

For Further Improvement of Audit Quality
- Basic Policies for Examinations and Inspections -

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Certified Public Accountants and Auditing Oversight Board (CPAAOB)

The mission of Certified Public Accountants (CPAs), who are auditing and accounting professionals, is to promote fair corporate activities and to protect investors and creditors by ensuring the reliability of financial information from an independent standpoint, so that they shall contribute to the sound development of the national economy (Article 1 of the CPA Act). The Japanese Institute of Certified Public Accountants (JICPA) shall review the quality control practice of its members – namely CPAs or audit firms – in view of their mission to serve the public interest, and shall report the results of such reviews to the Certified Public Accountants and Auditing Oversight Board (CPAAOB or the “Board”), in order to promote the further improvement and advancement of its members’ auditing of financial information, and ultimately to enhance the quality of such audit activities (Article 46.9 (2) of the CPA Act).

Based on reports of quality control review by the JICPA, and from the standpoint of serving the public interest independently from the JICPA, the Board shall examine whether or not the JICPA’s review of audit firms and the audit practices of audit firms are operated properly and may, if deemed necessary, make an on-site inspection of audit firm in question, the JICPA, etc. If deemed necessary, the Board may recommend that the Commissioner of the Financial Services Agency (FSA) to take administrative sanctions and/or other measures necessary to ensure the proper operation of the JICPA and audit firms (Article 41.2 of the CPA Act).

Through its reviews and inspections conducted during the first 3-year term (April 2004, when the Board was established, through June 2007), the Board notified audit firms subject to such inspections of the results thereof, while publicizing a summary of deficiencies of the JICPA’s quality control reviews and of any other issues relating to the quality control aspect of the firm’s auditing practices, if such measures were deemed to help maintain and further enhance the auditing quality of that firm and the overall system.

Specifically, during Business Year 2004 (July 2004 to June 2005), the Board assessed the situation

surrounding quality control reviews by the JICPA for the period before the quality control review was formally incorporated into the CPA Act. The results of the assessment were summarized and published in a report entitled “Proposal for Further Improvements to the Quality Control Review – Assessment of and Recommendations Pertaining to the Quality Control Review System of the Japanese Institute of Certified Public Accountants”. During Business Year 2005 (July 2005 to June 2006), the Board conducted an inspection of the Big 4 audit firms in Japan, in light of the prevailing situation surrounding audit practices in general and the global trend toward strict oversight and monitoring of audit firms, the results of which were summarized in another report entitled “Quality Control of Audits of the Four Largest Japanese Audit Firms,” for public release (the follow-up on these inspections was then summarized in another release in June 2007). Furthermore, the Board published a report entitled “Regarding Quality Control of Audits by Small Scale Audit Firms” and “Regarding Quality Control of Audits by Small and Medium Scale Audit Firms” during Business Year 2006 (July 2006 to June 2007), where the key issues and themes, etc., pertaining to small- and medium-scale audit firms (including sole practitioners) were raised for further discussion.

During the second 3-year term (July 2007 to June 2010), in light of the track record of the examinations and inspections conducted during the first 3-year term, the Board will carry out its examinations and inspections, based on the viewpoint and goals specified below.

Viewpoint

In its examination and inspection efforts, the Board must exercise its fullest capacity from the standpoint of serving the public interest, where the viewpoints of members of the public are always respected, so that the maintenance and improvement of the quality of audit will be promoted in a proactive way. Furthermore, the Board will respond in a positive fashion to international development in this field, while trying to collect information on foreign countries and to provide information of its own, both domestically and globally.

Goals

The reviews and inspections implemented by the Board shall not be for the direct and principal purpose of judging whether an audit opinion provided by an individual audit firm is appropriate or not, but for the purpose of further promoting the functional improvement of the JICPA’s quality control reviews, from the Board’s standpoint of serving the public interest. This shall constitute its basic principle.

In light of the matters discussed above, the Board shall determine its “Basic Policy for Examinations” and “Basic Policy for Inspections” with regard to the implementation of quality

control review examinations and any on-site inspections, the details of which are given below. These Policies shall be reviewed on an annual basis, and the respective “Basic Plan for Examinations” and “Basic Plan for Inspections” shall be determined every year, in consideration of the wider scope of audit practices enforced as a result of the introduction of quarterly financial reporting and internal control reports, etc., the amendment of relevant laws and regulations including the CPA Act, changing social and economic situations, and so on.

Furthermore, in light of its duties, the Board shall present the results of its examinations and inspections to the relevant parties in the form of proposals, if and when they are deemed beneficial to maintaining and improving the quality control of audit firms, as part of fulfilling the missions assigned to it (note).

(Note) On the basis of these visions, among those deficiencies regarding firm-wide quality control of inspections conducted by the Board, we summarized and publicized some deficiencies, which can be regarded as useful for relevant audit firms in improving the quality control of audit firms, as a report entitled “List of examples of issues on audit quality control identified through inspections” in February 2008. The Board intends to review the list and update it, taking into account the developments of inspections.

1. Basic Policy for Examinations

(1) Basic Concept

Based on the results of examinations and inspections conducted during the first 3-year term, the Board will pursue the following fundamental concepts as its “Basic Policy for Examinations” for the second 3-year term:

(a) Ensuring that steady improvement is made and maintained with regard to the deficiencies identified so far

The Board shall conduct examinations with priority placed on examining whether or not steady improvement has been made regarding any deficiencies already identified by the Board concerning the audit quality control of the firm in question. In doing so, the Board will endeavor to identify any other items that would require further improvement, in order to promote the establishment of proper audit quality control practices at the relevant firm.

Meanwhile, the Board will conduct examinations with a focus on the audit firms that mainly provide audit services for listed companies, especially targeting medium- and large-scale audit firms, so that the objectives of the Board’s examinations will be achieved in the most effective way under limited administrative resources.

(b) Response to New Developments

From Business Year 2007 onward, the Board will conduct its examinations in consideration of the fact that the JICPA has been implementing its quality control reviews under the newly introduced “Standards for Quality Control of Audit Practices” and that a new measure, “Registration System for Listed Company Audit Firms” has been enforced by the JICPA on firms that provide listed companies with audit services.

(2) Examination Framework

- (a) Having received the quality control review reports from the JICPA and at the same time having collected any other supplementary reports and documents, the Board shall conduct its examinations based upon the contents thereof and by employing various other information sources, in order to examine the following points:
- (i) Whether or not the quality control review system is properly operated by the JICPA
 - (ii) Whether or not the audit firms are conducting their audit services properly, based on the results of the quality control reviews, and whether the findings from the JICPA’s reviews are duly reflected in the firm’s subsequent audit practices
- (b) As a result of the examinations specified above, the Board may, on a case-by-case basis, present its opinions to the relevant parties in the form of proposals, advice and so on, while taking any other appropriate measures, including recommending the Commissioner of the FSA to take administrative sanctions and/or other measures necessary to ensure the proper operation of the JICPA and audit firms.

2. Basic Policy for Inspections

In light of the results of its examination pursuant to the “Basic Policy for Examinations” based on the quality control review reports by the JICPA, the Board shall conduct an on-site inspection of the audit firms etc., if deemed necessary.

(1) Inspection Framework

The basic framework for inspections by the Board is set out as follows:

- (a) If it is deemed necessary as a result of its examination of the JICPA’s quality control reviews, the Board shall conduct an on-site inspection of the JICPA, audit firms, etc., in order to confirm that the overall system of quality control reviews by the JICPA is being operated properly.
- (b) If it is deemed necessary and appropriate as a result of its examinations of the JICPA’s quality control reviews, the Board shall implement an on-site inspection of the audit firm, in order to verify that the audit practices at said firm are conducted properly and/or whether the findings from the JICPA’s reviews are appropriately reflected in the

firm's subsequent audit practices.

- (c) If it has deemed it necessary and appropriate in the process of conducting procedure (b) above, the Board shall implement an on-site inspection of other relevant parties including the entity that has been audited by the firm, in order to confirm the situation surrounding that firm's audit practices.

The Board will notify the JICPA and the audit firm subjected to its inspection of the results thereof and, if necessary, recommend that the Commissioner of the FSA to take administrative sanctions and/or other measures necessary to ensure proper audit practices.

(2) Implementation of the Board's Inspection

The Board shall conduct inspections in cases such as the ones specified below:

- (a) In cases when the Board deems it necessary to further verify the completeness or thoroughness of the quality control reviews by the JICPA (e.g. if any important review procedures were found lacking, or if the administration of such review procedures was judged improper or insufficient), an on-site inspection, principally of the JICPA, shall be conducted.
- (b) In cases when the Board deems it necessary, through the quality control reviews by the JICPA, to further verify whether or not the auditing practices at the subject firm are conducted properly, and/or whether the findings from the JICPA's reviews are appropriately reflected in the firm's subsequent audit practices, and/or whether the operation control system at the firm is functioning in an effective way, an on-site inspection, principally of the audit firm, shall be conducted.
- (c) In cases when the Board deems it necessary to verify the internal control situation of a client of the audit firm, which should correspond to the audit procedures provided by the firm, or if there is any need to examine the audit practices by the subject firm on the side of its client, an on-site inspection, principally of said client of the audit firm, shall be conducted.
- (d) In cases when the Board deems it necessary to confirm the across-the-board observance of relevant laws, regulations, standards and so on, an on-site inspection of the relevant party will be conducted.
- (e) In addition to the cases mentioned above, if and when the Board deems it necessary and appropriate for the public interest or investor protection, depending on the results of its individual examinations and on a case-by-case basis, an on-site inspection of any relevant party will be conducted.

(3) Inspection Procedures

The Board shall, if it has judged it necessary, conduct an inspection pursuant to the proper procedures stipulated under the “Rules on CPAAOB Administration” and the “Guidelines on Inspection Conducted by the CPAAOB.”

3. Response to foreign audit firms

Since April 2008, certain foreign audit firms are obliged to make notification to the FSA, and the revised CPA Act empowers the CPAAOB to conduct on-site inspections of firms, when deemed necessary and appropriate in light of public interest and investor protection in Japan.

The CPAAOB strives to gather and analyze information concerning quality control of the relevant audit firms, as well as to develop a collaborative relationship among relevant organizations and international audit oversight authorities, taking into account the subsequent developments of notification from the subject firms and the content of notification documents. The Board intends to conduct inspection when deemed necessary after making specific examinations on the inspection procedure, the selection of audit firms to be inspected, and the utilization of inspection results.