

Provisional Translation

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

The Council of Experts
on the Audit Firm Governance Code

Effective on March 31, 2017
Revised on March 24, 2023

Revision of the “Principles for Effective Management of Audit Firms”
(The Audit Firm Governance Code)

March 24, 2023

The Council of Experts on the Audit Firm Governance Code

Approximately six years have passed since the Audit Firm Governance Code was formulated by the “Council of Experts on the Audit Firm Governance Code” (hereinafter referred to as the “Council”) on March 31, 2017. To date, 19 audit firms have declared their commitment to the Audit Firm Governance Code.

Under these circumstances, “Act for Partial Amendment of the Certified Public Accountants Act and the Financial Instruments and Exchange Act,” which for instance introduces a registration requirement for audit firms that provide audit services for financial documents of listed companies etc., was enacted and published in May 2022, followed by the promulgation and the execution of relevant government ordinances on January 25, 2023. As a result, audit firms that audit listed companies etc. have been obliged to develop systems to conduct their business in accordance with the Audit Firm Governance Code and to disclose enhanced information.

With regard to the Audit Firm Governance Code, the summary of issues compiled by the Advisory Council on the Systems of Accounting and Auditing (administrative year 2021) in November 2021 and the report compiled by the Financial System Council Subcommittee on Certified Public Accountant System in January 2022 called for all audit firms that audit listed companies etc. to accept the Code, while maintaining the “comply or explain” framework regarding the implementation of specific principles.

It was also decided that it would be desirable to review the Code to ensure that its contents are designed to be appropriate for small and medium-sized audit firms etc. that audit listed companies to adopt and are proportionate to the size and characteristics etc. of audit firms, as well as to broadly consider whether there are any other points in the Code that ought to be revised.

For this reason, the Financial Services Agency has convened the Council for a total of three meetings since October 2022 to discuss the revision of the Code. Based on these discussions, the Council has compiled a revised version of the Audit Firm Governance Code (hereinafter referred to as the “Code”).

The Code consists of five principles for ensuring the audit quality as organizations and related guidance for effective implementation of the principles proportionate to the size and characteristics etc. of the audit firms.

The Code states the following:

- The top of an audit firm should exercise its leadership to accomplish the 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 its personnel 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 formulated with the effective management of audit firms that audit listed companies etc. in mind, but they do not preclude other audit firms from voluntarily implementing the Code. Based on this, in determining how to implement the Code and to accomplish effective organizational management, each audit firm would be required to take its own initiatives, based on its own size and characteristics etc. With regard to the implementation of the Code, we assume the approach of “comply or explain” (i.e., either comply with a principle or, if not, explain why not) to be adopted.

In the event that each audit firm believes that the implementation of the principles or the guidance would be unreasonable in view of the firm’s size and characteristics etc., the firm must provide sufficient and specific explanations of the reasons why the principles or guidance are not being implemented and what alternative measures are being taken. Moreover, if the audit firm changes the way in which the principles or guidance are implemented, or if it decides that it will implement principles or guidance that are currently not being implemented, such effects should be explained as well.

Each audit firm is required to establish an appropriate system based on its own size and characteristics etc., and to provide a specific explanation of the implementation status of the Code in accordance with the firm’s actual circumstances. In order to ensure this, the Japanese Institute of Certified Public Accountants (JICPA) is expected to leverage the knowledge and experience in self-regulation it has acquired thus far and play a role in instructing or supervising audit firms expected as a professional organization.

Furthermore, joint practitioners and sole practitioners that audit listed companies etc. are required to implement the Code by replacing the term “an audit firms” with “a joint practitioners” or “a sole practitioner” and to explain that they are carrying out effective management by adopting the “comply or explain” approach.

The JICPA is expected to promote efforts to transform sole practitioners currently auditing listed companies etc. to audit firms in orderly manner, as part of its support for cultivating small and medium-sized audit firms.

We hope that each audit firm strongly promotes its improvements through their own creativity and ingenuity, to accomplish the effective management of the firm from the viewpoint of the changing circumstances surrounding audits and the public's expectations of 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 personnel 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 the 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. In particular, audit firms that audit listed companies etc., regardless of their size, are required to develop an organizational structure that ensures even higher standards for the audit quality. 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 its personnel 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 attention to the establishment of an environment for human resources development which offers adequate motivation and a system for human resources management and performance evaluation, so that employees at the firm can sufficiently exercise their professional skepticism.

Furthermore, there are cases where some audit firms are engaged in group management through participating in global network or forming comprehensive business alliances with other firms. While such relationships are expected to ensure and continuously improve the audit quality through the development of shared audit tools and investment in IT, they also pose the potential risks to hinder ensuring and continuously enhancing the audit quality, by

potentially influencing the decision-making of the audit firm. In particular, since such relationships are established through individual global network and group contracts, if their relationship and positioning are not clarified, it will be difficult for participants in capital markets to have a full understanding of the benefits and risks that affect the ensuring and the continuous improvement of the audit quality. Sufficient disclosure of the relationship between the audit firm and its global network or group will lead to ensuring the credibility of the audit among capital market participants etc., and is important for capital market participants etc. to properly evaluate the approaches and the efforts made by the audit firm to improve the audit quality.

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 the firm personnel will proactively accomplish their respective roles, as well as so that 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 its personnel and also develop the code of conduct to put these values into practice.
- 1-3 An audit firm should appropriately motivate its personnel 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 its personnel to share issues, knowledge and experiences related to audits and proactively participate in a dialogue and discussion.
- 1-5 An audit firm should clarify not only its stance toward non-audit services (provided by the firm and its group organizations), but also what specific measures are being taken, based on the size and characteristics etc. of the firm, to address concerns related to conflicts of interest or independence. Furthermore, if employees of the audit firm are allowed to hold concurrent or secondary jobs, the firm should clarify what specific measures are being taken to address concerns related to conflicts of interest or independence, including the firm's approach to the people retention and development.
- 1-6 In the event that an audit firm participates in a global network or conducts group management through comprehensive business alliances with other firms etc., such an audit firm should clarify how it seeks to manage its business with regard to its relationship to and positioning within the global network or its group.

[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 is incorporated based on the legal structure of partnership organized by five or more certified public accountants. Under the CPA Act, in principle, it is assumed that all partners will execute and monitor the business, and there is no requirement to establish an organization. However, audit firms that audit listed companies etc., in particular, are required to have effective management functions from the standpoint of ensuring and continuously improving the audit quality, regardless of the legal structure, such as unlimited liability audit firms or limited liability audit firms, or any other formal or substantive differences.

In addition, recent audit firms may have several hundred partners and thousands of members. From the standpoint of ensuring the audit quality, the management is required to adequately keep up with the expansion of its business and the increasing complexity in its management and operations.

In order to address these issues, an audit firm should for example establish a management structure that can effectively function in its organization and ensure its effective management and operations. Moreover, even if a management structure is not established in view of the size and characteristics etc. of the firm, the firm as an organization should have effective management functions from the standpoint of seeking to ensure and continuously improve the audit quality.

Guidance

- 2-1 An audit firm should establish an effective management structure to ensure its effective management and operations. Furthermore, in the event that an audit firm decides not to establish a management structure in view of its size and characteristics etc., the firm should ensure it has effective management functions.
- 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's 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 from the capital market, and proactive involvement in those significant issues by utilizing the structure mentioned above;

- The development of an environment that allows audit teams to conduct a macroscopic analysis based on an understanding of the economic environment and frank and in-depth dialogue with audited companies in order to identify the risks of material misstatements and to respond to the assessed risks appropriately;
- Setting an appropriate environment for people development, human resources management and performance evaluation in order to raise the morale of the firm personnel and help them to maintain and demonstrate their professional competence; and
- Consideration and development related to the implementation of IT infrastructure (including the proactive and effective utilization of technology) in order to enhance the efficiency and effectiveness of audits, in consideration of the improvement of the efficiency of audit-related operations and the advancement of technologies, including digitalization, at audited companies.

2-3 An audit firm should appoint people who can perform the management functions not only by taking into account their thorough knowledge and experience of audit practice but also by ensuring the effectiveness of the management functions for its organizational operations of the firm.

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 function of the management structure etc., 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 that audit listed companies etc. to ensure highly transparent, effective management and organizational operations to continuously improve its audit quality and to accomplish its public interest role in the capital market, the firm should for example establish a structure responsible for supervision and evaluation and effectively utilize the knowledge and experience of independent third persons who have, for instance, experience of the organizational management of corporations or other audit firms, the perspective of a capital market participant, and expertise in audits.

Moreover, even if the firm decides not to establish a structure responsible for supervision and evaluation in view of its size and characteristics etc., for instance, the firm should use its creativity and ingenuity to effectively utilize the knowledge and experience of independent third persons, such as by having independent third persons participate in meetings on management and operations.

In utilizing an independent third person at an audit firm, it is important to clarify the roles expected for the independent third person to play and its approach to independence, taking into account factors such as its size, governance structure, and organizational management and operational issues.

Guidance

3-1 An audit firm should establish a structure to supervise and evaluate the effectiveness of its management etc. and thereby support to enhance its effectiveness, and clarify the role of the structure. In the event that an audit firm decides not to establish a structure responsible for supervision and evaluation in view of its size and characteristics etc., the firm should ensure the function of supervising and evaluating the effectiveness of its management functions and thereby supporting the enhancement of its effectiveness.

3-2 An audit firm should effectively utilize the knowledge and experience of independent third persons to deal with the issues recognized by the firm from the perspective of ensuring effective management and organizational operations and accomplish its public interest role. At the same time, the firm

should clarify the role expected for the third person to play and its approach to independence.

- 3-3 An audit firm should clarify the role of the members of the supervision and evaluation structure or independent third persons considering that those persons are expected to be involved in the following matters, for example:
- Advice and recommendations that contribute to improving the effectiveness of its management functions;
 - Oversight of the evaluation of the effectiveness of the management ;
 - Oversight of the process of the election or appointment, retirement, evaluation and remuneration of the people who can perform the management functions or independent third persons;
 - Oversight of developing the policies for people development, human resources management, performance evaluation and remuneration;
 - Oversight of 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
 - In fulfilling their oversight role, independent third persons should also be involved in dialogue with audited companies, shareholders and other participants in the capital market.
- 3-4 An audit firm should develop an environment in which necessary information is provided to the members of the structure responsible for supervision and evaluation or independent third persons in a timely and appropriate manner, and in which assistance is provided in the execution of their operations so that the supervision and evaluation structure etc. can effectively fulfill their responsibilities.

[Operation]

Principle 4

An audit firm, based on the size and characteristics etc., should develop an operational structure to effectively manage its organizational operations. The audit firm should also strengthen its people retention and development and proactively engage, in 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 audit quality, the management etc. of the firm needs to be effectively functioning in its operations. Furthermore, the philosophy and values defined by the management etc. need to be spread throughout the organization, and the management of the firm needs to develop a structure to make that possible.

In order to make this structure work, 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 the enhancement of audit quality will not be effective as well.

Furthermore, it is also important to facilitate the communications and information streams not only from the management team etc. to each audit team but also from the audit teams to the management team etc.

Through the initiatives mentioned above, it is expected that more frank and broad-minded dialogue and discussion among the firm personnel 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 etc. to share necessary information from each audit team in a timely manner and also pervade 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 encouraged 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 personnel and help them to maintain and demonstrate their professional competence. In doing so, whether the firm personnel sufficiently exercised 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 the firm personnel to respective teams in terms of the extensive knowledge and experience to allow the teams to exercise their professional skepticism;
- Providing the firm personnel with opportunities to gain extensive knowledge and experience relevant to audit, such as experience in non-audit service and/or temporary transfer to companies outside the audit industry;
- Appropriate evaluation and well-planned utilization of the firm personnel with extensive knowledge and experience; and
- Developing an environment in which the firm personnel can fully engage in capacity building alongside their work.

4-4 An audit firm should make efforts for audit teams to have candid and in-depth dialogue about audit risks with the top management of audited companies, such as the CEO and CFO, and those charged with governance including the members of the 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 and disclose policies and procedures regarding whistleblowing 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 such transparency as 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 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 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 dialogue with stakeholders in the capital market, to further improve 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 publicly available documents etc., 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 in terms of quality management, governance, IT and digitalization, human resources, finances, and international response, based on the firm's size and characteristics etc.:

- The tone at the top toward the continuous enhancement of the audit quality in order for the management and the firm personnel of the firm proactively fulfill their respective roles;
- The defined values to be commonly maintained by the firm personnel, and way of thinking and code of conduct to put these values into practice;
- Information that contributes to assessments by the capital market participants, including the audit firm's medium to long-term goals, audit quality indicators (AQI) that specify the firm's direction toward those goals, or its initiatives for

the improvement of audit quality;

- The status of quality management systems at the audit firm;
- The composition and role of the management etc.;
- The composition and role of the structure etc. to supervise and evaluate the effectiveness of the management and organizational operations, as well as the reasons for the appointment, the role, contribution and the approach to independence of independent third persons;
- The stance toward non-audit services (provided by the firm and its group organizations), and the response to concerns related to conflicts of interest or independence;
- The status of efforts to implement IT infrastructure (including the proactive and effective utilization of technology, fraud detection, and cybersecurity countermeasures) in order to enhance the efficiency and effectiveness of audits, in consideration of the improvement of the efficiency of audit-related operations and the advancement of technologies at audited companies;
- Status of securing diverse and necessary personnel at the firm in view of its size and characteristics etc., and people development policies, including training and education;
- Status of securing a financial base that is not dependent on compensation from any particular audited companies;
- The status of response to audits of companies with overseas subsidiaries etc.; 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 structure etc. responsible for the supervision and evaluation.

5-3 An audit firm that participates in a global network or conducts its management on a group basis through comprehensive business alliances with other firms should explain the following matters.

- A broad outline of the global network or group and its organizational structure, and the status of the audit firm's participation in the global network or group's decision-making;
- The significance and purpose of participation in the global network or of conducting management on a group basis (including an overview of benefits and risks that affect ensuring and continuously enhancing the audit quality);
- Measures taken to mitigate risks posed by the relationship with the global network or group with regard to ensuring and continuously improving audit quality, and their evaluation; and
- An overview of contracts and others with global network or group that has a significant impact on ensuring and continuously improving the audit quality.

- 5-4 An audit firm should strive for proactive dialogue about its initiatives for the 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 the members of the structure responsible for supervision and evaluation, or of independent third persons.
- 5-5 An audit firm should periodically assess the Code's implementation and the effectiveness of its initiatives for enhancement of the audit quality.
- 5-6 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 effective management and organizational operations.