

Audit Firms Inspection Policy for Fiscal Year 2014

On April 4, 2014, the Certified Public Accountants and Auditing Oversight Board (CPAAOB) made public its Audit Firms Inspection Policy for fiscal year 2014. The highlights of the policy are as follows.

1. Surrounding Environment and Challenges for Audit Firms

- Difficult business environment for audit firms under reduced audit fees;
- Increasing needs for audit firms to respond to more globalized business of companies as well as new requirements of relevant accounting and auditing standards;
- Higher expectation from the public and investors towards audit firms' preemptive role against financial fraud; and
- Deficiencies of audit quality, in particular, among smaller audit firms

2. Risk Assessment and Off-site Monitoring

(1) Assessment of Effectiveness and Efficiency of JICPA's Quality Control Review

The quality control review by the Japanese Institute of Certified Public Accountants (JICPA) is an important source for the CPAAOB's on-site inspection as well as off-site risk assessment. In response to the new framework of the JICPA's quality control review, the CPAAOB will conduct a comprehensive assessment of the new review system as to whether it is operating in an effective and efficient manner.

(2) Enhanced Off-site Monitoring

Through more in number and in depth off-site monitoring of audit firms, the CPAAOB will assess effectiveness of the design and operation of the firm's quality control system and identify common issues across the audit industry. To that end, the CPAAOB will collect more detailed information regarding the firm's business strategy and structure including, for example, financial condition as well

as human resources.

3. On-site Inspections

(1) Basic Idea of On-site Inspections

Through interactive discussions with audit firms, the CPAAOB will identify deficiencies and weaknesses regarding individual firm's audit quality as well as their root causes. In addition, the CPAAOB will collaborate with the JICPA towards enhancing its quality control review through, for example, providing its inspection reports to the JICPA for analysis. Further, by issuing "Case Report from Audit Firm Inspection Results," the CPAAOB will continue to make public the best practices as well as examples of the deficiencies and weaknesses that were identified by the inspections. Not just audit firms, but also other stakeholders for audit quality are expected to read and make references to these materials for improved audit quality.

(2) Common Focuses of Inspections

The CPAAOB will conduct inspections focusing on the following issues.

- (a) Effective internal and quality control that fits risk and business profile of audit engagements, with particular focus on the followings:
 - Business strategy of audit firms and its dynamic updating in response to changing environments for audit firms;
 - Initiative by the top management of the firms for audit quality (tone at the top);
 - Human resource management, including staff recruitment, training and assignment to audit engagements;
 - Incentive mechanism, including performance evaluation and compensation; and
 - Audit execution system to ensure audit quality across engagements.
- (b) Policies and procedures for acceptance and retention of audit engagements in response to their risk profile as well as those for risk assessment and audit planning

- (c) Policies and procedures to implement at each firm new “Standard to Address Risks of Fraud in an Audit.”

The CPAAOB will focus on root causes of deficiencies identified by its inspections in order to ensure effective corrective actions.

(3) Focuses of Inspections based on risk and business profile of audit firms

In response to difference in risk and business profiles among audit firms, the following three level approaches are taken.

(a) Top-tier Large Firms (Big 4 firms)

Regular inspections will be conducted every two years. Due to the existing quality control which is subject to regular quality control reviews by the JICPA (every two years) as well as reviews by international networks, the CPAAOB’s inspection will introduce thematic/horizontal inspections which will focus on the issues that are critical to these firms, benchmarking against best-practices among leading firms.

The horizontal inspections will cover common issues among large firms, such as

- revenue recognition,
- accounting estimate
- professional skepticism
- group audit (in particular, communication between principal auditor and overseas component auditors); and
- engagement quality control review (EQCR)

The horizontal inspections will focus as well on the following issues which have been identified as critical by recent EQCR and the inspections.

- quality control over local offices
- engagements for financial institutions, and
- reviews by international networks

(b) Second-tier Large Firms

Due to the deficiencies identified by the inspections of second-tier large firms in recent years as well as their audit engagements of a significant number of listed companies, the CPAAOB will introduce regular inspections of the firms, in principle, every two-three years. The inspections of second-tier large firms will focus on the following issues, in particular, those which pose challenges for the firms.

- quality control, including competence of auditors, for engagements with financial institutions as well as global companies; .
- group audit (in particular, communication between principal auditor and overseas component auditors)
- communication with corporate auditors
- corrective actions against weaknesses identified by JICPA's quality control review
- communication with preceding/succeeding auditors in case of a rotation of auditors; and
- any measures in response to changes surrounding environments

(c) Small- and Mid-sized Firms

The CPAAOB believes it necessary to review among small- and mid-sized audit firms the issues including acceptance and retention of audit engagements, corrective measures against the deficiencies identified by the JICPA's quality control review as well as quality control over those audit engagements whose revenues are over 15% of the firm's total revenue.

In that regard, the inspections will focus on the following issues,

- deficiencies originating from their size and limited resources;
- those firms which were reviewed by the JICPA for the first time after their establishment, in particular, regarding expertise and competence of their auditors;
- audit engagements which require higher level of audit expertise, including those on financial institutions and collective investment schemes, as well as on global companies;
- communication with corporate auditors

- group audit (in particular, communication between principal auditor and overseas component auditors)
- quality control regarding rotation of auditors

4. Post-inspections Follow up

Post inspections, the CPAAOB, in close cooperation with FSA, will follow up and review effectiveness of corrective actions taken by audit firms. The results of the reviews will be used for off-site monitoring as well as for next on-site inspections. In case of a lack of effective corrective actions, next on-site inspections might be necessary earlier than otherwise.

Horizontal and in-depth analysis of the results of individual off-site monitoring and on-site inspections will be conducted to identify industry-wide issues across audit firms. For enhanced audit quality, the CPAAOB will, through exchange of views and proactive outreach, share the results of the analysis with relevant stakeholders, including FSA, JICPA, stock exchanges, IFIAR (International Forum of Independent Audit Regulators) as well as international networks of audit firms. In particular, exchange of views and information with quality control reviewers of the JICPA is deemed useful to enhance their roles.

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