

# **Basic Policy for Monitoring Audit Firms**

## **— Promoting Sustainable Improvement of Audit Quality —**

**Certified Public Accountants and Auditing Oversight Board**  
**May 20, 2022**

Since its establishment in April 2004, the Certified Public Accountants and Auditing Oversight Board (hereinafter, the "CPA AOB") has spent 18 years in six terms endeavoring to improve the quality of CPA (certified public accountant) audits and to ensure their reliability in order to fulfil its mission of improving the fairness and transparency of capital markets in Japan and fostering the trust that investors place in the capital markets.

For its 7th Term (April 2022 – March 2025), the CPA AOB conducts monitoring<sup>1</sup> of individual CPAs and audit firms (hereinafter referred to as "audit firms") based on the surrounding environment and in line with the objectives of monitoring and the approach to achieving them as stated below, aiming to foster the trust that investors place in the capital markets, and contributing to the further development of the national economy.

### **[Environment Surrounding Audit Firms]**

The environment surrounding audit firms is evolving rapidly. In tandem with the society-wide progress made in digitalization, large-sized audit firms<sup>2</sup> have prominently been promoting digitalization of audit services in order to ensure and improve audit quality and enhance the efficiency of operations. In the meantime, the expansion of COVID-19 infections triggered the rapid prevalence of remote auditing. Furthermore, it has been confirmed that the changes in the international environment, including the

---

<sup>1</sup> Monitoring encompasses both inspections and activities other than inspections. Activities other than inspections include gleaning information through the collection of reports from and the conduct of interviews with audit firms, through information exchanges and cooperation with relevant FSA departments, the Japanese Institute of Certified Public Accountants (JICPA), and industry groups etc. involved in audits, and through dialog with audit firms.

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

- Large-sized audit 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 policy, 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 audit firms. In this basic policy, 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-sized and second-tier audit firms

status of Ukraine, impact on audits for companies operating globally.

Initiatives which have continually been taken for improving audit quality and for ensuring trust in audits encompass the revision of the auditing standards concerning not only the key audit matters (KAMs) but also other information in audit reports, the revision of the audit quality management standards embedding a quality control system on a risk-based approach, and the revision of the ethical rules to strengthen independence regarding remuneration, etc. In addition, investors are becoming increasingly interested in non-financial information, such as sustainability-related information.

In this situation, when it comes to the audits for listed companies, the trend of switching from a large-sized audit firm to a mid-tier or small and medium-sized audit firm persists, which makes it crucial for such smaller firms to ensure and improve audit quality with their role increasing as an auditor. In response to increasing expectations over audit quality, audit firms have been making efforts to respond to accounting fraud through the development and introduction of tools for detecting it.

### **[Objectives of Monitoring and Approach to Achieving Them]**

The CPAAOB is committed to conducting monitoring from the perspective of citizens' public interest by making the utmost use of empowerment, which encourages audit firms to continue making progress voluntarily to ensure and improve audit quality, thereby achieving the objective of ensuring trust in audits in the capital markets.

The main focus of monitoring is to be placed not on examining the appropriateness of individual audit opinions, but on encouraging further improvements in the effectiveness of quality control reviews performed by the Japanese Institute of Certified Public Accountants (hereinafter, "JICPA"), as well as securing an appropriate management system, including the quality control system of audit firms through CPAAOB's effective and efficient monitoring with consideration given to their size and operational management, and risk levels underlying audited companies.

On that occasion, the CPAAOB not only confirms the adherence of audits performed by audit firms to the auditing standards, but also places importance on the effectiveness of the quality control system for the purpose of ensuring and improving audit quality via the kind of professional skepticism capable of detecting accounting fraud. In addition, emphasis is also placed on whether the governance of audit firms, including policies of the top management that are impactful to firm-wide organizational culture, effectively contributes to securing proper operations. Furthermore, another focus is whether audit firms are endeavoring to find out root causes of the problems detected through the JICPA quality control reviews and the CPAAOB monitoring and are taking appropriate

remedial measures.

The CPAAOB gathers information through information exchanges and cooperation with relevant FSA departments, the JICPA, and industry groups, etc. involved in accounting and audits (hereinafter referred to as "relevant organizations"), through dialog with audit firms, as well as through cooperation with the International Forum of Independent Audit Regulators (IFIAR)<sup>3</sup> and foreign audit regulatory authorities, and utilizes the information obtained in subsequent monitoring. Moreover, the CPAAOB disseminates useful information obtained through monitoring to relevant organizations and also proactively provides such information to the public. Efforts are also being made to actively utilize digital technologies in monitoring.

In light of the above, the CPAAOB has published the Basic Policy for Monitoring Audit Firms during the 7th Term as follows. Furthermore, based on this Basic Policy, the CPAAOB formulates the Basic Plan for Monitoring Audit Firms for each program year (July to the following June).

The content of this Basic Policy may be revised as necessary in tandem with the reviews of relevant laws and regulations.

## **1. Basic Policy for Monitoring (for Activities Other than Inspections)**

The CPAAOB receives reports of the results of quality control reviews from the JICPA and executes collection of reports concerning those reports of review results if necessary. Furthermore, the CPAAOB gathers information through information exchanges and cooperation with relevant FSA departments, the JICPA, and relevant organizations, as well as through dialog with audit firms, and shares identified challenges and concerns with them.

Moreover, through the analysis of gathered information, the CPAAOB accurately ascertains circumstances and risks at audit firms to conduct inspections more effectively and efficiently.

Through these efforts, the CPAAOB aims to ensure and improve the audit quality of audit firms.

---

<sup>3</sup> The International Forum of Independent Audit Regulators (IFIAR) is an international institution established in 2006 comprising independent audit regulatory authorities that carry out inspections of audit firms. Its secretariat is located in Tokyo. Its aim is to improve audit quality globally through cooperation/collaboration between authorities. Its membership as of April 30, 2022, comprised audit regulatory authorities from 54 countries/regions, including Japan.

## **(1) Verification etc. of JICPA Quality Control Reviews**

The CPAAOB reviews the effectiveness of the quality control reviews performed by the JICPA, shares the results with the JICPA through information exchanges, etc., and encourages the JICPA to take action to ensure and improve audit quality. The JICPA has been taking steps to strengthen and enhance its system on quality control reviews, such as shortening or extending the intervals of its regular reviews, through information exchanges, etc. with the CPAAOB.

In order to ensure that such cooperation surely contributes to leveraging the JICPA's functions in terms of guidance and supervision through its quality control reviews, the CPAAOB reviews the effectiveness of the reviews and the effects of remedial measures based on the review results, and continues information exchanges, etc. regarding the review results.

The CPAAOB also attempts to continue discussions with the JICPA, which is in charge of the operations of the Registration System for Listed Company Audit Firms, in order to maximize the effect both of the CPAAOB's inspection and JICPA's quality control reviews, with regards to roles of the CPAAOB and the JICPA, and further deepened collaboration based thereof.

## **(2) Collection of Reports**

The CPAAOB shall glean the latest information on audit firms through the effective use of the collection of reports and ascertain what challenges the audit firms are wrestling with so as to encourage all audit firms in Japan to make efforts to ensure and improve their audit quality. Based on this point of view and from the perspective of encouraging the audit firms to develop appropriate operations management and quality control system (hereinafter referred to as "operations management system, etc."), the CPAAOB collects reports in an effective manner with regard to audit firms' status of the development and operations of their operations management system, etc. (including the status of the implementation of remedial measures), while taking into account the sizes and characteristics of audit firms and the results of CPAAOB's inspection and JICPA's quality control reviews. On that occasion, the CPAAOB also conducts interviews as necessary concerning the contents of the reports so as to achieve effects equivalent to those through inspections.

- a. In the case of large-sized and mid-tier audit firms, the CPAAOB periodically ascertains and analyzes quantitative and qualitative information concerning their operations management system, etc. through the collection of reports so as to

enhance the efficiency of inspections. In particular, the expected information is to lay out how those audit firms have developed and are operating their operations management system, etc. under effective governance and functional management (including efforts for enhancing operational efficiency, such as the development of auditing methods utilizing digital technologies, and efforts for fostering human resources and securing personnel). Still, the information is expected to cover their cybersecurity measures too.

- b. In the case of small and medium-sized audit firms, the CPAAOB collects reports based on the results of the JICPA's quality control reviews and gleans information and conducts an analysis of the status of their operations management system, etc. in light of the sizes and characteristics of individual audit firms. Given that in recent years, the number of small and medium-sized audit firms auditing listed companies is on the rise, from the perspective of whether appropriate operations management system, etc. are developed enough to be in charge of audits for listed companies, the CPAAOB ascertains small and medium-sized audit firms' policies concerning the conclusion of new audit contracts and the status of their efforts for securing audit resources and for promoting digitalization, such as the introduction of electronic audit documentation. Furthermore, given the influence of the top management is especially strong at small and medium-sized audit firms, the CPAAOB also ascertains top management's awareness toward audit quality.
- c. When it comes to the problems that small and medium-sized audit firms are notified of in the form of inspection results, the CPAAOB ascertains the status of their actions through the collection of reports after a certain period of time since the notification of the inspection results, and encourages the audit firms to make improvements voluntarily.
- d. If, as a result of an inspection, the operation of services of an audit firm is deemed to be unfavorable and in need of immediate remediation, the CPAAOB collects a report at the time of the notification of the inspection results, and encourages the audit firm to make improvements promptly.

### **(3) Periodic Dialog etc. with Audit Firms**

The CPAAOB not only gleans information on operation of services through periodic dialog with executives, including the top management of large-sized audit

firms and mid-tier audit firms, but also shares with them audit-related challenges and concerns. Given that executives who are expected to have a substantial influence on the organizational culture of their audit firms are selected, this perpetual dialog with executives is, therefore, extremely important for encouraging their audit firms to act independently to improve audit quality, and the CPAAOB endeavors to ensure in-depth discussion during dialog.

On the occasion of dialog with an audit firm, the CPAAOB encourages it to enrich and expand the disclosed information concerning quality control voluntarily and to be proactive in disclosure so as to ensure that market participants can obtain useful information.

Furthermore, in addition to this periodic dialog with audit firms, the CPAAOB is also proactive in the area of information exchanges and cooperation with relevant organizations.

## **2. Basic Policy for Inspections**

The CPAAOB endeavors to conduct effective and efficient inspections based on the environments at audit firms and the degree of risks underlying audited companies, while also utilizing digital technologies. Furthermore, performing inspection consistent with monitoring other than inspections, the CPAAOB aims to ensure and improve the audit quality of individual audit firms as a whole.

For inspections, the CPAAOB takes the following matters into account, and ensures that the inspections are performed based on proper procedures in accordance with such standards as the Basic Guidelines on Inspections by the CPAAOB. In addition, the CPAAOB conducts inspection monitoring,<sup>4</sup> which involves listening to the opinions of inspected audit firms with the aim of securing the appropriateness of the inspections and referring to the information obtained for enhancing the efficiency of inspections.

### **(1) Conduct of Inspections**

- a. Given that large-sized audit firms fulfill important roles in the capital markets in terms of auditing large, listed companies, the CPAAOB inspects them every year,

---

<sup>4</sup> Obtaining opinions from inspected parties, the CPAAOB finds it possible to ascertain the inspection in place and ensure appropriateness. With the aim of making inspections more efficient, the CPAAOB listens to the opinions of engagement partners concerning the inspection methods employed by inspectors, by way of visiting parties, for example, during the period from the first day of on-site inspections to the time of notification of inspection results.

in principle (with regular inspections and follow-up inspections being conducted alternately).

Conceptually, follow-up inspections focus on reviewing remedial measures for findings identified in regular inspections. The CPAAOB confirms the efforts made for remediation by collecting reports rather than carrying out an inspection when an inspection is deemed to be unnecessary in consideration of the results of the most recent regular inspections.

- b. For mid-tier audit firms, given that they audit a considerable number of listed companies and are fulfilling a certain role in the capital markets, the CPAAOB conducts inspections periodically (generally once every three years).
- c. For small and medium-sized audit firms, the CPAAOB conducts inspections as necessary in view of the results of JICPA's quality control reviews as well as the operations management system, etc., and the degree of risks underlying audited listed companies. As their roles in audits for listed companies are increasing, the CPAAOB attempts to perform monitoring with a focus on the inspection for small and medium-sized audit firms.
- d. In addition to the above, if there is a need to confirm the operations management system or quality control system at an audit firm immediately, the CPAAOB conducts inspections on an ad hoc basis.

## **(2) Focus points and concerns of Inspections**

- a. With respect to the Quality Management System<sup>5</sup> required by the revision of the quality control standards, the CPAAOB not only ascertains the extent to which audit firms have prepared and taken actions but also reviews what the audit firms have set up and have had in place.

In addition to the above, the CPAAOB also reviews whether the audit firms are taking appropriate measures for procedures, etc. required upon the revision of the audit standards.

- b. Large-sized and mid-tier audit firms are apt to have certain difficulties in fully

---

<sup>5</sup> The Quality Management System refers to a quality control method consisting of the following steps: an audit firm [i] sets up quality goals, [ii] identifies and evaluates quality risks that hinder the achievement of those quality goals, [iii] establishes and implements policies and procedures for dealing with the evaluated quality risks, and [iv] makes improvements for any defects based on an analysis of the root cause thereof.

instilling the headquarters' policies to engagement level, and small and medium-sized audit firms often have problems securing resources who have sufficient and appropriate experience and capabilities of coping with risks underlying their audited companies. Accordingly, the CPAAOB reviews whether quality control measures at individual audit firms are appropriate in the context of their sizes and characteristics.

- c. The policies and awareness toward quality control of executives, including the top management, of an audit firm has a substantial influence over the organizational culture formation and the development and operation of the operations management system, etc. Provided that the executives do not put high priority on audit quality, a problem in that the development of an operations management system, etc. does not correspond to the firm's business expansion is observed. For this reason, the CPAAOB tries to ascertain perceptions among and actions taken by executives, including the top management, concerning the policies and quality control, and reviews their impact on the operations management system, etc. at individual audit firms.
- d. With respect to audit procedures followed by audit firms, the focus of the review is to be placed on whether auditors carry out the procedures with a full understanding of the audit standards and the expectations. In particular, the CPAAOB inspects whether audit firms demonstrate a kind of professional skepticism, not limited to their formal compliance with audit standards, specifically, whether they always keep an eye on the business risks of audited companies and assess audit-related risks (including the assessment and actions regarding the impact on audit services in a remote work environment).
- e. To ensure that audit firms continue to make effective quality control improvements voluntarily, it is important to go beyond merely treating the symptoms of problems and to investigate the root causes based on the actual status of individual audit firms' operations management system, etc. To that end, when pointing out findings to an audit firm, the CPAAOB takes care to provide precise details in order to help the audit firm to analyze the root causes.



### **3. Basic Policy for Monitoring Foreign Audit Firms**

#### **(1) Cooperation with Foreign Audit Regulatory Authorities**

When conducting monitoring of foreign audit firms,<sup>6</sup> the CPAAOB actively shares information through the use of the Multilateral Memorandum of Understanding (MMoU)<sup>7</sup> and bilateral information exchange frameworks (EoL: exchange of letters),<sup>8</sup> and endeavors to ensure smooth and effective monitoring by cooperating closely with foreign audit regulatory authorities, international organizations, etc.

The CPAAOB is also involved actively in IFIAR discussions and collaborates with foreign audit regulatory authorities to glean information on trends at the global networks and ascertain inspection methods employed by the foreign audit regulatory authorities with the aim of utilizing such knowhow in its monitoring.

#### **(2) Collection of Reports and Inspections**

Provided that the audit system and supervisory structure for auditors in a country in which a foreign audit firm is located are equivalent to those of Japan, necessary information can be obtained under agreements, etc. on information exchanges or other matters, and the reciprocity is guaranteed, the CPAAOB relies on collection of reports and inspections conducted by the authorities of the firms' home jurisdictions. However, if any of these conditions is not satisfied and the mutual reliance is not guaranteed, the CPAAOB collects reports from and conducts inspections for foreign audit firms.

The collection of reports and inspections are to be conducted through appropriate procedures in accordance with the Basic Guidelines on Information Requirements and Inspection on Foreign Audit Firms etc. by the Certified Public Accountants and Auditing Oversight Board.

### **4. Policy on Provision of Monitoring Information**

To encourage audit firms to ensure and improve audit quality, it is important not

---

<sup>6</sup> Foreign audit firms that have notified the Commissioner of the Financial Services Agency that they engage in services that are found to be equivalent to audit and attestation services regarding financial documents submitted by foreign companies under the provisions of the Financial Instruments and Exchange Act in foreign countries.

<sup>7</sup> As of April 30, 2022, audit regulatory authorities from 22 countries/regions had signed the MMoU.

<sup>8</sup> As of April 30, 2022, the CPAAOB has exchanged letters (EoL) with audit regulatory authorities from nine countries.

only to correctly disclose inspection results to them, but to share monitoring results with relevant FSA departments, the JICPA, and relevant organizations and actively make them broadly available to the public as well, as a means of raising interest in and deepening understanding of audits. From this perspective, the CPAAOB endeavors to publicly provide information on monitoring and enhance the content thereof.

- a. Informing audit firms of the results of inspections, the CPAAOB ensures that audit firms precisely understand the crux of the findings identified and properly convey them to auditors, etc. of audited companies,<sup>9</sup> and that the auditors, etc. precisely understand the status of quality control at the relevant audit firms and the crux of the findings identified. To achieve them, the CPAAOB endeavors to improve the statements concerning inspection results.
- b. With the aim of contributing to deepening the understanding of accounting and audit among market participants etc., the CPAAOB compiles and publishes the results, etc. of monitoring as an annual Monitoring Report. The CPAAOB will continue working to further improve and expand the information to be disclosed in light of user needs so as to obtain understanding broadly from the public.
- c. To promote proactive efforts made by audit firms to ensure and improve audit quality, the CPAAOB compiles and publishes findings etc. confirmed on the occasion of inspections as an annual Case Report from Audit Firm Inspection Results. The CPAAOB endeavors to improve the content of the case report by updating the latest findings. In addition, the CPAAOB continues lectures and briefings at local branches of the JICPA nationwide and proactively disseminates information to market participants, etc.

---

<sup>9</sup> Before an audit firm discloses the details of inspection results to a third party, it needs to obtain permission from the CPAAOB in advance. However, advance permission from the CPAAOB is not required in cases such as simply informing an auditor, etc. of audited companies of the existence of findings found during the inspections or the content of the "key points" in a notice of inspection results as they are.