

**Basic Plan for Monitoring Audit Firms**  
**in Program Year 2022 (from July 2022 to June 2023)**

To ensure audit quality and enhance the effectiveness of audits, the Certified Public Accountants and Auditing Oversight Board (the “CPA AOB”) hereby establishes the Basic Plan for Monitoring Audit Firms in Program Year (“PY”) 2022 (from July 2022 to June 2023) (the “Basic Plan 2022”), reflecting the perspectives and objectives stated in the Basic Policy for Monitoring Audit Firms (the “Basic Policy”)<sup>1</sup> and the environment surrounding audit firms.

**1. Environment surrounding audit firms**

**(1) Audit trends**

a. Progress in digitalization of audits

- In recent years, the development and introduction of audit tools leveraging digital technologies have been promoted in line with progress in digitalization throughout society. Specifically, tools have been developed and introduced to use artificial intelligence for analyzing previous fraud cases and quantifying accounting fraud risks and to match vouchers. Common platforms leveraging digital technologies for confirming bank balances and common electronic audit documentation systems have also been developed and introduced. In such way, the use of digital technologies for auditing has been promoted.
- Progress in the digitalization of audits is expected to help distribute audit resources (human, technological, intellectual and other resources) effectively and efficiently by improving the effectiveness of fraud detection procedures and by allowing certified public accountants (“CPAs”) as professionals to spend more time on more highly judgmental areas (including accounting estimates) and in-depth communication with top managers. It is also pointed out that digitalization should be leveraged for auditing in the remote work environment developed under the COVID-19 spread and for reforming working styles at audit firms.
- Meanwhile, progress in digitalization has led to an increase in cyberattack

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1. It sets the standpoint, objectives, and basic policy for each term regarding monitoring implemented by the CPA AOB. The basic policy for the CPA AOB’s seventh term (April 2022 to March 2025) was formulated and announced on May 20, 2022. (<https://www.fsa.go.jp/cpaob/english/oversight/20220706/20220706.html>)

threats. Audit firms that handle confidential information on audited companies are required to take cybersecurity measures that respond adequately to more advanced and malicious cyberattacks.

b. Impacts of COVID-19 and the international situation on audit engagements

- As COVID-19 has spread since around March 2020, constraints have arisen on some audit practices, such as attendance at physical inventory counting, confirmation of bank balances, and group audits involving overseas subsidiaries. In response, the Japanese Institute of Certified Public Accountants (“JICPA”) has published “Audit Consideration related to COVID-19,” “Remote Work Series” and other guidance as necessary. Audit firms, for their part, have implemented audits in a remote environment.
- The recent international situation, including the Ukraine crisis and lockdowns in Shanghai, have affected not only the business operations of globally operating companies but also audit engagements, including the withdrawal of the Big 4 global networks<sup>2</sup> from Russia. In response, the JICPA released “Audit Consideration for the Fiscal Year Ended March 31, 2022 (Regarding audit responses in light of the current international situation in Ukraine)” in April 2022, summarizing notes on the consideration on necessity to revise risk assessments based on events under the recent international situation.

c. Status of inappropriate accounting cases

The annual number of listed companies that disclosed matters such as inappropriate accounting treatments in the timely disclosure of stock exchanges has remained above 50. In one case, an auditor failed to find inappropriate accounting treatment at a company audited by the auditor since preparations for its initial public offering (“IPO”). It is suspected that the auditor’s professional skepticism was undermined due to their close relationship with the audited company.

Inappropriate accounting is attributable to dysfunctional corporate governance and internal control, including insufficient control on overseas and other group companies.

It goes without saying that top company managers are responsible for the preparation of financial statements and the design/implementation of effective internal control systems. It has become increasingly important for audit firms to

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2. Of globally operating audit firm networks, the Big 4 are Deloitte Touche Tohmatsu, Ernst & Young, KPMG, and PricewaterhouseCoopers. The four, and BDO and Grand Thornton are referred to as the Big 6 global networks.

undertake audit procedures based on their in-depth understanding of audited companies' business characteristics and environments when assessing such companies' internal control. Audit firms are required to inform audited companies in case they identified internal control deficiencies in a timely manner.

d. Changes in auditors of listed companies

- Large-sized audit firms<sup>3</sup> have continuously accounted for an overwhelming share, above 90%, of audits of listed companies in Japan in terms of market capitalization. The annual number of changes in audit firms of listed Japanese companies surpassed 220 (excluding those resulting from audit firm mergers). The change of large-sized firms to mid-tier or small and medium-sized ones remained remarkable.

Factors behind the changes include audited companies' review of auditors from such viewpoints as audit fees, audit durations and these companies' business sizes. Among factors on the side of audit firms is large-sized firms' review of their client portfolios.

While the range of listed company auditors has widened, all auditors, including small and medium-sized firms, are urgently required to secure and improve the quality of audits. When auditors are changed, the transition work from the previous auditors to the successors should be implemented appropriately according to Auditing Standards Committee Statements No. 900 "Change of Auditors."

- The number of IPOs on Japanese stock exchanges totaled 125 in 2021, increasing from the previous year. Mid-tier, and small and medium-sized audit firms have been increasing their share of IPO audits.

e. Accounting and disclosure trends

- Accounting Standard No. 29 "Accounting Standard for Revenue Recognition" has been applied since the fiscal year that started in or after April 2021. Auditors are required to identify and assess the risk of material misstatements under the presumption that revenue recognition entails fraud risks. They are required to perform sufficient professional skepticism for audit procedures

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3. The CPAAOB classifies audit firms into the following three categories according to their sizes:

- Large-sized audit firms: Audit firms that audit about 100 or more listed companies in Japan and have at least 1,000 full-time audit practitioners. In this Basic Plan, they specifically refer to four firms: KPMG Azsa LLC, Deloitte Touche Tohmatsu LLC, Ernst & Young ShinNihon LLC and PricewaterhouseCoopers Aarata LLC.
- Mid-tier audit firms: Audit firms that are second only to large-sized firms in size. In this Basic Plan, they refer to five 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

regarding revenue recognition.

- As investors have increasingly become interested in non-financial information, such as sustainability information, initiatives to formulate international sustainability disclosure standards have been promoted, including a public consultation by the International Sustainability Standards Board on draft standards for sustainability disclosure regarding climate change. CPAs who have undertaken financial information assurance engagement are expected to play a certain role in non-financial information assurance as well. In the future, discussions on non-financial information assurance may be promoted with a view to trends regarding the development of international disclosure and assurance standards.
- As for quarterly disclosure, the Financial System Council's Disclosure Working Group has been considering abolishing quarterly disclosure based on the Financial Instruments and Exchange Act while leaving quarterly disclosure based on stock exchange rules. In June 2022, the working group published a report titled "Toward Building a Capital Market that Enhances Corporate Value over the Medium to Long Term."
- In May 2022, the Certified Public Accountants Act ("the CPA Act") was revised to introduce statutory registration requirement on listed company audits and reform on-site inspection and other authorities assigned to the CPAAOB.

## **(2) Initiatives to ensure and enhance audit quality**

### **a. Revision of quality control standards**

In recent years, initiatives have been continuously promoted to improve audit quality and secure the reliability of audits.

- 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 in March 2021 onwards. In this respect, the Financial Services Agency (FSA) published a report titled "Typical Practices of Key Audit Matters (KAM) and Key Points for Description" in March 2022, based on an analysis of KAM in audit reports for these financial statements and discussions at a study group on KAM.
- Auditing standards were revised in November 2020 to clarify auditors' procedures regarding "other information in documents" regarding non-financial information and enhance the approaches toward risk regarding such information in audits. The standard will be applied to audits on financial statements for the fiscal year ended in March 2022 onwards. The risk approach

enhancement will be applied to audits on financial statements for the fiscal year ending in March 2023 onwards.

- Based on 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), the Business Accounting Council at its general meeting in November 2021 approved the revision of quality control standards. The revised standards require audit firms to introduce a quality management system based on a risk approach in which they (1) set out quality goals to achieve, (2) identify and assess risks that could impede the achievement of the quality goals and (3) establish and implement policies or procedures to respond to assessed risks. In response to the revision, the JICPA in June 2022 published Quality Control Standards Committee Report No. 1 on quality management at audit firms, Audit Standards Committee Report No. 220 on the revision of quality management in auditing, and Quality Control Standards Committee Report No. 2 on audit engagement reviews.
- The International Ethics Standards Board for Accountants has published the "International Code of Ethics for Professional Accountants (including International Independence Standards)." In response to the publication, the JICPA plans to unify four existing relevant rules/guidelines (code of ethics, guidance on independence, guidance on conflict of interest and guidance on response to illegal acts) and revise the code of ethics to introduce rules on how to secure the objectivity of engagement quality reviewers and amend rules regarding the dependence of audit fees.

b. Governance systems of audit firms

The "Principles for Effective Management of Audit Firms" (the "Governance Code") was formulated in March 2017 to promote effective management functions at audit firms and has been adopted by four large-sized, five mid-tier, and nine small and medium-sized audit firms.

A report by the Financial System Council's subcommittee on Certified Public Accountant System has pointed out that the Governance Code was created for large-sized audit firms and should be revised so as to contribute to securing the quality of listed company audits by mid-tier, and small and medium-sized audit firms, and require effective discipline according to audit firms' sizes.

**(3) Current state of quality control at audit firms**

- The CPAAOB has specified overall inspection ratings<sup>4</sup> on a scale of five categories on inspected audit firms' business operations in inspection result notifications (excluding those for follow-up inspections) since PY 2016 (July 2016-June 2017).
- None of the large-sized or mid-tier audit firms has been given the highest rating of "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.
- 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 challenges include cooperation between the head-office quality control departments and the business units, as well as the evaluation of the permeation of remedial measures among frontline auditors and their effectiveness.
- Mid-tier audit firms, though developing systems for organized business operations, are plagued with insufficient communications between quality control departments and business units and personnel training challenges, including 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 managers about the importance of ensuring/enhancing quality control and their cooperation with quality control divisions.
- It is observed that small and medium-sized audit firms have failed to recognize the need for developing organized/integrated operational management and quality control systems, to take leadership in developing an organizational culture giving priority to compliance with professional ethics, or to fully understand the quality control and audit procedure levels required by the current audit standards. Furthermore, some of them have not developed sufficient systems to adequately audit companies with high audit-related risks.
- Irrespective of audit firms' sizes, deficiencies regarding audit procedures for accounting estimates, fraud risks and group audits have continuously been found

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4. The "Key points" section of the inspection results notification contains an overview of deficiencies in operational management systems, quality control systems and individual audit engagements and gives one of the five overall inspection ratings based on the status of those areas. The five ratings are accompanied by the respective assessment comments as follows:

- (1) 1st-highest rating: "Favorable (Overall Rating 1)"
- (2) 2nd-highest rating: "Generally favorable with some deficiencies requiring remediation (Overall Rating 2)"
- (3) 3rd-highest rating: "Unfavorable with significant deficiencies requiring remediation (Overall Rating 3)"
- (4) 4th-highest rating: "Unfavorable with significant deficiencies with respect to operational management systems, etc. requiring immediate voluntary remediation (Overall Rating 4)"
- (5) 5th-highest (lowest) rating: "Extremely unacceptable (Overall Rating 5)"

in individual audit engagements.

#### **(4) Trends of international audit regulators**

From the perspective of enhancing the international status of Japanese capital markets, the CPAAOB and the FSA support the International Forum of Independent Audit Regulators (IFIAR),<sup>5</sup> with its permanent secretariat located in Tokyo. The IFIAR has long endeavored to ensure and improve audit quality globally through continuous dialogue with the six largest global networks and the publication of the “Survey of Inspection Findings 2021.”

## **2. Concept of Basic Plan for Monitoring Audit Firms in PY 2022**

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

In PY 2022, the CPAAOB will monitor<sup>6</sup> audit firms with a focus on the following points:

#### **a. Operational management systems**

##### **(i) Audit firm management’s commitment to improving audit quality**

To improve audit quality on an ongoing basis, top management leaders should take leadership to foster an organizational culture emphasizing audit quality and compliance with professional ethics and to develop organized and integrated operational management and quality control systems. Therefore, the CPAAOB will primarily evaluate whether management teams, including top leaders, recognize this point and reflect the recognition in specific measures.

##### **(ii) Effectiveness of operational management systems**

The CPAAOB will primarily evaluate whether operational management systems are developed and implemented under effective governance and well-functioning management to ensure and enhance audit quality. With regard to audit firms that have adopted the Audit Firm Governance Code, in particular,

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5. The 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 2022, the number of IFIAR member countries/regions totaled 54, including Japan.

6. Monitoring covers inspections and non-inspection monitoring. Non-inspection monitoring includes the collection of reports and interviews regarding audit firms and information gathering through the exchange of opinions and cooperation with relevant FSA divisions, the JICPA and other business organizations related to auditing, as well as dialogue with audit firms.

the CPAAOB will continue to primarily evaluate the activities of supervisory and assessing bodies comprising independent third parties (commitments to assessing the effectiveness of organized operations and to evaluating internal and external whistleblowing).

b. Quality control systems

(i) Effectiveness of quality control systems

The CPAAOB will primarily evaluate not only whether audits by audit firms comply with audit standards in form, but also whether such audits demonstrate professional skepticism to find accounting fraud, and other points regarding whether quality control systems developed by audit firms are effective for ensuring and enhancing audit control.

(ii) Responses to quality control standards revisions

The revised quality control standards are planned to be applied for large-sized audit firms under the CPA Act from the fiscal year starting in or after July 2023 and for other audit firms from the fiscal year starting in or after July 2024 (any earlier application is acceptable). Therefore, the CPAAOB will primarily confirm preparations for and responses to the introduction of a quality management system based on risk approaches.

(iii) Securement, training and distribution of audit resources

To ensure and enhance audit quality, it is vital for audit firms to secure, train and adequately distribute sufficient audit resources commensurate with the number of companies that it audits, as well as audit risks. Given this, the CPAAOB will primarily evaluate the status of the securement, training and distribution of audit resources at audit firms, including the development of the work environment, initiatives to reduce the turnover rate and policies for audit fees.

(iv) Backgrounds on new client acceptance and cancellation

While the annual number of audit firm changes by listed Japanese companies has surpassed 220 (excluding those resulting from audit firm mergers), the change of large-sized firms to mid-tier or small and medium-sized ones has remained remarkable. Given such situation, the CPAAOB will primarily evaluate backgrounds to audit firms' new client acceptance and cancellation with listed companies (including details about the new client acceptance with large listed companies or listed companies suspected of



having high audit risks), the adequacy of risk assessment for the new client acceptance and processes for determining audit fees, the development of auditing arrangements and details of contract takeovers.

(v) Responses to the impact from COVID-19 and the Ukraine crisis

As COVID-19 has spread, constraints have been seen on some audit procedures, such as attendance at physical inventory observation, confirmation of bank balances, and group audits involving overseas subsidiaries. The recent international situation, including the Ukraine crisis and lockdowns in Shanghai, has also affected audit engagements. Given the above, the CPAAOB will primarily evaluate audit firms' responses based on the JICPA's notices (including "Audit Consideration related to COVID-19," "Remote Work Series," and "Audit Consideration for the Fiscal Year Ended March 31, 2022")

(vi) Introduction of audit tools leveraging digital technologies (including cybersecurity measures)

Considering that progress in the digitalization of audits is expected to enhance the effectiveness of audit procedures for detecting fraud and realize the effective and efficient distribution of audit resources, the CPAAOB will continue to grasp audit firms' development and introduction of audit tools leveraging digital technologies through the monitoring of large-sized and mid-tier audit firms. The CPAAOB will also check if audit firms have taken adequate cybersecurity measures according to the advancement of cyberattacks.

(vii) Responses to the revised code of ethics

As the revised code of ethics is planned to be applied from April 2023 in principle, the CPAAOB will primarily confirm audit firms' responses to the revision (including how to secure the objectivity of engagement quality reviewers and the introduction or revision of rules regarding the rate of dependence on audit fees).

c. Individual engagements

(i) Implementation of audit procedures regarding fraud risks

Considering the status of inappropriate accounting treatments, the CPAAOB will primarily evaluate how audit procedures on fraud risks are implemented (whether auditors fully perform their professional skepticism

more carefully or critically to identify fraud risk factors, including incentives and pressure to commit fraud, and events and conditions that provide opportunities to commit fraud, as well as to assess the risks of material misstatement, and whether auditors appropriately develop and implement audit procedures in response to identified risks and obtain sufficient, appropriate audit evidence).

(ii) Implementation of audit procedures regarding revenue recognition

As Accounting Standard No. 29 “Accounting Standard for Revenue Recognition” has been applied since the fiscal year that started in or after April 2021, sufficient professional skepticism is required for audit procedures regarding revenue recognition. Given this point, the CPAAOB will primarily evaluate how audit procedures on revenue recognition are implemented (whether auditors develop and implement audit procedures responding appropriately to assessed fraud risks after appropriately assessing the type of revenue, transactions or assertions linked to the generation of fraud risks).

(iii) Implementation of audit procedures regarding accounting estimates and group audits

Given that deficiencies regarding audit procedures for accounting estimates and group audits have continuously been found through inspections, the CPAAOB will primarily evaluate whether audit firms consider the extent of uncertainty about estimates, appropriately identify and assess risks of material misstatement regarding accounting estimates, take note of the rationality of managers’ assumptions and implement audit procedures that respond appropriately to the risks. Regarding group audits, the CPAAOB will primarily evaluate whether audit firms prepare detailed audit plans based on appropriate risk assessment involving group financial statements, whether audit firms appropriately engage with the work of component auditors and whether audit firms obtain sufficient, appropriate audit evidence by assessing reports from their component auditors and requesting additional audit procedures as necessary.

(iv) Procedures for making decisions on KAM and descriptions of audit responses

Given that audit firms have been required to describe Key Audit Matters (KAM) in their audit reports regarding financial statements for the fiscal year ended in March 2021 onwards, the CPAAOB will primarily evaluate

procedures for making decisions on KAM (whether audit firms proactively communicate with managers and audit committee members of audited companies when making decisions) and descriptions of audit responses (whether procedures conforming to factors described in reasons for decisions on KAM or audit approaches are specifically described).

(v) Implementation of procedures regarding “other information in documents”

Given that “auditors’ responsibilities regarding other information in documents” (Audit Standards Committee Report No. 720) is applied for audits on financial statements for the fiscal year ended in March 2022 onwards, the CPAAOB will primarily evaluate the implementation of procedures regarding “other information in documents” (through reading of other information in documents, consideration and assessment of other information in documents, etc.)

(vi) Responses to risk approach enhancement

Given that the enhancement of risk approaches in the revised auditing standards will be applied to audits on financial statements for the fiscal year ended in March 2023 onwards, the CPAAOB will check the revision of audit manuals and other responses to the auditing standard revision at audit firms.

d. Others

(i) Status of assurance on non-financial information

Given that non-financial information assurance needs and hopes with respect to CPAs’ engagement with such assurance are growing, the CPAAOB will grasp the status of non-financial information assurance at audit firms.

(ii) Provision of auditing services for companies preparing for IPOs

From the perspective of whether efforts are promoted to pave the way for IPO-seeking companies to undergo appropriate audits according to their growth stages, the CPAAOB will check the status of audit firms’ provision of auditing services to companies preparing for IPOs.

**(2) Consideration of monitoring methods**

The CPAAOB has reformed its traditional face-to-face inspections since PY 2020. In some inspections, the CPAAOB borrowed laptops from audit firms to browse audit work papers and held online interviews. In the current program year, the CPAAOB will implement remote inspections as mentioned above, while

considering the digitalization of audit work papers at audit firms.

The CPAAOB will continuously consider how to implement remote inspections through dialogue with audit firms in pursuit of further improvements.

### **3. Basic plan for non-inspection monitoring**

#### **(1) Verification of JICPA quality control review reports and cooperation with JICPA**

- The CPAAOB verifies the effectiveness of the JICPA's quality control reviews, shares evaluation results with the JICPA through the dialogue and encourages the JICPA to ensure and enhance audit quality. The JICPA, for its part, reduces or increases the frequency of regular reviews to enhance and improve its system of quality control review.
- JICPA quality control reviews and CPAAOB inspections differ in terms of implementation scheme and methodology. In recent years, the JICPA has continued efforts to improve the effectiveness and transparency of quality control reviews. In some cases, however, audit firms that were described as free from significant deficiencies in JICPA quality control reviews were found through CPAAOB inspections to have had a remarkably unacceptable system of quality control. The JICPA should encourage audit firms to spontaneously improve their quality control systems and should enhance the effectiveness of its quality control reviews. The CPAAOB will share the results of its examination on the effectiveness of quality control reviews with the JICPA through the dialogue to encourage the JICPA to further improve the effectiveness of quality control reviews, considering that a registration system for audit firms for listed companies has become a legal requirement.
- Considering that cooperation between the CPAAOB and JICPA plays a critically important role in ensuring and enhancing audit quality for all audit firms, the CPAAOB and JICPA will continuously discuss the respective roles of CPAAOB inspections and JICPA quality control reviews and their deeper cooperation. They will also discuss the JICPA's enhancement of instruction and supervision of small and medium-sized audit firms to ensure and enhance audit quality and how the examination of quality control systems should be.

#### **(2) Collection of reports**

##### **a. Basic concept**

- To encourage all of Japan's audit firms to ensure and enhance audit quality

and each audit firm to develop appropriate operational management and quality control systems, the CPAAOB will appropriately grasp the status of audit firms and risks regarding individual audit engagements in a timely manner. The CPAAOB will also collect reports effectively on the design and implementation of operational management and quality control systems at audit firms (including the implementation of remedial measures). To collect reports efficiently, the CPAAOB will utilize information gained through inspections and dialogue with audit firms, considering the workload on audit firms.

- To efficiently inspect large-sized and mid-tier audit firms, the CPAAOB will regularly collect and analyze quantitative and qualitative information from them on operational management systems.
- From small and medium-sized audit firms, the CPAAOB will collect and analyze information in a timely manner according to their sizes and characteristics, considering the results of JICPA audit quality reviews and audit risks regarding audited listed companies. When encouraging small and medium-sized audit firms to spontaneously ensure and enhance audit quality, the CPAAOB will hold interviews on their reports to secure effects similar to those of inspections.
- The CPAAOB will collect reports from small and medium-sized audit firms on responses to issues identified in inspection results and encourage them to spontaneously improve their practices.
- From audit firms that are rated unfavorable with significant deficiencies with respect to operational management systems and are required to improve their practices immediately, the CPAAOB will collect reports when notifying them of inspection results and encourage them to quickly improve their practices.

b. Focus points of reports for collection

Based on “2 (1) Focus points of monitoring,” common focus points of reports for collection are as follows. In collecting reports from small and medium-sized audit firms, the CPAAOB will evaluate whether they have developed appropriate operational management and quality control systems as auditors of listed companies and primarily grasp their top managers’ policies and their revenue and financial structure.

- (i) Audit firm management’s commitment to enhancing audit quality
- (ii) Effectiveness of operational management systems (systems developed based on the Governance Code for firms that have adopted the code), including top managers’ policies, and revenue and financial structure

- (iii) Effectiveness of quality control systems
- (iv) Responses to quality control standards revisions, etc.
- (v) Responses to code of ethics revisions
- (vi) Securement, training and distribution of audit resources (including the development of the work environment and initiatives to reduce the turnover rate)
- (vii) Backgrounds to new client acceptance and cancellation of audit contracts
- (viii) Responses to the impacts of COVID-19 and the Ukraine crisis
- (ix) Introduction of audit tools leveraging digital technologies (including the implementation of cybersecurity measures)
- (x) Non-financial information assurance

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

#### **a. Dialogue with audit firms**

The CPAAOB will continue to conduct periodic dialogue with top and other managers of large-sized and mid-tier audit firms in order to collect information about the latest operational management systems at the firms, ascertain the problems that audit firms and the audit industry are facing and share problem awareness with them. Considering that the number of listed companies audited by small and medium-sized audit firms has been increasing, the CPAAOB will have dialogue with managers at relatively larger firms among the small and medium-sized audit firms that audit listed companies, as necessary.

#### **b. Cooperation with relevant organizations at home and abroad**

The CPAAOB will enhance the exchange of opinions and cooperation with relevant FSA divisions, the JICPA, financial instruments exchanges and the Japan Audit & Supervisory Board Members Association, as well as the IFIAR, foreign audit regulators and global audit firm networks. The CPAAOB will proactively utilize information gained through the exchange of opinions and cooperation for monitoring and endeavor to collect and analyze various documents and information according to risks at audit firms. The CPAAOB will also continue to promote personnel who can analyze domestic and foreign information, the internationalization of accounting practices and Japanese audit firm systems, and take appropriate actions, and those who can provide guidance for efficient and effective monitoring. The CPAAOB will promote the fostering of personnel through their proactive participation in international meetings.

## **4. Basic Inspection Plan**

### **(1) Common points for evaluation/confirmation**

#### **a. Common focus points for evaluation**

Based on “2 (1) Focus points of monitoring,” common focus points for evaluation in inspections of large-sized, mid-tier, and small and medium-sized audit firms are as follows:

- (i) Audit firm management’s commitment to enhancing audit quality
- (ii) Effectiveness of operational management systems
- (iii) Effectiveness of quality control systems
- (iv) Securement, training and distribution of audit resources
- (v) Backgrounds to new client acceptance and cancellation of audit contracts (including the adequacy of risk assessment for concluding new contracts, the development of audit performance systems and the implementation of takeover procedures)
- (vi) Implementation of audit procedures regarding fraud risks
- (vii) Implementation of audit procedures regarding accounting estimates
- (viii) Implementation of audit procedures regarding revenue recognition
- (ix) Implementation of audit procedures regarding group audits
- (x) Procedures for making decisions on KAM and descriptions of audit responses
- (xi) Implementation of discussions with managers and communications with auditing committee members
- (xii) Implementation of procedures regarding “other information in documents”

#### **b. Common focus points for confirmation**

Based on “2 (1) Focus points of monitoring,” common focus points for confirmation in inspections of large-sized, mid-tier, and small and medium-sized audit firms are as follows:

- (i) Responses to quality control standards revisions, etc.
- (ii) Responses to code of ethics revisions
- (iii) Provision of auditing services for companies preparing for IPOs
- (iv) Responses to risk approach enhancement

### **(2) Inspections of large-sized audit firms**

#### **a. Inspection frequency, etc.**

- Given that large-sized audit firms fulfill an important role in the capital markets, 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 of audit firms, refrain from evaluating individual audits in principle, and evaluate remedial measures taken to address issues detected in the previous regular inspections. In addition, the CPAAOB may collect reports to confirm remedial measures instead of conducting an inspection.
- If a serious accounting problem at an audited company having a material impact on markets is detected or suspected and the CPAAOB finds it necessary to immediately confirm the status of the quality control systems of the audit firm accountable for audit procedures, the CPAAOB will perform inspections expeditiously without being bound by the abovementioned principle.

b. Inspection methods

In order to improve the efficiency and effectiveness of monitoring and reduce the workload of audit firms, the CPAAOB will continue to implement remote inspections of large-sized audit firms and conduct face-to-face interviews as necessary.

c. Focus points for evaluation

Each large-sized audit firm has thousands of employees and multiple business units that are each led by directors and comprise hundreds of employees. Each firm also has multiple local offices, including rural ones. To ensure and enhance levels of quality control throughout such organization, its management, including the chief executive officer, must take strong leadership. At the same time, its quality control department and business units close to the audit frontline need to penetrate measures to ensure and enhance audit quality throughout the organization. Each large-sized audit firm has tended to transfer part of quality control functions from its head-office quality control department to business units close to the audit frontline. As a result, each business unit plays a greater role in spreading remedial measures among audit teams. In addition, some large-sized audit firms are integrating quality control departments into business units, and the CPAAOB must pay attention to the effects and impacts of such organizational changes and personnel management on audit quality.

Given the above, the CPAAOB will pay particular attention to the following focus points for evaluation in inspections for the current program year:

- Implementation of functions by the management, including the top leader, and the quality control department to check the audit frontline (business units, etc.) to ensure and enhance audit quality



- Permeation and settlement of quality control measures at the audit frontline
- Monitoring by the quality control department on individual audits
- Audit procedure deficiencies for cases where inappropriate accounting treatments are found at audited companies, including those preparing for IPOs, evaluation of root causes of such deficiencies, and implementation of remedial measures

### **(3) Inspections of mid-tier audit firms**

#### **a. Inspection frequency**

Mid-tier audit firms audit a considerable number of listed companies and play certain roles in the capital markets. Compared to large-sized firms, however, they have developed less sufficient operational management and quality control systems. For this reason, the CPAAOB inspects mid-tier firms every three years in principle. If the CPAAOB finds it necessary to immediately confirm the quality control systems of a mid-tier audit firm accountable for audit procedures for a company where a serious accounting problem is detected or suspected, however, the CPAAOB expeditiously inspects the audit firm.

#### **b. Inspection methods**

To improve the efficiency and effectiveness of monitoring and reduce the workload of audit firms, the CPAAOB will continue to implement remote inspections on mid-tier audit firms and conduct face-to-face interviews as necessary.

#### **c. Focus points for evaluation**

While mid-tier audit firms are identified as promoting the development of quality control systems, some of them have yet to enhance head-office functions sufficiently. At some mid-tier audit firms, top leaders' consciousness of quality control has failed to catch up with their business expansion, or partners other than executive officers have not proactively participated in developing and operating quality control systems. These firms have also failed to sufficiently analyze the root causes of problems based on their business trends and operational management systems.

Given the above, the CPAAOB will pay particular attention to the following focus points for evaluation in inspections for the current program year:

- Top and other managers' recognition of quality control
- Cooperation between the quality control departments and the audit frontline (business units, etc.)

- Monitoring by the quality control department on individual audits

#### **(4) Inspections of small and medium-sized audit firms**

##### **a. Inspection frequency**

- As for small and medium-sized audit firms, the CPAAOB considers the need for confirming their quality control systems immediately, based on the JICPA's quality control review results and the extent of risks regarding their operational management systems and the listed companies they audit.
- Considering that they play greater roles in auditing listed companies, the CPAAOB gives greater priority to inspections of small and medium-sized audit firms.

##### **b. Inspection methods**

The CPAAOB will implement remote inspections on small and medium-sized audit firms as far as possible, based on conditions regarding the introduction of digital audit work papers.

##### **c. Focus points for evaluation**

At many small and medium-sized audit firms, chief executive officers' recognition of and engagement with quality control exert a decisive influence on the development of an organizational culture emphasizing quality control, of compliance with laws and regulations, and of professional ethics. In particular, recent inspections found that chief executive officers failed to take leadership in developing an organizational culture emphasizing compliance with professional ethics, that chief executive officers or managers responsible for quality control failed to recognize their and audit practitioners' lack of understanding on current audit standards, and that they have failed to understand the level of deep analysis on root causes of deficiencies found in quality control reviews to prevent a recurrence of similar deficiencies. Some audit firms lack sufficient systems to appropriately audit listed companies with higher audit risks.

Given the above, the CPAAOB will pay particular attention to the following focus points for evaluation in inspections for the current program year:

- Top and other managers' recognition of quality control
- Initiatives to develop an organizational culture emphasizing compliance with laws and professional ethics
- Permeation of quality control measures among the audit frontline
- Development and operation of organized quality control systems covering local offices

- Implementation of remedial measures for issues pointed out in quality control reviews
- Partners' and employees' recognition of professional ethics, independence and compliance with laws

#### **(5) Foreign audit firms, etc.**

When selecting foreign audit firms, etc.<sup>7</sup> for inspections, the CPAAOB will consider reports collected in PY 2021 and the audit-related risks of foreign companies audited by relevant foreign audit firms, etc. When implementing inspections, the CPAAOB will consider the COVID-19 infection status and conduct prior consultations and coordination with audit regulators having jurisdiction over the foreign audit firms, etc. selected for inspections.

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

To ensure and enhance audit quality, it is important to adequately convey the results of inspections to audit firms and the audit committee members of audited companies and disseminate information on the monitoring results to the public so as to spur interest in and awareness of audits. From that viewpoint, the CPAAOB gives consideration to the following points on the occasion of monitoring information provision:

#### **a. Conveyance of inspection results to audit committee members**

The CPAAOB endeavors to enhance descriptions of inspection results so as to accurately convey inspection findings to audit firms and their quality control levels, inspection findings on operational management systems and other findings to audit committee members at audited companies. (For overall inspection ratings specified in inspection results notifications, the CPAAOB has revised assessment descriptions since PY 2021). The CPAAOB also confirms whether audit firms appropriately convey the results of inspections to audit committee members at audited companies.

#### **b. Monitoring Report**

To contribute to furthering market participants' understanding of audits, the CPAAOB has published the annual Monitoring Report compiling monitoring

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7. "Foreign audit firms, etc." refers to foreign audit firms that have submitted notification to the FSA Commissioner that they provide in foreign countries services that amount to audit attestation for the financial documents of foreign companies to be submitted under the Financial Instruments and Exchange Act.

results and insights since 2016. The CPAAOB will strive to further enhance its contents and dissemination with the needs of readers in mind. The CPAAOB will also endeavor to disseminate the Monitoring Report to foreign readers by translating it into English.

c. Case Report from Audit Firm Inspection Results

In order to encourage audit firms to ensure and enhance audit quality, the CPAAOB has published the annual Case Report from Audit Firm Inspection Results, compiling specific cases identified through inspections. The CPAAOB will continue to enhance the report by replacing cases with new ones to make the report a useful reference for audit firms' improvement initiatives. The CPAAOB will also continue to hold lectures and briefings on the Case Report at each branch of the JICPA nationwide, proactively disseminate the report to market participants and translate it into English to provide relevant information to foreign readers.