

July 14, 2020

Certified Public Accountants and Auditing Oversight Board

Basic Plan for Monitoring Audit Firms in Program Year 2020 (from July 2020 to June 2021)

To maintain audit quality and improve the effectiveness of audit, the Certified Public Accountants and Auditing Oversight Board (the “CPAFOB”) hereby establishes the Basic Plan for Monitoring Audit Firms in Program Year (“PY”) 2020 (from July 2020 to June 2021) (the “Basic Plan 2020”), reflecting the perspectives and objectives stated in the Basic Policy for Monitoring Audit Firms (the “Basic Policy”)¹ and environment surrounding audit firms.

1. Environment surrounding audit firms

Audit trends

(1) Overview

Although Japan’s economy had been recovering moderately until last year, the recent impact of novel coronavirus disease (COVID-19) has led to a sharp and ongoing deterioration, and the circumstances are extremely challenging.

The number of IPOs at stock exchanges totaled 86 in 2019, the same high level as in 2018, though recently some companies have been canceling their IPOs in response to the impact of COVID-19.

Audits of listed companies are performed by audit firms (both individual certified public accountants and audit firms; the same hereinafter), and large audit firms² continued to account for an overwhelming 90%-plus of these

¹ Basic Policy for Monitoring Audit Firms: It sets the standpoint, objectives, and basic policy for each term regarding monitoring implemented by the CPAFOB. The basic policy for the sixth term (April 2019 to March 2022) was formulated and announced on May 17, 2019.

(<https://www.fsa.go.jp/cpaob/shinsakensa/kihonhoushin/20190517.html>)

² The CPAFOB classifies audit firms based on their size, and there are three categories as follows:

- Large 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 plan, they specifically refer to the four firms of KPMG Azsa LLC, Deloitte Touche Tohmatsu LLC, Ernst & Young ShinNihon LLC, and PricewaterhouseCoopers Aarata LLC.
- Mid-tier audit firms: Audit firms whose business scale is second only to large audit firms. In this basic

audits (based on market capitalization). The number of audit firm changes by listed companies has remained high recently. Large audit firms have been reviewing their client portfolios, and in conjunction with this switches from large to mid-tier² or small and medium audit firms stand out.²

Recently, increasing efforts are being made to enhance the quality and ensure the reliability of accounting audits. A number of explicit measures have already been taken for this. First, as a means of improving the transparency of audit procedures, audit firms are required to describe Key Audit Matters (KAM) in their audit reports.³ Second, as a means of elaborating information on accounting-audits, audit firms are ramping up their provision of explanations and information concerning atypical audit opinions⁴ and their disclosure of reasons for audit firm changes. Third, as an initiative for ensuring independence, the Japanese Institute of Certified Public Accountants ("JICPA") has introduced the "rotation of audit team members" as part of self-regulation. Furthermore, public companies are increasingly being demanded to develop non-financial and descriptive information, and audit firms are expected to play a proper role to assume their responsibilities.

Regarding audits of newly-listing companies, as mentioned in the Report; the Liaison Council on the Appointment of Audit Firms (External Auditors) for Initial Public Offering (IPO) Audits, which was published by the Financial Services Agency (FSA) in March 2020, a challenge is to pave the way in establishing an environment in which new/emerging companies can proportionally receive audits corresponding to their growth stage.

(2) Impact on audit engagements of COVID-19

As COVID-19 has spread rapidly from around March 2020, some audit deferrals have been observed mainly at companies adopting a financial year ending in March, and the related audit engagements were also delayed as a result of wide-ranging constraints on audit practices, such as attendance at

plan, 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 and Mid-tier audit firms

³ The inclusion of Key Audit Matters (KAM) in audit reports will begin for audits of financial statements for the year ending March 2021, though it may begin optionally for audits of financial statements for periods prior to that.

⁴ Atypical audit opinions refer to qualified opinions, adverse opinions, and disclaimers of opinion.

physical inventory counting, confirmation of balances, overseas group audit, and so on, which gave rise to some concerns over audit deferral and impact on audit opinions.

In response to these circumstances, from March 2020 onwards, JICPA released "Audit Consideration related to COVID-19," while the FSA released the "Notice regarding the deadline for submission of annual securities and other reports in connection with COVID-19," the Ministry of Justice, meanwhile, issued guidance on the scheduling of annual shareholders meetings, and the Accounting Standards Board of Japan (ASBJ) published its views on how to incorporate impacts of COVID-19 on accounting estimates.

Response to accounting scandals

The number of listed companies that have unveiled timely disclosure of matters such as inappropriate accounting treatments has been moving upward. This is likely attributable to the raised awareness across listed companies about the importance of the timely disclosure, but there are cases observed where internal control systems are not functioning adequately as well as where the management of group companies, including overseas group companies, remains insufficient.

It goes without saying that the top management of companies is responsible for the preparation of financial statements and the development/implementation of effective internal control systems. Thus, it is increasingly important that on the occasion of evaluating internal controls, audit firms undertake audit procedures based on an in-depth understanding of audited companies' business characteristics and their own environment, including their overseas businesses. Audit firms are required to inform audited companies of internal control deficiencies in a timely manner.

Current state of quality control at audit firms

The CPAAOB has implemented 5-level overall ratings,⁵ based on which it assigns an overall rating to the inspected audit firm's business operation in the inspection result notification (excluding follow-up inspections), since PY 2016 (July 2016 – June 2017).

⁵ The "Important points" section of the inspection report notification contains an overview of deficiencies in the operations management environment, quality control environment, and individual audit engagements. Overall ratings are classified into 5 levels: "generally satisfactory," "satisfactory with minor deficiencies," "unsatisfactory," "unsatisfactory and in need of immediate remediation" and "extremely unsatisfactory." For detailed information, see the Monitoring Report published on the CPAAOB's website.

In the results of inspections of large and mid-tier audit firms since PY 2016, no audit firm has been given the highest rating "generally satisfactory." Most inspected audit firms were given the second highest rating "satisfactory with minor deficiencies," while some were given the rating of "unsatisfactory." In light of small and medium-sized audit firms, meanwhile, partly because these inspected firms are selected based on their risks, they tend to be rated as "unsatisfactory" or lower.

As seen from the inspection results conducted recently, large audit firms tend to be shifting the primary responsibility for audit quality control from head-office quality control departments to business units, which becomes closer to the audit frontline. The recent inspection results revealed that unsatisfactory cooperation between the head-office quality control department and the business units is one of the issues.

Furthermore, a snapshot of large audit firms' revenue structures shows that their revenues from non-audit services as a proportion of total revenues had increased steadily until PY 2014, but have recently been hovering at around 40%.

Other recent developments made by large audit firms include the deployment of clerical staff and non-CPAs, and the establishment of not only administrative centers devoted to clerical works, albeit with the restructuring driven by their global networks. It has also been observed that control organizations in each group region, e.g. Asia, were formed.

As for mid-tier audit firms, even though they have been establishing operational control systems at a firm-wide level, communication between the quality control department and business unit is sometimes deemed unsatisfactory. Problems can also arise with the clerical staff, as the leveraging of non-CPAs is on the rise, although it is mooted to foster education/training systems for these staff. Furthermore, there is sometimes a lack of awareness among management, including the top management, and of the importance of ensuring/improving quality control.

In the case of small and medium-sized audit firms, even some of the larger ones have failed to sufficiently establish business operations or quality control systems corresponding to their business expansion. Furthermore, the systems of some audit

firms are still not sufficient to audit high-risk listed companies.

Governance systems of audit firms

Large and mid-tier audit firms have adopted the “Principles for Effective Management of Audit Firms” (the “Audit Firm Governance Code”), and have generally put together governance systems in line with it. Going forward, further tasks would need to be engaged in to firmly entrench their governance in terms of effectiveness.

Progress in adoption of IT

Audit firms, mainly large audit firms, have been accelerating their adoption of IT in pursuit of ensuring and improving audit quality as well as enhancing the efficiency of audit engagements. Specifically, they are not only employing tools to introduce techniques capable of replacing the going sampling audit with detailed audit and of automating/centralizing processes, but also exploring possibilities of the risk analysis backed by AI and/or bringing in real time audits. It is hoped that these initiatives will not only be beneficial to ensure the effectiveness of audit engagements, but also to ease the workload on the audit engagement teams, and that they will contribute to working for more in-depth audits in areas with underlying risks. Furthermore, so-called “remote audits,” which involve auditors conducting audit engagements from remote locations such as their homes, are now being performed in response to the current spread of COVID-19.

In conjunction with these developments to adopt IT, large audit firms, in particular, are stepping up hiring and fostering IT experts.

However, amid such developments and with data exchanges with audited companies accelerating, cybersecurity has become a pressing issue, and the firms therefore need to steadily strengthen their cybersecurity.

Trends of international independent audit regulators

The FSA and the CPAAOB provide the necessary support to facilitate the operation of the International Forum of Independent Audit Regulators (IFIAR)⁶ from the

⁶ International Forum of Independent Audit Regulators (IFIAR): An international organization established in 2006, consisting of independent audit regulators that inspect audit firms. Its permanent secretariat is located in Tokyo. The IFIAR aims to improve audit quality globally through collaboration among authorities. As of the end of June 2020, the number of IFIAR member countries/regions totaled 55, including Japan.

perspective of enhancing the international status of capital markets in Japan. The IFIAR has long endeavored to ensure and improve audit quality globally, through continuous dialogue with the six largest global networks.⁷ In this sense, the CPAAOB will continually contribute to the IFIAR's activities. Also, the CPAAOB is working together with foreign audit regulators and staying vigilant about their responses to COVID-19, their handling of inappropriate practices taken by foreign audit firms that are affiliated with the Big 4 global networks,⁷ and trends with organizational changes at foreign audit regulators.

2. Concept of Basic Plan for Monitoring Audit Firms in PY 2020

Based on Section 1 "Environment surrounding audit firms" and the monitoring perspectives, objectives, etc. stated in the Basic Policy, the CPAAOB will monitor⁸ audit firms based on the following five basic concepts from (1) to (5).

For conducting monitoring in PY 2020, the CPAAOB will consider the status of COVID-19 infections and the work on audit firms, gauge impacts of COVID-19, and behave in a flexible manner by altering the focus points of monitoring in response to the individual circumstances of audit firms.

Furthermore, in light of the fact that new working styles are being proactively adopted, the CPAAOB identifies the spread of COVID-19 as an opportunity to review monitoring methods to ensure that CPAAOB's monitoring is efficient and effective mutually.

(1) Focus points of monitoring

In PY 2020, the CPAAOB will monitor audit firms while focusing on the following points.

Note that there is wide variation in the sizes of audit firms, with some small and medium firms having just a handful of staff while large firms have thousands of

⁷ Refers to the six global networks of BDO, Deloitte Touche Tohmatsu, Ernst & Young, Grant Thornton, KPMG, and PricewaterhouseCoopers, which are among the accounting-firm networks that operate worldwide. If BDO and Grant Thornton are excluded, they are referred to as the Big 4 global networks.

⁸ The CPAAOB's monitoring includes both on-site monitoring and off-site monitoring. On-site monitoring refers to inspections, while off-site monitoring means activities other than inspections, such as collection of reports regarding audit firms, interviews, and information gathering through the exchange of opinions and cooperation with audit firms and relevant parties.

employees. There are also gaps observed in business management, operational control systems, and so on. Because of these factors, when conducting monitoring, the CPAAOB takes into account the size and nature of the firms.

(i) Tone at the top towards the improvement of audit quality

To improve audit quality on an ongoing basis, it is important for top management themselves to exercise leadership in harnessing a culture that centers on the quality of audit engagements, and the CPAAOB will therefore grasp whether this is reflected in the recognition of the management, including the attitudes of the top management, and in tangible measures.

(ii) Effectiveness of business management

The CPAAOB will assess whether business management and operational management systems are contributing to ensuring and improving audit quality.

In particular, with regard to large and mid-tier audit firms that have adopted the Audit Firm Governance Code, the CPAAOB will examine whether the governance systems in response to the Code is effective for enhancing audit quality.

During these reviews, the CPAAOB will endeavor to share information and cooperate with the relevant departments at the FSA.

(iii) Fact-finding in light of audit trends

i. Impact of COVID-19 on audit engagements

CPAAOB will assess the impact of COVID-19 on audit procedures, other aspects of audit engagements and the status of audit firms' responses to changes of structures for conducting audits while taking into account the workload on audit firms.

ii. Group audit of overseas subsidiaries

As the domestic market matures, many listed companies are seeking to develop their businesses overseas to drive their future growth, and against this backdrop, accounting problems at overseas subsidiaries are continually being observed. Given these circumstances, with regard to group audits of overseas subsidiaries, the CPAAOB will focus on monitoring audit teams'

assessments of internal controls including the control systems for overseas businesses, their communication with component audit teams of overseas subsidiaries, the organizational responses of audit firms, and so on.

iii. Conclusion of new audit engagements

In recent years, many cases have been seen in which listed companies are changing their auditors, so in the case of audit firms that have concluded new audit engagements with large listed companies or other listed companies considered to be high risks, the CPAAOB will verify whether risk assessments relating to these engagements have been properly performed and acted on, and look into the background that led up to the conclusion of the contracts. The CPAAOB will also monitor the impact that the contracts will have on firm-wide audit quality.

(iv) IT-based audit approaches and cybersecurity measures

Some of the global networks to which large and mid-tier audit firms belong are endeavoring to slash costs and development times by developing IT tools centrally rather than having the member audit firms do so independently. As a result, IT-based audit engagements are accelerating with the use of the tools with efficacies that employ AI to detect irregular figures in journal entries and that are used to identify fraud risks.

This trend toward the acceleration of IT-based audits is likely to ensure and improve audit quality, so the CPAAOB will continue to capture progress made through monitoring large audit firms etc.

At the same time, the CPAAOB will confirm what cybersecurity measures are being taken in conjunction with increased IT adoption, and also monitor whether personnel who can accommodate more in-depth and complex audit techniques are being secured and developed.

(2) Strengthening off-site monitoring

To conduct efficient and effective monitoring, the CPAAOB will continually have periodic dialogue with management to exchange views, including those of the top management, of large and mid-tier audit firms and further strengthen the information sharing through cooperation with relevant parties, such as the FSA and related organizations. The CPAAOB will also step up information collection

and analysis regarding the environment surrounding audited companies, such as industry trends, and utilize the information and results of analyses for inspections, thereby achieving seamless on and off-site monitoring.

(3) Enhancement of the monitoring environment

The CPAAOB will strengthen its monitoring environment to collect/analyze information and perform inspections in manners suited to the individual environments at audit firms.

To do this, the CPAAOB will actively appoint personnel who can analyze domestic and international information, the internationalized audit operations, and the environment at domestic audit firms, and given these analyses, etc., take appropriate actions in response. It will also appoint personnel who can provide guidance for efficient and effective monitoring. Furthermore, the CPAAOB will positively promote the fostering of personnel by encouraging its staff members to engage in international conferences etc.

(4) Consideration of monitoring methods

With the development of technology and impacts stemming from COVID-19 mainly at large audit firms, it is expected that audit firms will review their methods of audit procedures, such as physical inventory counting and confirming balances, and operational management. In light of this background and the impacts of COVID-19, the CPAAOB will give consideration to reviewing monitoring methods, such as on-site inspections, so that the monitoring performed by the CPAAOB is more efficient and effective mutually.

(5) International cooperation with foreign audit regulatory bodies

The CPAAOB will make use of the Multilateral Memorandum of Understanding (MMoU) and bilateral information exchange frameworks⁹ to obtain information necessary for monitoring, and provide information in response to requests from foreign audit regulators. The CPAAOB will also participate actively in IFIAR discussions in order to understand the current practices observed at the global networks and audit regulatory techniques employed by foreign audit

⁹ As of June 30, 2020, we have exchanged letters (EoL) concerning information exchange frameworks with audit regulatory authorities from eight countries (the U.S., Canada, Malaysia, the Netherlands, Luxembourg, the U.K., France, and China).

regulators. Furthermore, the CPAAOB will remain vigilant regarding the responses of foreign audit regulators against COVID-19, a remedy to inappropriate practices taken by foreign audit firms that are affiliated with the Big 4 global networks, and trends with organizational restructuring at foreign audit regulators.

3. Basic plan pertaining to off-site monitoring

In order to conduct efficient and effective off-site monitoring, the CPAAOB will make effective use of information, such as quality control review reports from the JICPA, analyses of past CPAAOB inspections, and collection of reports. Furthermore, given the CPAAOB's constrained inspection resources, it is important for it 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.

Therefore, in PY 2020, in order to understand the environments at audit firms, including the impacts that COVID-19 has on them and their responses to it, as well as the risks entailed in audit engagements both accurately and in a timely manner, the CPAAOB conducts off-site monitoring with consideration on burdens by employing channels as follows: collection of reports/interviews, analysis of JICPA's quality control reviews, and cooperation with the JICPA corresponding to the sizes and environments of audit firms.

(1) Collection of reports

- (i) In the case of large and mid-tier audit firms, by way of the collection of reports, the CPAAOB continuously obtains qualitative and quantitative information required for the investigation; control systems of business and operational management from the governance perspective in accordance with the Audit Firm Governance Code, as well as the status of cooperation with global networks, IT-based audit techniques, cybersecurity measures, the compliance status with legal requirements, such as the Act on Prevention of Transfer of Criminal Proceeds, etc. The CPAAOB also conducts fact-finding concerning the in-house audit, review systems, etc. at listed financial institutions, which is a must to ascertain the audit procedures and technologies.

After being analyzed, the information obtained through the collection of reports is utilized to make inspections more effective and efficient, and is also put to use for the comparative analysis of large audit firms and for identifying horizontal problems etc. The CPAAOB efficiently executes the collection of reports bearing in mind utilization of the information obtained through inspections and dialog.

- (ii) In the case of a small and mid-tier audit firm, the CPAAOB collects reports whenever it is appropriate to do so based on the results of JICPA's quality control reviews, with the aim of encouraging the audit firm to stably implant proper audit quality management.

In doing so, the CPAAOB focuses on investigating the audit firm's establishment of a quality control system as well as matters such as the policy of top management, the firm's profit/financial structure, its organization and human resources, and the background to the conclusion of new audit engagements. On the occasion of the collection of reports, the CPAAOB ensures the effectiveness of reviews by not only having a physical meeting when needed but also redoing the collection of reports in the ensuing year if the targeted audit firm has not made satisfactory improvements in light of quality control reviews.

Still, if the audit firm is assessed as potentially having a serious issue as a result of the collection of reports, the CPAAOB will use the results as key reference information for inspections.

- (iii) If the CPAAOB has notified a small and mid-term audit firm of problems in its inspection results, unless it is seen as an urgent case to take a step swiftly as described in (iv), the CPAAOB will identify the remedies that the inspected audit firm has taken, and urge the audit firm to address them through applicable channels, holding meetings as necessary, etc. after a certain period of time has passed since the notification of the inspection results.

In such cases, the CPAAOB will team up with the FSA and the JICPA to make an attempt to review the nature of the deficiencies, corresponding to their severity.

(iv) As a result of an inspection, if operational control systems of an audit firm are deemed to be unfavorable and the need to promptly take a remedy action is recognized in particular, the CPAAOB will perform the collection of reports at the time of the notification of the inspection results, and encourage the firm to address them promptly.

Following the collection of reports pursuant to (iii) or (iv) above, if the status of improvement is considered inadequate, the CPAAOB will consider taking additional actions, such as further collection of reports and follow-up inspection.

(2) Examination of the JICPA's quality control reviews and cooperation with the JICPA

In the case of problems etc. concerning the effectiveness of quality control reviews identified through monitoring for audit firms, the CPAAOB shares them with the JICPA and, through ongoing consultations with the JICPA at reviewer level, urges action further in order to enhance the effectiveness of quality control reviews.

Knowing the recent situation with quality control reviews, the JICPA will determine and alter review periods flexibly based on factors such as the situation underlying quality control at audit firms, and select audit engagements to be subject to review based on risk level. The JICPA is also expected to heighten the frequency of risk-based reviews for small and mid-tier audit firms.

While JICPA quality control reviews and CPAAOB inspections differ in terms of implementation scheme and methodology, JICPA quality control reviews have apparently become more conscious of risks in recent years. However, there are also cases where operational control systems at audit firms are not identified as qualified conclusions under quality control reviews, but they have been identified to be highly inappropriate under CPAAOB inspections.

In view of this situation, the JICPA finds it necessary to urge audit firms to proactively make improvements, and further enhance the effectiveness of its quality control reviews, so going forward the CPAAOB will be verifying the

effectiveness and impact of the measures that the JICPA is supposed to implement.

The CPAAOB and the JICPA will be endeavoring to deepen their cooperation, as it is vital for ensuring and improving audit quality throughout all audit firms in Japan. Furthermore, regarding the balanced demarcation between CPAAOB inspections and JICPA quality control reviews, the CPAAOB and the JICPA are engaged in discussions, mainly with regard to the nature of quality control reviews for large audit firms and ways of improving and expanding the role of guidance and supervision that the JICPA plays, targeting small and mid-tier audit firms. The JICPA has already taken steps based on these discussions, but from the viewpoint of ensuring that CPAAOB inspections and JICPA quality control reviews deliver maximum benefits as a whole, the CPAAOB will hold more concrete and constructive discussions this program year.

(3) Collection and analysis of information regarding audit firms

The CPAAOB is continuing to engage in periodic dialog with the management, including the top level, of large and mid-tier audit firms in order to understand the latest business operations and problems at audit firms/the audit business. Management, including the top level, has a significant impact on the organizational culture of audit firms, so the CPAAOB will continue to engage in dialog and endeavor to have more in-depth discussions. On the occasion of dialog with audit firms, the CPAAOB grasps the extent to which they have had in place such matters as KAM, the voluntary implementation of which has been introduced this year.

Additionally, the CPAAOB encourages them to elaborate and proactively disclose the information concerning quality control in order to assure that market participants can access such useful information.

The CPAAOB will also strengthen information sharing through exchanges of views, cooperation, etc., with the IFIAR, foreign audit regulators and the global audit networks, in addition to the FSA, the JICPA, financial instruments exchanges, and the Japan Audit & Supervisory Board Members Association. Furthermore, the CPAAOB will endeavor to upgrade organizational capabilities for collecting and analyzing data, information, etc. in accordance with the risks

embedded in audit firms.

4. Basic Inspection Plan

Based on the Basic Policy, the CPAAOB will perform more effective and efficient inspections corresponding to the sizes of and environments at audit firms as well as the degree of risk pertaining to audited companies. The CPAAOB will also strive to fulfill the increase in the effectiveness of inspections; improving inspection techniques. In addition, through integrated operations with the off-site monitoring aforementioned, the CPAAOB will endeavor to ensure and improve audit quality at audit firms.

For inspections on audit firms in PY 2020, the CPAAOB will focus on the following: whether the operational control and quality control systems are properly formed according to their sizes, characteristics, etc.; how the awareness and engagements of management, including the top level, concerning quality control, affect the business operations; and whether audit practitioners demonstrate professional skepticism based on an understanding of the undertone intentions and provisions of rules, such as auditing standards, when performing audit procedures. The CPAAOB will evaluate those points according to the firms' sizes and features.

Furthermore, while taking account of the work on audit firms, the CPAAOB will also assess the impact of COVID-19, the status both of the quality control and business operation systems as affected by this impact, and the circumstances with the performance of audit procedures and the expression of audit opinions in light of operations, such as the approach to guidances issued by the JICPA.

(1) Large audit firms

Given that large audit firms fulfill an important role in the capital markets, by auditing numerous large listed companies, the CPAAOB generally inspects them every year (with regular inspections and follow-up inspections being conducted alternately). When conducting follow-up inspections, the CPAAOB gives consideration to the workload on the audit firms and endeavors to pursue more effective and efficient inspections, with a focus on verifying remedial measures taken to address issues considered to be insufficient on the occasion of the past regular inspections.

Additionally, note that if a serious accounting problem at an audited company having a mighty impact on the capital markets is detected or suspected, and the CPAAOB finds it necessary to immediately confirm the quality control systems of the audit firm accountable for the audit procedures in the audited company, the CPAAOB performs inspections on an ad hoc basis relying on flexible interpretations of the principle above.

Large audit firms are conglomerate organizations, consisting of thousands of staff members and numerous divisions and regional offices. Thus, it is of importance for them to trickle the culture centering on the significance of quality control and operational control down to audit practitioners. In particular, since management, including the top level, has a substantial impact in terms of harnessing a sound organizational culture, its attitudes and behaviors are of particular importance.

Considering the above, the CPAAOB will focus on the following inspection points in PY 2020:

- The CPAAOB will evaluate not only the awareness and engagements of management, including the top level, concerning quality control, but also the impact that they have on operational control and quality control systems
- With regard to governance systems (particularly supervision/review bodies), the CPAAOB will verify their effectiveness from the standpoint of operational status; e.g. whether they are contributing to ensuring and improving quality control
- The CPAAOB will review operational control systems, and in particular cooperation between the head-office quality control department and each business unit, from the standpoint of whether they make an attempt to cascade quality control down to the engagement team level
- The CPAAOB will evaluate the reasonableness of procedures coming to a conclusion on new audit contracts (particularly ones with large listed companies and listed companies considered to be high risk), the background leading to the conclusion of the new audit engagements, and the impact that the audit teams composition in charge of reviewing these contracts with large listed companies have on the firm-wide audit quality system

- The CPAAOB will assess the status of the discussions with management etc. and communication with audit and supervisory board members
- The CPAAOB will review the status with regard to group audits that encompass overseas subsidiaries
- The CPAAOB will examine the status of education/training and HR development for audit assistants,¹⁰ IT specialists, etc.
- The CPAAOB will examine progress made to enhance disclosure information concerning accounting audits, such as KAM
- The CPAAOB will evaluate the status with regard to the assessment of internal controls relating to financial statement audits as well as internal control audits, and steps being taken to address fraud risk, including the implementation status of Standard to Address Risks of Fraud in an Audit
- The CPAAOB will review responses to monitoring activities led by global networks

(2) Mid-tier audit firms

Regarding mid-tier audit firms, they audit a considerable number of listed companies, and are expected to fulfill a certain role in the capital markets. Compared to large audit firms, however, their management operation and quality control systems sometimes remain inadequate. For this reason, the CPAAOB will be vigilant on these status, and generally perform inspections once every three years. However, if a serious accounting problem at an audited company having a mighty impact on the capital markets, is detected or suspected, and in the case that the CPAAOB finds it necessary to immediately confirm the quality control systems of the audit firm accountable for the audit procedures in the audited company, the CPAAOB performs inspections on an ad hoc basis.

Considering the above, the CPAAOB will focus on the following inspection points in PY 2020:

- The CPAAOB will evaluate not only the awareness and engagements of management, including the top level, concerning quality control, but also the impact that it has on operational control and quality control systems

¹⁰ Audit assistants include persons with the CPA qualification, persons who have passed the CPA exam or similar, audit support staff who do not possess such qualifications, and administrative staff who assist with the conduct of audits.

- With regard to governance systems (particularly supervision/review bodies), the CPAAOB will verify their effectiveness from the standpoint of operational status; e.g., whether they are contributing to ensuring and improving quality control
- The CPAAOB will review operational control systems, and in particular cooperation between the head-office quality control department and each business unit, from the standpoint of whether they make an attempt to cascade quality control down to the audit engagement level
- With regard to audit firms that are expanding the range of business as a result of mergers etc., the CPAAOB will assess the management and business operating systems, on the basis of comprehensiveness, etc.
- The CPAAOB will evaluate audit resources by ascertaining whether personnel possess sufficient and suitable experience, capabilities, etc. to cope with risks arising from the internationalization of audited companies, etc.
- In the case of group audits, the CPAAOB will review, in particular, the effectiveness of communication with auditors of components located overseas
- The CPAAOB will assess the status of discussions with the management etc. and communication with audit and supervisory board members
- The CPAAOB will verify audit firms' responses against auditor change. The CPAAOB will also evaluate the reasonableness of procedures coming to a conclusion on new audit contracts (particularly ones with large listed companies and listed companies considered to be high risk), the background leading to the conclusion of the new audit contracts, and the review systems responsible for these contracts
- The CPAAOB will examine the status of education/training and HR development for audit assistants, IT specialists, etc.
- The CPAAOB will examine progress made to enhance the disclosure of information concerning accounting audits, such as KAM
- The CPAAOB will review the status with regard to the assessment of internal controls relating to financial statement audits as well as internal control audits, and steps being taken to address fraud risk, including the implementation status of Standard to Address Risks of Fraud in an Audit.

(3) Small and mid-tier audit firms

In the case of small and mid-tier audit firms, the CPAAOB will confirm the compliance with the audit standards associated with quality control systems and/or audit engagements, and thereby assess the awareness and involvement of the top management as well as operational control systems that have an impact on the compliance with the standards above. For this, the CPAAOB will consider whether identified deficiencies are due to the nature of the business model and whether the remedies taken to address deficiencies are deemed to be merely an improvised measure. When it comes to the selection of inspected firms, taking into account such factors as JICPA's quality control review results, and the degree of risk underlying audited companies, the CPAAOB will consider the necessity to immediately confirm the quality control systems.

The CPAAOB will focus on the following inspection points in PY 2020:

- The CPAAOB will evaluate the operational control systems, including the recognition, involvement and firm-wide comprehensiveness of the top and partners
- The CPAAOB will review audit resources by ascertaining whether personnel possess sufficient and suitable experience, and the capability to cope with risks arising from audited companies
- The CPAAOB will assess audit procedures and fraud risk assessments in particular, relating to revenue recognition and accounting estimates from the standpoint of performing professional skepticism
- The CPAAOB will verify the status with regard to discussions with management etc., communication with audit and supervisory board members etc., guidance and supervision given to audit practitioners, interaction with specialists, and responses to cross-industry problems identified hitherto through monitoring
- The CPAAOB will evaluate the background on new audit engagements with large listed companies or the listed companies considered to be high risk, as well as the reasonableness of risk assessments etc. and the review systems responsible for these contracts
- The CPAAOB will review the status of compliance with Standard to Address Risks of Fraud in an Audit
- In the case of group audits, the CPAAOB will assess, in particular, the status of communication with auditors of components located overseas

- The CPAAOB will verify the progress made in response to findings identified, etc. under the framework of JICPA quality control reviews
- The CPAAOB will examine the status of education/training and HR development for audit assistants, IT specialists, etc.
- The CPAAOB will examine progress made to enhance the disclosure of information concerning accounting audits, such as KAM
- The CPAAOB will assess the assessment of internal controls relating to financial statement audits as well as the status of internal control audits

5. Provision of monitoring information

To ensure and improve audit quality, it is important not only to accurately convey the results of inspections to audit firms and audit/supervisory board members of audited companies, but also to compile the results and insights through monitoring, and given that, the CPAAOB broadly disseminates the information to the public so as to spur interest and awareness in accounting audits. From that viewpoint, the CPAAOB gives consideration to the following points on the occasion of compilation and information sharing:

- (i) The CPAAOB accurately conveys the findings, etc. identified in audit firms and simultaneously makes an attempt to elaborate descriptions of inspection results so as to accurately convey them, including the level of quality control and operational control systems, to audit and supervisory board members etc. at audited companies. The CPAAOB also confirms whether audit firms appropriately convey the results of inspections to audit and supervisory board members, etc. at audited companies. Furthermore, with the aim of contributing to improving internal control systems at audited companies, the CPAAOB encourages audit firms to promote the interaction with audit and supervisory board members etc. in order for audit and supervisory board members to be able to make effective use of inspection results.
- (ii) With the aim of contributing to furthering an in-depth understanding of accounting audits across market participants etc., since 2016 the CPAAOB has published an annual Monitoring Report compiling the results and insights etc. of monitoring, weighting on the explanation with a visual format, featuring numerous tables and graphs. Having made revisions of the Report annually since 2017, the CPAAOB will continue to strive to further develop its contents

and dissemination, leading to a broad understanding among the public, bearing in mind reader preferences. In addition, the CPAAOB strives to disseminate the contents of the Monitoring Report translated in English to non-Japanese readers.

- (iii) In order to encourage audit firms to make voluntary efforts toward ensuring and improving audit quality, the CPAAOB compiled examples etc. of matters identified through inspections in the form of an annual report; the Case Report from Audit Firm Inspection Results for the first time in 2008. Since 2009, the CPAAOB has revised the Report annually to renew novel contents, such as recent cases, and will continue to do so in order for the contents to be deemed useful when audit firms make improvements.

The CPAAOB also delivers the contents of the Case Report on the occasion of making a speech and briefing at local branches of the JICPA nationwide, and in addition to these opportunities etc., the CPAAOB also endeavors to proactively disseminate the Report to market participants etc., as well as to translate it into English so as to further the dissemination to non-Japanese readers.