Annual Report

June 2017

Certified Public Accountants and Auditing Oversight Board

About this Annual Report

Pursuant to Article 16 of the Certified Public Accountants and Auditing Oversight Board (CPAAOB) Rules of Operation as below, which is stipulated on the basis of Article 2 of the CPAAOB Cabinet Order, this Annual Report publishes the activities of the CPAAOB for FY2016 (from April 1, 2016, to March 31, 2017).

To better meet the needs of readers, the Report also includes information on activities taken before and after FY2016.

Note that FY2016 and "this fiscal year" refer to the period from April 1, 2016 to March 31, 2017, while PY2016 and "this program year" refer to the period from July 1, 2016 to June 30, 2017.

○ CPAAOB Rules of Operation
Article 16 The CPAAOB shall, after the end of each fiscal year, publish its activities for that year, such as measures taken and the number of inspections conducted.

<<If you have any comments, etc., please contact the following address>>
Person in charge, Office of Coordination and Examination, Executive Bureau of the CPAAOB
Telephone: 03-3506-6000 (Ext. 2440)

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1 Overview of the CPAAOB

1.1 *Certified Public Accounts and Auditing Oversight Board (CPAAOB)*

The CPAAOB, government organization which has a council system, was established by the Financial Services Agency (FSA) in April 2004, based on Article 35, Paragraph 1 of the Certified Public Accountants Act (CPA Act) and on Article 6 of the Act for Establishment of the FSA.

The CPAAOB is comprised of the Chairperson and up to 9 Commissioners with understanding and knowledge of matters concerning CPAs who are appointed by the Prime Minister after the approval of both Diet houses. Most of the Commissioners serve part-time, but one of them can serve full-time. They are appointed for a term of three years (Articles 36, 37-2 and 37-3 of the CPA Act).

The Chairperson and Commissioners exercise authority independently. They shall not be dismissed against their will except for the reasons stipulated by the laws during their appointed terms (Articles 35-2 and 37-4 of the CPA Act).

The CPAAOB, comprising 10 members (newly-appointed Chairperson Toshiro Hiromoto, newly-appointed full-time Commissioner Takayuki Matsui, and eight part-time Commissioners, including three who have been newly appointed), has been launched for its fifth term (from April 2016 to March 2019) (See Annex 1, page 34).

The key responsibilities of the CPAAOB are as follows:
- Examination and inspection of audit firms
- Implementation of CPA Examinations
- Deliberation of disciplinary actions against CPAs and audit firms

1.2 *Executive Bureau*

The CPAAOB has an Executive Bureau to handle its administrative duties (Article 41, Paragraph 1 of the CPA Act).

The Executive Bureau is comprised of the Office of Coordination and Examination and the Office of Monitoring and Inspection, led by the Secretary-General of the Executive Bureau. The Office of Coordination and Examination is in charge of implementing the CPA examinations, investigating and deliberating on disciplinary actions against CPAs, etc.

., and coordinating general issues of the Executive Bureau.

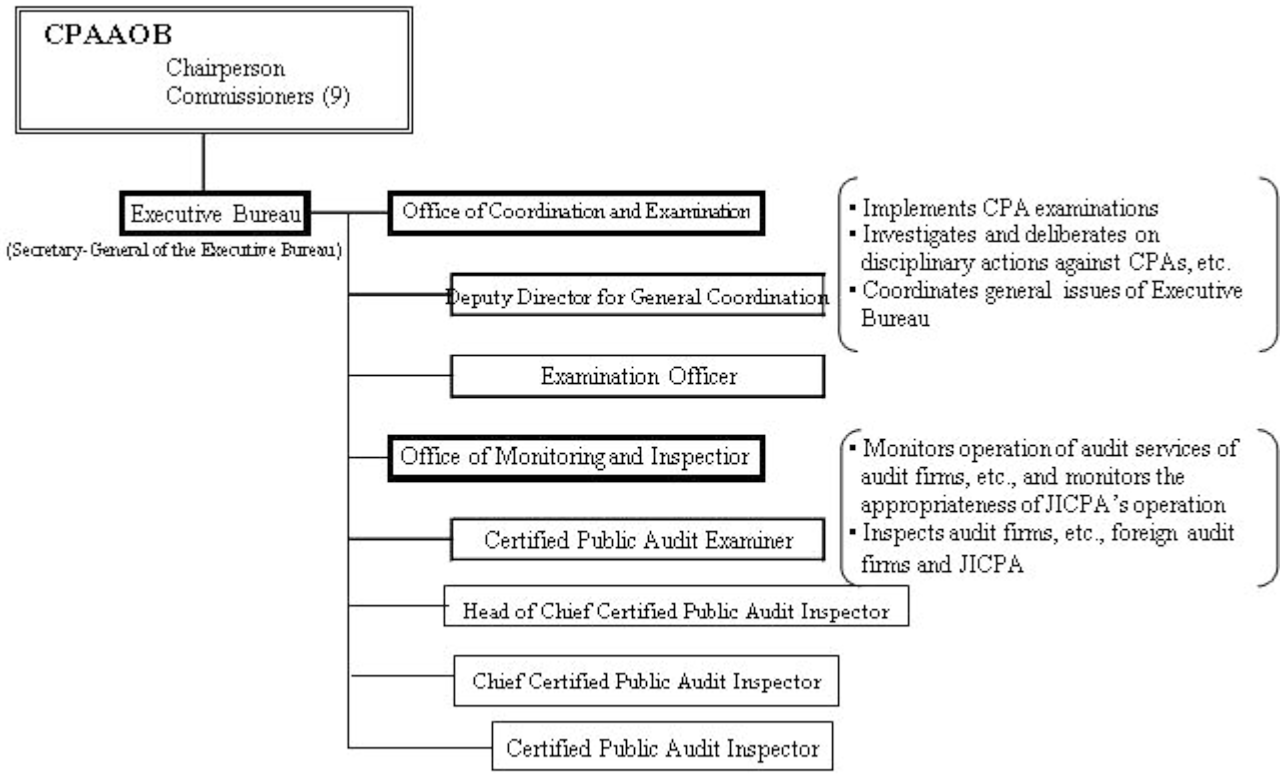
The Office of Monitoring and Inspection is in charge of monitoring the operation of audit services provided by audit firms, etc., monitoring the appropriateness of the operation of the Japanese Institute of Certified Public Accountants ("JICPA"), and inspecting audit firms, etc., foreign audit firms and JICPA.

The Executive Bureau had 40 staff members when it was launched in April 2004. Its staff was steadily increased thereafter, to 14 in the Office of Coordination and Examination, and 42 in the Office of Monitoring and Inspection: for a total of 56 staff members on March 31, 2017.

Staffing of the Executive Bureau (Fiscal year-end basis)

FY	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016
Office of Coordination and Examination	11	12	12	12	12	14	14	14	14	14	14	14	14
Office of Monitoring and Inspection	29	29	31	35	39	41	44	43	42	42	42	42	42
Head of Chief Inspector	-	-	-	-	-	-	-	-	-	-	-	-	1
Chief Inspectors	4	4	4	4	5	5	7	7	7	7	7	7	6
Inspectors	18	18	20	24	26	28	28	27	26	26	26	26	26

Organization Chart of the CPAAOB



(Note) Figures in parentheses denote the number of personnel at the end of FY2016.

2 Oversight and Inspection of Audit Firms

2.1 *Outline*

Previously, JICPA's quality control reviews (see Note) of audit firms had been self-regulated. However, from the perspective of ensuring the fairness and transparency of capital markets and establishing a market capable of gaining the trust of investors, and as a measure for enhancing and strengthening the monitoring and oversight functions over audit firms, the June 2003 revision of the CPA Act resulted in quality control reviews becoming statutory. Under the revision, the CPAAOB receives reports on the results of these reviews from JICPA, examines them, and if the CPAAOB deems it necessary, requests additional information and conducts inspections.

Furthermore, for the purpose of ensuring the soundness of Japan's financial and capital markets, as a result of the June 2007 revision of the CPA Act, foreign audit firms that conduct audits of foreign companies subject to the disclosure regulations under the Financial Instruments and Exchange Act became subject to the inspections and supervision of Japan's authorities, and the CPAAOB was given the mandate to collect the relevant information and conduct on-site inspections.

Specifically, the authority related to the following matters has been delegated from the Commissioner of the FSA to the CPAAOB (Article 49-4, Paragraphs 2 and 3 of the CPA Act):

- Business pertaining to the receipt of reports on the results of reviews by JICPA on the operation of members' services (audit and attestation services) set forth in Article 2, Paragraph 1 of the CPA Act (Article 46-9-2, Paragraph 2 of the CPA Act)
- Collection of reports and inspections on JICPA, CPAs and audit firms, which are conducted in relation to the above mentioned reports (Article 46-12, Paragraph 1 and Article 49-3, Paragraphs 1 and 2 of the CPA Act)
- Collection of reports and inspections on foreign audit firms, etc. (Article 49-3-2, Paragraphs 1 and 2 of the CPA Act)

As a result, the CPAAOB is required to examine quality control review reports, and, if the CPAAOB considers it necessary and appropriate in light of public interest or investor protection, to collect the relevant information and conduct inspections.

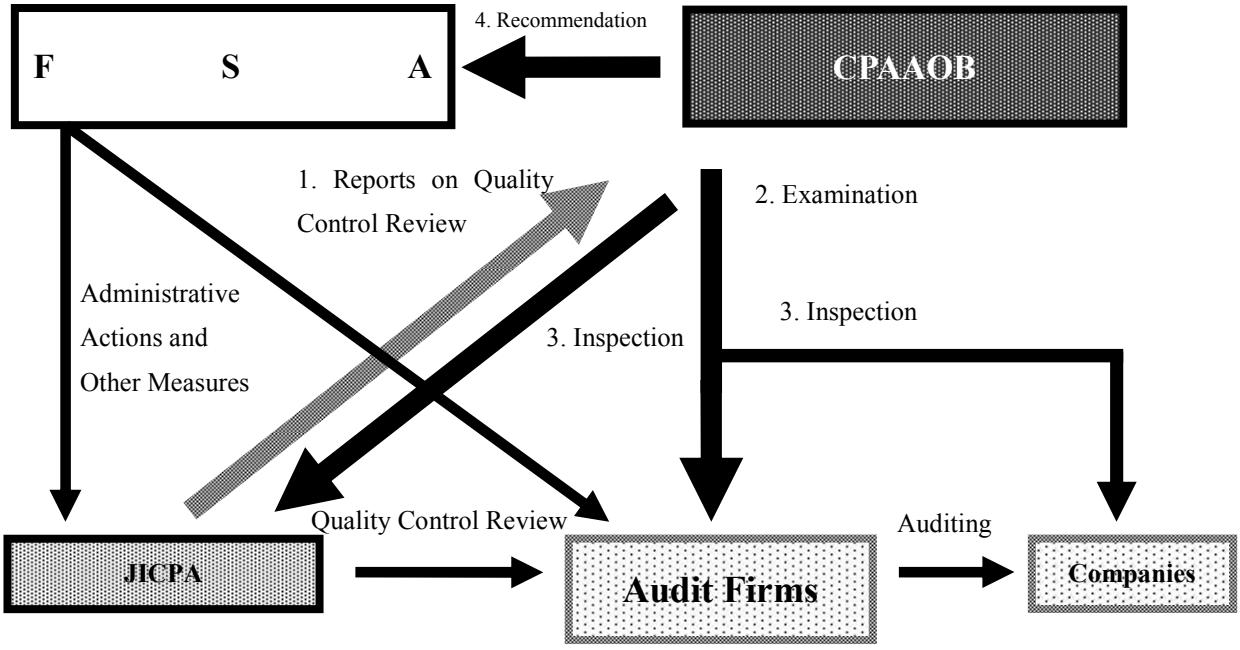
Furthermore, based on the results of examination or inspection, if the CPAAOB considers it necessary, it shall make a recommendation to the Commissioner of the FSA

for administrative actions or other measures (Article 41-2 of the CPA Act).

(Note) Quality control reviews
Quality control reviews are performed by JICPA to assess the status of audit quality control. According to the CPA Act, "JICPA shall review the status of the operation of services by members set forth in Article 2(1) of the Act" (Article 46-9-2(1) of the CPA Act).

Specifically, with the aim of maintaining and improving an appropriate quality level of audit service as well as maintaining and enhancing social confidence in auditing, JICPA reviews the status of the quality control of audits performed by audit firms and CPA offices (audit firms), makes recommendations for improvement as necessary, and receives reports on the status of improvement with regard to those recommendations.

Outline of Oversight and Inspections



1. Reports on quality control review

Once every three years in principle (or once every two years, if JICPA finds it necessary), JICPA reviews and assesses an audit firm's compliance with laws, regulations, audit standards, JICPA's rules, and other related regulations. The CPAAOB obtains reports on the results of those reviews.

2. Examination

The CPAAOB examines JICPA's reports and ascertains: (i) whether the quality control review system is being appropriately operated by JICPA, and (ii) whether audit services are being appropriately provided by audit firms. The CPAAOB may request the submission of reports or other materials from JICPA or audit firms, if in the course of its examination, the CPAAOB finds it necessary to do so.

3. Inspection

If the CPAAOB considers it necessary and appropriate in light of public interest or investor protection, it conducts inspections of audit firms (including entities which are audited by audit firms).

Furthermore, if the CPAAOB considers it necessary to do so from the viewpoint of securing the appropriate operation of JICPA, it conducts inspections of JICPA.

4. Recommendation

Based on the results of examination or inspection, the CPAAOB may make a recommendation to the Commissioner of the FSA for administrative actions or any other measures for securing fair

operation of audit services by audit firms or that of administrative operations of JICPA, when the CPAAOB considers it necessary.

Note: Regarding the collection of reports from and inspections on foreign audit firms, etc., refer to item (ii), Section 2.3.7 “A framework for information requirements and Inspections on foreign audit firms, etc.” (see page 19).

2.2 *Basic Policy for Monitoring Audit Firms*

2.2.1 *Basic Policy for Monitoring Audit Firms (Basic Policy for Examination and Inspection)*

From the viewpoints of further improving the audit quality and improving the effectiveness of audits conducted by audit firms through examinations and inspections, the CPAAOB formulated and, published on May 13, 2016, the "Basic Policy for Monitoring of Audit Firms (Basic Policy for Examination and Inspection) – To Ensure More Effective Auditing –" for the fifth term (April 2016 to March 2019), based on the results of examinations and inspections during the first through the fourth terms (April 2004 to March 2016).

<Outline of the basic policies>

(i) Perspectives

The CPAAOB shall conduct effective and efficient monitoring (see Note) in light of the situation at audit firms, and work actively to ensure the credibility of audits by maintaining and enhancing audit quality.

In addition, the CPAAOB shall proactively provide useful information about industry-wide issues that resulted from analyzing information obtained from monitoring to JICPA, the FSA, etc. as well as endeavor to expand the range of information it publicly disseminates.

(Note) Monitoring includes both on-site monitoring, i.e. inspections, and off-site monitoring, which refers to activities other than inspections. These include obtaining information through the collection of reports, the exchange of opinions, etc.

(ii) Goals

The basic goal shall be to ensure proper operation of audit firms. In particular, given the fact that audit firms are primarily responsible for maintaining and enhancing audit quality, the CPAAOB shall conduct monitoring that is effective in encouraging audit firms to take action voluntarily.

The CPAAOB shall also focus not only on whether audit firms formally conform to audit standards, but also on whether they substantively serve to maintain and enhance audit quality. For example, it is important for them to have an appropriate level of professional skepticism designed to find out accounting fraud and so on.

(iii) Basic policy for off-site monitoring

The CPAAOB receives reports on the results of quality control reviews, which are conducted by JICPA, and with regard to these reports, collects reports from and conducts interviews with audit firms, etc. when this is deemed necessary, and endeavors to make the collection and analysis of information more effective and sophisticated by exchanging opinions and cooperating with affiliates .

Furthermore, with the aim of accurately determining the circumstances and risks relating to audit firms and individual audit engagements, the CPAAOB utilizes the information it has obtained to conduct effective off-site monitoring that reflects the circumstances of audit firms. For example, it verifies the quality control reviews performed by JICPA and collects information.

(iv) Basic policy on inspections

In addition to conducting effective and efficient inspections that reflect the risks and circumstances of audit firms, the CPAAOB endeavors to enhance the effectiveness of inspections by, for example, improving inspection methods. The CPAAOB also strives to integrate inspections with off-site monitoring, and works to maintain and enhance audit quality at audit firms.

Given the role they play in the capital markets, the CPAAOB conducts periodic inspections of Large audit firms (see Note 1) and Second-tier audit firms (see Note 2) based on reports of the results of quality control reviews.

The CPAAOB also conducts inspections of small and medium-sized audit firms (see Note 3) based on the results of quality control reviews as necessary.

(Note 1) Large audit firm is an audit corporation with 100 or more listed companies as audit clients and 1,000 or more full-time auditors.
Large audit firms audit 72.7% of listed companies (as of April 30, 2016).

(Note 2) Second-tier audit firm is an audit corporation that while not meeting the criteria for a Large audit firm nevertheless has a relatively large number of listed companies as audit clients.
Second-tier audit firms audit 11.8% of listed companies (as of April 30, 2016).

(Note 3) A small and medium-sized audit firm is an audit firm other than a Large or Second-tier audit firm.
Small and medium-sized audit firms audit 15.6% of listed companies (as of April 30, 2016).

(v) Policy on the provision of monitoring information

The basic policy is to contribute to maintaining and enhancing audit quality not only by informing audit firms and audited entities of audit quality control issues

related to audit firms, but also by providing investors, etc. and other members of the general public with information on the outcomes of monitoring, including inspection results, in the form of reports, etc.

2.2.2 *Basic Plan for Monitoring Audit Firms*

Based on the Basic Policy for Monitoring Audit Firms, the CPAAOB formulates the Basic Plan for Monitoring Audit Firms, to provide a direction for monitoring in each program year.

The PY2016 Basic Plan for Monitoring Audit Firms was formulated based on the circumstances described below and announced on July 14, 2016. Note that from 2016 the monitoring period has been changed to the program year (AY, July through June of the following year).

- Recent incidents of accounting fraud have led to questions being raised once again about the credibility of accounting audits, and "Advisory Council on the Systems of Accounting and Auditing" has issued recommendations for ensuring confidence in accounting audits (announced by the FSA on March 8, 2016). As a result, appropriate action needs to be taken to prevent accounting fraud.
- Furthermore, with the aim of further enhancing the effectiveness of inspections in view of the risks involving audit firms, the CPAAOB, for its part, reviewed the nature, methods, etc. of inspections performed until now, and announced a package of measures under the title "Improvement of Effectiveness of the CPAAOB's inspection" (announced on March 24, 2016, hereinafter referred to as the "Effectiveness Improvement Measures").

<Outline of the Basic Plan>

(i) Basic Plan Pertaining to Off-site Monitoring

(a) Verification of quality control reviews by the CPAAOB

The CPAAOB shall comprehensively verify the policies, measures, etc. adopted by JICPA as a self-regulatory organization to enhance audit quality, with a particular focus on the effectiveness of quality control reviews and other aspects of the system for quality control reviews.

The CPAAOB shall also endeavor to cooperate in an effective way with JICPA, such as by continuing to exchange opinions concerning quality control reviews. Furthermore, CPAAOB shall engage in discussions with JICPA the appropriate division of roles between the CPAAOB and JICPA,

taking into account measures to enhance the effectiveness of JICPA's quality control reviews.

(b) Collection of reports

- Continuous collection of reports from Large audit firms

  The continuous collection of reports containing qualitative and quantitative information that is required for the verification of the management system, including governance, business operation system, etc. is required, and the information obtained in this way is analyzed and then used to help to make subsequent inspections more effective and efficient. It is also used for comparative analysis with other Large audit firms, for identifying issues that affect the entire audit sector, and so on.

- Collection of reports from Second-tier and small and medium-sized audit firms not subject to on-site inspections

  Reports concerning engagements at audit firms are collected in a timely manner in order to encourage audit firms to ensure appropriate control of audit quality.

  In addition to verifying the design of quality control systems at audit firms where there are wide-ranging deficiencies of quality control, the CPAAOB shall also focus on investigating cross-sectoral issues that are frequently seen at small and medium-sized audit firms, while taking into account the characteristics of each audit firm.

- Collection of reports on status of improvement after conducting inspections (follow-up)

  The CPAAOB shall, as necessary, require reports to be submitted after a certain period of time has elapsed since the notice of inspection results. It shall also conduct interviews in a timely manner to confirm and verify the situation of quality control.

(ii) Basic Plan for On-site Inspections

Important matters are: (1) verification of whether audit firms' management policies and business management-related measures, etc. are appropriate in light of their size, characteristics, etc.; and (2) verification, etc. of whether audit firms conduct audits by properly assessing the business risks of audited entities. The Plan also focuses on encouraging audit firms to independently take action to make effective improvements based on the analysis of root causes, and inspections, which take into account the characteristics of the audit firm

concerned, are performed as follows:

(a) Large audit firms

Periodic inspections are conducted based on the results of examinations of the results of quality control reviews received from JICPA, in the light of factors such as the role of Large audit firms in capital markets and domestic and international trends concerning audit and supervision. However, inspections can also be performed in a timely manner when confirmation is required swiftly, such as when a serious accounting issue with an audited entity that will have a significant impact on the market is identified.

During this program year, the CPAAOB's inspections will focus on verifying management systems, business operation systems, and the extent of quality control over the frontline of the organization; verifying audit procedures concerning revenue recognition and accounting estimates; verifying systems, independence, audit procedures, etc. pertaining to IPO-related audits, and so on.

Furthermore, with the aim of strengthening follow-up after inspections, if a serious deficiency is identified during a normal, regular inspection, a follow-up inspection will be performed the following program year to verify that the issue has been addressed.

(b) Second-tier audit firms

The CPAAOB will focus on inspecting selected Second-tier audit firms, taking into account the entities they audit, the practices they conduct, their importance within the Japanese audit sector, and so on. Inspections that can be conducted effectively and efficiently and that are focused on common risks will be performed on a regular basis. However, inspections can, as necessary, be performed in a timely manner, same as Large audit firms.

During this program year, taking into account the risks inherent in individual audit engagements, essential issues in management of firms will be targeted for investigation, and emphasis will be placed on reviewing management systems, business operation systems, etc.

(c) Small and medium-sized audit firms

The CPAAOB will conduct inspections of small and medium-sized audit firms as necessary. The focus will be on confirming audit quality by verifying quality control system and business operation systems, taking into account the policies and competence of representatives and partners, and on compliance with Auditing Standards, etc. for individual audit engagements.

During this program year, inspections will emphasize the investigation of business operation and quality control issues stemming from the structure of the audit firm concerned as well as the verification of audit resources, including whether personnel have adequate and appropriate experience and abilities to cope with audit risks such as the internationalization of audited entities.

2.3 *Examination and Inspections of Audit Firms*

Audit firms, using the name "certified public accountant", may audit or attest financial documents for fees at the request of others (Article 2(1) of the CPA Act) and compile financial documents, examine or plan financial matters, or provide consulting services on financial matters for fees at the request of others (Article 2(2) of the CPA Act). As of the end of FY2016, the number of registered certified public accountants totals 29,367, and the number of audit firms totals 222.

Of the above, the number of CPAs belonging to Large audit firms is 11,002 or approximately 40% of the total (as of the end of March 2017).

(Reference)

	End of 2012	End of 2013	End of 2014	End of 2015	End of 2016
Number of registered certified public accountants	24,964	26,260	27,313	28,286	29,367
Large audit firms	9,313	10,074	10,312	10,846	11,002
Number of audit firms	214	216	219	214	222

2.3.1 *Quality Control Reviews by the Japanese Institute of Certified Public Accountants (JICPA)*

(i) FY2015

In FY2015, JICPA performed 83 quality control reviews of audit firms (57 audit firms (including 2 Large and 2 Second-tier audit firms; 6 joint CPA offices), and 26 CPAs). The conclusions are presented in the following table

Conclusions based on the Results of Reviews (FY2015) (Number of audit firms)

Category	Unqualified conclusion		Qualified conclusion		No conclusion is expressed		Negative conclusion		Total
	(a)	a/e	(b)	b/e	(c)	c/e	(d)	d/e	(e)
Audit firm	42	73.7%	13	22.8%	–	–	2	3.5%	57
CPA	21	80.8%	5	19.2%	–	–	–	–	26
Total	63	75.9%	18	21.7%	–	–	2	2.4%	83

(Note) 80 out of 83 cases include recommendations for improvement.

(ii) FY2016

In FY2016, JICPA performed 101 quality control reviews of audit firms (71 audit firms (including 2 Large and 3 Second-tier audit firms; 1 joint CPA office), and 30 CPAs). As the table below shows, all had been performed by February 28, 2017.

Status of Implementation of Quality Control Reviews

Date of quality control review	2016						2017			
	Jul.	Aug.	Sep.	Oct.	Nov.	Dec.	Jan.	Feb.	Mar.	Total
Number of audit firms reviewed for quality control	7	22	5	24	20	13	7	3	0	101

50 cases had been reported to the CPAAOB as of March 31, 2017. The conclusions of those reports were as follows.

- Unqualified conclusion: 45 cases (27 audit firms, 18 CPAs)
- Qualified conclusion: 5 cases (2 audit firms, 3 CPAs)

2.3.2 *Examination of Quality Control Reviews*

(i) Scope and perspectives for examination

PY2016 (includes results for April-June 2016 due to the change from fiscal year to program year) includes the quality control reviews conducted by JICPA in FY2015 (83 cases) and FY2016 (101 cases) were examined.

(ii) Outline of examination

The CPAAOB analyzes the particulars of deficiencies in quality control reviews and reports on the conditions of audit firms subject to review, and

conducts examinations from the following perspectives:

- Appropriateness of JICPA's quality control reviews
- Status of the development and operation of quality control systems established for ensuring the quality of audit services in audit firms in a reasonable manner
- Compliance of the quality control systems established in audit firms for individual audit services

The examinations take into account the number and nature of deficiencies at audit firms, such as matters subject to qualified items or large numbers of deficiencies, and the CPAAOB decides whether to perform inspections based on them. They also involve:

- collection of reports (see 2.3.3 below) and confirmation of the audit firm's quality control system and
- through inspections, verification of the appropriateness of deficiencies identified in the quality control reviews.

Information obtained as a result of cooperation with related departments inside the Financial Services Agency and related organizations, etc. such as JICPA, securities exchanges, the Japan Audit & Supervisory Board Members Association, etc. (see "2.4 Cooperation with Relevant Organizations," p.21), is also used during examinations.

2.3.3. *Collection of Reports, from Audit Firms*

(i) Ongoing collection of reports from Large audit firms

In PY2016 the CPAAOB collected reports from four big audit firms for the purpose of verifying their governance and other aspects of their management, their business operation, and so on. In addition to analyzing information obtained through these reports and employing the findings to ensure that inspections would be effective and efficient, the CPAAOB also used them to obtain overall understanding with regard to quality control at Large audit firms. The CPAAOB plans to continue collecting reports annually in the future.

(ii) Collection of reports from Second-tier Large audit firms and small and medium-sized audit firms not subject to on-site inspections

Based on the PY2016 Basic Plan for Monitoring Audit Firms, in August 2016 the CPAAOB collected reports from 83 audit firms in order to verify

improvements made by Second-tier audit firms and small and medium-sized audit firms in response to quality control reviews and determine the situation with regard to management systems, etc. at such firms.

History of Collection of Reports

	Record of Report Collection in PY2016			Record of Report Collection in PY2015		
	No. of firms undergoing report collection (a)	No. of firms undergoing QC reviews in FY2015 (b)	Report collection ratio a/b	No. of firms undergoing report collection (c)	No. of firms undergoing QC reviews in FY2014 (d)	Report collection ratio c/d
Audit firms	83	83	100%	58	89	65.2%
Audit firms	51	51	100%	40	65	61.5%
Individual firms (Note)	32	32	100%	18	24	75.0%

(Note) Including CPA joint office

(iii) Collection of reports on status of improvement after conducting inspections (follow-up)

In PY2016 the CPAAOB collected reports from five audit firms (including one that had also submitted a report in FY2015) that had been informed of the results of inspections in order to confirm the status of improvements made in response to deficiencies identified during inspections.

2.3.4 *Inspections of Audit Firms*

In PY2016 the CPAAOB conducted ordinary inspections (2 firms) and follow-up inspections (2 firms) of Large audit firms. It also conducted inspections of two Second-tier audit firms. Furthermore, four small and medium-sized audit firms were inspected in response to deficiencies identified in their quality control reviews.

During these inspections, the CPAAOB carried out investigations aimed at encouraging the audit firms to make effective improvements based not only on the direct causes of deficiencies but also on the analysis of the root causes of the deficiencies concerned.

Status of commencement of inspections in most recent five years (as of March 31, 2017)

FY/PY	24	25	26	27	28
Number of inspections	11	13	15	9	10

Note: From July 2016 periods have been changed to program years (July through the following June). Because PY2016 was the year in which this change was made, the data for it includes inspections commenced in April-June 2016.

2.3.5 *Recommendations to the Commissioner of the Financial Services Agency (FSA)*

As a result of inspection, the CPAAOB found that the following audit firm performed audit services in a grossly inappropriate manner. Pursuant to the provisions of Article 41-2 of the CPA Act, the CPAAOB recommended that the Commissioner of the FSA take administrative actions and other measures against it:

- Yotsuba Audit Corporation (November 9, 2016)

2.3.6 *Dissemination of Information*

(i) Preparation and publication of "Case Report from Audit Firm Inspection Results"

From the viewpoint of maintaining and enhancing audit quality of audit firms, the CPAAOB annually reviews and revises the Case Report, which was published in February 2008.

The CPAAOB published a revised version of the Case Report in July 2016 (see Annex 2, page 36). The key changes made are as follows:

- "I. Root Cause Analysis" and "II. Quality Control System"
  Because audit firms' management and operation, particularly quality control systems, vary depending on the size of the firms, cases of inspection results tend to be categorized by the size of the firms. Therefore, cases at Large audit firms and small and medium-sized audit firms are separately described.

- "III. Individual Audit Engagements"
  To enhance understanding of the importance of deficiencies in audit procedures, the Case Report presents as much information as possible about the backgrounds to the cases. This information includes the operating environment surrounding the audited entity and the circumstances of the audit. Criteria for selecting cases have also been revised from the standpoint

of contributing to improvements in audit quality.

The 2016 Case Report also includes “Recent Trends in Audit Firms (FY2016 Monitoring Report)” for reference purposes.

An English version was also published in December 2016.

(ii) Production/publication of “Outline of Audit Firms (FY2016 Monitoring Report)”

With the aim of deepening understanding of auditing among investors, etc., in July 2016 the CPAAOB produced and published “Recent Trends in Audit Firms (FY2016 Monitoring Report)” after compiling information on the circumstances of audit firms and monitoring by the CPAAOB.

Going forward, the CPAAOB plans to review the contents of the report each year, expanding its contents to include as much information about the CPAAOB’s monitoring activities as possible. Furthermore, while the 2016 edition has been issued as a supplement to the Case Report, from the 2017 edition onwards it will be published separately from the Case Report.

(iii) Lectures, etc. on inspection results (Case Report)

The CPAAOB chairman and inspectors give lectures, etc. at workshops organized by JICPA or other relevant organizations to lecture on inspection results (Case Report) in order to contribute to making the performance of audit procedures more appropriate.

In PY2016, the CPAAOB delivered eight lectures for certified public accountants at seven workshops held at JICPA regional chapters across Japan from October to December 2016, to promote voluntary activities aimed at securing and improving audit quality. The CPAAOB also delivered two lectures for audit & supervisory board members at the Japan Audit & Supervisory Board Members Association (JASBA) in December 2016 so that the Case Report may be widely used to understand the conditions regarding external audits.

In addition, the CPAAOB gave wide publicity to the inspection results, such as by printing the Case Report in the bulletins and other publications of relevant organizations such as JICPA and JASBA, so that audit firms, etc., can actively use them for reference purposes.

(iv) Lectures on activities, etc. of the CPAAOB

In addition to producing a pamphlet describing its work, the CPAAOB delivers lectures for market players, including audit & supervisory board members of listed companies and internal audit departments, etc., to introduce its activities and future challenges.

In PY2016, the CPAAOB delivered lectures at the JASBA, the Institute of Internal Auditors-Japan (IIAJ), the Securities Analysts Association of Japan (SAAJ), and the Capital Markets Research Institute (CaMRI) to introduce various issues, etc. identified during its inspections of audit firms.

2.3.7 *Inspections and Oversight on Foreign Audit Firms*

(i) Notifications of foreign audit firms

When providing services deemed to correspond to audit attestation services for financial statements submitted by foreign companies, etc. under the Financial Instruments and Exchange Act, foreign audit firms, etc., shall notify the Commissioner of the Financial Services Agency in advance. (As of March 31, 2017, 88 audit firms, etc. from 31 countries)

Number of notifications of foreign audit firms, etc. (as of March 31, 2017)

	Number of countries/regions	Number of audit firms, etc.
North America	3	15
Central & South America	2	2
Europe	15	43
Asia & Pacific	10	27
Middle East	1	1
Total	31	88

(ii) A framework for information requirements and inspections on foreign audit firms, etc.

In relation to the treatment of foreign audit firms, etc., the CPAAOB and the FSA prepared and published “A Framework for Inspection/Supervision of Foreign Audit Firms, etc.” in September 2009, based on the “FY2009 Basic Plan for Examinations and Inspections”.

In view of "A Framework for Inspection/Supervision of Foreign Audit Firms, etc.", the CPAAOB also published the "Basic Guidelines on Information Requirements and Inspection on Foreign Audit Firms, etc. by the CPAAOB" in January 2010. The Guidelines establish basic procedures and points to be considered regarding inspections and information gathering from foreign audit firms, etc.

Under the above Framework and Guidelines, the CPAAOB will collect reports from foreign audit firms, etc. that have submitted notifications to the FSA. It will do this once every three years, in principle. It will then analyze and assess the content of the materials submitted, and if it deems it necessary to conduct an inspection to confirm, for example, that operations regarded as equivalent to audit attestation services are being performed appropriately, it will conduct an inspection of the foreign audit firm, etc. concerned.

However, with respect to information requirements and inspections regarding foreign audit firms, etc., the CPAAOB will rely on such actions by the competent authorities of the firms' home jurisdictions ("foreign competent authorities"), instead of seeking to obtain information from or conducting inspections on firms themselves provided (a) audit and public oversight systems in the firms' home jurisdictions are equivalent to those of Japan, (b) necessary information can be provided from the foreign competent authorities through appropriate arrangements of information exchange, and (c) reciprocity is ensured in the Framework and Guidelines.

(iii) Information requests to foreign audit firms

In accordance with the Framework and Guidelines described in (ii) above, in FY2015 the CPAAOB collected reports from 72 foreign audit firms from 27 countries.

In PY2016, the CPAAOB analyzed and assessed the content of the responses and materials submitted through the information collection process described above, and as a result, decided to conduct an inspection of one foreign audit firm.

Furthermore, when consistency with the information notified to the FSA pursuant to the CPA Act was confirmed, some foreign audit firms, etc. were found to have not submitted appropriate notifications (concerning changes to or closure). The CPAAOB therefore instructed these firms to submit the required

notifications.

(iv) Inspections of foreign audit firms, etc.

With regard to the foreign audit firm mentioned in (iii) above, the CPAAOB, in order to make solid preparations for the inspection of the firm, has requested the cooperation of the competent authorities in the country in which the firm is located and is gathering information from them ahead of the inspection.

2.4 *Cooperation with Relevant Organizations*

To maintain and improve the quality of audits, it is important not only to secure the effectiveness of audits conducted by audit firms but also to share information on common audit-related challenges and take the same stance on issues by further enhancing cooperation with audit firms and relevant organizations of companies subject to audit (individual companies, etc.)

For this purpose, the CPAAOB exchanges opinions not only with the relevant FSA divisions but also with other relevant organizations, including the JICPA and stock exchanges.

2.4.1 *Cooperation with Relevant Divisions of the Financial Services Agency*

Since it is expected that cooperation with relevant FSA divisions (Planning and Coordination Bureau, the Securities and Exchange Surveillance Commission, etc.) which investigate or inspect companies subject to audit will enable more effective and efficient inspection, etc. of audit-related issues, etc. in individual audit engagements, the CPAAOB positively enhanced cooperation with the relevant FSA divisions, including information sharing and exchange of opinions. Furthermore, the CPAAOB shared information with local finance bureaus concerning issues, etc. with recent audits.

2.4.2 *Cooperation with the JICPA*

The CPAAOB conducts examination and inspections to facilitate further improvements in the effectiveness of JICPA's quality control reviews from the public interest standpoint, and ensure that audit firms perform audit services in a proper manner. It is expected that, as the organ responsible for conducting quality control reviews, JICPA further improves the effectiveness of its reviews through enhancement of the review implementation structures to ensure that audit firms manage the quality of audits in a proper manner. Therefore, the CPAAOB holds discussions with the JICPA's executives and reviewers on problems identified

through examination and inspections.

In PY2016, the CPAAOB exchanged opinions with JICPA about measures to enhance quality control reviews and the operation of the Registration System for Listed Company Audit Firms, as well as issues surrounding quality control reviews detected in inspections, etc. by the CPAAOB and the expansion in the disclosure of review findings.

2.4.3 *Cooperation with Stock Exchanges*

The CPAAOB has a mission to enhance the fairness and transparency of capital markets in Japan by ensuring audit reliability through inspections, etc. Therefore, the CPAAOB cooperated with Stock Exchanges which self-regulate listed companies by exchanging opinions concerning industry-specific audit-related issues, etc. which are obtained from the results of inspections, etc. so that both parties can have the same stance on issues.

2.4.4 *Cooperation with the Japan Audit & Supervisory Board Members Association (JASBA)*

Considering that cooperation with auditors and those charged with governance who perform a corporate governance function for their companies is important in facilitating appropriate disclosure of financial information by companies, the CPAAOB has verified the state of communication between those charged with governance and auditors in inspections, etc. of audit firms. In addition, as a result of the revision of the Companies Act and the implementation of the Corporate Governance Code, the roles and duties of those charged with governance have become increasingly important.

Therefore, the CPAAOB endeavored to cooperate with the JASBA by, for example, providing information to those charged with governance, etc. with information on deficiencies identified in inspections and problems, etc. at audit firms through lecture meetings, etc. held by the JASBA.

2.5 Actions for issues *in PY2016*

2.5.1 *Improvement of Effectiveness of Inspections Mainly for Large audit Firms*

(i) Flexibility in the conduct of inspections

In PY2016 the CPAAOB stated in the PY2016 Basic Plan for Monitoring Audit Firms that inspections can be conducted flexibly whenever there is a risk of a material accounting issue occurring at an audited entity or it is necessary to

swiftly confirm the quality control system of the audit firm conducting the audit engagement with respect to the audited entity concerned.

(ii) Tougher follow-up on inspections of Large audit firms

In PY2016 follow-up inspections were conducted at Large audit firms that were subject to ordinary inspections in FY2015.

(iii) Appropriate division of roles between the CPAAOB and JICPA

Achieving an appropriate division of roles between the CPAAOB and JICPA is important for improving overall standards of audit quality delivered by audit firms. Any discussion of division of roles needs to be preceded by an investigation of the differences between the quality control reviews of individual audit engagement and the inspections conducted by the CPAAOB in terms of their content, standards, improvements methods, and so on. As stated in "2.4 Cooperation with Relevant Organizations, 2.4.2 Cooperation with the JICPA" on page 21 above, the CPAAOB and JICPA worked to share information and step up cooperation by organizing meetings for inspectors and reviewers to exchange views based on actual inspection cases.

(iv) Improving inspection methods

With regard to the verification of the management systems, including governance, business operation systems, etc. at Large audit firms, the CPAAOB pursued a policy of conducting inspections efficiently by obtaining the qualitative and quantitative information required for this verification in advance and increasing the volume of analysis performed before inspections commence. The goal with this was to make the verification process more effective and efficient.

Going forward the CPAAOB intends to continue collecting reports in a specified period in order to obtain the qualitative and quantitative information it needs.

(v) Handling of inspection results (enhancing the visibility of audit quality)

To ensure that inspected firms take appropriate action to address deficiencies identified during their inspections, it is important for them to be accurately informed about what the deficiencies actually are. Therefore, in PY2016 the CPAAOB reorganized the section presenting significant matters to be fully considered in the inspection results notifications delivered to them. This revamp saw the section divided into separate parts for the overall assessment,

quality control system assessment, individual audit engagement assessments, and message from the CPAAOB.

2.5.2 *Enhancement of the Self-regulating Functions of JICPA, Including Further Improvement of its Function of Quality Control Review*

With respect to the strengthening of JICPA's self-regulating functions, including the further improvement of functions of JICPA's quality control reviews, which were stated in the recommendations of the "Advisory Council on the Systems of Accounting and Auditing," which was publicized in March 2016, the CPAAOB has continued, since its foundation, to review the appropriateness of quality control review systems and operations and to conduct a two-way discussion with JICPA.

In PY2016 the CPAAOB continued to implement initiatives like these and was able to enhance JICPA's quality control reviews by sharing its views on issues with quality control reviews identified through its inspections, areas that could be improved and so on.

2.5.3 *Strengthening the Dissemination of Information*

With the aim of expanding the range of audit quality-related information provided to the general public, the CPAAOB produced "Recent Trends in Audit Firms (FY2016 Monitoring Report)" and published it in July 2016 (see 2.3.6 (ii) Production/publication of "Outline of Audit Firms (FY2016 Monitoring Report)" above, page 18).

2.6 *Next Challenges*

2.6.1 *Improvement of Effectiveness of Inspections Mainly for Large audit Firms*

Recent incidents of accounting fraud have led to questions being raised once again about the credibility of accounting audits, and the CPAAOB has therefore put together and announced a package of effectiveness improvement measures.

As stated in "2.5 Actions for issues in PY2016" (page 22), while the CPAAOB has already been implementing these effectiveness improvement measures, it intends to respond in an even more timely and appropriate fashion.

2.6.2 *Response to the Audit Firm Governance Code*

On March 31, 2017 the FSA finalized and announced "Principles for Effective Management of Audit Firms (The Audit Firm Governance Code)."

The Code sets forth principles for ensuring the sound organizational operation of audit firms that conduct audits of large listed companies.

The CPAAOB, for its part, is already focusing its investigations more on the management systems, including governance as well as business operation systems, and because audit firms, particularly Large ones, are currently working to improve these systems in response to the Code, the CPAAOB will be verifying the systems that have been established and strengthened by each audit firm.

2.6.3 *Ongoing Follow-up of Efforts by JICPA to Improve the Functionality of Quality Control Reviews, etc.*

Ever since the system of JICPA quality control reviews was first established, the CPAAOB has made encouraging improvements to be made in the functionality of these reviews from a public standpoint one of its objectives.

Taking on board the recommendations of the "Advisory Council on the Systems of Accounting and Auditing," which was announced in March 2016, the CPAAOB has implemented whatever measures it could for the FY2016 quality control reviews and intends to continue exploring ways of tackling issues in the future.

The CPAAOB needs to contribute to the further enhancement of JICPA's self-regulating functions, including the quality control review and the registration system for listed company audit firms, by verifying the adequacy and appropriateness of its initiatives through two-way discussions, inspection results, etc.

2.6.4 *Strengthening the Dissemination of Information*

In PY2016 the CPAAOB revised the information presented in inspection results notification to ensure that audit firms subject to inspections are accurately informed of the details of identified deficiencies. Furthermore, the section presenting significant matters to especially pay attention to in the notifications issued to Large audit firms was reworked to ensure that these points are correctly conveyed to persons charged with governance at audited entities. The CPAAOB now plans to expand this method of presentation to audit firms other than Large ones.

Furthermore, with the aim of deepening understanding of auditing among investors and persons charged with governance and contributing to the assessment

of audit firms, the CPAAOB has published "Recent Trends in Audit Firms (FY2016 Monitoring Report)," and plans to continue expanding the content of the Report by gathering and accumulating even more information from monitoring.

2.6.5 *Enhancing the Structure for Addressing Problems Surrounding Audit Firms*

The internationalization of accounting procedures and use of IT at audit firms is progressing due to increased overseas expansion, a rise in overseas transactions, etc. Furthermore, the results of recent inspections, etc. of Large audit firms revealed that they have fundamental problems in terms of business operation. For example, improvements in quality control are failing to reach the frontlines of their organizations. In addition, it has become more important than ever to address the risk of fraud in audits.

Given these circumstances, the CPAAOB believes it important to continue to enhance its inspection system, including the procurement of personnel and the enhancement of its information collection system, so that its inspections will be carried out in a proper manner.

3 Cooperation with Relevant Organizations in Other Jurisdictions

3.1 *Activities of the International Forum of Independent Audit Regulators (IFIAR)*

Triggered by accounting scandals such as at Enron and WorldCom in the United States (the U.S.A.), the need to ensure and improve the audit quality was recognized, and since 2002, audit oversight regulators independent from the accounting profession have been established in jurisdictions throughout the world.

Amid such circumstances, the first unofficial meeting of audit oversight regulators was held in Washington, D.C., in September 2004, organized by the Financial Stability Forum (FSF) (now the Financial Stability Board (FSB)), for the purpose of sharing information among respective members' jurisdictions. The meeting was attended by nine jurisdictions: Japan, the U.S.A., the U.K., Germany, France, Italy, Canada, Australia, and Singapore. Subsequently, a series of further informal meetings were held. Momentum was gathered for the establishment of a permanent international forum, and at the fifth meeting of audit oversight regulators held in Paris in September 2006, formal approval was given for the establishment of the International Forum of Independent Audit Regulators (IFIAR). Its first Plenary Meeting was held in Tokyo in March 2007, hosted by the CPAAOB, and was attended by the audit oversight authorities of 22 jurisdictions.

3.1.1 *Organization*

The IFIAR comprises audit oversight authorities from jurisdictions with eligibility for membership, and decision-making is in principle performed at the Plenary Meeting, in which audit oversight authorities from all member jurisdictions participate. As of March 2017, the number of participating jurisdictions was 52. The Plenary Meeting held in London in April 2016 was the 16th such meeting, and the 17th meeting took place in April 2017 in Tokyo to coincide with the establishment of a permanent Secretariat in Tokyo.

To enable the IFIAR to conduct its activities efficiently, the posts of Chair and Vice-Chair are assigned to individuals. As of March 31, 2017, the Chair country was the Netherlands while the Vice-Chair nation was Canada. The Forum also features an Advisory Council to provide assistance and advice to the Chair and Vice-Chair, which as of March 31, 2017 comprised seven countries: Australia, France, Germany, Japan, Singapore, the U.K., and the U.S.A. Following the establishment of the permanent Secretariat in April 2017, the IFIAR Board, a new governing body comprising 15 board members, was established.

Furthermore, as of March 31, 2017 the IFIAR has six working groups. The purposes and activities are described in detail in 3.1.3 (ii).

IFIAR Organization Chart

3.1.2 *Purpose*

According to the Charter adopted at the 4th Plenary Meeting, which was held in Cape Town in September 2008, the purpose of the IFIAR is to engage in the following activities:

i Sharing knowledge of the audit market environment and practical experience of independent audit regulatory activity with a focus on inspections of auditors and audit firms;
ii Promoting collaboration and consistency in regulatory activity;
iii Initiating and leading dialogue with other policy-makers and organizations that have an interest in audit quality; and
iv Forming common and consistent views or positions on matters of importance to its Members, taking into account the legal mandates and missions of individual members.

3.1.3 *Activities*

i Activities of the Plenary Meeting

(i) 16th Plenary Meeting in London

The 16th Plenary Meeting was held in London from April 19 to 21, 2016, and was hosted by the U.K.'s Financial Reporting Council (FRC).

At the meeting, agreement was reached on the establishment of a permanent Secretariat in Tokyo and the formation of the Advisory Group to the Investor and Other Stakeholders Working Group. There was also a discussion involving the Chairs of standards-setting bodies (International Auditing and Assurance Standards Board (IAASB) and International Ethics Standards Board for Accountants (IESBA)) and the Public Interest Oversight Board (PIOB) on how standards setting can contribute to enhancing audit quality. The CEOs of the six largest international audit networks (see Note) also discussed audit quality.

(Note) The six largest international audit networks are comprised of Deloitte Touche Tohmatsu, Ernst & Young, KPMG, PricewaterhouseCoopers, BDO and Grant Thornton.

(ii) Interim Meeting

Since 2013, the frequency of the Plenary Meeting has been reduced from twice to once a year. On the other hand, an Interim Meeting limited to the Officers (i.e. the IFIAR Chair and Vice-Chair), the members of the Advisory

Council, and Working Group Chairs, etc. has been held to conduct high-level discussions on IFIAR's management of the IFIAR's work, etc. In 2016, the Interim Meeting was held in Singapore on October 31 and November 1.

ii Activities of each working group

(a) Global Audit Quality (GAQ) Working Group

The aim of this working group (WG) is to exchange views with the six largest international audit networks on the quality control of global audits. The WG maintains dialogue with each network on such topics as the quality control systems of global audit networks, and shares information between authorities on improvements in quality control and on the organizational expansion of each network.

Meetings were held on November 2 to 4, 2016 in Singapore and February 28. During FY2016-2017, the GAQWG meetings were held on November 2 to 4, 2016 in Singapore and February 28 to March 2, 2017 in Frankfurt. At these meetings, the participants discussed such matters as data analytics initiatives at audit firms, project management, and group audits.

The WG had also proposed to have several authorities conduct joint inspections of audit firms that are part of large audit networks in order to assess the effectiveness of group audits of multinational companies, and in 2015 Japan (CPAAOB) took the lead in conducting the first such inspections. Joint inspections have also been conducted under the leadership of the CPAAOB in 2016.

(b) Standards Coordination Working Group

The aim of this WG is to exchange views on such topics as the setting of international auditing standards at the International Auditing and Assurance Standards Board (IAASB) and on cooperation with respective standards-setting bodies that set auditing standards.

(c) Inspection Workshop Working Group

This WG plans, coordinates and evaluates the IFIAR inspection workshop. This workshop is held every year for the purpose of skill training for inspectors and to share inspection methods and experiences.

At the first IFIAR Plenary Meeting in Tokyo in 2007, it was agreed that the inspection workshop would be held, led by the inspectors of the IFIAR

members, for the purpose of sharing information on the inspection methods of audit oversight authorities and on issues related to inspections, as well as providing training for inspectors. Since then, the workshop has been held every year, with planning and coordination provided by the Inspection Workshop Working Group.

This fiscal year, the 11th workshop was held between February 8 and 10, 2017, and was hosted by the Hellenic Accounting and Auditing Standards Oversight Board (HAASOB) More than 120 inspectors and others participated from 41 jurisdictions, including Japan, and the CPAAOB sent its chief inspector to serve as a moderator.

(d) Investor and Other Stakeholders Working Group

The aim of this WG is to engage in dialogue with investors and other stakeholders as users of audit reports on issues such as the audit quality and what audit reports ought to be like. The WG also plans and coordinates the exchange of views with investor representatives at the IFIAR Plenary Meeting.

(e) International Cooperation Working Group

The aim of this WG is to promote the practical exchange of information on regulations and inspections between audit oversight authorities and to work on establishing the Multilateral Memorandum of Understanding (MMOU) concerning co-operation in the exchange of information for audit oversight.

The MMOU was finalized in June 2015, after which the IFIAR reviewed the applications from the first group of jurisdictions applying to be signatories. Japan was one of the 23 jurisdictions comprising this first group, and after having its application examined by the IFIAR, and in February 2017 the FSA and the CPAAOB received approval from the IFIAR to become MMOU signatory authorities. The MMOU is set to be signed and become effective during the Tokyo Plenary Meeting in April 2017.

(f) Enforcement Working Group

The aim of this WG is to promote cooperation between audit oversight authorities in the area of enforcement, including investigations, and facilitate exchange of information on enforcement regimes and developments in member jurisdictions, in order to enhance investor protection and improve audit quality.

Japan has been chairing this WG since its foundation in July 2013.

3.1.4 *Progress on the Hosting of a Permanent Secretariat in Tokyo*

In recent years, the IFIAR has been rapidly transformed from just a forum among members' jurisdictions to an organization conducting practical activities as an international organization. In addition, it is increasingly necessary for the IFIAR to enhance its relationships with other international organizations, including the Financial Stability Board (FSB), the International Organization of Securities Commissions (IOSCO) and the Basel Committee on Banking Supervision (BCBS). Under these circumstances, the establishment of a permanent secretariat was discussed at the Washington, D.C. 14th Plenary Meeting in April 2014.

From the viewpoint of international contribution to the improvement of audit quality through the IFIAR, improvement of Japan's influence in international financial regulatory activities, including audits, and contribution to the establishment of Tokyo's presence as an international financial center, in January 2015 the CPAAOB and the FSA ran for candidacy to host the permanent Secretariat to be established. The CPAAOB and the FSA, in cooperation with related ministries and agencies, sought support for Tokyo as the host country of the permanent Secretariat from IFIAR's other member authorities. Private-sector business groups, audit-related organizations, etc. also issued statements in support. As a result of these efforts, a decision was made to establish a permanent Secretariat in Tokyo at the 16th Plenary Meeting in London in April 2016. The Secretariat opened in April 2017, and the CPAAOB and FSA are now providing necessary assistance to ensure its smooth operation.

Furthermore, in December 2016 the Japan IFIAR Network was established by stakeholders active in Japan for the purpose of supporting the activities of the permanent Secretariat and raising awareness of audit quality in Japan.

3.2 *Bilateral Cooperation*

In light of the globalization of corporate activities, ensuring the quality of audit procedures that, such as using the audit results of overseas audit firms in the audit of consolidated financial statements, has become globally more important than ever before. Moreover, enhancing cooperation with foreign audit oversight authorities has become indispensable for establishing a global audit oversight system. In addition to the participation in the activities at the IFIAR, for the purpose of sharing information on international audit firms and audits and inspections' issues, the CPAAOB has

been also constantly exchanging views with audit oversight authorities from various jurisdictions and has been striving to build and enhance its bilateral cooperative relationships with foreign audit oversight authorities, including the establishment of a framework for exchanging information on audit oversight activities (see Note), to facilitate its examination and inspection activities .

(Note) Overseas authorities which have a framework for exchanging information on audit supervisory activities with the CPAAOB and FSA

- The U.S. Public Company Accounting Oversight Board (PCAOB)
- The Canadian Public Accountability Board (CPAB)
- The Audit Oversight Board of Malaysia (AOB)
- The Netherlands Authority for the Financial Markets (AFM)
- The Commission de Surveillance du Secteur Financier (CSSF)
- The U.K. Financial Reporting Council (FRC)
- The Haut Conseil du Commissariat aux Comptes (H3C)

3.3 *Next challenges*

Given that the globalization of corporate activities has led to the advance of cross-border audit services, such as the use of the audit results by overseas audit firms in the audit of consolidated financial statements of internationally active enterprises, ensuring audit quality globally is a challenge.

Under these circumstances, special attention also needs to be paid to the quality control method in the whole network of international audit firms, the introduction of the data analysis method in audits, and the effects that the global economic and financial situation, etc. has on the audit quality.

Regarding international trends in discussion on accounting and audit systems, the CPAAOB believes it essential to analyze the potential impact of discussions conducted at international organizations and in multiple countries on audit firm activities and the CPAAOB's operations, etc. and to take appropriate measures, as needed, including reflecting them in the CPAAOB's inspections of audit firms.

It is therefore essential to continue to strengthen cooperation with audit oversight authorities in each jurisdiction and reinforce bilateral cooperation networks by making an active contribution to the activities of the IFIAR, which has established a permanent Secretariat in Tokyo. Cooperation could involve sharing views on global audit-related issues, creating opportunities for person-to-person interaction, and so on.

It will also be important to develop and secure globally-minded personnel who are capable of responding to these trends.

Annex 1

List of Members of Certified Public Accountants and Auditing Oversight Board (CPAAOB) (As of April 1, 2017)

Chairperson (full-time)	Toshiro Hiromoto	Professor Emeritus Hitotsubashi University
Commissioner (full-time)	Takayuki Matsui	Former Professor Graduate School of Professional Accountancy , Aoyama Gakuin University
Commissioner (part-time)	Akiko Kimura	Of Counsel Anderson Mori & Tomotsune Outside Corporate Auditor Fuji Electric Co., Ltd. Outside Corporate Auditor Daiichi Sankyo Co., Ltd. Outside Director Nomura Asset Management Co., Ltd.
Commissioner (part-time)	Yoshiko Sato	Executive Managing Director Japan Investor Relations Association
Commissioner (part-time)	Yoshihiro Tokuga	Vice-President and Professor, Kyoto University
Commissioner (part-time)	Yasuyuki Fuchita	Executive Fellow Nomura Institute of Capital Markets Research
Commissioner (part-time)	Keiko Mizuguchi	Counselor and Chief Analyst Japan Credit Rating Agency, Ltd.
Commissioner (part-time)	Kazunori Yagi	Advisor Yokogawa Electric Corporation Outside Corporate Auditor Yokogawa Bridge Holdings Corp. Outside Director JSR Corporation Outside Corporate Auditor TDK Corporation Outside Director OYO Corporation
Commissioner (part-time)	Tatsumi Yamada	Partner KPMG AZSA LLC
Commissioner (part-time)	Keita Yoshida	Partner Deloitte Touche Tohmatsu LLC

Annex 2

About "Case Report from Audit Firm Inspection Results"

Since its establishment in April 2004, the Certified Public Accountants and Auditing Oversight Board (CPAAOB) has been conducting inspections of audit firms from the viewpoint of securing public interest and protecting investors with the aim of maintaining and improving the quality of auditing in Japan. Since 2008, the CPAAOB has been issuing the "Case Report", a compilation of examples of major deficiencies identified in the inspections, every year, in order to promote voluntary efforts by audit firms to maintain and improve their audit quality. During this time, the CPAAOB has been improving the content of the Case Reports, for example, by presenting the audit-quality level expected by the CPAAOB. Furthermore, with an eye to improving the function of the Case Reports as an information provider, we have been endeavoring to also get company executives and market participants such as ordinary investors to use them. With this in mind, in FY2016 we produced a "Monitoring Report" that we hope will help users, such as shareholders, who are not accounting experts, to deepen their understanding of accounting audits.

The Case Report published on July 29, 2016 not only reflects the results of inspections conducted until 2015, but also contains as much information as possible about the background to the deficiencies described in light of comments obtained from a user survey regarding the contents of last year's edition, targeting audit firms, auditors, etc. The main changes are as follows:

- "I. Root Cause Analysis" and "II. Quality Control System"
  Because audit firms' management and operation, particularly quality control systems, vary depending on the size of the firms, cases of inspection results tend to be categorized by the size of the firms. Therefore, cases at large audit firms and small and medium-sized audit firms are separately described.

- "III. Individual Audit Engagements"
  To enhance understanding of the importance of deficiencies in audit procedures, in the Case Report we have presented as much information as possible about the backgrounds to the cases. This information includes the operating environment surrounding the audited entity and the circumstances of the audit. We have also revised our criteria for selecting cases from the standpoint of contributing to improvements in audit quality.

The CPAAOB hopes that audit firms, with reference to identified deficiencies and their root causes, etc. which are stated in the Case Report, will voluntarily inspect their individual audit engagements and quality control systems, and if deficiencies are identified in their quality control systems, they will not only improve such deficiencies but also investigate the relevant root causes to remove them.

The Case Report also comes with a supplement for reference purposes entitled "Recent Trends in Audit Firms (FY2016 Monitoring Report)," which contains diagrams and charts of information concerning the

circumstances of audit firms. From next year, we intend to publish this separately after improving the information it contains, which will also include details of our monitoring activities.

The full text of the Case Report can be viewed on the CPAAOB website by accessing "Oversight" => "Case Report from Audit Firm Inspection Results" (December 27, 2016)
http://www.fsa.go.jp/cpaaob/english/oversight/20161227.html
http://www.fsa.go.jp/cpaaob/shinsakensa/kouhyou/20160729.html (Japanese Version, July 29, 2016)

(This paper summarizes "I. Root Cause Analysis" and "II. Quality Control System" of the Case Report.)

I. Root Cause Analysis

Deficiencies identified in inspections may be only a part of the deficiencies, which have not been identified yet. It is likely that the audit firm has other undiscovered deficiencies arising from the same root causes. Moreover, there may be a root cause that would invalidate the effect of the improvement measures implemented to cope with the direct causes of the deficiencies.

Improvement measures developed only to cope with the direct causes, without considering the root causes of the deficiencies, would not improve the audit quality control system. Not only that, they might also increase the burden on audit practitioners. For this reason, audit firms shall sufficiently understand the importance of the root cause analysis of deficiencies, and substantive measures that reflect the size and characteristics of the audit firms should be implemented.

1. Large audit firms

Although quality control systems are designed at large audit firms, we understand that there are deficiencies in the effectiveness of their operation, since many deficiencies have been identified in some individual audit engagements.

Root causes of deficiencies identified in large audit firms in CPAAOB's inspections are categorized as follows:

(1) Lack of awareness of quality management

- There was a lack of atmosphere among the management, including the CEO, to review operations from a broad perspective and to enable engagement teams to voluntarily improve the audit quality engagement teams.
- Divisions, which are responsible for audit quality improvement, had not thoroughly enforced efforts to improve audit quality by engagement teams based on the policy of the management, including the CEO.

(2) Insufficient verification of improvement measures

- Regarding improvement measures for the deficiencies identified, the CEO and person in charge of quality control (PICOQC) only provided instruction to engagement teams as in the past, and did

not verify the appropriateness or effectiveness of the improvement measures, as they did not understand the necessity of verification.

2. Small and medium-sized audit firms

Small and medium-sized audit firms vary in size and history, and the level of quality control also differs significantly among firms. However, they typically have difficulty in providing sufficient organized support, such as a quality control system, to engagement teams. The features among small and medium-sized audit firms is that the level of operation and quality control often depends significantly on the competence of individuals that belong to the audit firm, including the CEO, and the relationship between the partners and the firm.

Root causes of deficiencies identified in small and medium-sized audit firms in CPAAOB's inspections are categorized as follows:

(1) Management system, management policy or business model of the audit firms

- Engagement partners thought that they could earn stable audit income by maintaining good relationships with entities. They emphasized maintaining their relationships with the entities, rather than focusing on the primary purpose of the audit, i.e., protecting the interests of investors and creditors.

(2) Quality control efforts by the CEO, PICOQC and engagement partners

- Professionals, including engagement partners, had a poor understanding of the current audit standards because the education and training provided by an audit firm did not address audits of listed companies.

(3) Partners' awareness of responsibilities; mutual monitoring between partners

- Because the current audit firm was incorporated based on the private audit office of the CEO and the CEO led the acceptance of major engagements, other partners considered that the firm was still the private business of the CEO, and thus relied on the CEO for most of the management of the firm.

Many second-tier audit firms expand their operations through mergers and the undertaking of new audit contracts. Under these circumstances, deficiencies concerning post-merger integration have been identified, such as cases where the quality control system has not been sufficiently designed and operated for the expansion of operations, and cases where sufficient measures, to maintain the level of quality control of each audit engagement after the merger, have not been taken while there have been partners of the merged firms who do not fully understand the purport and requirements of audit standards.

II. Quality Control System

As mentioned earlier, from this year's edition, information on large audit firms and small and medium-sized audit firms is presented separately. Outlines of deficiencies identified for each are presented below:

Large audit firms

1. Initiatives to improve performance

(Outline of identified deficiencies)

Deficiencies that are the same as or similar to those found in the previous CPAAOB inspection or QC review have been identified at some large audit firms. In this regard, the CPAAOB has identified deficiencies in various stages of operation of the QC system, such as initiatives to instill improvement measures throughout the entire organization, the understanding by individual engagement teams, or the monitoring of how improvement measures had spread across the entire firm in the process of improving the deficiencies. In particular, there were cases where improvements were not permeated throughout firms whose engagement partners in engagement teams were responsible for many audit engagements and at those whose departments and regional offices had no personnel exchange with other departments, resulting in static human resources.

(Cause analysis of identified deficiencies)

In order to disseminate improvement measures planned by the QC department at the headquarters to the entire organization as a response toward improvement and achieve sufficient effects, the entire firm should respond to any deficiency together with the management of the firm, such as division managers, based on the understanding of all members of the firm involved in quality control, instead of response only by limited divisions, such as the QC division.

2. Operation of the quality control systems

(Outline of identified deficiencies)

There were many cases where the engagement partners or equivalent who review audit documentation, the engagement quality control (EQC) reviewer and the person in charge of cyclical inspections had not fully understood the changes in the environment surrounding entities, the circumstance of the entities, or the audit procedures performed by the engagement team, and failed to identify the deficiencies that were inherent in individual engagements. (Cause analysis of identified deficiencies)

Although there were differences in awareness of audit quality and abilities of quality control among partners such as engagement partners and EQC reviewers, the QC department could not fully understand the differences or assign the appropriate engagement partners and EQC reviewers, and, in addition, the engagement teams did not proactively consider how to ensure audit quality as they relied on manuals and the headquarters' instructions.

Small and medium-sized audit firms

1. Operational control system

(1) Initiatives to improve performance

(Outline of identified deficiencies)

Some small and medium-sized audit firms are failing to take enough action to address deficiencies identified in quality control reviews. In some cases, measures to address multiple identified deficiencies have either not been implemented or the improvements made have been inadequate.

(Cause analysis of identified deficiencies)

The PICOQCs merely carried out measures as a formality, such as simply disseminating information on the deficiencies through training and only instructing on items without considering why the matter was identified as a deficiency in the quality control review. The audit firm had not established a system to effectively monitor the improvement of deficiencies.

(2) Establishment, dissemination, and implementation of internal rules

(Outline of identified deficiencies)

Deficiencies were seen in the establishment of internal rules relating to independence and the provision of non-audit services and rules relating to contract management.

(Cause analysis of identified deficiencies)

Causes of identified deficiencies include insufficient understanding of the laws, regulations, and professional standards that apply to audit firms and the adoption of internal rules in the template suggested by the JICPA, with no modifications made to them to reflect the actual situation, etc. of the audit firm concerned.

(3) Compliance with laws, regulations and professional standards

(Outline of identified deficiencies)

Deficiencies included the absence of rules for ensuring compliance by partners with the prohibition of competition and the existence of partners who do not meet requirements of operational control. There are also audit firms whose actual operations differ from the operations stated in the business purpose section of their articles of association.

(Cause analysis of identified deficiencies)

Causes of identified deficiencies are that the PICOQC fails to sufficiently understand the applicable laws, regulations and professional standards, or did not appoint practitioners to take charge of confirmation of regulatory compliance of each task that requires such confirmation, and did not establish a clear and concrete workflow for confirmation.

(4) Information Security

(Outline of identified deficiencies)

There are some small and medium-sized audit firms where the preventive measures against information leakage set forth in the audit firm's internal rules on information security are not implemented in a proper manner and where the internal rules to control the use of the internet server

service for the firm's operation are not established.

(Cause analysis of identified deficiencies)

Causes of identified deficiencies are that the person in charge of information security management establishes the internal rules on information security management only for formality's sake and leaves the operation of the internal rules to audit practitioners (including part-time audit team members) using computers and other information devices, and that the person in charge of information security management fails to update the internal rules on information security management depending on actual conditions of use of information equipment at the audit firm.

2. Professional ethics and independence

(Outline of identified deficiencies)

There are some small and medium-sized audit firms where procedures for confirming independence prescribed in internal rules are not being properly followed.

(Cause analysis of identified deficiencies)

With regard to procedures for confirming independence, the PICOQC has not specified the procedures to be performed (including methods for obtaining the latest information about consolidated subsidiaries, etc. of audited entities), when they are to be performed, and whom they should be performed by.

3. Acceptance and continuance of engagements

(1) Assessment of risk associated with acceptance and continuance of engagements

(Outline of identified deficiencies)

The acceptance and continuance of engagements is a central matter in an audit firm's managerial judgment. However, there are small and medium-sized audit firms, where the following deficiency was identified: the information about the audited entity obtained by the prospective engagement partner is not shared with the partners having authority to approve the acceptance and continuance of engagements (members of the Partners' Meeting) and as a result, a deep risk assessment is not conducted.

(Cause analysis of identified deficiencies)

- The prospective engagement partner did not have sufficient experience to make appropriate decisions on management fraud, audit of internal control, accounting estimates and other matters. Therefore, the prospective engagement partner fails to properly identify and assess the audit risk based on facts obtained through preliminary audit or information provided by the predecessor auditor.
- When discussing a proposed engagement, the partners did not recognize how important it was to assess the risk associated with the proposed engagement based on information gathered by the predecessor auditor, and other partners were reluctant to express critical opinions as to whether or not the engagement should be accepted.

(2) Communication between predecessor and successor auditors

(Outline of identified deficiencies)

There are some small and medium-sized audit firms where the predecessor auditor was not asked appropriate questions or investigations have not been performed in accordance with internal rules.

(Cause analysis of identified deficiencies)

Causes of identified deficiencies are that the prospective engagement partner prioritized quick acceptance and quick commencement of the audit engagement rather than performing careful risk assessment, solving any identified problems or performing procedures required by the audit firm in an adequate and timely fashion.

4. Recruitment, education/training, assessment, and selection

(1) Education/training

(Outline of identified deficiencies)

At some small and medium-sized audit firms education/training systems have not been properly established, while at others education/training is not effective. With regard to important audit-related matters such as the formulation of audit plans based on a risk-based approach, specific cases are not employed with respect to the procedures that ought to be followed or the extent of such procedures.

(Cause analysis of identified deficiencies)

One of the causes of the identified deficiencies is that with regard to the acquisition of knowledge, etc. of audit engagement, the PICOQC or equivalent leaves all responsibility for instruction and supervision to the partner in charge of the audit. Furthermore, with respect to part-time audit practitioners, it is regarded as sufficient to leave each of them to their own devices, and the audit firm as a whole has little volition to maintain and enhance audit quality.

(2) Evaluation, compensation, and promotion

(Outline of identified deficiencies)

The evaluation of audit practitioners, etc. is not based on their abilities as specialists (particularly their abilities in the area of quality control) and their compliance with professional ethics.

(Cause analysis of identified deficiencies)

One of the causes of the identified deficiency is that with regard to the evaluation and compensation of audit practitioners, the CEO makes decisions based on subjective information.

(3) Assignment

(Outline of identified deficiencies)

At some small and medium-sized audit firms the assignment of the partners to be in charge of audit engagements, the formation of audit teams, etc. is inappropriate.

(Cause analysis of identified deficiencies)

- The audit firm prioritizes the winning of new audit engagements and does not give adequate consideration to the abilities and experience of audit practitioners or the overall ability of the firm to carry out audit engagements.

- The audit firm lacks accurate knowledge of the quality management-related abilities of partners in charge of audits, the amount of time they can devote to audit engagements, etc.

5. Audit documentation

(1) Preparation and review of audit documentation

(Outline of identified deficiencies)

Numerous deficiencies where audit procedures could not be deemed to have been performed were observed. These included the failure to state the audit procedures that the audit team had performed or the grounds for arriving at the conclusions it reached in the audit documentation.

There were also cases of deficiencies in audit documentation resulting from the fact that engagement partners had not reviewed them from the perspective of whether the details of the audit procedures performed are appropriately presented in the audit documentation.

(Cause analysis of identified deficiencies)

- Audit practitioners lack awareness of the importance of audit documentation.
- The engagement partner mistakenly believes that the members of the audit team share a common understanding of issues at the audited company concerned and the audit procedures they should follow, which leads the engagement partner to feel that there is no need to review the audit documentation. Audit procedures are therefore left in the hands of audit assistants.

(2) Final assembly of audit files and control and retention of audit documentation

(Outline of identified deficiencies)

Deficiencies observed included the failure to specify such matters as how audit records, etc. should be organized at the end of an engagement, how they should be managed, and so on, as well as the organization of audit records at the end of an engagement being completed despite the fact that important audit procedures have not been completed.

Audit firms had not established specific procedures for the completion of audit files and the retention of audit documentation. Some firms registered audit documents as the final assembly despite the fact that they had not completed important audit procedures.

(Cause analysis of identified deficiencies)

- There is a lack of awareness concerning the control of audit documentation.
- The audit practitioner did not fully understand the important role of the audit documentation when performing quality control operations in the audit firm and providing explanation of audits to others.

6. Engagement quality control review

(Outline of identified deficiencies)

The EQC review is an important procedure that constitutes the “final check,” whereby the operations performed by the audit team are assessed by the audit firm before it states its opinion. Despite this, there are cases where the effectiveness of engagement quality control reviews is not being ensured. For example, the EQC reviewer did not fully review the appropriateness and sufficiency of the audit procedures and its judgment process related to significant matters, from a viewpoint that the EQC

reviewer evaluates objectively; the EQC reviewer could not find deficiencies in the important audit procedures in individual engagements.

(Cause analysis of identified deficiencies)

- An EQC reviewer with sufficient knowledge and experience corresponding to the audit risk as well as who has spent enough time on reviews, was not assigned.
- The EQC reviewer assumed, from the daily communications with the engagement team, that there were no deficiencies in the audit procedures performed by the team. Thus, the EQC reviewer did not examine their audit procedures through audit documentation.

7. Monitoring the firm's system of quality control policies and procedures

(Outline of identified deficiencies)

In some cases, practitioners responsible for ongoing monitoring and cyclical inspection (including external practitioners) completed their operation only as a formality by using checklists, etc.

(Cause analysis of identified deficiencies)

One of the causes of the identified deficiency is that the audit firm does not have an appropriate understanding concerning the monitoring of the quality control system, and therefore fails to allocate sufficient time and personnel to it.

Common matters

8. Cooperation with those charged with governance

(1) Cooperation between accounting auditors and those charged with governance

Regarding the explanations about the CPAAOB inspection and QC review on the audit firms, which the audit firms reported to those charged with governance, there were many cases where, although there were many significant deficiencies in the CPAAOB inspection and improvement recommendations by the QC review, audit firms only gave a conclusion verbally instead of in writing, saying "no material deficiencies were identified in the QC review," because the CPAAOB inspection did not lead to a recommendation for administrative action and the overall QC review conclusion was satisfactory with improvement recommendations.

Some audit firms did not notify the inspection and review results because those charged with governance of the entity did not ask for reporting of the results.

It should be noted that Audit Standards Committee Statement No. 260 "Communication with Those Charged with Governance," revised in May 2015, stipulates that when performing an audit of an entity, the audit firm should keep close communication with those charged with governance in the entity regarding particularly important matters, and specifies matters that should be communicated to those charged with governance, including the content and method of communication to those charged with governance concerning the results of the quality control review or the CPAAOB's inspection as part of the explanations made by the accounting auditor regarding the establishment and operation of a quality control system.

(Note) Disclosure of the results of the CPAAOB inspection to a third party needs the advance approval of the CPAAOB, in principle. However, no advance approval of the CPAAOB is

necessary if the disclosure is made to those charged with the governance or equivalent of the entity audited and the disclosed information is “whether or not there were deficiencies in the establishment or operation of the quality control system of the audit firm and the outline of such deficiencies” or “whether or not there were deficiencies related to the engagement for the entity and the outline of such deficiencies.”

(2) Response to detection of fraud/illegal act

One example of audit firms’ effective efforts is the following case:

- When regulations regarding responses to detected facts such as legal violations were introduced under the Financial Instruments and Exchange Act, some audit firms ensured all partners understood them by, for example, showing to partners and employees cases of how to notify those charged with the governance of the entity in the case of the detection of facts such as an illegal act.