Auditing the auditors

Following a series of accounting scandals, Japan is tightening responsibility and oversight.

Kazutaka Kuroda

After a series of accounting scandals, Japan's regulatory Principles for Effective Management of Audit Firms (The Audit Firm Governance Code, hereinafter referred to as the "Code") has been reviewed and a draft code published.

Concerns over audit firms were initially highlighted in a final report by the third-party panel responsible for Toshiba's accounting probe in July 2015.

Advisory council

However, a lack of details on the ineffectiveness and expected responsibility of the audit firm in the Toshiba case led to public criticism and the Japanese Financial Services Authority (FSA) launching the Advisory Council on the Systems of Accounting and Auditing in October 2015.

By March 2016, the Advisory Council had released its recommendations, which included the establishment of the Audit Firm Governance Code. Responding to the recommendations, the Council of Experts on Audit Firm Governance Code was set up in July 2016 and released a draft of its Code in early December 2016 asking for public comments.

Final draft

The deadline of the public comments was the end of January 2017. Subsequently, the Council of Experts for Auditing Firm Governance Code has discussed the submitted public comments and will release its final draft shortly.

The Code is based on a comply or explain approach and consists of a brief preamble, five principles and 22 guiding principles. A brief summary of the five principles is as follows:

- **Principle 1** describes the expected role of audit firms, consisting of top commitment (guiding principle 1-1 hereinafter), values and code of conducts (1-2), motivation management (1-3), open culture (1-4), and policy on non-audit services (1-5).
- **Principle 2** refers to the executive management of audit firms. Their management bodies (2-1) should clarify their role on issues including organisational structure development and the

business environment to enable frank and in-depth dialogue with audited companies on human resource management and effective use of information technology (2-2). This principle also offers guidance on the member selection for audit company management bodies (2-3).

- **Principle 3** explains the supervision of the executive management. Audit firms' supervisory bodies (3-1) should appoint independent members (3-2).
  The supervisory bodies should also clarify their roles regarding issues including: effectiveness of executive management; appointment of management bodies, and their resignation, evaluation, and remuneration; human resource development; whistleblowing policies and practices; and dialogue with other market participants except for audited companies (3-3).
  This principle also focuses on the significance of having a supporting system for members of supervisory bodies (3-4).
- **Principle 4** details the guidance of daily operations covering issues including: communication of the management bodies' philosophy (4-1), human resource development policy (4-2), diversity in knowledge and experience of human resources (4-3), dialogue with audited companies (4-4), and internal and external whistleblowing while maintaining confidentiality (4-5).
- **Principle 5** mentions public disclosure consisting of publishing a transparency report (5-1), disclosure of the issues detailed in Principles 1, 2, and 3 (5-2), dialogue with market participants except for audited companies (5-3), periodical review of the Code's implementation (5-4), and effective use of the review results (5-5).

In addition to these principles, I recommend two more points to be included for effective implementation of the Code: 1) mandatory audit firm rotation, and 2) restriction of non-audit services offered by audit firms.

Both were also discussed in the European Union audit reform legislation and are necessary if the Japanese Code is to meet the requirements of global best practice.

Kazutaka Kuroda is a Sustainable Finance Specialist at the Japan Research Institute, Ltd. The views expressed here do not represent those of the Japan Research Institute, Ltd.

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