Case Report from Audit Firm Inspection Results

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Certified Public Accountants and Auditing Oversight Board

Table of Contents

Introduction······1

Quality Control System

1. Management Systems······3
2. Professional Ethics and Independence······14
3. Acceptance and Continuance of Engagements······17
4. Employment, Education and Training, Evaluation and Assignment······22
5. Audit Documentation······26
6 Engagement Quality Control Review······29
7. Monitoring the Firm's Quality Control Policies and Procedures······32
8. Joint Audit······35

Individual Audit Engagements

Audit Engagement Performance······36

(1) Planning an Audit Based on Risk Approach and the Audit Procedures to be Performed······37
(2) Auditing Accounting Estimates······43
(3) Audit of Internal Control over Financial Reporting······46
(4) Other Audit Procedures······48

Introduction

Since its establishment in April 2004, the Certified Public Accountants and Auditing Oversight Board (CPAAOB) has been performing inspections of Japanese audit firms from the viewpoint of enhancing the quality of audit in Japan, securing public interests, and protecting investors.

In the course of those inspections, the CPAAOB identified various deficiencies in audit firms concerning matters pertaining to audit quality control, such as management systems of audits, professional ethics and independence, acceptance and continuance of engagements, performing of audit engagements, audit documentation, engagement quality control review, and monitoring of quality control systems. From the perspective of promoting voluntary efforts by audit firms to maintain and improve their audit quality, the CPAAOB has been issuing, since February 2008, a Japanese version of the "Case Report: Deficiencies in Audit Quality Control," a compiled list of examples of deficiencies identified through the most recent inspections.

In the 2012 Case Report, the following revisions have been made from the perspective of promoting voluntary efforts to maintain and improve audit quality, presenting the standards expected by the CPAAOB, and providing reference information to directors and statutory auditors of listed entities, etc. and to market players including public investors, etc., with the content divided into two parts: "Quality Control System" and "Individual Audit Engagements" (note 1).

- 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, (outline of examples that are considered highly useful in addressing identified deficiencies and/or improving quality control) and expected response by audit firms.
- In the Individual Audit Engagements part, the points of focus in inspection, etc. are described with a particular focus on the areas where many deficiencies were identified: the planning an audit based on a risk approach, audit for accounting estimates, and audit of internal control over financial reporting. In addition to the examples of identified deficiencies, the points to note in performing audit procedures are appended.

The CPAAOB hopes that this Case Report will be actively used as a reference document by audit firms as they strive to establish and maintain better quality control systems, and be widely referenced by capital market players, including statutory auditors of entities, in order for them to understand the actual conditions of the external audits (note 2).

Note 1: In introducing the examples of identified deficiencies, in addition to the revisions described in the main text, as much background information behind and causes of such identified deficiencies is provided as possible. In addition, regarding the matters specific to individual audit firms, etc., expressions are partially modified. In consideration of the fact that most audit guidelines, etc. in accordance with the new draft policy are already applied at the time when this Case Report is issued, the old standards, etc., which were effective and applied at the time when the inspections were performed, are, as a general rule, replaced with new standards, etc. when they are quoted. In cases where there are multiple applicable provisions in the standards, etc., which serve as a basis for the deficiency identification, only the principal provisions are quoted. Furthermore, the name has been changed from “Case Report: Deficiencies in Audit Quality Control” to “Case Report from Audit Firm Inspection Results.”

Note 2: Examples of identified deficiencies in the quality control reviews performed by the Japanese Institute of Certified Public Accountants are introduced in the “Outline of Recommendation Reports Issued, etc.” section in the Annual Report of the Quality Control Committee; please refer to those examples along with this Case Report. In addition, it is recommended that statutory auditors, etc. of entities make efforts to understand the actual conditions of the quality control of audit firms, by, for example, using the notice from audit firms of matters related to the execution of duties prescribed in Article 131 of the Company Accounting Ordinance and/or other relevant documents.

Definition of terms

- The term “Act” refers to the Certified Public Accountants Act.
- The term “Ordinance” refers to the Cabinet Office Ordinance for Enforcement of the Certified Public Accountants Act.
- The term “audit firm” refers to an audit corporation or a sole practitioner.
- The term “local office” refers to a secondary office of an audit firm.
- The term “CPE” stands for Continuing Professional Education.
- The term “JICPA” stands for Japanese Institute of Certified Public Accountants.

Quality Control System

1. Management Systems

(1) Basic Policy and Plan on Inspection

Point of focus

In the inspection of the CPAAOB, the management system of audits of audit firms, particularly the status of establishment and maintenance of quality control systems, is considered as one of the most important inspection items; and the inspection is performed from the following perspectives:

- Whether quality control systems have been established and maintained in order to reasonably ensure that audit firms and engagement team perform audit engagements in compliance with the professional standards and laws and regulations, etc. and issue appropriate auditor's reports;
- Whether appropriate policies and procedures have been specified in order to promote an internal culture recognizing that quality is essential in performing engagements;
- Whether the CEO is fulfilling his/her duties as the ultimately responsible person for the quality control systems of the audit firm;
- Whether the audit firm has specified policies and procedures for ensuring that the person in charge of quality control has sufficient and appropriate experience and ability, and necessary authority to assume his/her responsibility; and
- Whether the person in charge of quality control is fulfilling his/her duties as a person responsible for the establishment and maintenance of quality control systems.

Outline of inspection results

The results of inspections of the status of quality control systems at each audit firm showed that there are audit firms that are actively working to maintain and improve quality control systems by, for example, appointing a full-time person in charge of quality control (partner).

On the other hand, as shown in the Case Example section below, there are audit firms, primarily small and medium-sized audit firms, where the measures to establish and maintain their quality control systems are insufficient, and where the CEO, the person in charge of quality control, or other responsible persons are not fully performing the duties related to quality control.

Expected response

It is necessary for audit firms to review the way audit engagements are performed and to promote an internal culture recognizing that quality is essential in performing engagements, for example, building a structure where the CEO, the person in charge of quality control, and other responsible persons are actively involved in the appropriate establishment and maintenance of quality control systems.

Case Examples

Case 1: **Establishment of quality control systems**

The CEO did not fully recognize the need for the establishment of management systems of audits. It was left to each personnel and their conscience as to the compliance with rules on professional ethics, the establishment of professional capabilities, and the appropriate performance of audit engagements. These facts indicated that a systematic control was not fully functioning.

In addition, the partners manage their own accounting firms and some live in distant locations, making it difficult for them to be fully involved in audit engagements. Sufficient time was not spent on the establishment of management systems of audits, and sufficient personnel were not made available.

Furthermore, although the CEO and the person in charge of quality control were aware that the audit firm's internal rules are not consistent with actual audit engagement conditions, the rules had not been revised. They were also aware that sufficient engagement team members are not made available and assigned to ensure appropriate performance of audit engagements; however, they did not take adequate corrective actions. These facts indicated that they had not properly established and maintained quality control systems. (Fiscal 2011 Inspection)

(Quality Control Standards Committee Statement No. 1, paragraphs 15 through 18)

Case 2: **Establishment of quality control systems**

Matters to be resolved by the board of partners, such as the acceptance and continuance of audit engagements, were implemented without discussion or approval of the board of partners. A system in which each partner monitors and examines other partners' performance, to ensure, collectively as an organization, the appropriate performance of audit engagements had not been established.

In addition, although many deficiencies were pointed out in the JICPA quality control review regarding the performance of individual audit engagements, no action was taken to understand and examine the implementation status of corrective actions in a concrete manner. This indicated the audit firm as a whole had not established a system to maintain and improve audit quality.

Furthermore, the CEO, who has the ultimate responsibility for the quality control system, just entrusted a partner in charge of quality control with the quality control-related duties, and did not properly understand the conditions of quality control at the audit firm or secure the necessary personnel, etc. required to perform the quality control-related duties.

In addition, the person in charge of quality control did not understand, as a person in charge of quality control, the contents of duties to be performed in a concrete manner or spend sufficient time on the quality control-related duties. (Fiscal 2011 Inspection)

(Quality Control Standards Committee Statement No. 1, paragraphs 15 through 18)

Case 3: **Quality control systems at local office**

The audit firm had not specifically prescribed policies and procedures for grasping the operational condition of the quality control system at the local offices, which resulted in insufficiency in the understanding of the following matters:

- Status of risk assessment concerning the acceptance and continuance of audit engagements at local offices and the actual condition of acceptance and continuance of engagements;
- Whether or not an engagement quality control review was performed on those engagements that are under the supervision of local offices and the results thereof, and the status of issuance of auditor's reports; and
- Monitoring of the results of quality control system at local offices.

(Fiscal 2010 Inspection)

(Quality Control Standards Committee Statement No. 1, paragraphs 15 through 18)

Case 4: **Quality control-related responsibilities of CEO, etc.**

In the situation where the person in charge of quality control could not spend sufficient time on the establishment and maintenance of quality control systems, he/she did not properly divide the quality control-related work into two parts: work to be done by himself/herself, and work to be done by other partners. Regarding the work to be done by other partners, clear instructions were not provided before the work, and no examination was performed after the work. In addition, the CEO had not clearly defined the authority given to the person in charge of quality control, did not understand the actual condition of work performed by the person in charge of quality control, and did not provide specific instructions to ensure the appropriate establishment and maintenance of quality control systems.

(Fiscal 2011 Inspection)

(Quality Control Standards Committee Statement No. 1, paragraphs 15 through 18)

(2) Initiatives to Improve Performance

<u>Point of focus</u>

In the inspection of the CPAAOB, which is performed based on the reports of the JICPA quality control review, the CPAAOB inspects particularly the improvement status of deficiencies identified in the quality control review performed at audit firms. Specifically, as a general rule, it selects multiple individual audit engagements, and inspects, for each item, the improvement status of deficiencies identified in each individual audit engagement. In the case where the improvement is deemed insufficient, the CPAAOB seeks to identify the operational and structural problems that may be the cause of such insufficiency.

<u>Outline of inspection results</u>

The results of inspections of the status of initiatives to improve performance at each audit firm showed that there are audit firms at which most of the deficiencies identified in the JICPA quality control review have been sufficiently and properly remedied. Such improvement is deemed a result of initiatives in which the audit firms established specific improvement measures for each case in accordance with the unique characteristics, etc. of the entity based on the improvement plan submitted to the JICPA, and the status of such improvement measures was examined in a timely manner by the engagement partner and the quality control review partner, etc. of the corresponding individual engagement.

On the other hand, as shown in the Case Example section below, there are audit firms where initiatives to improve the deficiencies identified in the quality control review have not been sufficiently undertaken, and insufficient or no improvement has been made regarding multiple identified deficiencies.

Expected response

It is necessary for audit firms to improve the overall performance of audit engagements, by examining whether improvements have been made regarding the deficiencies identified in the quality control review, particularly from the perspective of whether or not the improvement is merely superficial; for example, the improvement measures are undertaken only for the individual audit engagements related to the identified deficiencies.

Case Examples

Case 1: **Establishment of specific policies and procedures for improvement, etc.**

The CEO and the person in charge of quality control had not established specific policies and procedures for the implementation of the improvement plan to address the deficiencies identified in the JICPA quality control review, and did not grasp the implementation status of improvement measures. (Fiscal 2010 Inspection)

Case 2: **Review of status of improvement**

Although many deficiencies were pointed out in the past JICPA quality control reviews, and the action under Article 131 of the JICPA Rules (note), etc. was ordered, the CEO left the engagement partner to implement improvement measures, and did not review the status of improvement. In addition, the engagement partner had not taken necessary improvement measures. (Fiscal 2011 Inspection)

Note: An action that is ordered to urge the improvement, etc. of the condition of audit quality control, when substantial suspicions are raised concerning the condition of an audit firm's audit quality control during JICPA quality control review.

Case 3: **Initiatives for improvement**

Partners, including the CEO and the person in charge of quality control, viewed that the deficiencies identified in the quality control review were caused by something unique to the reviewed audit engagement; as a result, they did not examine the root cause of the identified deficiencies. This indicated that the audit firm did not undertake sufficient initiatives to improve their overall audit engagements, and did not take action to understand and examine the implementation status of corrective actions in a concrete manner. (Fiscal 2011 Inspection)

(3) Establishment, Dissemination, and Implementation of Internal Rules

<u>Point of focus</u>

It is expected that audit firms, in order to reasonably secure the audit quality, document policies and procedures for the establishment and maintenance of quality control systems in the internal rules, etc., disseminate them to engagement team, and ensure their compliance with them.

<u>Outline of inspection results</u>

The results of inspections of the status of establishment, dissemination, and implementation of internal rules at each audit firm showed that there are audit firms at which internal rules for quality control had been established using a template in the JICPA's "Rules for Quality Control of Audit" as a base, and by reflecting the actual condition of the audit firm; and also audit firms at which thorough compliance with internal rules is ensured by, for example, assigning a dedicated person and establishing a workflow for each quality control-related task.

On the other hand, as shown in the Case Example section below, there are audit firms where deficiencies relating to the establishment, dissemination, and implementation of internal rules were identified, including those where the above-mentioned template in the "Rules for Quality Control of Audit" was adopted, as it is, as their internal rules without performing a necessary review to reflect the actual condition of the audit firm.

<u>Expected response</u>

It is necessary for audit firms to perform a sufficient examination and review as to whether engagements are performed in accordance with the internal rules, and to establish a management system concerning the appropriate establishment, dissemination, and implementation of internal rules by, for example, establishing a workflow in accordance with the actual condition of the individual audit firm.

Case Examples

Case 1: **Implementation of internal rules (operation of Board of Partners, etc.)**

The CEO, etc., in managing the operation, did not sufficiently consult the internal rules, including the articles of incorporation, the rules for quality control of audit, etc., and did not review, as necessary, the internal rules to reflect the actual condition of the operation. This resulted in a situation where the acceptance and continuance of audit engagements, and the evaluation and determination of compensation for personnel, which are matters to be resolved by the board of partners under the internal rules, were performed without referring such matters to the board of partners.

In addition, although it is prescribed in the articles of incorporation that an engagement partner shall be appointed by the unanimous agreement of all partners, engagement partners were assigned for the audit engagement of some listed entities without obtaining an agreement from a partner who was absent from the board of partners' meeting, and engagement partners were assigned for the audit

engagement of unlisted entities without the unanimous agreement of all partners. (Fiscal 2011 Inspection)
(Quality Control Standards Committee Statement No. 1, paragraphs 15 and 16)

Case 2: **Establishment of internal rules (review when laws and regulations, etc. are revised)**
The person in charge of quality control, etc. was not aware of the revisions made to laws, regulations, and professional standards; as a result, the cabinet office ordinances, which were already repealed, were quoted in the internal rules. (Fiscal 2011 Inspection)
(Quality Control Standards Committee Statement No. 1, paragraphs 15 and 16)

Case 3: **Establishment of internal rules (review when JICPA Rules are revised)**
Although, under the JICPA Rule, the number of required units of Continuing Professional Education (CPE) that each personnel should undertake during one business year was changed to two units in professional ethics, and six units in audit quality control, the person in charge of quality control, etc. had not made revisions to the internal rules accordingly. (Fiscal 2011 Inspection)
(Quality Control Standards Committee Statement No. 1, paragraphs 15 and 16)

Case 4: **Establishment and dissemination of internal rules**
The majority of the internal rules are created by the CEO and the person in charge of quality control without consulting the board of partners, and other personnel were not aware of the existence of such rules. (Fiscal 2011 Inspection)
(Quality Control Standards Committee Statement No. 1, paragraphs 15 and 16)

Case 5: **Dissemination of internal rules**
Part-time personnel were not provided with an internal rules booklet when they were newly employed, and were not provided with explanations, etc. about changes in the internal rules when such changes were made. (Fiscal 2011 Inspection)
(Quality Control Standards Committee Statement No. 1, paragraph 16)

(4) Compliance with Laws, Regulations, and Professional Standards

<u>Point of focus</u>

A variety of restrictions and obligations, etc. are imposed on certified public accountants and audit firms by the Certified Public Accountants Act and other laws, regulations, and professional standards, from the perspective of ensuring appropriate operation. In the inspection, the CPAAOB inspects the status of compliance with applicable laws, regulations, and professional standards, and the status of the establishment and implementation of the management systems to ensure such compliance.

<u>Outline of inspection results</u>

The results of inspections of the status of compliance with applicable laws, regulations, and professional standards at each audit firm revealed that, as shown in the Case Example section below, there are audit firms where deficiencies were identified relating to the provision of services not stated in the articles of incorporation, prohibition of the concurrent provision of services, non-compete obligation by partners, restriction on appointment of retired engagement partners, matters stated in the business report, notification of a change to the articles of incorporation, etc.

<u>Expected response</u>

It is necessary for audit firms to establish appropriate management systems for compliance with laws, regulations, and professional standards by identifying the operations where it is required to check the status of compliance with laws, regulations, and professional standards, and by assigning persons in charge for each such operation.

Case Examples

Case 1: **Provision of services not stated in the Articles of Incorporation**

Although it is stated in the articles of incorporation that the audit firm performs only audit and attestation services, it also provides non-audit and attestation services. (Fiscal 2010 Inspection)
(Article 34-5 of the Act)

Case 2: **Prohibition of the concurrent provision of services**

The audit firm, as an organization, did not check or examine whether or not their services violated Article 34-11-2 of the Act, which prohibits concurrent provision of audit services and non-audit services, by leaving such judgment to the partner who was to start providing audit services or non-audit services as an individual. (Fiscal 2009 Inspection)
(Article 34-11-2, paragraph (1) of the Act)

Case 3: **Non-compete obligation by partners**

Certain partners, as individuals, accepted non-audit service engagements that are included in the scope of business of the audit firm, without obtaining approval from all other partners. (Fiscal 2008 Inspection)

(Article 34-14, paragraph (2) of the Act)

Case 4: **Non-compete obligation by partners**

No measure was taken to grasp and control as to whether or not there is business competition between partners as individuals and the audit firm. (Fiscal 2010 Inspection)

(Article 34-14, paragraph (2) of the Act)

Case 5: **Restriction on appointment of retired engagement partners**

Regarding the restriction on appointment of retired engagement partners in the position of director, statutory auditor, etc., no measures, such as obtaining written pledges, were taken. (Fiscal 2010 Inspection)

(Articles 28-2 and 34-14-2 of the Act)

Case 6: **Matters stated in business report**

A centralized system had not been established for gathering and managing information to be stated in business reports; the CEO, who is in charge of report preparation, wrote reports, and nobody else other than himself/herself verified the accuracy of the reports. This resulted in errors in the description of "status of partners, employees, etc.," "status of cyclical inspection of audit engagements," etc. of the submitted business report. (Fiscal 2011 Inspection)

(Article 34-16 paragraph (2) of the Act; Article 38 of the Ordinance)

Case 7: **Notification of changes to the Articles of Incorporation**

The audit firm just entrusted the CEO with the duties of submitting various notifications, etc. and did not take any measures to manage and verify the submission status of legally required notifications. This resulted in a failure to submit a notification of changes to the Articles of Incorporation by the legally required due date. (Fiscal 2011 Inspection)

(Article 34-10 paragraph (2) of the Act)

(5) Information Security

<u>Point of focus</u>

Certified public accountants are in a position where they might be often exposed to the confidential information of entities, etc. in the course of performing their duties. Particularly in recent years, as pointed out in the

“Guidelines for Information Security in the Services of Certified Public Accountants” (IT Committee Statement No.4), certified public accountants, in the daily performance of their duties, carry around personal computers and exchange business information with their clients, etc. through e-mails (refer to “I. Introduction of the said statement). In such circumstances, audit firms are required to establish and maintain information security systems that fully and appropriately meet the sensitive needs of the IT environment, etc.

In consideration of the above, in the inspections, the CPAAOB inspects the status of establishment and maintenance of the information security systems of audit firms, from such perspectives as whether or not audit firms properly assess the risk of information leakage by, for example, analyzing the type of information, etc. held by the audit firms, and whether security policies, etc. have been established and maintained in accordance with such risk.

Outline of inspection results

The results of inspections of the status of establishment and maintenance of the information security systems at each audit firm showed that there are audit firms which, for reducing the risk of information leakage, had implemented the following measures:

- Prohibiting, as a general rule, carrying a PC, on which data obtained from entities, etc. is stored;
- Preparing a self-check list for information security in accordance with the IT Committee Statement No.4; and required full-time and part-time personnel to go through the checklist for the information devices, such as PCs used for their audit engagements.

On the other hand, as shown in the Case Example section below, there were deficiencies identified, including a case where, although internal rules concerning information security were in place, preventive measures against information leakage set forth in the said internal rules were not implemented.

Expected response

It is necessary for audit firms to fully understand the damage, etc. that may occur in the event of information leakage, and establish information security systems in accordance with how information devices are used at each audit firm.

Case Examples

Case 1: **Monitoring of the operation of information security systems, etc.**

Although the internal rules concerning information security specify the implementation of periodic training, and the monitoring of the condition of password setting and management, as well as the operation of information security systems, the specified monitoring was not performed for some business use PCs, including the checking of whether the passwords are changed periodically, and whether the antivirus program is updated.

In addition, some personnel did not set a password for their business use PCs. (Fiscal 2011 Inspection)

(Article 27 of the Act; IT Committee Statement No.4, IV5 and V3)

Case 2: **Monitoring of the condition of electronic data storing, etc.**

Monitoring of the condition of electronic data storing, etc. was not performed for PCs provided for use by full-time personnel, etc., or for PCs personally owned by part-time personnel and used for audit engagements of the audit firm. (Fiscal 2010 Inspection)

(Article 27 of the Act; IT Committee Statement No.4, IV5)

(6) Prevention of Insider Trading

Point of focus

Certified public accountants, who for serve the public good to ensure the fairness and transparency of the market, should never ever be involved in insider trading, that is, they should never take advantage of the insider information obtained through their engagement activities. It is expected that audit firms constantly implement highly effective measures in order to prevent insider trading by their members.

Outline of inspection results

The results of inspections of the status of establishment and maintenance of the systems to prevent insider trading at each audit firm showed that most of the audit firms had established and implemented rules for preventing insider trading that contain provisions relating to, for example, the prohibition of trading of specified securities issued by the entities to which services are provided, ensuring a thorough notification of entities to which services are provided, and obtaining written pledges, by using, as a base, such materials as a template “Rules for Preventing Insider Trading” provided at the JICPA’s training program. In addition to the measures mentioned above, the following measures were also undertaken:

- Periodically collecting from members records of transactions relating to specified securities, etc. to check the conditions concerning the holding and transactions of specified securities, etc.;
- Take measures including imposing a certain level of restrictions on the trading of specified securities other than those issued by the entities to which services are provided.

On the other hand, as shown in the Case Example section below, there were small and medium-sized audit firms that only prepared internal rules by using the template “Rules for Preventing Insider Trading” as a guide, and never implemented the insider trading preventive measures specified in such rules.

Expected response

It is necessary for audit firms to carefully study the “Q&A concerning insider trading” issued by JICPA (September 2, 2008), etc., re-examine the conditions of establishment, dissemination, and implementation of the rules for preventing insider trading, and consider whether or not the strengthening of systems to prevent insider trading is required.

Case Examples

Case 1: **A notification of entities to which services are provided, etc.**

It is specified in the rules for preventing insider trading that a list of entities to which services are provided shall be distributed to members in order to provide a warning about insider trading, and that members shall submit written pledges to the effect that they will not carry out any transactions for themselves to buy/sell specified securities issued by the entities to which services are provided; however, a list of entities to which services are provided had not been prepared, and part-time personnel had not been requested to submit written pledges.

(Fiscal 2010 Inspection)

(Article 26 of the Act; Quality Control Standards Committee Statement No. 1, paragraph 19)

Case 2: **A thorough notification regarding entities to which services are provided**

When accepting engagements (audit services and non-audit services), notification was not given to members regarding entities to which services are provided. (Fiscal 2009 Inspection)

(Article 26 of the Act; Quality Control Standards Committee Statement No. 1, paragraph 19)

Case 3: **List of entities to which services are provided**

In the list of entities to which services are provided, which is distributed to members as part of measures to prevent insider trading, a list of entities to which non-audit services are provided was not included. (Fiscal 2010 Inspection)

(Article 26 of the Act; Quality Control Standards Committee Statement No. 1, paragraph 19)

2. Professional Ethics and Independence

Point of focus

In order for the audits performed by certified public accountants to be viewed as trustworthy by related parties, it is important that auditors maintain a fair and impartial attitude, not represent any special interest, and make fair judgments on the appropriateness of financial statements. To that end, audit firms are required to establish policies and procedures regarding compliance with professional ethics and independence requirements to objectively show that auditors maintain a fair and impartial attitude. In addition, the engagement partner is required to comply with such policies and procedures and to ensure that their assistants comply with them.

In consideration of the above, in its inspections, the CPAAOB inspects the appropriateness of the procedures for confirming the satisfaction of independence requirements mainly from the following perspectives:

- Whether or not audit firms obtain, at least once every year, confirmation letters concerning compliance with policies and procedures for the maintenance of independence from all engagement team members who are required to maintain independence;
- Whether or not all persons who are subject to the independence confirmation procedures are covered; and
- Whether or not, regarding the independence confirmation procedures, the most recent information is provided concerning subsidiaries, etc. of the entity.

Outline of inspection results

The results of inspections of the appropriateness of independence confirmation procedures, etc. at each audit firm revealed that, as shown in the Case Example section below, there are audit firms where deficiencies were identified, including cases where the independence confirmation procedures specified in the internal rules, etc. were not implemented and where the independence confirmation procedures were not implemented for non-audit and attestation services.

Expected response

It is necessary for audit firms to establish a system to implement procedures for confirming the independence in a timely and sufficient manner in order to ensure the reliability of audits.

Case Examples

Case 1: **Procedures for independence confirmation**

Although it is specified in the internal rules that personnel shall annually submit an independence checklist for the confirmation of their independence, the person in charge of quality control did not request personnel to submit an independence checklist. (Fiscal 2010 Inspection)
(Quality Control Standards Committee Statement No. 1, paragraph 23)

Case 2: **Procedures for independence confirmation, etc. for some personnel**

On the part of the person in charge of quality control, etc., due to the insufficient consideration of the scope of targets and method of investigation regarding the maintenance of independence, the following deficiencies were identified concerning the independence confirmation procedures:

- In the annual independence confirmation procedures, “checklists for accounting firms in the Ethics Rules section,” and “checklists for audit firm partners in the Laws and Regulations section” were not obtained from the audit firm and the partners;
- The annual independence confirmation procedures were not performed for those personnel who are not partners; and
- The independence confirmation procedures were not performed for some affiliated entities of the audit firm.

(Fiscal 2011 Inspection)

(Quality Control Standards Committee Statement No. 1, paragraph 23)

Case 3: **Procedures for independence confirmation, etc. for some personnel**

Due partially to the fact that the audit firm leaves the maintenance of independence to each personnel and his/her self-discipline, the following deficiencies were identified concerning the independence confirmation procedures:

- The person in charge of quality control did not implement the independence confirmation procedures for some newly joined partners at the time of joining as well as of annual implementation;
- Although the person in charge of quality control indicated that he/she verbally provided information to part-time personnel about audit engagements performed by the audit firm at the time of conclusion of the employment agreement and that he/she confirmed independence using an independence checklist, he/she did not notify the said personnel of the names, etc. of affiliates of the entities;
- As the person in charge of quality control was not aware that the “Independence checklist for auditors” (Ethics Committee Statement No. 1) had been recently revised, the old independence checklist was used for the confirmation of independence; and
- In the independence confirmation procedures for partners, the person in charge of quality control distributed independent checklists with “NO” already checked for all items.

(Fiscal 2011 Inspection)

(Quality Control Standards Committee Statement No. 1, paragraph 23)

Case 4: **List of entities**

Due partially to the fact that the person in charge of quality control did not take measures to centrally collect the most recent information of entities, etc. and reflect such information in the “List of entities” that is distributed at the time of annual independence confirmation, some entities were omitted from

the “List of entities” that was distributed at the time of independence confirmation procedures. (Fiscal 2011 Inspection)
(Quality Control Standards Committee Statement No. 1, paragraphs 21 and 23)

Case 5: **Procedures to confirm independence until the date of auditor’s report**

The engagement partner did not confirm, in the confirmation procedures of compliance with independence requirements by personnel, whether there was no change in interest in the relationship with entities, etc. during the period from the time of implementation of annual independence confirmation procedures until the date of the auditor’s report or whether there were no problems concerning the maintenance of independence. (Fiscal 2010 Inspection)
(Auditing Standards Committee Statement No. 220, paragraph 10)

3. Acceptance and Continuance of Engagements

<u>Point of focus</u>

In order to reasonably secure audit quality, it is necessary that audit firms carefully assess potential risks involved in the acceptance and continuance of engagements, by collecting information regarding the integrity, etc. of the entity from a wide range of sources, before the acceptance or continuance of engagements. If an insufficient consideration is given in the process of risk assessment regarding the conditions of entities or if a judgment as to whether or not audit engagement should be accepted, etc. is made based on a wrong understanding of the audit performance system, it would most likely result in the situation where auditors cannot fully execute their responsibilities, such as not expressing the auditor's opinion. It is therefore evidently required that careful judgment based on properly collected, sufficient information is required in accepting or continuing audit engagements. In addition, it is necessary to perform such audit engagements taking into consideration the risk assessment and the information regarding entities, etc., which was obtained in the course of making such a judgment.

<u>Outline of inspection results</u>

The acceptance and continuance of audit engagements is a central matter in the audit firm's managerial judgment; however, in reality, as shown in the Case Example section below, there were deficiencies identified, including the cases where internal procedures relating to the acceptance and continuance of audit engagements were not executed, where proper risk assessment was not performed, and where records of matter handed over were not properly kept.

<u>Expected response</u>

It is necessary for audit firms, in consideration of the importance of the policies and procedures relating to the acceptance and continuance of audit engagements, to re-examine the status of establishment and implementation of such policies and procedures from the perspective of whether or not the procedures for risk assessment, etc. implemented at the time of acceptance and continuance of engagements have lost their substance, and to enhance and strengthen the risk assessment procedures at the time of acceptance and continuance of engagements.

(1) Execution of Internal Procedures, etc.

<u>Point of focus</u>

In accepting or continuing audit engagements, audit firms are required to meet all of the following conditions:

- That the audit firm is competent and has necessary capabilities, including time and human resources, to perform audit services;

- That the firm is capable of complying with relevant ethical requirements; and
- That the audit firm examines the integrity of the entity and does not identify any matter that would have a significant negative effect on the acceptance and continuance of engagements.

Regarding the examination of integrity of the entity in particular, audit firms are required to obtain information deemed necessary in light of the situations in accepting engagements and the case of continuing existing engagements, as well as to, in the case of accepting or continuing engagements despite the fact that problems were identified, document how the audit firm resolved such problems.

Outline of inspection results

The results of inspections of the execution status, etc. of the internal procedures relating to the acceptance and continuance of engagements at each audit firm revealed that, as shown in the Case Example section below, there were deficiencies in the internal procedures relating to the acceptance and continuance of engagements and in the risk assessment procedures. There were also deficiencies identified, such as the case where, at the time of continuing audit engagement, in-depth risk assessment was not performed; instead, only check marks indicating “no problems found” were placed in the check boxes of the checklist that is specified in the internal procedures.

Expected response

It is necessary for audit firms to re-examine whether or not the policies and procedures relating to the acceptance and continuance of audit engagements have been properly established and implemented.

Case Examples

Case 1: **Implementation of internal procedures**

The engagement partner (prospective) considered that, regarding the acceptance and continuance of audit engagements, decisions could be made in consultation with the CEO or the person in charge of quality control on an as needed basis; as a result, the acceptance and continuance of audit engagements, which is a matter to be resolved by the board of partners under the internal rules were performed without holding board of partners’ meetings. (Fiscal 2011 Inspection)
(Quality Control Standards Committee Statement No. 1, paragraph 25)

Case 2: **Implementation of risk assessment procedures**

When accepting or continuing audit engagements, risk assessment based on the “Checklist when accepting audit engagement” or “Checklist when continuing audit engagement,” which are specified in the internal rules, was not performed. (Fiscal 2010 Inspection)
(Quality Control Standards Committee Statement No. 1, paragraph 25)

Case 3: **Documentation of risk assessment results**

The engagement partner (prospective) considered that it was not necessary to document the assessment results, etc. in the cases of juridical persons other than listed entities and SPCs, as audit risk involved in such cases is minimal. As a result, the assessment results, etc. of matters that would significantly affect the judgment on the acceptance and continuance of engagements were not recorded. (Fiscal 2011 Inspection)

(Auditing Standards Committee Statement No. 220, paragraphs 11 and 23)

Case 4: **Documentation of consideration process of identified problems**

The engagement partner, who was aware of the fact that the entity (listed entity) became insolvent as of the end of the fiscal year and that its shares were designated as shares subject to a grace period leading to insolvency, did not record the process of consideration of this matter in the "Checklist when continuing audit engagement."

(Fiscal 2011 Inspection)

(Quality Control Standards Committee Statement No. 1, paragraphs 26; Auditing Standards Committee Statement No. 220, paragraph 11)

Case 5: **Documentation of consideration process of identified problems**

The engagement partner, who was aware that there were events or circumstances that pose a significant uncertainty regarding the going concern assumption, including the fact that the entity reported operating losses and net losses in consecutive years, did not record the process of consideration of these matters when the audit engagement was continued. (Fiscal 2011 Inspection)

(Quality Control Standards Committee Statement No. 1, paragraphs 26; Auditing Standards Committee Statement No. 220, paragraph 11)

(2) Communications between Predecessor and Successor Auditors

<u>Point of focus</u>

In cases where auditors change, the information collected and obtained by the predecessor auditor in the course of performing audit engagements is extremely important. The predecessor auditor and successor auditor are therefore required to ensure the following are addressed:

- The predecessor auditor must carry out the communications in a timely and adequate manner in order to provide the successor auditor with useful information that can be used when the successor auditor makes a judgment as to whether or not the audit engagement should be continued and when the successor auditor performs the audit engagement; when inquired by the successor auditor, the predecessor auditor must provide information with integrity in an articulate manner. Especially in the case where the predecessor auditor is aware of information or circumstances concerning significant fraud in the financial statements that affected or would affect the auditor's opinion, the predecessor auditor must provide such information to the successor auditor, and

- The successor auditor must communicate with the predecessor auditor regarding the handover of the audit engagement, by making inquires, reviewing audit working papers, and other means; and the results must be properly documented. In addition, the successor auditor must, in order to make a proper judgment as to whether or not the audit engagement should be accepted, inquired of the predecessor auditor at least the following matters:

(i) Whether there is any concern about the integrity of the management;

(ii) The predecessor auditor's opinion regarding the change of auditor;

(iii) Whether there are major differences of opinions regarding the accounting, presentation, and audit procedures;

(iv) Whether there is any fraud by management or significant fraud by any employee, or any signs of such fraud;

(v) Whether there are any significant unlawful acts or acts suspected to be unlawful;

(vi) Whether there are any significant contingent liabilities or events that would possibly become significant contingent liabilities;

(vii) Whether there are any significant deficiencies regarding the internal control of financial reporting;

(viii) Whether there are any events or circumstances that would pose significant uncertainty regarding the going concern assumption;

(ix) In the event of a change during the fiscal year, whether there are any uncorrected misstatements that have been already identified; and

(x) Whether there were any misstatements that were identified and eventually corrected in the course of past audits.

Outline of inspection results

The results of inspections of the status, etc. of communications between predecessor and successor auditors at each audit firm showed that, in the case of change during the fiscal year, there were cases where the predecessor auditor passed on to the successor auditor detailed information regarding the condition of the entity obtained in the course of audits, including the provision of an explanation about the content of notification, etc. issued to the entity pursuant to Article 193-3 of the Financial Instruments and Exchange Act.

On the other hand, as shown in the Case Example section below, there were deficiencies, such as the case where inquires to and responses from the predecessor auditor were not documented, and the case where there was concern about the scope and accuracy of the information provided to the successor auditor.

Expected response

The predecessor auditor needs to understand that it is necessary to provide the information relating to the audit risk of the entity, etc. obtained in the course of performing audit engagements to the successor auditor in a sufficient and accurate manner. In addition, the predecessor auditor needs to establish a system in which the information relating to the audit risk of the entity, etc. obtained from the predecessor auditor in the process of communications between auditors, etc. is properly documented and fully used in the audit engagements.

Case Examples

Case 1: **Documentation of content of inquiries, etc. to the predecessor auditor**

The successor auditor indicated that, in accepting audit engagements, he/she inquired of the predecessor auditor the matters listed in the Auditing Standards Committee Statement No. 33 (before amendment), paragraph 13 and obtained responses; however, the content of such inquiries and responses was not documented. (Fiscal 2011 Inspection)

(Auditing Standards Committee Statement No. 900, paragraphs 8 and 9; No. 230, paragraph 7 of the same Statement)

Case 2: **Documentation of content of inquiries, etc. to the predecessor auditor**

Under the internal rules, it is required: (i) to comply with the Auditing Standards Committee Statement No. 33 (before amendment), paragraph 13; and (ii) for the person in charge of quality control to confirm whether or not the communication is performed in compliance with the policies and procedures specified by the audit firm; however, there were audit engagements, with which the documentation of content of inquiries to and responses from the predecessor auditor was not properly performed. (Fiscal 2010 Inspection)

(Auditing Standards Committee Statement No. 900, paragraphs 8 and 9; No. 230, paragraph 7 of the same Statement)

Case 3: **Documentation of procedures to assess reasonableness of evaluation of beginning of the year balance, etc.**

The engagement team indicated that they inquired of the predecessor auditor whether or not there were significant unrealized losses, in order to assess the reasonableness of the evaluation of the beginning of the year balance for the accounts associated with accounting estimates; however, the performed audit procedures and the results were not documented in the audit working papers. Moreover, in some cases, regarding the accounts associated with accounting estimates and the liability items, which were significant in monetary terms, the substantiality, etc. of the beginning of the year balance was not verified; instead, they were only checked against the trial balance, etc. (Fiscal 2011 Inspection)

(Auditing Standards Committee Statement No. 510, paragraph 5; No. 230, paragraph 7 of the same Statement)

4. Employment, Education and Training, Evaluation, and Assignment

(1) Education and Training

Point of focus

Auditors, as professional experts, are expected to always strive to develop their expertise and accumulate knowledge that can be obtained through practical experience, etc. In the inspection, the CPAAOB inspects the conditions of education and training, etc. at each audit firm, from the following perspectives:

- Whether or not the audit firm emphasizes the importance that personnel receive continuous training, and maintains and develops the personnel's necessary competence and capabilities by providing necessary training opportunities; and
- Whether or not the audit firm properly manages and supervises the status of participation in the CPE program and the units earned by the personnel

Outline of inspection results

The results of inspections of the status, etc. of implementation and management of education and training at each audit firm revealed that, as shown in the Case Example section below, there were deficiencies identified, including the case where the status of participation in the CPE program was not properly managed.

Expected response

It is necessary for audit firms to maintain and develop the personnel's necessary competence and capabilities by providing personnel with appropriate training opportunities, and by properly managing and supervising the status of participation in the CPE program.

Case Example: Management of participation status in the CPE program

As a result of the audit firm not properly confirming the status of participation in the CPE program and units earned, there was a case where personnel had not earned necessary units of the compulsory training subjects. (Fiscal 2010 Inspection)
(Item 116 of the JICPA Rules; No. 230, Article 6 of the Rules for Continuing Professional Education)

(2) Evaluation, Compensation, and Promotion

Point of focus

Audit firms are expected to set out appropriate policies and procedures for evaluation, compensation, and promotion to ensure that a culture is cultivated that places a high priority on audit quality. In the inspection, the CPAAOB inspects the conditions of establishment and implementation of procedures for the evaluation, compensation, and promotion of personnel, from the following perspectives:

- Whether or not the attitude of placing a high priority on audit quality is reflected in the policies and procedures relating to personnel affairs; and
- Whether or not the procedures for evaluation, compensation, and promotion are implemented in such a way that efforts and performance to maintain and enhance capabilities and to comply with professional ethics by personnel are fairly evaluated, and such efforts and performance are sufficiently rewarded.

Outline of inspection results

The results of inspections of the status, etc. of establishment and implementation of the procedures for evaluation, compensation, and promotion of personnel at each audit firm revealed that there are audit firms, regardless of the size, that implement such evaluation procedures in which the quality of audits performed by personnel are regularly evaluated according to the evaluation items specified by the audit firm, and the results of such evaluation are communicated to the personnel.

On the other hand, at some small and medium-sized audit firms, as shown in the Case Example section below, there were deficiencies identified, including a case where specific policies etc. had not been established as to how the audit quality should be reflected in the performance evaluation of personnel.

Expected response

It is necessary for audit firms to establish and implement the policies and procedures to evaluate the personnel's efforts and performance to maintain and enhance professional capabilities and to comply with professional ethics, taking into consideration the size and personnel structure of each audit firm, etc.

Case Example: Policies and procedures for evaluating personnel

Although it is specified in the internal rules that the evaluation of personnel shall be performed by paying attention to the audit quality and the status of compliance with professional ethics, the compensation of each personnel was determined in a situation where there are no specific policies or procedures established as to how the capability of personnel and quality of audits performed by them should be evaluated and how the results of such evaluation should be reflected in their compensation and promotion. (Fiscal 2011 Inspection)
(Quality Control Standards Committee Statement No. 1, paragraph 28)

(3) Assignment

Point of focus

Audit firms must establish policies and procedures for the assignment of personnel, and must assign personnel who are independent and have the ability and experience to properly perform audits in accordance with the business of the entities, etc. and who can spend sufficient time on audit engagements. In addition, in assigning personnel, the engagement partner is expected to confirm that the members of the engagement team are independent and have the necessary ability and experience to perform audit engagements, and that they can spend sufficient time on audit engagements.

In consideration of the above, in the inspections, the CPAAOB inspects the appropriateness, etc. of the assignment of engagement team from the following perspectives:

- Whether or not the audit firm, regarding the assignment of engagement team (including the engagement partner), has specified policies and procedures to ensure the assignment of engagement team who have the required competence and capabilities; and
- Whether or not, when assigning engagement team, proper and sufficient examinations had been made for each engagement team regarding the time that can be spent on audit engagements, understanding of professional standards and applicable laws and regulations, practical experience, ability to exercise judgment, etc.

Outline of inspection results

The results of inspections of the appropriateness, etc. of the assignment of engagement team at each audit firm revealed that, as shown in the Case Example section below, there were deficiencies, including the case where the engagement partner, etc. were not properly assigned.

Expected response

It is necessary for audit firms to assign engagement team who have professional knowledge, practical experience, ability to exercise judgment, etc. required in accordance with the size and business of entities, and to establish a system for properly carrying out engagements to ensure such engagement team can spend sufficient time on audit engagements, for example, by monitoring the work load.

Case Examples

Case 1: **Assignment of engagement partner**

A partner who lives in a distant place from the audit firm and the entity, and mainly performs operations other than the operations of the certified public accountant, was assigned as the engagement partner. The said partner performs substantially no audit procedure other than visiting the entity once every quarter and is thus deemed not to spend sufficient time on audit engagements. (Fiscal 2011 Inspection)

(Quality Control Standards Committee Statement No. 1, paragraph 29)

Case 2: **Assignment of engagement team**

The audit engagement team for a listed entity consisted, in reality, of three persons: the engagement partner and two junior accountants. Moreover, despite lacking sufficient capabilities and experience to perform the audit the junior accountants were assigned to a task related to significant items. These facts indicated that sufficient time and human resources were not spent in light of the audit risk involved. (Fiscal 2011 Inspection)

(Quality Control Standards Committee Statement No. 1, paragraph 30)

5. Audit Documentation

(1) Preparation and Review of Audit Documentation

<u>Point of focus</u>

Audit documentation provides evidence to show that an auditor obtained a basis for issuing an auditor's report and that the auditor performed an audit in accordance with audit standards, etc. Thus, the audit documentation serves as evidence to directly and specifically show the content of the audit procedures performed by engagement team. On the other hand, especially in the cases of audit procedures for making an important judgment, if the content of procedures, etc. is not recorded in the audit documentation, evidence other than the audit documentation (for example, oral explanation, etc. by the engagement team who, according to his/her words performed the procedures) cannot serve as solid and reliable evidence. Auditors, as professionals, must pay full attention to this matter.

In consideration of the above, in its inspections, the CPAAOB inspects the status of the preparation and review of audit documentation from the following perspectives:

- Whether or not audit documentation was prepared in such a way that an experienced auditor, who had not been involved in that audit, can understand the status of compliance with audit procedures, timing and scope of implementation of audit procedures, the conclusions reached, etc.;
- Whether or not the engagement partner confirmed that sufficient and appropriate audit evidence had been obtained to support the conclusions reached and auditor's opinion through the review of audit documentation and discussions with the engagement team; and
- Whether or not more experienced members of the engagement team properly reviewed the audit documentation performed by less experienced members.

<u>Outline of inspection results</u>

The results of inspections of the status, etc. of preparation and review of audit documentation at each audit firm revealed that, as shown in the Individual Audit Engagements part of this Case Report (page 31 ff), there were deficiencies, including the case where audit procedures which were said to be performed, the extent of procedures subject to audit sampling, obtained audit evidence, process of judgment, conclusions, etc. were not recorded in the audit documentation. In addition, as shown in the Case Example section below, there were other deficiencies identified, including the case where the reasons, etc. for omitting audit procedures were not recorded in the audit documentation.

<u>Expected response</u>

It is necessary for engagement team to ensure that more experienced members of the engagement team properly review audit documentation, and provide instruction and supervision, etc. to less experienced members; and to record necessary and sufficient information regarding the performed audit procedures.

Case Examples

Case 1: **Statement of reasons for omitting audit procedures, etc.**

Regarding the audit procedures listed in the statement of auditing procedures, engagement team neglected to perform a part of the procedures; however, the reasons for neglecting such audit procedures, and a statement to the effect that the engagement partner approved the neglecting of such procedures were not included in the audit documentation. (Fiscal 2011 Inspection)

(Auditing Standards Committee Statement No. 230, paragraph 7)

Case 2: **Statement of cross-referencing working papers, etc.**

The relationship between accounts in the financial statements and the audit working papers in which the content of discussion on each account is stated is not made clear by putting the reference working paper numbers, etc. As a result, the corresponding relationship between the amounts of subject-to-audit accounts and the amounts of accounts in the audit working papers, which contain audit evidence, is unclear. (Fiscal 2011 Inspection)

(Auditing Standards Committee Statement No. 230, paragraph 7)

Case 3: **Statement of engagement team members, etc.**

Names of engagement team members and reviewers, and dates of review were not stated in the audit documentation. (Fiscal 2011 Inspection)

(Auditing Standards Committee Statement No. 230, paragraph 7)

(2) Retention of Engagement Documentation

<u>Point of focus</u>

Audit firms are expected to pay sufficient consideration to the retention of audit working papers prepared by auditors. For this reason, in the inspection, the CPAAOB inspects the status of retention of audit working papers from the perspective of whether or not the policies and procedures for the management of audit working papers to ensure their confidentiality, safe custody, integrity, accessibility, and retrievability are properly established and implemented.

<u>Outline of inspection results</u>

The results of inspections of the status of retention of audit working papers at each audit firm revealed that, as shown in the Case Example section below, there were deficiencies concerning the retention of audit working papers.

<u>Expected response</u>

It is necessary for engagement team to re-examine the status of management and retention of audit working papers and to implement full-scale measures to prevent the occurrence of loss of audit evidence, leakage of confidential information, etc. resulting from the loss, etc. of audit working papers.

Case Example: Retention of audit working papers

The following deficiencies were identified concerning retention of audit working papers.

(Quality Control Standards Committee Statement No. 1, paragraph 45)

- The implementation procedures, the person in charge of implementation, and other specific matters regarding the completion of audit files and the retention of audit working papers were not specified (Fiscal 2011 Inspection);
- The number of audit files, year prepared, retention period, etc. were not recorded and managed (Fiscal 2011 Inspection);
- Only the names of entities, business year, and the number of audit files were recorded in the register; however, the serial numbers placed on each audit file and brief explanations of the content were not included (Fiscal 2009 Inspection); and
- Some of the audit working papers were not managed in the audit firm; instead, they were placed in the home-cum-office of the engagement partner. (Fiscal 2009 Inspection)

6. Engagement Quality Control Review

<u>Point of focus</u>

Auditors, before expressing an opinion, must undertake engagement quality control review ("EQCR") concerning the expression of the opinion in order to confirm that their opinion is appropriate and is in accordance with generally accepted auditing standards. In addition, audit firms are expected to establish policies and procedures setting out the nature, timing and extent of EQCR, and to require, in the said policies and procedures, that the engagement report not be dated until the completion of the EQCR.

In consideration of the above, in its inspections, the CPAAOB inspects the appropriateness of review performed by the persons in charge of EQCR from the following perspectives:

- Whether or not reviews are performed at an appropriate time for the planning an audit, significant audit judgment, and expression of audit opinion;
- Regarding significant judgments and audit opinions made by engagement team, whether or not communications with the engagement partner, review of audit working papers, evaluation of audit opinions, review of financial statements and proposed report, etc. are performed;
- Whether or not the appropriateness is examined regarding the evaluation of the engagement team members' independence, the necessity of seeking expert opinions and the conclusion reached, and records of significant judgments in audit working papers; and
- Whether or not the facts are properly documented, that procedures required in the review policy of the audit firm were performed, that the review was completed before the date of auditor's report, and that the quality control reviewer did not determine the significant audit judgments and conclusions reached to be inappropriate.

<u>Outline of inspection results</u>

The results of inspections of the implementation status, etc. of reviews at each audit firm revealed that, as shown in the Case Example section below, there were deficiencies, including the case where the deficiencies in the audit procedures were not identified in the review.

<u>Expected response</u>

It is necessary for audit firms to re-examine whether or not the review system is fully functioning as originally intended (in other words, function to confirm, from an independent standpoint from the engagement team, that the audit opinion is appropriate and is in accordance with generally accepted auditing standards). In addition, it is necessary for the quality control reviewer to perform effective reviews, with a full understanding of the importance of his/her responsibility.

Case Examples

Case 1: **Review of planning an audit**

Effective reviews of planning an audit were not performed, including the case where the risk of material misstatement and responses to address such risk were not discussed. (Fiscal 2011 Inspection)
(Auditing Standards Committee Statement No. 220, paragraph 19)

Case 2: **Timing of review of planning an audit**

Reviews of the planning an audit for the financial statement and the internal control were performed concurrently with the review of forming the auditor's opinion under the Companies Act. (Fiscal 2010 Inspection)
(Quality Control Standards Committee Statement No. 1, paragraph 35)

Case 3: **Examination and evaluation of audit procedures (going concern assumption)**

In the reviews of planning an audit and forming the auditor's opinions, the quality control reviewer performed reviews only on matters related to the going-concern assumption, and did not examine other risks that required special consideration. As a result, many deficiencies were not identified in the audit procedures performed by the engagement team. Moreover, regarding the examination of the going-concern assumption, although the engagement team failed to record the process of examination, etc. of the business plan, which was submitted from the entity, in the audit working papers, the quality control reviewer overlooked that deficiency. (Fiscal 2011 Inspection)
(Auditing Standards Committee Statement No. 220, paragraphs 19 and 20)

Case 4: **Examination and evaluation of audit procedures (revision of materiality level)**

Although the figures of financial statements, which served as a basis of calculation of the performance materiality, significantly changed, the engagement team did not consider the necessity of revising the materiality in forming the auditor's opinion. The quality control reviewer overlooked the above-mentioned deficiency. (Fiscal 2011 Inspection)
(Auditing Standards Committee Statement No. 220, paragraph 19)

Case 5: **Examination and evaluation of audit procedures (summary of exceptions)**

The quality control reviewer overlooked the fact that the engagement team failed to assemble exceptions, which should be summarized as uncorrected misstatements. (Fiscal 2011 Inspection)
(Auditing Standards Committee Statement No. 220, paragraphs 19 and 20)

Case 6: **Examination and evaluation of audit procedures (internal control audit)**

Regarding the internal control audit, the engagement team did not sufficiently record the audit procedures relating to the understanding of the flow of transactions and understanding of the

accounting process, management’s judgment on the appropriateness of identified control, and need for and extent of the use of work of internal auditors in the audit working papers. However, the quality control reviewer did not examine the sufficiency of the above-mentioned audit procedures, and as a result, overlooked the said deficiency. (Fiscal 2011 Inspection)
(Auditing Standards Committee Statement No. 220, paragraph 20)

Case 7: **Documentation of review**

The quality control reviewer, who is required to record the conclusions of the EQCR regarding auditor’s opinion in the audit working paper in accordance with the policies and procedures specified by the audit firm, did not state in the audit working paper his/her agreement or disagreement with the engagement team’s audit opinion. (Fiscal 2011 Inspection)
(Quality Control Standards Committee Statement No. 1, paragraph 41; Auditing Standards Committee Statement No. 220, paragraph 20)

Case 8: **Management of auditor’s report issuance**

The person in charge of quality control, etc. considered that they could grasp the progress of all audit engagements, as the number of audit engagements is small. Because of this, a system had not been established to confirm the completion of review at the time of auditor’s report issuance.
(Fiscal 2011 Inspection)
(Quality Control Standards Committee Statement No. 1, paragraph 35)

7. Monitoring the Firm's Quality Control Policies and Procedures

Point of focus

The monitoring of the quality control system plays an important role in the maintenance and improvement of audit quality as a process to voluntarily identify and understand problems relating to the quality control system and to address such problems. For this reason, audit firms are expected to perform ongoing monitoring of the quality control system to ensure the sufficient and appropriate establishment and implementation of policies and procedures relating to the quality control system; and to perform cyclical inspections of completed audit engagements at least once in a specified period for each engagement partner.

In consideration of the above, in its inspections, the CPAAOB inspects whether or not such monitoring is effectively functioning, mainly from the following perspectives:

- Whether or not a person with sufficient and appropriate experience for the role is assigned as the person responsible for the monitoring of the quality control system, and whether or not the assigned person is vested with sufficient and appropriate authority;
- Whether or not a person with sufficient and appropriate experience is assigned as the person in charge of monitoring; and
- Whether or not the impact of identified deficiencies is evaluated, and appropriate corrective actions are taken in accordance with the results of impact evaluation.

The CPAAOB also inspects the implementation status of cyclical inspections of audit engagements at audit firms, from the following perspectives:

- Whether or not the person in charge of cyclical inspections performs effective inspections by, for example, making inquiries of engagement team and reviewing audit working papers and other documents; and
- Whether or not the person in charge of cyclical inspections evaluates the impact of deficiencies identified as a result of inspections and ensures the relevant engagement partner, etc. take appropriate corrective actions.

Outline of inspection results

The results of inspections of the implementation status, etc. of ongoing monitoring and cyclical inspections at each audit firm revealed that there are audit firms at which full monitoring functions are exercised at high levels, including the case where partners other than those who are assigned as the persons in charge of quality control objectively examine the appropriateness, etc. of quality control related operations; and as a result, multiple deficiencies related to such operations were voluntarily identified and corrected.

On the other hand, as shown in the Case Example section below, there are audit firms at which deficiencies were identified concerning the competence of the person in charge of monitoring quality control system and the depth, etc. of inspections. There are also audit firms at which monitoring was performed with an assumption that no particular deficiency exists in the quality control system; and the primary function of monitoring the quality control system, which is to voluntarily identify and correct deficiencies, was not fully exercised.

Expected response

It is necessary for audit firms to establish and maintain a system in which the primary function of monitoring the quality control system, which is to voluntarily identify, understand, and correct problems, can be fully exercised.

Case Examples

Case 1: **Establishment of procedures, etc. for ongoing monitoring**

Regarding the ongoing monitoring, specification of the procedures, scope, and criteria for each monitoring item was not carried out, and the content of implementation procedures, the implementation results, etc. were not documented or communicated to the CEO, etc. (Fiscal 2010 Inspection)

(Quality Control Standards Committee Statement No. 1, paragraphs 47, 52, and 56)

Case 2: **Competence of the person in charge of performing ongoing monitoring**

The person in charge of quality control, who is virtually the only person to perform the quality control related duties and concurrently serves as the person in charge of performing ongoing monitoring, is not in a position to objectively identify deficiencies and matters that must be corrected in the quality control related operations. As a result, multiple deficiencies in the quality control system were overlooked. (Fiscal 2011 Inspection)

(Quality Control Standards Committee Statement No. 1, paragraph 47)

Case 3: **Competence of the person in charge of performing cyclical inspection**

Partners involved in the performance and examination of audit engagements performed the cyclical inspections of the said audit engagements, which resulted in such cyclical inspections not being objective. (Fiscal 2011 Inspection)

(Quality Control Standards Committee Statement No. 1, paragraph 47)

Case 4: **Depth of cyclical inspection**

The person in charge of cyclical inspection, when performing cyclical inspection, did not examine audit working papers; instead, he/she checked the audit procedures only through verbal discussion with the engagement team. (Fiscal 2009 Inspection)

(Quality Control Standards Committee Statement No. 1, paragraph 47)

Case 5: **Response to deficiencies identified in cyclical inspection**

Although deficiencies were identified, during the cyclical inspection, in the planning an audit based on a risk approach, etc., the content of such deficiencies was not communicated to engagement partner, etc. (Fiscal 2010 Inspection)

(Quality Control Standards Committee Statement No. 1, paragraph 49)

Case 6: **Checklists for cyclical inspection**

The checklist used for cyclical inspection did not contain items related to the new accounting standards and audit guidelines, including the accounting standards for asset retirement obligations. (Fiscal 2011 Inspection)

(Quality Control Standards Committee Statement No. 1, paragraph 47)

8. Joint Audit

Point of focus

In the case of joint audit with other audit firms, audit firms are also required to reasonably secure the audit quality. For this reason, in the inspections, the CPAAOB inspects the cases of joint audit from the perspective of whether or not the audit firms confirm that the quality control system of the joint auditor is one that can reasonably secure the audit quality.

Outline of inspection results

The results of inspections of the status of implementation and management of joint audits at each audit firm revealed that there were deficiencies, including a case where the results of review of the joint auditor's quality control system were not recorded in the audit working paper.

Expected response

It is necessary for audit firms to secure the quality of joint audits by, for example, reviewing the other audit firm's quality control system.

Case Example: Review of joint auditor's quality control system

Although it was indicated that a confirmation was made that the joint auditor's quality control system is one that can reasonably secure the quality of joint audit, the content and conclusions of such confirmation were not recorded in the audit working papers. (Fiscal 2009 Inspection)
(Quality Control Standards Committee Statement No. 1, paragraph 61)

Individual Audit Engagements

Audit Engagement Performance

<u>Outline</u>

In the inspection of the CPAAOB, many deficiencies were still identified, primarily in the following items: the planning an audit based on a risk approach and the audit procedures to be performed; audit for accounting estimates; and audit of internal control. In the Individual Audit Engagements part, the CPAAOB introduces examples from the CPAAOB inspections, focusing on these items. The perspective of the CPAAOB inspections and points to note are also described. Please use them as a reference hereinafter.

In addition, other than the deficiencies mentioned above, there were many cases where the results of audit procedures implementation and the obtained audit evidence were not recorded in audit working papers. As described on page 26 in the section “5. Audit Documentation” of the Quality Control part of this Case Report, audit working papers must be prepared in such a way that experienced auditors, who had not been involved in the particular audit engagement, can understand the status of such audit engagement, and evidence other than the audit working papers, such as oral explanation, cannot serve as solid and reliable evidence of audit procedures.

It should be especially noted that identified deficiencies in documentation included not only those related to simple failure to record in audit working papers, but also those pointed out from the perspective of whether or not required audit procedures had been performed.

(1) Planning an Audit Based on Risk Approach and the Audit Procedures to be Performed

<u>Point of focus</u>

The planning an audit based on a risk approach, and the audit procedures to be performed, are particularly important procedures in the performance of audit engagements. In its inspections, the CPAAOB performs examinations mainly from the following perspectives:

- In the planning an audit, whether or not the audit procedures to be performed are planned based on effective risk assessment, which includes the full understanding of the actual condition of the entity and a proper understanding of potential risks involved; instead of preparing an audit plan just by filling out forms provided by the audit firm or the JICPA, etc.; and
- Regarding fraud in an audit of financial statement, whether or not necessary risk assessment procedures and the audit procedures to be performed are implemented throughout the entire audit process, regardless of the auditors' past experiences regarding the honesty and integrity of the management, etc., being aware of the potential risks of material misstatement due to fraud.

<u>Expected response</u>

It is necessary for engagement team to realize again the importance of keeping records in audit working papers. They should record in the audit working papers their understanding of the entity and its environment, including the entity's internal control, and the implemented risk assessment procedures and the results of such assessment; such records will serve as a basis for identifying and assessing the risks of material misstatement when planning an audit based on a risk approach. Particularly in dealing with fraud in an audit of financial statement, engagement team needs to perform their audit engagements, always with professional skepticism.

(a) Identifying and Assessing the Risks of Material Misstatement and Designing the Responses to Assessed Risks

Case 1: **Identifying and assessing the risks of material misstatement**

The engagement team considered that it was not necessary to identify the risks of material misstatement (risk that requires special audit consideration) due to fraud in revenue recognition, based on the facts that: the entity operates a restaurant business, and most sales are settled in cash, etc., which is common in this industry and type of business; that the entity checks its cash holding against the sales record on a daily basis; and that, after such checking, cash is transferred to and managed by an external security entity. However, the engagement team failed to identify possible fraud that could arise in the entity's sales transactions, and did not perform procedures to assess such risk. (Fiscal 2011 Inspection) (Auditing Standards Committee Statement No. 240, paragraphs 25 and 26)

Case 2: **Assessing the risks of material misstatement**

Because of the fact that the entity, in the past, made a correction of accounting errors after the account

closing date due to a large amount of sales return, the engagement team, when planning an audit, considered the possible overstatement of sales as a risk that requires special audit consideration. However, the engagement team did not understand the internal control and the related control activities of the process of sales return, in which such risk was identified. (Fiscal 2011 Inspection)
(Auditing Standards Committee Statement No. 315, paragraph 28)

Points to note:
In addition to the above-mentioned cases, there were many deficiencies identified in the CPAAOB's inspections, as described below.

- When assessing the risk of revenue recognition, the sales transactions of the entity were not divided into separate classes of transactions for risk assessment at the assertion level; instead, the risk was assessed only for the entire balance amount of sales.
- The engagement team did not sufficiently assess as to whether or not relevant risks fall under the category of the risk that requires special audit consideration.

In the identification and assessment of the risks of material misstatement, it is required: to (1) identify the risks of material misstatement by understanding the entity and its environment and by examining the classes of transactions, account balances, disclosures, etc.; (2) assess as to whether or not the identified risk is related more pervasively to the financial statements as a whole and potentially affects many assertions; (3) associate the said risk with different types of potential misstatement risks at the assertion level; and (4) assess the likelihood of occurrence of misstatements and the extent of impact of potential misstatements. Especially when identifying and assessing the risks of material misstatement, a judgment needs to be made regarding the probability of fraud-risk occurrence, as to what kind of revenue, transactions, and assertions are associated with such fraud risk. In addition, the judgment as to whether or not the identified risks of material misstatement falls under the category of risk that requires special audit consideration needs to be made in consideration of the qualitative aspect, such as the relationship with fraud risk, complexity of transactions, extent of subjectivity in judgment, etc.

Case 3: **Designing the audit procedures to be performed**

In the planning of the audit based on a risk approach, although significant accounts had been selected, identification and assessment of the risk of material misstatement for some of such accounts were not performed, and the corresponding designing of the audit procedures to be performed was not performed. (Fiscal 2011 Inspection)
(Auditing Standards Committee Statement No. 300, paragraph 8)

(b) Fraud in Financial Statement Audits

Case 1: **Discussions among the engagement team**

In the planning of the audit, although it was indicated that the team discussed the possibility of risks of material misstatement due to fraud, there was no item related to the risks of material misstatement due

to fraud recorded in the agenda list or a minute of discussion on such an item. (Fiscal 2011 Inspection)
(Auditing Standards Committee Statement No. 240, paragraphs 14 and 43; No. 315, paragraphs 9 and 31 of the same Statement)

Case 2: **Inquiries of management**

Although it was indicated that the engagement team made inquiries of the management in order to identify the risks of material misstatement due to fraud, there was no recording of responses to the inquires related to fraud in audit working papers. Moreover, there was no understanding about the assessment of the management regarding the risks of material misstatement due to fraud, and a series of management processes established by the management for the identification of and response to fraud risk. (Fiscal 2011 Inspection)
(Auditing Standards Committee Statement No. 240, paragraphs 16 and 43)

Case 3: **Audit Procedures Responsive to Risks Related to Management Override of Controls**

In the audit procedures responsive to risks related to management override of controls, the adjusting journal entries were merely scanned over; and the examination was not performed as to whether or not there is a possibility that the management is biased toward making material misstatements by fraud concerning the test of appropriateness of journal entries recorded in the general ledger and concerning accounting estimates. (Fiscal 2011 Inspection)
(Auditing Standards Committee Statement No. 240, paragraphs 31 and 44)

Points to note:

In addition to the above-mentioned cases, there were many cases identified in the CPAAOB inspections where there were concerns about the maintaining professional skepticism as described below.

- Fraud-related inquiries of management and discussions among the engagement team members were only carried out as a matter of formality, and such discussions, etc. were not deemed to be meaningful.
- In the audit procedures responsive to risks related to management override of controls, journal entry testing was performed as a matter of formality without fully taking the fraud risk into consideration.

Although the fundamental responsibility to prevent fraud lies with the management, considering the situation where many fraud cases have occurred at entities, it is necessary to perform audit engagements with a sufficient understanding of auditors’ responsibilities and with professional skepticism throughout the entire audit process.

(c) Analytical Procedures

Case 1: **Planning an audit**

Analytical procedures, which should be performed in the planning stage of audit as procedures for risk assessment, were not performed. Extraordinary transactions and tendencies that require special consideration in the audit were not identified; instead, the engagement team only compared the figures

of the previous fiscal year and those of the first quarter, and stated in the audit working paper: “for reasons for increase/decrease, see the Summary of Financial Results for the First Quarter.” (Fiscal 2011 Inspection)
(Auditing Standards Committee Statement No. 315, paragraph 5)

Points to note:

The analytical procedures in the planning stage of audit are performed for the purpose of obtaining a basis for planning and implementing the audit procedures to be performed through the assessment of the risks of material misstatement. For this reason, in performing the said procedures, auditors need to identify extraordinary or unexpected relationships and the conditions of the entity that were not identified before.

Case 2: **Substantive procedures**

In the substantive analytical procedures for sales and selling, general and administrative expenses, the engagement team only compared the figures with those of the previous fiscal year and identified changes; and did not develop the expectation, investigate and assess the significant differences, or perform further investigations. (Fiscal 2011 Inspection)
(Auditing Standards Committee Statement No. 520, paragraph 4)

Points to note:

The substantive analytical procedures are performed for the purpose of obtaining audit evidence that substantiates specific assertions related to accounts or transactions. For this reason the following steps need to be taken: (1) develop an expectation and assess the level of its precision; (2) determine the amount of difference from the expected amount that can be accepted in audit; (3) calculate the difference in amount or ratio between the expected values and the recorded amount; and (4) investigate and assess the significant differences that are beyond the acceptable range (including obtaining appropriate audit evidence regarding the inquiries of and responses from the management, and performing other audit procedures).

Case 3: **Forming an overall conclusion of audit**

In the analytical procedures in the forming an overall conclusion of audit, the engagement team only calculated, for each account, the difference between the figure as of the end of the previous fiscal year and that as of end of the current term; and did not perform analytical procedures required to form an overall conclusion. (Fiscal 2011 Inspection)
(Auditing Standards Committee Statement No. 520, paragraph 5)

Points to note:

The analytical procedures in the completion stage of audit are performed for the purpose of forming an overall conclusion regarding the consistency between the auditor’s understanding of the entity and its financial statements. It is therefore necessary to conclude, in these procedures, as to whether or not sufficient and appropriate audit evidence has been obtained in the overall financial statements, and for the identified extraordinary items or relationships, during the course of audit.

(d) Revision of Performance Materiality

Case 1: **Revision of performance materiality**

In determining performance materiality in the planning an audit, the amount of total assets had been selected as an appropriate index, and calculation had been performed using the relevant amounts in the financial statements of the previous fiscal years. Although the amount of total assets significantly decreased in the current year as a result of a sale of a subsidiary and business divestitures, and a huge gap was created between the current and past figures of the financial statements, no revision was made to the performance materiality. (Fiscal 2011 Inspection)

(Auditing Standards Committee Statement No. 320, paragraph 11; No. 450, paragraph 9 of the same Statement)

Case 2: **Change to planning decisions during the course of the audit**

Although a revision was made to the performance materiality, consideration was not given as to whether any change in the planning an audit is necessary, including the corresponding revisions to the scope of examinations, etc. (Fiscal 2008 Inspection)

(Auditing Standards Committee Statement No. 320, paragraph 12)

(e) Evaluation of IT Control Risk

Case 1: **General assessment of IT control**

In the general assessment of IT control in the planning an audit the assessment of the previous fiscal year was re-posted as it was in the current term's planning an audit, including the overview of IT infrastructure and configuration of application systems, without examining whether any changes had been made to the information systems. (Fiscal 2011 Inspection)

(IT Committee Practical Guideline No. 6, paragraph 4)

Case 2: **Control activities (examination of spreadsheets, etc.)**

Regarding the general control of IT-based information systems, the engagement team failed to examine the accuracy of calculation results made by the financial reporting related material spreadsheet and user-developed program. Although the engagement team was aware that the entity did not have a design for control to ensure security, they failed to perform alternative examination procedures for that. (Fiscal 2008 Inspection)

(Auditing Standards Committee Statement No. 500, paragraph 8; Auditing and Assurance Practice Committee Statement No.82, paragraphs 175 and 176)

Case 3: **Control activities (assessment and evaluation of general controls)**

The entity uses financial accounting, purchasing, and payroll systems with a cost accounting function added. Although this does not fall under the case where the potential risk of material misstatement from using IT systems is considered to be sufficiently low, the engagement team did not perform the assessment and evaluation of general IT controls. The engagement team chose to omit part of the procedures for assessing risk from the use of IT, in consideration of the facts that the degree of using IT is low, that the stability level of information systems is high, and that there had been no significant changes in the information systems since the previous year. In addition, although audit procedures were performed using IT application controls in the procurement process, the assessment and evaluation of IT general controls were not performed for the relevant procurement process. (Fiscal 2008 Inspection)

(IT Committee Practical Guideline No. 6, paragraphs 5 and 46)

Case 4: **Control activities (evaluating operating effectiveness of controls)**

Regarding the sales process of the software download sales business (in which sales are recognized at the time when electronic data that enables use of software posted on the Internet is sent to the customer), the procedures for assessing operating effectiveness were performed only for the manual controls regarding the cross-checking between the sales details and the total amount of sales data, which is performed on a monthly basis. However, such procedures were performed without understanding the part of controls that have been automated. (Fiscal 2009 Inspection)

(IT Committee Practical Guideline No. 6, paragraph 17)

Case 5: **Confirmation of accuracy and completeness of the information generated from IT system**

In performing audit procedures relating to the valuation of delinquent accounts receivable and inventories, the engagement team used information generated from the entity's IT system. However, the team failed to obtain the audit evidence concerning the accuracy and completeness of such information (Fiscal 2011 Inspection)

(Auditing Standards Committee Statement No. 500, paragraph 8; IT Committee Practical Guideline No. 6, paragraph 41; IT Committee Research Report No 42, Q17)

Points to note:

In addition to the above-mentioned cases, there were still many cases identified in the CPAAOB inspections where information obtained from entities was used as it was without confirming the accuracy and completeness of such information. When using information provided by the entities as audit evidence, auditors must sufficiently examine the reasonableness of the provided information, regardless of whether or not such information was generated from IT systems.

(2) Auditing Accounting Estimates

<u>Point of focus</u>

Accounting estimates often involve subjective assessment by management, and are often based on complex assumptions and a variety of information sourced from inside and outside entities. For this reason, the degree of estimation uncertainty eventually affects the risks of material misstatement of accounting estimates, because they are likely to be affected by the nature and reliability of assumptions, management's bias, and other factors.

In consideration of the above, in its inspections, the CPAAOB performs examinations mainly from the following perspectives:

- In the evaluation of the degree of estimation uncertainty, whether or not sufficient and appropriate audit evidence to support estimates had been obtained, instead of just obtaining the results of estimation from the management, and whether or not critical examination of such evidence was performed; and
- When using the work of experts in the process of auditing accounting estimates, whether or not the required audit procedures were performed.

<u>Expected response</u>

Auditing accounting estimates are extremely important procedures that are also required to be performed as fraud-related procedures in an audit of financial statement. For this reason, when obtaining sufficient and appropriate audit evidence concerning estimates by the management, and recording performed procedures in the audit working papers, auditors must exercise due professional care, and perform such activities with professional skepticism.

(a) Securities

Case 1: When a need for impairment of shares of an insolvent subsidiary was discussed, the entity insisted that the impairment was not necessary, because the amount of net assets of the subsidiary could recover, according to the subsidiary's business plan, to the acquisition cost within the next four years. The engagement team considered that the assessment of the entity was appropriate. Under the subsidiary's business plan prepared by the entity, a huge sales increase was anticipated from an introduction of a new product into the market; and the subsidiary's business was anticipated to turn profitable. However, due to the nature of the industry in which the subsidiary operates, it is difficult to forecast the sales of new products. Moreover, the subsidiary has consistently posted losses since its incorporation, and never achieved budgeted targets. Even in such a case, the engagement team did not obtain sufficient audit evidence to support the reasonableness of the subsidiary's business plan. (Fiscal 2011 Inspection)

(Accounting System Committee Statement No. 14, paragraphs 92 and 285; Auditing Standards Committee Statement No. 540, paragraphs 11, 12, and 17)

Case 2: In making a judgment about the need for impairment of shares in a subsidiary, the engagement team determined it was not necessary to record an impairment loss, because of the fact that, when comparing the amount of net assets per share, which was calculated based on the non-consolidated financial statements of the subsidiary, and the acquisition price of the share, the former was not significantly smaller than the latter. On the other hand, the entity posted, in consolidated accounts, additional promotion expenses for long-held inventories by the subsidiary, which would have a negative impact on the financial position of the subsidiary. However, the engagement team failed to take this matter into consideration and did not calculate the amount of net assets per share accordingly, when they made the judgment regarding the need for impairment. (Fiscal 2011 Inspection)

(Accounting System Committee Statement No. 14, paragraph 92; Auditing Standards Committee Statement No. 540, paragraphs 11, 12, and 17)

(b) Recoverability of Deferred Tax Assets

Case 1: In making a judgment about the recoverability of deferred tax assets, the engagement team determined that the entity is a entity that falls under the proviso to paragraph 5 (1) (iv) of the Audit Committee Statement No. 66, because the entity recorded a significant tax loss in the current period, which was carried forward. The entity incurred a tax loss, not only in the current period, but also in the previous fiscal year.

In this situation, the engagement team determined that the entity falls under the category of a entity that generates taxable income in every period, only because the amount of tax loss incurred in and carried forward from the previous period was not significant. In addition, regarding the cause of the significant tax loss incurred in and carried forward from the current period, the engagement team was simply told by the entity that “the loss incurred due to a significant decrease in sales and fluctuations in foreign exchange.” They did not consider whether or not the cause falls under an “unusual and special cause” listed in Audit Committee Statement No. 66. (Fiscal 2011 Inspection)

(Audit Committee Statement No. 66, paragraph 5 (1); Auditing Standards Committee Statement No. 540, paragraphs 11, 12, and 17)

Case 2: The entity recorded deferred tax assets for the deductible temporary differences related to unrealized losses on investment securities, such as listed stocks, considering that they are projected to be sold over a long period of time, and it is possible to perform scheduling. The engagement team failed to examine the probability of the sale of such stocks. (Fiscal 2011 Inspection)

(Audit Committee Statement No. 66, paragraphs 4 and 5 (1); Auditing Standards Committee Statement No. 540, paragraphs 11, 12, and 17)

Case 3: In making a judgment about the recoverability of deferred tax assets, the engagement team obtained a five-year business plan from the entity. However, they failed to check whether the business plan was one approved by the board of directors, etc. (Fiscal 2011 Inspection)

(Audit Committee Statement No. 66, paragraph 5 (3); Auditing Standards Committee Statement No. 540, paragraphs 11, 12, and 17)

(c) Impairment

Case: When a need for impairment of fixed assets was discussed, the entity insisted that, regarding the business locations at which signs of impairment were identified, impairment of property was not necessary, because, under the business plans for the relevant business locations, sufficient future cash flows can be expected due to a performance recovery resulting from relocations of their stores. The engagement team considered that the judgment of the entity was appropriate. However, in the process of drawing such a conclusion, the engagement team did not examine the reasonableness of the business plans, including the examinations of planners of such business plans, process of approval, specific content of improvement measures, and appropriateness of assumptions that form a basis, for each of the business locations at which signs of impairment were identified. (Fiscal 2011 Inspection)

(Application Guidelines for Accounting Standards No. 6, paragraph 36; Auditing Standards Committee Statement No. 540, paragraphs 11, 12, and 17)

(d) Reserve for Employees Retirement Benefits

Case 1: In the calculation of retirement benefit obligations, the engagement team used as audit evidence, a calculation results report of retirement benefit obligations, etc., which was prepared by a pension actuary. However, they failed to evaluate the necessary competence, capabilities and objectivity of the actuary. (Fiscal 2011 Inspection)

(Auditing Standards Committee Statement No. 620, paragraph 8)

Case 2: In the calculation of retirement benefit obligations, the engagement team failed to examine the appropriateness of the base data, which was submitted from the entity to the pension actuary, concerning the completeness of employees' data of calculation and the accuracy of the base amount for calculation of retirement benefits, etc. (Fiscal 2011 Inspection)

(Auditing Standards Committee Statement No. 620, paragraph 11)

Points to note:

In the auditing accounting estimates, there are cases where works of experts (such as pension actuary, lawyer, and real estate appraiser) are used when specialized skills or knowledge are required in making judgments on matters that could have a significant impact on the financial statements. Since there were cases identified in the CPAAOB inspections where works of experts were used without sufficiently performing the procedures required for such usage, engagement teams must ensure that the required audit procedures are performed.

(3) Audit of Internal Control over Financial Reporting

<u>Point of focus</u>

Regarding the audit of the internal control over financial reporting, which was introduced in business years beginning on or after April 1, 2008, the CPAAOB examines, in the inspections, management's assessment of internal control from the perspectives of whether or not auditors performed sufficient and appropriate examinations and whether or not required procedures were performed relating to the use of work of internal auditors.

<u>Expected response</u>

It is necessary for engagement team to re-examine the scope and depth, etc. of required audit procedures, and to ensure sufficient and appropriate implementation of audit procedures and their documentation.

(a) Evaluation of Significance of Deficiencies

Case 1: **Performance materiality**

The guideline for determining the materiality of internal control deficiencies should be the same as that for determining materiality in the financial statement audit, because it eventually affects the reliability of financial statements. However, the engagement team failed to examine the reasonableness of the performance materiality in the audit of internal control, although it was different from that in the audit of consolidated financial statements. (Fiscal 2011 Inspection)

(Auditing and Assurance Practice Committee Statement No.82, paragraph 188)

Case 2: **Determination of material weakness**

In the evaluation of significance of internal control deficiencies, although the entity considered that the misstatement identified in the audit of financial statement was caused by deficiencies in internal control; the entity determined that it had no significant impact on the financial reporting, as its quantitative materiality was low. However, the engagement team did not examine whether or not the significance of such internal control deficiencies constitutes a material weakness by taking into consideration the qualitative materiality, compensating control, potential quantitative impact of deficiencies and likelihood of having an actual impact and other factors. (Fiscal 2011 Inspection)

(Auditing and Assurance Practice Committee Statement No.82, paragraphs 42 and 190 through 211)

(b) Evaluation of the Scope of Assessment

Case: The entity uses sales before elimination of inter-company transactions as criteria for selecting significant locations or business units, since it is difficult to accurately determine the sales after elimination of inter-company transactions for each component. However, the engagement team did not

examine whether or not such criteria are appropriate. In addition, when the sales before elimination of inter-company transactions is used as criteria for selecting significant locations or business units, it is possible that the locations or business units with more inter-company sales would be ranked higher. However, the engagement team did not examine whether or not all significant locations or business units that should be selected were selected. (Fiscal 2011 Inspection)
(Auditing and Assurance Practice Committee Statement No.82, paragraph 91)

(c) Evaluation of Assessment of Internal Control

Case 1: **Assessment of Company-Level Internal Controls**

In the evaluation of assessment of the status of establishment and implementation of company-level internal controls, the engagement team failed to examine whether or not the assessment items adopted by the management are appropriate in light of the conditions of the entity, by referring to the assessment items shown in Exhibit 1 of the "Practice Standards for Management Assessment and Audit concerning Internal Control Over Financial Reporting." (Fiscal 2011 Inspection)
(Auditing and Assurance Practice Committee Statement No.82, paragraph 124)

Case 2: **Evaluation of assessment of internal control**

In the assessment of company-level internal controls and period-end financial reporting processes of consolidated subsidiaries, according to the engagement team, they obtained the results of assessment performed by consolidated subsidiaries and examined their appropriateness. However, the performed procedures and conclusions were not recorded in the audit working papers. (Fiscal 2011 Inspection)
(Auditing and Assurance Practice Committee Statement No.82, paragraphs 125, 130 and 251; Auditing Standards Committee Statement No. 230, paragraph 8)

Case 3: **Sampling**

In implementing procedures for the assessment of internal control operations, engagement team failed to record, in audit working papers, the population, scope and period of sampling, sampling method, etc. which were specified by them. (Fiscal 2011 Inspection)
(Auditing and Assurance Practice Committee Statement No.82, paragraphs 251; Auditing Standards Committee Statement No. 230, paragraph 8)

Case 4: **Roll-forward procedures**

In the assessment of the company-level internal controls and the internal controls over period-end financial reporting processes, according to the engagement team, they, in order to confirm whether or not the internal control was effective until the fiscal year end date, obtained a report relating to changes in such internal controls from the entity, and checked the content of the changes by inquiring. However, a review of relevant records, monitoring, etc. were not performed for that purpose. (Fiscal 2011

Inspection)

(Auditing and Assurance Practice Committee Statement No.82, paragraph 131)

(d) Using the Work of Internal Auditors, etc.

Case: In the procedures for evaluating business process operations in the audit of internal control, auditors fully utilized the work results of internal auditors, etc., instead of performing sampling themselves. However, engagement team did not examine the objectivity and capabilities of internal auditors, etc., and the degree of use of internal auditors, etc. (Fiscal 2011 Inspection)

(Auditing and Assurance Practice Committee Statement No.82, paragraphs 228 through 243)

(4) Other Audit Procedures

(a) Communication with Those Charged with Governance

Case: Although the engagement team insisted that they communicated with those charged with governance about the matters which the team noted as important from the perspective of those charged with governance's performing its duties, the team failed to document such communication in the audit working papers. (Fiscal 2010 Inspection)

(Auditing Standards Committee Statement No. 260, paragraphs 14 and 21)

(b) Evaluation of Compilation of Audit Results

Case: In the situation where works of component auditors were utilized in the audit of consolidated subsidiaries; and where an uncorrected misstatement of the financial statements was reported by the component auditors, the group engagement team failed to examine the following regarding the said uncorrected misstatement:

- In expressing an audit opinion, the amounts of financial statement items and the quantitative and qualitative impact on overall financial statements, linking with subtotal or total amounts as necessary;
- Whether or not the said uncorrected misstatement was caused by, or possibly caused by fraud; and
- The impact of the said uncorrected misstatement on the audit of internal control. (Fiscal 2011 Inspection)

(Auditing Standards Committee Statement No. 450, paragraph 10)

(c) Physical Observation

Case: In performing physical observation of on-site inventory taking, the engagement team did not examine,

in advance, the entity's inventory taking plan. In addition, in selecting locations for the physical observation, the team did not consider the types of inventories held, their quantitative materiality, etc. (Fiscal 2010 Inspection)
(Auditing Standards Committee Statement No. 501, paragraph 3)

(d) External Confirmations

Case 1: Regarding the deposit balance of the overseas subsidiaries, the engagement team performed external balance confirmations as of the term-end date with overseas financial institutions; and they had not received balance confirmation letters from some of those financial institutions. However, they did not perform alternative procedures. (Fiscal 2011 Inspection)
(Auditing Standards Committee Statement No. 505, paragraph 11)

Case 2: Regarding the balance confirmation of accounts receivable and notes receivable, although some confirmation letters were received by facsimile, the engagement team did not request for original letters. There was also a case where only the personal seal of the person in charge of confirmation was affixed on a received confirmation letter, and the engagement team failed to examine the reliability of the confirmation letter by, for example, contacting the relevant office. (Fiscal 2011 Inspection)
(Auditing Standards Committee Statement No. 505, paragraph 9)

Case 3: In the analysis of exceptions in outstanding balance of receivables and payables, the engagement team only obtained the results of exception analysis performed by the entity. They failed to examine the reasonableness of such analysis results. (Fiscal 2011 Inspection)
(Auditing Standards Committee Statement No. 505, paragraph 13)

Case 4: In the confirmation of outstanding balance of receivables and payables, the engagement team selects, by means of sampling, parties to which confirmation letters are sent. In this situation, regarding some identified exceptions, the engagement team failed to investigate the details and causes of such exceptions, deeming that the amount was insignificant. Moreover, the team failed to examine their impact on the purposes of audit procedures and on other audit areas, etc. The team also failed to make an estimate of the amount of misstatement in the entire population based on the amount of error identified in the sample population. (Fiscal 2011 Inspection)
(Auditing Standards Committee Statement No. 505, paragraph 13; No. 530, paragraphs 11 and 13 of the same Statement)

Case 5: In the confirmation of the outstanding balance of accounts payable, although the base date for confirmation is set to be before the term-end date, substantive procedures were not performed for the remaining period from the base date to the term-end date. (Fiscal 2011 Inspection)

(Auditing Standards Committee Statement No. 330, paragraph 21)

(e) Related Party Transactions

Case 1: In the procedures for related party transactions, the engagement team failed to examine the internal control regarding the approval and/or records of related party transactions. (Fiscal 2011 Inspection)
(Auditing Standards Committee Statement No. 550, paragraph 13)

Case 2: The engagement team failed to examine the completeness of information regarding related parties by, for example, obtaining a list of names of all indentified related parties from the entity. (Fiscal 2011 Inspection)
(Auditing Standards Committee Statement No. 550, paragraph 12)

Points to note:

Related party transactions are possibly subject to a greater risk of material misstatement of the financial statements compared with third-party transactions, because the related party transactions are complex, reflecting the breadth and complexity of their relationships, and because there are cases where terms and conditions of such transactions are different from normal market transactions. In addition, fraud activities become easier when there is a collusion, etc. between the entity and related parties

In the implementation of risk assessment procedures and audit procedures to be performed, it is necessary to obtain sufficient and appropriate audit evidence, paying careful attention to these characteristics of related-party transactions.

(f) Going Concern

Case: The entity recorded a significant sales decrease and a large amount of loss in the current period, which the engagement team considered as an event or condition that may cast significant doubt on the entity's ability to continue as a going concern. While the entity plans to undertake measures to solve or improve such event or conditions, including a review of sales mix, cost reductions and improvement of financial position, the team judged that material uncertainty regarding the going concern assumption still exists, and put a note accordingly under the section of "Matters Related to Going Concern Assumption" of the Annual Securities Report.

Under these conditions, the engagement team failed to perform the following evaluations regarding the audit procedures related to going concern assumption.

- Evaluating Management's Assessment
  Recognizing this significant uncertainty related to the going concern assumption as a risk that requires special audit consideration, the engagement team obtained, from the entity, a budget statement, a cash flow forecast, and statement of related assumptions as part of audit procedures to address this issue. Although the team indicated that they would examine the feasibility of the plans to be taken, they failed to examine the significant assumptions that form a basis of forecast

financial information or the reliability of the financial information by comparing the past year's forecast and actual figures, etc.

- Discussion with the management

  The engagement team insisted that, at the times of planning an audit and year-end audit, they discussed with the management regarding the going concern assumption. However, in the minutes of the discussions held on those dates, there were only records of the business overview, but there was no mention on the going-concern assumption.

- Subsequent events

  The entity's business plan was revised down by the resolution of the board of directors meeting which was held on or after the date of the auditor's report, under the Companies Act. As a result, a significant gap was created between the content of the budget statement obtained in the audit procedures concerning the going-concern assumption and that of the revised business plan. However, the engagement team was not aware of this situation until the time of expressing an audit opinion based on the Financial Instruments and Exchange Act; and they did not examine the impact of this situation on the financial statements. (Fiscal 2011 Inspection)

  (Auditing Standards Committee Statement No. 570, paragraph 15)

Points to note:

Management's assessment regarding the going-concern assumption involves a judgment, made at a certain point of time, about the uncertainty of a future outcome relating to events or conditions. Therefore, when examining the management's assessment, it is necessary to sufficiently examine the obtained audit evidence from a critical perspective, instead of just obtaining assessment results.

(g) Audit of an Entity using a Service Organization

Case 1: The entity outsources some of its payroll operations, including salary calculation, etc. to a third-party organizations. However, in the planning the audit, the engagement team failed to consider the effect of applying the operations provided by the service organization to the design and implementation of internal control of the entity, which is a service organization. (Fiscal 2010 Inspection)

(Auditing Standards Committee Statement No. 402, paragraphs 8 and 9)

Case 2: The engagement team used the service auditor's report in order to ascertain the status of design and implementation of internal control of the organization. However, the engagement team failed to check whether or not there had been any changes to its internal control from the auditor's report date to the financial year end of the entity. (Fiscal 2010 Inspection)

(Auditing Standards Committee Statement No. 402, paragraph 16)

Points to note:

In cases where an entity outsources aspects of their business to a third-party organization, the user auditor needs to understand the operations provided by the organization as well as the internal control of the user entity. In addition, for the understanding of internal control, an engagement team must assess the effect of applying the operations, including internal control, provided by the organization to the design and implementation of the entity's internal control. It should be noted that these procedures need to be performed not only in the financial statement audit, but also in the audit of internal control over financial reporting.

(h) Audits of Group Financial Statements

Case 1: In the audit of overseas consolidated subsidiaries, the group engagement team naturally considered that the component auditors performed audit setting a materiality level lower than the performance materiality for the consolidated financial statements. As a result, the group engagement team did not notify the component auditors of the materiality for the component, or the standard for determining the amount of misstatement that cannot be deemed as insignificant in the group financial statements. (Fiscal 2011 Inspection)

(Auditing Standards Committee Statement No. 600, paragraph 39)

Case 2: The engagement team only obtained, from the entity, documents which show the calculations of the amounts of journal entries. The team failed to check the reconciliation and elimination of intra-group transactions and unrealized profits, and intra-group account balances. (Fiscal 2011 Inspection)

(Auditing Standards Committee Statement No. 330, paragraph 19; No. 500, paragraph 8 of the same Statement)

Case 3: In the audit procedures for the consolidated statement of cash flows, as the consolidated statement of cash flows was generated by the consolidated accounting system, the engagement team only confirmed that the amounts in the cash flow worksheet produced by the system match the amounts in the consolidated statement of cash flows. They did not examine the consistency with other financial statements or the appropriateness of the journal entries related to the consolidated statement of cash flows. (Fiscal 2010 Inspection)

(Auditing Standards Committee Statement No. 330, paragraph 39)

Case 4: In the situation where the component auditor reported to the group engagement team that there were retirement benefit obligations that the entity, the parent company, was not aware of, and that there were loan guarantees provided to non-consolidated subsidiaries, the engagement team failed to perform additional audit procedures to address such reported matters. (Fiscal 2011 Inspection)

(Auditing Standards Committee Statement No. 600, paragraphs 41 and 42)

(i) Presentation and Disclosure of Financial Statements

Case 1: In the case where the provisions for environmental measures are recorded in the financial statements, the engagement team overlooked the fact that the said provisions were not recorded under the list of allowances, provisions and reserves in the supplemental schedule to the Annual Securities Report. (Fiscal 2011 Inspection)
(Auditing Standards Committee Statement No. 330, paragraph 23)

Case 2: The engagement team overlooked the fact that, regarding a non-consolidated subsidiary not accounted for by the equity method, a note explaining the reason for excluding the subsidiary from the scope of consolidation was not included in the scope of equity method section under the Significant Accounting Policies of the Annual Securities Report. (Fiscal 2011 Inspection)
(Auditing Standards Committee Statement No. 330, paragraph 23)

Case 3: The engagement team overlooked the fact that, regarding the difference in valuation of investment securities for which the entity determined not to record deferred tax assets because scheduling was deemed impossible, the total amount of deferred tax assets and valuation allowance was not presented in the Notes to Income Tax of the Annual Securities Report.
(Fiscal 2011 Inspection)
(Accounting System Committee Statement No. 10, paragraph 31; Auditing Standards Committee Statement No. 330, paragraph 23)

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