

July 9, 2021

Certified Public Accountants and Auditing Oversight Board

## **Basic Plan for Monitoring Audit Firms in Program Year 2021 (from July 2021 to June 2022)**

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”) 2021 (from July 2021 to June 2022) (the “Basic Plan 2021”), reflecting the perspectives and objectives 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

##### (1) Overview

Japan’s economic condition still remains severe due to the impact of COVID-19.

The number of IPOs on Japanese stock exchanges totaled 93 in 2020, remaining high even under the influence of COVID-19.

Of audits of listed companies performed by individual certified public accountants and audit firms (hereinafter referred to as “audit firms”), large-sized audit firms<sup>2</sup> continuously accounted for an overwhelming share of more than 90% (in terms of market capitalization). The number of audit firm changes by domestic listed companies in 2020 continued to remain above 100 (excluding those resulting from audit firm mergers). Conceivable factors behind

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<sup>1</sup> It sets the standpoint, objectives, and basic policy for each term regarding monitoring implemented by the CPA AOB. The basic policy for the sixth term (April 2019 to March 2022) was formulated and announced on May 17, 2019. (<https://www.fsa.go.jp/cpaaob/shinsakensa/kihonhoushin/20190517.html>)

<sup>2</sup> The CPA AOB classifies audit firms based on their size, and there are three categories as follows:

- Large-sized firms: Audit firms that have more than approximately 100 domestic listed audited companies and whose full-time staff performing actual audit duties total at least 1,000. In this basic plan, they specifically refer to the four firms of KPMG Azsa LLC, Deloitte Touche Tohmatsu LLC, Ernst & Young ShinNihon LLC, and PricewaterhouseCoopers Aarata LLC.
- Mid-tier audit firms: Audit firms whose business scale is second only to large-sized firms. In this basic plan, they refer to five audit firms: Gyosei & Co., BDO Sanyu & Co., Grant Thornton Taiyo LLC, Crowe Toyo & Co., and PricewaterhouseCoopers Kyoto.
- Small and medium-sized audit firms: Audit firms other than large and Mid-tier audit firms

the changes may include audited companies' review of auditors from such viewpoints as audit durations and fees, as well as large-sized firms' review of clients. The changing of large-sized firms to mid-tier<sup>2</sup> or small and medium-sized<sup>2</sup> ones remained remarkable.

In recent years, initiatives have continued to be promoted to enhance the quality of accounting audits and secure their reliability. Specifically, audit firms have been required to describe Key Audit Matters (KAM) in their audit reports for listed companies regarding financial statements for the fiscal year ended March 2021 onwards. The Business Accounting Council at its meeting in November 2020 revised auditing standards to clarify auditors' procedures regarding "other information in documents" excluding financial statements and enhance their risk approaches.<sup>3</sup> Furthermore, the council's Audit Standard Committee is discussing the revision on the audit quality management standards in response to the revision of the International Standard on Quality Management 1 (ISQM1) for audit firms' quality management, the International Standard on Quality Management 2 (ISQM2) for engagement quality reviews and the International Standard on Auditing 220 (ISA220). Audit firms are required to sensibly respond to and prepare for the revision of these audit and quality management standards.

Regarding audits of IPO companies, initiatives are being undertaken to pave the way for new and emerging companies to receive proportional audits according to their growth stages.

## (2) Impact on audit engagements of COVID-19

As COVID-19 has rapidly spread since around March 2020, constraints have been seen on some audit practices, such as attendance at physical inventory counting, confirmation of balances, and group audits involving overseas subsidiaries. In audits for the fiscal year ended March 2020, however, remote audits and other alternative procedures were implemented flexibly in response to such constraints. Similar responses have been made for the year to March 2021, and thereby avoiding any major problems, such as the failure to form audit opinions due to substantial delays in audit procedures.

Among accounting stakeholders responding to the COVID-19 pandemic, the Japanese Institute of Certified Public Accountant ("JICPA") released several "Audit Considerations

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<sup>3</sup> Under the revised auditing standards, the procedures regarding "other information in documents" will take effect for audits of financial statements for the fiscal year ending March 2022 onwards but may be applied to audits of financial statements for the fiscal year ended March 2021. The enhancement of risk approaches will take effect for audits of financial statements for the fiscal year ending March 2023 but may be applied to audits of financial statements for earlier years.

related to COVID-19” (hereinafter referred to as “Audit Considerations”) and “Remote Work Series.” The Accounting Standards Board of Japan, for its part, released and updated a paper titled “Incorporating the Effects of the Novel Coronavirus Pandemic when Making Accounting Estimates under Japanese GAAP (Generally Accepted Accounting Principles).

#### Response to accounting scandals

The annual number of listed companies that disclosed matters such as inappropriate accounting treatments in a timely manner turned down last year, but it remained above 50. The high level is likely attributable to the raised awareness across listed companies about the importance of timely disclosure, but there were cases where internal control systems were not functioning adequately as well as where the management of group companies, including overseas ones, remained insufficient.

It goes without saying that the top management of companies is responsible for the preparation of financial statements and the development/implementation of effective internal control systems. Thus, it is increasingly important that on the occasion of evaluating internal controls, audit firms undertake audit procedures based on an in-depth understanding of audited companies’ business characteristics and their own environment, including their overseas businesses. Audit firms are required to inform audited companies of internal control deficiencies in a timely manner.

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

The CPAAOB has specified overall ratings<sup>4</sup> on a scale of five categories on inspected audit firms’ business operations in inspection results notifications (excluding those for follow-up inspections) since PY 2016 (July 2016-June 2017). None of the large or mid-tier audit firms has been given the highest rating “generally satisfactory.” Instead, they have received second or third highest ratings. Most of the inspected small and medium-sized audit firms have been given third highest or lower ratings as they have been selected for inspections based on their risks.

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<sup>4</sup> The “Important points” section of the inspection report notification contains an overview of deficiencies in the operations management environment, quality control environment, and individual audit engagements.

Overall ratings are based on a scale of five categories. The highest rating means “generally satisfactory,” the second highest one “satisfactory with minor deficiencies,” the third highest one “unsatisfactory,” the fourth highest one “unsatisfactory and in need of immediate remediation” and the fifth highest (lowest) one “extremely unsatisfactory.” From inspections to be launched in PY 2021, the assessment is changed to “favorable” for Overall Rating 1, to “generally favorable with some deficiencies requiring remediation” for Overall Rating 2, to “unfavorable with significant deficiencies requiring remediation” for Overall Rating 3, to “unfavorable with significant deficiencies with respect to operation control system etc. requiring immediate voluntary remediation” for Rating 4 and to “extremely unacceptable” for Overall Rating 5.

For details of the changes in the assessment descriptions, see Monitoring Report 2021 on the CPAAOB website.

Large-sized firms tend to be shifting the primary responsibility for audit quality control from head-office quality control departments to business units close to the audit frontline. The recent inspection results indicate that sufficient cooperation between the head-office quality control departments and the business units, the permeation of remedial measures among frontline auditors, and the need for recognizing the significance of professional ethics have become challenges.

At large-sized audit firms, revenues from non-audit services expanded their share of total revenues year by year until PY 2014, before remaining around 40% in recent years.

Mid-tier audit firms, though developing arrangements for organized business operations, are plagued with personnel training challenges, including insufficient communications between quality control departments and business units, the growing utilization of non-CPA clerical employees, and relevant education and training. Furthermore, there is a lack of awareness or recognition among top and other administrators about the importance of ensuring/improving quality control and their cooperation with quality control divisions.

Small and medium-sized audit firms lack the recognition of the need for developing organized/integrated business management and quality control arrangements and understanding about quality control and audit procedure levels required by the current audit standards.

Furthermore, the systems of some audit firms are still not sufficient to audit high-risk listed companies.

#### Governance systems of audit firms

Large and mid-tier audit firms have adopted the “Principles for Effective Management of Audit Firms” (the “Audit Firm Governance Code”) and have generally put together governance systems in line with it. Going forward, further tasks would need to be engaged in to firmly entrench their governance in terms of effectiveness.

#### Progress in adoption of IT

The COVID-19 pandemic has triggered a rapid spread of remote audits among audit firms, though on different scales.

As audited companies have increasingly computerized their accounting and business data corresponding to progress made in social IT adoption, meanwhile, audit firms including large ones have been accelerating their adoption of IT to ensure and improve audit quality and enhance the efficiency of audit engagements. Specifically, they have not only employed tools to introduce techniques capable of replacing the traditional sampling audit with detailed audit and of automating/centralizing processes but also explored risk analysis using AI and systems to access audited companies' business management systems and analyze their financial information.

It is expected that these initiatives will not only ensure the effectiveness of audit engagements but also ease the workload on the audit engagement teams through the improvement of efficiency, contributing to more in-depth audits in areas with underlying risks.

However, amid such developments and with data exchanges with audited companies accelerating, cybersecurity has become a high priority issue, and the firms therefore need to steadily strengthen their cybersecurity.

#### Trends of international independent audit regulators

Foreign countries have been reforming audit systems and regulations, prompted by accounting scandals involving listed companies. Specifically, the UK has required big audit firms to separate audit divisions from others to secure the effectiveness of audit engagements and has taken initiatives to reorganize audit regulation authorities. Germany is grappling with reforming financial regulation authorities and enhancing their empowerment.

In Japan, the FSA and the CPAAOB provide the necessary support to facilitate the operation of the International Forum of Independent Audit Regulators (IFIAR)<sup>5</sup> with its permanent secretariat located in Tokyo, from the perspective of enhancing the international status of Japanese capital markets. As IFIAR has long endeavored to ensure and improve audit quality globally through continuous dialogue with the six largest global networks,<sup>6</sup> the FSA and the CPAAOB will support the Japanese Vice Chair<sup>7</sup> of the IFIAR appointed in April 2021 and

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<sup>5</sup> IFIAR is an international organization established in 2006, consisting of independent audit regulators that inspect audit firms. Its permanent secretariat is located in Tokyo. It aims to improve audit quality globally through collaboration among authorities. As of the end of June 2021, the number of IFIAR member countries/regions totaled 54, including Japan.

<sup>6</sup> Refers to the six global networks of BDO, Deloitte Touche Tohmatsu, Ernst & Young, Grant Thornton, KPMG, and PricewaterhouseCoopers, which are among the accounting-firm networks that operate worldwide. If BDO and Grant Thornton are excluded, they are referred to as the Big 4 global networks.

<sup>7</sup> In April 2021, the FSA Deputy Commissioner for International Affairs and the Director General of the Office of Japanese Delegation for IFIAR was elected Vice Chair of the IFIAR.

continue contributing to IFIAR activities. The FSA and the CPAAOB will also cooperate with foreign audit regulators and keep vigilant on how they respond to COVID-19, how foreign audit firms belonging to the Big 4 global networks<sup>6</sup> respond to undesirable business practices, and how foreign audit regulators are reformed.

## 2. Concept of Basic Plan for Monitoring Audit Firms in PY 2021

Based on Section 1 “Environment surrounding audit firms” and the monitoring perspectives, objectives, etc. stated in the Basic Policy, the CPAAOB will monitor<sup>8</sup> audit firms based on the following five basic concepts from (1) to (6).

In the current program year, the CPAAOB will review monitoring methods to make its monitoring even more efficient and effective as in the previous year.

As Japan’s revision of quality control standards based on the reform of international quality control standards is expected to greatly influence audit firms’ auditing practices and quality control, the CPAAOB will consider revising its monitoring methods, etc.

### (1) Focus points of monitoring

In PY 2021, the CPAAOB will monitor audit firms with a focus on the following points.

Note that there is wide variation in the sizes of audit firms, with some small and medium-sized firms having just a handful of staff, while large-sized firms have thousands of employees. There are also gaps observed in business management, operational control systems, and so on. Because of these factors, when conducting monitoring, the CPAAOB takes into account the size and nature of the firms.

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

To improve audit quality on an ongoing basis, it is important for top management themselves to exercise leadership in harnessing a culture that centers on the quality of audit engagements, and the CPAAOB will therefore grasp whether this is reflected in the recognition of the management team, including top executives, and in tangible measures.

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<sup>8</sup> Monitoring covers inspections and non-inspection monitoring. Non-inspection monitoring includes the collection of reports regarding audit firms, interviews and information gathering through the exchange of opinions and cooperation with audit firms and relevant parties.

(ii) Effectiveness of business management

The CPAAOB will assess whether business management and operational management systems are contributing to ensuring and improving audit quality. In particular, with regard to large-sized and mid-tier audit firms that have adopted the Audit Firm Governance Code, the CPAAOB will review mainly their exchange of opinions with audited companies towards the improvement of audit quality and the activities of control and assessment entities comprising independent third parties in regard to the effectiveness of governance systems developed in line with the Code.

On the occasion of these reviews, the CPAAOB will endeavor to share information and cooperate with the relevant departments at the FSA.

(iii) Verification of facts based on audit trends

i. Responses to the impact of COVID-19

The CPAAOB will identify the impact of COVID-19 on audit engagements, including procedures, and review responses to the impact on audit engagements and audit firms' countermeasures (including changes in audit implementation arrangements) based on "Audit Considerations" and "Remote Work Series" published by the JICPA.

ii. Group audit regarding overseas subsidiaries

Accounting problems have continuously emerged at overseas subsidiaries of listed companies. Irrespective of audit firm sizes, deficiencies in group audits regarding overseas subsidiaries have been continuously identified. Given such situation, the CPAAOB will review audit teams' assessment of internal control, including foreign operational management, their communications with auditors of overseas subsidiaries, and audit firms' organized responses.

iii. Conclusion of new audit contracts

In recent years, many listed companies have changed their auditors. At audit firms that have concluded new audit contracts with large and/or high-risk listed companies, therefore, the CPAAOB will review whether risk assessments relating to these contracts have been properly performed and responded to, and how these contracts have been concluded and how these contracts would influence overall audit quality at audit firms.

iv. IT-based audit approaches and cybersecurity measures

Large-sized and mid-tier audit firms have accelerated IT adoption and digitalization to

conduct auditing efficiently and effectively, introducing tools using AI to detect irregular figures in journal entries, those for identifying fraud risks, and systems to access digital information of audited companies and obtain information required for auditing.

As these initiatives are expected to contribute to securing and improving audit quality, the CPAAOB will continuously monitor relevant progress through the monitoring of large and other audit firms.

At the same time, the CPAAOB will confirm what cybersecurity measures are being taken in conjunction with accelerated IT adoption, and also monitor whether personnel who can accommodate more in-depth and complex audit techniques are being secured and developed.

## (2) Enhancing non-inspection monitoring

To perform efficient and effective monitoring, the CPAAOB will have periodic dialogue with top and other executives of large sized and mid-tier audit firms for exchanging views and further strengthening information sharing through cooperation with relevant parties, such as the FSA and related organizations. It will also enhance information collection and analysis regarding the environment surrounding audited companies, including sectoral trends, and use information and analysis results effectively for inspections in efforts to integrate information collection and analysis, and inspections.

## (3) Enhancement of the monitoring environment

The CPAAOB will strengthen its monitoring environment to collect/analyze information and perform inspections in manners suited to the individual environment at audit firms.

To do this, the CPAAOB will actively appoint personnel who can analyze domestic and international information, the internationalized audit operations, and the environment at domestic audit firms, and given these analyses, etc., take appropriate actions in response. It will also appoint personnel who can provide guidance for efficient and effective monitoring. Furthermore, the CPAAOB will positively promote the fostering of personnel by encouraging its staff members to engage in international conferences, etc.

## (4) Consideration of monitoring methods

In line with progress made in IT deployment, mainly at large-sized firms, and impacts



stemming from COVID-19, audit firms are reviewing their audit procedures, such as physical inventory counting and confirming balances, and their operational management.

In the previous program year, the CPAAOB, based on the Basic Plan, reformed its face-to-face inspections to introduce and implement remote inspections<sup>9</sup> and non-inspection monitoring for some audit firms so as to improve the monitoring of efficiency and effectiveness and reduce burdens on audit firms in view of the spread of COVID-19.

In the current program year, the CPAAOB will continuously reform monitoring methods to perform more efficient and effective monitoring by expanding the remote inspection coverage while considering the digitalization of audit working papers, etc. at audit firms.

#### (5) Responses to quality control standard revisions

Based on the revision of the international standard on quality management (ISQM1, ISQM2 and ISA220), the Business Accounting Council is considering revising domestic quality control standards to introduce the quality management system in which audit firms (i) establish quality targets, (ii) identify and assess quality risks impeding the achievement of quality targets, (iii) fix and implement policies or procedures to address assessed quality risks and (iv) apply control systems to improve any deficiencies based on root cause analysis.

The CPAAOB for its part will grab each audit firm's preparations for and responses to the standard revision and review targets, implementation methods, and arrangements for monitoring in view of the revision's impact on quality control at audit firms.

#### (6) Enhancement of international audit regulation cooperation

The CPAAOB will make use of the Multilateral Memorandum of Understanding (MMoU) and bilateral information exchange frameworks<sup>10</sup> to obtain information necessary for monitoring and provide information in response to requests from foreign audit regulators. The CPAAOB will also participate actively in IFIAR discussions in order to understand the current practices observed at the global networks and audit regulatory techniques employed by foreign audit regulators. Furthermore, the CPAAOB will remain vigilant regarding the

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<sup>9</sup> Remote inspections refer to inspections in which the CPAAOB reviews audit working papers and interviews audit firm officials online.

<sup>10</sup> As of June 30, 2021, we had exchanged letters concerning information exchange frameworks with audit regulatory authorities in nine countries (the United States, Canada, Malaysia, the Netherlands, Luxembourg, the United Kingdom, France, China and Switzerland).

responses of foreign audit regulators against COVID-19, a remedy to inappropriate practices taken by foreign audit firms that are affiliated with the Big 4 global networks, and trends with organizational restructuring at foreign audit regulators.

### **3. Basic plan pertaining to non-inspection monitoring**

In order to conduct efficient, effective non-inspection monitoring, the CPAAOB will make effective use of information, such as quality control review reports from the JICPA and analyses of past CPAAOB inspections and collected reports. Given the CPAAOB's limited inspection resources, it is important to make effective use of the collection of reports so as to encourage audit quality to be ensured and improved at all audit firms in Japan.

In PY 2021, in order to understand the environments at audit firms, including the impacts of COVID-19 on them and their responses to such impacts, as well as the risks entailed in audit engagements, accurately and in a timely manner, the CPAAOB will continue to conduct non-inspection monitoring as follows, including the collection of reports from audit firms, interviews with audit firm officials, the verification of the JICPA's quality control reviews and cooperation with the JICPA, according to the sizes and types audit firms, while considering their burdens.

In the current program year, the CPAAOB will also implement the triennial collection of reports from foreign audit firms to understand their business status.

#### **(1) Collection of reports**

(i) From large-sized and mid-tier audit firms, by way of the collection of reports, the CPAAOB will continuously obtain qualitative and quantitative information required for verifying business control and operational management systems developed from the governance perspective in accordance with the Audit Firm Governance Code, as well as the status of cooperation with global networks, IT-based audit techniques, cybersecurity measures, and the status of compliance with legal requirements, such as the Act on Prevention of Transfer of Criminal Proceeds, etc.

The CPAAOB will also find facts regarding arrangements for auditing and examination of listed financial institutions for which advanced technical knowledge and understanding about IT are required, as well as regarding KAM-related auditing.

Information obtained through the collection reports will be analyzed and utilized to contribute to efficient/effective inspections, compare large-sized firms, and find their common problems. The collection of reports will be implemented more efficiently through the timely utilization of information obtained through inspections and dialogue.

- (ii) From small and mid-tier audit firms, the CPAAOB will collect reports whenever it is appropriate to do so based on the results of the JICPA's quality control reviews, with the aim of encouraging them to stably implement proper audit quality management.

In doing so, the CPAAOB will focus on reviewing each audit firm's establishment of a quality control system as well as matters such as the policy of top management, the firm's profit/financial structure, its organization and human resources, and the background to the conclusion of new audit engagements. On the occasion of the collection of reports, the CPAAOB will ensure the effectiveness of reviews by not only having a physical meeting when needed but also redoing the collection of reports in the ensuing year if the targeted audit firm has not made satisfactory improvements in light of quality control reviews.

Still, if the audit firm is assessed as potentially having a serious problem as a result of the collection of reports, the CPAAOB will use it as key reference information for inspections.

- (iii) If the CPAAOB has notified a small or mid-tier audit firm of problems in its inspection results, unless it is seen as an urgent case to take a step swiftly as described in (iv), the CPAAOB will identify the remedies that the inspected audit firm has taken, and urge the audit firm to address the problems through applicable channels, holding meetings as necessary, etc. after a certain period of time has passed since the notification of the inspection results.

In such cases, the CPAAOB will team up with the FSA and the JICPA to make an attempt to review the nature of the deficiencies, corresponding to their severity.

- (iv) As a result of an inspection, if operational control systems of an audit firm are deemed to be unfavorable and the need to promptly take a remedy action is recognized in particular, the CPAAOB will perform the collection of reports at the time of the notification of the inspection results, and encourage the firm to address them promptly.

Following the collection of reports pursuant to (iii) or (iv) above, if the status of

improvement is considered inadequate, the CPAAOB will consider taking additional actions, such as the collection of further reports and follow-up inspection.

(2) Examination of the JICPA's quality control reviews and cooperation with the JICPA

In the case of problems, etc. concerning the effectiveness of quality control reviews identified through monitoring for audit firms, the CPAAOB shares them with the JICPA and, through ongoing consultations with the JICPA at the reviewer level, urges action further in order to enhance the effectiveness of quality control reviews.

Based on recent quality control reviews, the JICPA revised the quality control review system in FY2020 to make the frequency of regular reviews more flexible according to risks and revised it from a scale of 4 to that of 3 for ratings on regular review results.

While JICPA quality control reviews and CPAAOB inspections differ in terms of implementation scheme and methodology, JICPA quality control reviews have apparently become more conscious of risks in recent years, as noted above. However, there are cases where operational control systems at audit firms that are not identified as subject to improvements under quality control reviews are identified as highly inappropriate under CPAAOB inspections.

In view of this situation, the JICPA should encourage audit firms to make voluntary improvements and further enhance the effectiveness of its quality control reviews. The CPAAOB, for its part, will be verifying the effectiveness and impact of the measures that the JICPA is supposed to implement.

The CPAAOB and the JICPA will be endeavoring to deepen their cooperation, as it is vital for ensuring and improving audit quality throughout all audit firms in Japan. Regarding the adequate sharing of roles between CPAAOB inspections and JICPA quality control reviews, the CPAAOB and the JICPA are discussing how quality control reviews should be for large-sized firms, how the JICPA should enhance its guidance and supervision of small and mid-tier audit firms, and how the JICPA should verify their operational control arrangements. In PY 2021, the CPAAOB and the JICPA will continue specific and substantive discussions to ensure that CPAAOB inspections and JICPA quality control reviews deliver maximum benefits as a whole.

### (3) Collection and analysis of information regarding audit firms

The CPAAOB is continuing to engage in periodic dialog with large-sized and mid-tier audit firms' management teams, including top executives, in order to understand the latest business operations and problems at audit firms and the audit industry. Given that management teams, including top management, have a significant impact on the organizational culture of audit firms, the CPAAOB will continue to engage in such dialog and endeavor to have more in-depth discussions. The CPAAOB will take this opportunity to find facts regarding these audit firms' preparations for and responses to quality control revisions.

The CPAAOB will also encourage them to elaborate and proactively disclose the information concerning quality control in order to assure that market participants can access useful information.

The CPAAOB will strengthen information sharing through exchanges of views, cooperation, etc. with IFIAR, foreign audit regulators and the global audit networks, in addition to the FSA, the JICPA, financial instruments exchanges, and the Japan Audit & Supervisory Board Members Association. Furthermore, the CPAAOB will endeavor to upgrade organizational capabilities for collecting and analyzing data, information, etc. in accordance with the risks embedded in audit firms.

## 4. Basic Inspection Plan

Based on the Basic Policy, the CPAAOB will perform more effective and efficient inspections according to the sizes of and environments at audit firms as well as their risk degrees. The CPAAOB will also strive to increase the effectiveness of inspections by improving inspection methods. The CPAAOB will integrate inspections with the abovementioned non-inspection monitoring to ensure and improve audit quality at audit firms.

For inspections on audit firms in PY 2021, the CPAAOB will focus on the following: whether the operational control and quality control systems are properly formed according to their sizes, characteristics, etc.; how the awareness and engagements of management teams, including the top management, concerning quality control, influence business operations; and whether audit practitioners demonstrate professional skepticism based on an understanding of the undertone intentions and provisions of rules, such as auditing standards, when performing audit procedures. The CPAAOB will evaluate those points according to the firms' sizes and features,

as specified below.

Furthermore, while taking account of burdens on audit firms, the CPAAOB will also assess the impact of COVID-19, the status of the quality control and business operation systems as affected by this impact, and the circumstances surrounding the performance of audit procedures and the expression of audit opinions in light of operations, such as the approach to guidance issued by the JICPA.

#### (1) Large-sized firms

Given that large-sized firms fulfill an important role in the capital markets by auditing numerous, large, listed companies, the CPAAOB in principle inspects them every year (with regular and follow-up inspections being conducted alternately). When conducting follow-up inspections, the CPAAOB will give consideration to the workload on the audit firms, refrain from verifying individual audits in principle and pursue more effective and efficient inspections, with a focus on verifying remedial measures taken to address problems detected in the past regular inspections.

If a serious accounting problem at an audited company having a mighty impact on markets is detected or suspected and the CPAAOB finds it necessary to immediately confirm the quality control system of the audit firm accountable for the audit procedures in the audited company, the CPAAOB will perform inspections flexibly without being bound by the abovementioned principle on the inspection schedule.

Large-sized firms are giant organizations, consisting of thousands of staff members in numerous divisions and regional offices. Thus, it is important for each audit firm to spread quality and operational control policy measures among audit practitioners and lead them to recognize the significance of professional ethics. Since its management team, including the top, has a substantial impact on organizational culture, the team's attitudes and behaviors are of particular importance.

Based on the above, the CPAAOB will focus on the following inspection points in PY 2021 (the asterisk symbol (\*) indicates additional or revised priority points to be verified or checked):

- The CPAAOB will evaluate not only the awareness and engagements of management teams, including top executives, concerning quality control, but also the impact that they have on operational and quality control systems.

- With regard to governance systems (particularly supervision/review bodies), the CPAAOB will verify their effectiveness from the standpoint of operational status; e.g. whether they are contributing to ensuring and improving quality control.
- The CPAAOB will review operational control systems, and in particular cooperation between the head-office quality control department and each business unit, from the standpoint of whether quality control is entrenched among audit practitioners.
- The CPAAOB will verify discussions with management members and communications with auditors (particularly about audits on KAM and accounting estimates) (\*).
- The CPAAOB will review the status with regard to group audits that encompass overseas subsidiaries
- The CPAAOB will verify the status of education/training and human resources development for audit assistants<sup>11</sup> and IT experts.
- The CPAAOB will verify procedures for deciding KAM and describing audit responses (\*).
- The CPAAOB will evaluate the status with regard to the assessment of internal controls relating to financial statement audits as well as internal control audits, and steps being taken to address fraud risks, including the implementation of the Standard to Address Risks of Fraud in an Audit.
- The CPAAOB will review responses to monitoring activities led by global networks.
- The CPAAOB will check responses to quality control standard revisions (\*).
- The CPAAOB will check responses to the clarification of procedures to be implemented in regard to “other information in documents” (\*).
- The CPAAOB will check responses, including the development of arrangements for IPO audits (\*).

## (2) Mid-tier audit firms

Mid-tier audit firms audit a considerable number of listed companies and are expected to fulfill certain roles in the capital markets. Compared to large-sized firms, however, they have inadequate management operation and quality control systems sometimes. For this reason, the CPAAOB will be vigilant regarding the relevant status and generally perform inspections every three years. However, if a serious accounting problem at an audited company having a mighty impact on the capital markets is detected or suspected or if the CPAAOB finds it necessary to immediately confirm the quality control systems of the audit firm accountable for the audit procedures in the audited company, the CPAAOB performs inspections on an

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<sup>11</sup> Audit assistants include persons with the CPA qualification, persons who have passed the CPA exam, audit support staff who do not possess such qualification, and administrative staff who assist with the conduct of audits.

ad hoc basis.

The CPAAOB will focus on the following inspection points in PY 2021 (the asterisk symbol (\*) indicates additional or revised priority points to be verified or checked):

- The CPAAOB will evaluate not only the awareness and engagements of management teams, including top managements, concerning quality control, but also the impact that they have on operational and quality control systems.
- With regard to governance systems (particularly supervision/review bodies), the CPAAOB will verify their effectiveness from the standpoint of operational status; e.g., whether they are contributing to ensuring and improving quality control.
- The CPAAOB will review operational control systems, particularly cooperation between the head-office quality control department and each business unit, from the standpoint of whether they have entrenched quality control among audit practitioners.
- The CPAAOB will verify business administration and operational management arrangements, including organizational integrity covering regional offices.
- The CPAAOB will evaluate audit resources by ascertaining whether personnel possess sufficient and suitable experience, capabilities, etc. to cope with risks arising from the internationalization of audited companies, etc.
- In the case of group audits, the CPAAOB will review, in particular, the effectiveness of communication with auditors of components located overseas.
- The CPAAOB will verify discussions with management members and communications with auditors (particularly about audits on KAM and accounting estimates) (\*).
- The CPAAOB will verify audit firms' responses to auditor change. The CPAAOB will also evaluate the reasonableness of procedures coming to a conclusion on new audit contracts (particularly ones with large, listed companies and listed companies considered to have high risks), the background leading to the conclusion of the new audit contracts, and the review systems responsible for these contracts.
- The CPAAOB will verify the status of education/training and human resources development for audit assistants and IT experts.
- The CPAAOB will verify procedures for deciding KAM and describing audit responses (\*).
- The CPAAOB will evaluate status with regard to the assessment of internal controls relating to financial statement audits as well as internal control audits, and steps being taken to address fraud risks, including the implementation of the Standard to Address Risks of Fraud in an Audit.
- The CPAAOB will check responses to quality control standard revisions (\*).



- The CPAAOB will check responses to the clarification of procedures to be implemented in regard to “other information in documents” (\*).
- The CPAAOB will check responses including the development of arrangements for IPO audits (\*).

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

In inspecting small and medium-sized audit firms, the CPAAOB will check not only their quality control arrangements and their individual audits’ compliance with audit standards but also their understanding of quality control and audit procedure levels required by the current audit standards and will verify their tops’ awareness and engagements influencing the abovementioned matters, as well as business control arrangements.

For this, the CPAAOB will consider whether identified deficiencies are due to the nature of the business model and whether the remedies taken to address deficiencies are deemed to be merely an improvised measure. When it comes to the selection of firms for inspection, taking into account such factors as the JICPA’s quality control review results and the degree of risks underlying audited companies, the CPAAOB will consider whether specific firms’ quality control systems should be immediately confirmed.

The CPAAOB will focus on the following inspection points in PY 2021 (the asterisk symbol (\*) indicates additional or revised priority points to be verified or checked):

- The CPAAOB will evaluate operational control arrangements, including top executives’ and employees’ recognition of and engagement with quality control, as well as organizational integrity.
- The CPAAOB will review audit resources by ascertaining whether personnel possess sufficient and suitable experience and the capability to cope with risks arising from audited companies.
- The CPAAOB will verify audit procedures and fraud risk assessments in particular, relating to revenue recognition and accounting estimates, from the standpoint of performing professional skepticism
- The CPAAOB will verify discussions with management members and communications with auditors (particularly about audits on KAM and accounting estimates).(\*) It will also check the guidance and supervision of audit practitioners and the utilization of experts.
- The CPAAOB will evaluate the background on new audit contracts with large listed companies or listed companies considered to have high risks, as well as the reasonableness of risk assessments, etc. and audit implementation arrangements.

- The CPAAOB will review the status of compliance with the Standard to Address Risks of Fraud in an Audit.
- In the case of group audits, the CPAAOB will assess, in particular, the status of communication with auditors of components located overseas.
- The CPAAOB will verify progress made in response to findings identified, etc. under the framework of JICPA quality control reviews.
- The CPAAOB will verify the status of education/training and human resources development for audit assistants and IT experts.
- The CPAAOB will verify procedures for deciding KAM and describing audit responses (\*).
- The CPAAOB will verify the assessment of internal controls relating to financial statement audits as well as the status of internal control audits.
- The CPAAOB will verify responses to auditor replacements (\*).
- The CPAAOB will check responses to quality control standard revisions (\*).
- The CPAAOB will check responses to the clarification of procedures to be implemented in regard to “other information in documents.” (\*)

## 5. Provision of monitoring information

To ensure and improve audit quality, it is important not only to accurately convey the results of inspections to audit firms and audit/supervisory board members of audited companies, but also to compile the results and insights through monitoring, and given that, the CPAAOB broadly disseminates the information to the public so as to spur interest and awareness in accounting audits. From that viewpoint, the CPAAOB gives consideration to the following points on the occasion of compilation and information sharing:

- (i) The CPAAOB accurately conveys the findings, etc. identified in audit firms and simultaneously makes an attempt to elaborate descriptions of inspection results so as to accurately convey them, including the level of quality control and operational control systems, to audit and supervisory board members, etc. at audited companies.

(For overall ratings specified in inspection results notifications, the CPAAOB has revised assessment descriptions for PY 2021 onwards.<sup>4)</sup>)

The CPAAOB also confirms whether audit firms appropriately convey the results of inspections to audit and supervisory board members, etc. at audited companies. Furthermore, with the aim of contributing to improving internal control systems at audited

companies, the CPAAOB encourages audit firms to promote the interaction with audit and supervisory board members, etc. in order for audit and supervisory board members to be able to make effective use of inspection results.

(ii) With the aim of contributing to furthering an in-depth understanding of accounting audits across market participants, etc., since 2016 the CPAAOB has published an annual Monitoring Report compiling the results and insights, etc. of monitoring, featuring numerous tables and graphs. Having updated the Report annually since 2017, the CPAAOB will continue to strive to further develop its contents and dissemination for a broad understanding among the public while bearing in mind reader preferences. In addition, the CPAAOB will disseminate the contents of the Monitoring Report translated into English to non-Japanese readers.

(iii) In order to encourage audit firms to make voluntary efforts toward ensuring and improving audit quality, since 2008 the CPAAOB has compiled specific cases identified through inspections in the form of an annual report titled Case Report from Audit Firm Inspection Results. The CPAAOB has updated the report with new cases, planning to modify the report into a useful reference for audit firms' improvement initiatives.

The CPAAOB uses the Case Report for lectures and briefings at local branches of the JICPA nationwide and plans to proactively disseminate the report to market participants, etc. and translate it into English for communication to non-Japanese people.