

**Audit Firms Monitoring Policy for Fiscal Year 2015  
(On-site Monitoring and Inspection)**

The Certified Public Accountants and Auditing Oversight Board (CPAAOB) has published the Audit Firms Monitoring Policy for Fiscal Year 2015. This is the summary of the Policy.

**1. Background: Surrounding Environment and Challenges for Audit Firms**

- Some signs of economic upturn are observed such as the increase in the number of IPOs and growing market capitalization while the number of listed companies and the average audit fee revenues have been slightly decreased.
- Increasing global business expansion of Japanese companies, in particular, to the Asia, requires further globalization of accounting and auditing practices.
- The implementation of the revised Companies Act and the newly created Corporate Governance Code in 2015 requires enhanced role of audit committees and statutory auditors of the companies. This also involves higher expectations for audit firms regarding their roles for effective corporate governance of the companies.
- More deficiencies are found in quality control review by the Japanese Institute of Certified Public Accountants (JICPA), in particular, among smaller audit firms.
- Enhanced audit quality is underlined in “*Japan Revitalization Strategy Revised in 2014*” from the perspective of strengthening global competitiveness of Japanese companies. At the same time, International Forum of Independent Audit Regulators (IFIAR) has also stressed the importance of root cause analysis of identified deficiencies, governance of audit firms and economic model of audit firms.

**2. Principal concepts of the Policy of Audit Firms Monitoring**

The followings are the principal concepts of the CPAAOB’s policy of audit firms’ monitoring for fiscal year 2015;

- Further enhanced risk-based approach in response to different risks and business profiles of audit firms, particularly categorized by the size of assurance activities (Please refer to **4. Inspections** for details)
- Comprehensive assessment of the effectiveness of quality control review by JICPA and other self-regulatory functions.
- Enhanced off-site monitoring
- Enhanced collaboration with foreign regulators; and
- Enhanced resources and infrastructure to support the monitoring

### **3. Risk Assessment and Off-site Monitoring**

#### (1) Assessment of Effectiveness of JICPA's Quality Control Review

Quality control review by the JICPA is an important source for monitoring by the CPAAOB. In light of recent enhancement of the roles and the process of the JICPA's quality control review, the CPAAOB will conduct a comprehensive assessment of their effectiveness.

#### (2) Enhanced Off-site Monitoring

The CPAAOB will review, through reports provided by audit firms, the effectiveness of the design and operation of their quality control system and identify common issues across the audit industry.

As root cause for audit deficiencies, the CPAAOB will particularly focus on business models and strategies of audit firms, including tone at the top, their revenues and human resources.

### **4. Inspections**

#### (1) Principal Idea of Inspections

During on-site inspections of individual firms, the CPAAOB will identify deficiencies and weaknesses regarding the firm's audit quality and analyze their root causes through interactive discussion with each firm. In addition, the CPAAOB will collaborate with the JICPA towards enhancing its quality control review through, for example,

providing its inspection reports to the JICPA for reference. Further, by publishing “*Case Report from Audit Firm Inspection Results*”, the CPAAOB will continue to outreach to the audit industry and to other stakeholders for audit quality and communicate the examples of deficiencies and weaknesses identified through the inspections as well as best practices for audit quality control.

## (2) Common Focuses of Inspections

The following issues will be reviewed for all categories of inspections.

- (a) Quality control in line with the size and the business profile of audit firm, in particular;
  - Business strategies and their dynamic review in response to the changes in surrounding environment for audit firms
  - Initiatives taken by the top management for audit quality (tone at the top)
  - Human resource management, including staff recruitment, training and assignment according to risk profiles of audit engagements
  - Incentive mechanism, including performance evaluation and compensation policies; and
  - Measures for consistency of audit quality across the engagements
- (b) Understanding and evaluation of risk profiles of audit engagements including their business environment, in determining acceptance and renewal of audit engagements and in planning and executing audit procedures
- (c) Root cause analysis of deficiencies identified as a basis for effective corrective actions

## (3) Focuses of Inspections in response to risk and business profile of audit firms

The CPAAOB will take three level approaches in consideration of different risks and business profiles among audit firms.

- (a) Top-tier Large Firms (Big 4 Firms)

Regular inspections will be conducted every two years. Considering JICPA’s

quality control reviews (every two years) and global review by the international networks of the firms, the CPAAOB will continue thematic and horizontal inspections with focus on issues that are common among the top-tier firms as follows;

- revenue recognition
- accounting estimate
- professional skepticism
- group audit (in particular, communication between principal auditor and overseas component auditors); and
- engagement quality control review (EQCR) by the JICPA

In addition, the following issues will also be covered by the thematic/horizontal inspections.

- quality control over local offices
- engagements for financial institutions
- reviews by international networks; and
- response to domestic and overseas regulatory changes regarding their audit engagements and the firms

The inspections will review not just compliance with minimum standards required by relevant accounting and auditing standards, but also anticipate higher expectation including best practices among the global audit firms.

(b) Second-tier Large Firms

Regular inspection will be conducted every three years for this group of audit firms, with focus on some common issues among the group, as follows;

- audit engagements which require higher level of audit expertise, such as financial institutions, collective investment schemes, and globally operating companies
- communication with corporate auditors
- corrective measures in response to the findings identified during JICPA's quality control review
- quality control regarding rotation of auditors within the firm
- group audit (in particular, communication between principal auditor and

overseas component auditors); and

- any measures taken nationwide in response to the changes in surrounding environments

(c) Small and Mid-sized Firms

A number of deficiencies have been noted among small and mid-sized firms, in relation to quality control for acceptance and continuance of audit engagements, corrective measures against the deficiencies identified by the JICPA and audit engagements with high dependency (more than 15% of the firm's total revenue). Inspection will be conducted in response to risk profile of the firms with focuses on the following issues;

- capacity for quality control under their resource constraints
- expertise and competence of engagement team members
- audit engagements which require higher level of audit expertise, such as financial institutions, collective investment schemes, and globally operating companies
- communication with corporate auditors
- quality control regarding rotation of auditors within the firms
- group audit (in particular, communication between principal auditors and overseas component auditors); and
- corrective actions against deficiencies and weaknesses identified by JICPA's quality control review

## **5. Post-inspection Follow-up**

After the inspection of individual audit firms, the CPAAOB will follow up and review the effectiveness of their corrective actions. It will also consider the results of quality control reviews by JICPA for the follow-up and for next inspections of the firms. In case of inadequate improvements, next inspection of the firm might be considered earlier than otherwise.

Horizontal and in-depth analysis of the results of individual off-site monitoring and inspections will be conducted to identify industry-wide issues. In addition, the CPAAOB will actively reach out to relevant stakeholders for audit quality including FSA, JICPA,

the stock exchanges, investors, International Forum of Independent Audit Regulators (IFIAR) and international networks of the audit firms.

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