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 200 cases of changing auditors of domestic listed companies in the year to June 2024. Of these, changes due to the mergers of audit firms accounted for 85 cases, including mergers between large-sized and mid-tier audit firms (76 cases) and mergers between small and medium-sized audit firms. Excluding those due to mergers, the number of changes has been on a downward trend since reaching a peak at the year to June 2022 (Figure III-5-1). For information on mergers, see "[I. Overview of the Audit Sector, B. Audit Firms, 4. Mergers of Audit Firms](#)".

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



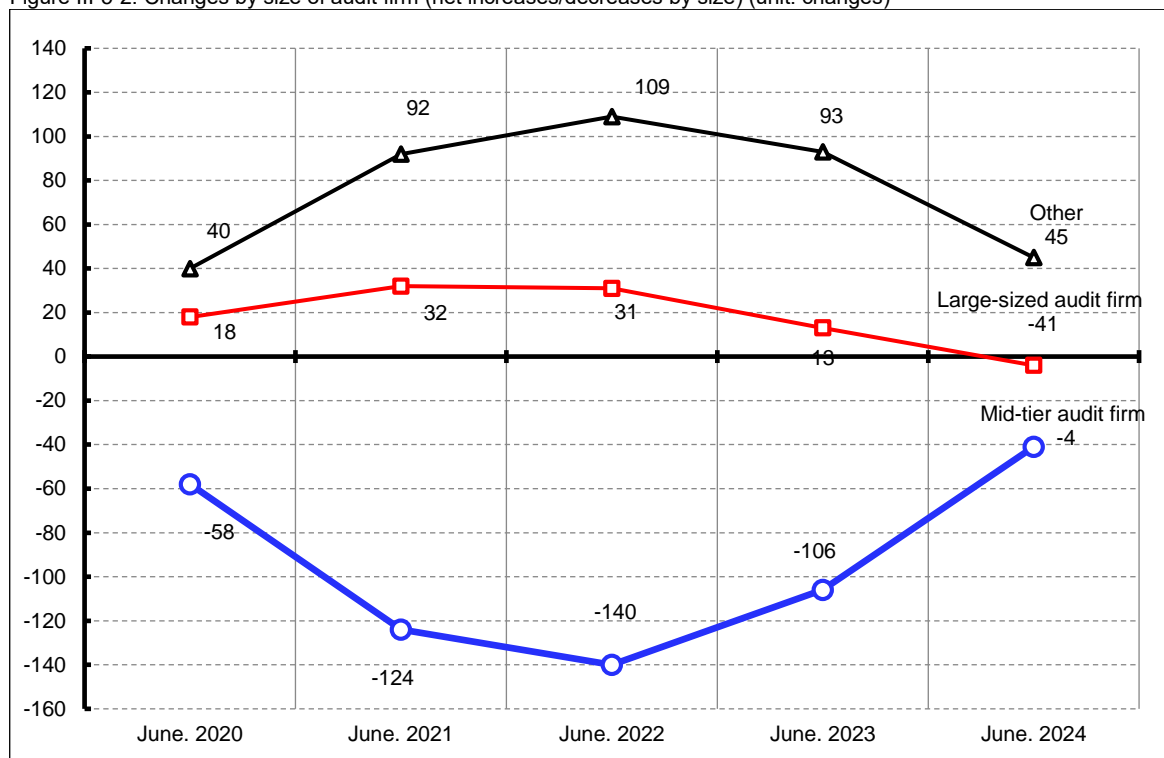
(Note) The number of companies that had decided on an incoming auditor by the end of June of each period based on timely disclosure of listed domestic companies.

As can be seen from changing in audit firms by size for the reasons other than audit firm mergers, the number of changes tended to decrease in the year to June 2024, but changing from large-sized audit firms to mid-tier audit firms or small and medium-sized audit firms, partnerships and solo practitioners still continued (Figures III-5-2 and III-5-3). This trend can be attributed to the factors such as audit firms (mainly large-sized firms) considering whether to continue the audit contracts, taking into account audit fees, audit risks and the staff required to perform the audit engagement, and audited companies selecting auditors, taking into account the length of continuous audit periods and the reasonableness of audit fees, have come to an end. 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](#)".

The above-mentioned shift from large audit firms to mid-tier as well as small and medium-sized audit firms indicates an increasing the role of small and medium-sized audit firms in auditing listed companies.

However, the CPAAOB's recent inspection of small and medium-sized audit firms identified 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 place greater emphasis on inspections of small and medium-size audit firms.

Figure III-5-2: Changes by size of audit firm (net increases/decreases by size) (unit: changes)



(Note1) Net increases/decreases in the number of changes

(Note2) 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

(Note3) Figures in the above table do not include changes due to mergers of audit firms.

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

From/To	June 2023	June 2024	Increase/Decrease
Large-sized → Large-sized	17	12	▲5
→ Mid-tier	26	10	▲16
→ Other	85	40	▲45
Mid-tier → Large-sized	0	5	5
→ Mid-tier	1	0	▲1
→ Other	17	11	▲6
Other → Large-sized	5	4	▲1
→ Mid-tier	4	2	▲2
→ Other	49	31	▲18
Total	204	115	▲89

(Note1) Aggregates of number of companies that had decided on a successor auditor by the end of June of each period, based on timely disclosures by listed domestic companies

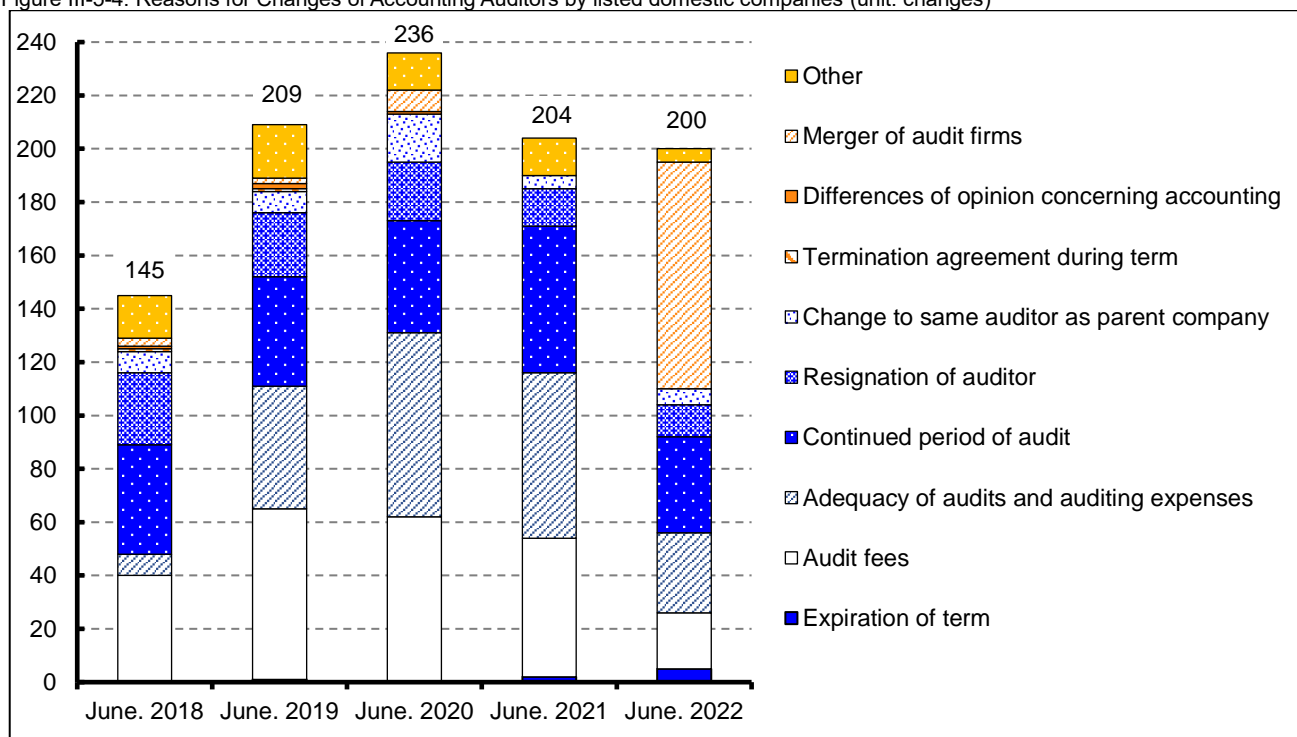
(Note2) "Other" in the figure refers to small and medium-sized audit firms, partnerships and solo practitioners.

(Note3) Figures in the above table do not include changes due to mergers of audit firms.

## 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 immediately (Article 402 of the Securities Listing Regulations, Tokyo Stock Exchange). In this case, the substantial reason for the change and the background thereof must be specifically disclosed. Under the regulations above, many firms stated the proposal of increase in audit fees as well as the adequacy of audit work in light of the size of the company's business and the reasonableness of audit fees as reasons for changes. In addition, in many cases, the reason for changes in auditors is stated as a result of comparison with other audit firms in consideration of the prolonged continuous audit period of the current auditor. (Figure III-5-4). In the year to June 2023, except for mergers of audit firms, many companies stated that the change of auditor was due to these reasons.

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



(Note1) Compiled by the CPAAOB based on timely disclosures by listed domestic companies choosing new auditors by the end of June each year.

(Note2) In the case of two or more reasons disclosed, the classification was made based on principal reasons.

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

There were no case of changes in auditors during the period in the year to June 2024. In the year to June 2023, in one cases, out of 204 cases, companies changed auditors in the middle of the fiscal year. The reason of this change is that the auditor proposed to resign due to conflict of views between auditor and audited company, and so on.



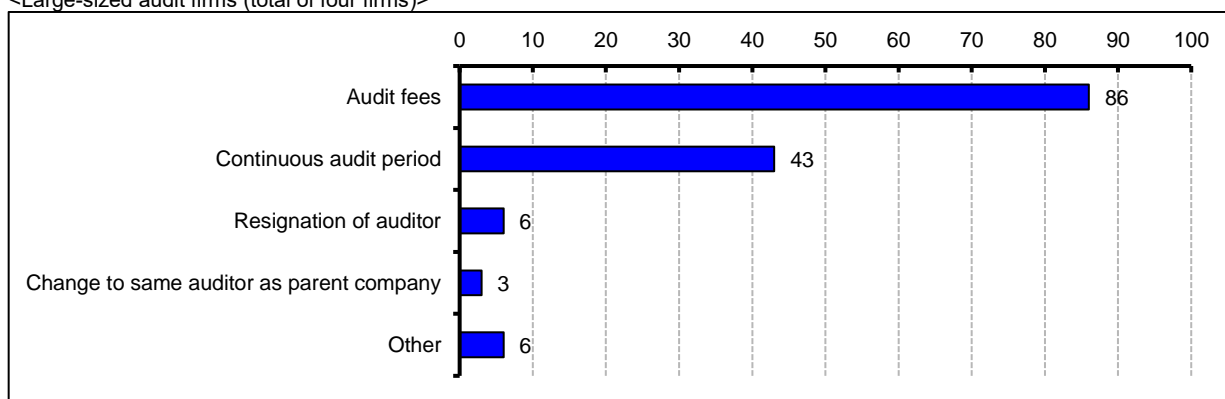
### 3. Reasons for Changes of Accounting Auditors as Identified Through Monitoring Activities

This section lays out reasons for changing accounting auditors ascertained through monitoring activities in PY2023 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 PY2023 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" while 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 when considering whether to renew audit contracts.

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)>



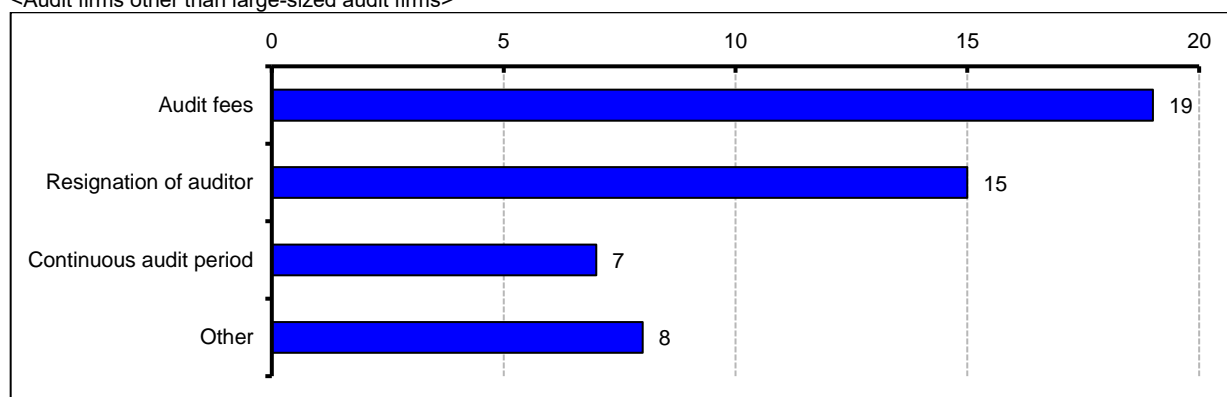
(Note1) Based on data from 107 changes identified through inspections and report collection during PY2023. On December 1, 2023, PwC Aarata and PwC Kyoto merged to form PwC Japan. The reasons for the changes in PY 2023 were obtained from PwC Aarata prior to the merger.

(Note2) If there was more than one reason, that change is included in the figure for each reason (a cumulative total of 144)

- #### b. Mid-tier audit firms and small and medium-sized audit firms, partnerships and solo practitioners
- "Audit fee" was the most common reason among 45 cases of changing auditors (who replied as former auditors) that were identified through the inspection of mid-tier audit firms and small and medium-sized audit firms and the collection of reports from them. "Resignation proposed by auditors" formed the second largest number of reasons. 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. “Other” included the objective of unifying auditors with parent companies as well as the desire of the audited company to replace its auditor with a firm that has specialized knowledge and experience in the business in which the audited company is expanding (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>



(Note1) Based on data from 45 changes for which the reason was identified through the inspection by the CPAAOB in PY2023 and reports collected from five mid-tier audit firms, 54 small and medium-sized audit firms and 24 solo practitioners. On December 1, 2023, PwC Aarata and PwC Kyoto merged to form PwC Japan. The reasons for the changes in PY 2023 were obtained from PwC Aarata prior to the merger.

(Note2) If there was more than one reason, that change is included in the figure for each reason (a cumulative total of 49)

## 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, most recently amended in July 2022, 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 according to applicable technical and professional standards. Therefore, the quotation of a low fee causes auditor's self-interest that disturbs auditor from observing the principles concerning proper capacity and attention required to professional specialists.

### 2. Methods for Calculating Audit Fees

The JICPA's "Guidelines for the Calculation of Audit Fees" give "hourly rates" and "fixed fees and hourly rates" as possible approaches. These methods are used when calculating estimated amount. The actual audit fee is determined through negotiations with audited companies (Figure III-6-1).

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

Methods	Methods for calculating estimated audit fees
Hourly rates	Audit fees are calculated by multiplying the number of hours an audit team spend by a certain unit price (hereinafter referred to as the "charged rate").
Fixed fees and hourly rates	<p>Audit fees comprise two components: the fixed fee (a fixed amount) and the hourly rates (a variable amount).</p> <p>The fixed fee is determined based on the factors such as the type of audit (FIEA audits, Companies Act audits, etc.) and the size of audited companies (capital, assets, sales, etc.), while the hourly rates are calculated by multiplying the time planned to spend on the audit by the charged rate.</p>

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

According to the reports collected in PY2023, audit fee estimates are calculated as follows.

a. Large-sized audit firm

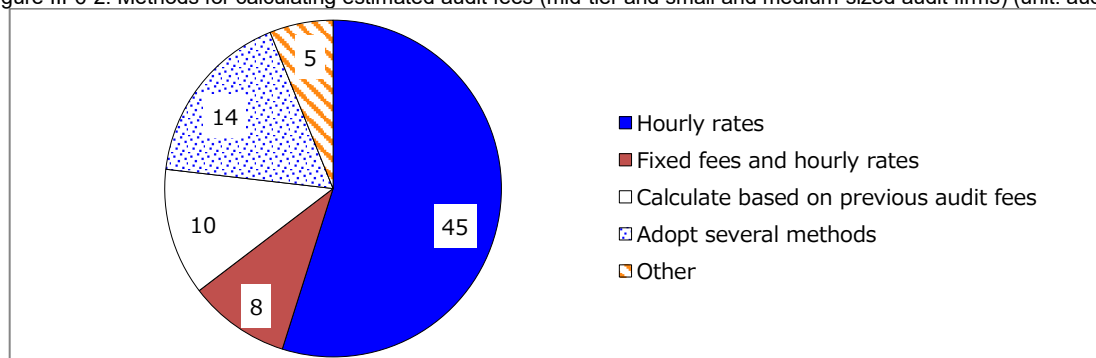
All large-sized audit firms state that they adopt the hourly rates approach for audit fee estimates. Hourly rates are set for each hierarchy level of employee, and the rate is determined while considering indirect costs associated with firm management and quality control such as the payrolls of administrative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

Some large-sized audit firms set elaborate charge rates, taking into account not only job classification but also the complexity of the audit engagement and each 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 multiple calculation methods (Figure III-6-2).

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



(Note1) Aggregated from reports collected from mid-tier and small and medium sized audit firms in PY2020

(Note2) Data for PwC Kyoto (currently PwC Japan), which merged with PwC Aarata in December 2023, is aggregated by including pre-merger information for mid-tier audit firms.

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

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

Settings	Number of audit firms	Percentage
Rates set	33	40%
Rates not set	49	60%
Total	82	100%

(Note1) Aggregated from reports collected from mid-tier and small and medium sized audit firms in PY2023

(Note2) Data for PwC Kyoto (currently PwC Japan), which merged with PwC Aarata in December 2023, is aggregated by including pre-merger information for mid-tier audit firms.

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

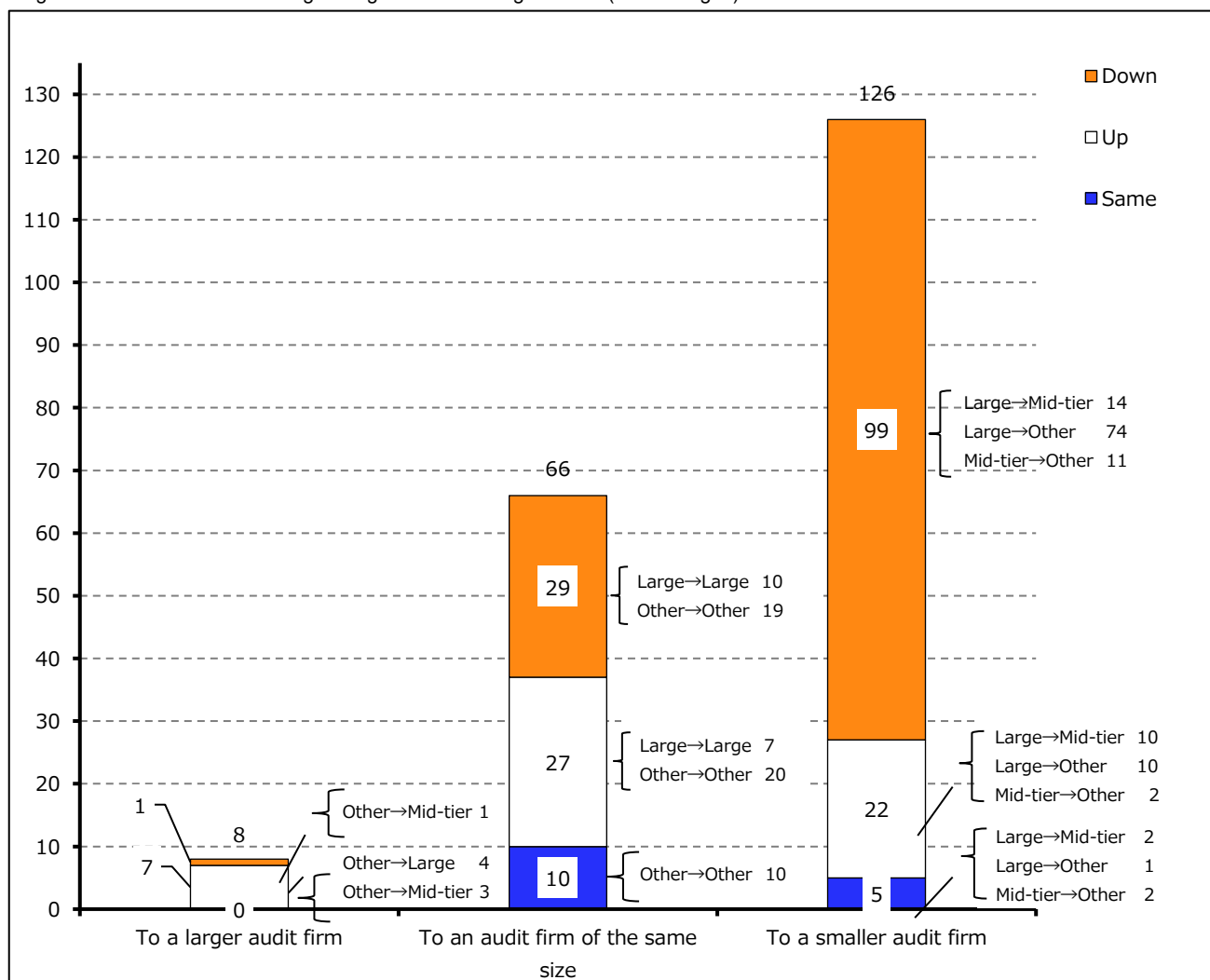
As audit fees are often reviewed after changing auditors, the CPAAOB analyzed pre- and post-transfer fees for 200 cases of changes in auditors at listed domestic companies that submitted timely disclosure from July 2022 to June 2023, and found that the differences in the margin of rise or fall in them depending on the scale of new accounting auditors.

Audit fees often rise in changes to bigger audit firms.

In moves from an audit firm to another of the same scale, fees rose in about 40% of transfers (27 of 66 cases) but dropped in some 40% (29 of 66 cases).

In changes to a smaller firm, audit fees decreased in approximately 80% (99 of 126 cases). Changes from a large-sized audit firm to a small or medium-sized firm resulted in audit fee falls in some 90% (74 of 85 cases).

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



(Note1) Tabulated timely disclosures of changes in accounting auditors by listed domestic companies (from July 2022 to June 2023) are included, provided that the audit fees before and after the changes were publicly disclosed

(Note2) Breakdowns of these changes are shown in the graph

(Note3) "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 2024

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

When the audit fees of a specific audited company represent a certain rate to the total revenues<sup>7</sup> of the audit firm, etc.<sup>8</sup>, significant reliance on a specific company and the concern about losing the source of revenue affect the level of self-interest that disturbs auditors from maintaining their independence and generate unreasonable pressure from the audited company.

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

- a. Prior to the issuance of the audit opinion on or after the second year's financial statements, the

<sup>7</sup> Total of audit and attestation revenue and non-audit and attestation revenue (various advisory services, tax processing and so forth)

<sup>8</sup> Audit firms and business enterprises that control business enterprises and audit firms through their contracts, human relations and so forth.

audit firm requests a professional accountant, who is not a member of the audit firm, to perform an engagement quality control review of that engagement

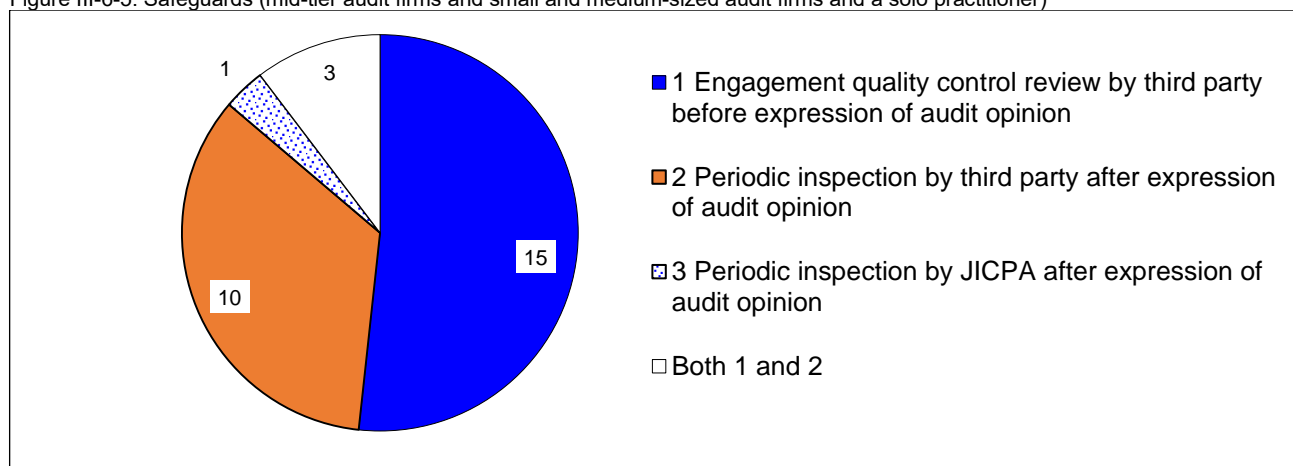
- b. After the audit opinion on or after the second year's financial statements has been issued and before the issuance of the audit opinion on the third year's financial statements, the audit firm requests a professional accountant, who is not a member of the firm to perform a periodic inspection of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

As of March 31, 2023, the "Guidelines for Independence" was abolished as a result of the revision of the Code of Ethics by the JICPA and the publication of the Practical Guidance on the Code of Ethics No.1, "Q&A on the Code of Ethics (Practical Guidance)." Rules on remuneration dependency were newly established in the revised "Code of Ethics", and a pre-audit opinion review is mandatory as a safeguard in cases where the reliance on remuneration for a particular audited company exceeds or is likely to exceed 15% for two consecutive years.

With regard to the status of implementing safeguards according to the previous "Guidelines for Independence," no large-sized audit firms breached the threshold (15%). Of 83 mid-tier audit firms and small and medium-sized audit firms traced through inspections and the collection of reports in PY2023, one mid-tier audit firm resorted to safeguards for one engagement while 18 small and medium-sized firms resorted to safeguards for 28 engagements.

These audit firms addressed the question of safeguard through reviews before the expression of opinions and periodic inspections after the expression of opinions, conducted by third-party CPAs, who are not members of the audit firm, and so forth (Figure III-6-5).

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



(Note) Tallied for 19 audit firms (29 engagements) out of 83 audit firms that were inspected or from which reports were collected in PY2023.