

II. The CPAAOB monitoring

A. Overview of System and Situation with Implementation

1. Legal Position of the CPAAOB

The CPAAOB is an administrative body¹ serving as a council that was established in April 2004 in accordance with Article 35-1 of the CPA Act and Article 6-2 of the Act for Establishment of the Financial Services Agency. It comprises a chairperson and a maximum of nine members (who serve three-year terms). Although the members are part time, one full-time member can be appointed.

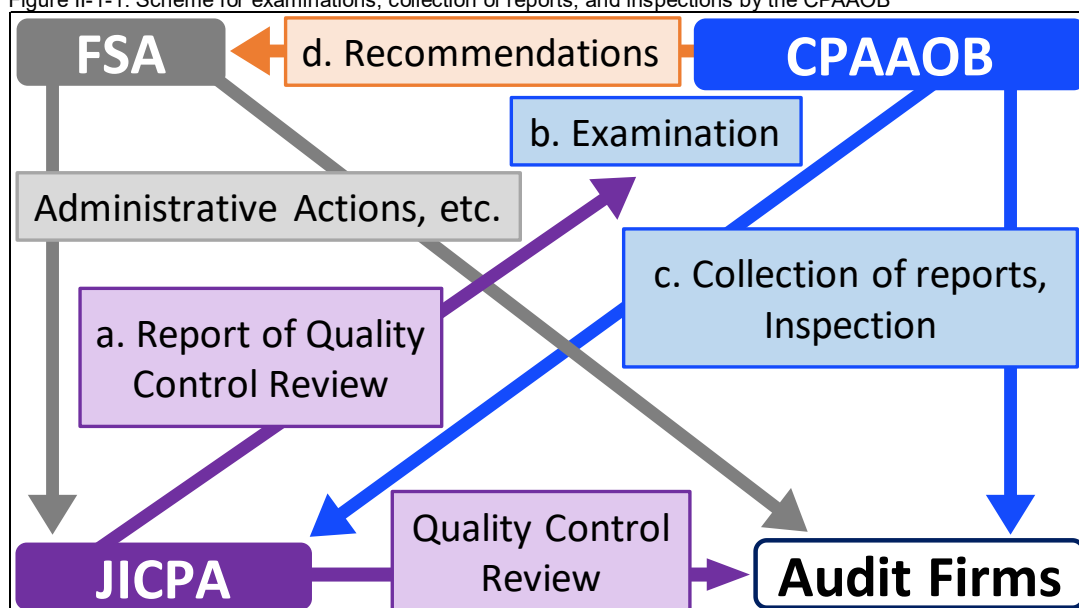
The CPAAOB receives and examines reports concerning quality control reviews by the JICPA, collects reports from and conducts inspections of the JICPA and audit firms etc. Based on the results of inspections etc., the CPAAOB recommends administrative actions or other measures to the FSA Commissioner when necessary.

2. Overview of Examinations, Collection of Reports, and Inspections by the CPAAOB

Figure II-1-1 shows the relationship between examinations, collection of reports, and inspections by the CPAAOB on the one hand, and the JICPA quality control reviews, the FSA's administrative actions, etc. on the other.

Based on the JICPA quality control review reports (a), the CPAAOB assesses whether the JICPA has carried out the quality control reviews properly and whether the audit firms have properly performed its audit services (b), and collects reports from the JICPA, audit firms, etc. and conducts on-site inspections when deemed necessary (c). If it finds it to be necessary as results of inspections, the CPAAOB recommends administrative actions or other measures to the FSA Commissioner (d).

Figure II-1-1: Scheme for examinations, collection of reports, and inspections by the CPAAOB



¹ Appointed by the Prime Minister with the consent of both houses of the Diet from persons with an understanding of and insight concerning matters relating to CPAs

3. Report of JICPA Quality Control Review

The JICPA is an organization of CPAs in Japan established in accordance with Article 43 of the CPA Act. To maintain the integrity of its member CPAs and audit firms and improve/promote audit and attestation services, the JICPA guides, connects, supervises its members and performs administrative tasks pertaining to the registration of CPAs and specified partners.

The quality control reviews are conducted by the JICPA to maintain/improve suitable qualitative standards for audit services and to ensure public trust in audits. More specifically, the JIPCA reviews the administration of audit engagements conducted by audit firms, reports results to the audit firms and, when necessary, recommends improvements and monitors the status of improvements².

Quality control reviews were introduced by the JICPA in FY1999 as self-regulations, and in 2003 a revision to the CPA Act made it mandatory for the JICPA to conduct reviews of the administration of audit and attestation services by audit firms and report its findings of these reviews to the CPAAOB.

The JICPA regularly submits to the CPAAOB monthly and annual reports and updates the status of quality control review as needed. The specific information reported is as follows:

- a. Review plan
- b. Details on any deficiencies observed during reviews and the audit firms' perspectives
- c. "Quality Control Review Reports" and "Recommendation for Improvement Reports" provided by the JICPA to audit firms based on review findings
- d. Specific measures based on review findings (warnings, severe warnings, recommendation to withdraw from audit engagements)
- e. "Remediation plan" prepared by the audit firm and submitted to the JICPA

Quality control reviews evaluate the audit firms' quality control systems by means of the extent to which the systems have made progress as well as how effective the systems have been in place. Specifically, they confirm whether their quality control systems (all policies and procedures for quality control pertaining to audit, including quality control procedures relevant to audit engagements) have been suitably and sufficiently developed in compliance with quality control standards³, and whether these quality control systems are operating effectively.

In addition, quality control reviews comprise regular reviews, which are conducted on the overall quality control of an audit firm, and special reviews on quality control related to the audit firm's specific sector or audit service.

In FY2021, there was a total of 38 reviewers (as of July 1, 2021) who conducted regular reviews of 75 audit firms.

² For details concerning quality control reviews, see the JICPA website and the annual report from the Quality Control Committee.

³ The Public Accountant Act and other laws and regulations, auditing criteria, correspondence criteria for addressing fraud risks in auditing, quality control criteria related to auditing, the JICPA's rules and regulations, and so forth.

4. Examination

a. Overview

The CPAAOB receives quality control review reports from the JICPA, and then reviews the reports to examine the appropriateness of these quality control reviews and audit services performed by the audit firms. More specifically, the CPAAOB confirms the context of quality control reviews and the instruction to audit firms on necessary remediation measures, and analyses the findings of quality control reviews as well as the details of remediation plans submitted to the JICPA. In addition to considering the need for inspection and collecting reports in light of the outcomes of the analysis, the CPAAOB engages in exchanges of opinions with the JICPA concerning matters such as the effectiveness of quality control reviews. Still, the CPAAOB also utilizes information from the relevant FSA departments, relevant organizations, etc. on the occasion of the examination.

b. State of implementation of examinations and results

The CPAAOB examined quality control reviews conducted in FY2021 by the JICPA in PY2021 and an overview of the review was given below.

i. FY2021 quality control reviews

Conclusions of quality control reviews, conducted on 76 audit firms in FY2021, were approved for 75 of them by June 30, 2022. Specifically, no significant deficiencies were confirmed at 69 audit firms, while significant deficiencies were observed at six audit firms, and no extremely significant deficiencies were observed. In addition, improvements were recommended to 73 audit firms (Figure II-1-2).

Figure II-1-2: FY2020 quality control reviews (unit: audit firms)

Classification	Reviewed parties	Conclusions			Recommendations for improvement	
		Conclusion finding no significant deficiencies	Conclusion finding significant deficiencies	Conclusion finding extremely significant deficiencies	Yes	No
Audit firms	56	50	6	0	55	1
Partnerships	2	2	0	0	2	0
Solo practitioner	17	17	0	0	16	1
Total	75	69	6	0	73	2

(Note 1) Conclusion finding significant deficiencies is declared when there is significant concern about serious compliance violations of standards as well as laws and regulations applicable to an audit firm as a professional expert in the development and management of its quality control system.

(Note 2) Conclusion finding extremely significant deficiencies is declared when there is significant concern about extremely serious compliance violations of standards as well as laws and regulations applicable to an audit firm as a professional expert in the development and management of its quality control system.

(Note 3) Even if declaration finding no significant deficiencies is declared to an audit office, a recommendation for improvement is issued where an issue worthy of a recommendation for improvement is observed.

(Note 4) As the conclusion for one of the 75 audit firms reviewed had yet to be made as of June 30, 2022, it was not included in the state above.

(Reference) Prepared by the CPAAOB based on data from the JICPA.

ii. Examination of FY2021 quality control reviews

The following examinations and analysis were conducted on quality control review reports from the JICPA to verify the appropriateness of its reviews.

- Examination and confirmation of the policies for FY2021 quality control reviews, efforts for improvement, and improvements in each review operation.
- Identification of significant deficiencies or extremely significant deficiencies as a result of quality control reviews of audit firms and analysis of items and contents of specific deficiencies pointed out amid quality control reviews
- Analysis of specific deficiencies pointed out in quality control review reports and instruction for improvements to examine whether the JICPA has effectively prompted audit firms for fulfillment

As a result of the above-mentioned examinations, the following were found in quality control reviews in FY2021:

- To ensure that issues pointed out with specific audit engagements are not cast aside as marginal documentation problems (presentation errors in audit papers) but as based on the reality of deficiencies, measures, such as revising review procedures and providing training to reviewers, have been taken. As a result, the ratio of documentation deficiencies to total deficiencies is decreasing.
- In order to strengthen the risk-based approach, the JICPA conducted the following:
 - (i) understand audit firms' operation control structures; and
 - (ii) made review plans while taking into account the results of past quality control reviews and risk assessments performed at the selection stage of audit engagements; after the commencement of reviews, furthermore, flexibly extend the review period and increase reviewers depending on the change of the situation (hereinafter referred to as "flexible review").

As a result, issues pointed out with individual audit engagements have increased, while in some matters such as quality control structures, outcomes could not be confirmed,

The JICPA will further deepen understanding of audit firms' operation management structures and will continue efforts to conduct flexible review. The CPAAOB will continuously check the effectiveness of quality control reviews.

As a feature of the FY2021 quality control review, issues pointed out about audit of accounting estimates increased from the previous year.

5. Collection of Reports

a. Overview

The CPAAOB may collect reports from the JICPA or audit firms when necessary. With limited inspection resources at its disposal, it is important for the CPAAOB to make effective use of the

collection of reports so as to ensure and enhance audit quality at all audit firms in Japan. In this view, we wield collection reports in consideration of their business formats, the results of the CPAAOB inspections and JICPA's quality control reviews, and so on.

i. Collection reports for large-sized and mid-tier audit firms

In the case of large-sized audit firms and mid-tier audit firms, we periodically analyze quantitative and qualitative information concerning their business management (governance) system and operations management system so as to contribute to further effective inspection. We also attempt to grasp the status of digitization in audit engagements and cybersecurity measures taken by each audit firm. In addition, we employ the information through the collection reports to perform comparative analysis of audit firms and to identify sector-wide issues, etc.

ii. Collection of reports from small and medium-sized audit firm, partnership and solo practitioner

In the case of small and medium-sized audit firm, partnership and solo practitioner, we select firms partly based on the results of quality control reviews. We then gather and analyze information about measures taken to address issues pointed out amid quality control reviews, their operations management system, their quality control system, and so on. Furthermore, in many cases, as small and medium-sized audit firms are especially influenced by the leadership of top management, we understand top management's awareness towards the current status of audit quality and efforts for improvement. And we conduct hearings as necessary.

iii. Collection reports for small and medium-sized audit firm, partnership and solo practitioner (follow-up after notification of inspection results)

With regard to problems notified as results of inspections to small and medium-sized audit firm, partnership and solo practitioner, we follow up the progress of improvement through collecting reports about their mitigation after a set period of time or conducting hearings as needed.

iv. Collection reports for audit firms in need of particularly immediate remediation

As a result of inspection, where the overall rating of the firm's business administration is "Unsatisfactory and in need of immediate remediation in operations management system, etc (Overall rating 4)," we wield collection reports at the time of the notification of the inspection results, and prompt the firms to make improvements (for information about overall ratings, see "7. Notification of Inspection Results" (page 40)).

b. Implementation

i. Collection of reports from large-sized audit firms and mid-tier audit firms

In PY2021, the CPAAOB collected reports from all large-sized audit firms and mid-tier audit firms in order to review their business management (governance) system, operations management system, etc. Furthermore, we analyzed the information through the collection of reports and utilized the analysis results to ensure effective and efficient inspection, and also

conducted inter-corporation fact-finding of business management (governance) system and operations management system at large-sized audit firms and mid-tier audit firms.

ii. Collection of reports from small and medium-sized audit firms, partnership and solo practitioner

In PY2021, reports were collected from 43 small and medium-sized audit firms (mainly from those subject to quality control reviews in PY2020) chosen on the basis of results of the reviews. The reports contained recommendations for improvement issued by quality control review, matters related to business management (organizations and manpower, arrangement and implementation of training, etc.), matters related to the global network of audit firms, the impact of and responses to COVID-19 infections, key audit matters (KAMs) and so forth.

Of the 43 firms, 11 firms (those deemed to have concerns about operating management systems according to their reports, founded in the recent past and larger than a set scale, etc.) were subjected to face-to-face or online hearings.

At the hearing, we have intensively heard about the development of quality control systems including responses to review findings, top management's management policy, organizations and human resources, and so forth, while conveying the CPAAOB's awareness of problems, to promote the establishment of quality control that can ensure proper audit services.

While the hearings identified concerns about the quality control system, etc. at certain audit firms as described below, firms larger than a set scale were found to have distinctive cases of management system, etc., in comparison to other firms. These results will be used as important reference information in future examination, inspection and so forth.

- To address recommendations for improvement in the previous review, top management of a firm has been trying to figure out root causes but received the same recommendations in the latest review due to inadequate efforts.
- Although a firm has implemented measures to address recommendations for improvement, all audit staff has possibly carried them out without fully understanding the purport of the measures because review results are not shared with part-time staff but only among partners.
- A firm is prompting the appointment of new partners, conscious of the change of generation as an urgent issue due to the high average age of its existing partners. But such effort has failed to advance as candidates decline to join on the grounds that partners have unlimited liabilities.
- Firms larger than a certain scale have adopted distinctive programs, such as computerization of audit working papers, exchange of personnel with member firms of a global network they belong to, and dispatch of employees to quality control reviewers.

iii. Collection of reports from small and medium-sized audit firms etc. (follow-up after notification of inspection results)

In PY2021, among small and medium-sized audit firms etc. that had been notified of inspection results by the CPAAOB in past program years, the CPAAOB collected reports from one audit

firm for which about one year had passed since the notification in order to confirm the improvements that had been made to address the findings observed during the inspection.

iv. Collection of reports from audit firms in need of particularly urgent remediation

In PY2020, three firms were assessed to be "unsatisfactory and in need of immediate remediation". In PY2021, of the three, one firm, from which a report was collected simultaneously with the notification of inspection results, continually reported the improvement of operations management. Another firm reported the implementation of improvement efforts, including an improvement plan simultaneously with the notification of inspection results.

These firms include those in which the implementation of audit services is unsatisfactory and there are many deficiencies in the audit of specific companies listed in Japan, in which integrated organizational management is not implemented and the development and implementation of organized operations management system are unsatisfactory, and in which an organizational culture to place emphasis on the quality of audit services has yet to be fostered and the development and implementation of quality control system are unsatisfactory.

6. Inspections

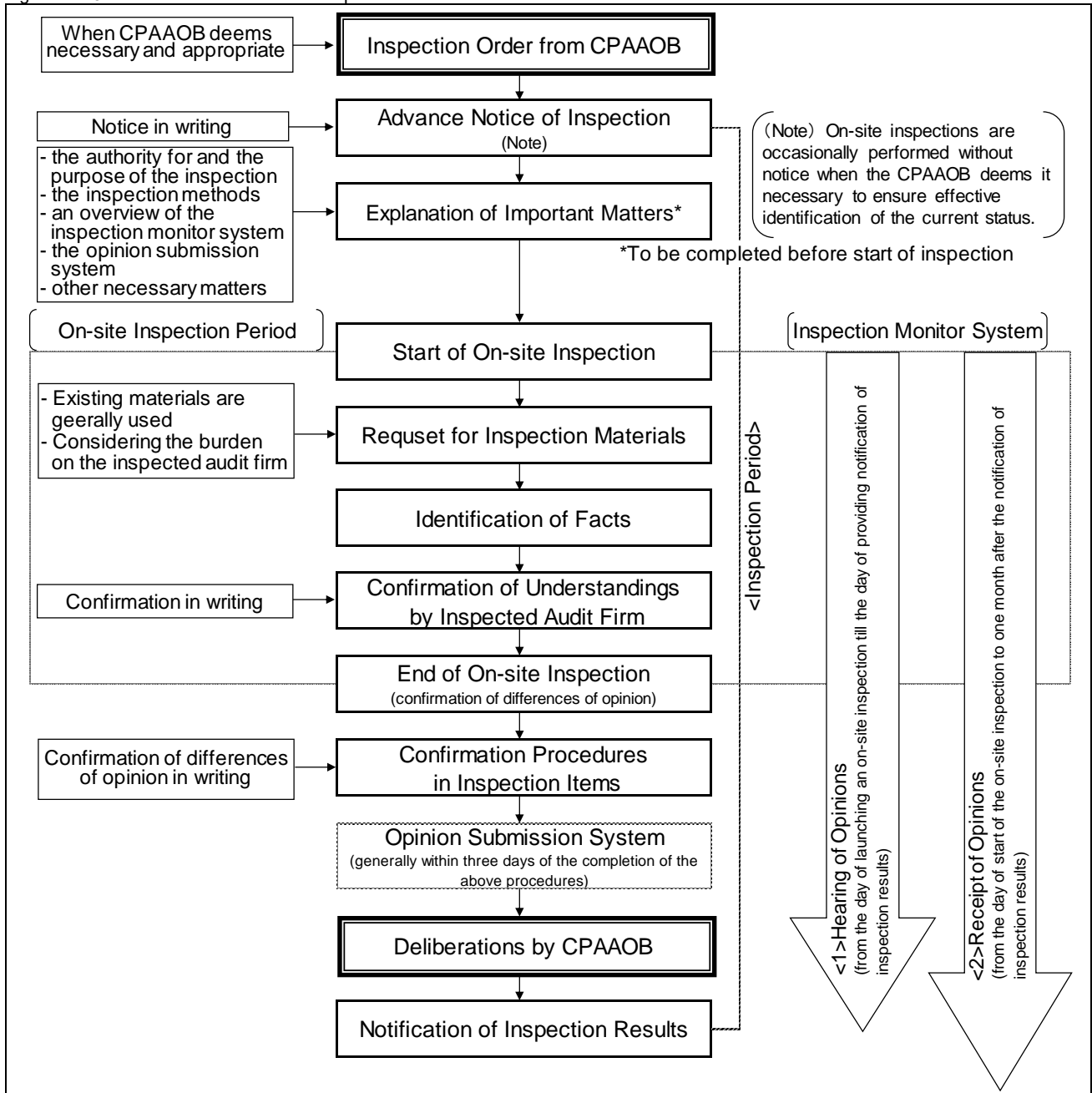
a. Overview

When deemed necessary and appropriate for the public interest or the protection of investors as the result of 4. or 5. above, the CPAAOB inspects audit firms (Article 49-3-2 of the CPA Act). Furthermore, when deemed necessary for ensuring the proper administration of the JICPA, the CPAAOB also inspects the JICPA (Article 46-12-1 of the CPA Act).

Basic matters concerning the CPAAOB's inspections, procedures for inspections, the handling of inspection results, etc. are prescribed in the "Basic Guidelines on Inspections Conducted by the Certified Public Accountants and Auditing Oversight Board" (latest revised in April 2022).

The standard workflow on inspections for audit firms in accordance with the Basic Guidelines is depicted below (Figure II-1-3).

Figure II-1-3: The standard workflow for inspections



* An inspection starts on the day of conducting it (the day of notification in the case of an inspection with advance notice and the day of launching an on-site inspection in the case of without advance notice) and ends on the day of notifying inspection results.

The following is an explanation of the main components of the standard workflow:

i. Inspection order from the CPAAOB

The CPAAOB issues an order to inspectors to inspect an audit firm.

ii. Explanation of important matters

Before the on-site inspection, the inspectors explain to the responsible person at the audit firm the authority for and the purpose of the inspection, the inspection methods, an overview of the inspection monitor system and the opinion submission system, and other necessary matters.

iii. On-site inspection

Generally, the inspectors visit the audit firm and inspect its operations management environment, quality control environment, and audit engagements. The audit engagements inspected are selected based on the size of the audit firm, the key points of the basic plan on monitoring, and the audited company's audit risks.

Inspectors examine whether the audit firm's procedures on quality control comply with regulations, auditing standards and quality control policies established by the audit firm through the inspection of books, records and other materials and interviews of the audit firm's executives and staffs.

Furthermore, inspectors obtain confirmation of facts and background information (findings) identified during the inspection in writing from the responsible person at the audit firm.

iv. Confirmation procedures on inspection items

After the on-site inspection, the CPAAOB communicates to the audit firm any problems discovered during the inspection, solicits the views of the audit firm on these problems, and confirms with the audit firm matters whether there are any discrepancies of opinion between the CPAAOB and the audit firm.

v. Opinion submission system

If there is a chasm of opinion, the audit firm may submit its opinion to Secretary-General of Executive Bureau in writing, usually within a three-day period (excluding weekends and public holidays) from the day on which the procedures for confirmation of inspection items were completed. Furthermore, if it receives a request from the audit firm to extend the submission period, the CPAAOB considers extending the submission period by up to two days.

If an opinion is submitted by an audit firm, a person (hereinafter "the head of the CPA Examination Division, etc."), designated by the head of the CPA Examination Division of the CPAAOB Executive Bureau Planning Management or the head of the Planning Management and CPA Examination Division, review the opinion and facts concerned, compile the results of the review and submit them to the CPAAOB.

The results, if approved by the CPAAOB, is conveyed to the audit firm through the head of the CPA Examination Division, etc.

vi. Inspection monitor system

The CPAAOB accepts opinions from audit firms about inspectors' inspection methods and so forth to grasp the CPAAOB' inspections and help ensure that they are conducted properly and efficiently.

Inspection monitoring is conducted by "asking for opinions" and "receiving opinions," and the head of the CPA Examination Division, etc. takes action, when necessary, such as giving instructions to inspectors.

b. State of implementation of inspections

i. Recent conduct of inspections

The frequency of inspections differs depending on the size of the audit firm.

The CPAAOB conducts regular inspections of large-sized audit firms once every two years and, since PY2016, has run follow-up inspections designed to verify improvements in the program year following the regular inspection.

Inspections of mid-tier audit firms are generally conducted once every three years.

Inspections of small and medium-sized audit firms are conducted as necessary, in light of deficiencies pointed out in quality control reviews.

Details of the inspections conducted during the past five years are presented below (Figures II-1-4 and II-1-5).

Figure II-1-4: State of implementation of inspections in the past five years (based on commencement of inspections)(unit: audit firms)

Fiscal/PY	2017 (Note 2)	2018 (Note 2)	2019 (Note 2)	2020 (Note 2)	2021 (Note 2)
Large-sized audit firms	4(2)	4(2)	4(2)	4(2)	4(2)
Mid-tier audit firms	2	1	2	2	1
Small and medium-sized audit firms, partnerships and solo practitioners	3	5(1)	3	4	4
Foreign audit firms, etc. (Note 2)	0	0	1	0	0
Total	9(2)	10(3)	10(2)	10(2)	9(2)

(Note 1) Figures in parentheses are the number of follow-up inspections.

(Note 2) See "B. Foreign Audit Firms" (page 44) for information on foreign audit firms etc.

(Source) Prepared by the CPAAOB based on results of inspections by the CPAAOB

Figure II-1-5: Number of inspections, inspectors, inspection periods and number of audit engagements

	Large-sized audit firms	Mid-tier audit firms	Small and medium-sized audit firms
Number of inspections(case)	8	7	12
Average number of inspectors(headcount)	9.1	7.1	5.6
Average inspection period(calendar days)	175.3	131.7	130.6
Average number of inspected audit engagements (companies)	6.4	5.0	3.2

(Note 1): Inspections conducted and completed in the five years from PY2017 through 2021 are covered. Inspections of foreign audit firms and others, follow-up inspections, cases involving the submission of opinions and cases recommended to the Commissioner of the FSA were excluded because they involved procedures different from those of normal inspections.

(Note 2) Inspection period means the period(calendar day basis)between the date on which notice of the inspection was made (in the case of inspections with no advance notice; the date on which the on-site inspection started) and the date on which notification of the inspection results was issued. Corrected in PY2022 due to errors in the previous period of inspections.

(Source) Prepared by the CPAAOB based on the results of inspections

ii. Deficiencies

a. Characteristics of deficiencies identified through inspections of quality control system

Results of the CPAAOB inspections in and after PY2019 were as follows:

Large-sized audit firms tended to shift primal responsibility for quality control from the quality control section to the business section, which was closer to the audit sites, at their headquarters. The results of recent inspections presented the outstanding issues, such as adequate cooperation between the quality control and business sections at the headquarters, penetration of improvement measures into audit sites (where auditing services are actually performed), and the verification of effectiveness, etc. (for information on the organization of large audit firms, see "III. Operation of Audit Firms, A. Operations Management System, 1. Organizational Structure of Audit Firms" (page 51)).

Although mid-tier audit firms made structural improvements to take systematic approaches, they are facing problems amid expansion of operations, such as the need to strengthen the functions of the headquarters, and to verify the penetration of quality control measures into audit sites and their effectiveness. In addition, the management team, including a top, lacked the adequate awareness of the need to ensure and enhance quality control and to work together with the quality control section.

It was found that small and medium-sized audit firms etc. lack understanding of the levels of quality control and auditing procedures required by the existing auditing standards, or do not fully understand the means and the depth of analysis concerning causes of deficiencies pointed out in quality control review, etc., which is necessary for preventing an occurrence of similar deficiencies. In addition, there were firms that were not fully capable of auditing the listed companies with high risk.

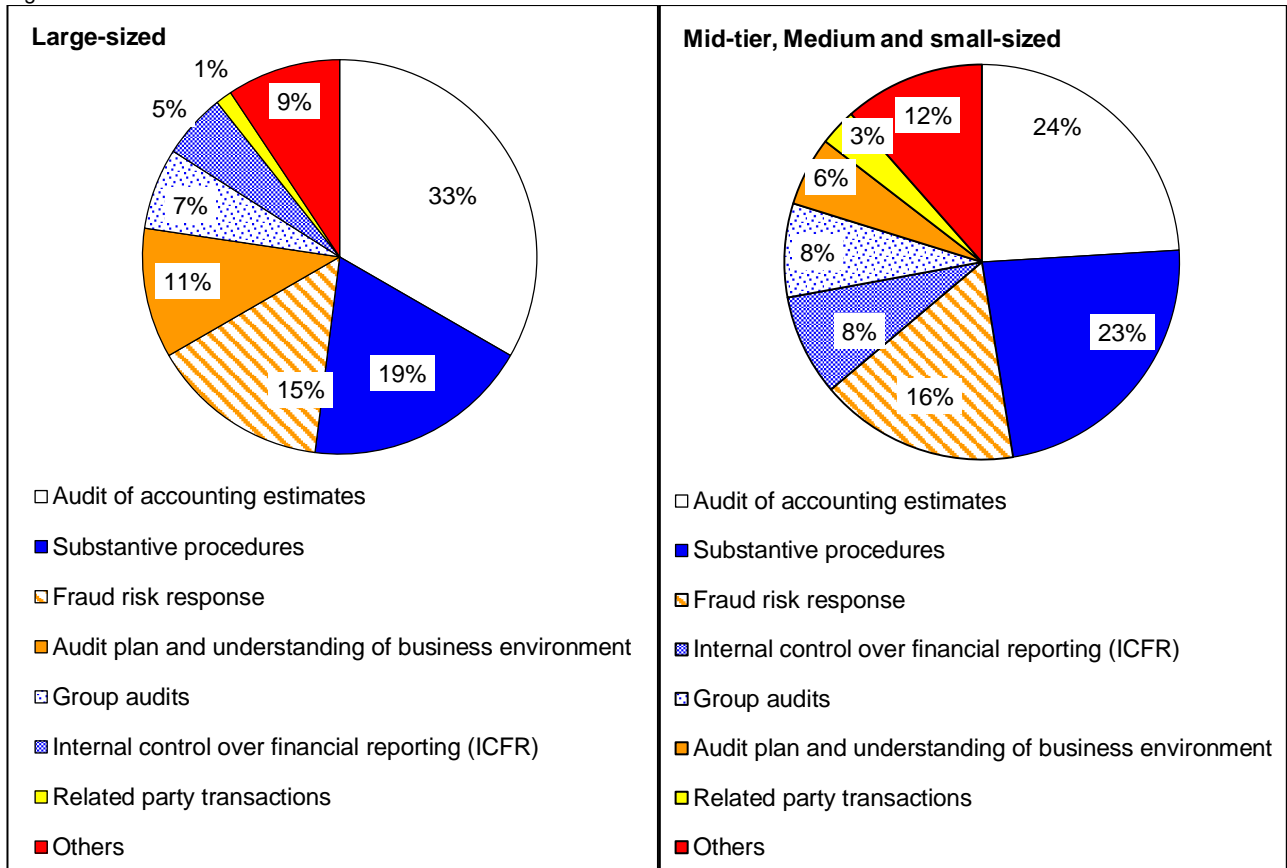
b. Characteristics of deficiencies identified through inspections of audit engagements

Deficiencies identified through inspections of audit engagements from PY2019 to PY2021 can be classified in line with the ASCS structure as follows (Figure II-1-6).

Regardless of the size of audit firms, deficiencies related to the audit of accounting estimates were the most common, followed by deficiencies in substantive procedures (audit procedures, such as analytical verification procedures and detailed tests that were conducted with regard to transaction types, account balances, and footnotes to address the risk of material misstatements). In addition, deficiencies concerning dealing with fraud risk were continually found. CPAAOB therefore performed inspections with a focus on such deficiencies.

The CPAAOB encourages inspected audit firms to take their initiatives in improving their operation through its reviews, by analyzing the causes of the deficiencies identified in the inspections and sharing them through dialogue with the inspected audit firms. You can see the Case Report from Audit Firm Inspection Results for detailed information about examples of deficiencies identified during the inspections and their causes.

Figure II-1-6: Deficiencies in PY2019-21



(Note) Classifications of deficiencies noted at four large-sized audit firms (total), five mid-tier audit firms, and 11 small and medium-sized audit firms

(Source) Prepared by the CPAAOB based on the results of inspections by the CPAAOB

7. Notification of Inspection Results

a. Inspection results notification

The responsible person at the audit firm is notified of the inspection results in writing (inspection results notification).

The current inspection results notification contains the information shown in Figure II-1-7⁴.

Figure II-1-7: Items included in inspection results notification

1. Key points
2. Inspection viewpoints
3. Measures against deficiencies developed by the inspected audit firm to ensure the proper execution of services with the aim of maintaining and improving quality control (quality control environment)
4. Conduct of audit services (audit engagements)

a. “Key points” section

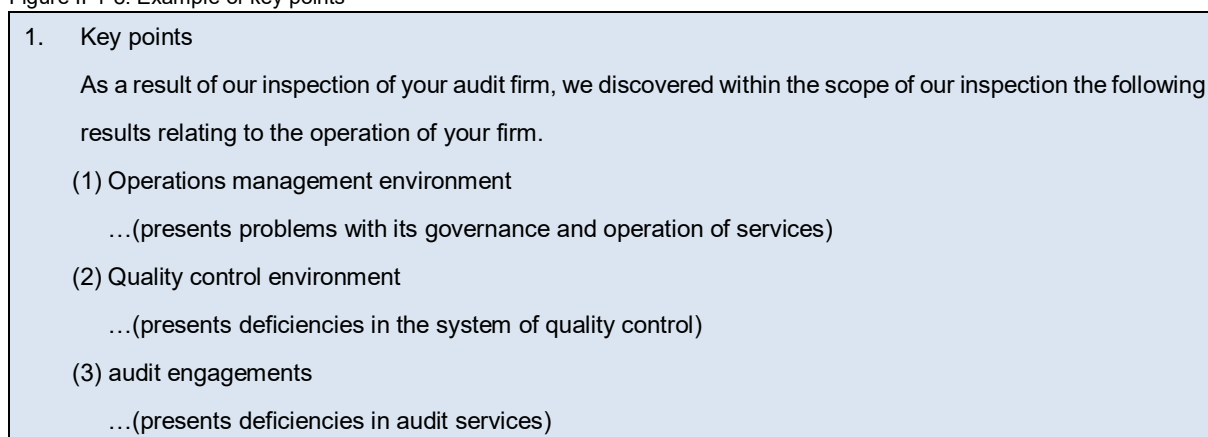
Among the sections in an inspection results notification, the “Key points” section elaborates deficiencies identified during the CPAAOB inspections that are regarded as significant. It

⁴ Overall ratings will not be given for ad hoc inspections or follow-up inspections of large-sized audit firms as the inspection results notifications in those cases differ from the ones of regular inspections

comprises three subsections (operations management environment, quality control environment and audit engagements) and confers an overall rating based on the comprehensive situation individually.

The overall rating of the operation of services at the inspected audit firm is presented at the beginning of the "Key points" section of the inspection results notification, as shown in Figure II-1-8.

Figure II-1-8: Example of key points



The CPAAOB has included overall ratings of audit firms' operation of services in the inspection results notification since the inspections commenced in PY2016. The aims are to accurately convey the CPAAOB's assessment to audit firms and to ensure proper understanding of their level of quality control among audit and supervisory board members etc. of audited companies, to whom the inspection results notification is provided.

b. Overall rating grades

The overall rating takes the form of one of the following five grades and is based on the assessment results of audit firms' operations management system, quality control system and audit engagements. Each grade is assessed with the following descriptions (for changes in the description of assessments that took effect starting with inspections in PY2021, see "II. The CPAAOB Monitoring A. Overview of System and Situation with Implementation 7. Notification of Inspection Results g. Review of assessment result descriptions in overall ratings" in 2021 Monitoring Report.

"Satisfactory" (Overall rating: 1)

The description is used when the operation of services is deemed satisfactory, e.g., there are almost no deficiencies in the operations management system, quality control management and audit engagements.

"Generally Satisfactory with minor deficiencies" (Overall rating: 2)

The description is used when the operation of services is deemed satisfactory on the whole though there are problems that need to be fixed, e.g., there are no significant deficiencies despite the presence of some deficiencies in the operations management system, quality

control management or audit engagements.

"Unsatisfactory due to presence of significant deficiencies that need to be fixed" (Overall rating: 3)

The description is used when the operation of services is deemed unsatisfactory, e.g., there are significant deficiencies in the operations management system, quality control management or audit engagements that need to be fixed.

"Unsatisfactory and in need of immediate remediation in operations management system, etc." (Overall rating: 4)

The description is used when the operation of services is deemed unsatisfactory and in need of immediate remediation.

"Extremely unsatisfactory" (Overall rating: 5)

The description is used when significant deficiencies are identified in the quality control system and audit engagements, and voluntary remediation by the audit firm cannot be expected.

In the case of an audit firm rated as "unsatisfactory and in need of immediate remediation (overall rating 4)," we collect a report at the time of the notification of inspection results and encourage the firm to promptly make improvements (for more details, see "5. Collection of Reports" (page 32). In the case of an audit firm rated as "extremely unsatisfactory (overall rating: 5)," we make recommendations concerning administrative actions and other measures to the Commissioner of the FSA.

c. Distribution of overall ratings

The distribution of overall ratings for regular inspections launched and completed between PY2016 and PY2021 is shown below (Figure II-1-9).

No audit firms were qualified as "satisfied (overall rating: 1)," the highest grade in the overall rating scheme. All audit firms, therefore, were rated as "generally satisfactory with minor deficiencies (overall rating: 2)" or lower based on the assessment of their operations management system, quality control and audit engagements.

Many small and medium-sized audit firms, partnerships and solo practitioners had overall ratings lower than those of large-sized and medium-tier audit firms. This is because the CPAAOB mainly selects small and medium-sized audit firms for the inspection based on recommendations in quality control reviews, etc. - their quality control environment needs to be confirmed immediately. At small and medium-sized audit firms with low overall ratings, there was insufficient awareness of quality control among the top management. In addition, partners and staff members lacked an awareness of recent environmental changes pertaining to accounting and auditing understanding of adequate levels required by the current audit standards.

Figure II-1-9: Overall ratings for inspections in PYs 2016/2020 (based on commencement of inspections) (unit: audit firms)

Overall rating	Large-sized and mid-tier audit firms	Small and medium-sized audit firms, partnerships and solo practitioners
Satisfactory" (Overall rating: 1)	-	-
Generally satisfactory with minor deficiencies" (Overall rating: 2)	4	3
Unsatisfactory due to presence of significant deficiencies that need to be fixed" (Overall rating: 3)	5	6
Unsatisfactory and in need of immediate remediation in operations management system, etc." (Overall rating: 4)	-	6
Extremely unsatisfactory" (Overall rating: 5)	-	8

(Note 1) Totals for audit firms subject to regular inspections that were commenced and completed between PY2016 and PY2021

(Note 2) For audit firms underwent multiple regular inspections in the period under review, overall ratings in the latest inspection are tallied.

In the PY2021 version of the "Certified Public Accountants and Auditing Oversight Board's Annual Report", all overall ratings in multiple regular inspections in the period under review were tallied.

d. Communication of "key points" to audit and supervisory board members etc. of all audited companies

Audit firms are required to communicate the "key points" in their inspection results notifications and the action they are taking in response to them to audit and supervisory board members etc. of all audited companies⁵.

In addition, audit firms are required to communicate the details of the deficiencies and the action to them to the audit and supervisory board members etc. of audited companies where their audit engagements were selected for the inspections.

To accurately convey inspection results, the CPAAOB requests audit firms to inform auditors and others at audited companies of "key points", starting inspection launched in PY2016.

Moreover, for the purpose of enabling audit and supervisory board members etc. of audited companies to compare inspection results with those for other audited firms and better understand the business administration levels of audit firms, we have published the distribution of overall ratings in d. above since the 2019 Monitoring Report.

e. Handling of inspection results

An inspected audit firm is required to obtain prior consent from the CPAAOB to disclose⁶ inspection results to a third party. In recent years, there has been a large number of requests to the CPAAOB from audit firms for prior consent for the disclosure of inspection results and others as requested by directors at audited companies, auditors and directors (including outside directions) at parent companies of audited firms and potential audited companies (e.g., companies considering which accounting auditors to appoint).

However, an inspected audit firm does not need to obtain the CPAAOB's prior consent if it conveys inspection results to auditors and others at audited companies, mentioned above in (5),

⁵ The ASCS requires audit firms to convey in writing to the audit and supervisory board members etc. the details of inspection results notifications and the measures for improvements (ASCS 260, No. 16, A31-2).

⁶ Details on disclosing inspection results to third parties are listed on the CPAAOB website.

and presents them to the JICPA based on rules of the JICPA Quality Control Committee's detailed operational rules pertaining to the handling of notification documents for inspection results.

This approach is expected to facilitate communication between auditors and others of audited companies and audit firms through the utilization of inspection results and improve the effectiveness of quality control reviews by the JICPA.

We hope that not only audit and supervisory board members etc. of audited companies but also the directors etc. of audited companies and potential audited companies make use of the CPAAOB inspection results etc. in order to confirm the status of establishment and implementation of quality control systems by accounting auditors.

B. Foreign Audit firms

1. System for Foreign Audit Firms

Financial statements which shall be submitted under the FIEA by domestic listed companies must generally require an audit attestation by Japanese CPAs or audit firms. However, if the issuer is a foreign company, its financial statements generally undergo audit attestation by CPAs or audit firms in the home country. Therefore, to avoid duplicate audits, an exception is granted in cases where the issuer company has taken an audit attestation deemed to be equivalent to that prescribed under the FIEA.

With the aim of further enhancing the soundness of Japan's capital markets, the CPA Act was amended in 2007 to require foreign CPAs and audit firms auditing the financial statements of foreign companies, etc. subject to the FIEA disclosure rules to submit the notification to the FSA Commissioner.

Having submitted the notification to the FSA, the audit firms are regarded as foreign audit firms (Article 1-3(7), Article 34-35 (1) of the CPA Act) and are subject to inspection and supervision by the CPAAOB and the FSA.

Based on the "Approach to Inspections and Supervision of Foreign Audit Firms (published on September 14, 2009), the CPAAOB generally collects reports from foreign audit firms once every three years, most recently having collected from 35 foreign audit firms in 14 countries/regions in PY2021. The CPAAOB also conducted an inspection of one foreign audit firm each in 2014, 2017 and 2019.

2. Foreign Audit Firms

Regarding the locations of foreign audit firms that have registered with the FSA, the largest number are based in Europe, with the second largest number being headquartered in the Asia-Pacific region (Figure II-2-1).

The top countries/regions are France, with eight firms, the Cayman Islands, with seven firms, and the U.S., Ireland and Hong Kong, with six firms. Foreign audit firm registrations are published and updated as "Registered Foreign Audit Firms" on the FSA website.

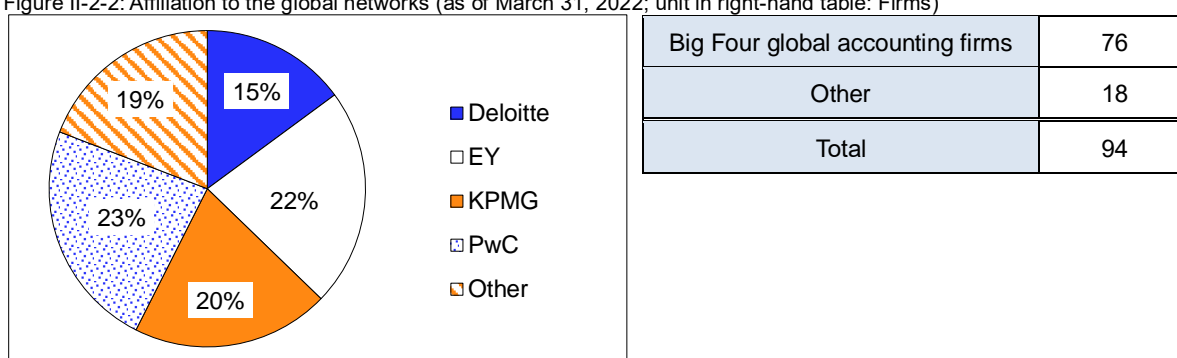
Figure II-2-1: Number of registered foreign audit firms, etc. (as of March 31, 2022)

	Number of countries/regions	Number of foreign audit firms, etc.
Europe	15	56
Asia-Pacific	10	27
North America	2	9
Central/South America	1	1
Middle East	1	1
Total	29	94

(Source) Prepared by the CPAAOB based on information from the FSA website

Out of the foreign audit firms, around 80% is affiliated with one of the Big Four global accounting firms (Figure II-2-2).

Figure II-2-2: Affiliation to the global networks (as of March 31, 2022; unit in right-hand table: Firms)



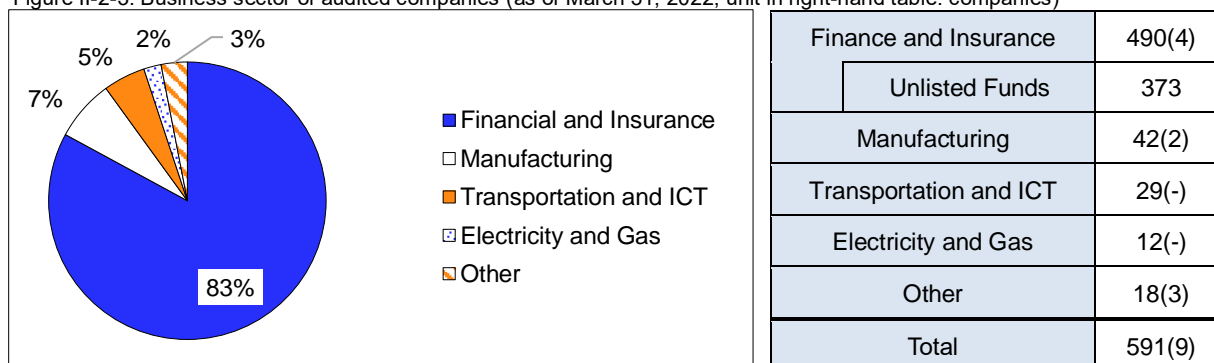
(Note) Compiled the foreign audit firms under the Big Four global

3. Audited Companies

Securities issued by foreign companies that are subject to the FIEA disclosure regulations include not only shares issued by companies listed in Japan, but also bonds issued by foreign companies, beneficiary certificates issued by foreign investment trusts, and foreign investment securities. Among foreign companies currently subject to disclosure rules, most are unlisted funds (foreign investment trusts and foreign investment securities).

Regarding the business sectors of companies audited by foreign audit firms, 83% are classified as finance and insurance, and around 76% of these are unlisted funds (Figure II-2-3).

Figure II-2-3: Business sector of audited companies (as of March 31, 2022; unit in right-hand table: companies)



(Note) Figures in parentheses are the number of companies (including funds) listed in Japan

(Source) Prepared by the CPAAOB based on information on the FSA website

C. The CPAAOB monitoring Perspectives, Objectives etc. (Basic Policy and Basic Plan)

Since its establishment in April 2004, the CPAAOB has endeavored to reinforce trust that investors place in the capital markets based on its mission to enhance the fairness and transparency of Japanese capital markets by raising the quality and ensuring the reliability of audits by CPAs.

As part of these efforts, the CPAAOB formulates a Basic Policy for Monitoring Audit Firms each cycle (three years) and a Basic Plan for Monitoring Audit Firms, which is based on the Basic Policy, each program year. In this way, the CPAAOB articulates the objectives and approach for monitoring, priorities for each program year, and so on.

1. Basic Policy for Monitoring Audit Firms

The entire text of the Basic Policy for Monitoring Audit Firms for the CPAAOB's 6th Cycle (April 2022 – March 2025) is presented on the CPAAOB's website, but monitoring perspectives, objectives, etc. are summarized below:

[Principal Points in the Basic Policy]

The 7th Cycle of the CPAAOB will encourage audit firms on a continuous basis to voluntarily ensure and improve the quality of audits and achieve the appropriate management of operations, including the quality control of audits, through effective and efficient monitoring, taking into account rapid changes around audit firms, such as the digitization of the entire society, spread of COVID-19 infections and changes in the international situation, including the Ukraine problem. In particular, the following points will be emphasized in monitoring.

- Confirmation and validation of preparedness for smooth introduction of quality control system and responses to it at audit firms

As the standard on quality control for audits has been revised, audit firms will be required to introduce a quality control system based on the following risk approaches(*):

- a. To set quality objectives
- b. To identify and assess quality risks that will block the achievement of quality objectives
- c. To determine and implement a policy or process of addressing assessed quality risks, and
- d. To correct deficiencies, if any, based on root causes

The 7th Cycle of monitoring by the CPAAOB will lay weight on audit firms' preparedness for the introduction of such a system and responses to it and post-introduction improvement and operation of the system.

(*) The revised quality control standards will become applicable, starting with the auditing of financial statements in the business year or fiscal period that will begin after July 1, 2023 (In the case of audit firms other than large-sized audit firms as defined by the Certified Public Accountants Act, the application will take effect in the business year or fiscal period that will begin after July 1, 2024).

- Securement and improvement of service quality at audit firms that audit listed firms

In auditing listed companies, the replacement of large-sized audit firms with mid-tier or small and medium-sized audit firms continues. The role of mid-tier, small and medium-sized audit firms in

auditing listed companies is thus expanding.

As a result, the 7th Cycle will put greater emphasis on the inspection of small and medium-sized audit firms considered in need of immediately ensuring and improving the quality of audits.

2. Basic Plan for Monitoring Audit Firms in Program Year 2022

The entire text of the Basic Plan for Monitoring Audit Firms in Program Year 2022 (July 2022 - June 2023) is presented on the CPAAOB's website), but monitoring priorities, etc. are summarized below.

[Basic Plan for Monitoring (Non-inspection basic plan)]

a. Examination of JICPA's quality control reviews and cooperation with JICPA

The CPAAOB examines the effectiveness of the JICPA's quality control reviews and shares findings with the JICPA through the exchange of opinion and other processes to encourage the JICPA to adopt measures to ensure and improve the quality of audits. Based on the legalization of the Registration System for Listed Company Audit Firms, the CPAAOB will encourage further improvement in the effectiveness of the quality control review.

b. Collection of reports

Quantitative and qualitative information on the operations management system, etc. at large-sized and mid-tier audit firms is collected and analyzed on a regular basis from the viewpoint of efficiently implementing inspections.

For small and medium-sized audit firms etc., information matching their scale and features is collected and analyzed at the CPAAOB's discretion, taking into account results of the JICPA's quality control reviews, audit risks related to listed company and so forth. Hearings are also conducted on reports, when necessary, to encourage voluntary efforts to ensure and improve the quality of audits.

In collecting reports, responses to the revision of the quality control standards, the process of accepting and cancelling audit contracts and so forth are principal inspection and verification points. Small and medium-size audit firms etc. are especially examined on whether they have established appropriate operations management and quality control systems as auditors of listed companies. In addition, the operations policy of their top management and the earnings and financial structures of them, which greatly affects the securement and improvement of audit quality, are primarily figured out.

c. Collection, analysis, etc. of information pertaining to audit firms

Regular dialogues with executives, including the top management, of large-sized and mid-tier audit firms are held in a bid to collect the latest information on their operations management system, etc. and share awareness of problems. As the number of listed companies audited by small and medium-sized audit firms etc. is increasing, dialogues with small and medium-sized audit firms etc., which engage in services including the audit of listed companies, are conducted when necessary.

[Basic Inspection Plan]

The CPAAOB inspects all audit firms with common key inspection matters described hereafter: commitment of the management of audit firms to improve audit quality, effectiveness of operations management and quality control system, fraud risks, accounting estimates, recognition of earnings, implementation of audit procedures pertaining to group audits, etc. Inspections are held as follows.

a. Large-sized audit firms

The CPAAOB in principle inspects large-sized audit firms every year (with regular inspections and follow-up inspections conducted in alternate years). In follow-up inspections, the CPAAOB does not inspect audit engagements in principle, taking the burden on audit firms into account. It primarily inspects the implementation of measures and so forth to address issues pointed out during regular inspections. (There are cases in which reports are collected in places of inspections to confirm the exercise of remedy measures.)

In the inspection of large-sized audit firms, the CPAAOB primarily pays attention to the monitoring of audit engagements by the quality control section, deficiencies in audit procedures in case of fraudulent accounting at an audited company, including a case in which an audit firm is involved from the stage of preparations for an initial public offering (IPO), post-factum verification of their causes and implementation of remedy measures, etc.

b. Mid-tier audit firms

The CPAAOB inspects mid-tier audit firms every three years in principle.

In the inspection of mid-tier audit firms, the CPAAOB primarily pays attention to the awareness of quality control among management, including the top managements, cooperation between the quality control section and the vanguard of auditing (business section), and monitoring of audit engagements by the quality control section.

c. Small and medium-sized audit firms

In the inspection of small and medium-sized audit firms etc., the CPAAOB examines the immediate need of confirming their quality control systems and carries out the inspection taking into account such factors as the JICPA's quality control review results and the degree of risks pertaining to audited companies. Given an increase in the role of small and medium-size audit firms in auditing listed companies, the CPAAOB will place more importance on the inspection of them.

The inspection of small and medium-sized audit firms etc. especially pays attention to their efforts to foster an organizational culture to respect law and professional ethics as well as partners and staff members' professional ethics and awareness of independence and legal and other forms of compliance, etc.

d. Foreign audit firms and others

In the case of foreign audit firms and others, the CPAAOB will inspect those selected based on

results of reports collected in PY2021 and other factors. It will take the spread of COVID-19 infections and other conditions into account for inspecting them. It will also conduct advance consultation and coordination with audit and supervisory authorities in jurisdictions that foreign audit firms, etc. belong to.