

## **Basic Plan for Monitoring Audit Firms in Program Year 2024 (from July 2024 to June 2025)**

To ensure audit quality and enhance the effectiveness of audits, the Certified Public Accountants and Auditing Oversight Board (the "CPA AOB") hereby establishes the Basic Plan for Monitoring Audit Firms in Program Year ("PY") 2024 (from July 2024 to June 2025) (the "Basic Plan 2024"), reflecting the perspectives and objectives stated in the Basic Policy for Monitoring Audit Firms (the "Basic Policy")<sup>1</sup> and the environment surrounding audit firms.

### **1. Environment surrounding audit firms**

#### **(1) Audit trends**

##### **a. Status of auditors of listed companies**

- Large audit firms<sup>2</sup> have continuously accounted for an overwhelming share, above 90%, of audits of listed companies in Japan in terms of market capitalization. Of the accounting auditors of 3,930 listed domestic companies as of the end of FY 2023, 2,349 were large audit firms, 610 were mid-tier audit firms, and 971 were small and medium-sized audit firms.
- The annual number of changes in audit firms of listed companies for the Program Year ended June 2024 was 115 (excluding those resulting from audit firm mergers), down from 204 in the Program Year ended June 2023, but the trend of large firms to mid-tier or small and medium-sized ones continues.
- As the range of audit firms of listed companies expands in this way, the Japanese Institute of Certified Public Accountants (JICPA) is implementing various support measures for small and medium-sized auditing firms (including publication of tools and Q&A on revised quality control standards, direct guidance for training and support of audit firms, etc.) to strengthen their management foundations (quality control infrastructure, organizational and governance infrastructure, human resources infrastructure, IT infrastructure, financial infrastructure, and international response infrastructure).

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<sup>1</sup> It sets the standpoint, objectives, and basic policy for each term regarding monitoring implemented by the CPA AOB. The basic policy for the CPA AOB's seventh term (April 2022 to March 2025) was formulated and announced on May 20, 2022.

(<https://www.fsa.go.jp/cpaaoob/shinsakensa/kihonkeikaku/20220520/20220520.html>)

<sup>2</sup> The CPA AOB classifies audit firms into the following three categories according to their sizes:

- Large audit firms: Audit firms that audit about 100 or more listed companies in Japan and have at least 1,000 full-time audit practitioners. In this Basic Plan, they specifically refer to four firms: KPMG Azsa LLC, Deloitte Touche Tohmatsu LLC, Ernst & Young ShinNihon LLC and PricewaterhouseCoopers Japan LLC.
- Mid-tier audit firms: Audit firms that are second only to large firms in size. In this Basic Plan, they refer to four firms: Gyosei & Co., BDO Sanyu & Co., Grant Thornton Taiyo LLC, and Crowe Toyo & Co.
- Small and medium-sized audit firms: Audit firms other than large and mid-tier audit firms.

- b. Status of inappropriate accounting cases
  - The annual number of listed companies that disclosed matters such as inappropriate accounting treatments in the timely disclosure of stock exchanges has continued to be above 50.
  - Inappropriate accounting is attributable to dysfunctional corporate governance and internal control, including insufficient control on domestic and overseas group companies.
  - It goes without saying that the top management of companies is responsible for the preparation of financial statements and the design/implementation of effective internal control systems. On the other hand, it has become increasingly important for audit firms to conduct audits based on their in-depth understanding of audited companies' business characteristics and environments when assessing such companies' internal control. In addition, it is necessary for audit firms to review the assessment of the risk of material misrepresentation of financial statements and the procedures for responding to it in the audit of financial statements, as well as the scope of assessment in the audit of internal control.
- c. Accounting and disclosure trends
  - Abolition of quarterly securities reports
    - In November 2023, the Act for Partial Amendment of the Financial Instruments and Exchange Act, Etc., was promulgated, including the abolition of the quarterly securities reports, and came into effect on April 1, 2024.
    - In response to the abolishment of the quarterly securities reports by the abovementioned amendment, (i) the Business Accounting Council (BAC) revised the Quarterly Review Standards to the Mid-Term Review Standards and revised the quality control standards for auditing; (ii) the Accounting Standards Board of Japan (ASBJ) revised the Accounting Standards for Interim Financial Statements and the Guidelines for the Application of the Accounting Standards for Interim Financial Statements; (iii) the JICPA revised the Quarterly Review Standards Report No. 1 "Quarterly Review" and established the Mid-Term Review Standards Report No. 2 "Review of Mid-Term Financial Information Conducted by Independent Auditors," and (iv) the Tokyo Stock Exchange partially revised the Securities Listing Regulations, etc.
  - Enhancing disclosure and assurance of sustainability information
    - In January 2023, the Cabinet Office Order for Partially Amending the Cabinet Office Order on Disclosure of Corporate Affairs and the Cabinet Office Order on Disclosure of Information on Regulated Securities was promulgated, which included a new section for "Approach to Sustainability and Sustainability-Related Efforts" in securities reports and enhanced disclosure on corporate governance. The amended Cabinet Office Orders has been applied to annual securities reports for business years ending on or after March 31, 2023.
    - Significant progress has been made in the disclosure of sustainability information. In June 2023, the International Sustainability Standards Board (ISSB) finalized the General Requirements for Disclosure of Sustainability-related Financial Information (S1) and the Climate-related Disclosure Standard (S2). In Japan as well, the Sustainability Standards Board of Japan (SSBJ)

published exposure drafts of the Japanese S1 and S2 Standards, which are equivalent to the ISSB's S1 and S2 Standards, in March 2024.

- As attention is focused on ensuring the reliability of sustainability-related information, the International Auditing and Assurance Standards Board (IAASB) held a consultative meeting in August 2023 on the General Requirements for Sustainability Assurance Engagements (ISSA5000), which is a new international standard for assurance of sustainability reporting, and had on-going discussions to finalize the standard towards September 2024.
  - In light of these domestic and international trends, the Financial System Council has newly established the Working Group on Sustainability Disclosure and Assurance and has begun discussions among experts on the introduction of sustainability disclosure standards and assurance systems.
- Disclosure of "Important Contracts" in annual securities reports, etc.
- The Cabinet Office Order for Partial Amendment of the Cabinet Office Order on Disclosure of Corporate Affairs, Etc., was promulgated in December 2023 and came into effect on April 1, 2024.
  - This amendment specifies the types of contracts to be disclosed and the content of disclosure required for "important contracts," one of the items to be mentioned in securities registration statements and annual securities reports (hereinafter referred to as "annual securities report, etc."). It clarifies that (i) agreements on governance between companies and shareholders, (ii) agreements between companies and shareholders on the disposal or purchase of shares held by shareholders, and (iii) financial covenants should be disclosed as "important contracts" in annual securities reports, etc.
  - The amendment shall be applied to annual securities reports, etc., for business years ending on or after March 31, 2025.

## **(2) Initiatives to ensure and enhance audit quality**

- a. Registration system for auditors of listed companies, etc.
- Accompanying the enforcement of the Certified Public Accountants Act amended in May 2022 (the "amended CPA Act"), a legal registration system for auditors of listed companies, etc., was introduced in lieu of the registration system for audit firms of listed companies, which the JICPA had operated as a self-regulatory mechanism.
  - At the time of the introduction of the registration system, the JICPA has established the legal registration system for auditors of listed companies and developed the environment where those applying for the registration on the official roster of auditors of listed companies, etc., are screened and assessed by the Board based on their confirmed qualification through quality control reviews, etc. In addition, the JICPA has established the Guidelines for the confirmation of eligibility of audit firms that conduct audits of listed companies, etc, for confirming whether a system for auditing listed companies is developed through quality control reviews.
- b. Application of revised Quality Control Standards, etc.
- In November 2021, the Quality Control Standards for Auditing were revised, which includes the introduction of a quality control system based on risk

approaches. And, in response to such revision, the Quality Control Standards Committee Report No. 1 on “Quality Control at Audit Firms” and the Audit Standards Committee Report No. 220 on “Quality Control in Auditing” were amended, and the Quality Control Standards Committee Report No. 2 on “Audit Engagement Reviews” was newly formulated.

- Large audit corporations under the Certified Public Accountants Act<sup>3</sup> apply and comply with the aforementioned standards from audits of financial statements for business years that start on or after July 1, 2023, and other audit firms apply and comply with them from audits of financial statements for business years that start on or after July 1, 2024.
- In addition, the amended Certified Public Accountants Act imposes an obligation on registered auditors of listed companies, etc., to develop a system to publicize the results of inspection, etc., concerning the status of quality management of operations (Article 93 of the Regulations for Enforcement of the Certified Public Accountants Act), and this provision is applied from the fiscal year of an auditing firm or the fiscal year of a certified public accountant that starts on or after the first day of the accounting period of the audited company, etc., that starts on or after July 1, 2024 (July 1, 2023 for a large audit corporation).

c. Governance system of audit corporations

- The amended Certified Public Accountants Act imposes on registered auditors of listed companies, etc., (i) the obligation to develop a system to publicize the results of inspection, etc., concerning the status of quality control of operations (Article 93 of the Regulations for Enforcement of the Certified Public Accountants Act), (ii) the obligation to develop a system to publicize the status of business management, etc., (Article 95 of the same Regulations), and (iii) the obligation to develop a system to implement operations in accordance with the principles designated by the Commissioner of the Financial Services Agency for organizational management and a system to publicize the status of application (Article 96 of the same Regulations). With regard to the principles designated by the Commissioner of the Financial Services Agency for organizational management under (iii) above, the Principles for Effective Management of Audit Firms (the "revised Governance Code") was published.
- The obligation to develop systems set forth in (ii) and (iii) above is applied from the first day of the fiscal year of an audited company, etc., that starts on or after July 1, 2024 (July 1, 2023 for a large audit corporation). Registered auditors of listed companies are supposed to publicize the status of management control, the governance and the application of the revised Governance Code, etc., at appropriate times after the systems set forth in (ii) and (iii) above are developed.

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<sup>3</sup> Audit corporations that audit a total of 100 or more listed companies, etc., in the latest accounting year. See Article 24 of the Regulations for Enforcement of the Certified Public Accountants Act.

### **(3) Quality control challenges at audit firms**

#### **○ Outline of the overall inspection ratings**

The CPAAOB has specified overall inspection ratings<sup>4</sup> on a scale of five categories on inspected audit firms' business operations in inspection result notifications (excluding those for follow-up inspections) since PY 2016 (July 2016-June 2017).

#### **○ Distribution of overall inspection ratings**

Distribution of overall inspection ratings for the most recent five Program Years (from PY 2019 to PY 2023) is as follows:

- There are no audit firms that have been given the highest rating.
- Large audit firms were all given the second-highest rating.
- Mid-tier audit firms were given the third or fourth rating.
- Most of the inspected small and medium-sized audit firms were given third-highest or lower ratings as they were selected for inspections based on their risks.

#### **○ Challenges at large audit firms**

Large audit firms face challenges such as ensuring sufficient cooperation between the head-office quality control departments and the business units, verification of the status of penetration of remedial measures among frontline auditors and its effectiveness, and implementation of critical reviews by employees in charge of examination of audit procedures conducted by audit teams.

#### **○ Challenges at mid-tier audit firms**

Some mid-tier audit firms are facing the following challenges:

- (i) Management has not exercised sufficient leadership to ensure an appropriate level of audit quality;
- (ii) Management has not been able to accurately ascertain the level of audit quality of the entire firm, for example, because they are not aware of the fact that there are some auditors who lack understanding of the level of procedures required by current audit standards, etc.;
- (iii) Management does not have sufficient awareness of compliance with professional ethics and internal rules, etc., and lacks consciousness of fostering a culture that emphasizes audit quality and building an effective and organized operational control system;
- (iv) Management and quality control departments fail to sufficiently verify the effectiveness of remedial measures;
- (v) Supervisory and assessing bodies are not sufficiently fulfilling their

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<sup>4</sup> The "Key points" section of the inspection results notification contains an overview of deficiencies in operational management systems, quality control systems and individual audit engagements and gives one of the five overall inspection ratings based on the status of those areas. The five ratings are accompanied by the respective assessment comments as follows:

- (1) Highest rating: "Favorable (Overall Rating 1)"
- (2) 2nd-highest rating: "Generally favorable with some deficiencies requiring remediation (Overall Rating 2)"
- (3) 3rd-highest rating: "Unfavorable with significant deficiencies requiring remediation (Overall Rating 3)"
- (4) 4th-highest rating: "Unfavorable with significant deficiencies with respect to operational management systems, etc., requiring immediate voluntary remediation (Overall Rating 4)"
- (5) 5th-highest (lowest) rating: "Extremely unacceptable (Overall Rating 5)"

functions; and

- (vi) It is not sufficiently verified whether human and temporal resources are sufficient for each of the audit procedures in light of the actual conditions of the audit frontline.

○ Challenges at small and medium-sized audit firms

Among small and medium-sized audit firms, the following challenges are recognized, and some audit firms are required to further develop a relevant system to conduct audits of listed companies.

- (i) Management has not exercised sufficient leadership to improve the audit quality throughout the firms;
- (ii) Management is not aware of the situation in which auditors lack understanding of the level of quality control and audit procedures required by current auditing standards;
- (iii) They do not understand the required levels of in-depth analyses of causes regarding inspection findings through quality control reviews, etc., for the purpose of preventing the recurrence of deficiencies of the same type;
- (iv) They lack the awareness regarding the importance of being honest and maintaining credibility as professionals (such as substituting audit documentation after an inspection notice is issued);
- (v) They lack the attitude to critically examine the audit quality of the firm as a whole (such as lacking the awareness to critically examine the quality of other staff members' individual audit work), and they lack the awareness to critically examine managers' views by demonstrating professional skepticism; and
- (vi) They lack the awareness to carefully assess whether sufficient and appropriate audit evidence for audit risk has been obtained.

○ Challenges in individual audit engagements

Irrespective of audit firms' sizes, deficiencies regarding audit procedures for accounting estimates and those to respond to fraud risks (including identification and assessment of fraud risks in revenue recognition and responses to fraud risks) have continuously been found in individual audit engagements. In addition, deficiencies have also been found in procedures relating to Key Audit Matters (KAM) and procedures related to notes to financial statements, etc.

#### **(4) Trends of international audit regulators**

From the perspective of enhancing the international status of Japanese capital markets, the CPAAOB and the FSA support the International Forum of Independent Audit Regulators (IFIAR)<sup>5</sup>, whose permanent secretariat is located in Tokyo.

The IFIAR has long endeavored to ensure and improve audit quality globally through continuous dialogue with the six largest global networks<sup>6</sup> and the publication of the

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<sup>5</sup> The IFIAR is an international organization established in 2006, consisting of independent audit regulators that inspect audit firms. Its permanent secretariat is located in Tokyo. It aims to improve audit quality globally through collaboration among authorities. As of the end of June 2024, the number of IFIAR member countries/regions totaled 56, including Japan.

<sup>6</sup> Out of all global networks of audit firms, Deloitte Touche Tohmatsu, Ernst & Young, KPMG, PricewaterhouseCoopers, BDO, and Grant Thornton account for the six largest global networks.

Survey of Inspection Findings 2023, which compiles findings in inspections by independent audit regulators, including the CPAAOB. At the 2024 IFIAR Plenary Meeting held in Osaka in April 2024, the IFIAR members representing 48 countries and regions gathered, where the outline of the Survey of Inspection Findings 2023 mentioned above is introduced to them. In addition, the members attended a keynote speech and panel discussion on the “Governance of Auditing Firms”, and breakout sessions on the “Governance of Auditing Firms”, “Assurance of Sustainability Reporting”, and “Utilization of Technology in Auditing” to actively discuss and exchange opinions.

## **2. Concept of Basic Plan for Monitoring Audit Firms in PY2024**

### **(1) Focus points of monitoring**

Based on "1. Environment surrounding audit firms" above, the CPAAOB will conduct monitoring<sup>7</sup> of audit firms with a focus on the following points in PY 2024.

#### **a. Operational management systems**

##### **○ Audit firm management's commitment to improving audit quality**

To improve audit quality on an ongoing basis, it is important for top management to exercise leadership and for management to accurately ascertain the level of audit quality across the entire firm to foster an organizational culture emphasizing audit quality and compliance with professional ethics and to develop organized and integrated operational management and quality control systems. Therefore, the CPAAOB will primarily evaluate whether management teams, including top management, recognize this point and reflect the recognition in specific measures.

##### **○ Effectiveness of operational management systems**

In order for an audit firm to properly fulfill its role as a gatekeeper of the capital market and meet society's expectations for accounting audits, it is essential that each audit firm establish appropriate governance suited to its size and characteristics. Therefore, the CPAAOB will primarily evaluate whether operational management systems are developed and implemented under effective governance and well-functioning management to ensure and enhance audit quality. In particular, regarding audit firms that audit listed companies, etc., the CPAAOB will primarily evaluate (i) whether they have an effective management function as an organization from the perspective of securing and sustainably improving their audit quality and (ii) whether they are securing a function to supervise and assess the effectiveness of the management function from a standpoint independent of the firms' management and a function to support the demonstration of the effectiveness through the supervision and assessment.

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<sup>7</sup> Monitoring covers inspections and non-inspection monitoring. Non-inspection monitoring includes the collection of reports and interviews regarding audit firms and information gathering through the exchange of opinions and cooperation with relevant FSA divisions, the JICPA and other business organizations related to auditing, as well as dialogue with audit firms.

b. Quality control systems

○ Effectiveness of quality control systems

The CPAAOB will primarily evaluate not only whether audits by audit firms comply with audit standards in form, but also whether such audits demonstrate professional skepticism to find accounting fraud, and other points regarding whether quality control systems developed by audit firms are effective for ensuring and enhancing audit quality.

○ Inspection of status of development and operation of quality control systems in compliance with the revised Quality Control Standards, etc.

Large audit corporations apply and comply with the revised Quality Control Standards, etc., from audits of financial statements for business years that start on or after July 1, 2023, and other audit firms apply and comply with them from audits of financial statements for business years that start on or after July 1, 2024. Given this, the CPAAOB will primarily inspect the status of development and operation of the quality control system based on the risk approach required by the revised Quality Control Standards, etc.

○ Securement, training and distribution of audit resources

To ensure and enhance audit quality, it is vital for audit firms to secure, train and adequately distribute sufficient audit resources commensurate with the number of companies that they audit, as well as in consideration of audit risks. Given this, the CPAAOB will primarily evaluate the status of the securement, training and distribution of audit resources at audit firms, including the development of the work environment, initiatives to reduce the turnover rate and policies for audit fees.

○ Background to new client acceptance and cancellation

Based on the situation where a considerable number of changes of audit firm for listed companies taking place, the CPAAOB will primarily evaluate the background of audit firms' new client acceptance and cancellation with listed companies (including details about the new client acceptance with large listed companies or listed companies suspected of having high audit risks), the adequacy of risk assessment for the new client acceptance and processes for determining audit fees, the development of audit performance systems and the implementation of takeover procedures.

○ Compliance with the revised Code of Ethics

The revised Code of Ethics started to be applied to auditing for the fiscal years beginning on or after April 1, 2023, except for some provisions. The CPAAOB will, therefore, primarily evaluate the status of compliance with the revised Code of Ethics (provisions regarding the dependence on audit fees, non-assurance services, and the rules on how to secure the objectivity of engagement quality reviewers).

○ Introduction of audit tools leveraging digital technologies (including the implementation of cybersecurity measures)

Considering that progress in the digitalization of audits is expected to enhance



the effectiveness of audit procedures for detecting fraud and realize the effective and efficient distribution of audit resources, the CPAAOB will continue to ascertain audit firms' development and introduction of audit tools leveraging digital technologies. The CPAAOB will also check whether audit firms have taken adequate cybersecurity measures according to the advancement of cyberattacks.

c. Individual audit engagements

○ Implementation of audits in response to fraud risks

Considering the status of the occurrence of inappropriate accounting treatments, the CPAAOB will primarily evaluate how audits in response to fraud risks are implemented (whether auditors take special care and critical approaches to fully demonstrate their professional skepticism in order to identify fraud risk factors, including incentives and pressure to commit fraud, and events and conditions that provide opportunities to commit fraud, and also in order to assess the risks of material misstatement, and whether auditors appropriately develop and implement audit procedures in response to identified and assessed risks).

○ Implementation of audits regarding revenue recognition

Considering the status of deficiencies being found in audits regarding revenue recognition, the CPAAOB will primarily evaluate how audits on revenue recognition are implemented (based on the presumption that revenue recognition poses fraud risks, whether auditors develop and implement audit procedures responding appropriately to identified and assessed fraud risks after appropriately judging the type of revenue, transactions or assertions linked to the generation of fraud risks and other points).

○ Implementation of audits regarding accounting estimates

Considering the status of deficiencies being found in audits regarding accounting estimates, the CPAAOB will primarily evaluate whether audit firms consider the extent of uncertainty about estimates, appropriately identify and assess risks of material misstatement regarding accounting estimates, take note of the rationality of managers' assumptions and implement audit procedures that respond appropriately to the risks.

○ Procedures for making decisions on KAM and descriptions and implementation of audit responses

Considering the status of deficiencies being found in procedures concerning KAM, the CPAAOB will primarily evaluate procedures for making decisions on KAM (whether audit firms proactively communicate with managers and audit committee members of audited companies when making decisions, and whether audit firms prepare audit reports with the same content as those for the previous term (including reports prepared by the predecessors) without conducting special deliberations), descriptions of audit responses (whether procedures conforming to factors described in reasons for decisions on KAM or audit approaches are specifically described), and the implementation status regarding audit responses (whether procedures described as audit responses are properly implemented).

- Implementation of auditing of notes to financial statements, etc.  
 With regard to financial statements (including notes), in light of the purpose of the disclosure system, which is to contribute to investment decisions of users of financial statements, it is strongly required to ensure the accuracy and sufficiency of the information provided. However, there have been cases of deficiencies in inspections, such as misstatements in notes to financial statements being overlooked in the audit process. For this situation, the CPAAOB will primarily evaluate whether appropriate studies are conducted on the accuracy of notes to financial statements, etc., based on an accurate understanding of relevant accounting standards and disclosure laws and regulations.
- Implementation of procedures regarding "other information in documents"  
 Considering the recent moves to enhance the disclosure of non-financial information and to clarify the content of disclosure, the CPAAOB will primarily evaluate the implementation of procedures regarding "other information in documents" (through "reading of other information in documents", "consideration and assessment of other information in documents", etc.).
- d. Others
  - Effectiveness of quality control reviews  
 Accompanying the introduction of a registration system for auditors of listed companies, etc., the importance of quality control reviews is increasing as a means to check the qualification of registered auditors of listed company, etc. Given this fact, the CPAAOB will primarily evaluate the effectiveness of quality control reviews.
  - Practical efforts and responses in connection with the abolition of the quarterly securities report system  
 In relation to the impact on auditing due to the abolition of the quarterly securities report, the CPAAOB will check the review of the financial statements for the first and third quarters (review is optional, or mandatory in certain cases), as well as any practical impacts and concerns associated with the review.
  - Status of initiatives for assurance on non-financial information (including sustainability information)  
 Given that non-financial information assurance needs and hopes with respect to CPAs' engagement with such assurance are growing, the CPAAOB will check the status of initiatives for non-financial information assurance at audit firms.
  - Provision of auditing services for companies preparing for IPOs  
 From the perspective of whether efforts are promoted to pave the way for IPO-seeking companies to undergo appropriate audits according to their growth stages, the CPAAOB will check the status of audit firms' provision of auditing services to companies preparing for IPOs.

## **(2) Monitoring methods**

- Since FY 2020, the CPAAOB has utilized online approaches such as borrowing laptops from audit firms to browse audit working papers and holding interviews

using a web-based video conferencing system, in addition to traditional face-to-face inspections.

- The CPAAOB will continue to conduct inspections using both of the above methods and consider even better methods through dialogue with audit firms.

### **3. Basic Plan for non-inspection monitoring**

#### **(1) Verification of JICPA quality control review reports and cooperation with the JICPA**

- Accompanying the introduction of a registration system for auditors of listed companies, etc., the JICPA has introduced a review of the registration screening, in addition to conventional regular reviews and special reviews, and, as part of the high level of discipline, it has taken measures such as formulating the Guidelines for Checking the Qualification of Audit Firms Auditing Listed Companies, Etc., with a view to conducting quality control reviews from a new perspective.
- As a policy for future quality control reviews, the JICPA will conduct quality control reviews from a new perspective as part of high discipline, and respond to new requirements such as the application of the revised Quality Control Standards and the development of a legal information disclosure system.
- The CPAAOB will hold in-depth discussions with the JICPA to strengthen the system for implementing quality control reviews and will also confirm the status of implementation of quality control reviews mentioned above. Regarding the results of the verification of the effectiveness of quality control reviews, which is cited as one of the focus points of monitoring, the CPAAOB will share relevant information on a timely basis to encourage the JICPA to further enhance the effectiveness of its reviews. Additionally, the CPAAOB and the JICPA will continuously discuss the respective roles of CPAAOB inspections and JICPA quality control reviews and their cooperation based thereon, and the JICPA's enhancement of instruction and supervision of small and medium-sized audit firms.

#### **(2) Collection of reports**

##### **a. Basic concept**

- To encourage all of Japan's audit firms to ensure and enhance audit quality and each audit firm to develop appropriate operational management and quality control systems, the CPAAOB will appropriately ascertain the status of audit firms and risks regarding individual audit engagements in a timely manner. The CPAAOB will also collect reports effectively on the design and implementation of operational management and quality control systems at audit firms (including the implementation of remedial measures). To collect reports efficiently, the CPAAOB will utilize information gained through inspections and dialogue with audit firms, etc., considering the workload on audit firms.
- To efficiently inspect large and mid-tier audit firms, the CPAAOB will regularly collect and analyze quantitative and qualitative information from them on operational management systems.
- From small and medium-sized audit firms, the CPAAOB will collect and

analyze information in a timely manner according to their size and characteristics, considering the results of JICPA audit quality control reviews and audit risks regarding audited listed companies. When encouraging small and medium-sized audit firms to spontaneously ensure and enhance audit quality, the CPAAOB will hold interviews on their reports to secure effects similar to those of inspections.

- The CPAAOB will collect reports from small and medium-sized audit firms to ascertain their responses to issues identified in inspection results after a lapse of a certain period time from the notification of inspection results, and encourage them to spontaneously improve their practices.
- From audit firms that are rated unfavorable with significant deficiencies with respect to operational management systems and are required to improve their practices immediately, the CPAAOB will collect reports when notifying them of inspection results and encourage them to quickly improve their practices.
- In this PY, the CPAAOB will collect reports from foreign audit firms, etc., which are supposed to be collected once every three years, and will ascertain the status of the services of foreign audit firms, etc.

b. Focus points of reports for collection

Based on "1. Environment surrounding audit firms," common focus points of reports for collection are as follows.

- (i) Audit firm management's commitment to enhancing audit quality
- (ii) Effectiveness of operational management systems (for audit firms adopting the Governance Code, a system developed based on it) (including top managers' policies, and revenue and financial structure)
- (iii) Effectiveness of quality control systems
- (iv) Development and operation of quality control systems in compliance with the revised Quality Control Standards, etc.
- (v) Compliance with the revised Code of Ethics
- (vi) Securement, training and distribution of audit resources (including the development of the work environment and initiatives to reduce the turnover rate)
- (vii) Background to new client acceptance and cancellation of audit contracts
- (viii) Introduction of audit tools leveraging digital technologies (including the implementation of cybersecurity measures)
- (ix) Practical efforts and responses in connection with the abolition of the quarterly securities report system
- (x) Status of initiatives for assurance on non-financial information (including sustainability information)
- (xi) Provision of auditing services for companies preparing for IPOs

### **(3) Collection and analysis of information regarding audit firms**

#### **a. Dialogue with audit firms**

- The CPAAOB will continue to conduct periodic dialogue with senior and other managers of large and mid-tier audit firms in order to collect information about the latest operational management systems at the firms, ascertain the problems that audit firms and the audit industry are facing and share problem awareness with them.
- The CPAAOB will also continuously hold dialogue with managers at relatively larger firms among the small and medium-sized audit firms that audit listed companies, as necessary.

#### **b. Cooperation with relevant organizations at home and abroad**

The CPAAOB will enhance the exchange of opinions and cooperation with relevant FSA divisions, the JICPA, financial instruments exchanges and the Japan Audit & Supervisory Board Members Association, as well as the IFIAR, foreign audit regulators and global audit firm networks. The CPAAOB will proactively utilize information gained through the exchange of opinions and cooperation for monitoring and endeavor to collect and analyze various documents and information according to risks at audit firms. In addition, the CPAAOB will continue to assign personnel who can analyze domestic and foreign information, the internationalization of accounting practices, and Japanese audit firm systems and take appropriate actions, and those who can provide guidance for efficient and effective monitoring. The CPAAOB will also promote the fostering of personnel through their proactive participation in international meetings, etc.

## **4. Basic Inspection Plan**

### **(1) Common points**

#### **a. Common focus points**

Based on "1. (3) Quality control challenges at audit firms," common focus points for evaluation in inspections are as follows.

- (i) Audit firm management's commitment to enhancing audit quality
- (ii) Effectiveness of operational management systems
- (iii) Effectiveness of quality control systems
- (iv) Development and operation of quality control systems in compliance with the revised Quality Control Standards, etc.
- (v) Diffusion and adoption of quality control measures (including remedial measures for findings through quality control reviews and CPAAOB inspections) at the audit frontline
- (vi) Securement, training and distribution of audit resources (including the status of implementation of monitoring of audit resources)
- (vii) Compliance with the revised Code of Ethics
- (viii) Background to new client acceptance and cancellation of audit contracts (including the adequacy of risk assessment for concluding new contracts, the development of audit performance systems and the implementation of takeover procedures)

- (ix) Implementation of audits in response to fraud risks
- (x) Implementation of audits regarding revenue recognition
- (xi) Implementation of audits regarding accounting estimates
- (xii) Procedures for making decisions on KAM and descriptions and implementation of audit responses
- (xiii) Implementation of auditing of notes to financial statements, etc.
- (xiv) Implementation of discussions with managers and communications with auditing committee members
- (xv) Implementation of procedures regarding "other information in documents"

b. Inspection methods

Based on the status of the introduction of electronic audit documentation at audit firms and their requests, etc., the CPAAOB will conduct inspections using both online methods (inspections through browsing audit working papers and holding interviews with partners and employees online or via web meeting, etc.) and face-to-face methods.

## **(2) Inspections of large audit firms**

a. Inspection frequency, etc.

- Given that large audit firms fulfill an important role in the capital markets, the CPAAOB in principle inspects them every year (with regular and follow-up inspections being conducted alternately).
- When conducting follow-up inspections, the CPAAOB will give consideration to the workload of audit firms, refrain from evaluating individual audits in principle, and evaluate remedial measures taken to address issues detected in the previous regular inspections. In addition, the CPAAOB may collect reports to confirm remedial measures instead of conducting an inspection.
- If a serious accounting problem at an audited company having a material impact on markets is detected or suspected and the CPAAOB finds it necessary to immediately confirm the status of the quality control systems of the audit firm accountable for audit procedures of such audited company, the CPAAOB will perform inspections expeditiously without being bound by the abovementioned principle.

b. Focus points

Based on the current state of quality control at large audit firms (see "1. (3) Quality control challenges at audit firms"), the CPAAOB will pay particular attention to the following focus points for evaluation in inspections for the current program year.

- (i) Implementation of functions by the management, including the top management, and the quality control department to check the audit frontline (business units, etc.) to ensure and enhance audit quality
- (ii) Monitoring by the quality control department on individual audits
- (iii) Audit procedure deficiencies for cases where inappropriate accounting treatments are found at audited companies, ex-post inspection of root causes of such deficiencies, and implementation of remedial measures

### **(3) Inspections of mid-tier audit firms**

#### **a. Inspection frequency**

- In principle, the CPAAOB will conduct inspections of mid-tier audit firms once every two years. Specifically, the CPAAOB will conduct inspections targeting all mid-tier audit firms during PY 2023 and PY 2024, and from PY 2025 it will conduct inspections for individual audit firms once every two years in principle.
- However, if the CPAAOB finds it necessary to immediately confirm the quality control systems of a mid-tier audit firm accountable for audit procedures for an audited company where a serious accounting problem is detected or suspected, the CPAAOB expeditiously inspects the audit firm.

#### **b. Focus points**

Based on the current state of quality control at mid-tier audit firms (see "1. (3) Quality control challenges at audit firms"), the CPAAOB will pay particular attention to the following focus points for evaluation in inspections for the current program year.

- (i) Initiatives by the management, including the top management, to develop an organizational culture emphasizing audit quality
- (ii) Initiatives to develop an organizational culture emphasizing compliance with laws and professional ethics
- (iii) Cooperation between the quality control departments and the audit frontline (business units, etc.)
- (iv) Monitoring by the quality control department on individual audits
- (v) Management of audit working papers (including the prevention of inappropriate correction and additional preparation, etc., of working papers)

### **(4) Inspections of small and medium-sized audit firms**

#### **a. Inspection frequency**

- As for small and medium-sized audit firms, the CPAAOB considers the need for confirming their quality control systems immediately, based on the JICPA's quality control review results and the extent of risks regarding their operational management systems and the listed companies they audit.
- Considering that they are playing greater roles in auditing listed companies, the CPAAOB will give greater priority to inspections of small and medium-sized audit firms this program year as well.

#### **b. Focus points**

Based on the current state of quality control at small and medium-sized audit firms (see "1. (3) Quality control challenges at audit firms"), the CPAAOB will pay particular attention to the following focus points for evaluation in inspections for the current program year.

- (i) Senior and other managers' recognition of quality control
- (ii) Initiatives to develop an organizational culture emphasizing compliance with laws and professional ethics
- (iii) Development and operation of organized quality control systems covering local offices
- (iv) Partners' and employees' recognition of professional ethics, independence

- and compliance with laws
- (v) Management of audit working papers (including the prevention of inappropriate correction and additional preparation, etc., of working papers)

## 5. Provision of monitoring information

To ensure and enhance audit quality, it is important to adequately convey the results of inspections to audit firms and the audit committee members of audited companies and disseminate information on the monitoring results to the public so as to spur interest in and awareness of audits. From that viewpoint, the CPAAOB gives consideration to the following points on the occasion of monitoring information provision.

a. Conveyance of inspection results to audit committee members

The CPAAOB continues to endeavor to enhance descriptions of inspection results so as to accurately convey inspection findings to audit firms and their quality control levels, inspection findings on operational management systems and other findings to audit committee members at audited companies. The CPAAOB also confirms whether audit firms appropriately convey the results of inspections to audit committee members at audited companies.

b. Monitoring Report

To contribute to furthering market participants' understanding of audits, the CPAAOB has published the annual Monitoring Report<sup>8</sup>, compiling monitoring results and insights, since 2016. The CPAAOB will strive to further enhance its content and dissemination with the needs of readers in mind. The CPAAOB will also endeavor to disseminate the Monitoring Report to foreign readers by translating it into English.

c. Case Report from Audit Firm Inspection Results

In order to encourage audit firms to ensure and enhance audit quality, the CPAAOB has published the annual Case Report from Audit Firm Inspection Results<sup>9</sup>, compiling specific cases identified through inspections, since 2008. The CPAAOB will continue to enhance the report by replacing cases with new ones to make the report a useful reference for audit firms' improvement initiatives. The CPAAOB will also continue to hold lectures and briefings on the Case Report at each branch of the JICPA nationwide, proactively disseminate the report to market participants and translate it into English to provide relevant information to foreign readers.

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<sup>8</sup> In the 2024 Monitoring Report (<https://www.fsa.go.jp/cpaob/english/oversight/20241128/20241128.html>), more detailed information is provided regarding "1. (1) Audit trends" and "1. (2) Initiatives to ensure and enhance audit quality" in this Basic Plan. Please refer to them.

<sup>9</sup> In the Case Report from Audit Firm Inspection Results (PY2024) (<https://www.fsa.go.jp/cpaob/english/oversight/20241128-3/20241128-3.html>), more detailed information is provided regarding "1. (3) Quality control challenges at audit firms" in this Basic Plan. Please refer to them.