

July 31, 2018

Certified Public Accountants and Auditing Oversight Board

**Basic Plan for Monitoring Audit Firms**  
**in Program Year 2018 (from July 2018 to June 2019)**

To maintain audit quality and improve the effectiveness of audit, the Certified Public Accountants and Auditing Oversight Board (the “CPA AOB”) hereby establishes the Basic Plan for Monitoring Audit Firms in Program Year (“PY”) 2018 (from July 2018 to June 2019) (the “Basic Plan 2018”), reflecting the viewpoints and purposes stated in the Basic Policy for Monitoring Audit Firms (the “Basic Policy”)<sup>1</sup> and environment surrounding audit firms.

**1. Environment surrounding audit firms**

Audit trends

Japan’s economy continues to recover moderately and the number of IPOs at stock exchanges totaled 90 in 2017, the same high level as in 2016. The total number of listed companies and the average audit fees paid by them are increasing, albeit a slight increase.

Audits of listed companies are performed by certified public accountants and audit firms, of which large-sized audit firms<sup>2</sup> accounted for an overwhelming 90% (as of the end of 2017, based on market capitalization). In terms of audit firm changes by listed companies in recent years, while many companies switched their audit firm to and from large-sized audit firms, there were some small listed companies that switched their auditors from large-sized to second-tier<sup>3</sup> or small and medium-sized audit firms<sup>4</sup>.

Given continuing strong M&A activities, companies expanding to overseas markets and increasingly complex and specialized business transactions, large-sized audit firms have endeavored to meet the needs for more in-depth and complex audit methods by retaining and

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<sup>1</sup> Basic Policy for Monitoring Audit Firms: It sets the standpoint, purposes, 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 and announced on May 13, 2016.

<sup>2</sup> Large-sized audit firms: Audit firms that have more than approximately 100 listed audit companies and whose full-time staff performing actual audit duties total at least 1,000. In this basic plan, they refer to KPMG Azsa LLC, Ernst & Young ShinNihon LLC, Deloitte Touche Tohmatsu LLC and PricewaterhouseCoopers Aarata LLC.

<sup>3</sup> Second-tier audit firms: Audit firms whose size of business is second only to large-sized audit firms. In this basic plan, they specifically refer to GYOSEI & CO., BDO Sanyu & Co., Grant Thornton Taiyo LLC, BDO Toyo & Co. and PricewaterhouseCoopers Kyoto.

<sup>4</sup> Small and medium-sized audit firms: Audit firms other than large-sized audit firms and second-tier audit firms.

training international human resources, introducing IT and other technologies and hiring more assistants to engagement partners.

#### Response to accounting scandals

The number of listed companies that disclosed accounting fraud has increased over the past few years. This is attributable to the increased awareness of listed companies towards timely disclosure of negative information and indication raised by auditors. Some disclosures reveals cases of insufficient internal control including those of significant group companies as accounting scandals associated with overseas subsidiaries of listed companies have continued to be disclosed.

It goes without saying that top management of companies is responsible for the preparation of financial statements and the development/implementation of an effective internal control system. Thus, it is increasingly important that audit firms perform audit procedures on internal control based on a thorough understanding of audited companies' business characteristics and the environment surrounding them, including their overseas businesses. Audit firms are required to inform audited companies of deficiencies in internal control in a timely manner.

Due to stricter listing examination, the number of accounting fraud occurred soon after listed has decreased in the IPO market. However, newly listed companies shall be audited with due care, in view of their somewhat vulnerable internal control and, as mentioned previously, the growing number of IPOs.

#### Current state of quality control at audit firms

The CPAAOB has implemented 5-level overall ratings<sup>5</sup>, based on which it assigns an overall rating to the inspected audit firm's business operations in the inspection result notification (excluding follow-up inspections) since PY 2016. Up to the present, no audit firm has been given the highest rating "generally satisfactory". All inspected audit firms were assigned either the second highest rating "satisfactory with minor deficiencies" or lower, based on the status of their business operations.

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<sup>5</sup> The CPAAOB provides an inspected audit firm with an overall rating based on "key points" section of the inspection results notifications. "Key points" section consists of an overview of deficiencies in operations management environment and quality control environment and individual audit engagements. Overall ratings are classified into 5 levels: "generally satisfactory", "satisfactory with minor deficiencies", "unsatisfactory", "unsatisfactory and in need of immediate remediation" and "extremely unsatisfactory." For detailed information, see the monitoring report 2018, published on the CPAAOB's website (English version will be published in December 2018).

Inspections conducted in PY 2017 confirmed that large-sized audit firms, albeit some deficiencies, systematically took measures to improve their quality management, keeping in mind the cooperation between the quality control department and business units. Second-tier audit firms worked to improve firm-wide business operations but not to a satisfactory level, due to the shortage of manpower in charge of quality management. Some small and medium-sized audit firms failed to build appropriate quality control environment, due to excessive emphasis on business expansion or their management's lack of awareness towards quality control.

#### Development of framework based on the Audit Firm Governance Code

Based on the “Principles for Effective Management of Audit Firms” (the “Audit Firm Governance Code”), published by the Financial Services Agency (the “FSA”) on March 31, 2017, large-sized and second-tier audit firms are in the process of enhancing their governance to improve the quality of audit, such as by ensuring organizational, firm-wide operation by an effective management function and utilizing knowledge and experience of independent third persons as part of supervision and evaluation functions.

#### Security measures aligned with advancement of information technology (IT)

Audit firms, mainly large-sized audit firms, have worked to increase their IT usage to enhance audit approaches further, which is expected to promote the implementation of in-depth audit procedures, ensuring greater effectiveness and efficiency.

At the same time, amidst such trend and increasing data exchanges between audit firms and audited companies, cyber incident targeting audit firms in overseas happened. Cyber security issues are key management risks for audit firms. It is essential that audit firms enhance their cyber security measures in line with the advancement of IT.

#### Trends in international independent audit regulators

In April 2017, the International Forum of Independent Audit Regulators (IFIAR)<sup>6</sup> set up their permanent secretariat in Tokyo, Japan. The FSA and the CPAAOB provide the necessary support to facilitate the secretariat's operation from the perspective of strengthening the international status of Japan's capital markets. The IFAIR has endeavored to improve audit

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<sup>6</sup> International Forum of Independent Audit Regulators (IFIAR): An international organization established in 2006, consisting of independent audit regulators that inspect audit firms. The IFIAR aims to improve audit quality globally through collaboration among authorities. As of the end of June 2018, the number of IFIAR member countries/regions totaled 52, including Japan.

quality globally, through continuous dialogue with the six largest global audit networks<sup>7</sup>. The annual plenary meeting held in April 2018 approved the IFIAR 2018-2021 Strategic Plan which outlined the IFIAR's objectives. The CPAAOB will continue to contribute to the IFIAR's activities.

## **2. Concept of Basic Plan for Monitoring Audit Firms in PY 2018 (July 2018-June 2019)**

Based on Section 1 "Environment surrounding audit firms" and the Basic Policy, the CPAAOB will monitor audit firms<sup>8</sup> based on the following bullet points and the five basic concepts from (1) to (5).

- We will conduct examinations in ways that encourage audit firms to take actions by themselves as audit firms need to take the initiative in ensuring and improving the audit quality.
- We will verify not only whether audits conducted by audit firms are formally compliant with the standards, but also whether auditors are effectively conducting audits such as exercising appropriate professional skepticism to detect accounting fraud and assessing audit risks by paying attention to business risk of audited companies at all times.

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

In PY 2018, the CPAAOB will monitor audit firms focusing on the following points.

#### **(i) Tone at the top towards the improvement of audit quality**

We will confirm the top management's awareness and the way the awareness is reflected in firm's measures because it is important that the top management takes the lead in nurturing their culture that prioritizes audit quality to improve audit quality continuously.

#### **(ii) Development of governance system pursuant to the Audit Firm Governance Code**

For large-sized and second-tier audit firms that have adopted the Audit Firm

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<sup>7</sup> BDO, Deloitte, EY, Grant Thornton, KPMG and PwC

<sup>8</sup> The CPAAOB's monitoring includes both on-site monitoring and off-site monitoring. On-site monitoring refers to inspections, while off-site monitoring means activities other than inspections, such as collection of reports regarding audit firms, interviews, information gathering through the exchange of opinions and cooperation with audit firms and relevant parties.

Governance Code, we will continue to examine the effectiveness of their governance systems, established and enhanced in accordance with the Code, from the viewpoint of improving audit quality.

For small and medium-sized audit firms, we will examine the effectiveness of operations management and quality control in improving audit quality.

We will share information and cooperate with related departments in the FSA during inspection of this matter.

(iii) Audit trends

a) Group audit on overseas subsidiaries

Given mature domestic markets, many listed companies in Japan are pursuing markets outside Japan. In these circumstances, some accounting frauds have been identified in relation to overseas subsidiaries. Thus, we will continue to monitor handling of group audit in relation to overseas subsidiaries by audit firm, as well as the related engagement team.

b) Acceptance of new audit engagements

We will monitor audit firms which have undertaken new audit engagements and confirm how they assess factors that may have an impact on audit quality when preparing for new audit engagements since recent accounting scandals prompted many listed companies to change their audit firms.

(iv) IT-based audit approaches and cyber security measures

Some of the large-sized and second-tier audit firms have implemented IT-based audit procedures, introducing IT systems for the analysis of accounting data and implementing cross-divisional control of risk information. These activities are intended to ensure and improve the audit quality, and we will keep ourselves informed of the status through monitoring.

We will also check whether audit firms build sufficient cyber security capacities according to degree of utilization of IT as well as develop and secure human resources that are capable of extensive and complex audit methods.

There are a diverse range of audit firms, from small scale firms, individual-owned or

with a few partners, to large-scale firms that conduct numerous audit engagements with a few thousand CPAs. Approaches to business and operations management vary among these audit firms. Therefore, we will categorize them into large-sized, second-tier, and small and medium-sized audit firms and implement monitoring based on these categories.

(2) Enhancing international cooperation in audit oversight

The CPAAOB will obtain the information necessary for monitoring and provide information on request to overseas auditing supervisory authorities through the IFIAR Multilateral Memorandum of Understanding concerning Co-operation in the Exchange of Information for Audit Oversight (MMoU) and other bilateral frameworks for information exchange<sup>9</sup>. Additionally, we will keep up to date on supervisory approaches outside Japan and trends related to global audit networks through active participation in the IFIAR's discussions.

(3) Strengthening off-site monitoring

To conduct monitoring efficiently and effectively, the CPAAOB will continue periodic exchanges of views with large-sized and second-tier audit firms and further strengthen efforts for information sharing through cooperation with relevant parties, such as the FSA, other related organizations and overseas auditing supervisory authorities. We will also enhance its capabilities to gather and analyze information regarding the environment surrounding audited companies, such as industry trends, and utilize the information and results of analyses in inspections, thereby achieving seamless on- and off-site monitoring.

(4) Enhancement of the monitoring environment

The CPAAOB will strengthen the CPAAOB's monitoring environment to collect, analyze information and implement inspections that are well suited for the given characteristics of the audit firms.

To accomplish this goal, we will actively appoint talents who can take appropriate responses based on the analysis of information in and outside Japan, the status of internationalization of accounting practices and the environment surrounding audit firms and those who can provide guidance on efficient and effective monitoring. As a

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<sup>9</sup> Up to the end of June 2018, Japan exchanged letters on information sharing framework with audit supervisory authorities in 8 countries (the US, Canada, Malaysia, the Netherlands, Luxembourg, the UK, France and China).

part of human resources development, we will send its staff to foreign audit regulators and hold training sessions incorporating global trends and key accounting and audit issues.

(5) Overall examination of the JICPA's quality control review system

The CPAAOB examines the effectiveness of quality control review by the Japanese Institute of Certified Public Accountants (the "JICPA") through the monitoring of audit firms. We have communicated identified issues to the JICPA, which, in turn, has enhanced the quality review system. We will continue this overall examination for encouraging the JICPA to continue to upgrade its quality control review.

Further, the CPAAOB and the JICPA will consider appropriate role sharing and cooperation aiming to maximize effectiveness of the CPAAOB's inspection and the JICPA's review.

### **3. Basic Plan pertaining to off-site monitoring**

In order to conduct off-site monitoring efficiently and effectively, the CPAAOB will utilize obtained information such as the JICPA's quality control review reports and analyses of past inspection results. Additionally, we will conduct the following off-site monitoring tailored to the types of audit firms, such as collection of reports, interviews, examination of the JICPA's quality control review to understand the status of audit firms and the risks associated with individual audit engagements accurately and timely.

(1) Collection of reports

- (i) Based on the results of the JICPA's quality control review, we will collect reports from audit firms in a timely manner in order to encourage them to radicate appropriate quality control.

Especially for small and medium-sized audit firms, we will intensively examine the status of development of the quality control system at the audit firms, the management policies of their leaders, revenue/financial structures, organizational structure and human resources. The collection of reports should be conducted in an effective manner, for example, through face-to-face communication.

Further, in the case where any potentially material issue is identified through the

collection of reports, we will utilize the information as important reference in inspection, etc.

- (ii) In terms of large-sized audit firms, we will continue to collect the qualitative and quantitative information necessary to inspect their business management (governance) and operations management environment, and IT-based audit approaches (including cyber security measures), etc. for improved audit quality based on the Audit Firm Governance Code.

Acquired information will be analyzed and utilized for effective and efficient implementation of inspections. We will also utilize the information to make comparisons among large-sized audit firms and capture problems common across these audit firms. Reports shall be collected efficiently, utilizing information presented at inspections and exchanges of opinions.

- (iii) After a certain waiting period from the date on which inspection results are informed to the inspected audit firms, we will require applicable audit firms to provide reports in a timely manner and check the progress of their efforts to improve quality control. We will cooperate with related departments in the FSA and conduct inspections in alignment with the characteristics and importance of the identified deficiencies.

However, we will consider requiring the audit firm to provide information regarding the development of an improvement plan and the status of implementation, immediately upon issuance of the inspection results, without the waiting period in the case where the inspected audit firm's business operation is deemed inappropriate and immediate improvement is required.

If, based on the reports above, the status of improvement is considered inadequate, we will consider taking additional actions, such as further collection of reports and another inspection.

- (2) Overall examination of the JICPA's quality control review, etc.

When comparing the JICPA's quality control reviews in PY 2017 with 2016, the JICPA more frequently determined the length of review period and the number of reviewers flexibly based on the latest status of audit firms' quality control and



extended its review period based on issues identified during the reviews. Additionally, the JICPA more frequently handled issues identified through the assessment of individual audit engagements as wider audit procedural issues based on their characteristics, instead of as deficiencies in documentation for formality, and linked identified issues with deficiencies in the quality control environment.

As shown in the above, the quality of the JICPA's quality control review is improving. However, it remains questionable that the JICPA appropriately and effectively instructs and encourages audit firms to make improvements.

The CPAAOB will continue to examine the JICPA's quality control review through the overall examination based on reports of the quality control review and audit firm inspections.

Currently, the CPAAOB and the JICPA exchange views on desirable approaches to the quality control review that will lead to the improvement of audit practices and quality. Based on the results of overall examination, the CPAAOB will continue to work towards more effective cooperation and discuss appropriate role-sharing with the JICPA, considering the progress of initiatives to improve the effectiveness of the JICPA's quality control review.

(3) Collection and analysis of information regarding audit firms

The CPAAOB will continue periodic exchanges of views with large-sized and second-tier audit firms, including top management's views on improving audit quality for understanding the latest status of operations management environment and the challenges facing audit firms and the industry.

Through exchanges of views, cooperation, etc., we will enhance its information sharing with the IFIAR, foreign audit regulators and global audit networks, in addition to FSA departments, the JICPA and stock exchanges. Further, we will endeavor to upgrade its capabilities for collecting and analyzing information in accordance with the risks facing individual audit firms.

#### **4. Basic Inspection Plan**

Based on the Basic Policy, the CPAAOB will share its views with inspected audit firms through dialogue such as on measures necessary to address operational issues and their

fundamental causes, and endeavor to point out identified issues accurately and effectively. On that occasion, if we find audit firms made superior efforts to improve operations, we will assess such efforts and share the understanding with the audit firms.

We have revised the content of the inspection results notifications to ensure that issues identified through inspections, including operations management issues, are correctly communicated to not only the audit firms subject to inspection but also their audited companies. We will continue to enhance the contents of the notification through dialogue with audit firms, audited companies and other users of inspection results. Additionally, we will further promote cooperation between audit firms and audit & supervisory board, from the perspective of contributing to the enhancement of internal control in audited companies, thereby encouraging audit & supervisory board to utilize the results of inspection.

Based on the above, for PY 2018, we will perform inspections on audit firms according to their characteristics as detailed below, focusing on: (i) whether the inspected audit firm's operations management environment is appropriate in light of their size, characteristics, etc., (ii) whether professional skepticism is demonstrated appropriately in performing audit procedures, and (iii) whether the inspected audit firm takes effective measures to correct deficiencies voluntarily, considering their root causes.

(1) Large-sized audit firms

Considering their important roles in capital markets, the CPAAOB will inspect large-sized audit firms every two years (regular inspection) based on the results of the JICPA's quality control review.

Additionally, we will perform follow-up inspections in the PY immediately following the year of regular inspection to confirm the progress of improvements is made. We will endeavor to implement follow-up inspections efficiently to reduce the burden on inspected audit firms.

We will conduct inspections flexibly, in the case where material accounting issues are identified or suspected in relation to audited companies with significant influence in financial markets and immediate investigations of their audit firms' quality control are required.

Large-sized audit firms are huge organizations, consisting of thousands of members and numerous divisions and regional offices. Thus, it is important for them to have a system in place to lead audit teams to implement better quality control and operations management. Therefore, it is necessary to conduct inspections with more emphasis on these audit firms' business management and operations management, including their top management's mindset.

Based on the above, we will confirm the management's awareness on audit quality improvement and focus on the following inspection points in inspections for PY 2018.

- Inspection of the effectiveness of systems built to improve audit quality pursuant to the Audit Firm Governance Code. Inspection whether the business and operations management environment are established to the end of the organization, from the viewpoint that quality control system as audit firms are appropriately managed.
- 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 procedures to take on new audit engagements (especially with major listed companies) and related preparation/arrangement on the quality of audit
- Inspection of discussions with the management of audited companies and communication with audit & supervisory board
- Inspection of the internal control assessment of audited companies including overseas businesses, and group audits including overseas subsidiaries
- Inspection of the assessment of internal control in the audit of financial statements and audit concerning internal control, and responses to fraud risk including operation of the standards to address risk of fraud in an audit
- Inspection of responses to monitoring activities led by global audit networks

## (2) Second-tier audit firms

Second-tier audit firms, next to large-sized audit firms in size, audit numerous listed companies. Based on their importance in Japan's audit industry, the CPAAOB will inspect them every three years, based on the results of the JICPA's quality control review. We will conduct inspections flexibly, in the case where material accounting issues are identified or suspected in relation to audited companies with significant influence in financial markets and immediate investigations of their audit firms' quality control are required.

For PY 2018, we will implement inspections to understand the top management's awareness and actions towards the improvement of audit quality, putting an emphasis on the following inspection points.

- Inspection of effectiveness of systems built to improve audit quality pursuant to the Audit Firm Governance Code and business management and operations management environment, such as the integrity of the organization
- Inspection of audit resources including adequacy and appropriateness of capabilities/experience to respond to audit risks, such as the globalization of audited companies
- Inspection of communication in group audit, especially with component auditors auditing overseas subsidiaries
- Inspection of discussions with the management and communication with audit & supervisory board members of audited companies
- Inspection of procedures performed based on the standards in the case of auditors changes
- Inspection of internal control assessment in the audit of financial statements and the internal control audit, and response to fraud risk, including operation of the standards to address risk of fraud in an audit

### (3) Small and medium-sized audit firms

For small and medium-sized audit firms, the CPAAOB will mainly inspect their operations management, quality control and the individual audit engagements' conformity to audit standards. It should be kept in mind whether identified deficiencies have resulted from the business model and whether corrective measures against deficiencies are only a formality and palliative. When selecting inspection targets, we will consider a demand for an immediate inspection of the target's quality control environment, in light of the JICPA's quality control review results.

For PY 2018, we will inspect small and medium-sized audit firms, focusing on the following inspection points.

- Inspection of business and operations management environment, including the awareness of top management and partners towards quality control, their involvement in quality control, organizational integrity, etc.
- Inspection of audit resources, including adequacy and appropriateness of

capabilities/experience to respond to audit risks

- Inspection of communication with audit & supervisory board members of audited companies, guidance to and supervision of audit teams, use of experts, and response to issues common across the audit industry captured through monitoring
- Inspection of the appropriateness of risk assessment when undertaking audit of listed companies with high audit risk and audit environment for auditing high risk companies
- Inspection of response to the standards to address risk of fraud in an audit
- Inspection of communication in group audit, especially with component auditors auditing overseas subsidiaries
- Inspection of improvement regarding issues pointed out in the JICPA's quality control review
- Inspection of internal control assessment in the audit of financial statements and internal control audit

## **5. Provision of monitoring information**

To ensure and improve audit quality, the CPAAOB will compile monitoring results and status into the monitoring report and publish it to a wide ranging audience in and outside Japan, incorporating the following.

- (i) We will reflect latest monitoring outcome and audit firms' figures in the monitoring report for benefiting market participants' better understandings of audit. Additionally, we will endeavor to enhance the contents of the monitoring report and communication channels to expand the target audience and reach the general public, especially teachers and students related to audit and accounting.
- (ii) We will extract cases from the latest inspections, including noteworthy efforts of audit firms, conduct in-depth analyses, update and publish the Case Report from Audit Firm Inspection Results. The report shall be revised to enhance understanding of and use by audit firms and other market participants.

We have endeavored to increase public recognition regarding the case report through seminars at regional chapters and lectures to audit & supervisory board members. We will actively seek chances to communicate with market participants.