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 endeavored for 21 years over seven terms to improve the quality of CPA (certified public accountant) audits and to ensure their reliability in order to pursue its mission of enhancing the fairness and transparency of capital markets in Japan and strengthening the investor confidence in the capital markets.

During its 8th Term (April 2025 – March 2028), the CPAAOB conducts monitoring[1] 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, thereby fostering the investor confidence in the capital markets and contributing to the further development of the national economy.

[Environment for Audits and Audit Firms]

As a highly uncertain business environment accompanying fluctuations in international landscape, auditors continue to be required to make a high degree of professional judgments.

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 Center for Listed Company Audit Firms established within the Japanese Institute of Certified Public Accountants (hereinafter referred to as the "JICPA") has been reviewing applications, and the number of registered auditors of listed companies, etc. stood at 130 audit firms as of the end of May 2026.

[1] "Monitoring" as referred to here is a concept that includes both on-site monitoring (inspection) and off-site monitoring. Off-site monitoring refers to monitoring activities in general other than inspection, which include examining the results of the JICPA's Quality Control Reviews, ascertaining risks related to audit firms through the collection and analysis of information from the Financial Services Agency's relevant divisions and bureaus and business associations related to accounting audits, and conducting follow-up examination of improvements related to findings in inspections through the collection of reports from audit firms.

- The Quality Control Standards for Auditing were revised in November 2021 to introduce a quality management system based on a risk-based approach. In response to this revision, in June 2022, Quality Control Standards Committee Report No. 1, "Quality Control for Audit Firms," and Audit Standards Committee Report No. 220, "Quality Control for an Audit of Financial Statements," were revised, and Quality Control Standards Committee Report No. 2, "Engagement Quality Reviews," was issued. In addition, Audit Standards Committee Report No. 315, "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, "The Auditor's Responsibilities Relating to Other Information," were revised in January 2023. In July 2023, Financial Reporting Internal Control Audit Standards Committee Report No. 1, "Audit of Internal Control over Financial Reporting" was also revised. Thus, revisions to auditing standards have continued to be made on an ongoing basis.
- Regarding the disclosure of sustainability information, the International Sustainability Standards Board (ISSB) issued, in June 2023, the General Requirements for Disclosure of Sustainability-related Financial Information (S1) and the Climate-related Disclosures (S2), which are international standards for the disclosure of sustainability information. In Japan as well, the Sustainability Standards Board of Japan (SSBJ) issued the Universal Sustainability Disclosure Standard, "Application of Sustainability Disclosure Standards," and the Theme-based Sustainability Disclosure Standard No.1, "General Disclosure Standard" and the Theme-based Sustainability Disclosure Standard No.2, "Climate-Related Disclosure Standard" in March 2025. Furthermore, The Working Group on Disclosure and Assurance of Sustainability-related Financial Information and the Expert Study Group on Assurance of Sustainability-related Financial Information, established under the Financial System Council, are advancing discussions on the framework for the disclosure and assurance of sustainability-related financial information.
- The use of IT in audits, including the automation of data aggregation and processing, and the introduction of AI-based analytical tools, has been actively promoted, mainly led by large-sized audit firms[2] and mid-tier audit firms. Even small and medium-sized audit firms are digitizing audit working papers and introducing journal entry

[2] The CPAAOB classifies audit firms based on their size as follows:
- Large-sized audit firms: Audit firms that have approximately 100 or more listed companies as audited entities and at least 1,000 full-time personnel engaged in audit services. In this Basic Policy, the term refers to KPMG AZSA LLC, Deloitte Touche Tohmatsu LLC, Ernst & Young ShinNihon LLC, and PwC Japan LLC.
- Mid-tier audit firms: Audit firms whose scale is second only to that of large-sized audit firms. In this Basic Policy, the term refers to Gyosei & Co., BDO Sanyu & Co., Grant Thornton Taiyo LLC, and Crowe Toyo & Co.
- Small and medium-sized audit firms: Audit firms other than large-sized and mid-tier audit firms

analysis tools. In order to further promote the use of IT in audits, it is definitely necessary to enhance the IT skills of staff engaged in providing audit services. IT-related knowledge is expected to be broadly shared among those engaged in providing audit services, 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 engaged in providing audit services.

Under such circumstances, the CPAAOB is undertaking initiatives to broaden the pool of candidates for the Certified Public Accountant Examination and promote diversity among examinees. In addition, in cooperation with the JICPA, it communicates the significance and attractiveness of audit services. Audit firms are also working to improve audit efficiency and introduce more flexible working arrangements. Through these efforts, steps are being taken to address these concerns.

· The number of auditor changes among listed companies has declined since peaking in the fiscal year ended on June 30, 2022. In the meantime, it has continued to replace large-sized audit firms with mid-tier or small and medium-sized audit firms, and expand the range of auditors of listed companies.

[Objectives of Monitoring and Approach to Achieving Them]

The CPAAOB is committed to conducting monitoring from the standpoint of the public interest and by making full use of its authority, which encourages audit firms' voluntary efforts to ensure and improve audit quality, thereby achieving the objective of ensuring the reliability of 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 the sound operation of audit firms, including their quality management systems, through effective and efficient monitoring with consideration given to their size, operational management system, and the level of risks relating to audited companies.

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

· whether an audit firm's governance actually contributes to securing the sound operation of the firm;

· 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 such 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 allocates 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 appropriately identifies the root causes of the problems detected through the JICPA Quality Control Reviews and the CPAAOB monitoring and implements 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 Listed Company Audit Firms.

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 hereby sets forth the Basic Policy for Monitoring Audit Firms during the 8th Term as follows[4]. 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).

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

[4] Amid the changes in the environment surrounding audits and audit firms, such as the occurrence of accounting fraud cases, the expanding range of audit firms that audit listed companies, and the progress in the use of IT (e.g., introduction of AI) for audits, the CPAAOB published “Revision of the Approach to the Monitoring of Audit Firms” in July 2026 in order to conduct monitoring more appropriately in accordance with the situations of audit firms and the risks related to them. In view of the revision, necessary revisions were also made to this basic policy in July 2026.

1. Basic Policy for Monitoring Activities Other than Inspections

The CPAAOB receives reports of the results of Quality Control Reviews from the JICPA and executes collection of reports concerning the 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 Quality Control Review results and other information collected, the CPAAOB accurately ascertains the circumstances and risks of audit firms and conducts inspections more effectively and efficiently.

Through these efforts, the CPAAOB seeks to promote the assurance and improvement of audit quality by audit firms.

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

Differences have continued to be observed on audit firms' quality management systems 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 responses to the falsification of audit working papers.

The CPAAOB further encourages the JICPA to strengthen its efforts to enhance the guidance and supervisory functions and effectiveness of 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 Listed Company Audit Firms 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 management 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 analyzes 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 operational management system of an audit firm is found to be unsatisfactory and in need of immediate remediation, the CPAAOB collects a report at the time of the notification of the inspection results enhances follow-up on the firm's improvement efforts, and encourages the audit firm to make prompt improvements.

(3) Periodic Dialogue, etc. with Audit Firms

The CPAAOB not only analyzes 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, ongoing 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 management voluntarily and to proactively disclose information 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 characteristics of audit firms and the degree of risks relating to audited companies, while also utilizing digital technologies. Furthermore, by integrating inspections with other monitoring activities, the CPAAOB seeks to promote the assurance and improvement of audit quality at audit firms.

When it is necessary to quickly verify an audit firm's operational management or quality management system, inspections are conducted on an ad hoc basis. In addition, the CPAAOB will conduct verification regarding false or unjust attestation with respect to audit firms suspected of being involved in such conduct.

For inspections, the CPAAOB takes the following matters into account, and ensures that the inspections are performed based on proper procedures in accordance with the Basic Guidelines on Inspections by the CPAAOB. In addition, the CPAAOB conducts inspection monitoring,[5] which involves listening to the opinions of inspected audit firms, with the aim of ensuring the appropriateness of the inspections and utilizing the information obtained to conduct inspections more efficiently.

[5] By obtaining opinions from inspected parties, the CPAAOB seeks to ascertain the actual state of inspections and ensure the appropriateness of inspections. With the aim of making inspections more efficient, the CPAAOB listens to the opinions of engagement partners concerning the inspection methods employed by inspectors, including through visits to inspected parties, during the period from the first day of on-site inspections to the time of notification of inspection results.

(1) Conduct of Inspections

a. Considering the importance of large-sized audit firms' roles in the capital markets, the CPAAOB conducts full-scope inspections and follow-up inspections (which focus mainly on improvements related to findings identified in previous inspections). In addition, the CPAAOB conducts year-round monitoring[6] using both on-site and off-site monitoring methods, including inspections targeted at specific aspects of quality management systems and horizontal reviews on specific themes.

b. For mid-tier audit firms, the CPAAOB conducts inspections once every two years, in principle. However, for audit firms whose quality management status has improved and whose business operations remain consistently satisfactory, the CPAAOB will consider revising the inspection frequency in light of their risk profile and quality management status. In addition, the CPAAOB will consider applying an inspection approach similar to that used for large-sized audit firms, taking into account the circumstances of their global networks and quality management practices.

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 and the degree of risks relating to audited listed companies. Considering the importance of their roles as auditors of listed companies, the CPAAOB continues to place emphasis on inspections of small and medium-sized audit firms and will increase the number of inspections.

(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 management

- Audit firm management's commitment to improving audit quality
- Effectiveness of operational management systems
- Development and operation of quality management systems in compliance with the revised Quality Management Standards, etc.
- Implementation and embedding of quality management measures in the audit practice

[6] With respect to large-sized audit firms, designated inspectors will be assigned to conduct year-round monitoring.

- Securement, fostering (including education and training) and allocation of audit resources
- Background to new client acceptance and cancellation of audit contracts
- Management of audit working papers

○ In relation to individual audit engagements

- Implementation of audits in response to fraud risks
- Implementation of audits regarding revenue recognition
- Implementation of audits regarding accounting estimates

(Note) Horizontal reviews seek to identify leading practices by conducting a comparative review of four large-sized audit firms under specific themes.

b. To ensure that audit firms continue to make effective quality management 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,[7] the CPAAOB actively shares information through the use of the Multilateral Memorandum of Understanding (MMoU)[8] and bilateral information exchange frameworks (EoL: exchange of letters),[9] 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 collect information on trends at the global networks and ascertain inspection methods employed by the foreign audit regulatory authorities with the aim of utilizing such know-how in its monitoring.

[7] Foreign audit firms that have notified the Commissioner of the Financial Services Agency that they engage in services 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

[8] As of May 31, 2026, audit regulatory authorities from 22 countries/regions had signed the MMoU.

[9] As of May 31, 2026, the CPAAOB has exchanged letters (EoL) with audit regulatory authorities from nine countries.

(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 the 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 is conducted through appropriate procedures in accordance with the Basic Guidelines on Information Requirements and Inspection on Foreign Audit Firms etc. by the Certified Public Accountants and Auditing Oversight Board.

4. Policy on Provision of Monitoring Information

To encourage audit firms to ensure and improve audit quality, it is important not 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,[10] and that the auditors, etc. precisely understand the status of quality management at the relevant audit firms and the crux of the findings identified. To achieve this, 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

[10] 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 identified during inspections or the content of the "key points" in a notice of inspection results as they are.

continue working to further enhance the information 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.