

Annual Report

July 2016

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 FY2015 (from April 1, 2015, to March 31, 2016).

To better meet the needs of readers, the Report also includes information on activities taken before and after FY2015.

- 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, government organization which has a council system, was established by the Financial Services Agency (FSA) in April 2004, 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.

The CPAAOB is comprised of the Chairperson and up to 9 Commissioners with understanding and knowledge of matters concerning CPAs who are appointed by the Prime Minister after the approval of 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. They shall not be dismissed against their will except for the reasons stipulated by the laws during their appointed terms (Articles 35-2 and 37-4 of the CPA Act).

The CPAAOB, comprising 10 members (Chairperson Kunio Chiyoda, full-time Commissioner Toshiro Hiromoto, and eight part-time Commissioners), has been in operation for its fourth term (from April 2013 to March 2016) (See Annex 1, page 34).

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, led by the Secretary-General of the Executive Bureau. The Office of Coordination and Examination is in charge of implementing the CPA examinations, investigating and deliberating on disciplinary actions against CPAs, etc., and coordinating general issues 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 JICPA operation, and inspecting audit firms, etc., foreign audit firms and JICPA.

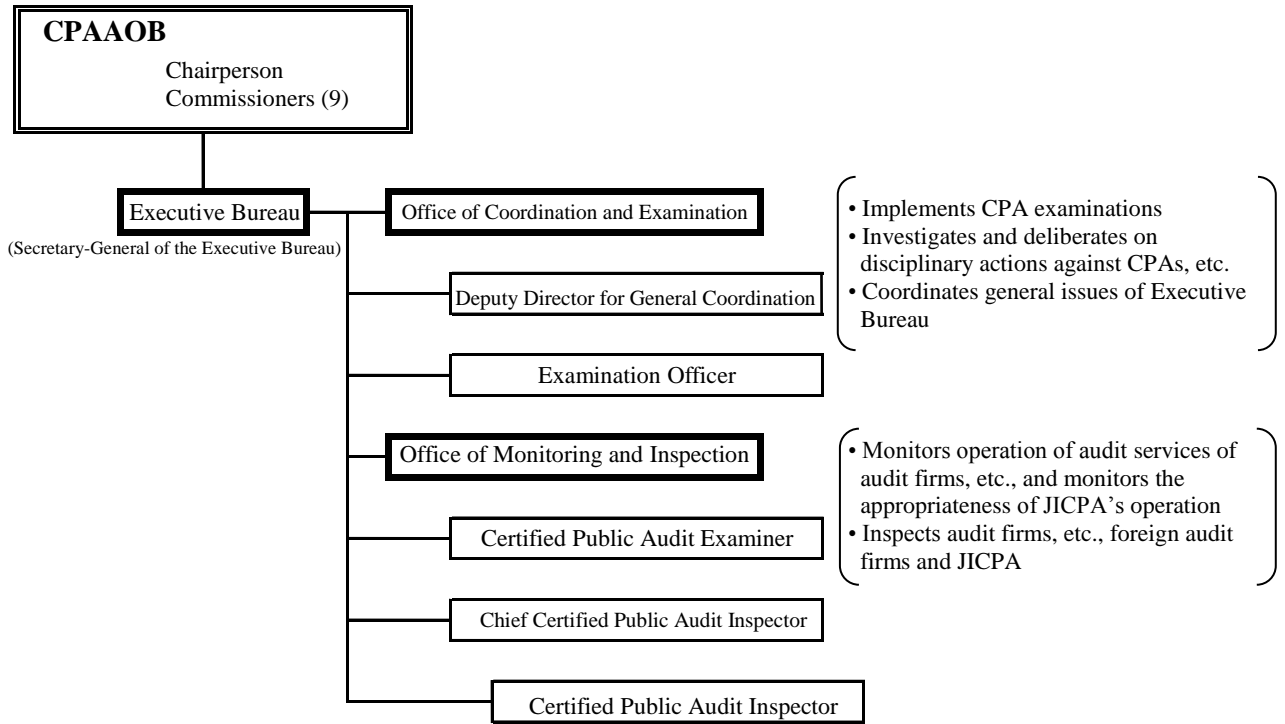
The Executive Bureau had 40 staff members when it was launched in April 2004. Its staff was steadily increased thereafter, to 14 in the Office of Coordination and Examination, and 42 in the Office of Monitoring and Inspection: for a total of 56 staff members on March 31, 2016.

Staffing of the Executive Bureau

(Fiscal year-end basis)

FY	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015
Office of Coordination and Examination	11	12	12	12	12	14	14	14	14	14	14	14
Office of Monitoring and Inspection	29	29	31	35	39	41	44	43	42	42	42	42
Chief Inspectors	4	4	4	4	5	5	7	7	7	7	7	7
Inspectors	18	18	20	24	26	28	28	27	26	26	26	26
Total	40	41	43	47	51	55	58	57	56	56	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 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.

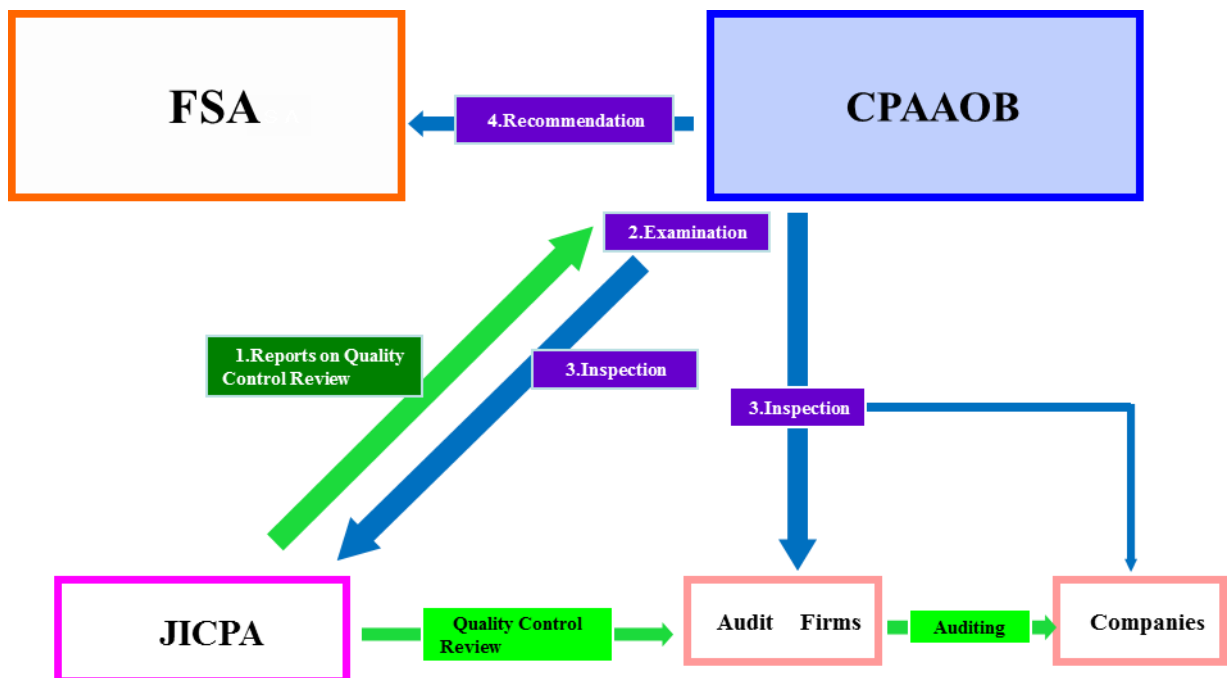
Furthermore, based on the results of examination or inspection, if the CPAAOB considers it necessary, it shall make a recommendation to the Commissioner of the FSA for administrative actions or other measures (Article 41-2 of the CPA Act).

(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 2.3.8(ii) “A framework for Information requirements 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 was 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 International Forum of Independent Audit Regulators (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 FY2015, based on the Basic Policies for Risk Assessment and Inspections mentioned above, the CPAAOB established and published on April 7, 2015, “Audit Firms Monitoring Policy for Fiscal Year 2015 (On-site Monitoring and Inspection)”(see Note), which provided for conducting well-balanced verifications focused on the essential problems in business operations by audit firms depending on their conditions, and laying down the conditions for responses to industry-specific problems which were detected in previous risk assessment and inspections

(Note) With effect from FY2015, the Basic Plan was changed to the Basic Monitoring Plan which covers both on-site monitoring which means inspections and off-site monitoring which means operations other than inspections.

<Summary of the FY2015 Basic Monitoring Plan for Audit Firms, Etc. (Basic Plan for Risk Assessment and Inspections)>

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, the CPAAOB has been making a significantly increasing number of recommendations in recent years to the commissioner of the Financial Services Agency regarding that the business operations of many audit firms were wholly inappropriate. Since inspection resources are limited, it remains important to recognize the actual conditions of audit firms in a more proper manner and implement more effective inspections, etc. depending on their actual conditions.

(i) Basic Plan for Off-site Monitoring

The Basic Plan for Off-site Monitoring states that the CPAAOB shall conduct off-site monitoring to more accurately identify the risks of audit firms and individual audit services by further enhancing and upgrading the system for collecting and analyzing information, etc. through the utilization of reports on JICPA quality control reviews and exchange of views with JICPA and other relevant domestic organizations as well as overseas audit supervisory authorities, etc.

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 stronger leadership by JICPA, including responses to industry-specific problems, and in view of the fact that JICPA's quality control review system was enhanced by changing its function to a guiding and supervisory function and by expanding the number of audit firms and the audit services subject to review .

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 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.

The Plan further states that reports should be collected basically through interviews from the viewpoint of conducting more effective monitoring since

inspection resources are limited, and if serious problems are detected, the facts should be used as important reference information for future on-site inspections.

(ii) Basic Plan for On-site Inspections

The FY2015 Basic Plan for On-site Inspections states that the important matters are: (1) verification whether audit firms' management policies and business management-related measures, etc. are appropriate in light of their size, characteristics, etc.; and (2) verification, etc. whether audit firms conduct audits by properly assessing the business risks of audited companies. In addition, the Plan clearly states that if deficiencies, etc. are detected in the process of inspection, the CPAAOB should verify not only direct causes of such deficiencies but also the root causes thereof and urge audit firms subject to inspection to take the necessary countermeasures.

The Plan states that on-site inspections should be conducted on a regular basis (once every two years), in principle, for top-tier large audit firms (audit firms which audit at least 100 companies or which employ at least 1,000 full-time auditors).

In the case of top-tier large audit firms, it can be determined that quality control has worked effectively to certain degree in view of their past inspection results, etc. Therefore, in this fiscal year, the CPAAOB will select themes thoroughly common to leading audit firms as in the previous fiscal year, and conduct inspections by limiting the scope of verification to said themes and high risk sectors (inspection by theme).

Regarding the themes for FY2015 inspection by theme, the CPAAOB selected "revenue recognition," "accounting estimate, etc.," in which important deficiencies are detected frequently, as common themes, and "verification of the state of compliance with the quality control policy by all departments of the organization, etc." as common themes for this fiscal year in particular in view of results of recent inspections, etc.

In the case of second-tier audit firms, an inspection will be conducted once every two or three years in principle. The Plan states that a priority should be placed on the verification of establishment and state of the operation control system, audit of financial institutions, audit of group companies, etc. from the viewpoint of focusing on risks common to second-tier audit firms.

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 (all of such problems arise from the organization of small and mid-sized audit firms). For this reason, the Basic Plan for On-site Inspections states that the CPAAOB shall conduct inspections of small and mid-sized audit firms, including newly established ones, 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 monitoring, 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 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 integrated 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 FY2015, the number of registered certified public accountants totals 28,286, and the number of audit firms totals 214. Audit firms earn approximately 80% of their business revenues from audit certification work.

Of the above, the number of CPAs belonging to top-tier audit firms is 10,203, while the number of those belonging to second-tier audit firms is 755 (as of the end of March 2015). Audit firms' shares of audits of listed companies are as follows: top-tier audit firms, approx. 73%; second-tier audit firms, approx. 11%; and small and medium-sized audit firms, approx. 16% (as of the end of April 2015, share of the number of the listed companies).

(Reference)

	End of FY2011	End of FY2012	End of FY 2013	End of FY2014	End of FY2015
Number of registered certified public accountants	23,119	24,964	26,260	27,313	28,286
Top-tier audit firms	8,474	9,313	10,074	10,312	-
Number of audit firms	213	214	216	219	214

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

In FY2015, JICPA performed 83 quality control reviews of audit firms (57 audit firms (including 2 top-tier and 2 second-tier audit firms; 6 joint CPA offices), and 26 CPAs). By March 31, 2016, 57 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	2015						2016			Total
	Jul.	Aug.	Sep.	Oct.	Nov.	Dec.	Jan.	Feb.	Mar.	
Number of audit firms reviewed for quality control	4	22	5	16	22	16	7	1	0	83

(ii) Results of Quality Control Reviews

Of 57 cases reported to the CPAAOB, 54 cases included recommendations for improvement. The conclusions of those reports were as follows.

- Unqualified conclusion: 51 cases (32 audit firms, 19 CPAs)
- Qualified conclusion: 6 cases (3 audit firms, 3 CPAs)
- Negative conclusion: None

Also, in FY2015, JICPA performed follow-up reviews (see Note) of 67 audit firms (57 audit firms and 10 CPAs). The results of 60 reviews, which were reported to the CPAAOB by March 31, 2016, were as follows.

- Improvement measures sufficiently completed: 59 cases (50 audit firms, 9 CPAs)
- Improvement measures insufficiently conducted: 1 case (0 audit firms, 1 CPA)

(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 FY2015, the quality control reviews conducted by JICPA in FY2014 and FY2015 were examined. The results of the examination of the FY2014 quality control reviews are as follows. As for the FY2015 quality control reviews, the CPAAOB has progressively commenced examination of 57 cases for which

reports had been received by March 31, 2016.

Quality Control Review Reports (FY2014)					(Number of audit firms)				
Category	Unqualified conclusion		Qualified conclusion		No conclusion is expressed		Negative conclusion		Total
	(a)	a/d	(b)	b/d	(c)	c/d	-	-	
Audit firm	61	89.7%	6	8.8%	1	1.5%	-	-	68
CPA	15	83.3%	3	16.7%			-	-	18
Total	76	88.4%	9	10.5%	1	1.2%	-	-	86

(Note) 80 out of 86 cases include recommendations for improvement.

(ii) Perspectives for examination

The CPAAOB analyzes the particulars of deficiencies in quality control reviews and reports on the conditions of audit firms subject to review, and conducts examinations from the following perspectives:

- 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

2.3.3 Collection of Reports, etc. from Audit Firms

(i) Risk assessment of audit firms

The CPAAOB enhances the risk assessment of the audit firms to make inspections, etc. of them more effective and efficient.

The risk assessment methods include: (1) collection of reports; and (2) cooperation with related departments inside the Financial Services Agency and related organizations, etc. such as JICPA, securities exchanges, the Japan Audit & Supervisory Board Members Association, etc. (see Section 2.4)

(ii) Collection of reports

Of the audit firms subject to quality control reviews, for audit firms (excluding top-tier and second-tier audit firms) for which inspections were not conducted by the CPAAOB, the CPAAOB conducts focused verification of improvements in quality control, collects reports to determine the problems involved in audits, and

basically takes a face-to-face approach, including visiting audit firms.

(a) Collection of reports for focused verification

The “Audit Firms Monitoring Policy for Fiscal Year 2015 (On-site Monitoring and Inspection),” states 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 collect reports in a timely manner, and that concerning reports to be collected in this fiscal year, 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, and that management related items, including the business policy, earnings and financial structures, organization and personnel, in particular, should be included in the items for which reports are collected from audit firms because such items are closely connected with potential operational problems.

In FY2015, based on the policy, the CPAAOB collected reports from 48 audit firms for which it is necessary to check the state of audit quality control, out of 89 audit firms for which JICPA conducted quality control reviews in FY2014. (implemented from August 2015).

(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 FY2014, with the aim of identifying problems involved in the audit industry, the CPAAOB collected reports from 10 audit firms (implemented from August 2015).

History of Collection of Reports for Focused Verification and Fact Finding

	Record of Report Collection in FY2015					Record of Report Collection in FY2014		
	No. of firms undergoing report collection (a)			No. of firms undergoing QC reviews in FY2014 (b)	Report collection ratio a/b	No. of firms undergoing report collection (c)	No. of firms undergoing QC reviews in FY2013 (d)	Report collection ratio c/d
	Focused verification	Fact finding						
Audit firms	58	48	10	89	65.2%	67	93	72.0%
Audit firms	40	34	6	65	61.5%	43	61	70.5%
Individual firms (Note)	18	14	4	24	75.0%	24	32	75.0%

(Note) Including CPA joint office

2.3.4 Inspections of Audit Firms

In FY2015, under the “Audit Firms Monitoring Policy for Fiscal Year 2015 (On-site Monitoring and Inspection)” the CPAAOB conducted inspections of audit firms depending on their conditions, including size. However, the number of on-site inspections in FY2015 sharply decreased from 15 in the previous fiscal year to 9 for the main reason that inspection resources were concentrated on audits of top-tier audit firms for which recommendations were sent to the Commissioner of the FSA.

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.

Status of implementation of inspections in most recent five years

	FY2011	FY2012	FY2013	FY2014	FY2015
Number of inspections	9	11	13	15	9

In the inspection of Ernst & Young ShinNihon LLC conducted in the current fiscal year, the CPAAOB inspected, in a focused manner, the audit company’s status of quality control of individual audit engagements, in particular, in which accounting fraud issues were identified. As a result, it was found that the audit firm’s operations were not in compliance with the law, the CPAAOB recommended that the Commissioner of the FSA take administrative actions and other measures against them.

2.3.5 Recommendations to the Commissioner of the Financial Services Agency (FSA)

As a result of inspection, the CPAAOB found that the following audit firms performed audit services in a grossly inappropriate manner. Pursuant to the provisions of Article 41-2 of the CPA Act, the CPAAOB recommended that the Commissioner of the FSA take administrative actions and other measures against them:

- Jinchi Audit Corporation (June 19, 2015)
- Ernst & Young ShinNihon LLC (December 15, 2015)
- Meisei Audit Corporation (January 12, 2016)
- KDA Audit Corporation (March 24, 2016)

2.3.6 Follow-up of improvements after the notification of inspection results

The “Basic Policy for Risk Assessment and Inspections – To Ensure the Implementation of More Effective Audits –” states 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.” Based thereon, the “Audit Firms Monitoring Policy for Fiscal Year 2015 (On-site Monitoring and Inspection)” states that “the CPAAOB shall collect reports from audit firms when a certain period of time has elapsed since giving notice of inspection results, so as to, if necessary, check and verify their status of quality control.”

In FY2015, the CPAAOB collected reports from four audit firms out of all the audit firms to which inspection results were notified in order to check and verify the status of improvements with regard to deficiencies detected in inspections.

2.3.7 Dissemination of Information

(i) Preparation and publication of “Case Report from Audit Firm Inspection Results”

From the viewpoint of securing and improving the level of audit quality of audit firms, the CPAAOB annually reviews and revises the Case Report, which was published in February 2008. In FY2015, the CPAAOB published a revised version thereof in July 2015 in which the CPAAOB introduced cases of deficiencies for the issues, etc. identified in inspections conducted up to FY2014 and added or deleted certain issues with the aim of contributing to the improvement of common deficiencies (see Annex 2, page 35). The English version was similarly revised and published in December 2015.

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 (summary of deficiencies, analysis of their causes, and commendable efforts), and actions to be taken by audit firms, and introduces the particulars of deficiencies in a concrete manner.

In the Case Report issued in this fiscal year, an “Investigation of Root Causes” part was added in addition to the Quality Control System part and the Individual Audit Engagements part, and the root causes identified in past inspections are broken down into patterns and examples are introduced.

(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 FY2015, the CPAAOB delivered nine lectures for certified public accountants at eight workshops hosted by JICPA across Japan from October to December 2015, 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 2015 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 internal audit departments, etc., to introduce its activities and future challenges.

In FY2015, 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) to introduce various issues, etc. identified during its inspections of audit firms.

2.3.8 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, 2016, 88 audit firms, etc. from 31 countries)

Number of notifications of foreign audit firms, etc. (as of March 31, 2016)

	Number of countries/regions	Number of audit firms, etc.
North America	3	14
Central & South America	2	2
Europe	15	43
Asia & Pacific	10	28
Middle East	1	1
Total	31	88

(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

The Basic Guidelines state that the CPAAOB should ask, once every three years in principle, foreign audit firms, etc. who submit a notification to the FSA and analyze and evaluate the particulars of the materials submitted. In this fiscal year, the CPAAOB will collect reports from 71 foreign audit firms from 27 countries under the Certified Public Accountants Act from November 2015.

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, stock exchanges and the Japan Audit & Supervisory Board Members Association (JASBA).

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 considered important to identify the actual conditions of control activities through reviews of member firms of networks of international audit firms, the CPAAOB exchanges opinions with executives and reviewers of leading networks.

2.4.1 Cooperation with Relevant Divisions of the Financial Services Agency

When conducting inspections of one of the top-tier audit firms for which the above-mentioned recommendations were sent to the Commissioner of the FSA, the CPAAOB timely cooperated, as far as possible, including the exchange of information, with the Securities and Exchange Surveillance Commission which investigated companies audited by the above audit firms and the Planning and Coordination Bureau which investigated the issue of false certification for the audited companies.

In addition, since it is expected that cooperation with relevant FSA divisions which investigate or inspect companies subject to audit will enable more effective and efficient inspection, etc. of audit-related issues, etc. in individual audit engagements, the CPAAOB positively enhanced cooperation with the relevant FSA divisions (Planning and Coordination Bureau, the Securities and Exchange Surveillance Commission, etc.), including information sharing and exchange of opinions. Furthermore, for the purpose of information sharing, the CPAAOB provided local finance bureaus with information concerning the state, etc. of audits which are conducted by small and mid-sized audit firms whose principal offices are located in local areas or by local offices of large audit firms.

2.4.2 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 public interest standpoint, 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's executives and reviewers on problems identified through risk assessment and inspections.

In FY2015, the CPAAOB exchanged opinions with JICPA about various challenges concerning the "enhancement of the system to conduct quality control reviews," the "guidance and supervision after quality control reviews" and the "Registration System for Listed Company Audit Firms" as well as measures to enhance communication between external auditors and internal auditors and the issues surrounding quality control reviews detected in inspections, etc. of the CPAAOB..

2.4.3 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 FY2015, the CPAAOB exchanged opinions with the Tokyo Stock Exchange, the Sapporo Stock Exchange and the Fukuoka Stock Exchange concerning audit-related challenges, etc.

2.4.4 Cooperation with the Japan Securities Dealers Association (JSDA)

In recent years, the CPAAOB has identified audit-related issues for companies, etc. registered on the green sheet market.

In view of the above, the CPAAOB cooperates, in FY2015, with the JSDA which self-regulates member companies, including securities companies, and operates the green sheet market, exchanges opinions on a regular basis with the JSDA on various audit-related issues with respect to securities companies, and makes efforts to take the same stance on various issues.

2.4.5 Cooperation with the Japan Audit & Supervisory Board Members Association (JASBA)

Considering that cooperation with auditors and those charged with governance 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 those charged with governance. and auditors in the course of inspections, etc. of audit firms. In addition, as a result of the revision of the Companies Act and the implementation of the Corporate Governance Code from June 2015, the roles and duties of those charged with governance have become increasingly important.

Therefore, the CPAAOB exchanged opinions with the JASBA concerning various issues,

etc. relating to communication between those charged with governance and auditors. Furthermore, those charged with governance were provided with information on deficiencies identified in inspections and problems, etc. of audit firms through lecture meetings, etc. held by the JASBA. Then, the CPAAOB asked those charged with governance to answer a questionnaire about the CPAAOB's Case Report from Audit Firm Inspection Results in order to collect information on the Case Report.

2.5 Future challenges

2.5.1 Improvement of effectiveness of inspections mainly for top-tier audit firms

Recent accounting fraud issues have raised questions about the reliability of accounting audits.

Under such circumstances, it has been recognized that it was difficult for the CPAAOB's inspections of top-tier audit firms which are huge organizations consisting of thousands of personnel in particular, including inspections of quality control systems at the lowest level of the organizations, to identify the real causes of organizational operation-related problems, etc.

Therefore, the CPAAOB examined the particulars of past inspections and inspection methods, etc. for audit firms, mainly top-tier audit firms, with the objective of further improving the effectiveness of audits in consideration of the risks to audit firms, and compiled and publicized the examination results in the report titled "Improvement of Effectiveness of the CPAAOB's On-site Inspections—Mainly for Large Audit Firms—" in March 2016.

In the future, the CPAAOB will make a specific study on the implementation for each of the items written in the "future responses" of the report and take responses in a timely and appropriate manner.

2.5.2 Enhancement of the self-regulating functions of JICPA, including further improvement of its function of quality control review

With respect to the strengthening of JICPA's self-regulating functions, including the further improvement of functions of JICPA's quality control reviews, which were stated in the recommendations of the "Advisory Council on the Systems of Accounting and Auditing," which was publicized in March 2016, the CPAAOB has continued, since its foundation, to review the appropriateness of quality control review systems and

operations and to conduct a two-way discussion with JICPA with the aim of stimulating further improvement of the functions of quality control reviews conducted by JICPA from a public standpoint.. In particular, 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.

The CPAAOB needs to strongly promote a framework whereby feedback on CPAAOB activities is given directly and indirectly to JICPA through the two-way exchange of views and results of inspections, etc. and to strengthen cooperation with JICPA for the purpose of enhancing its self-regulating functions, including the quality control review and the registration system for listed company audit firms.

2.5.3 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.

In the recommendations of the “Advisory Council on the Systems of Accounting and Auditing,” which was publicized in March 2016, the CPAAOB is required to enhance the provision of information on its monitoring activities in order to visualize the quality of audits.

With regard to problems in audit firms identified through examinations and inspections which constitute a central part of the information on the CPAAOB’s monitoring activities, the CPAAOB believes that in addition to voluntary improvements at audit firms, it is important to get an overall picture by conducting analyses in such a way as to extract cross-sectional industry-wide problems, to revise the Case Report with a view to enhancing the provision of information on the quality of audits which is provided to the general public, and to actively disseminate the information concerned.

At the same time, it is important for the CPAAOB to enhance the provision of information on the quality of audits which is provided to the general public by compiling the results of its monitoring activities, including inspections, into a

monitoring report and publicizing the same.

2.5.4 Enhancing the structure for addressing problems surrounding audits firms

The results of recent 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.

Given these circumstances, the CPAAOB believes it important to enhance its inspection system, including the procurement of personnel and the enhancement of its information collection system, so that its inspections will be carried out in a proper manner.

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 audit quality was recognized, and since 2002, audit oversight regulators independent from the accounting profession have been established in jurisdictions throughout the world.

Amid such circumstances, the first unofficial meeting of audit oversight regulators was held in Washington, D.C., in September 2004, organized by the Financial Stability Forum (FSF) (see Note), for the purpose of sharing information among respective members' jurisdictions. The meeting was attended by nine jurisdictions: Japan, USA, UK, Germany, France, Italy, Canada, Australia, and Singapore. Subsequently, a series of further informal meetings were held. Momentum was gathered for the establishment of a permanent international forum, and at the fifth meeting of audit oversight regulators held in Paris in September 2006, formal approval was given for the establishment of the International Forum of Independent Audit Regulators (hereinafter the "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, 15 meetings have been held by the end of March 2016; and the number of jurisdictions has grown to 51 as of March 2016.

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 audit quality.

(Note) In light of the declaration of the second Summit on Financial Markets and the World Economy (London Summit), held in April 2009, 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) Activities of IFIAR

The IFIAR's Charter specifies the following as 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 meeting at which all member authorities can 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 2016, the Advisory Council comprises the seven jurisdictions of Australia, France, Germany, Japan, Singapore, UK and the U.S.

As of the end of March 2016, there are six working groups established in the IFIAR, and the goals of which are described below.

(a) Global Audit Quality 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 respective standards-setting bodies that set auditing standards.

(c) Inspection Workshop Working Group

This WG plans, coordinates and evaluates IFIAR inspection workshop. This workshop is held every year for the purpose of skills training for inspectors and to share inspection methods and experiences.

(d) Investor and Other Stakeholders Working Group

The aim of this WG is to engage in dialogue with investors and other stakeholders as users of audit reports on issues such as the audit quality and what audit reports ought to be like. The WG also plans and coordinates the exchange of views with investor representatives at the IFIAR plenary meeting.

(e) International Cooperation Working Group

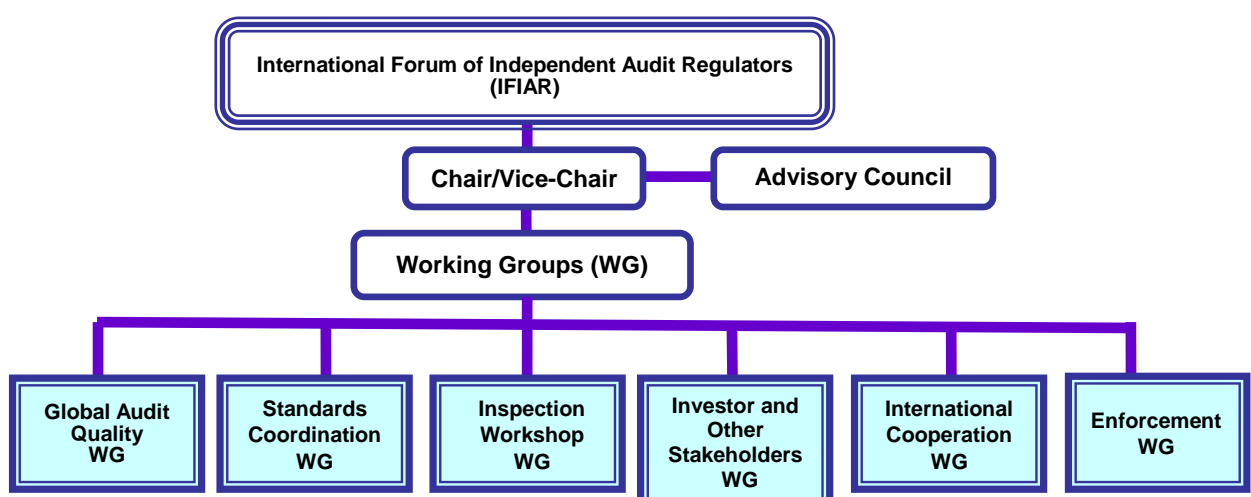
The aim of this WG is to promote the practical exchange of information on regulations and inspections between audit oversight authorities and to work on establishing the Multilateral Memorandum of Understanding (MMOU) concerning co-operation in the exchange of information for audit oversight.

(f) Enforcement Working Group (see Note)

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 *Main Activities of the IFIAR and Japan's Contribution*

(i) Plenary meeting

The 15th plenary meeting was held from April 21 to 23, 2015, and was hosted by Taiwan's Financial Supervisory Commission (FSC).

At the meeting, a basic agreement was reached on the Multilateral Memorandum of Understanding (MMOU) concerning co-operation in the exchange of information for audit oversight, and the business models and audit reports, etc. of audit firms were discussed.

(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 limited to the Officers, the members of the Advisory Council, and Working Group Chairs, etc. has been held to conduct high-level discussions on management, etc. of the IFIAR's work. In 2015, the Interim Meeting was hosted in Tokyo on October 8 and 9.

(iii) Global Audit Quality Working Group

Discussions are held concerning audit firms' business models, including changes in their earnings structure, personnel strategy and global governance of networks of international audit firms. In FY2015, joint inspections of member audit firms of leading networks were conducted for the first time by audit oversight authorities in different jurisdictions from the viewpoint of verifying the effectiveness of group audits of multinational enterprises. The joint inspections were conducted under the initiative of Japan.

(iv) Inspection workshop

At the first IFIAR plenary meeting in Tokyo, it was agreed that the inspection workshop 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 workshop has been held every year, with planning and coordination provided by the Inspection Workshop Working Group.

This fiscal year, the workshop was held between February 22 and 24, 2016, and was hosted by the Abu Dhabi Accountability Authority (ADAA) More than 160 inspectors and others participated from 34 jurisdictions, including Japan. Japan dispatched three moderators from the CPAAOB, etc.

(v) Situation for the hosting of a Permanent Secretariat

In recent years, the IFIAR has been rapidly transformed from just a forum among members' jurisdictions to an organization conducting practical activities as an international organization. In addition, it is increasingly necessary for the IFIAR to enhance its relationships with other international organizations, including the Financial Stability Board (FSB), the International Organization of Securities Commissions (IOSCO) and the Basel Committee on Banking Supervision (BCBS). Under these circumstances, the establishment of a permanent secretariat was discussed at the Washington, D.C., plenary meeting in April 2014.

From the viewpoint of international contribution to the improvement of audit quality through the IFIAR, improvement of Japan's influence in international financial regulatory activities, including audits, and contribution to the establishment of Tokyo's status as an international financial center, the CPAAOB and the FSA ran, in January 2015, for candidacy to host the permanent secretariat to be established. The CPAAOB and the FSA, in cooperation with related ministries and agencies, have been lobbying member authorities of the IFIAR for their supporting of Tokyo as the host country of the permanent secretariat.

Up to March 2016, the Tokyo Metropolitan Government and a number of Japanese and overseas private associations (see Note) have issued press releases supporting the establishment of the permanent secretariat in Tokyo.

(Note) Associations, etc. which have issued press releases supporting the establishment of the permanent secretariat in Tokyo

The Tokyo Metropolitan Government, the Japan Business Federation (JBF), the Japan Association of Corporate Executives (JACE), the Tokyo Chamber of Commerce and Industry (TCC), the Japan Exchange Group, Inc. (JPX), the Japanese Institute of Certified Public Accountants (JICPA), the Japanese Bankers Association (JBA), the Japan Securities Dealers Association (JSDA), the Investment Trusts Association, Japan (JITA), the Japan Investment Advisors Association (JIAA), the Financial Futures Association of Japan (FFAI), the Type II Financial Instruments Firms Association, the Life Insurance Association of Japan (LIAJ), the General Insurance Association of Japan (GIAJ), the Japan Audit & Supervisory Board Members Association (JASBA), the Institute of Internal Auditors-Japan (IIAJ), the Japan Auditing Association, the International Bankers Association (IBA), the American Chamber of Commerce in Japan (ACCJ), the European Business Council (EBC), the U.S.-Japan Business Council, Inc. (USJBC) and the Japan-U.S. Business Council (JUSBC)

3.3 Bilateral Cooperation

In light of the globalization of corporate activities, ensuring the quality of audit procedures that, such as using the audit results of overseas audit firms in the audit of consolidated financial statements, has become globally more important than ever before. Moreover, enhancing cooperation with foreign audit oversight authorities, etc. has become indispensable for establishing a global audit oversight system. In addition to activities at the IFIAR, for the purpose of sharing information on international audit firms and audits and inspections' issues, the CPAAOB has been also constantly exchanging views with audit oversight authorities from various jurisdictions and has been striving to build and enhance its bilateral cooperative relationships with foreign audit oversight authorities, including the establishment of a framework for exchanging information on audit supervisory activities (see Note), to facilitate its examination and inspection activities .

(Note) Overseas authorities which have a framework for exchanging information on audit supervisory activities with Japan

- The U.S. Public Company Accounting Oversight Board (PCAOB)
- The Canadian Public Accountability Board (CPAB)
- The Audit Oversight Board of Malaysia (AOB)
- The Netherlands Authority for the Financial Markets (AFM)
- The Commission de Surveillance du Secteur Financier (CSSF)
- The U.K. Financial Reporting Council (FRC)

3.4.1 Future challenges

(1) Strengthening cooperation with foreign audit oversight authorities

Given that the globalization of corporate activities has led to the advance of cross-border audit services, such as the use of the audit results by overseas audit firms in the audit of consolidated financial statements of internationally active enterprises, ensuring audit quality globally is a challenge. Under these circumstances, special attention also needs to be paid to the quality control method in the whole network of international audit firms, the introduction of the data analysis method in audits, and the effects that the global economic and financial situation, etc. has on the audit quality.

Based on such perspectives, the sharing of global audit issues and human exchange on multilateral and bilateral bases by making use of opportunities, including

meetings, etc. of the IFIAR, etc., are considered important. The CPAAOB needs to proceed with negotiations toward developing frameworks for the exchange of information between audit oversight authorities.

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

Regarding international trends in discussion on accounting and audit systems, the CPAAOB believes it important to analyze the potential impact of discussions conducted at international organizations and in multiple countries on audit firm activities and the CPAAOB's operations, etc. and to take appropriate measures, as needed, including translating the results of audits of audit firms and the CPAAOB's inspections.

**List of Members of
Certified Public Accountants and Auditing Oversight Board
(CPAFOB)
(As of March 31, 2016)**

Chairperson (full-time)	Kunio Chiyoda	Former Professor Graduate School of Accountancy, Waseda University
Commissioner (full-time)	Toshiro Hiromoto	Professor Emeritus Hitotsubashi University
Commissioner (part-time)	Yasuyoshi Ichikawa	Board Member Deloitte Touche Tohmatsu LLC
Commissioner (part-time)	Akiko Kimura	Of Counsel Anderson Mori & Tomotsune Outside Corporate Auditor Fuji Electric Co., Ltd. Outside Corporate Auditor Daiichi Sankyo Co., Ltd. Outside Director Nomura Asset Management Co., Ltd.
Commissioner (part-time)	Michiyoshi Sakamoto	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	Executive Managing Director 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

About “Case Report from Audit Firm Inspection Results”

1. Introduction

From the viewpoint of maintaining and 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 Report from Audit Firm Inspection Results.” These Case Reports have been publicized every fiscal year.

In the Case Report issued on July 21, 2016, the “Root Cause Analysis” part was added in addition to the quality control system part and the individual audit engagements part, and key elements of the Report are as follows:

- In the “Root Cause Analysis” part, the importance of examining root causes is mentioned, the root causes identified in past inspections by the CPAAOB are broken down into patterns, and descriptions of actual cases are introduced so that such root causes will be understood.
- In the “Quality Control System” part, examples of identified deficiencies are introduced in detail for each quality control item, with descriptions of “points of focus” in inspection, “outline of inspection results” (“observed effective efforts,” “outline of identified deficiencies” and “analysis of causes of deficiencies”) and “expected response” by audit firms. In particular, from the “Management Systems” to “Joint Audit” in the “Analysis of causes of deficiencies” topic, direct causes of deficiencies and their analysis are described results of direct causes.
- In the “Individual Audit Engagements” part, the same items as those of the Auditing Standards Committee Statement were adopted, while separate items were adopted for: the audit for accounting estimates in which many deficiencies are concentrated; the audit of financial institutions for which a higher priority is placed on inspection than other industries; fraud in the audit of financial statements for which future development by audit firms must be watched; and the audit of internal control over financial reporting to which standards different from those for the audit of financial statements apply. Each section describes the “points of focus” in the inspection, “outline of inspection results,” and “expected response,” followed by examples of identified deficiencies, while “points to note” to remember when performing audit procedures to improve deficiencies are appended.

The CPAAOB hopes that audit firms, with reference to identified deficiencies and their root causes, etc. which are stated in the Case Report, will inspect their quality control systems including individual audit engagements, and if deficiencies are identified in their quality control systems, they will not only improve such deficiencies but also investigate the relevant root causes to remove them.

This paper only summarizes the “Root Cause Analysis” part and the “Quality Control System” part of the Case Report. For full texts, including examples of detailed actual cases, please refer to the

website of the CPAAOB.

(<http://www.fsa.go.jp/cpaaob/shinsakensa/kouhyou/20150721/01.pdf>)

2. Root Cause Analysis

In addition to the analysis of the direct cause of a deficiency, the audit firm must identify the root cause that brought about the direct cause and develop improvement measures based on the analysis of the root cause. A deficiency detected in an inspection may be only a part of a greater deficiency. It is likely that the auditing firm has other undiscovered deficiencies arising from the same root cause. Moreover, there may be a root cause that would offset the effect of the improvement measures implemented to eliminate the direct cause of the deficiency. Improvement measures developed only to eliminate the direct cause, without considering the root cause of the deficiency, would not be effective or sufficient for improving the quality control system of the entire firm, and would not lead to a fundamental improvement; thus the quality of the audit by the audit firm would not be improved.

The root causes of deficiencies identified in past inspections by the CPAAOB are generally categorized into the following main types:

- 1) Problems concerning the management systems, management policies (including policies of assessment and compensation and other incentives) or business models of audit firms;
- 2) Problems concerning the quality control efforts by the CEO and other partners; and
- 3) Problems concerning partners' awareness of their duties, mutual check and balance among partners.

Furthermore, root causes include problems concerning audit firms' business condition, composition of the staff members' job classes, and the work place climate of the firm related to quality control.

Audit firms must recognize the importance of analysis of root causes of deficiencies. Concerning deficiencies identified in quality control reviews, cyclical inspections or other occasions, the audit firms must not only improve such deficiencies but also make efforts, by referring to the following examples, to improve their quality control systems by analysis root causes and taking effective measures.

(1) Cases concerning management system, management policies (including policies of assessment and compensation and other incentives) or business model of the audit firm

- The CEO tends to attach higher value to business expansion than to quality control of audits. For example, the CEO reflects partners' business performance in their assessment and compensation but does not reflect partners' quality of audit engagements and compliance with professional ethics in their assessment.
- Partners' compensation is determined based on the profit and loss of audit teams under their control, and partners tend to regard audit teams as their own firms. Each audit team tends to improve quality control or resolve problems only inside the team, and partners of other engagement teams find it difficult to make comments on such problems.

- All partners of an audit firm are allowed to engage in their own private practice. Partners other than the CEO are least involved in the audit firm's quality control matters, the audit firm is unable to establish a system to conduct an organizational audit. In such conditions, the CEO can't govern the firm effectively.
- Partners believe that they can earn stable audit income only if they maintain a good relationship with the entities who received their audits. Therefore, they are primarily interested in maintaining good relationships with their entities and awareness of their basic duty to conduct an audit for the benefit of investors and creditors slips.

(2) Cases concerning quality control initiatives of the CEO, etc.

- Under the situation where the CEO and the person in charge of quality control (hereinafter "PICOQC") have not been involved in the business operations of an audit firm, or have not worked on audit engagements for listed companies as engagement partner or equivalent until they joined the current audit firm, they are less willing to enrich their knowledge and therefore their understanding of the level required for audit is insufficient.
- The CEO and the PICOQC fail to understand the level of the quality control system which is required under the audit standard. They mistakenly assume that their audit firm makes enough effort to improve its quality control system.
- The partners involved in the management of the audit firm, including the CEO, have no sense of danger regarding the quality of audit conducted by their audit firm, and therefore they fail to establish and implement measures to rapidly improve the audit quality of all audit engagements conducted by their audit firm to a specific level or higher.
- Although he/she is finally responsible for the quality control system, the CEO fails to establish a system to improve the level of audit quality of the audit firm and implement organizational audits. Although the PICOQC must establish and implement the quality control system, he/she fails to understand its importance.
- While the CEO and other management recognize that the ratio of CPAs having sufficient experience of audit to act as engagement partner is low, they fail to make a full study on necessary measures to procure audit team members with appropriate capabilities.
- The CEO is overconfident that he/she can understand the audit risk of an audited company for the reason that he/she has long been involved with the audited company since he/she operated his/her own private auditing office or that he/she assesses the risks of the entity by himself/herself to which the audit firm is providing audit service for the first time.

(3) Cases concerning partners' awareness of their duties, mutual check and balance among partners

- Under the situation where the ratio of CPAs with limited experience is higher than that of experienced CPAs, individual partners believe that the CEO and the PICOQC shall be responsible for quality control of the services of the audit firm as a whole. Thus, partners are not aware of their duties or roles to contribute to the maintenance and improvement of audit quality

of the audit firm as a whole.

- The audit firm was established based on the private auditing office of the CEO and the CEO played a central role in the acceptance of major engagements. Therefore, partners other than the CEO understand that the audit firm is still a private business of the CEO, and rely on the CEO for most of the management of the audit firm.
- Partners are not aware of their duties to critically monitor and inspect the quality of audit engagements that other partners are in charge of from an equal standpoint.
- Since the board of partners is finally responsible for the quality control system, partners have a duty to contribute to the establishment and operation of the audit firm's quality control system as members of a Partners Meeting. However, the CEO and partners are not aware of their duties in operating the audit firm, and therefore the Partners Meeting did not function effectively.

3. Quality Control System

(1) Audit Management Systems

a. Quality control system

(Outline of identified deficiencies)

In some audit firms, primarily small and medium-sized audit firms, quality control operation is excessively concentrated on the CEO. In other audit firms, they adopted the template of the Audit Quality Control Regulations established by JICPA without customizing it to their actual operations, the improvement measures were not fundamental, and efforts to establish and operate the quality control system were insufficient. In other firms, the CEO, the PICOQC or equivalent, fail to check the effectiveness of quality control and therefore they do not fully perform their quality control duties.

(Cause analysis of identified deficiencies)

Causes of identified deficiencies are that the audit firm's governance capacity, including the CEO's leadership, is insufficient, that the CEO and the PICOQC are insufficiently experienced, and that the CEO makes light of quality control or the CEO's sense of crisis is weak.

b. Initiatives to improve audit engagements

(Outline of identified deficiencies)

There are some audit firms, primarily small and medium-sized audit firms, where the measures to improve deficiencies in quality control review are insufficient, and measures to improve multiple deficiencies are not taken or insufficient.

(Cause analysis of identified deficiencies)

Causes of identified deficiencies are that the PICOQC fails to investigate root causes in full consideration of the intent of indications made in quality control review, and that the audit firm is not willing to improve the entire audit operations.

c. Establishment, dissemination and implementation of internal rules

(Outline of identified deficiencies)

There are some audit firms, primarily small and medium-sized audit firms, where deficiencies were identified with respect to: the establishment of internal rules concerning independence and non-audit services; the notification of internal rules to part-time audit practitioners; and the operation of internal rules concerning the Partner's Meeting.

(Cause analysis of identified deficiencies)

Causes of identified deficiencies are that the audit firm members' understanding of laws, and standards as the basis of their internal rules is insufficient, and that the audit firm adopts the template of the "Audit Quality Control Regulations" as their internal rules without customizing to their actual operation.

d. Compliance with laws, regulations and professional standards

(Outline of identified deficiencies)

There are some audit firms, primarily small and medium-sized audit firms, where deficiencies were identified relating to the internal rules concerning the non-compete obligation of partners, and where violations of laws and rules were identified relating to the fulfillment of requirements of partners for operational control or the notification of a change to their articles of incorporation.

(Cause analysis of identified deficiencies)

Causes of identified deficiencies are that the PICOQC or equivalent fails to fully understand the applicable laws, regulations and professional standards, or did not appoint practitioners to take charge of confirmation of regulatory compliance of each task that requires such confirmation, and did not establish a clear and concrete workflow for confirmation.

e. Information security management

(Outline of identified deficiencies)

There are some audit firms, primarily small and medium-sized audit firms, where the following deficiencies were identified: the preventive measures against information leakage set forth in the audit firm's internal rules on information security are not implemented in a proper manner; the audit firm's internal rules on information security are not distributed to part-time audit practitioners; and internal rules to control the use of the internet server service for the firm's operation are not established.

(Cause analysis of identified deficiencies)

Causes of identified deficiencies are that the information security manager or equivalent establishes the internal rules on information security management only for formality's sake and leaves the operation of the internal rules to audit practitioners (including part-time audit team members) using computers and other information devices, and that the person in charge of information security management or equivalent fails to update the internal rules on information

security management depending on actual conditions of use of information equipment at the audit firm.

f. Prevention of insider trading

(Outline of identified deficiencies)

There are some audit firms, primarily small and medium-sized audit firms, where the internal rules are established by referring to the template of the “Rules for Preventing Insider Trading” but the operation of such internal rules is insufficient.

(Cause analysis of identified deficiencies)

Causes of identified deficiencies are that the person in charge of the prevention of insider trading fails to exhaustively identify the insider trading preventive measures which must be implemented based on the internal rules.

(2) Acceptance and Continuance of Engagements

a. Assessment of risks associated with acceptance of audit engagement

(Outline of identified deficiencies)

The acceptance and continuance of audit engagements is a central matter in the audit firm’s managerial judgment. However, there are audit firms, primarily small and medium-sized audit firms, where the following deficiencies were identified: before the acceptance and continuance of audit engagements, the information, of the audited company which is obtained by the prospective engagement partner is not shared with the partners having authority to approve the acceptance and continuance of audit engagements (members of the Partners’ Meeting) and as a result, a deep risk assessment is not conducted.

(Cause analysis of identified deficiencies)

Causes of identified deficiencies are as follows.

- The prospective engagement partner prioritizes the acceptance and the early start of the audit engagement over the timely and appropriate implementation of careful risk assessment and resolution of problems.
- The prospective engagement partner lacks the experience necessary to make a proper judgment on potential management fraud, and problems related to internal control audits, accounting estimates and other matters. Therefore, the prospective engagement partner fails to properly identify and assess the audit risk based on facts which were obtained through preliminary audit or information provided by the predecessor auditor.
- When discussions were made among partners to determine whether a new audit engagement should be accepted or not, they failed to understand the importance of risk assessment to be made by the audit firm as a whole based on information which was obtained from the predecessor auditor, and partners other than the prospective engagement partner are not willing to critically examine an audit engagement which another partner has procured.

b. Communication between predecessor and successor auditors

(Outline of identified deficiencies)

There are some audit firms, primarily small and medium-sized audit firms, where deficiencies were identified, including the case that inquiries for the predecessor auditor are not made in a proper manner.

(Cause analysis of identified deficiencies)

Causes of identified deficiencies are that the prospective engagement partner prioritizes the early acceptance and start of an audit engagement over the implementation of the careful risk assessment and resolution of problems, or over the timely and proper implementation of procedures to be taken by the audit firm.

(3) Engagement Quality Control Review

(Outline of identified deficiencies)

Many deficiency cases were identified, including the case where with respect to appropriateness and sufficiency of the audit procedures for important audit matters and judgment process, the engagement quality control reviewer fails to conduct an e review from a critical viewpoint and therefore an effective audit is not conducted (for example, deficiencies of important audit procedures in individual audit engagements are not detected or prevented). Thus, there still exists an important challenge to enhance the engagement quality control review system. Other deficiency cases were found where an engagement quality control reviewer having abilities corresponding to the audit risk was not appointed.

(Cause analysis of identified deficiencies)

Causes of identified deficiencies are as follows.

- A person who has sufficient knowledge, experience and capability necessary for responding to audit risks and can spend enough time in the engagement quality control review is not assigned as the engagement quality control reviewer.
- Under the situation where there is an insufficient number of partners who have the knowledge and experience necessary for conducting engagement quality control review, the audit firm fails to take measures to acquire and develop persons who have competence as engagement quality control reviewers.
- The quality control reviewer is not fully aware of his/her duty to objectively evaluate the sufficiency and appropriateness of important decisions made, or audit procedures followed, by the audit team, including the case where the engagement quality control reviewer assumes through daily communications with the engagement team that the audit procedures followed by the engagement team are sufficient and appropriate.
- Under the situation that only a small number of partners conduct the business operations of the audit firm, the engagement quality control reviewer prioritizes his/her own audit engagements and doesn't spend enough time in the engagement review.

- The engagement team fails to properly inform the engagement quality control reviewer (including the case where this job is outsourced to an external quality reviewer) of the conditions of the audited company or the details of important considerations in writing or by other means, and as a result the risk awareness is not shared by the audit team and the engagement quality control reviewer.
- The audit team fails to understand the necessity of obtaining the engagement quality control reviewer's objective assessment of the sufficiency and appropriateness of the audit procedures followed by the audit practitioners.

(4) Cooperation with Those Charged with Governance

a. Cooperation between accounting auditors and those charged with governance

The necessity of cooperation between accounting auditors and those charged with governance has been increasingly understood, although gradually, by the parties concerned. Although there is a variability in degree of cooperation, communications are now held on a regular basis.

However, the particulars of notifications concerning the quality control review which are sent from audit firms to those charged with governance reveal that in many cases, recommendations for improvement are given to those charged with governance in the quality control review process but only the conclusion that "no material deficiencies were identified in the quality control review" is verbally notified to those charged with governance, instead of in writing, because the overall quality control review conclusion was satisfactory with improvement recommendations.

There are certain audit firms where they only gave a notice on the fact of implementation of a quality control review to those charged with governance, instead of informing of the results of review, for the simple reason that they did not ask any questions.

It should be noted that Audit Standards Committee Statement No. 260 "Communication with Those Charged with Governance," revised in May 2015, stipulates that when performing an audit of an entity, the audit firm should keep close communication with those charged with governance in the entity regarding particularly important matters, and specifies matters that should be communicated to those charged with governance, including the results of the quality control review or the CPAAQB's inspection as part of explanations made by the accounting auditor regarding the establishment and operation of a quality control system.

b. Responses when fraud or illegal acts are identified

(Observed effective efforts)

Audit firms' effective efforts include the case where when regulations concerning responses to be taken when legal violations are identified were introduced in the Financial Instruments and Exchange Act, a certain audit firm made its partners and employees fully informed of such provisions by clarifying an example of notification to those charged with governance of the audited company when legal violations are identified.

Another commendable initiative is the case where with respect to the matter for which a

certain audit firm determined that the appropriateness of the audited company's financial statements could be influenced, the audit firm gave a notification to the audited company based on the provision of Article 193-3 of the Financial Instruments and Exchange Act, and as a result the audited company amended its quarterly report and properly improved its disclosure system.