

Basic Policy for Monitoring Audit Firms (Basic Policy for Examination and Inspection) —To ensure more effective auditing—

May 13, 2016

Certified Public Accountants and Auditing Oversight Board

Since its establishment in April 2004, the Certified Public Accountants and Auditing Oversight Board (“CPAFOB”) has been endeavoring to improve investors’ confidence in the capital markets with the mission of enhancing the fairness and transparency of the capital markets in Japan by improving the quality of audit and maintaining confidence in audit.

In the fifth term (April 2016 to March 2019), CPAFOB will improve investors’ confidence in the capital markets and contribute to the further development of the Japanese economy by implementing the monitoring of audit firms to further improve the quality of audit, based on the viewpoint and purpose mentioned below.

Moreover, under the basic policy, monitoring includes both on-site monitoring and off-site monitoring. Furthermore, on-site monitoring refers to inspections, while off-site monitoring means activities other than inspections, such as the collection of reports on certified public accountants or audit corporations (“audit firms”), interviews, information gathering through the exchange of opinions and cooperation between audit firms and relevant parties.

[Viewpoint]

The environment surrounding the audited entities has changed greatly, for instance, the strengthening of governance by the introduction of the corporate governance code, the acceleration of overseas expansion, the increasing complexity of transactions, and the development and increased usage of IT. Consequently, audit firms are required to conduct audit from a broad perspective, including group audit in response to a change in business environment of the audited entities and responses to the sophistication of the audit method, such as responses to the adoption of IT.

Under these circumstances, in the wake of recent accounting scandals in large listed companies and inappropriate cases regarding initial public offerings, confidence in audit has been questioned again. Accordingly, the formulation of a governance code for audit firms will

be discussed.

To cope with such a situation, CPAAOB will implement monitoring for the sake of the public interest, in other words, always giving due consideration to the viewpoint of the public; exercise its fullest capacity to implement monitoring effectively and efficiently, considering the actual situation of audit firms; and actively endeavor to maintain confidence in audit through the maintenance and improvement of the quality of auditing.

Furthermore, CPAAOB will actively provide the Japanese Institute of Certified Public Accountants (“JICPA”), relevant departments and sections in the Financial Services Agency (“FSA”), relevant parties, such as industry associations, the International Forum of Independent Audit Regulators (“IFIAR”), and foreign regulators with useful information including the analysis results of information obtained in the monitoring and issues identified across the industry. In addition to strengthening cooperative relationship with the parties mentioned above, CPAAOB will try to enhance the disclosure of information to the public as widely as possible so that shareholders can deepen their understanding of audit.

[Purpose]

The direct and principle purpose of the monitoring implemented by CPAAOB is to ensure proper practice of engagements at audit firms and foreign audit firms, instead of judging whether individual audit opinions are appropriate or not. Considering audit firms need to take the initiative in maintaining the quality of auditing and improving the effectiveness of auditing, CPAAOB will implement effective monitoring that encourages audit firms to take action by themselves.

Moreover, CPAAOB will place emphasis on not only checking if audits conducted by audit firms are in conformity with the standards on a formal basis, but also seeing if audit firms practically endeavor to maintain the quality of auditing and improve the effectiveness of auditing, for instance, appropriately exercising professional skepticism to detect corporate fraud and assessing audit risks by always paying attention to the business risk of the audited entity.

Considering the perspective mentioned above, CPAAOB sets its basic policy for monitoring audit firms as follows. Based on the basic policy, CPAAOB will formulate a “Basic Plan for Monitoring Audit Firms” for each term (July to June in the following year).

1. Basic Policy Pertaining to Off-site Monitoring

CPAAOB will receive reports on the results of the quality control review from JICPA. If necessary, it will strive to strengthen and advance a system to collect and analyze information by not only collecting reports from audit firms regarding relevant JICPA's reports and conducting interviews with audit firms but also exchanging opinions and cooperating with related parties. Furthermore, to precisely identify risks pertaining to audit firms and individual engagements, CPAAOB will conduct effective off-site monitoring in accordance with the type of audit firm, including the examination of JICPA's quality control review and collection of reports from audit firms, by using information obtained, as mentioned below.

(1) Examination of JICPA's quality control review

CPAAOB will examine further improvement in the effectiveness of JICPA's quality control review with the aim to encourage efforts toward the improvement of the quality of audit by JICPA as a self-regulatory organization for the sake of the public interest.

Furthermore, CPAAOB will have dialogue with JICPA about the appropriate sharing of roles between the two parties to have its inspections of audit firms and JICPA's quality control reviews show the maximum effect.

(2) Collection of reports

Regarding the appropriate performance of audit, CPAAOB will collect reports from audit firms in a timely manner based on the results of JICPA's quality control review, as mentioned below, to efficiently conduct monitoring by using its limited resources from the standpoint of encouraging audit firms to continue appropriate audit quality control.

- 1) CPAAOB will collect reports to intensively inspect the status of the development of the quality control system at audit firms and issues across the industry that are found in small- or medium-scale audit firms by taking into account the characteristics of each audit firm.
- 2) CPAAOB will collect reports to continuously grasp quantitative and qualitative information pertaining to the business management system, including governance, and service management system of audit firms.
- 3) CPAAOB will collect reports to grasp how audit firms responded to issues on the operation of business informed to them as the inspection results and encourage relevant audit firms to improve the operation of their business.

2. Basic Inspection Policy

CPAAOB will conduct effective and efficient inspection in accordance with the risks and type of audit firms and endeavor to enhance the effectiveness of the inspection, such as the improvement of the inspection method, while paying attention to the below mentioned issues. Furthermore, CPAAOB will try to conduct inspection integrally with the off-site monitoring mentioned above to maintain and improve the quality of audit by auditing firms.

(1) Implementation of inspection

- 1) CPAAOB will periodically inspect large-scale audit firms and second-tier large-scale audit firms, considering both their roles in the capital markets and the results of the quality control review. It will inspect small- or medium-scale audit firms as necessary, considering the results of the quality control review.
- 2) CPAAOB will flexibly conduct inspection when it immediately needs to check the internal control system of audit firms.

(2) Points to note in conducting inspection

- 1) To maintain and improve the quality control system, CPAAOB will inspect if measures for securing the fair execution of services prepared by audit firms correspond to the size and characteristics of the audit firm.
- 2) CPAAOB will inspect if audit firms appropriately assess business risks, including the economic environment and the corporate environment surrounding the entities, and implement appropriate audit procedures.
- 3) CPAAOB will precisely convey the inspection report and items pointed out in the results of the inspection that will help such audit firms take action to make effective improvement based on root cause analysis.

CPAAOB shall conduct inspection pursuant to the proper procedures stipulated under the “Rules on CPAAOB Administration” and the “Basic Guidelines on Inspection Conducted by the CPAAOB.”

Since it is essential to have the understanding and cooperation of audit firms to conduct inspection, CPAAOB shall in principle hear audit firms’ opinions on inspection (inspection monitoring) in all cases.

3. Policy for Providing Monitoring Information

To maintain and improve the quality of audit, CPAAOB will summarize issues in the audit quality control by audit firms, present them to audit firms and the entities, and publicize the results of monitoring, including the inspection results, to the public, such as investors, in the form of a report.

- 1) CPAAOB will convey the inspection results to audit firms. At the same time, it will try to upgrade information pertaining to the inspection results to ensure that items pointed out in the inspection are precisely conveyed to audit firms and the inspection results and inspection related information are precisely conveyed to the audited entities through audit firms.

(Note) Audit firms are required to share recognition with the corporate auditors of the audited entities regarding a system for ensuring that audit firms fairly perform their duties based on the inspection results in accordance with relevant laws and regulations.

- 2) CPAAOB will make better use of the inspection results, for instance, cooperating with related parties and providing information regarding issues across the industry that are extracted from the analysis.

(Note) To maintain and improve the quality of audit, CPAAOB encourages audit firms to make voluntary efforts, presents its expected level, compiles and publicizes cases identified in the inspections as “Case Report from Audit Firm Inspection Results” from the standpoint of presenting reference information to market participants and reviews their contents every year.

- 3) To help investors deepen their understanding of audit, CPAAOB will upgrade information related to the quality of audit that is widely provided to the public, for instance, summarizing the situation of monitoring to compile and publicize it (“monitoring report”).

4. Basic Policy for Report Collection and Inspection of Foreign Audit Firms

Regarding report collection and inspection of foreign audit firms, CPAAOB shall, in principle, rely on such actions by the regulators in the countries to which the relevant foreign audit firms belong, instead of conducting such itself, provided that: ① the audit and public oversight systems in the countries to which the relevant foreign audit firms belong are equivalent to those of Japan; ② the necessary information can be obtained through the arrangements of information exchange; and ③ the principle of reciprocity is ensured.

FSA and CPAAOB have been negotiating with the regulators in various countries about the framework of information exchange and exchanged letters with several regulators regarding cooperation on audit regulations including information exchange.

Of the foreign audit firms that have made a notification to the FSA, CPAAOB has been collecting reports on or conducting inspection of foreign audit firms, as necessary, which do not satisfy any of the above requirements ① to ③ and belong to countries where CPAAOB cannot rely on report collection or inspection by the relevant authorities, to grasp the actual situation of these foreign audit firms.

In the future, CPAAOB will continue collecting reports on or conducting inspection of foreign audit firms as necessary, if any of the above requirements are not satisfied or mutual reliance cannot be expected. CPAAOB will endeavor to implement report collection and conduct inspection smoothly and effectively by paying attention to strengthening the cooperative relationship with and close collaboration with foreign authorities and international institutions.

Furthermore, CPAAOB shall implement report collection and conduct inspection pursuant to the proper procedures stipulated under “Rules on CPAAOB Administration” and the “Basic Guidelines on Information Requirements and Inspection of Foreign Audit Firms Conducted by the CPAAOB.”