(Provisional Translation)

June 29, 2007
Certified Public Accountants and Auditing Oversight Board

Public Report on the Follow-Up Inspections of the Big Three Audit Firms

Introduction

The Certified Public Accountants and Auditing Oversight Board ("the Board") conducted inspections of the four largest audit firms ("the Big Four firms"), KPMG AZSA & Co., Deloitte Touche Tohmatsu, Ernst & Young ShinNihon, and ChuoAoyama Pricewaterhouse Coopers during the period between October 2005 and June 2006. Based upon the results of these inspections, on June 30, 2006 the Board recommended that the Commissioner of the Financial Services Agency ("the FSA") instruct all four firms to improve their audit quality control management. After receiving these recommendations from the Board, the FSA issued instructions on July 7, 2006 to the Big Four firms requesting that they improve their management of audit quality control. Based on these instructions, each firm submitted an improvement plan and reported subsequent implementations to the FSA. Each firm made public an outline of its improvement plan and implementation report.

In the 2006 Business Year Inspection Plan, the Board announced its intention to conduct inspections of the improvements made by the Big Four firms. From February 2007 to June 2007, the Board conducted inspections of the Big Three firms, omitting Misuzu Audit Corporation (the former ChuoAoyama Pricewaterhouse Coopers).

To the extent examined in the inspections, the Board found that all three firms had organized improvement management teams and appointed team leaders at their headquarters in accordance with the instructions issued by the firms' representatives, and had been systematically implementing improvement plans. However, deficiencies were identified at the firms mainly in regards to the management of implementations in practice and the progress thereof. The Board pointed these out in the course of its inspections. All three firms have made improvement in regards to the deficiencies identified in the process of inspections based on their own initiative.

The purpose of these inspections is to determine whether or not improvements have been made to the deficiencies in audit quality control that were identified during the previous inspections, and whether or not the FSA's instructions to make improvements to the firms' managements have been implemented. Furthermore, the coverage of the inspections are limited in the sense that the Board inspected several individual audit engagements selected during the previous inspections of each firm so as to confirm whether or not the deficiencies previously identified had been corrected. It is necessary to keep in mind that the deficiencies mentioned in this report are limited in scope to that of the inspections, and that these deficiencies have not been widely identified in all of the firm's engagements, and therefore, this does not necessarily mean that matters not mentioned in this report are being conducted appropriately.

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1. Summary of Inspections

(1) The Purpose and Term of Inspections

The purpose of these inspections is to inspect improvements made by the Big Four firms pertaining to the deficiencies in audit quality control identified as a result of the inspections in the 2005 business year (July 2005 to June 2006), and to inspect each firm's implementation of the FSA's instructions for improving their operations.

From February 2007 to June 2007, the Board inspected KPMG AZSA & Co., Deloitte Touche Tohmatsu, and Ernst & Young ShinNihon. In February 2007, as the Misuzu Audit Corporation (former ChuoAoyama Pricewaterhouse Coopers) issued a statement entitled "Consultations with Other Auditors for Personnel Transfer," the Board decided to monitor the developments for the time being and excluded it from these inspections. Furthermore, on May 30, 2007, the Misuzu Audit Corporation made an announcement entitled "Regarding the Firm's Dissolution," in which the firm made clear that the firm would be dissolved on July 31, 2007.

(2) Methodology and Scope of Inspections

The Board conducted on-site inspections of the firms' Tokyo and Osaka offices and other regional offices. The inspections aimed at determining whether or not individual improvement plans prepared by each firm have been properly implemented.

The inspection methodology includes hearings with the upper management of the firms, partners responsible for planning and managing improvement plans, and engagement partners, as well as reviews of relevant documents including working papers, etc. Furthermore, regarding the audit engagements subject to the previous inspections, since the annual audits had been conducted following the submission of the report as of the critical date of inspections, the Board decided to inspect deficiencies identified last time in order to confirm these improvements in its mid-term audits. Furthermore, audit engagements that were not subject to the previous inspections were not covered by these inspections.

2. Planning, Informing and Managing Progress in the Implementation of Improvement Plans

(1) Planning of Improvement Plans

Each firm formulated its own improvement plan based on instructions from the firm's upper management including chief executive officer.

Since the content of an improvement plan covers various matters pertaining to audit quality control, the respective teams formulated improvement plans of their own, with the quality control director etc. at the firms' headquarters being responsible for collecting and organizing such improvement plans.

Regarding firm structure reforms, to date some firms are in the process of reforming their corporate structure by way of integrating or forming blocks of their regional offices.

(2) Informing Staff of Improvement Plans

The upper management of all three firms informed their staff of their overall improvement plans by circulating messages pertaining to improvements as well as through staff meetings and various types of explanatory meetings. Furthermore, all the firms informed their staff about individual improvement plans through guidelines and notices.

Regional offices were informed of these improvement plans from their headquarters by way of national office heads' meetings etc. Thereafter, regional office heads disseminated the information throughout their offices.

Information on the deficiencies identified in audit engagements is provided through case study training for members of audit groups.

(3) Supervising the Progress of Improvements

Each firm has established an improvement progress management team and appointed a team leader. This team leader manages such progress by way of receiving implementation reports from each section and office. Progress reports are periodically dispatched to the board of directors.

3. An Outline of Inspection Results

(1) Summary

As mentioned in 2 above, all firms have set up, under instruction from upper management, an improvement progress management team and a team leader at their headquarters, and have been systematically implementing their improvement plan with having formulated, informed and managed its progress of their improvement plans.

To the extent identified in the inspection, although none of the firms' implementation of individual improvement plans has been significantly delayed or significantly deficient, as mentioned in (2) and (3) below, deficiencies have been identified in cases where the lower ranks of the organizations have not been adequately informed of the improvement plans, as well as cases where inadequacies have been observed in the management of the progress of improvements and the management and control of the implementation of individual improvement plans.

(2) Common Problems

① Informing Staff of Improvement Plans

Although each firm issued instructions for improvements from headquarters to audit divisions and regional offices by way of formulating, and disseminating guidelines, notices by posting these on electronic messaging boards and offering training programs, there remain staff members who are unaware of the necessity of the improvements or the content thereof. It is necessary for each firm to endeavor to improve its methods of communication and thoroughly disseminate information on improvements so that all staff members can fully understand the necessity of such improvements and the contents of the improvement plans.

② Managing Progress of Improvements

At each firm, the progress of individual improvement plans is managed primarily through reports by division heads to the headquarter heads for collecting and compiling such reports. However, deficiencies have been identified concerning confirmation by headquarters as to whether or not each division or regional office has implemented the improvement plans.

For example, although one firm required all staff members to submit confirmation letters to the division heads stating that the contents of notices had been read, since headquarters entrusted division chiefs with the collection of these confirmation letters without instructing them to confirm the content, there have been cases where confirmation letters with insufficient content have been received as they are. Furthermore, there was a case at another firm where hardly any improvements were carried out at some regional offices, and yet the headquarters had not grasped this situation until it was pointed out by the Board inspectors. It is necessary for the headquarters of each firm to manage whether or not improvement plans are being implemented effectively at each division and regional office.

③ Improving the System

From the perspective of systemic audits, although all the firms are engrossed in improving the operation of their management systems, deficiencies have been identified in system improvements in consideration of their effectiveness.

For example, at one firm, although a compliance committee has been established in order to strengthen its compliance system, there have been delays in improving regulations with regard to the headquarters personnel matters and compliance committee related matters.

④ Reform of Firm Structure

In order to implement systemic audits at large scale audit firms with over 3,000 staff members, it is essential to make improvements by strengthening headquarters' organization and improving the managing structure of regional offices.

Although there is a firm that has already merged regional offices and created blocks thereof and unified their finances as a whole, there are some firms that still have yet to complete their structural reforms. In reforming firm structure, it is necessary to properly distribute audit resources while giving due consideration to audit quality, as well as to evaluate personnel in a uniform manner.

(3)Specific Problems

Although all three firms are correcting the problems mentioned below, deficiencies have been identified in the management and control of the implementation of individual improvement plans.

As for improvements to the “performance of audit engagements” and “joint audits,” both of which were highlighted during the previous inspection, there were no problems worthy of mention in respect to these at any of the firms.

① Management of Audit Engagements

At some firms, deficiencies in the thoroughness of instructions from headquarters regarding improvements have been identified.

- Although all partners and staff are required to submit confirmation letters stating that the contents of notices regarding the improvement plan have been read, since the headquarters did not instruct all division heads to confirm the content of the submitted letters, some division heads have received confirmation letters with insufficient content.
- As for internal examinations of improvements, some regional offices have not implemented procedures in accordance with their headquarters’ instructions.

② Professional Ethics and Independence

At some firms, deficiencies have been identified in the examination and checking of the independence of engagement partners and staff, and limitations on the simultaneous provision of non-audit services by firms.

- Measures taken against violators of internal regulations regarding limits on share holdings have not been transparent.
- There have been non-audit services that have already been inaugurated or for which contracts have already been concluded prior to the examination of contracts for these non-audit services.

③ Acceptance and Retention of Clients

In all firms, deficiencies have been identified in regards to the approval procedures for audit contracts.

- There have been audit engagements for which the audit contracts are concluded before prior approval procedures, which are supposed to be implemented prior to entering into audit contracts.
- There have been audit engagements for which auditors have been appointed at the general stockholders’ meetings prior to the completion of contract risk evaluation procedures, in spite of the fact that firms should, upon receiving requests for audits from prospective clients, approve this upon the completion of such procedures.
- There have been audit engagements for which the submitter and the approver of the contract were the same staff member.

④ Human Resources, Education, and Training, etc.

At some firms, deficiencies have been identified in the management of CPE (Continuing Professional Education) training courses in which certified public accountants are required to participate. Furthermore, one firm was found to have deficiencies in its personnel evaluations, with another found to have deficiencies in assuring attendance at required training sessions, and another with deficiencies in its appointment of engagement partners.

⑤ Audit Working Papers

At all firms, deficiencies have been identified in the preservation of audit working papers.

- Although some management departments have realized that there are deficiencies in ensuring the preservation of audit working papers, they have not yet responded accordingly.
- Although instructions were issued by firm headquarters ordering the implementation of procedures aimed at ensuring the preservation of audit working papers, there are regional offices that have not implemented said procedures.
- There are audit departments that have not registered all of their preserved audit working papers. There are also regional offices that have not created maintenance ledgers for audit working papers.

⑥ Internal Reviews of Audit Engagements

Although all firms have endeavored to strengthen their internal review system for audit engagements, deficiencies have been identified at some firms in relation to system improvements and review procedures.

- A part of the review enhancement plans has not been implemented in a concrete manner.
- Since deadlines for submitting documents necessary for reviews to the review managing divisions at headquarters have been inadequate, it has been revealed that many review documents have been submitted to the divisions after the submission deadline and even after the completion of the reviews in question.

⑦ Monitoring Quality Control Systems

There are some firms with deficiencies in monitoring their quality control monitoring systems.

- Differences have been identified in internal regulations and actual applications of quality control monitoring systems.
- Based on the result of internal review, although special training courses had been implemented for engagement partners and staff whose auditing performances were revealed to contain extentive defiencies, necessary measures such as providing special retraining sessions for absentees had not been adopted.

Conclusion

As stated above, based on the findings of these inspections, all the firms in question have been conscientiously engaged in implementing improvements without waiting to be informed of inspection results by the Board. The Board hopes that through each firm's efforts in making improvements, the results of improvements will spread to individual audit engagements and the quality of audits at each firm will be further improved.

Since differences in the degree of improvements among the three firms and in the content of each firm's improvement plan have been identified through these follow-up inspections, and it is necessary to ensure that the results of each firm's operational improvements are reflected in individual audit engagements, the Board will continue to examine improvements to the deficiencies pointed out through this latest inspection and are expected to be made in the future, as well as individual audit engagements, through its inspections.

The Board expects the three firms to continue their efforts to ensure quality of audits and make improvements thereto under the leadership of their top management.