

II. The CPAAOB monitoring

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A. Overview of System and Situation with Implementation

1. Legal Position of the CPAAOB

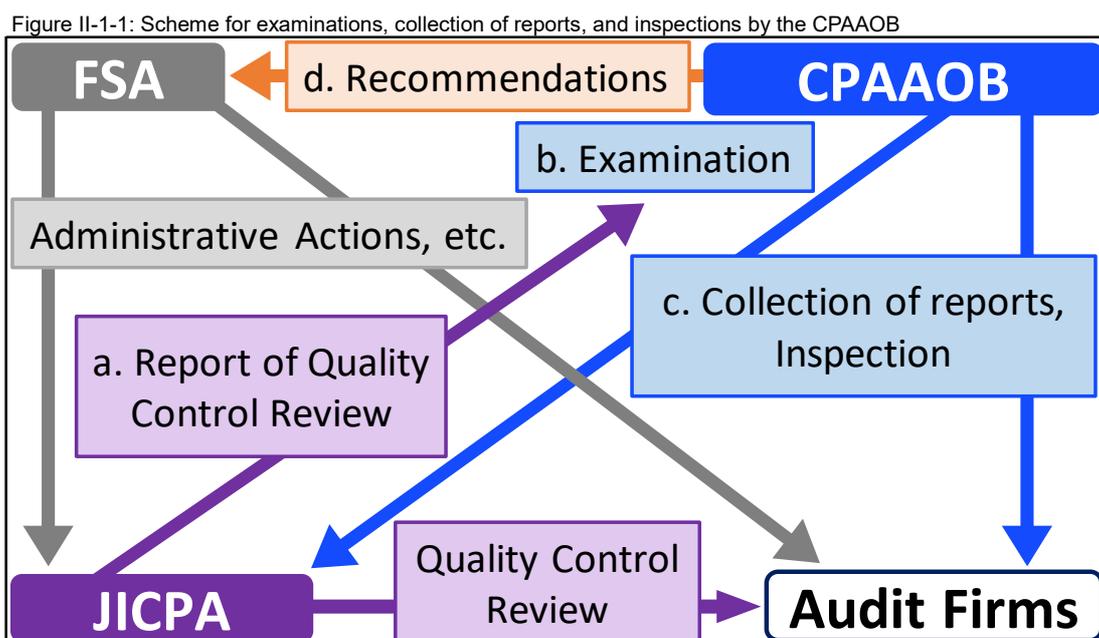
The CPAAOB is an administrative body³ serving as a council that was established in April 2004 in accordance with Article 35-1 of the CPA Act and Article 6-2 of the Act for Establishment of the Financial Services Agency. It comprises a chairperson and a maximum of nine members (who serve three-year terms). Although the members are part time, one full-time member can be appointed.

The CPAAOB receives and examines reports concerning quality control reviews by the JICPA, collects reports from and conducts inspections of the JICPA and audit firms etc. Based on the results of inspections etc., the CPAAOB recommends administrative actions or other measures to the FSA Commissioner when necessary.

2. Overview of Examinations, Collection of Reports, and Inspections by the CPAAOB

Figure II-1-1 shows the relationship between examinations, collection of reports, and inspections by the CPAAOB on the one hand, and the JICPA quality control reviews, the FSA's administrative actions, etc. on the other.

Based on the JICPA quality control review reports (a), the CPAAOB assesses whether the JICPA has carried out the quality control reviews properly and whether the audit firms have properly performed its audit services (b), and collects reports from the JICPA, audit firms, etc. and conducts on-site inspections when deemed necessary (c). If it finds it to be necessary as results of inspections, the CPAAOB recommends administrative actions or other measures to the FSA Commissioner (d).



³ Appointed by the Prime Minister with the consent of both houses of the Diet from persons with an understanding of and insight concerning matters relating to CPAs

3. Report of JICPA Quality Control Review

The JICPA is an organization of CPAs in Japan established in accordance with Article 43 of the CPA Act. To maintain the integrity of its member CPAs and audit firms and improve/promote audit and attestation services, the JICPA guides, connects, supervises its members and performs administrative tasks pertaining to the registration of CPAs and specified partners and the registration of auditors of .listed companies.

The quality control reviews are conducted by the JICPA to maintain/improve suitable qualitative standards for audit services and to ensure public trust in audits. More specifically, the JIPCA reviews the administration of audit engagements conducted by audit firms, reports results to the audit firms and, when necessary, recommends improvements and monitors the status of improvements⁴.

Quality control reviews were introduced by the JICPA in FY1999 as self-regulations, and in 2003 a revision to the CPA Act made it mandatory for the JICPA to conduct reviews of the administration of audit and attestation services by audit firms and report its findings of these reviews to the CPAAOB.

The JICPA regularly submits to the CPAAOB monthly and annual reports and updates the status of quality control review as needed. The specific information reported is as follows:

- a. Review plan
- b. Details on any deficiencies observed during reviews and the audit firms' perspectives
- c. "Quality Control Review Reports" and "Recommendation for Improvement Reports" provided by the JICPA to audit firms based on review findings
- d. Specific measures based on review findings (warnings, severe warnings, recommendation to withdraw from audit engagements)
- e. "Remediation plan" prepared by the audit firm and submitted to the JICPA

Quality control reviews evaluate the audit firms' quality control systems by means of the extent to which the systems have made progress as well as how effective the systems have been in place. Specifically, they confirm whether their quality control systems (all policies and procedures for quality control pertaining to audit, including quality control procedures relevant to audit engagements) have been suitably and sufficiently developed in compliance with quality control standards⁵, and whether these quality control systems are operating effectively.

Domestic Quality Control Standards and Quality Control Standards Statements were revised in response to the revision of international quality control standards, and the JICPA is now responsible for confirming the design and operation of audit quality systems, including risk assessment systems implemented by audit firms, such as setting audit quality objectives, recognition, evaluation, and handling of quality risks.

In addition, quality control reviews comprise regular reviews, which are conducted on the overall quality

⁴ For details concerning quality control reviews, see the JICPA website and the annual report from the Quality Control Committee.

⁵ The Public Accountant Act and other laws and regulations, auditing criteria, correspondence criteria for addressing fraud risks in auditing, quality control criteria related to auditing, the JICPA's rules and regulations, and so forth.

control of an audit firm, and special reviews on quality control related to the audit firm's specific sector or audit service.

As a result of the revision of the CPA Act in May 2022, the "Registration System for Auditors of Listed Companies" was introduced as a legal registration system (effective from April 2023). As a result, the JICPA is responsible for "confirmation of the eligibility" of auditors of listed companies. For confirming the eligibility of newly applying audit firms, JICPA established "review for the examination of registration" as a sort of quality control reviews. In the process of conducting quality control reviews, the JICPA checks whether auditors of listed companies fulfill their obligations for system development set forth in the Ordinance for Enforcement of the CPA Act. With regard to the system for publishing the evaluation results of the status of quality control of services, if such publication has not been conducted, or if the published matters are significantly different from the actual situation, the JICPA will consider revoking or rejecting the registration, And if an extremely significant deficiency or a significant deficiency is found as a result of a quality control review, and a recommendation to decline is made, the auditor is subject to examination for revocation of registration.

In addition, to improve its quality control review system, the JICPA plans to increase reviewers over three years, and to enhance reviewers' qualities and knowledge, which are necessary for examining audit firms' operation management system including information disclosure system, through educational program for reviewers. It will also take effort to recruit and cultivate sufficient reviewers through formulating reviewers' career plan.

In FY2022, there was a total of 37 reviewers (as of August 1, 2022) who conducted regular reviews of 92 audit firms.

4. Examination

a. Overview

The CPAAOB receives quality control review reports from the JICPA, and then reviews the reports to examine the appropriateness of these quality control reviews and audit services performed by the audit firms. More specifically, the CPAAOB confirms the context of quality control reviews and the instruction to audit firms on necessary remediation measures, and analyses the findings of quality control reviews as well as the details of remediation plans submitted to the JICPA. In addition to considering the need for inspection and collecting reports in light of the outcomes of the analysis, the CPAAOB engages in exchanges of opinions with the JICPA concerning matters such as the effectiveness of quality control reviews. Still, the CPAAOB also utilizes information from the relevant FSA departments, relevant organizations, etc. on the occasion of the examination.

b. State of implementation of examinations and results

The CPAAOB examined quality control reviews conducted in FY2022 by the JICPA in PY2022 and an overview of the review was given below.

i. FY2022 quality control reviews

Conclusions of quality control reviews, conducted on 92 audit firms in FY2022, were approved for 90 of them by June 30, 2023. Specifically, no significant deficiencies were confirmed at 84 audit firms, while significant deficiencies were observed at one audit firms, and extremely significant deficiencies were observed at four audit firms. In addition, one audit firm received disclaimer of conclusion, and improvements were recommended to all audit firms (Figure II-1-2).

Figure II-1-2: FY2022 quality control reviews (unit: audit firms)

Classification	Reviewed parties	Conclusions				Recommendations for improvement	
		Conclusion finding no significant deficiencies	Conclusion finding significant deficiencies	Conclusion finding extremely significant deficiencies	Disclaimer of conclusion	Yes	No
Audit firms	59	57	1	0	1	59	0
Partnerships	3	3	0	0	0	3	0
Solo practitioners	28	24	0	4	0	28	0
Total	90	84	1	4	1	90	0

(Note 1) Conclusion finding significant deficiencies is declared when there is significant concern about serious compliance violations of standards as well as laws and regulations applicable to an audit firm as a professional expert in the development and management of its quality control system.

(Note 2) Conclusion finding extremely significant deficiencies is declared when there is significant concern about extremely serious compliance violations of standards as well as laws and regulations applicable to an audit firm as a professional expert in the development and management of its quality control system.

(Note 3) Even if declaration finding no significant deficiencies is declared to an audit office, a recommendation for improvement is issued where an issue worthy of a recommendation for improvement is observed.

(Note 4) As the conclusion for one of the 2 audit firms reviewed had yet to be made as of June 30, 2023, it was not included in the state above. (Reference) Prepared by the CPAAOB based on data from the JICPA.

ii. Examination of FY2022 quality control reviews

The following examinations and analysis were conducted on quality control review reports from the JICPA to verify the appropriateness of its reviews.

- Examination and confirmation of the policies for FY2022 quality control reviews, efforts for improvement, and improvements in each review operation.
- Identification of significant deficiencies or extremely significant deficiencies as a result of quality control reviews of audit firms and analysis of items and contents of specific deficiencies pointed out amid quality control reviews
- Analysis of specific deficiencies pointed out in quality control review reports and instruction for improvements to examine whether the JICPA has effectively prompted audit firms for fulfillment

As a result of the above-mentioned examinations, the following were found in quality control reviews in FY2022

- To ensure that issues pointed out with specific audit engagements are not cast aside as marginal documentation problems (presentation errors in audit papers) but as based on the reality of deficiencies, measures, such as revising review procedures and providing training

to reviewers, have been taken. As a result, the ratio of documentation deficiencies to total deficiencies is decreasing.

- In order to strengthen the risk-based approach, the JICPA conducted the following:
 - (i) understand audit firms' operation control structures; and
 - (ii) made review plans while taking into account the results of past quality control reviews and risk assessments performed at the selection stage of audit engagements; after the commencement of reviews, furthermore, flexibly extend the review period and increase reviewers depending on the change of the situation (hereinafter referred to as "flexible review").

As a result, issues pointed out with individual audit engagements have increased, while in some matters such as quality control structures, outcomes could not be confirmed,

The JICPA will further deepen understanding of audit firms' operation management structures and will continue efforts to conduct flexible review. The CPAAOB will continuously check the effectiveness of quality control reviews.

As a feature of the FY2022 quality control review, issues pointed out about audit of accounting estimates increased from the previous year.

5. Collection of Reports

a. Overview

The CPAAOB may collect reports from the JICPA or audit firms when necessary. To ensure and enhance audit quality at all audit firms in Japan with limited inspection resources at its disposal, it is necessary that the CPAAOB continually understands challenges that audit firms are facing with effective use of collection of reports. In this view and the perspective of promoting audit firms to develop proper operation management system and quality control system (hereafter "operation management system etc.," the CPAAOB will collect reports regarding the status of development and implementation of operation management system etc.(including the status of implementing measures of improvement) in audit firms considering their scale and characteristics, the results of the CPAAOB inspections and JICPA's quality control reviews, and so on.

i. Collection reports for large-sized and mid-tier audit firms

In the case of large-sized audit firms and mid-tier audit firms, the CPAAOB periodically analyze quantitative and qualitative information concerning their operation management system etc. so as to contribute to further effective inspection. Particularly, it collects information related to the status of development and implementation of operation management system etc. under effective governance and efficiently functioning management (including the efforts to optimize operations such as developing audit methods utilizing digital technology and the efforts to develop and secure human resources) .It also understands the measures regarding cybersecurity.

Further, it utilizes the information through the collection reports to perform comparative analysis of audit firms and to identify sector-wide issues, etc.

With regard to large-sized audit firms, follow-up inspections are conducted for the purpose of verifying the status of improvements in the program year following regular inspections. However, there are some cases where such verifications are conducted through collection of reports instead of follow-up inspections. (For details, see 6. Inspections b. State of implementation of inspections i. Recent conduct of inspections (page 40)) .

ii. Collection of reports from small and medium-sized audit firm, partnership and solo practitioner

In the case of small and medium-sized audit firm, partnership and solo practitioner, the CPAAOB selects firms partly based on the results of quality control reviews. It then gathers and analyzes information about measures taken to address issues pointed out amid quality control reviews, their operations management system, their quality control system, and so on. Furthermore, in many cases, as small and medium-sized audit firms are especially influenced by the leadership of top management, it understands top management's awareness towards the current status of audit quality and efforts for improvement. And it conducts hearings as necessary.

iii. Collection reports for small and medium-sized audit firm, partnership and solo practitioner (follow-up after notification of inspection results)

With regard to problems notified as results of inspections to small and medium-sized audit firm, partnership and solo practitioner, the CPAAOB understands the progress of improvement through collecting reports and facilitates audit firms' voluntary improvements after a set period of time. It also conducts hearings as needed.

iv. Collection reports for audit firms in need of particularly immediate remediation

As a result of inspection, where the overall rating of the firm's business administration is "Unsatisfactory and in need of immediate remediation in operations management system, etc. (Overall rating 4)," the CPAAOB wields collection reports at the time of the notification of the inspection results, and prompts the firms to make improvements (for information about overall ratings, see "7. Notification of Inspection Results" (page 42)).

b. Implementation

i. Collection of reports from large-sized audit firms and mid-tier audit firms

In PY2022, the CPAAOB collected reports from all large-sized audit firms and mid-tier audit firms in order to review their operations management system, etc. including items such as their response to revisions to quality control standards, the impact of COVID-19 and the situation in Ukraine, their process of acceptance and termination of audit engagements, assurance engagements related to non-financial information. Furthermore, it analyzed the information through the collection of reports and utilized the analysis results to ensure effective and efficient

inspection, and also conducted inter-firm fact-finding of operations management system etc. at large-sized audit firms and mid-tier audit firms.

It also verified the efforts to remedy deficiencies found in regular inspections at two large-sized audit firms through collecting reports instead of conducting follow-up inspection.

- ii. Collection of reports from small and medium-sized audit firms, partnership and solo practitioner
In PY2022, reports were collected from 55 small and medium-sized audit firms (mainly from those subject to quality control reviews in PY2021) chosen on the basis of results of the reviews. The reports contained items related to recommendations for improvement issued by quality control review, matters related to business management (organizations and manpower, arrangement and implementation of training, etc.), matters related to the global network of audit firms, the impact of and responses to COVID-19 infections, key audit matters (KAMs), status of responses to the revision of quality control standards, status of assurance service related to non-financial information and so forth.

Of the 55 firms, 9 firms (those deemed to have concerns about operating management systems according to their reports, etc.) were subjected to face-to-face or online hearings. Inspectors participated in hearings to certain firms to enable in-depth discussion.

At the hearing, we have intensively heard about the development of quality control systems including responses to review findings, top management's management policy, organizations and human resources, responses to the revision of audit system, and so forth, while conveying the CPAAOB's awareness of problems, to promote the establishment of quality control that can ensure proper audit services.

Results of hearings will be used as important reference information in future examination, inspection and so forth.

- iii. Collection of reports from small and medium-sized audit firms etc. (follow-up after notification of inspection results)

In PY2022, among small and medium-sized audit firms etc. that had been notified of inspection results by the CPAAOB in past program years, the CPAAOB collected reports from one audit firm for which about one year had passed since the notification in order to confirm the improvements that had been made to address the findings notified as the inspection results.

- iv. Collection of reports from audit firms in need of particularly urgent remediation

In PY2022, three firms assessed as "unsatisfactory and in need of immediate remediation" continually reported the status of their improvements. Also, two firms assessed as "unsatisfactory and in need of immediate remediation" as results of inspections conducted in PY2022 submitted their reports simultaneously with the notification of inspection results.

These firms include:

- those in which the implementation of audit services is unsatisfactory and there are many deficiencies in the audit of specific companies listed in Japan,

- those in which integrated organizational management is not implemented and the development and implementation of organized operations management system are unsatisfactory,
- those in which an organizational culture to place emphasis on the quality of audit services has yet to be fostered and the development and implementation of quality control system are unsatisfactory,
- those in which leadership towards improving audit quality is not demonstrated and awareness of maintaining and improving audit quality is weak across the organization,
- those in which organizational culture that promotes actively providing opinions and proposals by broad range of partners has not been sufficiently developed because of their belief that decisions concerning the business operations of the firm can be made only through discussions among certain partners.

6. Inspections

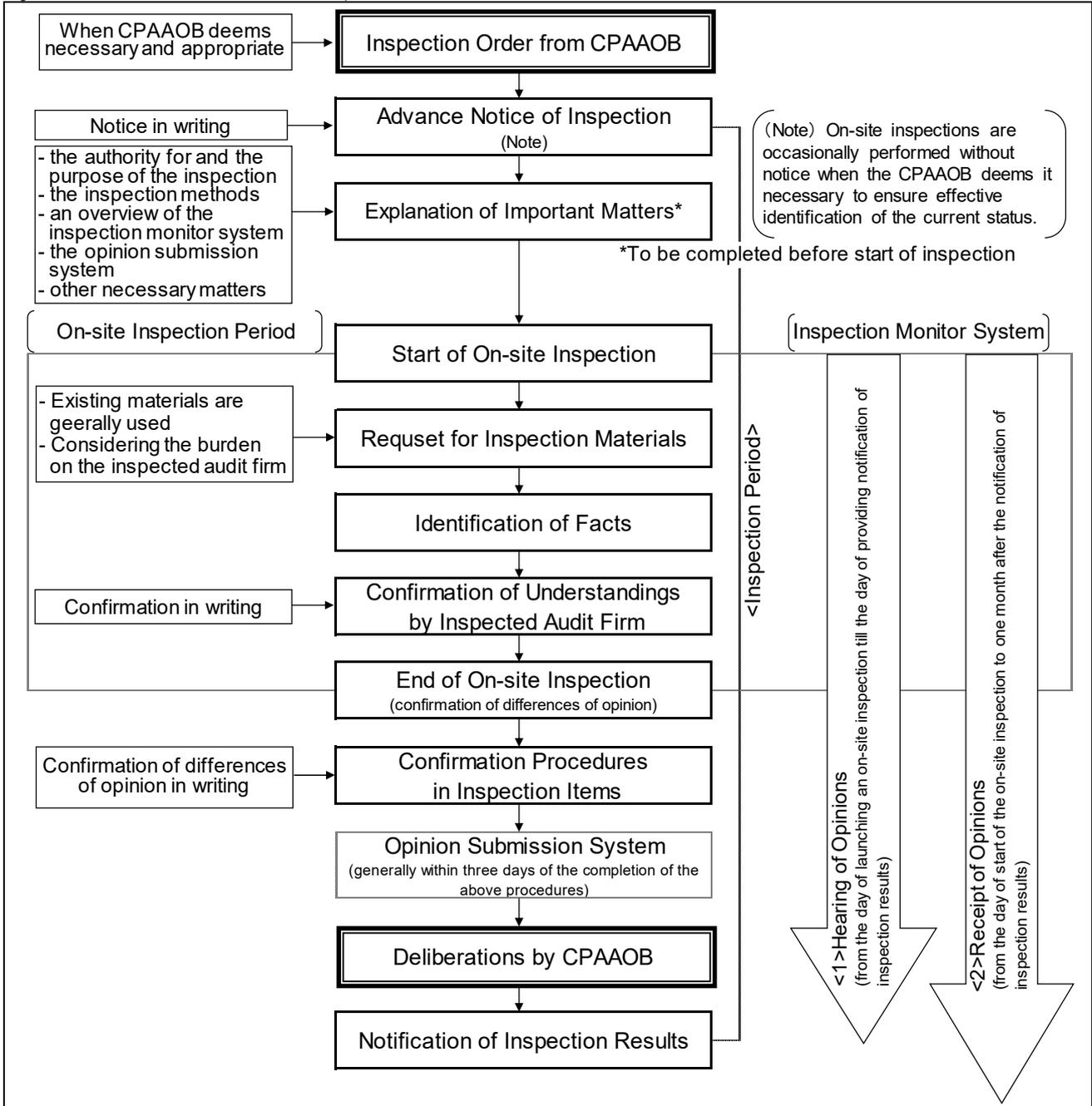
a. Overview

When deemed necessary and appropriate for the public interest or the protection of investors as the result of 4. or 5. above, the CPAAOB inspects audit firms (Article 49-3-2 of the CPA Act). Furthermore, when deemed necessary for ensuring the proper administration of the JICPA, the CPAAOB also inspects the JICPA (Article 46-12-1 of the CPA Act).

Basic matters concerning the CPAAOB's inspections, procedures for inspections, the handling of inspection results, etc. are prescribed in the "Basic Guidelines on Inspections Conducted by the Certified Public Accountants and Auditing Oversight Board" (lately revised in April 2022).

The standard workflow on inspections for audit firms in accordance with the Basic Guidelines is depicted below (Figure II-1-3).

Figure II-1-3: The standard workflow for inspections



The following is an explanation of the main components of the standard workflow:

i. Inspection order from the CPAAOB

The CPAAOB issues an order to inspectors to inspect an audit firm.

ii. Explanation of important matters

Before the on-site inspection, the inspectors explain to the responsible person at the audit firm the authority for and the purpose of the inspection, the inspection methods, an overview of the inspection monitor system and the opinion submission system, and other necessary matters.

iii. On-site inspection

Generally, the inspectors visit the audit firm and inspect its operations management system, quality control system, and audit engagements. The audit engagements inspected are selected based on the size of the audit firm, the key points of the basic plan on monitoring, and the audited company's audit risks.

Inspectors examine whether the audit firm's procedures on quality control comply with regulations, auditing standards and quality control policies established by the audit firm through the inspection of books, records and other materials and interviews of the audit firm's executives and staff.

Furthermore, inspectors obtain confirmation of facts and background information (findings) identified during the inspection in writing from the responsible person at the audit firm.

iv. Confirmation procedures on inspection items

After the on-site inspection, the CPAAOB communicates to the audit firm any problems discovered during the inspection, solicits the views of the audit firm on these problems, and confirms with the audit firm matters whether there are any discrepancies of opinion between the CPAAOB and the audit firm.

v. Opinion submission system

If there is a chasm of opinion, the audit firm may submit its opinion to Secretary-General of Executive Bureau in writing, usually within a three-day period (excluding weekends and public holidays) from the day on which the procedures for confirmation of inspection items were completed. Furthermore, if it receives a request from the audit firm to extend the submission period, the CPAAOB considers extending the submission period by up to two days.

If an opinion is submitted by an audit firm, a person designated by the head of the Planning, Management and CPA Examination Division (hereinafter "the CPA Examination Division"), of the CPAAOB Executive Bureau or the head of the CPA Examination Division, review the opinion and facts concerned, compile the results of the review and submit them to the Board of the CPAAOB.

The results, if approved by the Board of the CPAAOB, is conveyed to the audit firm through the head of the CPA Examination Division

vi. Inspection monitor system

The CPAAOB accepts opinions from audit firms about inspectors' inspection methods and so forth to grasp the CPAAOB's inspections and help ensure that they are conducted properly and efficiently.

Inspection monitoring is conducted by "asking for opinions" and "receiving opinions," and the head of the CPA Examination Division takes action, when necessary, such as giving instructions to inspectors.

b. State of implementation of inspections

i. Recent conduct of inspections

The frequency of inspections differs depending on the size of the audit firm.

The CPAAOB conducts regular inspections of large-sized audit firms once every two years and, since PY2016, has run follow-up inspections designed to verify improvements in the program year following the regular inspection. As to follow-up inspections, there are some cases in which remediation measures are examined through collection of reports in place of follow-up inspections.

Inspections of mid-tier audit firms are generally conducted once every three years.

Inspections of small and medium-sized audit firms are conducted as necessary, in light of deficiencies pointed out in quality control reviews.

Details of the inspections conducted during the past five years are presented below (Figures II-1-4 and II-1-5).

Figure II-1-4: State of implementation of inspections in the past five years (based on commencement of inspections)(unit: audit firms)

Fiscal/PY	2018 (Note 2)	2019 (Note 2)	2020 (Note 2)	2021 (Note 2)	2022 (Note 2)
Large-sized audit firms	4(2)	4(2)	4(2)	4(2)	2
Mid-tier audit firms	1	2	2	1	2
Small and medium-sized audit firms, partnerships and solo practitioners	5(1)	3	4	4	5
Foreign audit firms, etc. (Note 2)	0	1	0	0	1
Total	10(3)	10(2)	10(2)	9(2)	10

(Note 1) Figures in parentheses are the number of follow-up inspections.

(Note 2) See "B. Foreign Audit Firms" (page 47 for information on foreign audit firms etc.

(Source) Prepared by the CPAAOB based on results of inspections by the CPAAOB

Figure II-1-5: Number of inspections, inspectors, inspection periods and number of audit engagements

	Large-sized audit firms	Mid-tier audit firms	Small and medium-sized audit firms
Number of inspections(case)	10	6	11
Average number of inspectors(headcount)	9.1	7.8	6.2
Average inspection period(calendar days)	209.2	144.0	136.9
Average number of inspected audit engagements (companies)	6.2	5.0	3.3

(Note 1): Inspections conducted and completed in the five years from PY2018 through PY2022 are covered. Inspections of foreign audit firms and others, follow-up inspections, cases involving the submission of opinions and cases recommended to the Commissioner of the FSA were excluded because they involved procedures different from those of normal inspections.

(Note 2) Inspection period means the period (calendar day basis) between the date on which notice of the inspection was made (in the case of inspections with no advance notice; the date on which the on-site inspection started) and the date on which notification of the inspection results was issued.

(Source) Prepared by the CPAAOB based on the results of inspections

ii. Deficiencies

a. Characteristics of deficiencies identified through inspections of quality control system

Results of the CPAAOB inspections in and after PY2020 were as follows:

Large-sized audit firms tended to shift primal responsibility for quality control from the quality control section at their headquarters to the audit services section, which was closer to the audit sites. The results of recent inspections presented the outstanding issues, such as inadequate cooperation between the quality control section and audit services sections, need for penetration of improvement measures into audit sites (where auditing services are actually performed), and the verification of effectiveness of such improvement measures, etc. (for information on the organization of large audit firms, see "III. Operation of Audit Firms, A. Operations Management System, 1. Organizational Structure of Audit Firms" (page 53)).

Although mid-tier audit firms made structural improvements to take systematic approaches, they are facing problems amid expansion of operations, such as the need to strengthen the functions of the headquarters, and to verify the penetration of quality control measures into audit sites and their effectiveness. In addition, the management team, including a top, lacked the adequate awareness of the need to ensure and enhance quality control and to work together with the quality control section.

It was found that small and medium-sized audit firms etc. lack understanding of the levels of quality control and auditing procedures required by the existing auditing standards, or do not fully understand the means and the depth of analysis concerning causes of deficiencies pointed out in quality control review, etc., which is necessary for preventing an occurrence of similar deficiencies. In addition, there were firms that were not fully capable of auditing the listed companies with high risk.

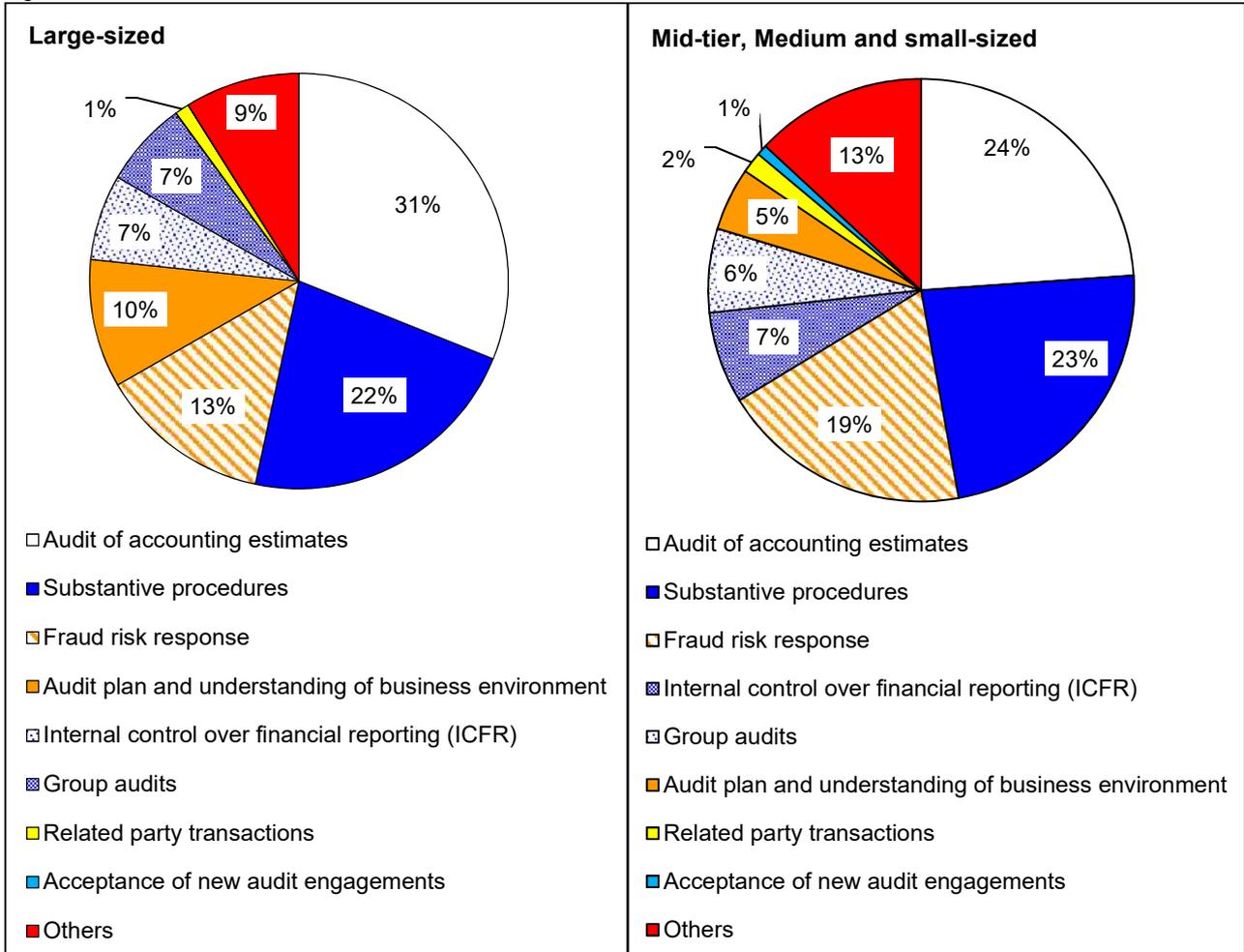
b. Characteristics of deficiencies identified through inspections of audit engagements

Deficiencies identified through inspections of audit engagements from PY2020 to PY2022 can be classified in line with the ASCS structure as follows (Figure II-1-6).

Regardless of the size of audit firms, deficiencies related to the audit of accounting estimates were the most common, followed by deficiencies in substantive procedures (audit procedures, such as analytical verification procedures and detailed tests that were conducted with regard to transaction types, account balances, and footnotes to address the risk of material misstatements). In addition, deficiencies concerning dealing with fraud risk were continually found. The CPAAOB therefore performed inspections with a focus on such deficiencies.

The CPAAOB encourages inspected audit firms to take their initiatives in improving their operation, by analyzing the causes of the deficiencies identified in the inspections and sharing them through dialogue with the inspected audit firms. You can see the Case Report from Audit Firm Inspection Results for detailed information about examples of deficiencies identified during the inspections and their causes.

Figure II-1-6: Deficiencies in PY2020-22



(Note) Classifications of deficiencies noted at seven (total number of inspections) large-sized audit firms, four mid-tier audit firms, and 13 small and medium-sized audit firms

(Source) Prepared by the CPAAOB based on the results of inspections by the CPAAOB

7. Notification of Inspection Results

a. Inspection results notification

The responsible person at the audit firm is notified of the inspection results in writing (inspection results notification).

The current inspection results notification contains the information shown in Figure II-1-7⁶.

Figure II-1-7: Items included in inspection results notification

1. Key points
2. Inspection viewpoints
3. Measures against deficiencies developed by the inspected audit firm to ensure the proper execution of services with the aim of maintaining and improving quality control (quality control environment)
4. Conduct of audit services (audit engagements)

⁶ As Overall ratings will not be given for ad hoc inspections or follow-up inspections of large-sized audit firms, the inspection results notifications in those cases differ from the ones of regular inspections

a. "Key points" section

Among the sections in an inspection results notification, the "Key points" section elaborates deficiencies identified during the CPAAOB inspections that are regarded as significant. It comprises three subsections (operations management system, quality control system and audit engagements) and confers an overall rating according to the status of these subsections.

The overall rating of the operation of services at the inspected audit firm is presented at the beginning of the "Key points" section of the inspection results notification, as shown in Figure II-1-8.

Figure II-1-8: Example of key points

1. Key points

As a result of our inspection of your audit firm and within the scope of our inspection, we discovered the operation of your firm is . . . (one of five overall rating grades).

(1) Operations management system
...(presents problems with its governance and operation of services)

(2) Quality control system
...(presents deficiencies in the system of quality control)

(3) audit engagements
...(presents deficiencies in audit services)

The CPAAOB has included overall ratings of audit firms' operation of services in the inspection results notification since the inspections commenced in PY2016. The aims are to accurately convey the CPAAOB's assessment to audit firms and to ensure proper understanding of their level of quality control among audit and supervisory board members etc. of audited companies, to whom the inspection results notification is provided.

b. Overall rating grades

The overall rating takes the form of one of the following five grades and is based on the assessment results of audit firms' operations management system, quality control system and audit engagements. Each grade is assessed with the following descriptions.

"Satisfactory" (Overall rating: 1)

The description is used when the operation of services is deemed satisfactory, e.g., there are almost no deficiencies in the operations management system, quality control management and audit engagements.

"Generally Satisfactory with minor deficiencies" (Overall rating: 2)

The description is used when the operation of services is deemed satisfactory on the whole though there are problems that need to be fixed, e.g., there are no significant deficiencies despite the presence of some deficiencies in the operations management system, quality control management or audit engagements.

"Unsatisfactory due to presence of significant deficiencies that need to be fixed" (Overall rating: 3)

The description is used when the operation of services is deemed unsatisfactory, e.g., there are significant deficiencies in the operations management system, quality control management or audit engagements that need to be fixed.

"Unsatisfactory and in need of immediate remediation in operations management system, etc." (Overall rating: 4)

The description is used when the operation of services is deemed unsatisfactory and in need of immediate remediation.

"Extremely unsatisfactory" (Overall rating: 5)

The description is used when significant deficiencies are identified in the quality control system and audit engagements, and voluntary remediation by the audit firm cannot be expected.

In the case of an audit firm rated as "unsatisfactory and in need of immediate remediation (overall rating 4)," the CPAAOB collects a report at the time of the notification of inspection results and encourages the firm to promptly make improvements (for more details, see "5. Collection of Reports" (page 34). In the case of an audit firm rated as "extremely unsatisfactory (overall rating: 5)," the CPAAOB make recommendations concerning administrative actions and other measures to the Commissioner of the FSA.

c. Distribution of overall ratings

The distribution of overall ratings for regular inspections launched and completed between PY2016 and PY2022 is shown below (Figure II-1-9).

No audit firms were qualified as "Satisfactory (overall rating: 1)," the highest grade in the overall rating scheme. All audit firms, therefore, were rated as "Generally satisfactory with minor deficiencies (overall rating: 2)" or lower based on the assessment of their operations management system, quality control and audit engagements.

Many small and medium-sized audit firms, partnerships and solo practitioners had overall ratings lower than those of large-sized and medium-tier audit firms. This is because the CPAAOB mainly selects small and medium-sized audit firms for the inspection based on recommendations in quality control reviews, etc. - their quality control environment needs to be confirmed immediately. At small and medium-sized audit firms with low overall ratings, there was insufficient awareness of quality control among the top management. In addition, partners and staff members lacked an awareness of recent environmental changes pertaining to accounting and auditing and did not understand adequate levels required by the current audit standards.

Figure II-1-9: Overall ratings for inspections in PYs 2016/2022 (based on commencement of inspections) (unit: audit firms)

Overall rating	Large-sized audit firms	Mid-tier audit firms	Small and medium-sized audit firms, partnerships and solo practitioners
Satisfactory" (Overall rating: 1)	-	-	-
Generally satisfactory with minor deficiencies" (Overall rating: 2)	4	-	3
Unsatisfactory due to presence of significant deficiencies that need to be fixed" (Overall rating: 3)	-	4	6
Unsatisfactory and in need of immediate remediation in operations management system, etc." (Overall rating: 4)	-	1	8
Extremely unsatisfactory" (Overall rating: 5)	-	-	10

(Note 1) Totals for audit firms subject to regular inspections that were commenced and completed between PY2016 and PY2022

(Note 2) For audit firms underwent multiple regular inspections in the period under review, overall ratings in the latest inspection are tallied. .

d. Communication of “key points” to audit and supervisory board members etc. of all audited companies

Audit firms are required to communicate the “key points” in their inspection results notifications and the action they are taking in response to them to audit and supervisory board members etc. of all audited companies⁷.

In addition, audit firms are required to communicate the details of the deficiencies and the action to them to the audit and supervisory board members etc. of audited companies where their audit engagements were selected for the inspections.

For accurate conveyance of inspection results, the CPAAOB requests audit firms to inform auditors and others at audited companies of “key points,” starting inspection launched in PY2016. Moreover, for the purpose of enabling audit and supervisory board members etc. of audited companies to compare inspection results with those for other audited firms and better understand the business administration levels of audit firms, the CPAAOB has published the above distribution of overall ratings since the 2019 Monitoring Report.

e. Handling of inspection results

An inspected audit firm is required to obtain prior consent from the CPAAOB to disclose⁸ inspection results to a third party. In recent years, there has been a large number of requests to the CPAAOB from audit firms for prior consent for the disclosure of inspection results and others as requested by directors at audited companies, auditors and directors (including outside directions) at parent companies of audited firms and potential audited companies (e.g., companies considering which accounting auditors to appoint).

However, an inspected audit firm does not need to obtain the CPAAOB's prior consent if it conveys inspection results to auditors and others at audited companies, mentioned above in d.,

⁷ The ASCS requires audit firms to convey in writing to the audit and supervisory board members etc. the details of inspection results notifications and the measures for improvements (ASCS 260, No. 16, A31-2).

⁸ Details on disclosing inspection results to third parties are posted on the CPAAOB website.

and presents them to the JICPA based on rules of the JICPA Quality Control Committee's detailed operational rules pertaining to the handling of notification documents for inspection results.

This approach is expected to facilitate communication between auditors and others of audited companies and audit firms through the utilization of inspection results and improve the effectiveness of quality control reviews by the JICPA.

It is desirable that not only audit and supervisory board members etc. of audited companies but also the directors etc. of audited companies and potential audited companies make use of the CPAAOB inspection results etc. in order to confirm the status of establishment and implementation of quality control systems by accounting auditors.

B. Foreign Audit firms

1. System for Foreign Audit Firms

Financial statements which shall be submitted under the FIEA by domestic listed companies must generally require an audit attestation by Japanese CPAs or audit firms. However, if the issuer is a foreign company, its financial statements generally undergo audit attestation by CPAs or audit firms in the home country. Therefore, to avoid duplicate audits, an exception is granted in cases where the issuer company has taken an audit attestation deemed to be equivalent to that prescribed under the FIEA.

With the aim of further enhancing the soundness of Japan's capital markets, the CPA Act was amended in 2007 to require foreign CPAs and audit firms auditing the financial statements of foreign companies, etc. subject to the FIEA disclosure rules to submit the notification to the FSA Commissioner.

Having submitted the notification to the FSA, the audit firms are regarded as foreign audit firms (Article 1-3(7), Article 34-35 (1) of the CPA Act) and are subject to inspection and supervision by the CPAAOB and the FSA.

Based on the "Approach to Inspections and Supervision of Foreign Audit Firms (published on September 14, 2009), the CPAAOB generally collects reports from foreign audit firms once every three years, most recently having collected from 35 foreign audit firms in 14 countries/regions in PY2021. Based on the results of analysis of the information provided by this collection, the CPAAOB also conducted an inspection of one foreign audit firm each in PY2022.

2. Foreign Audit Firms

Regarding the locations of foreign audit firms that have registered with the FSA, the largest number are based in Europe, with the second largest number being headquartered in the Asia-Pacific region (Figure II-2-1).

The top countries/regions are France, with eight firms, the Cayman Islands, with seven firms, and the U.S., Ireland and Hong Kong, with six firms. Foreign audit firm registrations are published and updated as "Registered Foreign Audit Firms" on the FSA website.

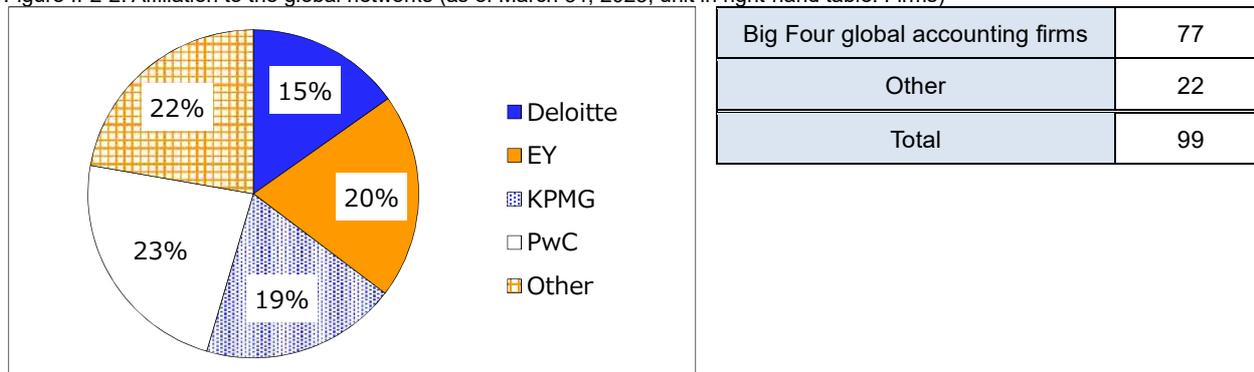
Figure II-2-1: Number of registered foreign audit firms, etc. (as of March 31, 2022)

	Number of countries/regions	Number of foreign audit firms, etc.
Europe	16	58
Asia-Pacific	10	29
North America	2	10
Central/South America	1	1
Middle East	1	1
Total	30	99

(Source) Prepared by the CPAAOB based on information from the FSA website

Out of the foreign audit firms, around 80% is affiliated with one of the Big Four global accounting firms (Figure II-2-2).

Figure II-2-2: Affiliation to the global networks (as of March 31, 2023; unit in right-hand table: Firms)



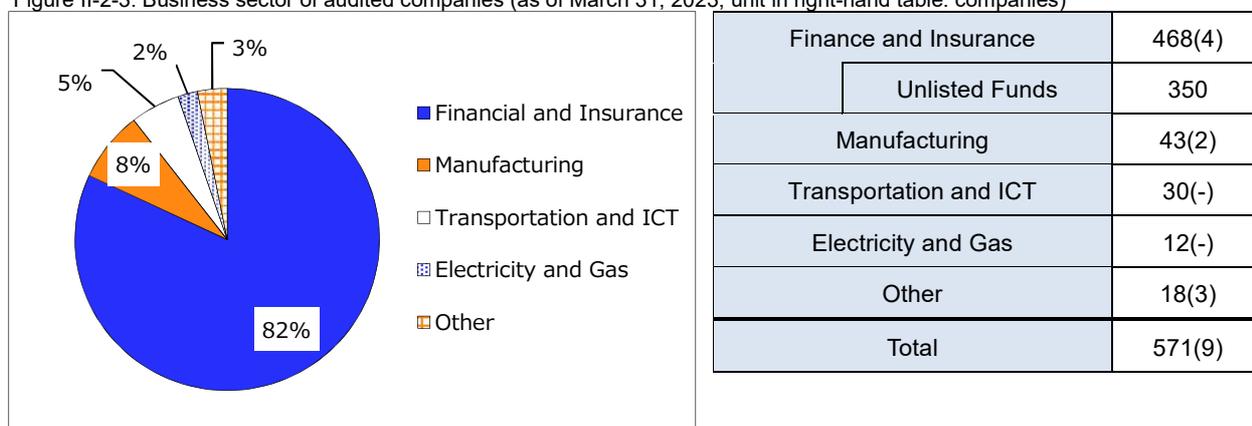
(Note) Compiled the foreign audit firms under the Big Four global

3. Audited Companies

Securities issued by foreign companies that are subject to the FIEA disclosure regulations include not only shares issued by companies listed in Japan, but also bonds issued by foreign companies, beneficiary certificates issued by foreign investment trusts, and foreign investment securities. Among foreign companies currently subject to disclosure rules, most are unlisted funds (foreign investment trusts and foreign investment securities).

Regarding the business sectors of companies audited by foreign audit firms, 82% are classified as finance and insurance, and around 75% of these are unlisted funds (Figure II-2-3).

Figure II-2-3: Business sector of audited companies (as of March 31, 2023; unit in right-hand table: companies)



(Note) Figures in parentheses are the number of companies (including funds) listed in Japan
 (Source) Prepared by the CPAAOB based on information on the FSA website

C. The CPAAOB monitoring Perspectives, Objectives etc. (Basic Policy and Basic Plan)

Since its establishment in April 2004, the CPAAOB has endeavored to reinforce trust that investors place in the capital markets based on its mission to enhance the fairness and transparency of Japanese capital markets by raising the quality and ensuring the reliability of audits by CPAs.

As part of these efforts, the CPAAOB formulates a Basic Policy for Monitoring Audit Firms each term (three years) and a Basic Plan for Monitoring Audit Firms, which is based on the Basic Policy, each program year. In this way, the CPAAOB articulates the objectives and approach for monitoring, priorities for each program year, and so on.

1. Basic Policy for Monitoring Audit Firms

The entire text of the Basic Policy for Monitoring Audit Firms for the CPAAOB's 7th Term (April 2022 – March 2025) is presented on the CPAAOB's website, but monitoring perspectives, objectives, etc. are summarized below:

[Principal Points in the Basic Policy]

In the 7th Term, the CPAAOB will encourage audit firms on a continuous basis to voluntarily ensure and improve the quality of audits and achieve the appropriate management of operations, including the quality control of audits, through effective and efficient monitoring, taking into account rapid changes around audit firms, such as the digitization of the entire society, spread of COVID-19 infections and changes in the international situation, including the Ukraine problem. In particular, the following points will be emphasized in monitoring.

- Confirmation and validation of preparedness for smooth introduction of quality control system and responses to it at audit firms

As the standard on quality control for audits has been revised, audit firms will be required to introduce a quality control system based on the following risk approaches(*):

- (1) To set quality objectives
- (2) To identify and assess quality risks that will block the achievement of quality objectives
- (3) To determine and implement a policy or process of addressing assessed quality risks, and
- (4) To make improvements, if any, based on root causes

The 7th Term of monitoring by the CPAAOB will place emphasis on audit firms' preparedness for the introduction of such a system and responses to it and post-introduction improvement and operation of the system.

(*) The revised quality control standards will become applicable, starting with the auditing of financial statements in the business year or fiscal period that will begin after July 1, 2023 (In the case of audit firms other than large-sized audit firms as defined by the Certified Public Accountants Act, the application will take effect in the business year or fiscal period that will begin after July 1, 2024).

- Securement and improvement of service quality at audit firms that audit listed companies

In auditing listed companies, the replacement of large-sized audit firms with mid-tier or small and medium-sized audit firms continues. The role of mid-tier, small and medium-sized audit firms in

auditing listed companies is thus growing.

As a result, in the 7th Term, the CPAAOB will put greater emphasis on the inspection of small and medium-sized audit firms considered in need of immediately ensuring and improving the quality of audits.

2. Basic Plan for Monitoring Audit Firms for Program Year 2023

The full text of the Basic Plan for Monitoring Audit Firms for Program Year 2023 (July 2023 - June 2024) can be found on the CPAAOB website. Monitoring priorities are described below.

[Basic Plan for Monitoring (Non-Inspection Basic Plan)]

a. Examination of JICPA quality control reviews and cooperation with JICPA

The CPAAOB has been encouraging the JICPA to take actions to ensure and improve audit quality through exchanges of opinions and other means. Going forward, the CPAAOB will engage in in-depth discussions with the JICPA to strengthen the quality control review system in light of the fact that quality control reviews will play an even more important role as a means of confirming the eligibility of registered auditors of listed companies.

b. Collection of reports

For large-sized audit firms and mid-tier audit firms, the CPAAOB will periodically collect and analyze quantitative and qualitative information on their operations management systems, from the viewpoint of efficiently conducting inspections.

For small and medium-sized audit firms, the CPAAOB will collect and analyze information as appropriate according to the size and characteristics of the firm, taking into account the results of the JICPA quality control reviews and audit risks associated with listed audited companies. In addition, the CPAAOB will hold hearings on the content of reports as necessary to encourage voluntary efforts to ensure and improve audit quality.

In collecting reports, priority items shall be the status of establishment and operation of a quality control system in compliance with the revised quality control standards, etc. (for large audit firms) or the status of responses to the revised quality control standards, etc. (for non-large audit firms), the status of compliance with the revised ethical rules, the status of introduction and implementation of measures to prevent the occurrence of erroneous statements related to CPA qualifications, etc.

c. Collection and analysis of information regarding audit firms

Through periodic dialogues with executives, including top management, of large-sized and mid-tier audit firms, the CPAAOB will collect information on the latest operations management systems at each audit firm and share awareness of problems. In addition, the CPAAOB will continue to hold dialogues with small and medium-sized audit firms that conduct audits of listed companies.

[Basic Plan for Inspection]

To all audit firms, inspections shall similarly focus on matters such as the commitment of the top

management of audit firms to improving audit quality, the effectiveness of the operations management system and quality control system, as well as the status of audits concerning fraud risks, revenue recognition, and accounting estimates. In addition, inspections shall be conducted as follows.

a. Large-sized audit firms

With regard to large-sized audit firms, the CPAAOB conducts inspections every year in principle (regular inspections and follow-up inspections are conducted alternately). In follow-up inspections, the CPAAOB does not, in principle, examine individual audit engagements, taking into account the burdens, etc. on the inspected firm. Instead, the CPAAOB mainly verifies the status of improvement measures for issues pointed out in regular inspections (in place of inspections, the CPAAOB may collect reports to confirm efforts toward improvement).

In conducting inspections of large-sized audit firms, the CPAAOB will pay particular attention to the implementation of monitoring of individual audit engagements by the quality control division, etc., as well as the follow-up examination of audit deficiencies and their causes in the event of inappropriate accounting treatment at audited companies, and the implementation of subsequent improvement measures.

b. Mid-tier audit firm

In light of their growing role as auditors of listed companies, the CPAAOB will conduct inspections of mid-tier audit firms once every two years, instead of once every three years in general.

When inspecting mid-tier audit firms, the CPAAOB shall pay particular attention to the status of efforts by management, including top management, to foster an organizational culture that emphasizes audit quality, as well as the status of collaboration between the quality control division and the audit frontline, and the implementation of monitoring of individual audit engagements by the quality control division, etc.

c. Small and medium-sized audit firms

With regard to small and medium-sized audit firms, the CPAAOB will consider the necessity of promptly confirming their quality control systems based on the results of quality control reviews conducted by the JICPA, as well as factors such as the operation control systems of audit firms and the degree of audit risk associated with listed audited companies. In light of the growing role of small and medium-sized audit firms as auditors of listed companies and the “Registration System for Auditors of Listed Companies” introduced by the revised CPA Act, the CPAAOB will place greater emphasis on inspections of small and medium-sized audit firms also in this program year.

When conducting inspections of small and medium-sized audit firms, the CPAAOB focuses in particular on their efforts to foster an organizational culture that ensures compliance with laws, regulations, and professional ethics, as well as their partners and employees’ awareness of professional ethics, independence, and legal compliance, and the control of audit documentation (including prevention of inappropriate correction of audit documentation).