

**Principles for Effective Management of Audit Firms**  
**(The Audit Firm Governance Code)**  
**(Draft)**

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Auditing plays a role as an essential infrastructure for the capital market. In October 2015, the “Advisory Council on the Systems of Accounting and Auditing” (hereinafter referred to as the “Advisory Council”) was established to discuss and consider future audit systems.

In March 2016, the recommendations from the Advisory Council were compiled and published. One of the recommendations from the Advisory Council was that an audit firm governance code stating principles for effective management of the audit firms should be developed for the firms auditing major listed companies.

Responding to the recommendation, the “Council of Experts on Audit Firm Governance Code” was established in July 2016, and it compiled principles for effective management of audit firms (draft version) (hereinafter referred to as the “Code”), through a five-time discussion.

The Code consists of five principles and related guidance for effective implementation of the principles.

The Code states the following;

- The top of an audit firm should exercise its leadership to accomplish public interest role of the firm.
- An audit firm should clarify the role of its management in order to meet the public expectation of audits and ensure effective management of the firm.
- An audit firm should enhance the function for supervision and evaluation for its effective management and operations, and effectively utilize the knowledge and experience of independent third persons.
- An audit firm should have proactive dialogue within the firm and with outside stakeholders about its management and operations. It should also promote the initiatives for people development, human resources management and performance evaluation in order for the firm members to appropriately demonstrate their professional competence.
- In addition, an audit firm should disclose its initiatives for effective management as stated above in plain language and proactively have dialogue with stakeholders about such initiatives.

The Code is basically intended for the largest firms with many partners and other members that conduct audits of major listed companies. As for other audit firms, they can also voluntarily implement the Code. In determining how to implement the Code to accomplish effective firm management, each audit firms, especially the largest audit firm, would be required its own initiatives, based on its own characteristic features. With regard to introduction of the Code, we expect the approach of “comply or explain” (either comply with

a principle or, if not, explain why not) to be adopted.

We hope that each audit firm strongly promotes its own initiatives for improvements to accomplish the effective management of the firm from the viewpoint of public expectations of audits and changing circumstances surrounding audits.

## [The Role to Be Accomplished by an Audit Firm]

### Principle 1

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.

### - Concept -

In order to ensure the credibility of the capital market and the smooth supply of funds for the growth of companies, it is essential for companies to disclose their reliable financial information. It is also necessary for companies to properly understand their financial information and share it with stakeholders in capital market in order to formulate their strategies and seek sustainable growth and enhancement of the corporate value on a medium/long term basis. Audit is an extremely important infrastructure that serves as the basis to ensure the proper understanding and reliable disclosure of the financial information, support their adequate and smooth economic activities and thereby contribute to the sustainable growth of the Japanese economy.

Under the Certified Public Accountants Act (hereinafter referred to as the “CPA Act”), an audit firm, together with certified public accountants, assumes the public interest role to ensure the credibility of corporate financial information, to protect stakeholders and contribute to the sound development of the national economy. For the continuous enhancement of the audit quality, which is a vital infrastructure of the capital market, it is important for the top of an audit firm to demonstrate leadership, raise the morale of members of the firm and support them to demonstrate their full competence, as well as all partners of the firm duly undertake their responsibilities to develop an operational structure required under the CPA Act. In doing so, the audit firm should also pay particular attention to avoid a situation where members of the firm do not sufficiently fulfill their professional skepticism in the structure of audits being conducted by receiving fees from audited companies.

### Guidance

- 1-1 An audit firm should recognize its public interest role and clearly express the tone at the top so that the top management and members of the firm will proactively accomplish their respective roles, as well as all partners of the firm duly undertake their responsibilities to develop the operational structure of the firm.

- 1-2 An audit firm should define the values to be commonly maintained by members of the firm and also develop the code of conduct to put these values into practice.
- 1-3 An audit firm should appropriately motivate members of the firm in order to raise their morale and help them to fully maintain and demonstrate their professional competence and skepticism.
- 1-4 An audit firm should develop an organizational culture of openness which encourages members of the firm to share problems, knowledge and experiences related to audits and proactively participate in a dialogue and discussion.
- 1-5 An audit firm should clarify its stance about non-audit services (provided by the firm and its group organizations).

## [Organizational Structure]

### Principle 2

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.

#### - Concept -

The audit firm system is based on the structure of partnership organized by five or more certificated public accountants. However, recent large-sized audit firms may have several hundred partners and thousands of members. From the viewpoint of ensuring the audit quality, the management of an audit firm is required to adequately keep up with the expansion of its business and the increasing complexity in its management and operations.

It is important for an audit firm to establish its management structure that can effectively function in its organization and ensure its effective management and operations.

#### Guidance

- 2-1 An audit firm should establish an effective management structure to ensure its effective management and operations.
- 2-2 An audit firm should clarify the role of the management in important operations, including the following matters, in order to meet the public expectations of audits and ensure its effective management and operations:
- Development of organizational structure to ensure appropriate judgments of the audit firm on important issues that potentially have a significant influence on the reliability of audit quality in the capital market, and proactive involvement in those significant issues by utilizing the structure mentioned above;
  - A macroscopic analysis based on understanding of the economic environment and the development of an environment that allows frank and in-depth dialogue with audited companies in order to identify audit risks and consider audit approach to deal with them;
  - Setting an appropriate environment for people development, human resources management and performance evaluation in order to raise the morale of members of the firm and help them to maintain and demonstrate their professional competence; and
  - Consideration and development of the effective utilization of information technology (IT) in order to enhance efficiency and effectiveness of audits, in a view to accommodating the advanced utilization of IT by audited companies is anticipated.

- 2-3 An audit firm should select members of its management team not only by taking into account their thorough knowledge and experience of audit practice but also by ensuring the effectiveness of the management function for its organizational operations as the team.

### Principle 3

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

#### - Concept -

In order to ensure the effective management and organizational operations in an audit firm, together with the strengthening of the management function, it is important to secure the function to supervise and evaluate the effectiveness of the management and thereby support to enhance its effectiveness.

Furthermore, in order for an audit firm to ensure effective management and organizational operations and accomplish its public interest role in the capital market, a function responsible for supervision and evaluation should effectively utilize the knowledge and experience of independent third persons who have, for instance, experience of the management of corporations and/or the perspectives as participants in the capital market.

#### Guidance

- 3-1 An audit firm should establish a function to supervise and evaluate the effectiveness of its management and thereby support to enhance its effectiveness, and clarify the role of the function.
- 3-2 An audit firm should appoint independent third persons as the members of the function responsible for the supervision and evaluation, and effectively utilize their knowledge and experience to deal with the issues recognized by the firm from the perspective to ensure the effective management and operations and accomplish its public interest role.
- 3-3 An audit firm should clarify the role of independent third persons to participate in the supervision and evaluation structure. In this regards, the audit firm should keep in mind that those persons are expected to be involved in the following matters, for example:
  - Involvement in the evaluation of the effectiveness of the management ;
  - Involvement in the process of the election or appointment, retirement, evaluation and remuneration of the management team members;
  - Involvement in developing the firm policies for people development, human resources management, performance evaluation and remuneration;
  - Involvement in the evaluation of the status of development of policies and procedures regarding whistle-blowing from within the audit firm and external



sources, and the status of verification and utilization of provided information;  
and

- Involvement in dialogue with audited companies, shareholders and other participants in the capital market.

3-4 An audit firm should develop an environment where necessary information is provided to the members of the function responsible for supervision and evaluation in a timely and appropriate manner and assistance is provided in the execution of its operations so that the members can effectively fulfill their responsibilities.

## [Operation]

### Principle 4

An audit firm should develop an operational structure to effectively manage its operations. The 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.

#### - Concept -

In order for an audit firm to continuously enhance the audit quality, the management of the firm needs to be effectively functioning in its operations. Furthermore, the philosophy and values defined by the management need to be infiltrated throughout the organization, and the management of the firm needs to develop a structure to make it possible.

In order to make this structure work, the comprehensive and adequately planned programs for people development, human resources management and performance evaluation are of extreme importance. If these programs would not function well, initiatives for enhancement of audit quality will not be effective as well.

Furthermore, it is also important to smoothen the communications and information streams not only from the management team to each audit team but also from the actual scenes of accounting audit to the management team.

Through the initiatives mentioned above, it is expected that more frank and broad-minded dialogue and discussion among the firm members would be ensured and more open-minded organizational culture would be created accordingly.

#### Guidance

4-1 An audit firm should develop a structure that allows its management to share necessary information from each audit team in a timely manner and also infiltrate their philosophy and defined values throughout the organization. The management should effectively utilize such a structure in the operations of the firm. In addition, a proactive dialogue and discussion for improvement of the audit quality should be enhanced within the firm.

4-2 An audit firm should develop and operate policies for managing people development, human resources management and performance evaluation in order to raise the motivation of the firm members and help them to maintain and demonstrate their professional competence. In doing so, whether the members of the firm sufficiently fulfilled their professional skepticism should be fully taken into consideration.

- 4-3 An audit firm should pay particular attention to the following points:
- Well-balanced assignment of members of the firm to respective teams in terms of the extensive knowledge and experience to allow the teams to fulfill their professional skepticism;
  - Providing members of the firm with opportunities to gain extensive knowledge and experience relevant to audit, such as experience in non-audit service and/or temporary transfer to the companies in other industries; and
  - Appropriate evaluation and well-planned utilization of the firm members with extensive knowledge and experience.
- 4-4 An audit firm should make efforts to have candid and in-depth dialogue about audit risks with the top management of audited companies, such as the CEO and CFO, and the members of audit and supervisory board as well. It should also ensure to have sufficient dialogue and discussion with audited companies at each audit team level.
- 4-5 An audit firm should develop policies and procedures regarding whistle-blowing from within the firm and external sources, and appropriately make use of the provided information. In doing so, the audit firm should pay particular attention to ensure that a whistleblower does not have to be concerned about the risk of disadvantage.

## [Ensuring Transparency]

### Principle 5

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 initiatives for improvement in its management and operations.

#### - Concept -

In order to continuously enhance audit quality, it is important to create a virtuous cycle where audited companies, shareholders and other stakeholders in the capital market can select an audit firm based on the appropriate assessment of its policies and initiatives for the enhancement of audit quality, and this will influence the audit firm to intensify its incentives to further enhance the audit quality and to increase its audit fees. Therefore, an audit firm should ensure the extensive disclosure on the status of the Code's implementation and the initiatives for enhancement of audit quality, to allow the stakeholders in the capital market to appropriately assess its audit quality, which will likely serve as an effective tool for a dialogue with stakeholders in the capital market.

An audit firm should also carry out an internal-assessment of the Code's implementation and the effectiveness of its initiatives for the enhancement of audit quality, and put the results of the assessment, coupled with a dialogue with stakeholders in the capital market, to further improvement of its audit quality.

#### Guidance

5-1 An audit firm should explain the status of the Code's implementation and its initiatives for the enhancement of audit quality in plain language, in the form of the "Transparency Report," for example, to allow audited companies, shareholders and other stakeholders in the capital market to appropriately assess its audit quality.

5-2 An audit firm should explain the following matters as well:

- The tone at the top toward the continuous enhancement of the audit quality in order for the management and members of the firm proactively fulfill their respective roles;
- The defined values to be commonly maintained by members of the firm, and way of thinking and code of conduct to put these values into practice;
- The stance about non-audit services (provided by the firm and its group organizations) ;
- The composition and role of the management;
- The composition and role of the function to supervise and evaluate the effectiveness of the management and operations, as well as the reasons for the

appointment, role and contribution of independent third persons appointed as the members of the function ; and

- The assessment with respect to the effectiveness of the initiatives for the enhancement of the audit quality, which is carried out by the firm including the members of the function responsible for the supervision and evaluation.

5-3 An audit firm should strive for proactive dialogue about its initiatives for enhancement of the audit quality with audited companies, shareholders and other stakeholders in the capital market. In doing so, the audit firm should effectively utilize the knowledge and experience of independent third persons appointed as the members of the function responsible for in supervision and evaluation.

5-4 An audit firm should periodically assess the Code's implementation and the effectiveness of its initiatives for enhancement of the audit quality.

5-5 An audit firm should effectively utilize the useful information obtained through the dialogue with stakeholders such as participants in the capital market and the results of the assessment of the Code's implementation for improving its management and organizational operations.