

# Annual Report

July 2014

Certified Public Accountants and Auditing Oversight Board



## **About this Annual Report**

Pursuant to Article 16 of the Certified Public Accountants and Auditing Oversight Board (CPAAOB) Rules of Operation as below, which is stipulated on the basis of Article 2 of the CPAAOB Cabinet Order, this Annual Report publishes the activities of the CPAAOB for FY2013 (from April 1, 2013, to March 31, 2014).

To better meet the needs of readers, the Report also includes information on activities taken before and after FY2013.

- CPAAOB Rules of Operation

Article 16 The CPAAOB shall, after the end of each fiscal year, publish its activities for that year, such as measures taken and the number of inspections conducted.

《If you have any comments, etc. , please contact the following address》

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## **1 Overview of the CPAAOB**

### **1.1 *Certified Public Accountants and Auditing Oversight Board (CPAAOB)***

The CPAAOB is a council system government institution established by the Financial Services Agency (FSA), based on Article 35, Paragraph 1 of the Certified Public Accountants Act (CPA Act) and on Article 6 of the Act for Establishment of the FSA (established April 2004).

The CPAAOB is comprised of a Chairperson and up to 9 Commissioners with understanding and knowledge of matters concerning CPAs who are appointed by the Prime Minister and approved by both Diet houses. Most of the Commissioners serve part-time, but one of them can serve full-time. They are appointed for a term of three years (Articles 36, 37-2 and 37-3 of the CPA Act).

The Chairperson and Commissioners exercise authority independently, and excluding situations where there are legal reasons, that independence shall not be violated by their dismissal during their appointed terms (Articles 35-2 and 37-4 of the CPA Act).

The CPAAOB, comprising ten members (Chairperson Kunio Chiyoda, full-time Commissioner Toshiro Hiromoto, and eight part-time Commissioners), is in operation for its fourth term (from April 2013 to March 2016) (See Annex 1.).

The main work of the CPAAOB is as follows:

- Reviews of the "quality control review" and inspections
- Implementation of CPA Examinations
- Deliberation of disciplinary actions against CPAs and audit firms

### **1.2 *Executive Bureau***

The CPAAOB has an Executive Bureau to handle its administrative duties (Article 41, Paragraph 1 of the CPA Act).

The Executive Bureau is comprised of the Office of Coordination and Examination and the Office of Monitoring and Inspection, under the Secretary-General of the Executive Bureau. The Office of Coordination and Examination is in charge of implementing the CPA examinations, deliberating disciplinary actions against CPAs, etc., and general coordination of the Executive Bureau. The Office of Monitoring and Inspection is in

charge of monitoring the operation of audit services provided by audit firms, etc., monitoring the appropriateness of the operation of JICPA, and inspecting audit firms, etc., foreign audit firms and JICPA.

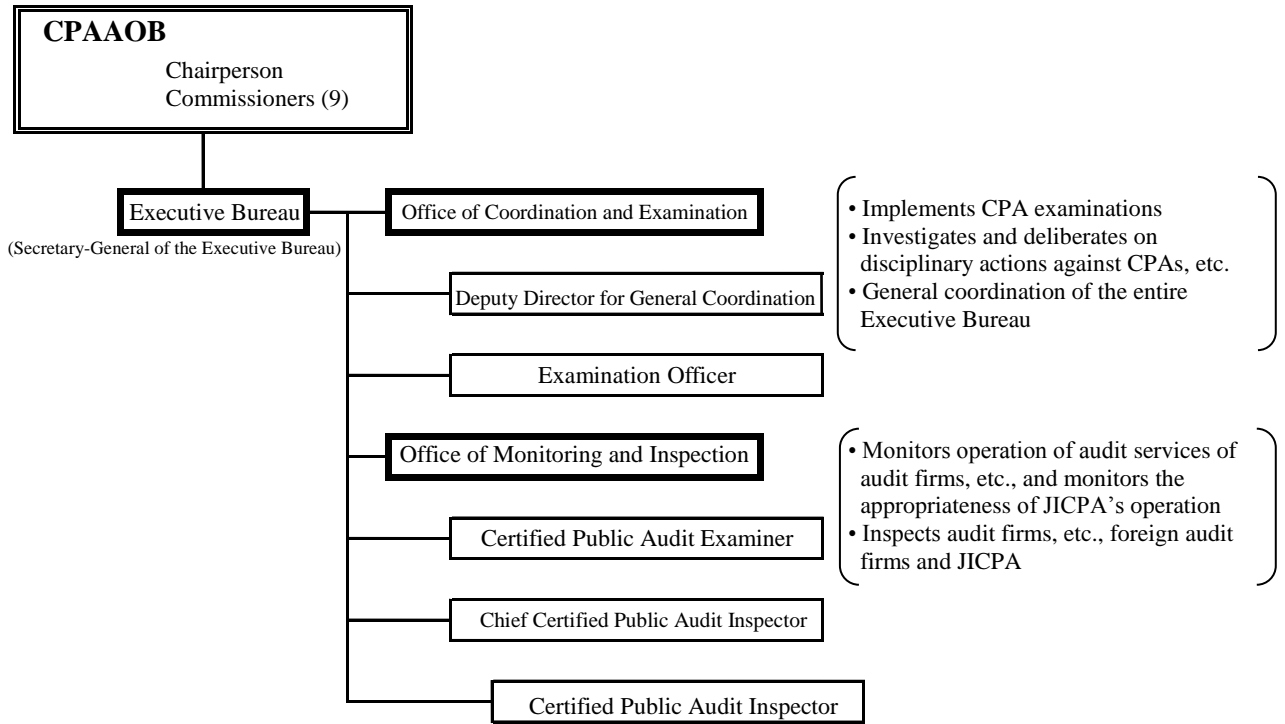
The Executive Bureau had 40 staff members when it was launched in April 2004. Its staff was steadily increased thereafter, to 14 in the Office of Coordination and Examination, and 42 in the Office of Monitoring and Inspection: for a total of 56 staff members on March 31, 2014.

Staffing of the Executive Bureau

(Fiscal year-end basis)

	FY2004	FY2005	FY2006	FY2007	FY2008	FY2009	FY2010	FY2011	FY2012	FY2013
Office of Coordination and Examination	11	12	12	12	12	14	14	14	14	14
Office of Monitoring and Inspection	29	29	31	35	39	41	44	43	42	42
Chief Inspectors	4	4	4	4	5	5	7	7	7	7
Inspectors	18	18	20	24	26	28	28	27	26	26
Total	40	41	43	47	51	55	58	57	56	56

## Organization Chart of the CPAAOB



## **2 Audit Firms Inspection and Post-Inspection Follow-up**

### **2.1 Outline**

Previously, JICPA's quality control reviews (see Note) of audit firms, etc. had been self-regulated. However, from the perspective of ensuring the fairness and transparency of capital markets and establishing a market capable of gaining the trust of investors, and as a measure for enhancing and strengthening the monitoring and oversight functions over audit firms, etc., the June 2003 revision of the law resulted in quality control reviews becoming statutory, and being monitored by the CPAAOB.

Furthermore, for the purpose of ensuring the soundness of Japan's financial and capital markets, as a result of the June 2007 revision of the law, foreign audit firms, etc. that audit foreign companies, etc. subject to the disclosure regulations under the Financial Instruments and Exchange Act became subject to the inspections and supervision of Japan's authorities, and the CPAAOB was given the mandate to collect reports and conduct on-site inspections.

Specifically, the authority related to the following matters has been delegated from the Commissioner of the FSA to the CPAAOB (Article 49-4, Paragraphs 2 and 3 of the CPA Act):

- Business pertaining to the receipt of reports on the results of reviews by JICPA on the operation of members' services (audit and attestation services) set forth in Article 2, Paragraph 1 of the CPA Act (Article 46-9-2, Paragraph 2 of the CPA Act)
- Collection of reports and inspections, etc. on JICPA, CPAs and audit firms, which are conducted in relation to the above mentioned reports (Article 46-12, Paragraph 1 and Article 49-3, Paragraphs 1 and 2 of the CPA Act)
- Collection of reports and inspections on foreign audit firms, etc. (Article 49-3-2, Paragraphs 1 and 2 of the CPA Act)

As a result, the CPAAOB is required to examine quality control review reports, and, if the CPAAOB considers it necessary and appropriate in light of public interest or investor protection, to collect reports and conduct inspections.

Furthermore, based on the results of examination or inspection, if the CPAAOB considers it necessary, it shall make a recommendation to the Commissioner of the FSA for administrative actions or other measures (Article 41-2 of the CPA Act).

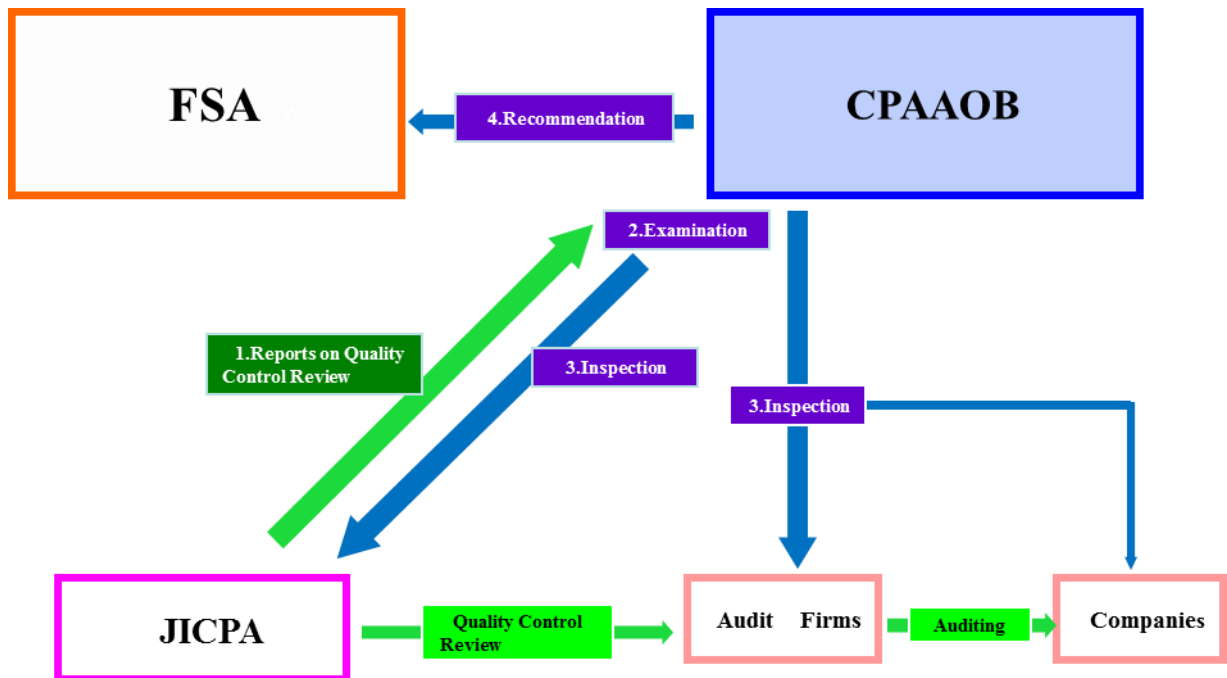


(Note) Quality control reviews

These reviews are performed by JICPA to assess the status of audit quality control. They are performed for the purpose of “review by JICPA of the status of the operation of services set forth in Article 2(1) of the Act” as specified in Article 46-9-2 of the CPA Act.

Specifically, with the aim of maintaining and improving an appropriate quality level of audit service as well as maintaining and enhancing social confidence in auditing, JICPA reviews the status of the quality control of audits performed by audit firms and CPA offices (audit firms), makes recommendations for improvement as necessary, and receives reports on the status of improvement with regard to those recommendations.

Outline of Examinations and Inspections



1. Reports on quality control review

Once every three years in principle (or once every two years, if JICPA finds it necessary), JICPA reviews and assesses an audit firm’s compliance with laws, regulations, audit standards, JICPA’s rules, and other related regulations. The CPAAOB receives reports on the results of those reviews.

2. Examination

The CPAAOB examines JICPA’s reports and ascertains: (i) whether the quality control review system is being appropriately operated by JICPA, and (ii) whether audit services are being appropriately provided by audit firms.

The CPAAOB may request the submission of reports or other materials from JICPA or audit

firms, if in the course of its examination, the CPAAOB finds it necessary to do so.

### 3. Inspection

Based on the results of its examination, the CPAAOB conducts inspections of JICPA, audit firms and any other audit related sites (such as those of audited companies), if the CPAAOB considers it necessary and appropriate in light of public interest or investor protection, or if the CPAAOB considers it necessary to do so from the viewpoint of securing the appropriate operation of JICPA.

### 4. Recommendation

Based on the results of examination or inspection, the CPAAOB may make a recommendation to the Commissioner of the FSA for administrative actions or any other measures for securing fair operation of audit services by audit firms or that of administrative operations of JICPA, when the CPAAOB considers it necessary.

Note: Regarding the collection of reports from and inspections on foreign audit firms, etc., refer to item (ii), Section 2.3.6 “Guidelines for Collection of Reports from and Inspections on Foreign Audit Firms, etc.” (see page 20).

## ***2.2 Basic Program for Risk Assessment and Inspections of Audit Firms***

### *2.2.1 Basic Program for Risk Assessment and Inspections*

Considering that FY2013 is the tenth year from the foundation of the board, and from the viewpoints of further improving the quality of audits and improving the effectiveness of audits conducted by audit firms through risk assessment and inspections, the CPAAOB established and, published on April 26, 2013 the “Basic Policy for Risk Assessment and Inspections – To Ensure the Implementation of More Effective Audits –” for the fourth term (April 2013 to March 2016), based on the results of risk assessment and inspections during the first through third terms (April 2004 to March 2013).

<Details of the basic policies>

#### (i) Perspectives

Considering that the “standards for addressing fraud risks in audit” have been established and published after fraudulent corporate accounting practices were detected recently, and that people strongly expect audit firms to conduct more effective audits with the aim of meeting these expectations, the CPAAOB shall take a public-interest standpoint, always from the people’s perspective, and shall maximize the use of its authority, so as to actively work to ensure and enhance

audit quality in carrying out risk assessment and inspections by ensuring that new laws and regulations, various standards, etc. are always reflected in auditing services.

Also, the CPAAOB shall enhance the dissemination of information in Japan and overseas. It shall provide useful information from risk assessment and inspections in exchanging views with JICPA and other relevant organizations while communicating, through the IFIAR, etc., with foreign audit oversight authorities concerned and proactively responding to international trends.

(ii) Goals

Risk assessment and inspections implemented by the CPAAOB do not focus directly on whether individual audit opinions themselves are suitable. Instead, the basic goal shall be to promote further improvement of the effectiveness of investigations into the operations of audit firms which are conducted by JICPA, from a public-interest standpoint, and to ensure proper operation of audit firms and foreign audit firms, etc. For this purpose, the CPAAOB shall implement the following:

- Information sharing through proactive cooperation with related parties;
- Two-way dialogue with JICPA, etc.; and
- Improved inspection methods, etc. through cooperation, etc. with foreign authorities.

(iii) Basic policy for risk assessment

The CPAAOB receives reports on the results of investigations into the operations of audit firms which are conducted by JICPA. For these reports, JICPA requests, as needed, reports or materials from parties concerned, collects information through exchange of opinions with related parties, and examines the analysis, etc. of the operations of audit firms.

Risk assessment is conducted based on the following policy.

- Positive entrenchment of audit quality control  
In view of the recent occurrence of fraudulent corporate accounting practices, it remains important to improve the effectiveness of audits. To ensure effective audits, therefore, the CPAAOB shall conduct risk assessment with a focus on whether audit firms are implementing quality control properly and encourage such audit firms to establish appropriate quality control.

- Ensuring effectiveness of risk assessment

Not only JICPA's reports on the results of their investigations into the operations of audit firms, but also various information from relevant organizations, shall be taken into comprehensive consideration, and the revision of laws, regulations, audit standards, etc. and the cross-sectional topics surrounding the audit profession are matters to be particularly kept in mind when conducting risk assessment. As such, the CPAAOB shall be mindful of conducting effective risk assessment, such as specifying the groups of audit firms that have these kinds of common issues, and the areas and matters to be reviewed.

Furthermore, aside from cases of inspection in which it is recommended that supervisory authorities take administrative actions or other measures, with respect to any problems notified as part of inspection results, from the perspective of confirming the subsequent state of quality control, the CPAAOB shall, as necessary, require reports to be submitted after a certain period of time has elapsed since the notice of inspection results and utilize the results of risk assessment of these reports as important reference information for future inspections, etc.

(iv) Basic policy for inspections

Based on the results of the risk assessment of reports, the CPAAOB conducts inspections as it deems necessary.

Under the basic policy for inspections, the CPAAOB shall specifically state the circumstances under which inspections will be required for each organization to be inspected, and shall conduct them in accordance with the separately established "Basic Policy for Inspections Conducted by the CPAAOB."

Furthermore, with regard to the collection of reports and inspections of foreign audit firms, etc., the CPAAOB shall conduct these in accordance with "A Framework for Inspection/Supervision of Foreign Audit Firms, etc." which was published in September 2009, and with the "Basic Guidelines on Collection of Reports from and Inspection on Foreign Audit Firms etc. by the CPAAOB," which was published in January 2010.

(Reference) Basic Policies for Examinations and Inspections (for the first through third terms)

During the first term (April 2004 to March 2007), the CPAAOB established and published in June 2004 "To Ensure Reliability of Audits – Basic Policy for Examinations, etc. –"

Under this policy, the CPAAOB conducted risk assessment and inspections during the first term, adopting the basic concepts of "proactively responding to expectations for ensuring

the quality and more effectiveness of audits” and “continuing oversight of audit services and further enhancing JICPA’s quality control review function.”

During the second term (April 2007 to March 2010), based on the results of risk assessment and inspections during the first term, the CPAAOB established and published in June 2007 “For Further Improvement of Audit Quality – Basic Policy for Examinations, etc. –” Based on this policy, the CPAAOB conducted risk assessment and inspections during the term, adopting the basic concepts of “firmly establishing improvements for previously identified issues” and “responding to new challenges.”

During the third term (April 2010 to March 2013), the CPAAOB established and published in June 2010 “Basic Policy for Examinations and Inspections – To Ensure Reliability of Audits” based on the results of risk assessment and inspections during the second term. Under this policy, the CPAAOB conducted risk assessment and inspections during the term, adopting the basic concepts of “positive entrenchment of audit quality control,” “improvement of the functions of JICPA’s quality control reviews” and “effective risk assessment .”

### *2.2.2 Basic Plan for Risk Assessment and Inspections*

The CPAAOB establishes a Basic Plan for Risk Assessment and Inspections every fiscal year as a guide for risk assessment and inspections for that year.

In FY2013, based on the Basic Policies for Risk Assessment and Inspections mentioned above, the CPAAOB established and published on April 26, 2013, “Audit Firms Inspection Policy for Fiscal Year 2013”, which provided for conducting well-balanced verifications focused on the essential problems in business operations by accurately analyzing where the risks of individual audit services lie, narrowing down the review items, and laying down the conditions for responses to industry-specific problems which were detected in previous risk assessment and inspections.

#### <Summary of the Audit Firms Inspection Policy for Fiscal Year 2013>

Based on the results of inspections conducted by the CPAAOB and quality control reviews conducted by JICPA, there have been cases confirmed of some audit firms whose establishment of quality control systems and whose voluntary improvements remain inadequate. In addition, it remains important to improve the effectiveness of audits in light of the fact that fraudulent corporate accounting practices were detected recently.

(i) Basic Plan for Risk Assessment and Off-site Monitoring

The Basic Plan for Risk Assessment and Off-site Monitoring states that the CPAAOB shall conduct risk assessment to accurately identify the risks of audit firms and individual audit services through reports on JICPA quality control reviews and exchange of views with JICPA and other relevant organizations.

The Plan also mentions that the CPAAOB shall comprehensively review the appropriateness of JICPA's quality control review system because it is expected that further improvement in the effectiveness of JICPA quality control reviews will contribute to the firm establishment of appropriate audit quality control at audit firms and to the demonstration of strong leadership by JICPA, including responses to industry-specific problems.

In addition, the Plan states that the CPAAOB shall focus on reviewing the establishment and management of the quality control systems of audit firms, such as those noted as having a wide range of deficiencies in quality control, or those for which voluntary improvements need to be encouraged, and reviewing common industry-specific problems, etc. which are found in small and mid-sized audit firms, taking into consideration the features of each such audit firm.

(ii) Basic Plan for On-site Inspections

The quality control reviews conducted by JICPA are carried out for top-tier large audit firms (audit firms which audit at least 100 listed companies or which employ at least 1,000 full-time auditors) once every two years. The Basic Plan for On-site Inspections states that, with respect to large audit firms, the CPAAOB, in principle, conducts its inspections based on the results of risk assessment of the quality control review reports from JICPA, considering such factors as their roles in capital markets, and domestic and foreign trends concerning audit supervision. The CPAAOB also inspects, as required, audit firms that have a relatively large number of listed companies as their audit clients.

In conducting such inspections, the CPAAOB conducts positive and well-balanced verifications focused on essential problems in business operations by obtaining important information on the quality control and individual audit services of audit firms, and in light of past inspection results and the monitoring activities of overseas alliance partners, etc., focusing on the risks of individual audit services, accurately analyzing where those risks are, and narrowing down the review items.

In relation to small and mid-sized audit firms, the results of recent risk assessment, inspections and quality control reviews have revealed occasional cases of problems with the risk assessment associated with the replacement of auditors, with the establishment of operation control systems, and with improvements in findings identified in quality control reviews. For this reason, the Basic Plan for On-site Inspections states that the CPAAOB shall conduct inspections of such audit firms as required, based on the results of risk assessment of JICPA's reports on quality control reviews, so as to effectively and flexibly verify or confirm their status of audit engagements execution, establishment of operation control systems, and efforts for the improvement of quality control reviews.

As follow-up measures after risk assessment and inspections, the CPAAOB shall collect reports from audit firms when a certain period of time has passed since giving notice of inspection results, so as to, if necessary, check and verify their status of quality control. On such occasions, the CPAAOB shall conduct checks and verifications, depending on the details or importance of the deficiency, in close coordination with the supervisory authorities of the Financial Services Agency, and the results of such checks and verifications shall be utilized in examining JICPA's reports on quality control reviews in order to improve the effectiveness and efficiency of inspections and enable smooth and seamless operations of risk assessment and inspections. The CPAAOB shall also ensure that the quality of audits is improved by extracting industry-specific problems, etc. from the deep analysis of the results of risk assessment and inspections and by exchanging views, etc. with JICPA and relevant organizations.

### ***2.3 Risk Assessment and Inspections of Audit Firms***

Audit firms (certified public accountants and audit corporations) may audit or attest financial documents for fees at the request of others (Article 2(1) of the CPA Act) and compile financial documents, examine or plan financial matters, or provide consulting services on financial matters for fees at the request of others (Article 2(2) of the CPA Act). As of the end of FY2013, the number of registered certified public accountants totals 26,260, and the number of audit firms totals 216. Audit firms earn approximately 80% of their business revenues from audit certification work.

(Reference)

	End of FY2009	End of FY2010	End of FY 2011	End of FY2012	End of FY2013
Number of registered certified public accountants	20,038	21,325	23,119	24,964	26,260
Number of audit firms	198	208	213	214	216

### 2.3.1 Quality Control Reviews by the Japanese Institute of Certified Public Accountants (JICPA)

In FY2013, JICPA performed 93 quality control reviews of audit firms (63 audit firms, including 2 joint CPA offices, and 30 CPAs). By March 31, 2014, 61 reports on those quality control reviews had been submitted to the CPAAOB (see Note). The status of quality control reviews is as follows.

(Note) The quality control review report (monthly report) consists of basically the following items:

- Quality control review report
- Recommendation for improvement report
- Response to recommendation for improvement report
- Quality control review documents

#### (i) Status of Implementation of Quality Control Reviews

The status of implementation of quality control reviews is as follows.

#### Status of Implementation of Quality Control Reviews

Date of quality control review	2013						2014			Total
	Jul.	Aug.	Sep.	Oct.	Nov.	Dec.	Jan.	Feb.	Mar.	
Number of audit firms reviewed for quality control	11	15	0	17	23	14	10	3	0	93

#### (ii) Results of Quality Control Reviews

Of 61 cases reported to the CPAAOB, 55 cases included recommendations for improvement. The conclusions of those reports were as follows.

- Unqualified conclusion: 57 cases (36 audit firms, 21 CPAs)
- Qualified conclusion: 4 cases (0 audit firm, 4 CPAs)
- Negative conclusion: None



Also, in FY2013, JICPA performed follow-up reviews (see Note) of 72 audit firms (45 audit firms and 27 CPAs). The results of 59 reviews, which were reported to the CPAAOB by March 31,2014, were as follows.

- Improvement measures sufficiently completed: 53 case (32 audit firms, 21 CPAs)
- Improvement measures insufficiently conducted: 6 cases (2 audit firms, 4 CPAs)

(Note)

A “follow-up review” is a review conducted by JICPA as part of its quality control review to assess the status of improvement measures implemented by an audit firm. Specifically, JICPA assesses the status of improvement measures by confirming the status of (i) changes to the quality control systems, (ii) communication to the auditors (including their education and training), and (iii) corrective actions implemented through monitoring the quality control systems, etc., all of which are expected to be performed by the audit firm in accordance with the improvement measures contained in the improvement plan submitted during the earlier quality control review.

### 2.3.2 Risk Assessment of Quality Control Reviews

#### (i) Scope and perspectives for examination

During FY2013, the quality control reviews conducted by JICPA in FY2012 and FY2013 were examined. The results of the examination of the FY2012 quality control reviews are as follows. As for the FY2013 quality control reviews, the CPAAOB has progressively commenced examination of 61 cases for which reports had been received by March 31, 2014.

Quality Control Review Reports (FY2012)					(Number of audit firms)		
Category	Unqualified conclusion		Qualified conclusion		Negative conclusion		Total
	(a)	a/c	(b)	b/c		-	
Audit firm	51	91.1%	5	8.9%	-	-	56
CPA	29	74.4%	10	25.6%	-	-	39
Total	80	84.2%	15	15.8%	-	-	95

(Note) All of the above 95 cases include recommendations for improvement.

During the examination, the CPAAOB uses the following perspectives to analyze the quality control review reports and to review the results of interviews and the collection of reports:

- Appropriateness of JICPA's quality control reviews
- Status of the development and operation of quality control systems established for ensuring the quality of audit services in audit firms in a reasonable manner
- Compliance of the quality control systems established in audit firms for individual audit services

(ii) Collection of reports

Of the audit firms subject to quality control reviews, for audit firms for which inspections were not conducted, the CPAAOB conducts focused verification of improvements in quality control and collects reports to determine the problems involved in audits. In this fiscal year, the CPAAOB conducted focused verification for, and collected reports from, more audit firms than the previous fiscal year to ensure that as many audit firms as possible were verified in order to conduct effective audits. From the same viewpoint, the CPAAOB took a face-to-face approach, including visiting audit firms as far as possible.

(a) Collection of reports for focused verification

“Audit Firms Inspection Policy for Fiscal Year 2013” state that, from the viewpoint of encouraging audit firms to perform audit services in a strictly fair manner based on the quality control reviews conducted by JICPA, the CPAAOB shall focus on reviewing the establishment of the quality control systems of audit firms, such as those noted as having a wide range of deficiencies in quality control and reviewing common industry-specific problems, etc. which are found in small and mid-sized audit firms, taking into consideration the features of each such audit firm

In FY2013, based on this policy, the CPAAOB collected reports from 61 audit firms for which it is necessary to check the state of audit quality control, out of 95 audit firms for which JICPA conducted quality control reviews in FY2012. To identify problems involved in the audit industry, in August 2013 the CPAAOB asked audit firms to report on the state of communications between accounting auditors and audit & supervisory board members, responses in cases where dependence on an audit firm's revenues on an audited company exceeds 15% and responses, etc. to the “standard of responses to risks of

fraudulent audits.”

(b) Collection of reports for fact finding

Although it was found unnecessary to immediately check the state of audit quality control based on the results of quality control reviews conducted in FY2012, with the aim of identifying problems involved in the audit industry, in August 2013 the CPAAOB collected reports from 9 audit firms on the state of communication between accounting auditors and audit & supervisory board members, responses in cases where dependence of an audit firm’s revenues on an audited company exceeds 15%, responses, etc. to the “standard of responses to risks of fraudulent audits,” responses, etc. to the Act on the Prevention of Transfer of Criminal Proceeds, and other matters.

History of Collection of Reports for Focused Verification and Fact Finding

	Record of Report Collection in FY2013					Record of Report Collection in FY2012		
	No. of firms undergoing report collection (a)		No. of firms undergoing QC reviews in FY2012 (b)	Report collection ratio a/b	No. of firms undergoing report collection (c)	No. of firms undergoing QC reviews in FY2011 (d)	Report collection ratio c/d	
	Focused verification	Fact finding						
Audit firms	70	61	9	95	73.7%	58	86	67.4%
Audit firms	34	28	6	50	68.0%	50	66	75.8%
Individual firms (Note)	36	33	3	45	80.0%	8	20	40.0%

(Note) Including CPA joint office

(c) Collection of reports following notification of inspection results

Under the basic policy for risk assessment and the basic policy for inspections, the CPAAOB shall, “if it considers it necessary, require reports to be submitted on an audit firm’s operation of audit services in order to ascertain the audit firm’s subsequent response, etc. for problems notified as part of inspection results, and utilize the results of examinations of such reports as important reference information for future inspections, etc.” Therefore, the basic plan for risk assessment and the basic plan for inspections state that the CPAAOB shall, as needed, check and verify the state of quality control by audit firms after a certain period of time has elapsed since they were notified of the inspection

results.

In FY2013, the CPAAOB collected reports from seven audit firms that had been notified of their inspection results to check that improvements had been made in matters identified in the inspections. The CPAAOB also requested audit firms to report on responses to communications between accounting auditors and audit & supervisory board members to identify actual issues across the audit industry.

(iii) Deliberation

Based on the results of examinations of quality control reviews, the CPAAOB deliberates on conducting inspections of audit firms. Also, based on the results of inspections of audit firms, the CPAAOB shall deliberate on recommending administrative actions and other measures to the Commissioner of the FSA.

In FY2013, the CPAAOB deliberated on the FY2012 quality control reviews (of 95 audit firms), and inspected 10 audit firms. It also deliberated on the results of the collection of reports based on FY2011 quality control reviews, and inspected three audit firms. It also made recommendations to the Commissioner of the FSA regarding one audit firm.

Status of Deliberation on Quality Control Reviews by JICPA (as of March 31, 2014)

	FY2012	FY2013
i. Deliberations related to quality control reviews (see Note)	86	95
ii. Decisions to conduct inspections of audit firms	11	13
iii. Decisions to recommend administrative actions or other measures to the Commissioner of the FSA	2	1

(Note) In principle, deliberations are carried out on quality control reviews that were conducted in the previous fiscal year.

### *2.3.3 Inspections to Audit Firms*

In FY2013, under the “Audit Firms Inspection Policy for Fiscal Year 2013,” the CPAAOB inspected 13 audit firms in total (10 audit firms in relation to the FY2012 quality control review and three in relation to the FY2011 review).

In the current fiscal year, the CPAAOB decided, in view of the limited number of personnel, etc., to conduct inspections with a focus on sharing information on problems, etc. concerning business operations of audit firms in particular and identifying findings in a proper and effective manner. For this purpose, necessary inspection teams are organized and utilized flexibly to use inspectors effectively and conduct inspections in an efficient manner. As a result, the number of inspections increased by two over the previous year (11 inspections) due to the use of flexible inspection methods, etc.

In the current fiscal year, if deficiencies, etc. are found in the course of inspections, the CPAAOB has not only verified the direct causes of such deficiencies but has also focused on identifying the root causes at the audit firms where the deficiencies occurred, in order to encourage audit firms subject to inspection to take effective remedial measures.

### *2.3.4 Recommendations to the Commissioner of the Financial Services Agency (FSA)*

As a result of the inspection on Tokyo Chuo Audit Corporation, the CPAAOB found that they performed audit services in a grossly inappropriate manner. Pursuant to the provisions of Article 41-2 of the CPA Act, the CPAAOB recommended on February 24, 2014, that the Commissioner of the FSA take administrative actions and other measures against them, as follows:

- (i) The audit firm had a severe cash flow problem due to cancelation of audit engagements and was forced to borrow funds from a representative of the firm. Under this harsh environment, the audit firm conducted business by excessively curtailing labor costs and expenses. Although employees retired, the firm didn't recruit the required personnel, and business operations were conducted by three employees in effect. Furthermore, the roles of employees were not clarified and audit services were provided only to secure revenues. The firm had no quality control manager in effect. The firm has not established a system for providing organized audit services.

Engagement partners had to perform audit procedures by themselves due to the retirement of employees. Therefore, engagement partners failed to guide or supervise other engagement partners, etc. in the audit team, and failed again to examine audit working papers prepared by other engagement partners, etc.

As described above, it was found that the quality control system of the firm doesn't function and their quality control system is insufficient and extremely inappropriate.

- (ii) With respect to the performance of audit services, it was found that there is a discrepancy between the audit plan and the actual audit procedure, and that the firm fails to obtain sufficient and appropriate audit evidence in the substantive procedures and the audit procedures for accounting estimates and the acquisition of a management confirmation letter, etc. It was also found that the firm fails to evaluate the appropriateness of the audit plan and the sufficiency and appropriateness of the audit evidence obtained, and that the firm fails to perform a wide range of audit services according to the audit procedures and in compliance with audit standards.
- (iii) When examining audit services, it was found that the firm fails to conduct audit plans based on revised audit standards and fails again to critically examine whether the audit team has obtained sufficient and appropriate audit evidence. Thus, the firm's examination setup was found to be totally insufficient because the firm failed to identify problems in audit services.
- (iv) The findings of JICPA's quality control reviews and findings concerning periodic verification showed that there is an excessive number of items (including the establishment of audit plans based on a risk approach, instructions to and supervision of auditors, and examination of audit working papers) for which improvements are insufficient or no improvements were made, and that the firm's efforts for improvement are totally insufficient.

#### *2.3.5 Dissemination of Information*

- (i) Preparation and publication of "Case Report: Audit Firm Inspection Results"

From the viewpoint of securing and improving the level of audit quality of audit firms, the CPAAOB yearly reviews and revises the Case Report, which was published in February 2008. In FY2013, the CPAAOB published a revised version thereof in July 2013 by adding or deleting certain examples of issues to

incorporate the issues identified in inspections conducted up to FY2012 and to reflect the revisions of accounting standards, etc. The English version was similarly revised and published at around the same time (see Annex 2).

From the viewpoint of “helping audit firms make voluntary efforts to maintain and improve the quality of their audits,” “presenting its level of expectation” and “providing reference information for directors and audit & supervisory board members of listed companies, etc., and general investors and other market players,” the version contains inspection standpoints, summarized inspection results (deficiencies and their causes, and commendable cases), and actions to be taken by audit firms, and introduces the particulars of deficiencies in a concrete manner.

(ii) Lectures, etc., on inspection results (Case Report)

The CPAAOB actively participates in workshops organized by JICPA or other relevant organizations to lecture on inspection results so as to help perform appropriate audit procedures.

In FY2013, the CPAAOB delivered eight lectures for certified public accountants at seven workshops hosted by JICPA across Japan from September to October 2013, to promote voluntary activities aimed at securing and improving audit quality.

The CPAAOB also delivered two lectures for audit & supervisory board members at the Japan Audit & Supervisory Board Members Association (JASBA) in November 2013 so that the Case Report may be widely used to understand the conditions regarding external audits.

In addition, the CPAAOB gave wide publicity to the inspection results, such as by printing the Case Report in the bulletins and other publications of relevant organizations, so that audit firms, etc., can actively use them for reference purposes.

(iii) Lectures on activities, etc. of the CPAAOB

The CPAAOB delivers lectures for market players, including audit & supervisory board members of listed companies and certified internal auditors, to introduce its activities and future challenges.

In FY2013, the CPAAOB delivered lectures at the JASBA, the Institute of Internal Auditors-Japan (IIAJ), the Securities Analysts Association of Japan

(SAAJ), and the Capital Markets Research Institute (CaMRI), etc. to introduce various issues, etc. identified during its inspections of audit firms.

### 2.3.6 Framework for Inspections and Oversight on Foreign Audit Firms

#### (i) Notifications of foreign audit firms

When providing services deemed to correspond to the audit attestation services prescribed in the CPA Act, for financial statements submitted by foreign companies, etc. under the Financial Instruments and Exchange Act, foreign audit firms, etc., shall notify the Prime Minister (who shall delegate his/her authority to the Commissioner of the Financial Services Agency under the CPA Act) in advance. (As of March 31, 2014, 86 audit firms, etc. from 31 countries)

Number of notifications of foreign audit firms, etc. (as of March 31, 2014)

	Number of countries/regions	Number of audit firms, etc.
North America	3	14
Central & South America	2	2
Europe	15	43
Asia & Pacific	10	26
Middle East	1	1
Total	31	86

#### (ii) A framework for Information requirements and Inspections on foreign audit firms, etc.

In relation to the treatment of foreign audit firms, etc., the CPAAOB and the FSA prepared and published “A Framework for Inspection/Supervision of Foreign Audit Firms, etc.” in September 2009, based on the “FY2009 Basic Plan for Examinations and Inspections.”

In view of “A Framework for Inspection/Supervision of Foreign Audit Firms, etc.”, the CPAAOB also published the “Basic Guidelines on Information Requirements and Inspection on Foreign Audit Firms, etc. by the CPAAOB” in January 2010. The Guidelines establish basic procedures and points to be considered regarding inspections and information gathering from foreign audit firms, etc.

With respect to information requirements and inspections regarding foreign audit firms, etc., the CPAAOB will, in principle, rely on such actions by the competent



authorities of the firms' home jurisdictions ("foreign competent authorities"), instead of seeking to obtain information from or conducting inspections on firms themselves, provided (a) audit and public oversight systems in the firms' home jurisdictions are equivalent to those of Japan, (b) necessary information can be provided from the foreign competent authorities through appropriate arrangements of information exchange, and (c) reciprocity is ensured in the Framework and Guidelines.

(iii) Information requests to foreign audit firms

From foreign audit firms who notified the FSA, the CPAAOB requested 23 from six jurisdictions in which the FSA and the CPAAOB did not expect inspection and oversight by foreign audit oversight authorities to submit information concerning the operation, etc. of the firm, the quality control system of the firm and the results of the latest inspection/review conducted by the supervisory authorities, etc.

As a result, no critical risks were identified in general. However, it was found necessary to check and verify whether the work conducted by foreign audit firms, etc., which is considered equivalent to audit attestation work, is conducted in a proper manner, in consideration of the fact that inherent risks may exist in the audit firms' supervision system of foreign supervisory authorities and foreign audit firms, etc.

(iv) Inspections of foreign audit firms, etc.

Based on the results of analysis and evaluation of the collected reports as specified in (iii) above, the CPAAOB conducts a detailed study of the implementation of inspection of foreign audit firms, etc., establishes a setup for implementing such inspections, and further enhances cooperation with foreign supervisory authorities.

## ***2.4 Cooperation with Relevant Organizations***

To maintain and improve the quality of audits, it is important not only to secure the effectiveness of audits conducted by audit firms but also to share information on common audit-related challenges and take the same stance on issues by further enhancing cooperation with audit firms and relevant organizations of companies subject to audit (individual companies, etc.)

For this purpose, the CPAAOB exchanges opinions not only with the relevant FSA divisions but also with other relevant organizations, including the JICPA and the Stock Exchange.

Furthermore, since it was increasingly important to secure effective audits from a global viewpoint due to increased overseas expansion, etc. of companies subject to audit and therefore it was urgently necessary to identify the actual conditions regarding reviews of member firms of networks of international audit firms, the CPAAOB exchanged opinions with executives and reviewers of leading networks.

#### *2.4.1 Cooperation with the Japanese Institute of Certified Public Accountants (JICPA)*

The CPAAOB conducts risk assessment and inspections to facilitate further improvements in the effectiveness of JICPA's quality control reviews from the standpoint of public interest, and ensure that audit firms perform audit services in a proper manner. It is expected that, as the organ responsible for conducting quality control reviews, JICPA further improves the effectiveness of its reviews through enhancement of the review implementation structures to ensure that audit firms manage the quality of audits in a proper manner. Therefore, the CPAAOB holds discussions with the JICPA Chairperson, other executives and reviewers on problems identified through risk assessment and inspections.

In April 2013, one of JICPA's project teams publicized "proposals for modification of the quality control review system" as part of its efforts to implement modifications to the quality control review system, for which purpose the CPAAOB has long exchanged opinions with JICPA, the CPAAOB exchanged opinions with the Quality Control Council and the Quality Control Committee in FY2013. In addition, the CPAAOB exchanged opinions with committees in other industries concerning audits of financial institutions, conducted discussions on measures to ensure compliance with the Act on the Prevention of Transfer of Criminal Proceeds which assures compliance with obligations concerning money laundering and terrorist funds, and exchanged opinions on measures to enhance communications between accounting auditors and audit & supervisory board members.

#### *2.4.2 Cooperation with the Stock Exchange*

The CPAAOB has a mission to enhance the fairness and transparency of capital markets in Japan by ensuring audit reliability through inspections, etc. Therefore, the CPAAOB

cooperates with the Stock Exchange which self-regulate listed companies by exchanging opinions concerning industry-specific audit-related issues, etc. which are obtained from the results of inspections, etc. so that both parties can have the same stance on issues.

In FY2013, the CPAAOB exchanged opinions with the Tokyo Stock Exchange, the Sapporo Stock Exchange and the Fukuoka Stock Exchange concerning audit-related challenges, etc. in capital markets.

#### *2.4.3 Cooperation with the Japan Securities Dealers Association (JSDA)*

In recent examinations, etc., the CPAAOB verified individual audit services for securities companies. In addition, the CPAAOB identified audit-related issues for companies registered on the green sheet market.

In view of the above, the CPAAOB cooperates with the JSDA which self-regulates member companies, including securities companies, and operates the green sheet market, exchanges opinions with the JSDA on various audit-related issues with respect to securities companies, and makes efforts to take the same stance on various issues.

#### *2.4.4 Cooperation with the Japan Audit & Supervisory Board Members Association (JASBA)*

Considering that cooperation with accounting auditors and audit & supervisory board members, etc. who perform a corporate governance function for their companies is important in facilitating proper disclosure of financial information by companies, the CPAAOB has verified the state of communication between audit & supervisory board members, etc. and accounting auditors in the course of inspections, etc. of audit firms. In the revised audit standards and the standards for addressing fraud risks in audits which were publicized in April 2013, communication between accounting auditors and audit & supervisory board members, etc. is required as part of the audit standards. In the 2013 revised Companies Act, the functions of accounting auditors are enhanced. Thus, cooperation between accounting auditors and audit & supervisory board members, etc. is increasingly important.

Therefore, the CPAAOB cooperates with the JASBA and exchanges opinions with them concerning various issues, etc. relating to communication between audit & supervisory board members, etc. and accounting auditors.

Furthermore, in view of the importance of communication between both parties, the CPAAOB clarified the method by which accounting auditors notify audit & supervisory board members of companies subject to inspection of the inspection results sent from the CPAAOB. In November 2013, the JASBA and the JICPA publicized a report on a joint study on communications between audit & supervisory board members, etc. and accounting auditors which contains the above disclosure method.

#### *2.4.5 Cooperation with Relevant Organizations of the Financial Services Agency*

The CPAAOB has identified industry-specific audit-related issues, etc. based on the results, etc. of inspections of individual audit services by audit firms for financial institutions (banks, Shinkin banks and credit cooperatives, securities companies, life insurance companies, etc.) Since it is expected that cooperation with relevant FSA divisions which supervise or inspect companies subject to audit will enable more effective and efficient supervision, inspection, etc., the CPAAOB positively enhanced cooperation with the relevant FSA divisions (Planning and Coordination Bureau, Inspection Bureau, Supervisory Bureau, Securities and Exchange Surveillance Commission), including information sharing and exchange of opinion. At deliberations on the revision of the audit standards at the Business Accounting Council's Audit Committee, the CPAAOB clarified issues, including matters to be noted in the auditing of funds, when it reported on the actual state regarding the auditing of funds which it has identified in inspections, etc.

#### *2.4.6 Cooperation with International Networks of Audit Firms*

Networks of international audit firms, large networks in particular, review the quality of audit services of member audit firms in each country included in such networks on a periodic basis and ask member audit firms to comply with networks' policies in order to maintain and improve the quality of the audit services of their member audit firms.

Therefore, the CPAAOB made efforts to identify the actual state of reviews, etc. made by networks. Furthermore, considering that if a network's supervision of member audit firms is conducted in a proper manner, more effective and efficient inspections, etc. will be possible by utilizing the results, etc. of such reviews, etc., the CPAAOB exchanged opinions and cooperated with executives and reviewers of those networks.

## ***2.5 Future challenges***

### **(1) Further improvement of the functions of quality control reviews by JICPA**

With the aim of stimulating further improvement of the functions of quality control reviews conducted by JICPA from a public-interest standpoint, since FY2004, the CPAAOB has continued to review the appropriateness of quality control review systems and operations and to conduct two-way discussion with JICPA. Given that the present framework has been one where the results of inspection are reported to JICPA via audit firms, any problems identified through examinations and inspections are being shared with JICPA in a more concrete form, and efforts are being made to share a sense of the issues surrounding quality control reviews through the bilateral exchange of views with JICPA.

With regard to the quality control reviews conducted by JICPA, given that ten years have passed since their legislation following the May 2003 revision of the law, and six years since the April 2007 introduction of the registration system for listed company audit firms, JICPA is in discussion on the improvement of the quality control review system. The CPAAOB believes it necessary to strongly promote a framework whereby feedback on CPAAOB activities is given directly and indirectly to JICPA through the exchange of views and results of inspections, etc.

### **(2) Strengthening of information collection and analysis systems**

The CPAAOB receives quality control reviews conducted by JICPA, and then uses a variety of information to conduct examinations and inspections. In order to conduct more efficient and effective examinations and inspections, the CPAAOB needs to strengthen its systems for information collection and *ex ante* and *ex post facto* information analysis.

For this reason, the CPAAOB believes it necessary to proactively collect information on audit firms, etc., and markets, as well as quality control review reports, so as to further promote cooperation with JICPA, relevant FSA divisions and other relevant organizations.

The CPAAOB also believes it important to strengthen both the quality and quantity aspects of its information collection and analysis systems, such as by further enhancing and strengthening report collection and through close cooperation with supervisory authorities after the notification of inspection

results.

The CPAAOB also considers it important to enhance the combination with continuous off-site monitoring efforts in which the analysis of various materials, information obtained from interviews, etc. is made to identify risks in audit firms on a real-time basis.

### (3) Implementation of effective inspections

The CPAAOB aims to conduct well-balanced inspections of large audit firms focusing on their essential problems in business operations by narrowing down the review items after having obtained important information on their quality control and individual audit services, reviewed past inspection results and the monitoring activities of overseas alliance partners, etc., and selected risks of individual audit services.

The CPAAOB also believes that, for audit firms of other sizes, an important issue is to conduct inspections paying attention to problems, such as the responsibility for business operations and quality control, which arise due to the structures observed in small and mid-sized audit firms, which includes audit firms now subject to quality control reviews.

Furthermore, the CPAAOB believes it important to identify industry-wide problems through the inspections and to share information through exchange of views on such problems with JICPA, relevant FSA divisions, and other relevant organizations.

### (4) Strengthening the dissemination of information

To help audit firms make voluntary efforts for maintaining and improving the quality of their audits, the CPAAOB disseminates a variety of information, such as by collating problem areas in audit firms identified through inspections and publishing them in the Case Report, and by holding briefing sessions on the Case Report as part of the training at JICPA.

Other than just voluntary improvements at audit firms, the CPAAOB believes that an important issue with regard to problem areas in audit firms identified through examinations and inspections is to get an overall picture, conducting analyses in a way so as to extract cross-sectional industry-wide problems from the inspection results and, through the exchange of views, making suggestions to JICPA, relevant FSA divisions and other relevant organizations.

Furthermore, the CPAAOB also believes it important to revise the Case Report taking into account the standpoint of providing market practitioners with reference information, and to actively disseminate information through briefing sessions on the Case Report.

(5) Enhancing the structure for addressing problems surrounding audits firms

The results of inspections, etc. of audit firms revealed that they have fundamental problems in their business operations, perhaps arising from the adoption of international accounting practices due to increased overseas expansion, etc. of companies subject to audit and an increase in overseas transactions, the introduction of IT-assisted audit procedures, etc. In this connection, it must be noted that new legal standards, such as the standards for addressing fraud risks in audits and the revised Companies Act, had to be complied with by audit firms. Furthermore, cooperation with various overseas authorities is progressing, such as the exchange of letters with the US PCAOB, Canadian CPAB, Malaysian AOB, Dutch AFM, and Luxembourgian CSSF regarding cooperation in the area of audit oversight.

Given these circumstances, the CPAAOB believes it important to provide effective training programs that pay attention to system revisions and international trends. Furthermore, it believes it to be still important to procure personnel who properly analyze and respond to domestic and foreign information, the internationalization of accounting practices, systems of Japan's audit firms, etc. in order to address this situation and for inspections to be carried out appropriately.

### **3 Cooperation with Relevant Organizations in Other Jurisdictions**

#### **3.1 Outline**

Triggered by accounting scandals such as at Enron and WorldCom in the United States(USA), the need to secure and improve the quality of audits was recognized, and since 2002, audit oversight institutions independent from the accounting profession have been established in jurisdictions throughout the world.

Amid such circumstances, the first unofficial meeting of audit oversight institutions was held in Washington DC in September 2004, organized by the Financial Stability Forum (FSF) (see Note), for the purpose of sharing information among each country's audit oversight institution. The meeting was attended by nine jurisdictions: Japan, USA, UK, Germany, France, Italy, Canada, Australia, and Singapore. Subsequently, a series of further informal meetings was held. Momentum gathered for the establishment of a permanent international meeting, and at the fifth meeting of audit oversight institutions held in Paris in September 2006, formal approval was given for the establishment of the International Forum of Independent Audit Regulators (IFIAR). Its first plenary meeting was held in Tokyo in March 2007, hosted by the CPAAOB, and was attended by the audit oversight authorities of 22 jurisdictions. Since then, 13 meetings have been held by the end of March 2014; and the number of jurisdictions has grown to 46 as of December 2013.

In addition to cooperating with the audit oversight authorities of each country through actively participating in the activities of the IFIAR, by exchanging views individually with the audit oversight authorities of each country, the CPAAOB is also making efforts to establish and enhance international cooperative relationships aimed at securing and improving the quality of audits.

(Note) In light of the declaration of the second meeting of the heads of state, held in April 2009 for the discussion of financial markets and the world economy (London Summit), the FSF was reorganized into the Financial Stability Board (FSB), as an organization with a stronger organizational base and with greater capacity.



## **3.2 International Forum of Independent Audit Regulators (IFIAR)**

### **3.2.1 Organization**

#### **(i) Goals**

The IFIAR's Charter specifies the following as the goals of its activities:

- i Sharing knowledge of the audit market environment and practical experience of independent audit regulatory activity with a focus on inspections of auditors and audit firms;
- ii Promoting collaboration and consistency in regulatory activity;
- iii Initiating and leading dialogue with other policy-makers and organizations that have an interest in audit quality; and
- iv Forming common and consistent views or positions on matters of importance to its Members, taking into account the legal mandates and missions of individual members.

#### **(ii) Organization**

The IFIAR is made up of the audit oversight authorities of various jurisdictions that have membership, and decisions are, in principle, made at the plenary meetings at which all member authorities participate. Individuals serve as the Chair and Vice-Chair to facilitate the activities of the IFIAR, and an Advisory Council providing support and advice to the Chair and Vice-Chair has been established. As of the end of March 2014, the Advisory Council comprises the seven jurisdictions of Abu Dhabi, Australia, Canada, France, Singapore, Sri Lanka and UK.

As of the end of March 2014, there are six working groups established in the IFIAR, the goals of which are described below.

#### **(a) Global Public Policy Committee (GPPC) Working Group**

The aim of this working group (WG) is to exchange views with the six largest international audit networks (see Note) on the quality control of global audits. The WG maintains dialogue with each network on such topics as the quality control systems of global audit networks, and shares information between authorities on improvements in quality control and on the organizational expansion of each network.

(Note) The six largest international audit networks are comprised of Deloitte Touche Tohmatsu, Ernst & Young, KPMG, PricewaterhouseCoopers, BDO and Grant Thornton.

(b) Standards Coordination Working Group

The aim of this WG is to exchange views on such topics as the setting of international auditing standards at the International Auditing and Assurance Standards Board (IAASB) and on cooperation with bodies that set standards related to audit services.

(c) Inspection Workshop Working Group

This WG plans, coordinates and evaluates IFIAR inspection workshops. These workshops have been established for the purpose of skills training for inspectors and to share inspection methods and experiences, and are held every year.

(d) Investor Working Group

The aim of this WG is to engage in dialogue with investors—the users of audit reports—on issues such as the quality of audits and how audit reports ought to be. The WG also plans and coordinates the exchange of views with investor representatives at the IFIAR plenary meetings.

(e) International Cooperation Working Group

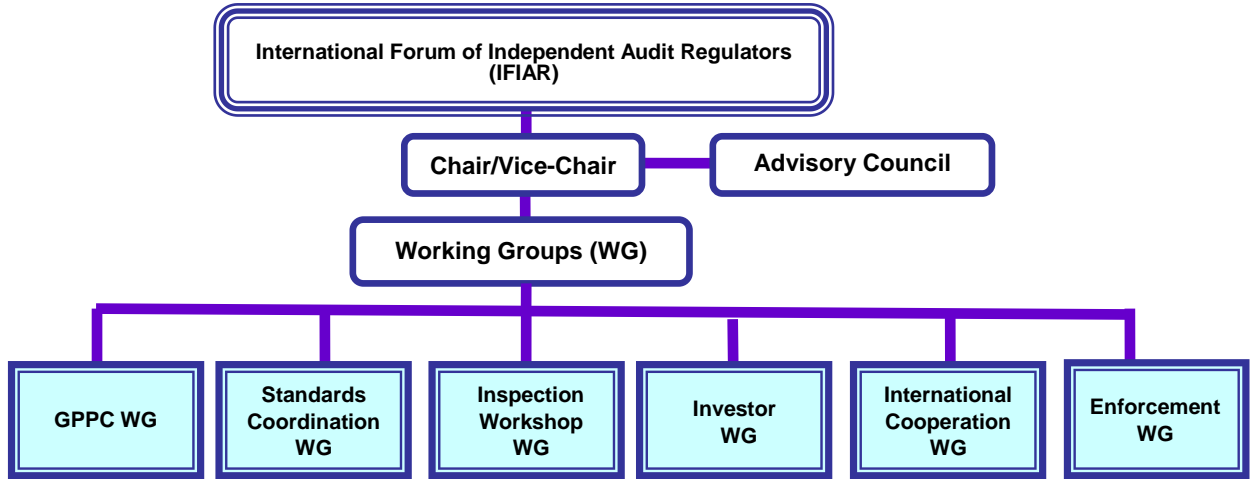
The aim of this WG is to promote the practical exchange of information on regulations and inspections between audit oversight authorities.

(f) Enforcement Working Group

The aim of this WG is to promote cooperation between audit oversight authorities in the area of enforcement, including investigations, and facilitate exchange of information on enforcement regimes and developments in member jurisdictions, in order to enhance investor protection and improve audit quality.

(Note) Japan has been chairing this WG since its foundation in July 2013.

## IFIAR organization chart



### 3.2.2 Activities

#### (i) Plenary meetings

##### ▪ Thirteenth meeting (Noordwijk)

The meeting was held from April 15 to 17, 2013, and was hosted by the Netherlands Authority for the Financial Markets (AFM). At the meeting, new officers (the Chair and Vice-Chair) were elected, a future work plan was agreed on, and the IFIAR Charter was revised. Furthermore, Japan recommended Mr. Oki Matsumoto, Managing Director & Chairman, Monex Group, Inc. as representative of investors, and Mr. Matsumoto participated in the meeting.

Past IFIAR plenary meetings

	Dates	Venue	Participating audit oversight authorities
First	March 22-23, 2007	Tokyo, Japan	22 jurisdictions
Second	September 24-25, 2007	Toronto, Canada	21 jurisdictions
Third	April 9-11, 2008	Oslo, Norway	22 jurisdictions
Fourth	September 22-24, 2008	Cape Town, South Africa	21 jurisdictions
Fifth	April 27-29, 2009	Basel, Switzerland	30 jurisdictions
Sixth	September 14-16, 2009	Singapore	29 jurisdictions
Seventh	March 22-24, 2010	Abu Dhabi, UAE	30 jurisdictions
Eighth	September 27-29, 2010	Madrid, Spain	37 jurisdictions
Ninth	April 11-13, 2011	Berlin, Germany	34 jurisdictions
Tenth	September 26-28, 2011	Bangkok, Thailand	29 jurisdictions
Eleventh	April 16-18, 2012	Pusan, South Korea	32 jurisdictions
Twelfth	October 1-3, 2012	London, UK	39 jurisdictions
Thirteenth	April 15-17, 2013	Noordwijk, the Netherlands	42 jurisdictions

(ii) Interim Meeting

Since 2013, the frequency of the plenary meeting has been reduced to once a year. On the other hand, an Interim Meeting attended only by officers and chairs of working groups, etc. has been held. At this Interim Meeting, high-level discussions on management, etc. of IFIAR's work are held (the Interim Meeting in 2013 was held in Paris).

(iii) Inspection workshops

At the first IFIAR plenary meeting in Tokyo, it was agreed that inspection workshops would be held, led by the inspectors of the IFIAR members, for the purpose of sharing information on the inspection methods of audit oversight authorities and on issues related to inspections, as well as providing training for inspectors. Since then, the workshops have been held every year, with planning and coordination provided by the Inspection Workshop Working Group.

This fiscal year, the workshop was held between March 10 and 12, 2014, and was hosted by the Audit Oversight Board of Malaysia (AOB). 113 inspectors and others participated from 36 jurisdictions.

Past IFIAR inspection workshops

	Dates	Venue	Participating audit oversight authorities
First	May 30-31, 2007	Amsterdam, the Netherlands	22 jurisdictions
Second	January 29-30, 2008	Berlin, Germany	20 jurisdictions
Third	February 11-13, 2009	Stockholm, Sweden	25 jurisdictions
Fourth	February 9-12, 2010	Paris, France	31 jurisdictions
Fifth	February 23-25, 2011	Washington DC, USA	30 jurisdictions
Sixth	March 5-7, 2012	Abu Dhabi, UAE	32 jurisdictions
Seventh	March 4-6, 2013	Zurich, Switzerland	38 jurisdictions
Eighth	March 10-12, 2014	Kuala Lumpur, Malaysia	36 jurisdictions

### **3.3 Bilateral Cooperation**

- *Exchange of views with foreign audit oversight authorities*

In light of the globalization of corporate activities, ensuring the quality of audit procedures that cross national borders, such as using the audit results of overseas audit firms in the audit of consolidated financial statements, has become more important than ever before. Moreover, enhancing cooperation with foreign audit oversight authorities, etc. has become indispensable for making audit oversight globally efficient and

effective. Through participation in the IFIAR plenary meetings and each working group, the CPAAOB is actively strengthening its cooperation and exchanging information with foreign audit oversight authorities. In addition to activities at the IFIAR, for the purpose of sharing information on internationally active audit firms and issues pertaining to audits and inspections, the CPAAOB is also constantly exchanging views with audit oversight authorities and other organizations from various jurisdictions on a bilateral basis and is striving to build and enhance its cooperative relationships with foreign audit oversight authorities.

The CPAAOB and the FSA also exchanged letters on cooperation in the area of audit oversight with the Commission de Surveillance du Secteur Financier (CSSF) on August 2, 2013. This exchange of letters has enabled them to exchange information for audit oversight more smoothly.

Based on the “Guidance on Equivalency Assessment on Audit and Public Oversight Systems of Foreign Jurisdictions” published by the FSA on July 10, 2012, the CPAAOB and the FSA assessed that audit and public oversight systems of the Netherlands and Luxembourg are equivalent to those of Japan, and published the fact on July 11, 2013.

(Reference) Letters exchanged until FY2012

- (i) October 6, 2011: the U.S. Public Company Accounting Oversight Board (PCAOB)
- (ii) March 23, 2012: the Canadian Public Accountability Board (CPAB)
- (iii) October 3, 2012: the Audit Oversight Board of Malaysia (AOB)
- (iv) March 26, 2013: the Netherlands Authority for the Financial Markets (AFM)

### **3.4 Future challenges**

#### **(1) Strengthening cooperation with foreign audit oversight authorities**

Given that the globalization of corporate activities has resulted in the advance of cross-border audit services, such as using the audit results of overseas audit firms in the audit of consolidated financial statements of internationally active enterprises, ensuring the quality of those cross-border audit services is the issue. Attention also needs to be paid to the effects that the global economic and financial situation has on the quality of audits.

Based on such perspectives, the enhancement of Japan’s presence in IFIAR and cooperation with foreign audit oversight authorities is becoming increasingly important. The CPAAOB needs to not only continue to actively participate in the

IFIAR activities, but also to use international conferences and working group meetings to actively exchange views regarding issues of interests of Japan and those of foreign audit oversight authorities and to provide useful information obtained through the CPAAOB's activities. It is also necessary to promptly share the results of those exchanges with parties concerned and actively use such results in the work of the CPAAOB.

While actively proceeding with negotiations toward developing bilateral frameworks for the exchange of information between audit oversight authorities, the CPAAOB believes that an important issue is to strengthen cooperation further by communicating closely with foreign authorities to utilize developed frameworks.

(2) Response to international trends in accounting and audit systems

Regarding international trends in discussion on accounting and audit systems, the CPAAOB needs to pay particular attention to discussions at international organizations, etc., and collect and promptly share information in a timely manner, through cooperation, with a wide range of relevant organizations, including the FSA divisions concerned, JICPA, and the Stock Exchange. The CPAAOB also believes it important to take necessary action properly in a timely manner, including analyzing and considering the potential impact of discussion on audit firm activities and the CPAAOB operations, and measures to be taken, and translating such results into off-site and on-site monitoring on audit firms.

## **4 Efforts to Enhance the Attractiveness of Certified Public Accountants (CPA)**

### **4.1 Outline**

CPAs are expected to play an active part not only in the audit industry but also in various other sectors, including the business community. Based on this concept, the relevant law was revised in 2003 in order to secure a number of qualified personnel by diversifying types of applicants and increasing the number of applicants. A new examination system was introduced from 2006. The number of successful applicants tentatively increased after the shift to the new examination system. However, the number of persons recruited by the audit industry significantly decreased due to the deterioration in economic conditions, etc. As a result, many persons who have passed the CPA examination could not obtain a position and became so-called “persons on waiting list.”

Since then, the employment situation at audit firms has improved and the issue of “persons on waiting list” has calmed down recently. On the other hand, the new challenges have occurred: the number of applicants for the CPA examination has tended to decrease; and audit fees have also tended to decrease.

Accounting and auditing are an important part of the infrastructure in financial and capital markets. CPAs who are experts in accounting and auditing are required to play an important role in broad sectors of the economy as “public goods” in financial and capital markets.

Under this environment, in an effort to enhance the attractiveness of the qualification of CPA, the CPAAOB has been exchanging opinions with the FSA, the JICPA, and other parties concerned since the summer of 2013 to consider effective measures from a wide viewpoint, not limited to institutional reform.

### **4.2 Future challenges**

The “Recommendations for Vitalizing Financial and Capital Markets” released by the Panel for Vitalizing Financial and Capital Markets on December 13, 2013 states that the quality of audit needs to be enhanced to maintain and ensure international confidence in the auditing system in Japan, and to this end, it is crucial to make the certified public accountant qualification more appealing. Therefore, in an effort to enhance the attractiveness of the qualification of CPA as “public goods” in financial and capital



markets and thereby secure excellent personnel, it is necessary to cooperate closely with the FSA, JICPA, the economic community, and market players, etc. in order to promote efforts to further improve the attractiveness of the qualification of CPA.

(Reference) For details of the “Recommendations for Vitalizing Financial and Capital Markets,” please visit the FSA website:

<http://www.fsa.go.jp/singi/kasseika/20131213.html>

**Certified Public Accountants and Auditing Oversight Board  
(CPAFOB)  
(As of April 1, 2014)**

Chairperson (full-time)	Kunio Chiyoda	Former Professor Graduate School of Accountancy, Waseda University
Commissioner (full-time)	Toshiro Hiromoto	Former Professor Graduate School of Commerce and Management, Hitotsubashi University
Commissioner (part-time)	Yasuyoshi Ichikawa	Partner Deloitte Touche Tohmatsu LLC
Commissioner (part-time)	Akiko Kimura	Of Counsel Anderson Mori & Tomotsune Outside Corporate Auditor Fuji Electric Co., Ltd.
Commissioner (part-time)	Michiyoshi Sakamoto	Certified Public Accountant Corporate Auditor(Full-Time) Bank of Tokyo-Mitsubishi UFJ, Ltd.
Commissioner (part-time)	Hisakatsu Sakurai	Professor Graduate School of Business Administration, Kobe University
Commissioner (part-time)	Yoshiko Sato	Secretary General, Chief Research Fellow Japan Investor Relations Association,
Commissioner (part-time)	Yasuyuki Fuchita	Executive Fellow Nomura Institute of Capital Markets Research
Commissioner (part-time)	Keiko Mizuguchi	Chief Analyst & General Manager of Rating Planning Department Japan Credit Rating Agency, Ltd.
Commissioner (part-time)	Kazunori Yagi	Advisor Yokogawa Electric Corporation Outside Corporate Auditor Yokogawa Bridge Holdings Corp. Outside Director JSR Corporation Outside Corporate Auditor TDK Corporation Outside Director OYO Corporation

**Annex 2**

# Case Reports from the Results of Audit Firm Inspections

## 1. Introduction

From the viewpoint of enhancing the quality of audits in Japan, ensuring public interest and protecting investors, the CPAAOB inspects audit firms and identifies a variety of deficiencies in matters relating to quality control of audits. Main cases of deficiencies in inspections are compiled in the “Case Reports from the Results of Audit Firm Inspections.” These Case Reports have been publicized every fiscal year.

In the case of the Case Reports publicized on July 5, 2013, the text is divided into quality control and individual audit services sections. The contents of the Case Reports are as follows.

- ▶ In the quality control section, for each audit quality control item, “inspection standpoints,” “summarized inspection results” (deficiencies and their causes, and an outline of commendable cases of quality control efforts made by audit firms), “actions to be taken by audit firms” and other matters are stated, and then particulars of cases of deficiencies are introduced.
  
- ▶ In the individual audit services section, the composition is the same as the structure of the report of the Audit Standards Committee based on a new drafting policy. However, audits of accounting estimates in which deficiencies are heavily identified, audits of financial institutes in the characteristic industry, fraudulent acts in audits of financial statements for which attention should be paid to future responses of audit firms, and audits of internal control on financial reporting for which standards different from those for financial statement audits apply are introduced under separate headings. Under each heading, “inspection standpoints, etc.” are stated, and depending on the contents, etc. of cases of deficiencies, “matters to be noted when performing audit procedures” are stated, in addition to the introduction of cases of deficiencies.

The CPAAOB expects each audit firm to inspect their quality control system with reference to cases of deficiencies and their causes, etc. introduced in the Case Reports, and if any deficiency is detected in the quality control system, for each audit firm not only to remedy the deficiency but also to investigate and remove its root causes. In particular, top management, the quality control manager, etc. should be primarily responsible for any deficiencies detected in the quality control system. However, it is often observed that the root or essential causes can be attributed to organizational issues at audit firms, including their business operation policy and business management system. Remembering that the maintenance and operation of the quality control system should not be handled only on the individual responsibility of top management, the quality control manager, etc.

but should be handled by all employees responsible for management of audit firms, because this is a challenge for business operations, employees of audit firms are required to identify the factors in business operations which may cause deficiencies in the quality control system and take organizational measures to rectify such deficiencies.

An overview is given here of parts of the quality control section in the Case Reports.

\*For the full text of the Case Reports, please visit the CPAAOB website:

(<http://www.fsa.go.jp/cpaaob/shinsakensa/kouhyou/20130705/01.pdf>)

## **2. Overview of Inspection Results**

### **(1) Operation control systems**

#### **(i) Quality control system**

At large audit firms, the quality control department is mainly involved in maintaining and improving quality control. Some small and mid-sized audit firms make positive efforts to maintain and improve their quality control by nominating a dedicated quality control manager, for example.

On the other hand, some audit firms' efforts to maintain and operate their quality control systems are insufficient, while there are some audit firms where top management, the quality control manager, etc. do not fulfill their responsibilities for quality control acceptably. This situation can be attributed to the following organizational causes. These audit firms are required to take drastic organizational measures to maintain and improve their quality control systems.

- The employees, etc. who are responsible don't work in an organized and integrated manner while they are carrying out their auditing duties.
- Employees, etc. carry out audits on behalf of the audit firms to which they belong concurrently with work for their own offices, and so they do not allocate enough time to the work for the audit firms.
- Top management, quality control manager, etc. do not understand the need to establish quality control systems to maintain the quality of their audits.
- Top management, quality control manager, etc. do not have enough knowledge and experience of working in an audit firm.
- Despite the fact that they are unable to assess the actual level required of a quality control system, top management concludes that the quality control system in their audit office has no

problems and meets the required level.

- The quality control manager does not allocate enough time to working for quality control.

**(ii) Efforts to improve business**

A significant number of audit firms have not implemented sufficient measures to remedy the deficiencies identified in quality control reviews conducted by the JICPA or improved deficiencies to a satisfactory level. One cause is that the audit controller, etc. believes that the deficiencies identified in the quality control review are the fault of the individual audit services or of the audit team which conducted those audit services and therefore they do not properly verify that the deficiencies in their own audit services have been improved.

**(iii) Establishment, notification and operation of internal rules**

There are cases involving deficiencies in the establishment, notification or operation of internal rules. These are caused by the fact that the audit quality control regulations publicized by the JICPA are adopted as internal rules without amending them to fit the actual conditions, etc. at the audit firm, or that the employees, etc. in charge of operations at the audit firm fail to adhere to their own internal rules when carrying out audit services.

**(iv) Compliance with laws and regulations and various standards**

There are cases involving flaws, including the provision of services not specified in a firm's articles of incorporation, prohibitions against employees being involved in work that competes with the work of the firm, and deficiencies relating to entries in business reports and notifications of changes in the articles of incorporation, etc. These cases are due to the fact that the quality control manager, etc. has not clarified the person in charge of verifying that the services comply with laws and regulations and various standards, or has not specified the work flow.

**(v) Information management**

There are cases involving deficiencies where internal information security rules are not distributed to auditors, or where internal information security rules are established but measures specified in the rules to prevent information leaks are not implemented. This is due to the fact that the persons, etc. responsible for information management only establish the form of the internal information security rules and leave the enforcement of those rules to auditors using PCs, etc. (including part-time auditors).

### **(vi) Preventing insider trading**

There are cases involving deficiencies where internal rules are established with reference to the form of the insider trading prevention regulations, but where measures to prevent insider trading as specified in the rules are not implemented. These are due to the fact that the persons in charge of preventing insider trading have not completely grasped the measures that should be implemented based on the internal rules.

### **(2) Concluding new contracts and renewing contracts**

There are cases involving deficiencies in internal procedures for concluding new audit contracts and renewing existing contracts, risk assessment procedures, and cases where, when audit contracts are renewed, check marks are only placed in the check boxes according to the internal rules to indicate that there are no problems and no careful risk assessment is made.

There are cases involving deficiencies in keeping records of the questions to and responses from former auditors, and where important audit-related matters are not transferred from a former auditor to the succeeding auditor clearly or sufficiently.

This is due to the fact that audit controllers, etc. put priority on early commencement of the audit procedures instead of on implementing careful risk assessment procedures, or on implementing a business transfer between the former and succeeding auditor, or on implementing internal procedures in the audit firm in a timely and proper manner. Because of their lack of experience, audit controllers are unable to properly identify or assess the risks in concluding a contract based on the facts obtained from preliminary investigations.

### **(3) Risk Assessment of audit services**

There are many cases where deficiencies in the review process, etc. are not documented in a proper manner and where shortcomings in the audit procedures are overlooked in the review.

These deficiencies are attributed to the following causes.

- Because they believe that audit controllers, etc., always behave in a professional manner, reviewers think that the audit team will have performed the audit procedures in a sufficient and proper manner, and for this reason the reviewers don't carry out their reviews from a critical standpoint.
- Reviewers place priority on their own audit services and don't spend enough time on reviews.
- Reviewers don't have the knowledge and experience needed to carry out a review.

- Audit teams being reviewed don't understand that they must receive an objective appraisal from the reviewer not only for their judgment on important accounting procedures but also for the sufficiency and appropriateness of the audit procedures performed by the auditors.

#### **(4) Cooperation with audit & supervisory board members**

##### **(i) Cooperation with accounting auditors and audit & supervisory board members, etc.**

Some audit firms state that they have informed the audit & supervisory board members, etc., at the audited company of the results of their quality control reviews and the current state of their quality control system as proof of their cooperation.

However, detailed verification of the contents of notifications sent by these audit firms revealed that only cursory remarks to the effect that no important deficiencies were identified in the quality control review are communicated to the audited companies in many cases, and it seems rare for substantive information on any deficiencies identified in the quality control review and the current state of the quality control system at the audited firm, which should be modified based on the review, to be disclosed to audited companies. In many cases, disclosure is given orally, while written disclosure is rare. On the other hand, some audit firms don't give any disclosure to audited companies, claiming that any deficiencies identified in the quality control review are insignificant and there is no need to inform the audit & supervisory board members, or that they have not received a request for disclosure or questions from audit & supervisory board members.

As illustrated above, many of the audit firms inspected tend to avoid exchanges of information or opinions with audit & supervisory board members, etc.

##### **(ii) Responding when fraudulent or illegal acts have been detected**

Some cases are disclosed based on the timely disclosure rules of the Stock Exchange. In addition, there are many cases where, if an audit firm determines that an issue could influence the perceived correctness of the financial statements, the audit firm gives notification to the audited company pursuant to Article 193-3 of the Financial Instruments and Exchange Act, and the audited company takes remedial actions that include amending the quarterly report or improving their internal control system.