

July 26, 2017

Certified Public Accountants and Auditing Oversight Board

Basic Plan for Monitoring Audit Firms **in the program year 2017 (July 2017 to June 2018)**

The Certified Public Accountants and Auditing Oversight Board (“CPAAOB”) will monitor¹ audit firms to maintain the audit quality and improve the effectiveness of audit based on the viewpoint and objectives stated in the Basic Policy for Monitoring Audit Firms² .

Environment surrounding audit firms:

The Japanese economy is on a moderate recovery. However, there are downside risks of the Japanese economy depending on the uncertainty in overseas economies and the trend in the financial and capital markets.

When it comes to the environment surrounding certified public accountants and audit firms, the number of newly listing companies has declined but has remained at a high level, while the total number of listed companies and the average audit fee paid by listed companies have grown slightly. There have been many recent cases in which listed customers of large-sized audit firms³ changed their auditors.

In response to the growth in the number of companies expanding overseas, mainly in Asia, and an increase in international business deals and M&As, there is development in internationalization of accounting practice and complication / specialization of transactions.

Under such circumstances, audit firms that perform their role for large, international listed companies are addressing auditing methods that are becoming deeper and more

¹ Monitoring includes both on-site monitoring and off-site monitoring. Furthermore, on-site monitoring refers to on-site inspections, while off-site monitoring means activities other than inspections, such as the collection of reports on audit firms, interviews, information gathering through the exchange of opinions and cooperation between audit firms and relevant parties.

² Basic Policy for Monitoring Audit Firms: It sets the standpoint, objectives, and basic policy for each term regarding monitoring implemented by the CPAAOB. The basic policy for the fifth term (April 2016 to March 2019) was formulated and announced on May 13, 2016.

³ Large-sized audit firms: Audit firms that have more than approximately 100 listed audited companies and whose full-time staff performing actual audit duties total at least 1,000. In this basic plan, they specifically refer to KPMG Azsa LLC, Ernst & Young ShinNihon LLC, Deloitte Touche Tohmatsu LLC and PricewaterhouseCoopers Aarata LLC.

complex, such as hiring and training global human resources, introducing IT and other technologies, hiring more support staff for auditing work, but their efforts have not brought satisfying results in some respects.

Response to accounting scandals:

The number of listed companies, which disclosed inappropriate accounting processing through the TD net (Timely Disclosure network), has exceeded 60 a year and has been on a rising trend over the past few years. There have still been cases where inappropriate practices related to IPOs were found, as well as accounting irregularities involving group companies including overseas subsidiaries.

In the wake of recent accounting scandals, confidence in audit has been questioned again. To address this situation, the Financial Services Agency (FSA) released the Principles for Effective Management of Audit Firms (“The Audit Firm Governance Code”) on March 31, 2017. Currently, large-sized audit firms, second-tier audit firms⁴ and some other firms are working to reorganize their governance environment for the improvement of the audit quality, through measures including management reforms and use of expertise of external entities.

Role of audit in corporate governance:

Enhancement of governance functions of firms are increasingly reinforced thanks to the recent amendment to the Companies Act and introduction of the Corporate Governance Code, which has helped enhance governance functions of firms, and has been introduced at most listed companies.

At the follow-up meeting about the Code in February 2016, the improvement of the independence and objectivity of the board of directors was suggested, and it was expected that the corporate governance of firms would be more effective.

On the other hand, there have been problems in internal controls including overseas group companies, for example, an accounting problems was reported recently at an overseas subsidiary of a listed company. Audit firms are thus required to thoroughly conduct specific assessment based on the actual state of business operations, including overseas operations, when they assess the internal controls of their audited companies.

⁴ Second-tier audit firms: Audit firms whose size of business is second only to large-sized audit firms. In this basic plan, they specifically refer to GYOSEI & CO., BDO Sanyu & Co., Grant Thornton Taiyo LLC, BDO Toyo & Co., PricewaterhouseCoopers Kyoto and YUSEI Audit & Co.

Current state of quality control at audit firms:

Looking at the current state of engagements at audit firms, the percentage of audit firms that received a qualified conclusion increased as high as in the preceding fiscal year, although most audit firms received an unqualified conclusion in the quality control review in fiscal year 2016 by the Japanese Institute of Certified Public Accountants (“JICPA”).

Moreover, there were two audit firms for which the CPAAOB made recommendations to the FSA Commissioner to execute administrative actions and/or other measures in the last program year, because their business operation were found to be significantly unsatisfactory as a result of the CPAAOB’s inspection.

In addition to the above mentioned cases, the other audit firm that was recognized as having an inappropriate business operation and was required to improve immediately, which was not to be subject to recommendation, though. The board has notified the audit firm of the inspection results, urging to implement adequate steps quickly to improve the situation.

The CPAAOB conducted follow-up inspections on two large-sized audit firms in the last program year and found that both were addressing the issues in a systematic manner, although they still have several insufficient points to be improved.

Trends in international independent audit regulators:

In April 2017, the International Forum of Independent Audit Regulators (IFIAR) set up the permanent Secretariat office in Tokyo and held the annual plenary meeting participated in by member regulators. In the plenary meeting in Tokyo, members from 22 countries and regions, including Japan, signed a multilateral memorandum of understanding (MMOU) to facilitate more effective information exchange and improve cooperation among members, and contribute to more efficient regulations on audit firms.

Taking the above situation into account, we have formulated our Basic Plan for Monitoring Audit Firms in the program year 2017 (July 2017 to June 2018) as follows.

1. Concept of Basic Plan for Monitoring Audit Firms in the program year 2017 (July 2017 to June 2018)

In this program year, we will monitor audit firms based on the six basic concepts from (1) to (6) mentioned below with a focus on the following points,

- As audit firms need to take the initiative in ensuring and improving the audit quality, we will conduct examinations in ways that encourage audit firms to take actions by themselves.
- We will verify whether the audit conducted by the audit firm is formally compliant with the standards, but also whether it appropriately exercises professional skepticism to detect corporate fraud and whether it assesses audit risks by paying attention to the business risk of audited companies at all times.

(1) Implementation of monitoring in accordance with the type of audit firm

Audit firms' operational characteristics are highly diverse by number of staffs, from several to thousands of staff. Therefore, the CPAAOB categorize them into large-sized audit firms, second-tier audit firms and small and medium-sized audit firms⁵ and will conduct our monitoring as appropriate according to their respective characteristics.

With regard to the audit firms that have adopted the Audit Firm Governance Code, the CPAAOB will examine whether or not the audit firms' governance environment established and enhanced based on the code are functioning effectively, and will share the results and collaborate with relevant department of the FSA.

① Large-sized audit firms

We will continue to strengthen off-site monitoring, such as the collection of reports on business management (governance) environment, including relationships with domestic group companies and overseas business partners (Global networks).

We also conduct effective inspections through updating the focus areas of inspection based on recent inspection results and examination of business management (governance) environment as well as service management environment of the firms. In the follow-up inspections, we will examine their efforts for improvement, encourage the audit firms to take steps toward voluntary improvement. we will conduct inspections in a timely manner instead of cyclical inspections, if needed.

⁵ Small and medium-sized audit firms: Audit firms other than large-sized audit firms and second-tier audit firms.

② Second-tier audit firms

Second-tier audit firms are expected to acquire the capability to audit large listed companies by establishing effective governance to make their management function effective and by having external parties (authorities) check their engagements to improve the audit quality. Presently, second-tier audit firms typically have more than 100 full-time employees and several dozen listed companies as their audited companies. In light of their importance in the Japanese audit industry, we will intensively monitor second-tier audit firms. Specifically, we will cyclically conduct inspection. If necessary, we will conduct an agile inspection instead of cyclical inspection. In particular, we will put a focus on the inspection of the business model including relationships with overseas business partners, business management (governance) environment, and service management environment.

③ Small and medium-sized audit firms

After appropriately collecting and analyzing information on the audit firm to be inspected, we will conduct monitoring from the standpoint of compliance with standards, including inspecting mainly the confirmation of the audit quality of individual engagements and the audit firm's service management environment and quality control environment based on the intention and nature of the managing partner and the partners. In particular, we will examine mainly focusing on whether any particular deficiency is attributable to the audit firm's organizational structure or business model, and whether the audit firm engages in effective remedial activities based on the root causes pointed out at our inspection.

(2) Overall examination of JICPA's quality control review system, etc.

The CPAAOB has been monitoring the JICPA's quality control review. Taking into account the results of the recent inspection of audit firms that received the JICPA's quality control review, we will continue overall examination of the JICPA's quality control review system, such as the effectiveness of the quality control review, and the JICPA's responses as a self-regulatory organization to improve the audit quality, mainly the Registration System for Listed Company Audit Firms. The CPAAOB and JICPA will consider appropriate role sharing and cooperate so that the CPAAOB's inspection and JICPA's review will demonstrate the maximum effect as a whole.

(3) Strengthening off-site monitoring

To conduct monitoring efficiently and effectively, we will step up our efforts to share information through the exchange of opinions and cooperation with related organizations, such as the JICPA, relevant departments of the FSA, and stock exchanges, international audit institutes and audit regulators in each country, and audit firms' overseas business partners. We will also further improve risk assessment methods, such as the gathering and analyzing of information on the environment surrounding audited companies including industry trends. Moreover, regarding information gathering and analysis results, we will not only implement the collection of reports and interviews as necessary, but also endeavor to operate off-site monitoring integrally with on-site monitoring by effectively using them for inspection.

(4) Understanding status of environment supporting audit services

Some of large-sized and second-tier audit firms have established environment supporting their audit services by introducing a system to centrally manage risk information across divisions and enhancing correspondence to group audits by international divisions, as well as taking advantage of IT by introducing tools to analyze the accounting data of audited companies. It is necessary for us to grasp these circumstances mentioned above, which may significantly affect assurance and improvement of the audit quality. In particular, we will comprehend the status of introduction of IT through dialogues with audit firms including overseas business partners, because it is related to the development policy and investment trends of overseas business partners of audit firms. We will also examine whether audit firms ensure and foster their staff in accordance with audit methods that are deepening and becoming more complexed.

(5) Enhancing international cooperation in audit oversight

In April 2017, representatives of IFIAR from 22 countries and regions, including Japan, signed the IFIAR Multilateral Memorandum of Understanding concerning Co-operation in the Exchange of Information for Audit Oversight (MMOU). In addition, Japan has exchanged the Letters on information exchange with seven countries. We will enhance dissemination and sharing of information by exploiting these frameworks.

(6) Enhancing of the monitoring environment

We will strengthen the CPAAOB's monitoring environment in order to perform effective information gathering/analysis and inspections according to the business situation of each audit firm.

Concretely, we will assign those who are capable for taking an appropriate responses after analyzing information from home and abroad, the internationalization of accounting practices and environment of audit firms in Japan. We will also appoint staff who can respond appropriately by analyzing the information from home and abroad, internationalization of accounting practices and the posture of our audit firms in Japan. In addition, we appreciate those who can provide efficient and effective monitoring guidance. Furthermore, we will promote training of human resources by holding staff dispatch to foreign audit supervisory authorities (regulators), holding international training on accounting and auditing as well as training on other key issues, etc.

2. Basic Plan pertaining to Off-site Monitoring

In order to conduct off-site monitoring efficiently and effectively, besides the reports on the JICPA's quality control review, we will step up our efforts to share information through exchange of opinions and cooperation with international audit institutes and audit regulators in each country, and audit firms' overseas business partners in addition to related organizations, such as the JICPA, relevant departments of the FSA, and stock exchanges. At the same time, we will effectively use the information of past reports from audit firms and inspection results.

In addition, we will strive to strengthen and advance a system to collect and analyze various materials and information according to the risk of audit firms. Furthermore, to precisely identify risk pertaining to audit firms and individual engagements, we will conduct off-site monitoring according to the type of audit firm, including the examination of the JICPA's quality control review, the reports from audit firms, and interviews, as mentioned below.

(1) Examination of JICPA's quality control review

The JICPA has recently reinforced the operational environment of its quality-control reviews, including an increase in the number of reviewers and introduction of flexible reviews.

By virtue of these efforts, there is a certain degree of improvement in terms of the contents of issues pointed out at the latest quality control reviews. We see,

however, that there is a problem as to whether or not the JICPA's review leads to an improvement in the audit quality of the audit firms.

In view of the above, we expect the JICPA strive to further improve the effectiveness of its quality control review for the establishment of an appropriate audit quality control at audit firms.

Consequently, we will collectively examine the JICPA's policy and responses toward the improvement of the audit quality as a self-regulatory organization, mainly the quality control review system including the effectiveness of the quality control review. We will contribute this examination through evaluation when receiving a review report from the JICPA and the examination of the results of the CPAAOB's inspection.

Furthermore, we will maintain effective cooperation between the CPAAOB and the JICPA, exchanging views on preferable manner of quality control review that can lead to an effective improvement in practices and improvement in audit quality.

In addition, we will discuss the appropriate role sharing with the JICPA, taking into account the JICPA's efforts to improve the effectiveness of its quality control review.

(2) Collection of reports

- ① Regarding the performance of audit engagements, we will collect reports from audit firms in a timely manner based on the results of the JICPA's quality control review in order to encourage them to continue appropriate audit quality control.

Especially, with regard to small and medium-sized audit firms, based on the their individual characteristics, we will intensively examine the status of the development of the quality control system at the audit firms, the management policies of their leaders, revenue/financial structures, organizational structures and human resources.

In addition, regarding audit firms that are found to have a material problem through the collection of reports, we will use the results as important reference information in inspection, etc.

Moreover, the collection of reports should be conducted in an effective manner, such as using a face-to-face method, if necessary.

- ② With regard to large-sized audit firms, we will continuously request them to provide quantitative and qualitative information in the collection of reports,

which are necessary for the inspection of business management (governance) environment and service management environment.

After analyzing the information obtained through the collection of reports, we will use it to make our inspections more effective and efficient. At the same time, we will use the information for comparative analysis of large-sized audit firms and identification of issues commonly found across large-sized audit firms.

- ③ After a certain period of time from the date of the notification of the inspection results, we will collect reports from the relevant audit firms to examine how much they have improved their quality control as necessary. On that occasion, we will cooperate with related departments of the FSA to attempt to check according to the degree of deficiency and importance. If the improvements of deficiencies are found to be inadequate or any problematic situations are found through the collection of reports, we will consider some appropriate measures that are suited to the characteristics and risk of the audit firm, including another collecting reports or conducting inspection.

If an audit firm is found through inspection to have deficiencies in its business operation and to be required immediate improvement, we will consider collecting a report on its improvement plan and the progress of the plan simultaneously with notification of the inspection results, without waiting for the passage of a certain period of time.

3. Basic Inspection Plan

Based on the Basic Inspection Policy, we will share the understanding of problems with the business operation through dialogue with the audit firms subject to inspection and endeavor to make precise and effective comments. On that occasion, if we find such audit firms made superior efforts to improve operations, we will assess such efforts and share the understanding with the audit firms.

We have revised the content of the inspection results report to ensure that the issues pointed out in inspection results are correctly communicated to audit firms and their audited companies. We will keep trying to upgrade information pertaining to the inspection results, including comparability of inspection results.

Under such circumstances mentioned above, we will conduct inspections with a focus on the below mentioned aspects according to the type of audit firm in this program year.

① Whether the below items, which are prepared by audit firms to ensure and improve the quality control environment, are appropriate according to the size and characteristics of the audit firms:

- the basic management policy and measures related to business management
- measures for securing the fair execution of services, such as measures related to compliance with laws and regulations.

Whether audit firms review measures related to the management policy and business management by taking into account the status of formulation of a medium-and long-term management policy/plan and the circumstances surrounding audit firms.

② Whether audit firms implement acceptance and continuance of engagements, formulation of audit planning, and other audit procedures by implementing an appropriate assessment of business risk including the economic circumstances and the corporate environment surrounding the audited companies.

③ Whether audit firms subject to inspection take their own initiatives in addressing identification of the root causes of their deficiencies and taking actions for effective improvements through fundamental measures.

(1) Inspection of large-sized audit firms

Taking into account their role in the capital market and domestic and international trends related to supervision of auditors, we will cyclically inspect large-sized audit firms based on our evaluation results pertaining to the JICPA's quality control review. However, if the internal control system of audit firms that perform audit engagements for audited companies requiring to be checked promptly in circumstances where the audited companies that may have a significant impact on the market are found or suspected to have material accounting problems, we will conduct inspection in a timely manner.

We need to conduct inspection with more emphasis on large-sized audit firms' business management (governance) environment and service management environment, such as the quality control and management of services to the engagement teams responsible for auditing, because large-sized audit firms comprised of multiple divisions and regional offices and have thousands of employees.

For this purpose, we will conduct inspection with a focus on the below mentioned items in this program year.

- Inspection whether the management control system and business administration system are established to the end of the organization, from the viewpoint that quality control system as an audit firm is appropriately managed. (regional offices included)
- Inspection of audit procedures related to revenue recognition and accounting estimates from the standpoint whether or not risk is appropriately assessed or professional skepticism is appropriately exercised.
- Inspection of procedures to take on new audit contracts, especially those pertaining to large-sized listed companies.
- Inspection of the status of communication with the audited companies
- Inspection of the status of internal control assessment of companies including overseas operations and group audits including overseas subsidiaries
- Inspection of the assessment of internal control in the audit of financial statements and the status of audit concerning internal control, and the status of responses to fraud risk including the status of operation of the standards to respond to fraud risk.
- Inspection of monitoring activities by overseas business partners

Moreover, from the standpoint of strengthening follow-up to inspection, we will conduct a follow-up inspection in the following program year in order to check if the deficiency pointed out at the inspection in the previous program year is being steadily remedied. In conducting follow-up inspection, we will pay close attention so that the audit firms can reduce their burden by utilizing an advanced report collection and narrowing the focus area of inspections.

(2) Inspection of second-tier audit firms

Taking into account the situation of the entities and an audit firm's business profile, we will cyclically inspect second-tier audit firms in light of their significance in the Japanese audit industry. In conducting inspections, we will inspect these audit firms based on our evaluation results on the JICPA's quality control review with giving consideration to effective and efficient implementation with a focus on common risk. However, if the internal control system of audit firms that perform audit engagements for audited companies requiring to be checked

promptly in circumstances where the audited companies that may have a significant impact on the market are found or suspected to have material accounting problems, we will conduct inspection in a timely manner.

For this purpose, we will conduct inspection with a focus on the below mentioned items in this program year.

- Inspection with a focus on essential problems in the business operation by obtaining information with high importance related to quality control and engagements at the audit firm, taking into account the previous inspection results and the status of monitoring by overseas business partners, and paying attention to engagement risk
- Inspection of business management environment and service management environment, such as unity as an organization
- Inspection of audit resources including whether there is sufficient and appropriate experience and capability to deal with an audit risk, such as the internationalization of audited companies
- Inspection of the status of communication in group audit, especially with component auditors overseas
- Inspection of communication with corporate auditors, the effectiveness of remedies to issues pointed out in the JICPA's quality control review and the CPAAOb's inspection, the review system of audit opinions, the status of use of professionals, and the status of response to issues across the industry obtained through past monitoring
- Inspection of the status of response to the case of auditor's changes based on the standards
- Inspection of the assessment of internal control in the audit of financial statements and the audit of internal control, and the status of responses to fraud risk including the status of operation of the standards to respond to fraud risk

(3) Inspection of small and medium-sized audit firms

Regarding small and medium-sized audit firms, we will conduct inspection, mainly confirmation of the audit quality, such as audit firm's quality control environment and service management environment based on the intention and nature of the managing partner and the partners and the conformity of individual engagements with audit standards. We will conduct inspection as needed, factoring in our evaluation results pertaining to the JICPA's quality control review.

For this purpose, we will conduct inspection with a focus on the below

mentioned items in this program year.

- Inspection with consideration of issues related to business operations and quality control attributable to a small and medium-sized audit firm's systems. Especially, inspection of business management environment and service management environment, including aspects such as unity as an organization
- Inspection of audit resources including whether there is sufficient and appropriate experience and capability to respond to audit risk, such as the internationalization of audited companies.
- Inspection of communication with corporate auditors, the status of guidance and supervision of audit practitioners, the status of use of professionals, and the status of response to issues across the industry obtained through past monitoring
- Inspection of the status of response as an audit firm based on the standards when an auditor is replaced
- Inspection of the appropriateness of risk assessment in assuming audits of listed companies deemed to carry high audit risk and audit environment of them
- Inspection of the status of response to the standards for fraud risk in the audit
- Inspection of the status of communication in group audit, especially with component auditors overseas
- Inspection of issues identified through off-site monitoring
- Inspection of the status of improvement of items pointed out in the JICPA's quality control review
- Inspection of the assessment of internal control in the audit of financial statements and the status of audit concerning internal control

4. Provision of Monitoring Information

We will conduct in-depth analysis on the results and status of monitoring, aiming to maintain and improve the audit quality. We will provide information widely in general as follows.

- ① We will extract cases confirmed in the recent inspections including superior efforts and will update the Case Report from Audit Firm Inspection Results. In addition, we will actively disseminate information to stakeholders through briefing sessions, etc., for not only related parties, such as the JICPA, audit firms,

and audited companies.

- ② We will revise the content of the Monitoring Report, which was first published in 2016, in light of helping investors deepen their understanding of audit. Thus, we will continue to enhance relevant information, incorporating the results of the latest monitoring results and condition of audit firms, etc.