

Basic Policy for Monitoring Audit Firms

- Aiming to Further Enhance Audit Effectiveness -

(Certified Public Accountants and Auditing Oversight Board
May 17, 2019)

Since its establishment in April 2004, the Certified Public Accountants and Auditing Oversight Board (hereinafter, the “CPAAOB”) has spent 15 years in five terms endeavoring to enhance the quality of audits by CPAs (certified public accountants) and to ensure the reliability of these audits in order to carry out its mission of improving the fairness and transparency of capital markets in Japan and increasing the level of trust that investors place in capital markets.

For the CPAAOB’s 6th Term (April 2019 – March 2022), we will be conducting monitoring¹ of audit firms (refers to both individual CPAs and audit firms; the same hereinafter) based on the current circumstances of audit firms and in line with the perspective and objectives of monitoring stated below, aiming to increase the level of trust that investors place in capital markets, and contributing to the further development of the Japanese economy.

[Current Circumstances of Audit Firms]

Regarding the current circumstances of audit firms, since the publication in March 2017 of Principles for Effective Management of Audit Firms (The Audit Firm Governance Code)², large-sized audit firms³, in particular, have been

¹ Monitoring encompasses both on-site monitoring and off-site monitoring. On-site monitoring refers to inspections. Off-site monitoring, on the other hand, refers to activities other than inspections. These include the gathering of information through the collection of reports from and the conduct of interviews with audit firms, through information exchanges and cooperation with relevant FSA departments, the Japanese Institute of Certified Public Accountants (JICPA), and industry groups etc. involved in audits, and through dialog with audit firms.

² Published by the FSA in March 31, 2017. Comprises five principles for audit quality that should be followed by organizations as well as guidelines for actual implementation of the principles.

³ The CPAAOB classifies audit firms based on their size, and there are three categories as follows:

- Large-sized audit firms: Audit firms that have more than approximately 100 domestic listed audited companies and whose full-time staff performing actual audit duties total at least 1,000. In this basic policy, they specifically refer to the four firms of KPMG Azsa LLC, Deloitte Touche Tohmatsu LLC, Ernst & Young ShinNihon LLC, and PricewaterhouseCoopers Aarata LLC. They are also referred to as the Big 4 accounting firms.
- Second-tier audit firms: Audit firms whose business scale is second only to large-sized audit firms. In this basic policy, they refer to five audit firms: Gyosei & Co., BDO Sanyu & Co., Grant Thornton Taiyo LLC, Crowe Toyo & Co., and PricewaterhouseCoopers Kyoto.
- Small and medium-sized audit firms: Audit firms other than large-sized and second-tier audit firms

rebuilding their governance environments, reviewing their audit portfolios, securing and developing personnel, deploying IT for audit tools, and making these tools more sophisticated.

However, regarding audit firms other than large-sized audit firms, while some of them are expanding the range of business they conduct as a result of mergers etc., it cannot be said that their governance environments or quality control environments are adequate, and some small and medium-sized audit firms have not made any changes at all in terms of business administration. Overseas, meanwhile, foreign audit regulatory authorities have been moving to a clamp down on foreign audit firms with inappropriate business practices that are members of the Big 4 global networks⁴.

With regard to the current circumstances of audited companies, their businesses are diversifying and they are becoming more globalized as a result of high levels of M&A and aggressive overseas expansion. However, with uncertainty surrounding overseas economies growing recently, the economic environment is becoming increasingly unstable. Furthermore, while companies have been moving to reinforce their governance environments as a consequence of such developments as more powers for audit and supervisory board members and the introduction of corporate governance codes, cases of fraud are continuing to occur both in Japan and overseas.

[Monitoring Perspective]

The CPAAOB will always adopt the perspective of citizens, as it seeks to serve the public interest, and will employ all the functions it possesses to the full to conduct more effective monitoring that reflects the sizes of audit firms, operations management environments, and degree of risk of audited companies. Furthermore, by continuously encouraging, through monitoring, audit firms to take steps voluntarily to ensure and improve audit quality, we will be aiming to ensure the trust in audits in the capital markets.

Moreover, the CPAAOB will share useful information that it has obtained through monitoring with relevant FSA departments, the Japanese Institute of Certified Public Accountants (hereinafter, "JICPA"), and industry groups etc. involved in audits (hereinafter, "relevant parties"), and will also proactively provide that useful information to the general public.

In addition, we will be cooperating and sharing information with the International Forum of Independent Audit Regulators (IFIAR)⁵ and foreign audit regulatory

⁴ Refers to the four global networks of Deloitte Touche Tohmatsu, Ernst & Young, KPMG, and PricewaterhouseCoopers, which are among the audit networks that operate worldwide.

⁵ International Forum of Independent Audit Regulators (IFIAR): an international institution established in 2006 comprising independent audit regulatory authorities that carry out inspections of audit firms. Its

authorities, and will, as necessary, reflect international discussions concerning the audits that we have learned about through this cooperation, as well as developments with the global networks, in the monitoring conducted by the CPAAOB.

[Objectives of Monitoring and Basic Approach to Achieving Them]

The main focus of monitoring performed by the CPAAOB is not on whether specific audit opinions are appropriate, but rather, is aimed at encouraging improvements in the effectiveness of quality control reviews performed by the JICPA, and ensuring that audit engagements, including audit quality control conducted by audit firms and foreign audit firms⁶, are performed appropriately.

To achieve such objectives, given that the entities responsible for ensuring proper conduct of audit engagements are audit firms, the CPAAOB performs effective monitoring to encourage audit firms to take action themselves.

Furthermore, we conduct monitoring that emphasizes whether the quality control environments established by audit firms for the purpose of ensuring and improving audit quality are effective. For example, we verify that they are not only adhering to formal audit standards, but also demonstrating the kind of professional skepticism needed to identify accounting fraud, and examine whether audit firms are always keeping an eye on business risks of audited companies and assessing audit-related risks.

In addition, in the case of audit firms that have adopted the Audit Firm Governance Code, we conduct ongoing monitoring of whether business management (governance) environments established based on the Code are contributing to ensuring proper conduct of audit engagements at the audit firms concerned.

In light of the above, the CPAAOB has determined a Basic Policy for Monitoring Audit Firms during the 6th Term as follows. Furthermore, based on this Basic Policy, we will formulate a Basic Plan for Monitoring Audit Firms for each of the program years (July to the following June) comprising the Term.

secretariat has been located in Tokyo since April 2017. Its aim is to improve audit quality globally through cooperation/collaboration between authorities. Its membership as of April 30, 2019 comprised audit regulatory authorities from 55 countries/regions, including Japan.

⁶ Refers to firms that have submitted a notification to the FSA Commissioner declaring that the firm provides services in foreign countries that are deemed to be equivalent to auditing and attesting services with respect to financial documents submitted by foreign companies pursuant to the provisions of the Financial Services and Exchange Act (FIEA).

1. Basic Policy for Off-site Monitoring

The CPAAOB will receive reports of the results of quality control reviews from the JICPA, and if it deems necessary, will collect reports concerning the results reports. Furthermore, we will gather information through information exchanges and cooperation with relevant FSA departments, the JICPA, and relevant parties, as well as through dialog with audit firms. We will also share problems we have identified. Moreover, with the aim of accurately gauging circumstances and risks at audit firms, we will endeavor to strengthen our analysis of the information we have gathered through this off-site monitoring.

Specifically, we will carry out the following:

(1) Verification etc. of JICPA Quality Control Reviews

The CPAAOB verifies the effectiveness of the quality control reviews performed by the JICPA, shares the results of these investigations with the JICPA through information exchanges etc., and encourages the JICPA to take action to ensure and improve audit quality. Furthermore, the JICPA, for its part, has been gradually taking steps to strengthen and enhance its quality control reviews in light of the results of the CPAAOB's investigations. Because this mutual cooperation helps to ensure and improve audit quality at all audit firms in Japan, we will endeavor to ensure that our investigations of and information exchanges concerning quality control reviews are conducted at a deep level.

Moreover, the CPAAOB has, until now, engaged in discussions concerning an appropriate division of roles between CPAAOB inspections and JICPA quality control reviews, and as a result, action has already been taken to a certain degree. This has centered mainly on the nature of the quality control reviews of large-sized audit firms and on improving and expanding the guidance and supervision that the JICPA provides to small and medium-sized audit firms. Going forward, we intend to continue to engage in discussions with the JICPA with a view to further improving the division of roles so as to ensure that the effectiveness of CPAAOB inspections and JICPA quality control reviews as a whole is maximized.

(2) Collection of Reports

With limited inspection resources at its disposal, it is important for the CPAAOB to make effective use of the collection of reports so as to encourage audit quality to be ensured and improved at all audit firms in Japan. Based on this point of view, we collect reports in a timely and effective

manner as follows after taking into account the sizes of audit firms, their operations management environments, the results of CPAAOB inspections and JICPA quality control reviews, and so on.

- a. In the case of large-sized audit firms and second-tier audit firms, we periodically analyze quantitative and qualitative information concerning their business management (governance) environments and operations management environments so as to make inspections more effective. We also monitor the adoption of IT and cybersecurity measures in connection with audit engagements, as this has been evolving recently.
- b. In the case of small and medium-sized audit firms, we select firms from which to collect reports based on the results of JICPA quality control reviews. We then gather and analyze information about operations management environments and quality control environments in light of the characteristics of each of the audit firms. Furthermore, because the influence of top management is especially strong at small and medium-sized audit firms, we understand top management's attitudes toward audit quality, and conduct interviews with them as necessary.
- c. In the case of problems that small and medium-sized audit firms have been notified of in the form of inspection results, once a certain period of time has passed since the notification of the inspection results, we monitor the action that has been taken, and if necessary, encourage the audit firm concerned to make improvements voluntarily through interviews etc.
- d. If, as a result of an inspection, the business administration of an audit firm is deemed to be poor and improvements need to be made particularly quickly, we collect a report at the time of the notification of the inspection results, and encourage the audit firm to make improvements promptly.

(3) Periodic Dialog etc. with Audit Firms

The CPAAOB gathers information on business administration through periodic dialog with the executives, including top management, of large-sized audit firms and second-tier audit firms, and shares with them its perceptions of audit-related issues and problems. Executives have a big influence on the organizational culture of their audit firms. This ongoing dialog with executives is therefore extremely important for encouraging audit firms to act independently to improve their quality control, so we will endeavor to ensure that in-depth dialog continues into the future.

Note that when engaging in dialog with audit firms, we encourage them to

improve and expand the information concerning quality control that they disclose voluntarily and to be proactive in the release of information so as to ensure that market participants can obtain useful information.

Furthermore, in addition to this periodic dialog with audit firms, we are also proactive in the area of information exchanges and cooperation with relevant parties.

2. Basic Policy for Inspections

The CPAAOB endeavors to conduct more effective and efficient inspections based on the environments at audit firms and the degree of risk pertaining to audited companies. We also strive to increase the effectiveness of inspections by, for example, improving inspection techniques. Moreover, we will encourage audit firms to ensure and improve audit quality by conducting inspections consistently with the above mentioned off-site monitoring.

When conducting inspections, we take the following matters into account, and ensure that the inspections are performed based on proper procedures in accordance with such documents as the Basic Guidelines on Inspections by the CPAAOB.

Because inspections require the understanding of and cooperation from audit firms, we conduct inspection monitoring⁷, which involves listening to the opinions of audit firms subject to inspections from time to time, and we refer to the information obtained when conducting inspections in the future.

(1) Conduct of Inspections

- a. Given that large-sized audit firms fulfill an important role in the capital markets by, for example, auditing numerous large listed companies, we generally inspect them every year (with regular inspections and follow-up inspections⁸ being conducted alternately).

⁷ By obtaining the opinions of parties subject to inspections, we are able to gain a better understanding of the circumstances of inspections and ensure that inspections are conducted properly. And with the aim of making inspections more efficient, we listen to the opinions of engagement partners concerning, for example, the inspection techniques employed by inspectors by, for example, visiting parties subject to inspections during the period from the first day to the last day of on-site inspections.

⁸ Regular inspections take into account the results of quality control reviews and involve the verification of the operations management environment and the JICPA quality control environment at the audit firm concerned. Follow-up inspections, meanwhile, are generally conducted in the program year following a regular inspection, and are limited to investigating the improvements that have been made in response to the issues identified during the regular inspection.

- b. Regarding second-tier audit firms, they audit a considerable number of listed companies, so they fulfill a certain role in the capital markets. Compared to large-sized audit firms, however, their operations management environments and quality control environments are sometimes inadequate. For this reason, we pay attention to these environments, and conduct inspections periodically (generally once every three years).
- c. Regarding small and medium-sized audit firms, we conduct inspections as necessary in view of the results of the most recent JICPA quality control review, the operations management environment at the audit firm concerned, the degree of risk pertaining to listed audited companies, and so on.
- d. In addition to the above, if the operations management environment or quality control environment at an audit firm needs to be confirmed immediately, inspections are conducted on an ad hoc basis.

(2) Focus of Inspections and Important Points

- a. There is wide variation in the sizes of audit firms, with some having just a few dozen personnel while others have headcounts that run into the thousands. There are also differences in operations management environments. Because of these factors, we investigate whether the quality control environment established by the audit firm is appropriate in view of the size of the firm and the operations management environment.
- b. The policy of the top management of an audit firm has a major influence over the formation of firm's organizational culture. For this reason, we understand perceptions among and action being taken by executives, including top management, concerning quality management and investigate the impact this is having on the operations management environment and quality control environment at the audit firm.
- c. We investigate whether the audit firm has properly assessed business risks, including the economic environment and business environment surrounding audited companies, and then established an environment for conducting audits that can cope with these risks. We will also investigate whether audit teams demonstrate professional skepticism when performing audit procedures.
- d. To ensure that audit firms continue to make effective quality control improvements voluntarily, it is important to go beyond merely treating the symptoms of problems and to investigate the root causes based on the

size of the audit firm and its operations management environment. To that end, when we point out deficiencies to an audit firm, we take care to provide precise details in order to help the audit firm concerned to analyze the causes.

3. Policy on Provision of Monitoring Information

To ensure and improve audit quality, it is important not only to disclose inspection results to the audit firms themselves, but also make them available to the general public in the form of reports etc. on the outcomes of monitoring as a means of raising interest in and awareness of audits. For this reason, the CPAAOB conducts the following initiatives, and is committed to further expanding and reviewing information.

- a. When informing audit firms of the results of inspections, it is important to ensure that details of issues identified are conveyed precisely, and that audited companies are accurately informed, via the audit firms, of the circumstances concerning quality control at the audit firms concerned, details of issues identified, and so on⁹. For this reason, we improve and expand information relating to inspection results to ensure that the information conveyed is easy to understand for persons such as audit and supervisory board members of audited companies.
- b. With the aim of contributing to a deepening in understanding of audits among market participants etc., since 2016 the CPAAOB has published an annual Monitoring Report compiling the results etc. of monitoring in a visual format, featuring numerous tables and graphs. However, in light of user needs, which require that content can be easily understood by the general public, we will continue working to further improve and expand the information we provide.
- c. To promote independent efforts by audit firms to ensure and improve audit quality, the CPAAOB published examples etc. of matters confirmed during inspections in the form of an annual Case Report from Audit Firm Inspection Results for the first time in 2008. Since 2009, the Report has been revised each year to include the latest cases and remove older ones, and going

⁹ If an audit firm is going to disclose details of inspection results notifications to a third party, it needs to obtain the permission of the CPAAOB in advance. However, the advance permission of the CPAAOB is not required in cases such as informing audit and supervisory board members etc. of audited companies of whether any issues were found during the CPAAOB inspection or the content of the “key points” section of the inspection results notification.

forward we will continue to review the content so that it can serve as a reference that audit firms can use when making improvements.

We also make use of the Case Report as material when conducting lectures and briefings at local branches of the JICPA nationwide, and in addition to these lectures etc., we also endeavor to proactively disseminate the Report to market participants etc.

4. Basic Policy for Monitoring Foreign Audit Firms

(1) Collection of Reports and Inspections

We collect reports from or conduct inspections of foreign audit firms as necessary, partly as a means of understanding their circumstances.

However, if the audit system and supervisory structure for auditors in the country in which the foreign audit firm is located are equivalent to those of Japan, the reports collected and inspections conducted by the authorities in the country concerned are relied on, and we generally do not collect reports from or conduct inspections of foreign audit firms from such countries¹⁰.

(2) Cooperation with Foreign Audit Regulatory Authorities

When conducting monitoring of foreign audit firms, we make use of the Multilateral Memorandum of Understanding (MMoU)¹¹ and bilateral information exchange frameworks (EoL: exchange of letters)¹². We also endeavor to ensure that such monitoring is performed smoothly and effectively by cooperating closely with foreign audit regulatory authorities, international organizations, etc.

We also participate actively in IFIAR discussions, and understand matters such as trends at the global networks and audit regulatory techniques employed by foreign audit regulatory authorities.

¹⁰ The collection of reports and inspections are conducted in accordance with the Framework for Inspection/Supervision of Foreign Audit Firms (published on September 14, 2009) and the Basic Guidelines on Information Requirements and Inspection on Foreign Audit Firms etc. by the Certified Public Accountants and Auditing Oversight Board (published on January 14, 2010).

¹¹ As of April 30, 2019, audit regulatory authorities from 22 countries/regions had signed the MMoU.

¹² As of April 30, 2019, we have exchanged letters (EoL) with audit regulatory authorities from eight countries.