

Basic Plan for Monitoring Audit Firms in Fiscal 2016

The Certified Public Accountants and Auditing Oversight Board (“CPA AOB”) will monitor Japanese audit firms to maintain the quality of auditing and improve the effectiveness of auditing, based on the viewpoints and objectives stated in the basic policy¹ for monitoring² audit firms.

(Environment surrounding audit firms)

Looking at the Japanese economy, business has continued to recover gradually despite some weakness. However, there is a risk that a possible business downturn in emerging Asian countries and resource-rich countries may drag the Japanese economy down.

When it comes to the environment surrounding certified public accountants and audit corporations (“audit firms”), the number of newly listed companies has increased substantially, while the overall number of listed companies and the average audit remuneration paid by listed companies have remained almost unchanged.

As the internationalization of accounting practices and complication and specialization of economic transactions have progressed in response to the growth in overseas business expansion and overseas transactions, and cross-border M&A by Japanese enterprises, particularly in Asia, the number of new issues with which audit firms need to cope has been increasing.

(Response to accounting scandals)

In such a situation, many inappropriate cases regarding IPOs were reported. Although the number of recommendations by the Securities and Exchange Surveillance Commission (“SESC”) to impose penalties on misstatements in securities reports decreased, even some large listed companies, so-called blue chip companies, misstated their financial results.

In the wake of recent accounting scandals, confidence in audit has been questioned again. On March 8, 2016, the *Advisory Council on the System of Accounting and Auditing* of the Financial Services Agency (“FSA”) published recommendations on initiatives necessary to ensure confidence in audit. Appropriate responses to accounting scandals are required.

(Role regarding corporate governance, etc.)

The function of governance has been strengthened. For instance, the Companies Act was revised and the corporate governance code was introduced to clarify the role and responsibility of management. Thus, audit firms are required to further enhance cooperation with enterprises including the provision of information for the function of governance, such as to corporate auditors. In the future, audit firms are expected to play an important role in realizing effective rather than nominal corporate governance by enhancing their support to enterprises in their corporate governance efforts.

¹ Basic policy for monitoring audit firms: It sets the standpoint, objectives, and basic policy for each term regarding monitoring implemented by the CPA AOB. The basic policy for the fifth term (April 2016 to March 2019) was formulated on May 13, 2016.

² Monitoring includes both on-site monitoring and off-site monitoring. Furthermore, on-site monitoring refers to inspections, while off-site monitoring means activities other than inspections, such as the collection of reports on audit firms, interviews, information gathering through the exchange of opinions and cooperation between audit firms and relevant parties.

However, misconduct by top management resulted in failure of internal control in the relevant enterprises in recent accounting scandals. Audit firms are required not only to assess the internal control of enterprises in the audit of financial statements, but also to audit the internal control of entities listed on the stock exchange. There are questions concerning whether or not audit firms have thoroughly implemented a specific assessment of management's attitude and the function of governance, such as the Board of Directors.

Therefore, it is indispensable that enterprises appropriately disclose their financial information to ensure the confidence of investors in the financial and capital markets and to promote the development of the Japanese economy. The role of CPA audit, which is conducted from an independent and professional standpoint, has become increasingly important in corporate governance.

(Current state of quality control at audit firms)

Meanwhile, looking at the current state of engagements at audit firms, the percentage of audit firms that received a qualified conclusion increased, although most audit firms received an unqualified conclusion in the quality control review by the Japanese Institute of Certified Public Accountants ("JICPA").

Moreover, the number of audit firms, against which CPAAOB recommended the FSA commissioner to take administrative sanctions and/or other measures because their services were found to be significantly unsatisfactory as a result of CPAAOB's inspection in the previous fiscal year, remained almost the same as in the preceding fiscal year. However, such audit firms did not receive a qualified conclusion in JICPA's quality control review.

To further improve the effectiveness of CPAAOB's inspection based on the risk of audit firms, CPAAOB examined the content and methods of the inspections that it had conducted. On March 24, 2016, CPAAOB published *Improvement of Effectiveness of the CPAAOB's Inspection*³ ("Effectiveness improvement measures").

In addition, in the International Forum of Independent Audit Regulators ("IFIAR"), slow improvement in the quality of engagements by audit firms raised a concern. Upon indicating numerical targets, IFIAR will support the achievement of the targets by upgrading its quality monitoring, increasing the occasion of dialogue with the network of international audit firms, and promoting the analysis of root causes.

Taking the above situation into account, we will formulate our basic plan for monitoring audit firms in fiscal 2016 (July 2016 to June 2017) as follows.

³ Under the effectiveness improvement measures, inspections are conducted on the assumption that *at large-scale audit firms, the quality control functions are effective to a certain extent*. However, although the form of the quality control system (organization and procedures) is prepared, we have to conclude that there are some deficiencies in the effectiveness of the system including its operations. As we have failed to identify the real causes of organizational and operational problems at large-scale audit firms in past CPAAOB inspections, we recognize that there is a need to examine the improvement of the inspection method so that verification can be made to track down the cause of organizational and operational problems further.

1. Concept of Fiscal 2016 Basic Plan for Monitoring Audit Firms

In the current fiscal year, focusing on the following points, we will monitor audit firms based on the five basic concepts from (1) to (5) mentioned below.

- As audit firms need to take the initiative in maintaining the quality of auditing and improving the effectiveness of auditing, we encourage audit firms to take actions by themselves.
- We will check not only if audit firms are in conformity with the standards on a formal basis, but also see if they practically endeavor to maintain the quality of auditing and improve the effectiveness of auditing, for instance, appropriately exercising professional skepticism to detect corporate fraud and assessing audit risks by always paying attention to the business risk of the entity.

(1) Implementation of monitoring in accordance with the type of audit firm

The business model, operations, audit performance system, and external surveillance largely differ according to the type of audit firm: large-scale audit firms⁴, second-tier large-scale audit firms⁵, and small- or medium-scale audit firms⁶. Therefore, we will conduct monitoring in accordance with the type of audit firm.

① Large-scale audit firms

We will strengthen off-site monitoring, such as the collection of reports on the business management (governance) system, including relationships with overseas business partners.

In our inspections up to the previous fiscal year, we had selected topics common to large-scale audit firms and inspected by narrowing the scope of verification to such topics on the assumption that *the quality control functions were effective to a certain extent*. However, based on problem recognition by taking into account recent inspection results, in the current fiscal year, we will inspect large-scale audit firms by focusing on the verification of the business management (governance) system and service management system and prioritized items that are set based on recent inspection results. Furthermore, we will step up our efforts to follow up the inspections and if necessary, we will conduct inspections in a timely manner instead of cyclical inspections.

② Second-tier large-scale audit firms

Audit firms other than large-scale audit firms are expected to acquire the capability to audit large listed companies by establishing effective governance to make their management function effective and by having external parties (authorities) check their engagements to improve the quality of audit.

Presently, second-tier large-scale audit firms typically have more than 100 full-time employees and several dozen listed companies as its entities. In light of their importance in the Japanese audit industry, we will intensively monitor second-tier large-scale audit firms. Specifically, we will cyclically conduct inspection. If necessary, we will conduct inspection in a timely manner instead of cyclical inspection. In particular, we will put emphasis on the inspection of the business model including relationships with overseas business partners, business management (governance) system, and service management system.

③ Small- or medium-scale audit firms

⁴ Large-scale audit firms: ones that have more than 100 listed companies as its entities and more than 1,000 full-time audit practitioners.

⁵ Second-tier large-scale audit firms: ones that have a relatively large number of listed companies as its entities other than large-scale audit firms.

⁶ Small- or medium-scale audit firms: ones other than large-scale audit firms and second-tier large-scale audit firms.

After appropriately collecting and analyzing information on the relevant audit firm, we will conduct monitoring from the standpoint of conformity with standards, including inspecting mainly the confirmation of the audit firm's quality control system and service management system based on the intention and nature of management and employees and the audit quality of individual engagements.

In particular, in the inspection, we will focus on the inspection of a small- or medium-scale audit firm's system and business model attributable to the background of their establishment.

(2) Overall inspection of JICPA's quality control review system, etc.

CPAAOB has been inspecting JICPA's quality control review. Taking into account the results of the recent inspection of audit firms that received JICPA's quality control review, we will continue overall inspection of JICPA's quality control review system, such as the effectiveness of the quality control review, and JICPA's responses as a self-regulatory organization to improve the quality of audit, mainly the Registration System for Listed Company Audit Firms.

To have inspections of audit firms and quality control reviews as a whole show the maximum effect, we will have dialogue with JICPA about the appropriate sharing of roles between us.

(3) Strengthening off-site monitoring

To conduct monitoring efficiently and effectively, we will step up our efforts to share information through the exchange of opinions and cooperation with related organizations, such as JICPA, relevant departments of FSA, and stock exchanges, international audit institutes and audit regulators in each country, and audit firms' overseas partners. We will also further improve risk assessment methods, such as the gathering and analyzing of information on the environment surrounding the entities, including industry trends. Moreover, regarding information gathering and analysis results, we will not only implement the collection of reports and interviews as necessary, but also endeavor to operate off-site monitoring integrally with on-site monitoring by effectively using them for inspection.

(4) Enhancing international cooperation

As we need to further enhance international cooperation, including the provision of information to and sharing of information with international audit institutes and audit regulators in each country, we will continue consultations about the Multilateral Memorandum of Understanding ("MMOU") IFIAR has been formulating in addition to the Exchange of Letters (EOL), a framework to exchange information between two countries.

(5) Examination of the monitoring system

To perform information gathering and analysis and inspection according to the type of audit firm, we will strengthen CPAAOB's system to conduct monitoring.

We will further improve our system to conduct monitoring by appointing staff that can take appropriate responses after analyzing information from Japan and abroad, in light of the internationalization of accounting practices, and systems of audit firms in Japan and staff that can manage monitoring efficiently and effectively as well as developing human resources through the dispatch of employees to overseas audit regulators and seminars that focus on international trends and the main issues related to accounting and audit.

2. Basic Plan Pertaining to Off-site Monitoring

To conduct off-site monitoring efficiently and effectively, we will step up our efforts to share information through the exchange of opinions and cooperation with international audit institutes and audit regulators in each country, and audit firms' overseas partners in addition to related organizations, such as JICPA, relevant departments of FSA, and stock exchanges besides reports on JICPA's quality control review. At the same time, we will effectively use the information from past reports and inspection results.

In addition, we will strive to strengthen and advance a system to collect and analyze various materials and information according to the risk of audit firms. Furthermore, to precisely identify risk pertaining to audit firms and individual engagements, we will conduct off-site monitoring according to the type of audit firm, including the inspection of JICPA's quality control review, collection of reports from audit firms, and interviews, as mentioned below.

(1) Inspection of JICPA's quality control review

Regarding JICPA's quality control review

- Some audit firms that did not receive a qualified conclusion in the quality control review received improvement recommendations in the CPAAOB inspection.
- As all services listed in Article 2, paragraph 1 of the Certified Public Accountants Act are subject to JICPA's quality control review from fiscal 2015, the number of audit firms that are newly required to undergo the quality control review has grown.

Taking into account the above situation, we expect JICPA to show stronger leadership in having audit firms continue appropriate audit quality control by further improving the effectiveness through upgrading of the review implementation system, including responses to issues across the industry.

Furthermore, regarding the quality control review, we reviewed the system, including changing its characteristic from a guiding function to a guiding and supervising function and newly establishing a flexible and temporary review, and increased the number of quality control reviewers. We need to carefully see how such initiatives will develop.

Consequently, we will collectively inspect JICPA's policy and responses toward the improvement of the quality of audit as a self-regulatory organization, mainly the quality control review system including the effectiveness of the quality control review through the examination when receiving a review report from JICPA and the inspection of responses to the results of a review in the inspection.

Furthermore, we will maintain effective cooperation with JICPA by continuing the exchange of opinions with quality control reviewers.

In addition, regarding the appropriate sharing of roles with JICPA, we will deliberate with JICPA by taking into account JICPA's efforts to improve the effectiveness of its quality control review.

(2) Collection of reports

- ① Regarding the appropriate performance of audit engagements, we will collect reports from audit firms in a timely manner based on the results of JICPA's quality control review in order to encourage them to continue appropriate audit quality control.

Regarding small- or medium-scale audit firms, taking into account the characteristics of each audit firm, we will intensively inspect issues across the industry that are found in small- or medium-scale audit firms in addition to the status of the development of the quality control system at audit firms to which a wide range of remarks related to quality control were given.

We will collect reports especially on items including the management policy, earnings, financial structure, organization and human resources of audit firms, problems with which could impact operations.

In addition, regarding audit firms that are found to have a material problem through the collection of reports, we will use the results as important reference information in inspection, etc.

Moreover, the collection of reports should be conducted in a face-to-face manner for effective inspection.

- ② With regard to large-scale audit firms, we will continuously request them to provide quantitative and qualitative information in the collection of reports, which are necessary for the inspection of the business management (governance) system and service management system.

After analyzing the information obtained through the collection of reports, we will use it effectively and efficiently for inspecting the relevant audit firms later on. At the same time, we will use the information for comparative analysis of large-scale audit firms other than the relevant firms and identify issues commonly found across large-scale audit firms.

- ③ After a certain period from the date of the notification of the investigation results, we will collect reports from the relevant audit firms to check and inspect the status of quality control as necessary. On that occasion, we will closely cooperate with related departments of FSA to conduct checking and inspection according to the degree of deficiency and importance. If the improvements to deficiencies are found to be inadequate as a result of the collection of reports, we will examine conducting the collection of reports again.

Furthermore, if we discover a situation that may cause a problem at audit firms where we conducted the collection of reports, we will conduct interviews accordingly and examine appropriate responses according to the type and risk of such audit firms.

If we do not find such audit firms made adequate improvements voluntarily at the checking and inspection after the inspection, we will examine the necessity of early re-inspection.

3. Basic Inspection Plan

Based on the basic inspection policy, we will share the understanding on problems on the operation of business through dialogue with audit firms subject to inspection and endeavor to make precise and effective comments.

On that occasion, if we find such audit firms made superior efforts to improve operations, we will assess such efforts and share the understanding with audit firms subject to inspection.

We will flexibly organize and operate the inspection teams necessary for the above purpose.

We will specifically and precisely convey items pointed out in the inspection results to audit firms. At the same time, we will try to upgrade information pertaining to the inspection results by reviewing the description method and content of the inspection report to ensure that the inspection results and inspection related information are conveyed to the entities through the entities. Taking into account the above, we will conduct inspection with emphasis on the below mentioned items according to the type of audit firm in the current fiscal year.

- ① To maintain and improve the quality control system, we will inspect if basic management policy and measures related to business management prepared by audit firms and measures for securing the fair execution of services, such as measures related to compliance with laws and regulations, are appropriate according to the size and characteristics of the audit firms.

Specifically, we will inspect the intentions and attitudes of audit firm's management toward services, hiring, development, and placement of human resources according to the risk of

services, policies on the evaluation and compensation of employees, as well as the status of establishment of an organization to conduct systematic audits, such as cooperation among employees and mutual checks-and balances.

Furthermore, we will also inspect the status of reviewing measures related to the management policy and business management by taking into account the status of formulation of a medium-and long-term management policy and management plan and the environment surrounding audit firms.

- ② We will appropriately assess business risk including the economic environment and the corporate environment surrounding the entities and inspect if the acceptance and continuance of engagements, formulation of audit planning, and other audit procedures are implemented.
- ③ As we need to identify the root causes of deficiencies and essentially respond to such causes to urge audit firms subject to inspection to take effective improvement measures, we will precisely convey the inspection report and items pointed out in the results of the inspection that help such audit firms take action to make effective improvement based on root cause analysis.

We will conduct inspection according to the type of audit firm in the current fiscal year as follows.

(1) Inspection of large-scale audit firms

Taking into account their role in the capital market and domestic and international movements related to supervision of auditors, we will cyclically inspect large-scale audit firms based on the inspection results pertaining to the results of JICPA's quality control review. However, if the internal control system of audit firms that perform audit engagements for entities requiring to be checked promptly in circumstances where entities that may have a significant impact on the market are found or suspected to have material accounting problems, we will flexibly conduct inspection.

Large-scale audit firms have several thousand employees and are large organizations controlled by several divisions and offices. They also have several hundred listed companies as their audited entities.

Taking into account the results of the recent monitoring of large-scale audit firms, we need to conduct inspection with more emphasis on their business management (governance) system and service management system, especially the quality control and management of services conducted by the engagement teams.

For this purpose, we will conduct inspection with an emphasis on the below mentioned items in the current fiscal year.

- Inspection of the business management and service management systems and the penetration of quality control to the lowest rank of the organization (especially, management of secondary offices) from the standpoint of whether or not a quality control system necessary for an audit firm is appropriately operated.
- Inspection of audit procedures related to revenue recognition and accounting estimates from the standpoint whether or not risk is appropriately assessed or professional skepticism is appropriately exercised.
- Inspection of a system to audit IPOs, the status of independence, and audit procedures.
- Inspection of the status of communication with the audited entities and the status of group audit.
- Inspection of the assessment of internal control in the audit of financial statements and the status of audit concerning internal control, and the status of responses to fraud risk including

the status of operation of the standards to respond to fraud risk.

- Inspection of the adequacy of monitoring by overseas business partners.

Moreover, from the standpoint of strengthening follow-up to inspection, if a material deficiency is pointed out in the regular inspection conducted cyclically, we will conduct a follow-up inspection to check if the deficiency is remedied in the regular inspection in the following fiscal year.

We will efficiently conduct follow-up inspection by limiting the scope of inspection and simplifying the inspection report (notice).

(2) Inspection of second-tier large-scale audit firms

Taking into account the situation of the entities and an audit firm's business profile, we will intensively inspect second-tier large-scale audit firms in light of their significance in the Japanese audit industry. Considering effective and efficient implementation with a focus on common risk, we will inspect second-tier large-scale audit firms cyclically based on the inspection results pertaining to the results of JICPA's quality control review. However, if the internal control systems of audit firms that perform audit engagements for the entities requiring to be checked promptly in circumstances where an entity that may have a significant impact on the markets is found or suspected to have material accounting problems, we will instantly conduct inspection.

For this purpose, we will conduct inspection with an emphasis on the below mentioned items in the current fiscal year.

- Inspection with a focus on essential problems in the operation by obtaining information with high importance related to quality control and engagements at the relevant audit firm, taking into account the previous audit results and relationships with overseas business partners, such as the status of monitoring by overseas business partners, and paying attention to engagement risk.
- Inspection of the business management and service management systems, such as unity as an organization.
- Inspection of audit resources including whether there is sufficient and appropriate experience and capability to respond to audit risk, such as the internationalization of the entities.
- Inspection of the status of communication in group audit, especially with component auditors, who are stationed overseas.
- Inspection of communication with corporate auditors, the status of inspection of the effectiveness of remedies to items pointed out in JICPA's quality control review and inspection, the inspection system of audit opinions, the status of use of professionals, and the status of response to issues across the industry obtained through past monitoring.
- Inspection of the status of response as an audit firm based on the standards when an auditor is replaced.
- Inspection of the assessment of internal control in the audit of financial statements and the status of audit concerning internal control, and the status of responses to fraud risk including the status of operation of the standards to respond to fraud risk.

(3) Inspection of small- or medium-scale audit firms

Regarding small- or medium-scale audit firms, we will conduct inspection, mainly confirmation of the quality of audit, such as the audit firm's quality control system and service management system based on the intention and nature of the management and employees and the conformity of individual engagements with audit standards. We will also perform inspection as necessary, taking into account the results of the review related to the results of JICPA's quality control

review.

For this purpose, we will conduct inspection with emphasis on the below mentioned items in the current fiscal year.

- Inspection with consideration of issues related to operations and quality control attributable to a small- or medium-scale audit firm's system
Especially, inspection of the business management and service management systems, such as unity as an organization.
- Inspection of audit resources including whether there is sufficient and appropriate experience and capability to respond to audit risk, such as the internationalization of the audited entities.
- Inspection of communication with corporate auditors, the status of guidance and supervision to audit practitioners, the status of use of professionals, and the status of response to issues across the industry obtained through past monitoring.
- Inspection of the status of response as an audit firm based on the standards when an auditor is replaced.
- Inspection of the status of response to the standards for fraud risk in the audit.
- Inspection of the status of communication in group audit, especially with component auditors, who are stationed overseas.
- Inspection of issues identified through off-site monitoring.
- Inspection of the status of improvement of items pointed out in the JICPA's quality control review.
- Inspection of the assessment of internal control in the audit of financial statements and the status of audit concerning internal control.

4. Provision of Monitoring Information

We will conduct in-depth analysis on the results and status of monitoring to maintain and improve the quality of audit and publicize information as follows.

- ① We will extract cases confirmed in the inspections including superior efforts and compile them as a collection of examples of inspection results. Using opportunities including briefing sessions, we will actively transmit information to not only related parties, such as JICPA, audit firms, and the audited entities, but also market participants.
- ② To help investors deepen their understanding of audit, we will upgrade information related to the quality of audit, for instance, summarizing the situation of monitoring to compile and publicize it as a monitoring report⁷.

⁷ We will prepare a monitoring report on the situation of monitoring in fiscal 2015 on a trial basis.