

Basic Policy for Monitoring Audit Firms

– For Achieving High-Quality Audits –

Certified Public Accountants and Auditing Oversight Board
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Since its establishment in April 2004, the Certified Public Accountants and Auditing Oversight Board (hereinafter, the "CPAAOB") has spent 21 years in seven terms endeavoring to improve the quality of CPA (certified public accountant) audits and to ensure their reliability in order to fulfil its mission of improving the fairness and transparency of capital markets in Japan and fostering the trust that investors place in the capital markets.

For its 8th Term (April 2025 – March 2028), the CPAAOB conducts monitoring¹ of individual CPAs and audit firms (hereinafter collectively referred to as "audit firms") based on the surrounding environment and in line with the objectives of monitoring and the approach to achieving them as stated below, aiming to foster the trust that investors place in the capital markets, and contributing to the further development of the national economy.

[Environment Surrounding Audits and Audit Firms]

In a highly uncertain business environment accompanying fluctuations in international circumstances, auditors are continuously required to make advanced judgments in audits.

The following changes have occurred in the environment surrounding audits and audit firms.

- Under the registration system for auditors of listed companies, etc., which was introduced under the amended Certified Public Accountants Act (enforced in April 2023), the Auditors of Listed Companies, etc. Registration Screening Board established in the Japanese Institute of Certified Public Accountants (hereinafter referred to as the "JICPA") has been conducting registration screening sequentially,

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

and the number of registered auditors of listed companies, etc. increased to 123 as of the end of April 2025.

- The Quality Control Standards for Auditing were revised in November 2021 in a manner to embed a quality control system based on a risk-based approach. Furthermore, in response to this revision, Quality Control Standards Committee Report No. 1 on "Quality Control at Audit Firms" and Audit Standards Committee Report No. 220 on "Quality Control in Auditing" were revised, and Quality Control Standards Committee Report No. 2 on "Audit Engagement Reviews" was formulated. Other than the above, Audit Standards Committee Report No. 315 on "Identifying and Assessing the Risks of Material Misstatement," was revised in June 2022, and Audit Standards Committee Report No. 600, "Special Considerations—Audits of Group Financial Statements," and Audit Standards Committee Report No. 720 on "The Auditor's Responsibilities Relating to Other Information," were revised in January 2023. In July 2023, Financial Reports Internal Controls Audit Standards Committee Report No. 1 on "Auditing of Internal Controls over Financial Reports" was also revised. In this manner, auditing standards have been revised on an ongoing basis.
- Regarding the disclosure of sustainability information, the International Sustainability Standards Board (ISSB) finalized and published, in June 2023, the General Requirements for Disclosure of Sustainability-Related Financial Information (S1) and the Climate-Related Disclosure Standard (S2), which are international standards for the disclosure of sustainability information. In Japan as well, the Sustainability Standards Board of Japan (SSBJ) finalized and published the universal sustainability disclosure standards, "Application of Sustainability Disclosure Standards," and Sustainability Standards by Theme No. 1 and No. 2, "General Disclosure Standard" and "Climate-Related Disclosure Standard" in March 2025. Furthermore, at the Working Group on Sustainability Disclosure and Assurance and the Expert Study Group on Assurance of Sustainability-Related Financial Information established in the Financial System Council, discussions have been held on disclosure and assurance of sustainability-related financial information.
- The utilization of information technologies in audits (automation of tabulation and processing of data, introduction of analysis tools using AI, etc.) has been actively promoted, mainly led by large-sized audit firms² and mid-tier audit firms. Even small

² The CPAAOB classifies audit firms based on their size, and there are three categories as follows:

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

and medium-sized audit firms are computerizing audit working papers and introducing sorting and analysis tools. In order to introduce and promote the utilization of IT in audits, it is definitely necessary to enhance the IT skills of staff performing actual audit duties. IT-related knowledge is expected to be broadly shared among those performing actual audit duties, irrespective of the size of audit firms.

- Compared with the rate of increase in the number of registered CPAs during the period from the end of March 2013 to the end of March 2023 (37.9%), the rate of increase in the number of CPAs belonging to audit firms is much lower (9.2% during the same period). Therefore, there are concerns over a shortage in CPAs performing actual audit duties.

Under such circumstances, the CPAAOB has been carrying out measures to expand the range of and secure diversity in people who take the certified public accountant examination. The JICPA takes the initiative in communicating the significance and attractiveness of auditing, and individual audit firms are working to improve the efficiency in audit work and make working conditions more flexible. In this manner, efforts are being made to resolve the aforementioned concerns.

- The number of listed companies changing their audit companies has declined after hitting a peak in the program year that ended on June 30, 2022. In the meantime, transfers from large audit firms to mid-tier or small and medium-sized audit firms have been continuing, and the range of auditors who audit listed companies has continued to expand.

[Objectives of Monitoring and Approach to Achieving Them]

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

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

When conducting monitoring, the CPAAOB focuses on the following points:

- whether an audit firm's governance actually contributes to securing its appropriate business operations;

· Small and medium-sized audit firms: Audit firms other than large-sized and second-tier audit firms

- with regard to audit firms that audit listed companies, etc., based on the purport of the Principles for Effective Management of Audit Firms (the Governance Code for Audit Firms), whether an audit firm's management function is being fulfilled effectively for ensuring and sustainably improving its audit quality, and whether an audit firm secures a function to supervise and assess the effectiveness of the management function from a standpoint independent of its management and a function to support the demonstration of the effectiveness through the supervision and assessment;
- whether an audit firm appropriately demonstrates professional skepticism in conducting audits, and whether an audit firm appropriately understands audit risks inherent to individual audit engagements, and secures and inputs audit resources commensurate with those risks;
- whether an audit firm conducts audits based on an accurate understanding of the auditing standards and the level of audit procedures required by the auditing standards; and
- whether an audit firm is endeavoring to find out root causes of the problems detected through the JICPA quality control reviews and the CPAAOB monitoring and is taking appropriate remedial measures.

In addition, the CPAAOB encourages the JICPA to further strengthen its efforts for improving the effectiveness of quality control reviews, whose importance is increasing under the registration system for auditors of listed companies, etc.

The CPAAOB gathers information through information exchanges and cooperation with relevant FSA departments, the JICPA, and industry groups, etc. involved in accounting and audits (hereinafter referred to as "relevant organizations"), through dialogue with audit firms, as well as through cooperation with the International Forum of Independent Audit Regulators (IFIAR)³ and foreign audit regulatory authorities, and utilizes the information thus obtained in subsequent monitoring. Moreover, the CPAAOB disseminates useful information obtained through monitoring to relevant organizations and also proactively provides such information to the public.

In light of the above, the CPAAOB has published the Basic Policy for Monitoring Audit Firms during the 8th Term as follows. Furthermore, based on this Basic Policy, the CPAAOB formulates the Basic Plan for Monitoring Audit Firms for each program year (July to the following June).

³The International Forum of Independent Audit Regulators (IFIAR) is an international institution established in 2006 comprising independent audit regulatory authorities that carry out inspections of audit firms. Its secretariat is located in Tokyo. Its aim is to improve audit quality globally through cooperation/collaboration between authorities. Its membership as of April 30, 2025, comprised audit regulatory authorities from 56 countries/regions, including Japan.

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

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

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

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

(1) Verification etc. of the JICPA's Quality Control Reviews

There have been cases where the results of evaluations on audit firms' quality control systems differ between the CPAAOB's inspections and the JICPA's quality control reviews. The CPAAOB verifies the effectiveness of the JICPA's quality control reviews and shares the verification results with the JICPA through opinion exchanges, etc., thereby having encouraged the JICPA to make further efforts for ensuring and improving audit firms' audit quality.

The JICPA has been taking required measures for enhancing the effectiveness of its quality control reviews, such as the strengthening of its system for implementing reviews, thorough adoption of a risk-based approach, clarification of quality control review reports, and strict countermeasures against falsification of audit working papers.

The CPAAOB further encourages the JICPA to strengthen efforts for fulfilling guidance and supervisory functions and enhancing the effectiveness of its quality control reviews through sharing the results of reviews for individual cases with the JICPA (working-level panel meetings) and providing training for officials in charge of quality control reviews (reviewers). The CPAAOB will also continue discussions with the JICPA, which is in charge of the operations of the registration system for auditors of listed companies, etc., with regard to ideal quality control reviews by the JICPA, roles of the CPAAOB and the JICPA, and further deepened collaboration based thereon, with the aim of maximizing the effects of both the CPAAOB's inspections and the JICPA's quality control reviews.

(2) Collection of Reports

From the perspective of encouraging audit firms in Japan to ensure and further improve their overall audit quality and also encouraging them to build an appropriate operational management system, the CPAAOB ascertains the current situations of audit firms and risks inherent to individual audit engagements accurately on a timely basis, and collects reports effectively on audit firms' development and operation of their operational management systems and quality control systems (including the implementation of remedial measures).

On that occasion, the CPAAOB fully utilizes information obtained through inspections and dialogue with audit firms, etc. or otherwise endeavors to collect information efficiently, in consideration of the burden on audit firms, etc., and also conducts interviews, as necessary, concerning the contents of the reports so as to achieve effects equivalent to those through inspections.

- a. In the case of large-sized and mid-tier audit firms, the CPAAOB periodically collects reports and analyzes quantitative and qualitative information concerning their operational management systems, etc. so as to enhance the efficiency of inspections.
- b. In the case of small and medium-sized audit firms, the CPAAOB collects reports based on the results of the JICPA's quality control reviews and gleans information and conducts an analysis of the status of their operational management systems, etc. in light of the sizes and characteristics of individual audit firms.
- c. When it comes to the problems that small and medium-sized audit firms are notified of in the form of inspection results, the CPAAOB ascertains the status of their actions through the collection of reports after a certain period of time since the notification of the inspection results, and encourages the audit firms to make improvements voluntarily.
- d. If, as a result of an inspection, the operation of services of an audit firm is deemed to be unfavorable and in need of immediate remediation, the CPAAOB collects a report at the time of the notification of the inspection results, and encourages the audit firm to make improvements promptly.

(3) Periodic Dialogue, etc. with Audit Firms

The CPAAOB not only gleans information on the operation of services through dialogue with executives of audit firms, but also shares with them audit-related

challenges and concerns. Given that executives have a substantial influence on the organizational culture of their audit firms, such perpetual dialogue with executives is, therefore, extremely important for encouraging their audit firms to act independently to ensure and improve their audit quality, and the CPAAOB continues endeavoring to ensure in-depth discussion during dialogue.

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

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

2. Basic Policy for Inspections

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

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

(1) Conduct of Inspections

- a. Considering the importance of large-sized audit firms' roles in the capital markets, the CPAAOB inspects them once every two years, in principle, and conducts follow-up inspections the next program year (verification of the implementation of remedial measures for findings identified in inspections in the preceding program year).

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

Follow-up inspections are basically conducted by way of collecting reports, but the CPAAOB may carry out inspections based on the results of the inspections in the preceding program year.

- b. For mid-tier audit firms, the CPAAOB conducts inspections once every two years, in principle.
- c. For small and medium-sized audit firms, the CPAAOB conducts inspections as necessary in view of the results of the JICPA's quality control reviews as well as audit firms' operational management systems, etc., and the degree of risks underlying audited listed companies. Considering the importance of their roles as auditors of listed companies, the CPAAOB continues performing monitoring with a focus on inspections for small and medium-sized audit firms.
- d. In addition to the above, if there is a need to confirm the operational management system or quality control system at an audit firm immediately, the CPAAOB conducts inspections on an ad hoc basis.

(2) Focus Points and Concerns in Inspections

- a. In inspections, the CPAAOB places a focus on the following points for verification. Focus points in inspections for each program year are published as necessary in the Basic Plan for Monitoring Audit Firms, which the CPAAOB formulates and publishes every program year.
 - In relation to quality control
 - Audit firm management's commitment to improving audit quality
 - Effectiveness of operational management systems
 - Development and operation of quality control systems in compliance with the revised Quality Control Standards, etc.
 - Diffusion and adoption of quality control measures at the audit frontline
 - Securement, fostering (including education and training) and distribution of audit resources
 - Background to new client acceptance and cancellation of audit contracts
 - Management of audit working papers
 - In relation to individual audit engagement
 - Implementation of audits in response to fraud risks
 - Implementation of audits regarding revenue recognition
 - Implementation of audits regarding accounting estimates

- b. To ensure that audit firms continue to make effective quality control improvements voluntarily, it is important to go beyond merely treating the symptoms of problems and to investigate the root causes based on the actual status of individual audit firms' operational management systems, etc. To that end, when pointing out findings to an audit firm, the CPAAOB takes care to provide precise details in order to help the audit firm to analyze the root causes.

3. Basic Policy for Monitoring Foreign Audit Firms

(1) Cooperation with Foreign Audit Regulatory Authorities

When conducting monitoring of foreign audit firms,⁵ the CPAAOB actively shares information through the use of the Multilateral Memorandum of Understanding (MMoU)⁶ and bilateral information exchange frameworks (EoL: exchange of letters),⁷ and endeavors to ensure smooth and effective monitoring by cooperating closely with foreign audit regulatory authorities, international organizations, etc.

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

(2) Collection of Reports and Inspections

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

The collection of reports and inspections are to be conducted through appropriate procedures in accordance with the Basic Guidelines on Information Requirements

⁵ Foreign audit firms that have notified the Commissioner of the Financial Services Agency that they engage in services that are found to be equivalent to audit and attestation services regarding financial documents submitted by foreign companies under the provisions of the Financial Instruments and Exchange Act in foreign countries

⁶ As of April 30, 2025, audit regulatory authorities from 22 countries/regions had signed the MMoU.

⁷ As of April 30, 2025, the CPAAOB has exchanged letters (EoL) with audit regulatory authorities from nine countries.

and Inspection on Foreign Audit Firms etc. by the Certified Public Accountants and Auditing Oversight Board.

4. Policy on Provision of Monitoring Information

To encourage audit firms to ensure and improve audit quality, it is important not only to correctly disclose inspection results to them, but to share monitoring results with relevant FSA departments, the JICPA, and relevant organizations, and actively make them broadly available to the public as well, as a means of raising interest in and deepening understanding of audits. From this perspective, the CPAAOB endeavors to publicly provide information on monitoring and enhance the content thereof.

- a. When informing audit firms of the results of inspections, the CPAAOB needs to ensure that audit firms precisely understand the crux of the findings identified and properly convey them to auditors, etc. of audited companies,⁸ and that the auditors, etc. precisely understand the status of quality control at the relevant audit firms and the crux of the findings identified. To achieve them, the CPAAOB endeavors to improve the statements concerning inspection results.
- b. With the aim of contributing to deepening the understanding of accounting and audits among market participants etc., the CPAAOB compiles and publishes the results, etc. of monitoring as an annual Monitoring Report. The CPAAOB will continue working to further improve and expand the information to be disclosed in light of user needs so as to obtain understanding broadly from the public.
- c. To promote proactive efforts made by audit firms to ensure and improve audit quality, the CPAAOB compiles and publishes findings etc. confirmed on the occasion of inspections as an annual Case Report from Audit Firm Inspection Results. The CPAAOB endeavors to improve the content of the case report by updating the latest findings. In addition, the CPAAOB continues lectures and briefings at local branches of the JICPA nationwide and proactively disseminates information to market participants, etc.

⁸ Before an audit firm discloses the details of inspection results to a third party, it needs to obtain permission from the CPAAOB in advance. However, advance permission from the CPAAOB is not required in cases such as simply informing an auditor, etc. of audited companies of the existence of findings found during the inspections or the content of the "key points" in a notice of inspection results as they are.