

Overview of Audit Firms in Japan and Their Monitoring

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In this paper, we will provide an overview of Japanese audit firms and the status of monitoring performed by the Financial Services Agency (hereinafter referred to as “FSA”) and the Certified Public Accountants and Auditing Oversight Board (hereinafter referred to as “CPAAOB”). We also explain the status of small and medium-sized audit firms in Japan, where some of those firms have become an issue in recent years, and draw some implications when regulators discuss the matter globally. First, chapter 1 of this paper discusses the importance of auditing in market governance. Chapter 2 discusses the situation surrounding auditing in Japan. Chapter 3 discusses the monitoring of audit firms in Japan by the CPAAOB. Chapter 4 discusses the situations/conditions of small and medium-sized audit firms. Through these discussions, we would like to present a brief overview of the situation, the roles of audit firms in Japan, and regulators’ responses.

1. The importance of auditing in “Market Governance”

The FSA is the financial regulator in Japan responsible for financial stability, investor protection, and financial facilitation. The FSA has a broad scope of responsibilities and comprehensively covers banking, markets and securities, insurance, accounting, etc. The FSA a unique authority in the world that is an integrated regulator with jurisdiction over a country’s entire financial sector. The CPAAOB is in charge of monitoring Certified Public Accountants (hereinafter referred to as “CPAs”) and audit firms by several means, including inspections. The CPAAOB has also been established in the FSA.

In the FSA Strategic Priorities of July 2024 - June 2025 (hereinafter referred to as “the strategic priorities”), the FSA emphasized the need to „further enhance the reliability of capital markets” in order to contribute to sustainable economic growth through the financial mechanism (Table 1). Specifically, the strategic priorities explains that „market governance needs to be enhanced through improvement of audit quality, etc.” The phrase „market governance” is used in various contexts, but here, it is broadly defined to include the function of audit firms, etc. that ensure



an environment in which market discipline functions autonomously, in addition to market discipline by market participants.

Table 1: Summary of the FSA Strategic Priorities of July 2024 - June 2025.

I. Contribute to Sustainable Economic Growth through Financial Mechanisms:
The FSA will:

- Ensure the full implementation of the “Policy Plan for Promoting Japan as a Leading Asset Management Center” published last December through:
 - Promoting appropriate use of expanded NISA (tax exemption program for retail investors).
 - Enhancing financial and economic education, in collaboration with the newly-established Japan Financial Literacy and Education Corporation.
 - Advancing corporate governance reforms.
 - Further enhancing the reliability of capital markets.
 - Improving the functioning of asset management companies and promoting new entrants.
 - Monitoring FIs’ asset management business operations that support asset owners.
 - Facilitating the financing for startups seeking growth
 - Strengthening external promotion of the Policy Plan, for example by hosting „Japan Weeks”.

FSA Strategic Priorities: July 2024 - June 2025 , 20240913_summary.pdf

In general, the term „market governance” is used ambiguously as a mechanism to ensure the efficiency, transparency, fairness, and credibility of capital markets (focusing on market discipline), the functions of self-regulatory organizations, etc. The Strategic Priorities broadly cover not only market discipline by market participants but rather emphasize the functions of audit firms to ensure an environment in which market discipline operates autonomously as explained above.

Enhancing market governance in a broad sense is important for maintaining fair and transparent markets and ensuring the credibility of capital markets. The FSA and the CPAAOB are working to ensure that market governance functions adequately, particularly through improving audit quality. The FSA and the CPAAOB will further

improve the quality of professional staff conducting audits and monitor them closely in response to changes in the environment surrounding audits, such as the increasing role of small and medium-sized audit firms in audits of listed companies.

Making audits more attractive

These initiatives are important as the foundation promoting Japan as a leading asset management center. The FSA reaffirms and emphasizes the importance of these initiatives by strengthening market governance. That will indirectly inform the public of how important it is to make the audit profession more attractive. Internationally, demand for audit services is increasing, while in some jurisdictions the supply of the audit profession, especially young professionals, is decreasing due to some reasons, including insufficient compensation, negative narratives, inadequate wellbeing, and lack of recognition of the importance of audits in the market ecosystem.

In Japan, the number of registered CPAs has been increasing moderately over the past few years, but the number of registered CPAs belonging to audit firms has not increased as much as the number of registered CPAs, and the proportion of the total number of registered CPAs who belong to audit firms has been declining year by year. For example, in Japan, the number of registered CPAs increased from 31,793 as of the end of March 2020 to 35,532 as of the end of March 2024, but the proportion of registered CPAs belonging to audit firms declined from 43.6% as of the end of March 2020 to 40.6% as of the end of March 2024. Amid the growing need for both the quality and quantity of audits, there are concerns about a shortage of professional staff for audits. As such, making audits more attractive and securing professionals for audits are also key issues in Japan, like they are in other countries around the world.

The roles of audits are sometimes considered to exist in the capital markets as a matter of course, like the existence of air. The significance of audits is not usually recognized, and it is occasionally noticed when only problems, such as accounting fraud, occur. Although audits are essential roles in the capital markets, auditors are not often treated as heroes in the way that police officers or firefighters are. Of course, there are cases where the audit firm itself has problems, and given that there are supervisory authorities to monitor audit firms and their qualities, the importance of audits remains unchanged, but it is also important for auditors themselves to have high self-discipline.

It is important to have an ecosystem in which the market recognizes the importance of audits and utilizes audit functions, auditors themselves have high self-discipline,

and the market governance of the capital markets as a whole is enhanced. When the FSA and the CPAAOB have explained the importance of market governance, the experts have also paid attention to the role of audits in the context of the broader governance function of the markets. Market governance is not necessarily the only phrase that identifies the importance of the audit profession, but given the lack of professionals to conduct audits, it is important to use such phrases to discuss how to make the audit profession more attractive.

2. The situation surrounding auditing in Japan

In Japan, audits of listed companies are generally conducted by audit firms in accordance with the Financial Instruments and Exchange Act and the Companies Act. Audit firms in Japan are established through investment by five or more CPAs. Those who have made such investment become partners and are directly involved in the management of the audit firm. They monitor each other to ensure organizational discipline.

The number of Japanese audit firms has been increasing, from 246 as of the end of March 2020 to 287 as of the end of March 2024. However, when audit firms are classified by the number of the CPAs (excluding part-time CPAs) they have, audit firms with fewer than 25 CPAs account for approximately 90% of the total, which indicates that the presence of small and medium-sized audit firms as providers of audit services is increasing, and that the downsizing of audit firms is progressing.

On the other hand, looking at the overall services provided by audit firms, approximately 70% of the CPAs belonging to audit firms are employed at large-sized audit firms, which is accounting for approximately 50% of the total number of audit and attestation services, and accounting for nearly 80% of audit services revenue (Table 2). The auditors of listed companies are oligopolistic, with large-sized audit firms. Large-sized audit firms audit approximately 60% of the total number of the listed companies, and approximately 90% of the market capitalization of the listed companies (Table 3, Table 4). This is likely because the companies with large market capitalizations conduct larger, more complex, and more international business operations. Consequently, the audits of such companies require many audit personnel and a diverse range of expert capabilities as well as an international network of audit firms, which is difficult for audit firms other than large-sized audit firms to handle.

Table 2. Market share by type of audit firm (FY2022).

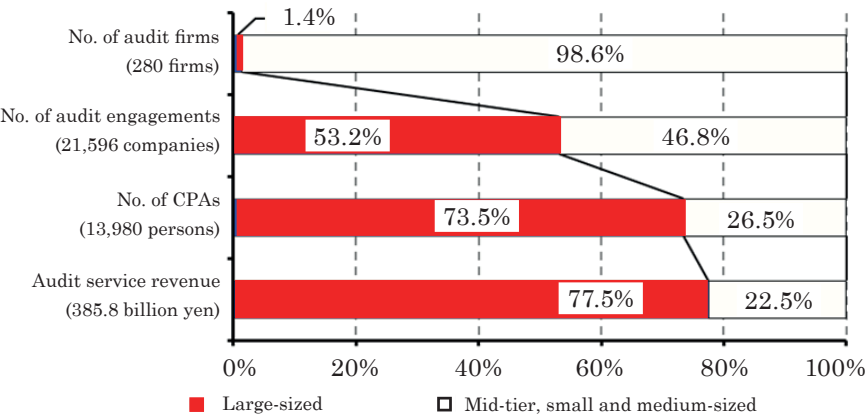


Table 3. Number of listed companies by scale of accounting auditor.

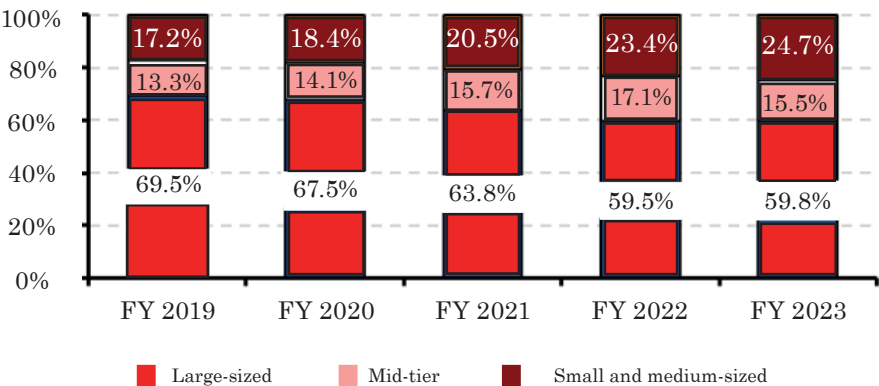
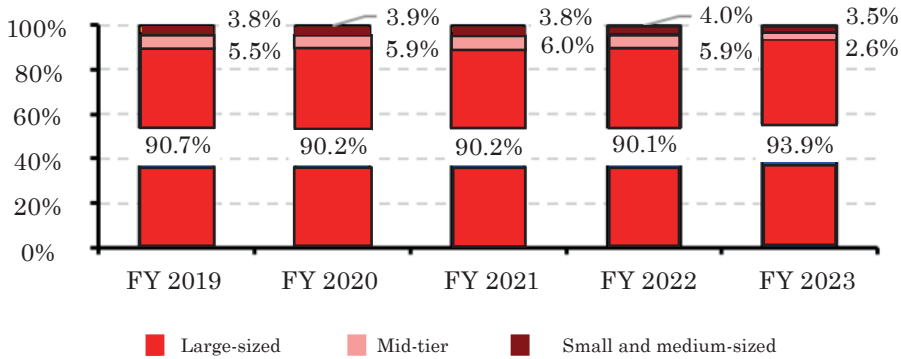


Table 4: Total market value of listed companies by scale of accounting auditor.



The oligopoly situation of large-sized audit firms tends to be similar in Europe and the US. Looking at the audit services (number of companies basis) of major listed companies, the share of audit services provided by the global network of large-sized audit firms is 97% in Japan, 99% in the US, and 91% in the UK (Table 5).

Table 5. Big Four Global networks' share of audit engagements for major listed companies (based on number of companies).

| | JAPAN | US | UK |
|---------------------------------|-------|-----|-----|
| Big Four global networks' share | 97% | 99% | 91% |

(Note) Shares were calculated based on the numbers of companies included in the following stock indexes. Japan: Nikkei 225, United States: S&P 500, UK: FTSE 350.

Audits of listed companies

Large-sized audit firms also hold a large share of audits of newly listed companies. In the year to December 2023, large-sized audit firms audited 48 of the 97 newly listed companies (excluding those listed on the TOKYO PRO Market¹). Although that accounts for approximately 49% of the total, from different angles, over half of all newly listed companies are audited by mid-tier audit firms and also small and medium-sized audit firms, and the shares of those audit firms in IPO (Initial Public Offering) audit markets have been increasing over the past five years

The reason that small and medium-sized audit firms conduct audits of listed companies to some extent is related to the fact that in Japan there is a certain number of listed companies that have not yet expanded their business to overseas, whereas in Europe, a high proportion of companies operate outside of their jurisdictions due to the limited size of market in their own countries. These factors may be the reason for the oligopoly of global networks of large-sized audit firms.

In May 2022, the statutory “Registration System for Auditors that Engage in Audits of Listed Companies and Similar Companies” (hereinafter referred to as “the registration system”) was introduced through the revision of the Certified Public Accountants Act to ensure the quality of audits of listed companies. The registration system was introduced due to changes in the environment surrounding accounting audits and concerns about audit quality. Audits of listed companies by small and medium-sized audit firms are also increasing, and some of them have pointed out that audit quality control for listed companies is insufficient. The registration system was introduced to ensure reliability in the capital markets, with further aims of improving the quality of audit services by audit firms and CPAs, as well as ensuring transparency and improving trust among investors and stakeholders.

Since April 2023, the Japanese Institute of Certified Public Accountants (hereinafter referred to as “JICPA”) created the “Review Board for Registration of Auditors that Engage in Audits of Listed Companies and Similar Companies” (hereinafter referred to as “the review board”) to administer the overall registration system. The JICPA constitution requires audit firms that audit listed companies to register with the JICPA, and the screening process is carried out by the review board, which confirms the eligibility of the registered audit firms of listed companies.

¹ TOKYO AIM, the previous form of TOKYO PRO Market, was established in June 2009 as a market operated by TOKYO AIM, Inc., which was created as a joint venture between Tokyo Stock Exchange Group, Inc. and London Stock Exchange, based on the provisions for markets for professional investors introduced in the 2008 amendments to the Financial Instruments and Exchange Act.

In addition, the JICPA will confirm whether, in the process of implementing quality control reviews, registered audit firms fulfill the obligations for system development provided for in the Ordinance for Enforcement of the Certified Public Accountants Act (hereinafter referred to as the “OECPA”). For example, with regard to the system for publicizing evaluation results, concerning the status of service quality control provided for in the OECPA, the Board will consider revoking the registration of an audit firm as a registered audit firm if such a system has not been publicly disclosed or if matters that have been publicly disclosed significantly deviate. In addition, if a quality control review reveals a significant deficiency in the audit firm’s quality control system and a recommendation is made to withdraw from audit services, such audit firm will be subject to examination by the board for revocation of registration as a registered audit firm.

As of the end of December 2024, there are 123 registered audit firms, and 9 deemed registered audit firms. These 132 audit firms conduct audits of domestic listed companies in Japan.

3. Monitoring of audit firms in Japan by the CPAAOB

Scheme of inspection and related monitoring measures by the CPAAOB

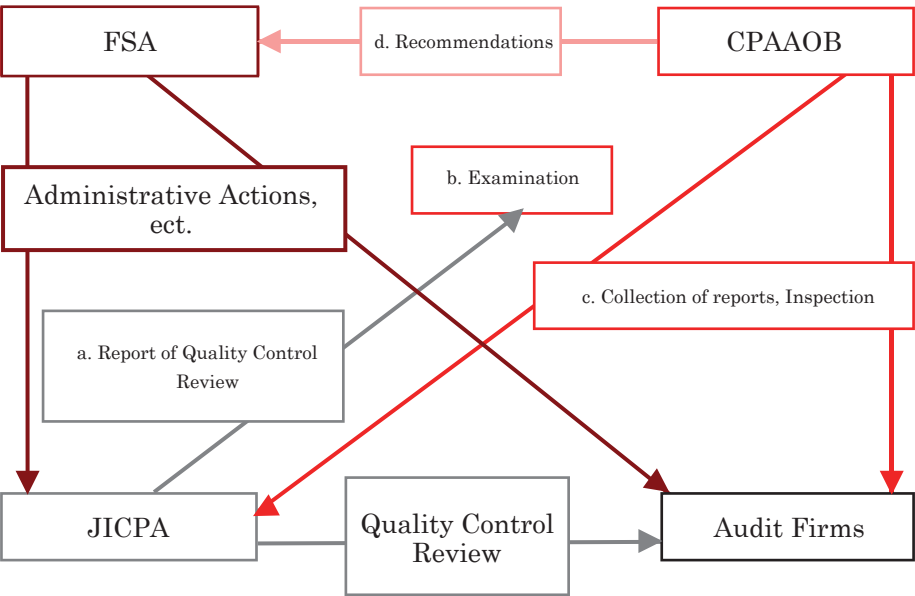
Monitoring function of the CPAAOB includes inspection and non-inspection monitoring. Non-inspection monitoring refers to activities other than inspection, such as collection of reports from and interviews with audit firms, and collection of information through an in-depth dialogue with audit firms and cooperation with related parties.

The CPAAOB also analyzes the findings of quality control reviews by the JICPA, and the details of improvement plans submitted by audit firms to the JICPA. In light of these analyses results, the CPAAOB considers the necessity of inspections and the collection of reports, and exchanges views with the JICPA on the effectiveness of quality control reviews.

The flow of the CPAAOB work is as follows: (i) receiving quality control review reports from the JICPA, (ii) examining whether the JICPA quality control reviews and audit firms’ audits are being conducted appropriately, (iii) when deemed necessary, collecting reports from the JICPA, audit firms, etc. and conducting inspections, and (iv) when deemed necessary as a result of inspections, recommending administrative

disciplinary actions to the FSA Commissioner. An overview of the flow oversight is shown below (Table 6).

Table 6: Overview of CPAAOB monitoring



Inspection and Overall Evaluation

The frequency of CPAAOB inspections differs depending on the size of the audit firm. For large-sized audit firms, the CPAAOB conducts regular inspections once every two years. From 2016, the CPAAOB has conducted follow-up inspections for the purpose of verifying the status of improvements in the year following the regular inspections. In some cases, the CPAAOB collects reports in lieu of conducting follow-up inspections to confirm efforts/effects toward improvements. For mid-tier audit firms, the CPAAOB conducts inspections once every three years, but from 2025, the CPAAOB has increased the frequency of inspections to once every two years. For small and medium-sized audit firms, the CPAAOB conducts inspections as necessary in light of deficiencies pointed out in quality control reviews.

Notification of inspection results is carried out by issuing a document called “Inspection Results Notice” to the professional responsible for the audit firm. The CPAAOB

assigns a five-grade rating to audit firms depending on their operations management environment, quality control environment, and the contents of individual audits. The CPAAOB has stated its overall ratings in its Inspection Results Notice since 2016, with the aim of accurately conveying the CPAAOB's view of their audits to the firms and enabling the audit and board members of audited companies to properly understand the level of quality control of audit firms.

An audit firm is required to communicate to the audited company the content of their inspection results notice, including the overall rating. Using this information, audit and board members are required to communicate with the audited company about the audit performance and procedures and further to provide more information so that the company can decide whether to continue auditing contracts based on an understanding of the CPAAOB's evaluation of the audit firm's audit quality and such.

The overall rating is classified into five grades: (i) Satisfactory (overall rating: 1), (ii) Generally satisfactory with minor deficiencies (overall rating: 2), (iii) Unsatisfactory due to presence of significant deficiencies that need to be fixed (overall rating: 3), (iv) Unsatisfactory and in need of immediate remediation in operations management system, etc. (overall rating: 4), and (v) Extremely unsatisfactory (overall rating: 5). Furthermore, the CPAAOB encourages audit firms rated as below (iv) to promptly make improvements by collecting improvements reports at the same time as notification of inspection results, and recommends administrative disciplinary actions, etc., to the FSA Commissioner for audit firms rated as below (v).

Table 7 shows the distribution of overall ratings for the most recent five years of inspections (regular inspections that were commenced and completed between July 2019 and June 2024). No audit firms received an overall rating of 1, while large-sized audit firms received an overall rating of 2, and mid-tier and small and medium-sized audit firms only received an overall rating of 3 or below.

Seven of the sixteen small and medium-sized audit firms inspected by the CPAAOB fall under the category of “Extremely unsatisfactory (overall rating: 5),” indicating that the ratings of small and medium-sized audit firms are generally lower than those of large-sized and mid-tier audit firms. This is partly because the CPAAOB mainly inspects small and medium-sized audit firms whose quality control environments need urgent confirmation, sometimes in response to JICPA quality control review reports. It does not necessarily mean that the quality of the average small and medium-sized audit firm is declining, but the FSA and CPAAOB are closely monitoring the trends.

Table 7: Overall ratings for inspections in the last five years (based on commencement of inspections) (unit: audit firms).

| Overall rating | Large-sized audit firms | Mid-tier audit firms | Small and medium-sized audit firms, partnerships and solo practitioners |
|--|----------------------------|-------------------------|---|
| Satisfactory (Overall rating: 1) | — | — | — |
| Generally satisfactory with minor deficiencies (Overall rating: 2) | 4 | — | — |
| Unsatisfactory due to presence of significant deficiencies that need to be fixed (Overall rating: 3) | — | 2 | 3 |
| Unsatisfactory due to presence of significant deficiencies that need to be fixed (Overall rating: 4) | — | 3 | 6 |
| Extremely unsatisfactory (Overall rating: 5) | — | — | 7 |

(Note1) Totals for audit firms subject to regular inspections that were commenced and completed between PY2019 and PY2023

(Note2) For audit firms that underwent multiple regular inspections in the period under review, overall ratings in the latest inspection are tallied.

Points of Monitoring by the CPAAOB

The CPAAOB has published its monitoring objectives and approaches to achieving those objectives, as well as priorities for each three-year term and program year. In its seventh term (April 2022 to March 2025), the CPAAOB set out the following strategies:

- Conduct effective and efficient monitoring in light of the rapidly changing environment surrounding audit firms.
- Encourage audit firms to continue ensuring and improving their own audit quality
- (At the same time) Ensure appropriate operation of services including audit quality control of audit firms
- (On top of that) Check and verify the preparation status of audit firms toward the smooth introduction of quality control systems, as well as the status of development and operation after introduction.
- Conduct inspections of audit firms, especially small and medium-sized audit firms, for which ensuring and improving audit quality is considered to be an urgent task.

Since new audit engagements have a significant impact not only on the quality level of individual audit engagements but also on the operation of the audit firm as a whole (particularly for small and medium-sized audit firms), the CPAAOB conducts oversight through monitoring activities mentioned above. In addition, the CPAAOB checks and analyzes the reasons for the replacement of auditors and the impact of the acceptance of new audit engagements on the quality control of the audit firm as a whole.

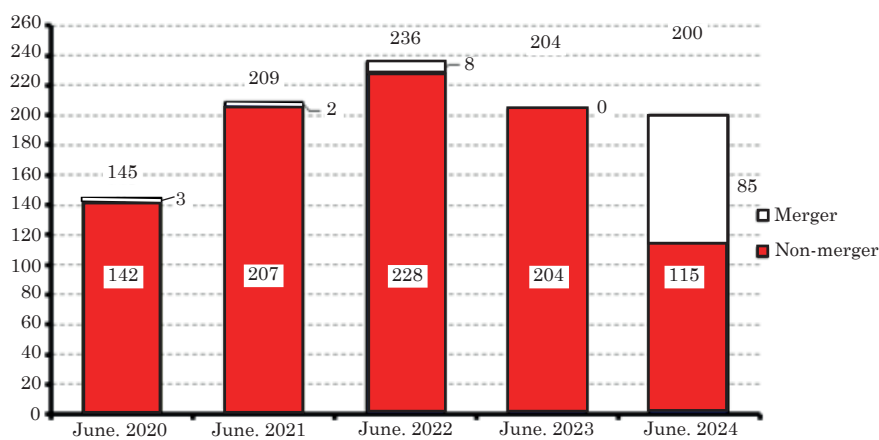
4. Small and mediumsized audit firms

Changes in auditors

With regard to changes in auditors of domestic listed companies, the number of changes in auditors from July 2023 to June 2024 was 200, but if changes due to mergers of audit firms are excluded, the number of changes in auditors becomes 115, indicating a decreasing trend.

In recent years, there has been a continuing trend of large-sized audit firms avoiding auditing certain listed companies because they consider audit fees, audit risks, and the number of professionals needed to be too high. Audited companies are also recently more carefully selecting auditors based on the lengthening of ongoing audit contracts, the appropriateness of audit fees, audit response suited to the scale of the business, and so on. Therefore, changes can be seen in that mid-tier audit firms or small and medium-sized audit firms are taking on more audits of those listed companies. For example, the number of changes in auditors (excluding mergers of audit firms) peaked at 228 in the period from July 2021 to June 2022 and was 204 in the period from July 2022 to June 2023 as seen in Table 8.

Table 8: Number of listed domestic companies that changed audit firms (unit: companies).

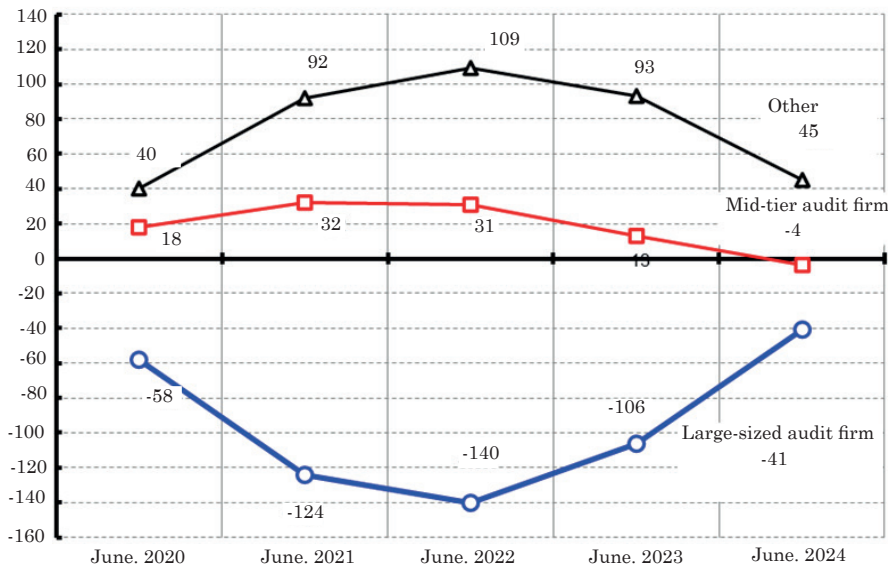


(Note) The figures above show the number of companies that had decided on an incoming auditor by the end of June of each period, based on timely disclosures of listed domestic companies.

Looking at changes in auditors (net increase / decrease) by audit firm size, from July 2021 to June 2022, the number of large-sized audit firms serving as auditors decreased by a net 140 and the number of small and medium-sized audit firms serving as auditors increased by a net 109. In addition, from July 2022 to June 2023, the number of large-sized audit firms serving as auditors decreased by a net 106 and the number of small and medium-sized audit firms serving as auditors

increased by a net 93. Furthermore, from July 2023 to June 2024, the number of large-sized audit firms serving as auditors decreased by a net 41 and the number of small and medium-sized audit firms serving as auditors increased by a net 45 (Table 9).

Table 9: Changes by size of audit firm (unit: companies).



(Note) Net increases/decreases in the number of changes.

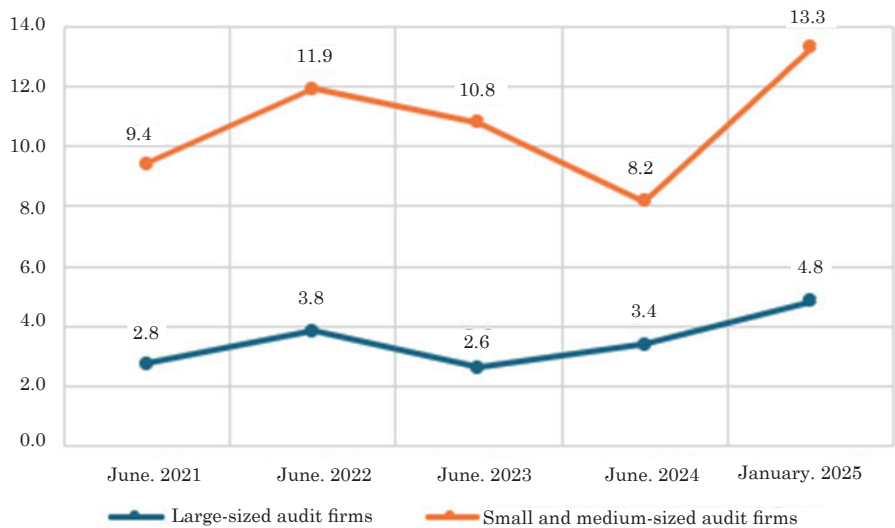
Despite the increasing role of small and medium-sized audit firms as providers of audit services for listed companies, recent CPAAOB inspections have found that the environment for appropriately performing audit engagements is inadequate in some cases. Maintaining and improving audit quality at small and medium-sized audit firms has therefore become an urgent issue, and the CPAAOB has decided to place greater emphasis on inspections of small and medium-sized audit firms as mentioned above.

Developments at small and medium-sized audit firms

As mentioned above, one of the main reasons for the replacement of auditors is audit fees (reasonableness of fees). This is often because large-sized audit firms have become more selective in audit risks and have reduced their audits of listed companies that do not balance resources, costs, and profits (changes after offering audit fee increases). In addition, there are cases in which the lengthening of ongoing audit periods has been taken into consideration, and cases in which auditors have resigned due to accounting fraud, governance issues, and disagreements between management and auditors over accounting treatment. These are contributing factors of the changes to small and medium-sized audit firms.

If auditors of listed companies with high audit risk (such as companies where management and auditors disagree over accounting fraud, governance issues, or accounting procedures; companies that have just gone public are also at high risk) are concentrated in small and medium-sized audit firms that lack the necessary resources and knowledge, risks will appear. In fact, it can be confirmed that the number of deficiencies pointed out at small and medium-sized audit firms has remained higher than the number at large-sized audit firms in recent years in Japan and is on an upward trend. (Table 10)

Table 10: Average number of findings per audit engagement by scale of accounting auditor.



This trend, however, is not unique to Japan as it can also be seen in Europe and countries in North America. These issues have been discussed at IFIAR meetings, where common developments and possible treatments regarding the issues are shared. On the other hand, the situation and monitoring status of small and medium-sized audit firms in each country are not exactly the same. In the first place, the definitions of smaller firms are different, and the market shares of audits of listed companies conducted by small and medium-sized audit firms are different, making it difficult to make simple comparisons. There are no legal provisions in Japan for the definition of small and medium-sized audit firms, and for the sake of convenience, audit firms other than large-sized audit firms and mid-tier audit firms are generally called small and medium-sized audit firms. In Europe and countries in North America, definitions are different, which is why we should be careful when discussing “smaller audit firms” in general.

Importance of international discussions

Although it is not easy to discuss how to deal with smaller audit firms issues in general, it is still beneficial for supervisors to engage in discussions internationally and learn from each other's issues because there are certainly similar problems elsewhere around the globe. We should exchange information between the authorities and consider possible measures to improve the audit quality of smaller audit firms, rather than treating them as problems unique to the home country. In doing so, however, the following points should also be taken into consideration as a prerequisite for analysis:

- ❑ Definition of small and medium-sized audit firms in each country.
- ❑ Market presence and roles of smaller audit firms compared with those of large-sized audit firms (including the roles expected of small and medium-sized audit firms by the authorities).
- ❑ Root causes of current audit quality issues of smaller audit firms (what is unique).
- ❑ Supervisors' monitoring functions, including inspections (difference from monitoring of large-sized audit firms), support functions of smaller audit firms, and balance between monitoring and support functions.

Small and medium-sized audit firms already have a certain presence in the market around the globe, and if a problem at any firm occurs, it could have a major impact on the market regardless of whether the firm is large, small or medium-sized, so it would be beneficial to continue exchanging information on the smaller audit firms at a global level. For that, it would be useful to recognize the above-mentioned differences.

We have explained the overall status of auditing in Japan, the attractiveness of auditing, the importance of the role of auditing in enhancing market governance, and the status of small and medium-sized audit firms. We have also pointed out the implications of international discussions when discussing smaller audit firms. We would be grateful if the authorities and auditors in each jurisdiction could somehow learn from each other, including Japan, and make efforts to improve the quality of audits together. Finally, it should be noted that this paper does not represent the views of our respective organizations.

