

I. Operations Management System (Root Cause Analysis)

1. Operations Management System and Root Cause Analysis

(1) Necessity of Root Cause Analysis

In inspections conducted by the CPAAOB, it is observed that a considerable number of audit firms implement only formalistic remedial measures for deficiencies identified through QC reviews or through the periodic evaluation of the system of quality management, without conducting a sufficiently thorough investigation into the underlying causes of their occurrence.

As the scope of the QC reviews and the CPAAOB inspections are highly limited, it is likely that, in addition to identified deficiencies, there remain undetected deficiencies with same root causes. If improvement measures are taken without root cause analysis, the effects will be temporary and similar deficiencies are likely to recur. In such cases, the improvement of the system of quality management of audit firms as a whole becomes ineffective or insufficient, does not lead to fundamental improvements, and consequently fails to enhance the quality of audits performed by audit firms.

On the contrary, for example, when audit firms adopt symptomatic and formalistic remedial measures—such as indiscriminately adding items to checklists in response to identified deficiencies—the amount of ineffective work imposed on the audit team is unnecessarily increased, which in turn becomes an obstacle to the effective and efficient provision of audit services.

Audit firms should recognize the importance of root cause analysis to realize substantial improvements of audit quality.

In recent years, large-seized audit firms have, with respect to deficiencies related to individual audit services identified through external inspections and the periodic evaluation of the system of quality management, not only communicated the nature of such deficiencies, but also undertaken investigations into their root causes as part of the audit firm's system of quality management.

For example, the quality control division performs thorough analysis of direct causes of deficiencies by interviews or questionnaires with the audit team and then considers what kinds of root causes exist in the operations management system or the quality control system for better improvement measures.

(2) Root Cause Analysis

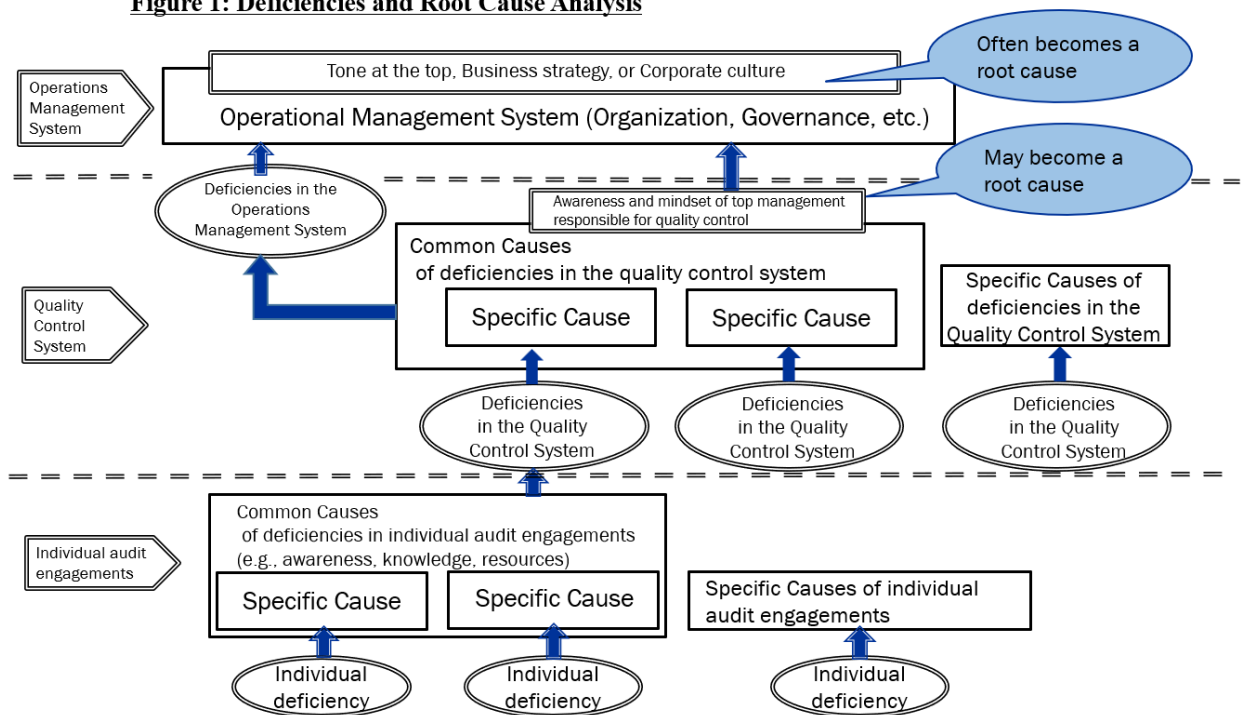
In root cause analysis, it is important to accurately identify the direct causes of deficiencies as a first step. In direct cause analysis, it is necessary not only to consider the knowledge, awareness, and experience of audit teams, but also to consider other aspects of the audit, such as situation of the audit teams and the audited companies.

Direct causes can be divided into "specific causes," which are unique to individual deficiencies, and "common causes" which are common to multiple deficiencies. Further analysis of common causes often leads to root causes of deficiencies.

In the past inspections, the root causes were frequently related to "tone at the top", "business strategy",

or “corporate culture” in the operations management system. Accordingly, it is especially necessary to pay attention to the effectiveness of the operations management system. In addition, the root causes sometimes exist in the quality control system (i.e. attitudes of PICOQC) (see [Figure 1]).

Figure 1: Deficiencies and Root Cause Analysis



Source: Prepared by the CPAAOB

The following is an example of a root cause analysis in which, as a result of analyzing the direct causes of deficiencies identified during inspections by CPAAOB, root causes were found in the operations management system and the quality control system.

[Large-sized audit firms]

[Case 1]

At the audit firm, multiple deficiencies, including significant deficiencies, were identified in a portion of the individual audit services reviewed as part of the inspections.

The direct causes of these deficiencies included insufficient professional skepticism on the part of the engagement partners and assistants to engagement when, in performing audits related to the application of the revenue recognition accounting standard and audits of significant accounting estimates, they critically assessed the consistency between the accounting treatments adopted by the audited companies and the information obtained from the audited companies. In addition, common root causes of deficiencies in the quality control system were identified, in that the Quality Management Division had not sufficiently implemented measures to enable audit teams to conduct critical assessments, based on the information obtained from the audited companies, in the performance of audits related to the application of the revenue recognition accounting standard and significant accounting estimates, and that engagement quality reviewers and those responsible for the periodic evaluation of the system of quality management had not sufficiently implemented measures to critically evaluate the audit procedures performed by the audit teams.

In light of these circumstances, as a result of further pursuit of the root causes, the following root cause was identified. Specifically, the executive management had believed that, by introducing and implementing audit quality improvement measures, all audit teams would proactively address accounting and auditing issues across all audit areas and obtain sufficient and appropriate audit evidence; moreover, they had assumed that, by implementing initiatives such as a system for appointing engagement quality reviewers in accordance with the risks of the audit services and efforts to secure sufficient advance preparation periods for the periodic evaluation of the system of quality management, all engagement quality reviewers and those responsible for the periodic evaluation of the system of quality management would enhance their awareness of the need to perform in-depth evaluations.

[Case 2]

At the audit firm, multiple deficiencies, including significant deficiencies, were identified in a portion of the individual audit services reviewed as part of the inspections.

The direct causes of these deficiencies included the engagement partners and assistants to engagement not sufficiently exercising critical assessment of management's assertions regarding the timeliness of accounting treatments related to accounting estimates, as well as not sufficiently recognizing the need to consider whether audit procedures commensurate with the assessed level of risk had been performed in areas where the risk of material misstatement was assessed as relatively low. In addition, common root causes of deficiencies in the quality control system were identified, in that sufficient coordination was not maintained between the Quality Management

Division and those responsible for implementing the improvement measures. For example, the Quality Management Division, which leads audit quality improvement initiatives, did not clearly specify the scope and level of procedures to be performed by the quality control partners in each audit division who were responsible for implementing the improvement measures when providing organizational support to audit teams facing heightened risks, nor did it sufficiently verify whether such measures were effectively producing improvement effects at the audit engagement level.

In light of these circumstances, as a result of further pursuit of the root causes, the following root cause was identified. That is, the executive management had not sufficiently recognized the need to confirm whether the Quality Management Division and those responsible for implementing improvement measures were closely coordinating with each other to ensure that such measures were operated in line with their original intent and objectives and were effectively producing improvement effects at the audit engagement level.

[Case 3]

At the audit firm, multiple deficiencies, including significant deficiencies, were identified in a portion of the individual audit services reviewed as part of the inspections.

The direct causes of these deficiencies included, in addition to the engagement partners and assistants to engagement lacking sufficient awareness of the need to reassess risks in audit areas assessed as having a relatively low risk of material misstatement in light of changes in the business environment, a lack of sufficient awareness of the need to consider whether audit procedures appropriately responsive to the assessed risks were being performed. In addition, the following common root cause of deficiencies in the quality control system was identified. That is, the Quality Management Division did not sufficiently instruct the audit divisions to confirm whether risks were appropriately assessed through an understanding of the business environment of the audited companies and whether risk response procedures addressing such risks were reliably implemented. In light of these circumstances, as a result of further pursuit of the root causes, the following root cause was identified. That is, the executive management, including the Chief Executive Officer, had assumed that, by establishing audit quality improvement measures, audit teams would appropriately perform risk assessments through an understanding of the business environment of the audited companies and properly implement risk response procedures addressing such risks, and had not sufficiently recognized the need to have the audit divisions confirm, through the Quality Management Division and other relevant functions, whether such measures were being appropriately implemented.

[Mid-tier audit firms]

[Case 1]

At the audit firm, multiple deficiencies, including significant deficiencies, were identified in a

portion of the individual audit services reviewed as part of the inspections.

The direct causes of these deficiencies included a tendency to carry forward audit approaches applied in prior years and a lack of professional skepticism in critically assessing management's assertions. In addition, a common root cause of deficiencies related to the quality control system was identified, namely that the PICOQC did not recognize that deficiencies had not been adequately detected or remediated because the level of staffing and involvement of the quality management function was insufficient relative to the expansion of audit services.

In light of these circumstances, as a result of further pursuit of the root causes, the following root cause was identified. That is, the Chief Executive Officer lacked sufficient awareness to personally verify the adequacy and effectiveness of the quality control system, as he had not grasped the situation in which the head office functions were unable to adequately assess the sufficiency of staffing amid the expansion of the firm's operations, and had believed that the strengthening of head office functions and improvements to the quality control system would be appropriately implemented if left to the respective responsible officers at the head office.

In addition, the following root cause was also identified. That is, despite insufficient awareness among engagement partners to perform their duties on their own responsibility and an insufficient overall enhancement of the skills of audit practitioners, the Chief Executive Officer and the respective responsible officers at the head office had not established a sufficient framework to verify the degree to which quality control-related measures had been disseminated and were effective at the audit engagement level.

[Case 2]

At the audit firm, pervasive and numerous deficiencies, including significant deficiencies, were identified across all of the individual audit services subject to inspections.

The direct causes of these deficiencies were that the engagement partners and assistants to engagement did not sufficiently understand the level of procedures required by the auditing standards and the current auditing standards, and, in addition, failed to sufficiently understand the significant assumptions used by management in the audit of accounting estimates and to critically assess management's assertions related to those significant assumptions, thereby not adequately exercising professional skepticism. In addition, the Quality Management Division had assumed that, by merely communicating quality control policies and procedures and quality control-related measures through training and other means, audit teams would respond appropriately, and therefore lacked sufficient awareness of the need to ascertain and evaluate the extent to which such policies and procedures had been disseminated and were effective, and to consider, based on the results thereof, whether revisions to such policies and procedures were necessary. Furthermore, when conducting reviews of audit documentation, reviews related to audit services, and the periodic evaluation of the system of quality management, the individual partners lacked a critically evaluative attitude toward the audit procedures performed by their own audit teams as well as by

other audit teams, and consequently did not appropriately fulfill their responsibilities as partners in maintaining and enhancing audit quality across the firm as a whole. As described above, common root causes of deficiencies in the quality control system were identified.

In light of these circumstances, as a result of further pursuit of the root causes, the following root cause was identified. That is, the executive management, led by the Chief Executive Officer, lacked sufficient awareness aimed at fostering a culture that emphasizes audit quality and at establishing an effective and organized operations management system, as evidenced by, among other factors, an insufficient commitment to compliance with professional ethics and internal rules in the firm's operations, including quality management. In addition, despite recognizing the ongoing shortage of audit teams and the need to enhance their overall skill levels, the executive management lacked sufficient awareness to personally practice initiatives aimed at ensuring appropriate audit quality across the firm as a whole, as they focused excessively on the early realization of increasing the number of full-time partners and staffs.

Furthermore, the following root cause was also identified. That is, the individual partners, including the Chief Executive Officer, did not accurately grasp the situation in which the audit teams, including themselves, lacked sufficient understanding of the level of procedures required by the auditing standards and the current auditing standards, nor the situation in which they lacked a sufficiently critical attitude toward assessing management's assertions in the audit of accounting estimates.

[Case 3]

At the audit firm, multiple deficiencies were identified across all of the individual audit services subject to inspections, and among them, numerous deficiencies, including significant deficiencies, were identified in individual audit services of a specific regional office.

These deficiencies in the individual audit services were attributable to common root causes of deficiencies in the individual audit services, namely that the engagement partners and assistants to engagement did not sufficiently understand the level required by the current auditing standards, as evidenced by a lack of professional skepticism in responding to fraud risks and in the audit of accounting estimates, and that they assumed that carrying forward audit procedures from the prior year would be sufficient, thereby lacking sufficient awareness of the need to reassess risk assessments and audit procedures responsive to assessed risks in each audit period. In addition, the deficiencies in the individual audit services of a specific regional office were attributable to common root causes of deficiencies in the individual audit services, in that some engagement partners assumed that audit procedures were being appropriately performed by other engagement partners serving as in-charge, and consequently lacked sufficient awareness of the need to provide appropriate direction and supervision to the audit team and to perform in-depth reviews.

Furthermore, the common root causes of the deficiencies in the individual audit services were

attributable to common deficiencies in the quality control system, in that the PICOQC believed that the dissemination of improvement measures to the audit engagement level should be led by the audit business division, and therefore lacked sufficient awareness to proactively encourage the need for coordination between the quality management function and the audit business division. In addition, the common root causes of the deficiencies in the individual audit services at a specific regional office were attributable to common deficiencies in the quality control system, in that the head of the audit business division assumed that, by appropriately appointing engagement partners, audit teams would be appropriately formed at the regional office, and consequently lacked sufficient awareness of the need for the audit business division to provide organizational support.

In light of these circumstances, as a result of further pursuit of the root causes, the following root causes were identified. That is, the Chief Executive Officer avoided exercising strong leadership in the planning and implementation of audit quality improvement measures and instead placed emphasis on the autonomy of the quality management function and the audit business division, resulting in a lack of awareness of the need to promote improvements in a timely manner. In addition, the executive management likewise respected the autonomy of the quality management function and the audit business division and lacked sufficient recognition of the need for strong coordination between the two functions. In addition, the following root cause was also identified. That is, although the executive management was aware of issues concerning audit quality at certain regional offices, they believed that those regional offices were capable of pursuing improvements on their own, and therefore lacked sufficient awareness of the need to provide proactive support to those regional offices.

[Small and medium-sized audit firms]

[Case 1]

At the audit firm, deficiencies were identified in the quality control system, and moreover, numerous deficiencies, including significant deficiencies, were also identified in the individual audit services subject to inspections.

The deficiencies in the individual audit services were attributable to the following common causes. That is, the engagement partners and assistants to engagement lacked sufficient understanding of the level of procedures required by the current auditing standards with respect to the assessment of and responses to fraud risks and the audit of accounting estimates, and, in addition, because the engagement partners placed excessive reliance on the assistants to engagement, they assumed that the assistants to engagement were appropriately performing their work and, as a result, did not perform in-depth reviews of the audit documentation. In addition, the common root causes of the deficiencies in the individual audit services were attributable to common deficiencies in the quality control system, in that the Chief Executive Officer and the PICOQC had not performed root cause analyses of findings identified through quality control reviews and ongoing monitoring activities

(including the periodic evaluation of the system of quality management) for the purpose of preventing the recurrence of similar deficiencies, and lacked sufficient awareness regarding the implementation of remedial actions, as well as failing to recognize that the assistants to engagement lacked sufficient understanding of the level of procedures required by the current auditing standards. In light of these circumstances, as a result of further pursuit of the root causes, the following root cause was identified. That is, the Chief Executive Officer and the PICOQC, based on the assumption that there were no issues with audit quality simply because no significant findings had been identified in past quality control reviews and similar activities, had become less conscious of the need to maintain and enhance audit quality, and, having believed that merely formally establishing a quality control system would naturally lead to improvements in audit quality, failed to exercise leadership toward improving audit quality.

[Case 2]

At the audit firm, pervasive and numerous deficiencies, including significant deficiencies, were identified in the individual audit services subject to inspections.

The deficiencies in the individual audit services had common causes, including insufficient understanding among the engagement partners and assistants to engagement of accounting standards, auditing standards, and the level of procedures required by the auditing standards, as well as a lack of professional skepticism, as evidenced by their failure to critically assess the assumptions used by management in the audit of accounting estimates. In addition, the common root causes of the deficiencies in the individual audit services were attributable to the following common root causes related to deficiencies in the quality control system. That is, among the partners, including the Chief Executive Officer, awareness was not shared of the importance of ensuring appropriate audit quality through in-depth evaluation of the audit procedures performed by assistants to engagement and audit teams, resulting in a failure to foster an organizational culture aimed at ensuring appropriate audit quality. Furthermore, the Chief Executive Officer and the PICOQC did not sufficiently recognize the need to verify the extent to which improvement measures in response to findings identified in quality control reviews and similar activities had been disseminated and were effective, and therefore had not planned or implemented measures for such verification.

In light of these circumstances, as a result of further pursuit of the root causes, the following root cause was identified. That is, the Chief Executive Officer lacked sufficient awareness to take the initiative in improving audit quality and did not exercise leadership toward establishing an effective and organized operations management system and quality control system to ensure appropriate audit quality. In addition, the Chief Executive Officer and the PICOQC assumed that an appropriate level of audit quality was being ensured because the firm's audit services were performed by partners with extensive practical experience and staffs with experience at large audit firms, and consequently were unable to accurately grasp the overall level of audit quality across the firm.

[Case 3]

Although the audit firm is small in size, since its establishment it has divided its audit business into two audit divisions, with each division independently managing its audit services, finance, and human resources, thereby fostering an organizational culture that prioritizes the independence of each division. In addition, among the audit team, only the partners are full-time, while all assistants to engagement are certified public accountants engaged as part-time staffs.

Under these circumstances, at the audit firm, multiple deficiencies, including significant deficiencies, were identified in the quality control system, and moreover, numerous deficiencies, including significant deficiencies, were also identified in the individual audit services subject to inspections.

The deficiencies in the individual audit services were attributable to common causes, namely that the engagement partners and assistants to engagement did not sufficiently understand the level required by the auditing standards and lacked professional skepticism, such as critically assessing management's assertions, and that the assistants to engagement, who were part-time staffs, lacked a sense of affiliation with the firm as well as awareness of the need to maintain and enhance audit quality. In addition, the common root causes of the deficiencies in the individual audit services were attributable to the following common root causes related to deficiencies in the quality control system. That is, the Chief Executive Officer and the PICOQC did not sufficiently understand the depth and methods of root cause analysis required to prevent the occurrence of similar deficiencies in response to findings identified through QC reviews and similar activities, and furthermore, they placed excessive reliance on the engagement partners and assistants to engagement based on the assumption that they possessed sufficient capabilities due to their extensive practical experience.

In light of these circumstances, as a result of further pursuit of the root causes, the following root cause was identified. That is, the Chief Executive Officer and the PICOQC did not recognize that all audit teams, including themselves, lacked sufficient understanding of the intent of the current auditing standards as well as the level of quality management and audit procedures required by those standards. In addition, because no significant findings had been identified in past QC reviews and similar activities, they believed that the existing organizational structure, which has remained unchanged since the firm's establishment, was adequate, and therefore did not recognize the need for integrated operations management, such as the consolidation of audit divisions, or the need to establish an organizational audit engagement structure, including enhancing the number of full-time assistants to engagement.

As illustrated by the cases presented above, the root causes of deficiencies often lie in the operations management system and the quality control system, and in order to remediate such deficiencies, it is necessary to address and eliminate these root causes.

Currently, audit firms are undertaking efforts to develop and strengthen their organizational management frameworks in line with the Audit Firm Governance Code; however, due attention should be paid to the

effectiveness of such efforts, and firms should strive to ensure that these initiatives truly contribute to the maintenance and enhancement of audit quality.

(3) Specific Examples of Root Causes

The cases presented below are specific examples of root causes identified through inspections, including the cases of root cause analysis described above in (2) Root Cause Analysis.

In addressing deficiencies, it is necessary to work toward genuine maintenance and enhancement of audit quality by identifying and remedying fundamental issues—such as problems related to the audit firm’s operations management system—while referring to these specific examples.

[Large-sized audit firms]

Large-sized audit firms often have issues in the operation of quality control system.

Since large-sized audit firms have thousands of employees, they often run its business by multiple divisions which have hundreds of people each, including local offices.

Under these circumstances, in order to enhance the level of quality management throughout the entire organization, it is necessary not only to establish the formal aspects of the quality control system, such as organizational structures and procedures, but also for the executive management, led by the Chief Executive Officer, to exercise strong leadership and to work in close coordination with business divisions and other units close to the audit engagements, so that policies and measures are effectively disseminated and embedded down to each individual audit team.

In recent years, large audit firms have shown a tendency to establish quality control systems not only at the head office level but also by involving business divisions closer to audit engagements in order to make their audit quality improvement initiatives sustainable. As a result, the role of business divisions in improving audit quality and in disseminating such improvements to audit teams has become increasingly important.

However, in initiatives aimed at improving audit quality, there are cases where, on the grounds of prioritizing the autonomy of business divisions, the executive management and the quality management function have left matters largely to those divisions, as well as cases where sufficient communication has not been maintained between the executive management and quality management function and the business divisions. As a result, problems may arise, such as an insufficient understanding of the actual conditions within business divisions and inadequate verification as to whether improvement measures have been appropriately implemented. Therefore, the executive management and the quality management function need to appropriately grasp the status of initiatives undertaken by business divisions and to sufficiently confirm the extent to which improvement measures have been disseminated and are effective.

Specific examples of root causes of deficiencies identified at large audit firms through past inspections by CPAAOB include the following:

- The executive management believed that, by introducing and implementing audit quality improvement measures, all audit teams would proactively address accounting and auditing issues, including through consultations with the Quality Management Division—across all audit areas, including key focus areas, and thereby obtain sufficient and appropriate audit evidence. In addition, they believed that, by implementing initiatives such as a system for appointing engagement quality reviewers in accordance with the risks of the audit services and efforts to secure sufficient advance preparation periods for the periodic evaluation of the system of quality management, all engagement quality reviewers and those responsible for the periodic evaluation of the system of quality management would enhance their awareness of the need to perform in-depth evaluations. (With regard to root cause analysis regarding this example, also refer to [Large-sized audit firms] [Case 1] on p. 4)
- The executive management did not sufficiently recognize the need to confirm whether the Quality Management Division, which led improvement measures based on the results of the root cause analysis of findings identified in the previous inspections by CPAAOB, and the quality control partners of the audit business divisions were closely coordinating with each other so as to ensure that such improvement measures were operated in line with their original intent and objectives and effectively produced improvement effects at the audit engagement level. (With regard to root cause analysis regarding this example, also refer to [Large-sized audit firms] [Case 2] on p. 5).
- The executive management, including the Chief Executive Officer, assumed that, by establishing audit quality improvement measures, audit teams would appropriately perform risk assessments through an understanding of the business environment of the audited companies and properly implement audit procedures responsive to assessed risks, and did not sufficiently recognize the need to have the audit business divisions confirm, through the Quality Management Division and other relevant functions, the status of such implementation. (With regard to root cause analysis regarding this example, also refer to [Large-sized audit firms] [Case 3] on p. 5).
- The executive management believed that audit responses in important areas other than those involving significant risks would be improved by disseminating guidance regarding the appropriate performance of audit procedures responsive to assessed risks in such other important areas.
- The executive management and the Quality Management Division believed that all engagement partners and assistants to engagement fully understood the significance and importance of the Certified Public Accountant registration system, and that when including information on CPA qualifications, the number of professionals by qualification, and hours worked by qualification in materials submitted outside the firm, appropriate verification and aggregation were being performed.

[Mid-tier audit firms]

With regard to mid-tier audit firms, while it can be observed that each firm is making efforts to develop

its quality control system, there are cases where the strengthening of head office functions remains insufficient. In addition, there are cases where the firm leadership's awareness with respect to quality management has not kept pace with the speed of business expansion, where audit services rely heavily on a large number of part-time staffs and assistants to engagement, and where challenges exist in quality management at specific regional offices. On the other hand, as each firm has a different operations management system depending on its history and size, the root causes of the issues differ from firm to firm.

Therefore, each firm needs to pursue the root causes based on a thorough understanding of its history and operations management system, and to engage in effective improvements.

The following are specific examples of root causes of deficiencies identified at mid-tier audit firms through past inspections by CPAAOB:

- While expanding the firm's operations, the Chief Executive Officer had not grasped the situation in which the head office functions were unable to adequately assess the sufficiency of staffing, and believed that the strengthening of head office functions and improvements to the quality control system would be appropriately implemented if left to the respective responsible officers at the head office, thereby lacking sufficient awareness of the need to verify the adequacy and effectiveness of the quality control system. In addition, the Chief Executive Officer and the respective responsible officers at the head office, despite insufficient awareness among engagement partners to perform their duties on their own responsibility and insufficient enhancement of the overall skill levels of audit teams, had not established a sufficient framework to verify the extent to which quality control-related measures had been disseminated and were effective at the audit engagement level. (With regard to root cause analysis regarding this example, also refer to [Mid-tier audit firms] [Case 1] on p. 6)
- The executive management, led by the Chief Executive Officer, lacked sufficient awareness aimed at fostering a culture that places emphasis on audit quality and at establishing an effective and organized operations management system, as evidenced by, among other factors, an insufficient commitment to compliance with professional ethics and internal rules in the firm's operations, including quality management. In addition, despite recognizing the ongoing shortage of audit teams and the need to enhance their overall skill levels, they lacked sufficient awareness to personally practice initiatives aimed at ensuring appropriate audit quality across the firm as a whole, as they focused excessively on the early realization of increasing the number of full-time partners and staffs. Furthermore, the individual partners, including the Chief Executive Officer, did not accurately grasp the situation in which the audit teams, including themselves, lacked sufficient understanding of the level of procedures required by the auditing standards and the current auditing standards, nor the situation in which they lacked a sufficiently critical attitude

toward assessing management's assertions in the audit of accounting estimates. (With regard to root cause analysis regarding this example, also refer to [Mid-tier audit firms] [Case 2] on p.6)

- In planning and implementing audit quality improvement measures, the Chief Executive Officer placed emphasis on the need to develop personnel responsible for maintaining and enhancing audit quality; however, since assuming the role of CEO, he also sought to avoid exercising excessively strong leadership and instead emphasized allowing the quality management function and the audit business division to act autonomously. As a result, he lacked sufficient awareness of the need to promote improvements in a timely manner. In addition, the executive management believed that coordination between the quality management function and the audit business division had been achieved through discussions at executive management meetings and similar forums, where issues were organized and shared, and therefore respected the autonomy of each division in advancing audit quality improvements. As a result, they lacked sufficient recognition of the need for strong coordination between the two functions. Furthermore, although the executive management was aware of issues concerning audit quality at certain regional offices, they believed that those regional offices could pursue improvements autonomously and consequently lacked sufficient awareness of the need to provide proactive support to those regional offices, such as arranging the personnel necessary for such improvements. (With regard to root cause analysis regarding this example, also refer to [Mid-tier audit firms] [Case 3] on p.11)
- The executive management assumed that issues related to human and time resources had been resolved through measures such as changes in the allocation of personnel to audit services, the introduction of monitoring of the levels of involvement of engagement partners and others, and an increase in the number of assistants to engagement.
- The executive management, including the Chief Executive Officer, lacked sufficient awareness to take the initiative in earnestly engaging in the maintenance and enhancement of audit quality, and therefore did not exercise leadership toward ensuring an appropriate level of audit quality across the firm as a whole. In addition, because no significant quality control issues were identified as a result of implementing remedial actions in response to deficiencies pointed out through external inspections, the executive management assumed that the personnel's insufficient understanding of the auditing standards had already been resolved and that the firm's audit quality had been improved to an appropriate level, and therefore has yet to accurately grasp the level of audit quality across the firm as a whole.

[Small and medium-sized audit firms]

Small and medium-sized audit firms vary in size and background, and accordingly, the level at which their quality control systems are designed, implemented and maintained also differs from firm to firm. However, it is common among such firms that, due to their relatively small organizational size, it is difficult to provide organizational support to audit teams in areas such as quality management.

Consequently, the level of business operations and quality management is often significantly influenced by the capabilities of the individuals belonging to the audit firm, including the Chief Executive Officer, as well as by the relationships between those individuals and the firm. Because there are many cases where a low level of awareness of and involvement in quality management by the Chief Executive Officer affects the firm-wide culture of quality management, it is important for the Chief Executive Officer to exercise leadership in quality management. In addition, attention should be given to the fact that, when significant changes arise in the business environment of an audit firm as a result of a merger, the Chief Executive Officer has the responsibility to fully exercise leadership and to appropriately design the audit firm's quality control system in line with such changes. Specific examples of root causes of deficiencies identified at small and medium-sized audit firms through past inspections by CPAAOB include the following. In recent inspections, there have been cases in which root causes were identified as a lack of leadership by the Chief Executive Officer toward improving audit quality and a failure to accurately grasp the overall level of audit quality across the firm as a whole.

- The Chief Executive Officer and the PICOQC, based on the assumption that there were no issues with audit quality because no significant findings had been identified in past QC reviews, became less conscious of the need to maintain and enhance audit quality. Furthermore, having believed that merely formally establishing a quality control system would naturally lead to improvements in audit quality, they failed to exercise leadership toward improving audit quality. (With regard to root cause analysis regarding this example, also refer to [Small and medium-sized audit firms] [Case 1] on p.12)
- The Chief Executive Officer lacked sufficient awareness to take the initiative in improving audit quality and therefore did not exercise leadership toward establishing effective and organized operations management and quality control systems to ensure appropriate audit quality. Furthermore, the Chief Executive Officer and the PICOQC assumed that an appropriate level of audit quality was being ensured because the firm's audit services were performed by partners with extensive practical experience and staffs with experience at large audit firms, and consequently were unable to accurately grasp the overall level of audit quality across the firm as a whole. (With regard to root cause analysis regarding this example, also refer to [Small and medium-sized audit firms] [Case 2] on p.12)
- The Chief Executive Officer and the PICOQC lacked an appropriate sense of ethics as professional practitioners, and within the firm, they prioritized avoiding findings in external inspections above all else, thereby fostering and allowing to spread a culture that places little importance on integrity and the preservation of credibility as professional practitioners. As a result, engagement partners instructed the performance of additional audit procedures after the audit report date and the subsequent preparation or falsification of audit documentation, and assistants to engagement carried out such instructions without hesitation. Consequently, among the partners and staffs,



awareness of the need to perform their duties in compliance with laws and regulations, auditing standards, and ethical rules has not been maintained.

- Although the audit firm is small in size, since its establishment it has divided its audit business into two audit divisions, with each division independently managing its audit services, finance, and human resources, thereby fostering an organizational culture that prioritizes the independence of each division. In addition, among the audit team, only the partners are full-time, while all assistants to engagement are certified public accountants engaged as part-time staffs.
- Under these circumstances, the Chief Executive Officer and the PICOQC did not recognize that all audit teams, including themselves, lacked sufficient understanding of the intent of the current auditing standards as well as of the level of quality management and audit procedures required by those standards. In addition, because no significant findings had been identified in past QC reviews, they believed that the current organizational structure, which has remained unchanged since the firm's establishment, was adequate, and therefore did not recognize the need for integrated business operations—such as the consolidation of audit divisions—or the need to establish an organizational audit engagement framework, including enhancing the number of full-time assistants to engagement. (With regard to root cause analysis regarding this example, also refer to [Small and medium-sized audit firms] [Case 3] on p.9)
- The individual partners, including the Chief Executive Officer, lacked a sufficiently critical attitude toward evaluating the quality of individual audit services performed by other partners, indicating an insufficient awareness of the need to improve and enhance audit quality across the firm as a whole. In addition, while extensively engaging in non-audit services through related entities, the individual partners, including the Chief Executive Officer, had become less conscious of placing emphasis on audit quality in performing individual audit services.
- The Chief Executive Officer and the PICOQC have not exercised leadership themselves toward maintaining and enhancing the audit quality of each individual audit service. In addition, the Chief Executive Officer and the PICOQC have not recognized that the audit teams, including themselves, lack sufficient understanding of the current auditing standards and of the level of quality management and audit procedures required by those standards.
- The Chief Executive Officer has not fostered an organizational culture that emphasizes compliance with professional ethics, and the partners and staffs of the audit firm exhibit a markedly insufficient awareness of the importance of professional integrity and the maintenance of credibility. In addition, the Chief Executive Officer and the PICOQC assumed that an understanding of the level of procedures required by the current auditing standards had been sufficiently disseminated within the firm through the hiring of certified public accountants with experience at large audit firms and through training programs required by the audit firm.
- The audit firm has been undertaking business improvements following the issuance of a business improvement order by the Financial Services Agency (improvement of the operations management system) and having received multiple improvement recommendations through the Institute's QC

reviews. Under these circumstances, at the audit firm, a high proportion of the partners are engaged in non-audit services through their own individual practices, resulting in diminished awareness toward maintaining and enhancing the firm's audit quality. Consequently, the above-mentioned improvement recommendations have not been recognized as issues that are fundamental to the firm's business operations. In addition, the Chief Executive Officer and the PICOQC have not exercised leadership toward improving audit quality, indicating a lack of awareness to establish a framework in which the quality control system functions effectively. Furthermore, the individual partners of the audit firm lack awareness of the need to monitor the status of quality improvements in individual audit services in which they are not personally involved, demonstrating an insufficient sense of responsibility as partners with respect to the firm's operations. As a result, the audit firm has not fostered an organizational culture in which partners mutually monitor and restrain one another to maintain and enhance audit quality, and it has not established a framework capable of conducting audits on an organizational basis.

- The audit firm has undergone a merger in recent years; however, although the Chief Executive Officer has stated that it is necessary to operate the firm in an integrated manner with respect to matters such as personnel evaluations, remuneration, and the composition of audit teams, he has not recognized the importance of realizing such integration at an early stage. In addition, the partners of the audit firm, having been engaged for an extended period in the audit services of specific listed audited companies, lack a sufficiently cautious attitude toward carefully assessing audit risks in light of the business environment in which the audited companies operate.
- The Chief Executive Officer believed that, with respect to the firm's operations, it was sufficient for the Chief Executive Officer, the engagement quality reviewer, and the PICOQC to consider important matters, and that there was no need to share information on such matters with the other partners. As a result, he has not endeavored to foster an organizational culture in which partners work collaboratively to maintain and enhance audit quality, nor has he established a framework that enables audits to be conducted on an organizational basis.
- The audit firm is composed of a small number of partners and staffs who have no audit experience at other audit firms, and it has continued to follow the operational structure in place since its establishment. In addition, for many years, a small number of listed companies have served as the firm's principal audited companies, resulting in a high proportion of audit fees from each of those listed audited companies relative to the firm's total operating revenue (i.e., a high level of fee dependence). Under these circumstances, the Chief Executive Officer, who also serves as the PICOQC, has prioritized above all else the maintenance and continuation of relationships with the audited companies that have existed since before the firm's establishment, and, given that there have been few changes in the audited companies over a long period, has assumed that there are no issues with the audits performed or with the firm's operations. In addition, he lacks sufficient awareness of the importance of audit quality and the professional attributes required of certified public accountants, including professional ethics and independence, and has not recognized the

need to establish organizational business operations or a quality control system. Furthermore, the firm's operations have routinely been managed solely by the Chief Executive Officer acting as the PICOQC, and the other partners have not recognized the need to fulfill their responsibilities as partners of the firm.

- In evaluating partners, the Chief Executive Officer places emphasis on quantitative indicators such as the number of audit engagements handled as an engagement partner or engagement quality reviewer and the number of newly contracted audited companies, and does not evaluate the quality of audit services. As a result, he lacks sufficient awareness toward designing, implementing and maintaining a quality control system that places emphasis on audit quality.
- The Chief Executive Officer and the PICOQC have not sufficiently recognized that they themselves, as well as others, lack an adequate understanding of the intent of the current auditing standards and of the level of quality management and audit procedures required by those standards. In addition, the Chief Executive Officer and the PICOQC placed excessive reliance on the firm's partners based on the assumption that they possessed sufficient capabilities due to their extensive practical experience.
- The Chief Executive Officer and the PICOQC, having believed that there were no issues with the firm's current operations, did not recognize the need to establish an organizational quality control system. In addition, the Chief Executive Officer and the PICOQC have not recognized that they themselves lack sufficient understanding of the intent of the current auditing standards and of the level of quality management and audit procedures required by those standards.
- The Chief Executive Officer placed top priority on issuing an unmodified audit opinion within the statutory deadline for the audit report and did not exercise due professional care, nor did he demonstrate sufficient awareness of the role and responsibilities expected by society of an audit firm to ensure the reliability of financial statements. Other engagement partners, including the PICOQC, aligned themselves with the Chief Executive Officer's views and did not exercise oversight or restraint over other engagement partners, including the Chief Executive Officer.
- The audit firm was established by partners who had previously worked together at a large audit firm. The Chief Executive Officer and the PICOQC assumed that, because the audit firm is composed of a small number of partners, they were able to grasp the capabilities of each partner and that each partner was fully demonstrating his or her capabilities. In addition, because no significant findings have been identified in QC reviews conducted to date, they believed that the minimum level of quality control system necessary commensurate with the size of the audit firm had been established. As a result, they have not sufficiently recognized the need to establish an organizational quality control system.

2. Response to the Audit Firm Governance Code

Based on the economic and social situation surrounding the accounting audits, the Act for Partial Amendment of the Certified Public Accountants Act and the Financial Instruments and Exchange Act

were enacted and promulgated in May 2022, and the related government orders were promulgated in January 2023 and came into effect in April 2023. The Act introduced a registration system of audit firms that engage in audits of listed companies in order to ensure the reliability of accounting audits and to contribute to further demonstration and improvement of the CPA's ability. As a result, audit firms that engage in audits of listed companies are obliged to establish a system to conduct its operations in accordance with the Audit Firm Governance Code and a system to realize an enhanced information disclosure.

The Audit Firm Governance Code was established in 2017. Based on the above laws and regulations, the Expert Review Committee on the Audit Firm Governance Code held discussions and revised the Audit Firm Governance Code in March 2023 to require effective disciplines suited to the size and the nature of audit firms. The purpose of the revision was to: (i) make small and medium-sized audit firms that engage in audits of listed companies to easily adopt the code; and (ii) enhance disclosure regarding the globalization of audit firms and others.

The Audit Firm Governance Code has been developed for organized business operation by audit firms that engage in audits of listed companies, but it does not exclude voluntary adoption by other audit firms. On this basis, each audit firm is required to determine if the Audit Firm Governance Code should be implemented for effective organizational management at their own discretion based on its size and characteristics.

For more information such as the adoption status by audit firm size, please refer to the "2025 Monitoring Report".

3. Responses to the Revision of Quality Control Standards

The Business Accounting Council of Japan published an opinion letter on the revision of quality control standards for audits ("Quality Control Standards") (November 16, 2021). The opinion letter included the introduction of a quality management system (a management method in which audit firms: (i) set quality objectives; (ii) identify and assess quality risks that hinder the achievement of quality objectives; (iii) define and implement policies or procedures to address the assessed quality risks; and (iv) make remediations based on root cause analysis if there are deficiencies), according to the revisions of international quality control standards such as "International Quality Management Standard 1" (Quality Management at Audit Firms - ISQM1), "International Quality Management Standard 2" (ISQM2), and "Quality Control for Financial Statement Audits" (ISA220). The revised Quality Control Standards are required to be implemented from the audits of financial statements for fiscal years starting on or after July 1, 2023 (for audit firms other than large-scale audit firms under the Certified Public Accountants Act, for fiscal years starting on or after July 1, 2024).

The JICPA published QCSS No. 1, Practical Guidance No. 3 (Q & A on Quality Control at Audit Firms and Audit Engagements, and Reviews of Audit Engagements) (February 16, 2023) and Quality Control Standards Statement No. 1, Practical Guidance No. 4 (Tools for Quality Control at Audit Firms) (last

amended on January 17, 2024) for applying the revised quality control standards. In addition, QCSCS No. 1 (Quality Control at Audit Firms) and ASS No. 220 (Quality Control in Audit Engagements) were revised and published in June 2022, and QCSCS No. 2 (Quality Control Reviews of Audit Engagements) was also published.

For more information about responses by the size of audit firms, please refer to the "2025 Monitoring Report".