Case Report from Audit Firm Inspection Results

July 2018

Certified Public Accountants and Auditing Oversight Board

Introduction

Since its inception in April 2004, the Certified Public Accountants and Auditing Oversight Board (CPAAOB) has been conducting inspections of Japanese audit firms from the viewpoint of securing the public interest and protecting investors with the aim of maintaining and improving the quality of auditing in Japan.
The CPAAOB compiled examples of deficiencies identified in its inspections as the “List of Examples of Issues on Audit Quality Control Identified through Inspections” in February 2008 (renamed the “Case Report from Audit Firm Inspection Results” in 2012), and has since issued revised editions every year.

The purpose of this Case Report is to promote voluntary efforts by audit firms to maintain and improve their audit quality, by providing specific examples of major deficiencies identified in the CPAAOB's inspections as well as observed effective efforts and by presenting the audit-quality level expected by the CPAAOB. In addition, this Report also serves as reference material to be provided to the directors/ company auditors of listed companies and other companies subject to audit by independent auditors, investors and other market participants.

This year’s edition has been updated to add the latest actual cases of inspections and redesigned to make the background to deficiencies more easily understood, following the last year’s edition in terms of its basic structure.

We plan to present details of the content of the Report and organize information exchanges by conducting briefings at regional chapters of the Japanese Institute of Certified Public Accountants (JICPA) and lectures at the Japan Audit & Supervisory Board Members Association.

In addition, we have published information about the inspection system and the situation at audit firms in the form of the “Monitoring Report in 2018.” Please also refer to this report.

Please submit any comments or requests regarding this year’s edition to the dedicated e-mail address below.
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Responses Expected of Audit Firms

1. Ensuring the Reliability of Audits

The number of listed companies that have provided timely disclosure of inappropriate accounting has been increasing in recent years. This is likely due to factors such as a rise in the number of deficiencies being pointed out by auditors, but there have also been cases recently of accounting issues occurring at the overseas subsidiaries of listed companies. To ensure the reliability of audits, it is therefore necessary for each audit firm to verify its individual audit engagements and system of quality control with reference to the deficiencies and their causes described in this Case Report.

In doing so, audit firms should pay attention not only to whether their engagements and systems comply with the standards formally, but also whether they strive to ensure and improve the quality of their audits. In effect, such as whether they exercise appropriate professional skepticism that could identify accounting fraud, and whether they constantly focus on the business risks of the audited companies upon evaluating audit risks.

If deficiencies are identified in the system of quality control, the audit firm should not only remedy the deficiencies but also analyze the root causes and improve them.

2. Organized Responses

The chief executive officer (CEO) of an audit firm, such as the chief director, and the person in charge of quality control (PICOQC) are required to exercise leadership in the design and operation of a system of quality control. However, this should not only be the individual responsibility of the CEO or PICOQC, but rather a corporate responsibility to be fulfilled by all the partners of an audit firm. Keeping this in mind, each partner of an audit firm should work together in an organized manner to improve the existing conditions.

With regard to the management of audit firms, the “Principles for Effective Management of Audit Firms” (The Audit Firm Governance Code) was issued in March 2017. In light of the fact that some audit firms, particularly large-sized audit firms, are already establishing/strengthening a governance environment, the CPAAOB plans to continue examining whether or not the governance environment established and/or strengthened by each audit firm based on the Code is effective.

3. Preparation of Appropriate Audit Documentation

We should bear in mind that if any audit document has not been prepared properly for an important audit matter, this is not simply a deficiency of documentation, but in most cases, it implies that the necessary audit procedures have not been implemented. It is therefore vital to enhance the ability of each auditor to prepare appropriate audit documentation through education/training. It is also important for senior staff to provide day-to-day guidance to partners and professional staff who work with engagement partners with regard to the review of audit documentation and engagement quality control reviews, periodic inspection, etc. of audit firms.

4. Responding to Issues According to Size

The following characteristics have been identified in the CPAAOB's inspections as problems relating to the size of the audit firm.

[Large-sized audit firms]
We can see that large-sized audit firms are working on improvements toward higher quality, such as the utilization of knowledge of outside third parties, strengthening of collaboration between different levels within the firm (management, quality control division, business divisions, engagement teams), and appropriate human resource development and personnel management and evaluation.
On the other hand, at large-sized audit firms, since their organizations are extremely large, issues such as the lack of frequent communication among divisions and between the head office and regional offices and difficulty in ensuring the penetration of the firm's measures across all divisions and offices have still been pointed out. One the reasons for this is that because they are huge organizations, the gathering and sharing of information from the frontline is inadequate, which means that they are failing to properly identify risks facing the firm. Because of this, large-sized audit firms need to continuously ask themselves whether their organizational structure allows risks to be identified and addressed as conditions inside and outside the firm change.

[Second-tier audit firms]
Post-merger management at these firms is often not sufficiently integrated, with little involvement of partners in the firm's operations and reliance on a large number of part-time employees for audit engagements. Another problem is that the establishment of an audit performance environment does not match the expanded operations of the firms, which have expanded as a result of factors such as the undertaking of new audit contracts.
In addition, with second-tier audit firms needing to improve their ability to conduct audits for large listed companies, they are beset by problems such as inadequate handling of international operations, including the building of relationships with overseas partners.

[Small and medium-sized audit firms]
At small and medium-sized audit firms, many CEOs and PICOQCs still do not understand the importance of quality controls and are failing to make proactive efforts. In addition, they still lack the resources for developing systems of quality control. Because of this, while they are directly addressing deficiencies identified in external audits, this action is often superficial, being based on treating the symptoms rather

than tackling the causes. Audit firms are also making inadequate effort on a day-to-day basis to improve audit quality independently.
There also continue to be many cases among small and medium-sized audit firms where they place priority on expanding their businesses and accept new engagements from audited companies with high audit risk or audited companies that frequently change auditors.

As mentioned above, each audit firm should pay close attention to the point that the problems differ depending on the size of the firm, and it is necessary to respond appropriately according to its situation.

To Directors, Company Auditors, Investors and Other Stakeholders

The relationship between the directors/company auditors of a business audited company and an independent auditor are being streamlined through the recent revision of the Companies Act and related regulations such as the Corporate Governance Code. Meanwhile, there has been a further rise in interest in the companies' disclosure of proper financial information, amid recent incidents of accounting fraud by large listed companies and accounting issues related to overseas group companies.

Management is responsible for the preparation of financial statements and the design of internal controls. Furthermore, from the perspective of investor protection and securing the reliability of the capital market, directors and company auditors are strongly expected to appropriately evaluate and select independent auditors, who provide assurance as to the accuracy of financial statements, as well as to fulfill their responsibilities in order to ensure proper audits, such as by allowing adequate auditing time to ensure high quality audits and by fully collaborating with the independent auditors.
It is also important for market participants such as shareholders of audited companies that the directors and company auditors of audited companies appropriately evaluate and select independent auditors, and that companies' proper financial information is disclosed on a continuous basis by securing proper auditing.

In view of such matters, this Case Report describes examples of deficiencies identified in the CPAAOB's inspections, which include recent accounting fraud cases, in the most easily comprehensible manner possible from the perspective of providing directors and company auditors in listed companies, as well as investors with reference materials. Furthermore, this Report describes excellent cases of improvement efforts by audit firms. Thus, we hope that this Report will be used as a reference for the appropriate evaluation of independent auditors.

Important Points for Users of this Case Report

1. Regarding Cases Included in the Report

(1) Although this Case Report is a compilation of relatively new cases of deficiencies that were identified in the inspections, that does not mean that the CPAAOB puts less importance on cases that were not included in the Case Report.
(2) The cases included in the Report may have had facts omitted or changed to the extent that does not affect the purport of the case.
(3) The number of cases pointed out on the following pages reflects neither the proportion of the number of deficiencies by the size of the audit firms, nor the ratio of the number of deficiencies by the inspection items.
(4) Deficiencies that were not included in the Case Report may include matters that should be noted by the audit firms and engagement teams, or may include the points to be expected in terms of appropriate audit procedures.
(5) In cases where there are multiple criteria for identifying the deficiencies, the principal provision is quoted.

2. Main Characteristics of the 2018 Edition

(1) "I. Root Cause Analysis" (title in last year's edition: "I. Root Cause and Service Management Environment") provides numerous examples of issues with the business management (governance) environment and operations management environment.
(2) In "III. Individual Audit Engagements," expanded descriptions of deficiencies and points to note have been included in "4. Group Audit" and "6. The Auditor's Responsibilities Relating to Fraud in Financial Statement Audits" to reflect the fact that accounting fraud at listed companies and accounting issues at overseas group companies continues to attract public attention.

[Contents]

(Definitions of terms)

The definition of terms in this Case Report is as follows:

Act	Certified Public Accountants Act
FIEA	Financial Instruments and Exchange Act
Audit firm	An audit firm, a partnership, and an individual firm
Large-sized audit firm	An Audit firm that has more than approximately 100 domestic listed audited companies and whose full-time staff performing actual audit duties total at least 1,000. In this case report, they specifically refer to KPMG Azsa LLC, Ernst & Young ShinNihon LLC, Deloitte Touche Tohmatsu LLC and PricewaterhouseCoopers Aarata LLC
Second-tier audit firm	An audit firm whose business scale is second only tolarge-sized audit firms. In this case report, this will refer to five audit firms: Gyosei & Co., BDO Sanyu & Co., Grant Thornton Taiyo LLC, Crowe Toyo & Co., and PricewaterhouseCoopers Kyoto.
Small and medium-sized audit firm	An Audit firm other than large-sized and second-tier audit firms
JICPA	Japanese Institute of Certified Public Accountants
Quality control (QC) review	Quality control review performed by the JICPA under Article 122 of the JICPA Rules

Ⅰ． Root Cause Analysis

1. Necessity of Root Cause Analysis

As a result of the CPAAOB's inspections, it has been recognized that when a deficiency was detected in a QC review or periodic inspection, many audit firms only developed and took cosmetic improvement measures, without fully identifying the cause of the deficiency.

Deficiencies identified in inspections may be only a part of deficiencies, which have not been identified yet. It is likely that the audit firms have other undiscovered deficiencies arising from the same root causes. Moreover, there may be root causes that would invalidate the improvement measures implemented to cope with the direct causes of the deficiencies. Therefore, improvement measures developed only to cope with the direct causes, without any root cause analysis, would not be effective or sufficient for improving the quality control system of the entire firms, and would not lead to fundamental improvement; therefore, the quality of the audits by the audit firms would not be improved.

On the contrary, taking perfunctory measures such as simply adding checklist items in response to individual deficiencies, for example, would lead to an increase in unnecessary and ineffective workload for professional staff to respond to the checklist and often prevent them from implementing an effective and efficient audit engagements.

Thus, audit firms shall understand the importance of root cause analysis of deficiencies in order to substantively improve quality control.

Recent cases of audit firms making proactive efforts to identify root causes include a large-sized audit firm, which has established an audit engagement improvement project after many deficiencies were identified in the CPAAOB's inspections, intending to raise awareness of all the staff, analyzing the cause of the deficiencies in connection with the firm’s quality control environment. The project divides the firm into four levels (management, quality control division, business divisions, engagement teams) and redefines the roles of each layer in terms of quality control as well as analyzing the current issues of each layer and their causes. Especially, the audit division, which directly controls each engagement team, is positioned as a significant layer in quality control, and is entrusted with improving the identified deficiencies according to the cause analysis, coordinating with the quality control division and proactively monitoring audit engagements, under the leadership of the management level.

2. Root Cause Analysis and Business Management (Governance) Environment and Operations Management Environment

Many of the issues pointed out as the root cause of deficiencies are related to the business management (governance) environments and the service management environment, for example, the policy of top management, the headquarters’ environment of monitoring audit field work, the culture of quality control and governance of the audit firm. Therefore, each audit firm should pay special attention to the effectiveness of the business management (governance) environments and the service management environment such as the governance of the audit firm, which could be a root cause, without being caught by the direct cause of individual deficiencies.

The following are examples of issues with the business management (governance) environment and the operations management environment. They were identified during the CPAAOB's inspections by analyzing direct causes of deficiencies and investigating root causes.

［Large-sized audit firms］

[Case 1]

Multiple significant deficiencies in internal control for some individual audit engagements were identified at a large-sized audit firm. For example, substantive audit procedures for tackling fraud risk in individual audit engagements had not been established or implemented.

The direct causes of these deficiencies included the fact that engagement partners had not been adequately providing appropriate guidance and supervision concerning risks relating to audit engagements. Furthermore, due to inadequate internal/external cooperation by the audit division, it failed to sufficiently identify this situation with engagement teams and changes in the circumstances of audited companies, which led to inadequate support being provided in the case of high-risk audit engagements. In light of this situation, we conducted further investigations into the causes, and discovered that division managers were designated as being responsible for quality control within their divisions regardless of the size of the division concerned. Because of this, the scope of control of the managers of large divisions was too broad. Against this backdrop, there was deemed to be a problem with organizational structure, whereby internal structures within divisions for gauging the situation on the audit frontline and ensuring cooperation had not been adequately developed, resulting in inadequacies in terms of detailed monitoring of audit engagements.

[Case 2]

Multiple significant deficiencies in internal control for specific audit engagements were identified at a large-sized audit firm. These concerned, for example, audit procedures relating to accounting estimates, related-party transactions, etc.

The direct causes of these deficiencies included the fact that even though engagement teams had changed significantly, with, for example, lead auditors having been replaced with mid-career hires, engagement partners were leaving team administration and audit documentation reviews to the frontline. In light of this situation, we conducted further investigations into the causes, and discovered issues with quality control. For example, the firm had increased the number of mid-career hires as a means of coping with its business expansion, but systematic measures for maintaining quality in the engagements conducted by these newly hired partners and professional staff who work with engagement partners had achieved inadequate penetration.

［Second-tier audit firms］

[Case 1]

Multiple significant deficiencies in internal control for individual audit engagements were identified at a second-tier audit firm.

The direct causes of these deficiencies included the fact that old audit procedures were being followed and audit documentation reviews were not being conducted effectively. This was because the engagement partners believed that there had been hardly any problems with past audit engagements. Furthermore, these deficiencies were occurring especially frequently at specific regional offices. In light of this situation, we conducted further investigations into the causes, and discovered issues with business administration. Specifically, the firm had been established through a merger, and regional offices were operating independently, with headquarters being insufficiently aware of the situation at regional offices.

[Case 2]

Many deficiencies in basic audit procedures were identified in the audit firm concerning accounting estimates and verification of notes by related parties.

The direct causes of such deficiencies were that some partners and staff followed the previous audit procedures without effectively understanding the auditing standards and were not reviewing the audit records. This tendency was especially noted among partners who worked concurrently at another firm and among part-time employees. As a result of further analysis of the cause in view of such circumstances, an operational issue was identified where the audit firm had many partners whose concurrent work accounted for a large percentage of their time and depended on its many part-time employees for its audit engagements, and the burden on full-time partners was large due to the small percentage of such employees, although the CEO was trying to shift the business structure to one that was operated mostly by full-time partners.

［Small and medium-sized audit firms］

[Case 1]

Numerous deficiencies in quality control were identified at a small and medium-sized audit firm.

The direct causes of these deficiencies included the fact that partners assigned tasks relating to quality control only perform the administrative tasks allocated to them, and are not acting independently to improve audit quality at the audit firm. Another cause was that quality control for individual audit engagements is entrusted to the partners concerned. In light of this situation, we conducted further investigations into the causes, and discovered issues with business administration. Specifically, because the firm had been established as a result of the merger of multiple individual firms, an organizational culture remained whereby partners were reluctant to interfere in the business of other partners.

[Case 2]
A large number of deficiencies were broadly identified in multiple individual audit engagements at the audit firm.
The direct causes of the deficiencies were that the engagement team including engagement partners was lacking understanding and knowledge on the auditing standards. The audit performance environment was weak in general at engagement teams, which consisted of newly hired part-time certified public accountants (CPAs) and employees not qualified as CPAs, etc. As a result of further analysis of the cause in view of such circumstances, operational issues were identified, such as the CEO lacking understanding and knowledge of audit standards and not being aware of the weakness in the audit performance environment as he/she focused on expanding non-audit business and was mainly engaged in the operation of group companies, and the CEO and PICOQC hardly being involved in quality control operations.

As the above cases show, an analysis of the causes of deficiencies revealed that they stem from issues with the audit firm's business management (governance) environment or operations management environment, so to address the causes of these deficiencies, it is important to improve the business management (governance) environment or operations management environment.
Although audit firms, and large-sized audit firms in particular, are currently working to strengthen their organizational administration in accordance with the Audit Firm Governance Code, they ought to be focusing not on superficial development and reinforcement, but instead on taking sufficient action to ensure audit quality as an organization.

3. Specific Examples of Root Causes

The following are specific examples of issues with the business management (governance) environment and operations management environment that were identified during inspections and described in 2.
To address deficiencies, it will be necessary for audit firms to refer to these examples as they work on tackling fundamental issues that affect the firm as a whole, such as problems relating to its operations management environment, in order to substantially enhance audit quality.

［Large-sized audit firms］

In light of the fact that several deficiencies have been continuously identified in individual audit engagements, although the quality control system of large-sized audit firms has been apparently developed we understand that there still remain several deficiencies in the effectiveness of their operation.
Root causes of deficiencies identified in large-sized audit firms in the CPAAOB's inspections can be categorized as follows:

(1) Lack of understanding of quality control

Since large-sized audit firms have several thousands of employees, they usually have multiple divisions, consisting of several hundreds of staff managed by a division manager, etc. So, we can see their characteristics that they have multiple offices, including some regional offices.
Under such circumstances, in order to improve the QC level across the entire organization, it is necessary not only for firms to design the organization and procedures of a quality control system, but also for the management, including the CEO, to provide strong leadership, and for each division to instill the improvement measures into the engagement teams.
However, there may be problems in leadership, including the management's awareness in quality control, and in initiatives of the divisions as well.
The following are specific examples of root causes:

- The management, including the CEO, has not fostered corporate cultures that review the work from a broader perspective and improve the audit quality conducted by the on-site engagement teams.
- Each division, etc., that is responsible for audit quality improvement has not thoroughly been implementing measures to improve audit quality by engagement teams based on the policy of the management including the CEO.
- Engagement partners comprise lead partners and executive partners, and some engagement teams retain the old view that executive partners should be mainly responsible for quality control in audit engagements. Because of this, voluntary involvement by the lead partner in quality control in audit engagements is inadequate, and in some engagement teams the executive partners are overworked.

(2) Insufficient understanding of the actual situation of audit fieldwork and verification of improvement measures

The CEO and PICOQC shall understand in detail the performance of professional staff of each division as well as the audited companies and verify whether or not quality control measures have been instilled over the entire organization, and lead the results of the verification to further improvement, so that the

improvement measures permeate the huge and complicated organization. In addition, each division must take the initiative in implementing measures to improve audit quality.
Whereas, there may be issues such as an insufficient understanding of the actual situation of each division and an insufficient verification of whether the improvement measures are appropriately carried out.
The following are specific examples of root causes:

- Although division managers are supposed to be responsible for quality control within their respective divisions, the scope of control of the managers of large divisions was too broad. As a result, structures for gauging the situation on the audit frontline and ensuring internal and external cooperation have not been adequately developed. Because of this, information from engagement quality control (EQC) reviewers from outside the division and information from engagement partners inside the division are not being sufficiently utilized, and as a consequence, flexible support based on changes in the circumstances of audited companies is not being adequately provided. (With regard to this example, also refer to [Large-sized audit firms] [Case 1] on p. 14)
- Each partner’s quality control abilities and awareness for audit quality had still not been grasped sufficiently, nor had the audit risks of audited companies been understood by the Quality Control Division or each division. Furthermore, since the ability of partners and audit risks had not been thoroughly grasped, engagement teams that can deal with audit risks of audited companies had not been thoroughly organized, as evidenced by audit engagements where no engagement partners or engagement quality control (EQC) reviewers that can deal with risks have been assigned.
- Although the PICOQC was supposed to verify whether or not the quality of all audits had been improved with periodic inspections and interim reviews, he/she had failed to establish environment to carry out effective monitoring (i.e., PICOQC did not take timely actions for audit procedures concerning audit engagements that require immediate improvement, despite combining periodic inspections and interim reviews).
- Regarding improvement measures for the deficiencies identified, the CEO and PICOQC only provided instruction to engagement teams as in the past, and did not verify the appropriateness or effectiveness of the improvement measures, as they did not understand the necessity of verification.

[Second-tier audit firms and small and medium-sized audit firms]

Second-tier audit firms and small and medium-sized audit firms vary in size and history, and the level of quality control differs significantly among firms. The size of their organization, however, is relatively small and it is difficult for them to provide sufficient organized support to engagement team; these features are common to both types of audit firms. The features among small and medium-sized audit firms are that the level of operation and quality control often depends significantly on the competence of individuals that belong to the audit firm, including the CEO, and the relationship between the partners and the firm.

Based on the background above, the root causes of deficiencies identified in the CPAAOB's inspections can be categorized into the following three:

(1) Business management environment, management policy (including policies related to evaluation, compensation and other incentives) or business model of audit firms
(2) Quality control stance and efforts by the CEO, PICOQC and engagement partners
(3) Partners' awareness of responsibilities; mutual monitoring among partners

Many second-tier audit firms, in particular, expand their operations through mergers with other audit firms and positive undertaking of new audit contracts. Under these circumstances, issues concerning post-merger integration have been identified, such as cases where the quality control system has not been sufficiently designed and operated, despite the expansion of operations, and cases where some of the merged firms have failed to maintain the level of quality control of each audit engagement after the merger, since the purport and requirements of audit standards are not fully understood.
Furthermore, at small and medium-sized audit firms, low levels of understanding of and involvement in quality control among CEOs often affect the quality control climate throughout the firm, so it is important for CEOs to demonstrate leadership in the area of quality control.

The following are specific examples of root causes:

(1) Business management environment, management policy (including policies related to evaluation, compensation and other incentives) or business model of audit firms

- Operations are performed independently at each regional office. Specifically, matters such as the composition of engagement teams, the determination of partners' remuneration, periodic inspections, and engagement quality control reviews are determined and implemented under an independent operations management environment. Furthermore, partners and employees at the different regional offices hardly ever come into contact with each other. Given this situation, the CEO recognizes the need for integrated business administration within the firm, and is taking steps to achieve this, such as strengthening headquarters functions. However, because the role of headquarters is not clearly prescribed in organizational rules etc., and there are no full-timers assigned to headquarters, the functions of headquarters are not being adequately performed, so the steps being taken are inadequate to ensure integrated business administration. (With regard to this example, also refer to [Second-tier audit firms] [Case 1] on p. 15)
- The number of audit engagements is increasing year by year, and the firm has recently undertaken engagements from high-risk listed companies. However, only a small number of partners comprise

the full-time professional staff, and partners and professional staff who work with engagement partners also include part-time employees. Because of this, partners focus only on their own audit engagements, and are not getting sufficiently involved in quality control.

- The audit firm had many partners who had a high percentage of concurrent work, and depended on a large number of part-time employees for its audit engagements. Although it was pointed out in the previous CPAAOB's inspections that such a business structure made it difficult for the management philosophy to be instilled and for the CEO, etc., to enforce governance, the firm has still not been able to make fundamental improvements to its business structure. Therefore, the development of effective governance is insufficient to thoroughly enforce quality control across the entire firm.(With regard to this example, also refer to [Second-tier audit firms] [Case 2] on p. 15)
- The CEO was mainly engaged in the operation of affiliated companies of the audit firm in order to focus on expanding non-audit business. Other representative partners were also engaged mainly in the operation of their individual firms. Therefore, not only were the CEO, etc., hardly involved in quality control operations of the audit firm, but were also not aware of the vulnerability in the audit performance environment such as the lack of professional skills of professional staff. (With regard to this example, also refer to [Small and medium-sized audit firms] [Case 2] on p. 16)
- The audit firm neither met the criteria for the statutory requirements of partners involved in the operation control structure nor secured enough human resources to perform proper audits. The audit firm has not established an environment for performing organized audits commensurate with audit risks.

(2) Quality control stance and efforts by the CEO, PICOQC and engagement partners

- The CEO believes that no significant audit-related issues have occurred in the past, and therefore sees little need to establish an integrated operations management environment for ensuring that audits are conducted in a systematic fashion. Furthermore, even though the most recent quality control review resulted in a qualified opinion, he/she has not demonstrated leadership in improving quality control. For example, he/she has not given instructions to the PICOQC to make improvements based on an adequate understanding of the causes of deficiencies.
- The CEO and the PICOQC lack an adequate understanding of recent environmental changes affecting auditing and accounting and levels of quality required under current audit standards. Furthermore, an environment for the ongoing provision of education and training has not been established.
- The PICOQC is replaced every two years, but the current PICOQC believes that his main role is to continue conducting periodic inspections, as his/her predecessor did. He/she therefore lacks awareness of the need to proactively get involved in quality control as a whole. Because of this, he/she is not properly fulfilling his/her role of managing quality control. For example, he/she is not providing adequate instructions to staff involved in quality control. Furthermore, even though the

CEO has been aware of this situation with quality control, he/she has not attempted to establish a more effective quality control environment.

- The CEO and engagement partners relied on the assertions of audited companies based on their audit experience, and were not sensitive to fraudulent risks. In particular, certain engagement partners relied on the assertions of a high audit risk audited company and did not perform audit procedures with professional skepticism. They did not understand current accounting and audit standards either.
- The PICOQC was busy dealing with a merger and other matters, and failed to thoroughly enforce the use of audit tools by the engagement teams in light of audit standards. He/she had not taken sufficient actions, such as sufficient verification of the improvement of identified deficiencies, in order to improve the quality of engagement teams that did not meet the quality level required for audits.
- The CEO did not appropriately evaluate the quality of individual audit engagements or the professional skills of professional staff, even though the most recent quality control review had identified material deficiencies. He had partners with insufficient understanding and knowledge of the quality levels required under current audit standards serve as engagement partners or EQC reviewers of listed companies for many years, and had not established an effective quality control system.
- Even though the audit firm was expanding its audit engagements, including new engagements from audited companies with high risk, the CEO and PICOQC assumed that the situation could be sufficiently handled by adjusting the workload of partners without increasing the number of professional staff. However, many of the audit engagements relied on partners with low evaluation on quality control. Amid such circumstances, the CEO and PICOQC did not make sufficient efforts in accordance with the expansion of the organization’s business, without improving the quality control skills of such partners.
- The CEO and PICOQC assumed that there would be no significant quality control issues as long as they avoided audit failures by fully addressing matters that the engagement team deemed significant in audit engagements. Furthermore, they responded to deficiencies identified in the quality control review by taking improvement measures merely as a formality without fully analyzing the cause, on the grounds that material deficiencies had not been identified in the past quality control reviews.

(3) Partners’ awareness of responsibilities; mutual monitoring between partners

- The audit firm was incorporated through the merger of multiple individual firms, so quality control for audit engagements was left to the partners themselves. And because each partner was responsible for the profitability, staffing, etc. of their own audit engagements, there remained an organizational climate in which they would not interfere with the work of other partners. So the operations management environment was not integrated. (With regard to this example, also refer to [Small and medium-sized audit firms] [Case 1] on p. 15)

- As the circumstances surrounding audits change, the partners lacked an attitude to maintain and improve the audit quality of the firm, such as proactive actions to revise conventional QC methods and audit procedures, and were reluctant to change themselves under a situation where major audit issues were unlikely to occur.
- Because the current audit firm was incorporated based on the individual firm of the CEO and the CEO led the acceptance of major engagements, other partners considered that the firm was something like a personal office of the CEO, and thus have a propensity to rely on the CEO for most of the management of the firm.
- As a partners' meeting has ultimate responsibility for the quality control system in an audit firm, each partner should be aware of the responsibility as a member of this meeting, in order to design and operate the quality control system of the audit firm. However, partners, including the CEO, were not aware of their responsibility regarding the operation of the firm. And therefore, the partners' meeting did not function well.
- Partners lacked experience in quality control operations of an audit firm or in forming audit opinions of listed companies prior to the establishment of the firm. They also had insufficient understanding and knowledge of the quality level required under audit standards. In addition, with regard to quality control of the audit firm and audits of listed companies, they lacked an attitude of seeking to improve audit quality and professional skills since they assumed that they could fully deal with issues based on their experience.
- Partners, including the CEO, have not carried out self-improvement on audits although audit levels required under audit standards have changed, and do not understand the levels required under current audit standards. In addition, they are not fully aware of the necessity of continuously reviewing the quality control environment according to quality levels required under current quality control standards.

Ⅱ.　Quality Control System

Implementation of Quality Control Operation

Outline

The CPAAOB inspects whether measures developed by audit firms to ensure adequate operations and maintenance/enhancement of the QC system are appropriate to the size and characteristics of the firm.

Responses to requirements for QC systems under the audit standards vary between large-sized audit firms with several thousand members, and small and medium-sized audit firms. Furthermore, many deficiencies identified in the past reflect the size and characteristics of each audit firm, and the background to the deficiency as well.

Therefore, in "II. Quality Control System", examples of deficiencies identified in the CPAAOB inspections are categorized into "Large-sized audit firms" and "Small and Medium-sized Audit Firms," and introduced basically according to the provisions of "Quality Control for Audit Firms" (Quality Control Standards Committee Statement No. 1).

Note that the examples of identified deficiencies include ones that could occur at any audit firm regardless of its size. Therefore when examining system of quality control in your firm, please also refer to examples of deficiencies in the categories other than your firm belongs.

Analysis of deficiencies that occurred

Regardless of the size of an audit firm, the purpose of establishing a QC system is to reasonably ensure the quality of audit engagements.

However, some audit firms developed a QC system only as a formality. In such cases, the QC system developed by the audit firm often does not work as expected and results in deficiencies, due to such causes as the failure to appropriately operate the system and to organically link the system to the improvement of individual audit engagements.

At large-sized audit firms, although deficiencies related to the design of a QC system have seldom been identified in recent years, there are still many deficiencies in individual audit engagements. Therefore, it can be assumed that there are deficiencies in the operation of the QC system. Specifically, operation-related deficiencies have been identified in areas such as reviews of audit documentation and periodic inspections.

Furthermore, deficiencies in individual audit engagements that were identified by the CPAAOB inspections and quality control reviews in the past were improved merely as a formality without uncovering their fundamental causes, which has led to continued identification of same deficiencies in other individual audit engagements. From such cases, it may be deemed that efforts to improve operations related to quality control are insufficient.

For example, there are cases where measures that were developed to improve the deficiencies have not fully permeated the divisions and engagement teams, which have resulted in failure to achieve the expected effects and in continued identification of the deficiencies in the division or engagement team.

At second-tier audit firms and small and medium-sized audit firms, deficiencies continue to be identified in a broad range of areas in terms of both the design and operation of the quality control system. In addition, as at large-sized audit firms, there were cases where deficiencies that had been identified in the past by the CPAAOB inspections and quality control reviews were not appropriately improved in individual audit engagement inspections. Many such cases were deemed attributable to the quality control system. The above resulted from the facts that the CEO and the PICOQC did not understand the purpose of quality control operations, and that the design and quality control system were not conducted or used appropriately. In addition, there were cases where sufficient resources were not applied to the establishment of a quality control system that directly affects the audit quality.
A cause that is unique to second-tier audit firms is the failure of quality control system functions to suit the expansion of the size of the corporation through merger or acceptance of new audit engagements. For example, although persons in charge of each function of the quality control system including EQC reviews and education/training were appointed, they could not identify and correct the deficiencies that are inherent in terms of quality control and individual audit engagement, because there was no one responsible for the quality of audit.

(Observed effective efforts)
There were cases such as the following had been taken to strengthen quality control of the firm:
In the area of quality control operations, a council has been established to clarify the consideration and integrate the administration of regional offices. This council comprises members of the quality control division at the headquarters as well as members from across the entire audit firm, including partners, managers, and senior staff involved in quality control at regional offices. Furthermore, the results of its consideration are shared with the board and partners at regional offices to ensure that there is no variation in the responses over the regional offices.

Expected response
Based on the primary purpose of a quality control system, which is to reasonably ensure the quality of audit engagements, all audit firms are required to establish such a system effectively and efficiently, depending on the size and characteristics of each audit firm, so that the QC system can effectively work in individual audit engagements. Specifically, the CEO and PICOQC of audit firms should understand the purpose and importance of the quality control system, and take the initiative in ensuring that each professional in a firm understands that the primary purpose of the QC system is to spread measures to improve the quality of audit throughout the entire organization, and monitors its effects at all times.
The content and scope of quality control policies and procedures stipulated by an audit firm are affected by various factors, such as the size and composition of professionals at the firm, the characteristics of management, and whether the firm belongs to a global network. In light of this, the CEO and PICOQC of audit firms should establish appropriate QC environment according to the size and characteristics of their firm and appropriately maintain the system by reviewing it as needed.

［Large-sized Audit Firms］

1. Initiatives to Improve Performance

Points of focus

Although large-sized audit firms have established QC systems as a formality, it is believed that there are certain deficiencies in the effectiveness of quality control, including the administration of the system. Therefore, the CPAAOB inspects, in particular, whether the firm is making effective efforts to improve its operations, instead of those merely as a formality, against deficiencies identified in the previous CPAAOB inspection or QC review at periodic inspections.

Specifically, the CPAAOB checks the status of cause analysis of the deficiencies identified in the past and the status of measures to improve operations, such as measures based on the status of analysis, as well as the effectiveness of the firm's improvement efforts by verifying individual audit engagements. In the case where issues are identified in the measures to improve operations, the CPAAOB seeks to identify the operational and structural issues that might be the cause of such insufficiency, and inspects the effectiveness of the remediation measures carried out by the firm.

Outline of inspection results

At large-sized audit firms, remediation measures for deficiencies identified in the CPAAOB inspections and QC reviews may be planned under the initiative of the QC division at the headquarters, and disseminate them to engagement teams through training and notifications. Each engagement team then responds through the revision of audit procedures based on the risks of each audited company considering the extent of efforts.

Such responses are effective for issues such as the lack of basic understanding of audit procedures. Although improvements that rely on the initiative of the QC division are insufficient to instill the purpose of the remediation measures throughout the entire organization of large-sized audit firms with few thousand employees and multiple regional offices. Therefore, in carrying out measures to remediate operations at large-sized audit firms, it is necessary to make firm-wide responses in an organized manner under the leadership of the CEO and with a high awareness toward improvement not only in the QC division but also among each divisions and partners.

However, the CPAAOB inspection has revealed that organized improvement measures are not sufficient at different levels within the firm, such as departments and partners. Specifically, there were cases where improvements were not permeated at firms whose departments and regional offices had no personnel exchange with other departments, resulting in static human resources.

Expected response

Large-sized audit firms employ several thousands of staff members and have multiple offices, including those outside major cities. Therefore, they usually have multiple departments, each consisting of several hundreds of staff members and managed by a department manager or equivalent. In order to disseminate improvement measures planned at the headquarters to the entire organization as a response toward improvement and achieve sufficient effects, the entire firm should respond to any deficiency together with division managers, based on the understanding of the entire firm in quality control, instead of response only by limited divisions, such as the QC division. Thus, the expected effects can be achieved.

The CEO in particular should take the initiative in encouraging all members, especially the engagement partners, who are in a position to lead the engagement teams, to improve operations, so that the intent of the improvement permeates the entire organization. Thereupon, the PICOQC is required to plan and implement the timely and appropriate measures under the instructions of the CEO, while division managers are not required to only improve operations but to provide appropriate instructions and urge professional staff under their management to make appropriate responses.

Furthermore, the CEO and PICOQC should together with division managers or equivalent, establish an effective system to monitor improvement and take appropriate actions to promptly resolve any issues that were identified in the inspection.

In carrying out measures to improve operations at large-sized audit firms, you have to pay close attention so that the measures do not become a formality, such as by avoiding giving uniform instructions for improving deficiencies throughout the entire firm. For this purpose, it is necessary to carry out moderated and effective measures, such as by fully analyzing the tendency and cause of the identified deficiencies to identify the target areas for performance improvement (for example, certain departments and subordinate offices, audit items such as accounting estimates and response to fraud, and IPO-related audits), and focusing on effective improvement measures that suit the target areas.

Case 1: Information sharing and cooperation within the firm

In response to the results of past external inspections, the audit firm is promoting consultations with engagement teams based on cooperation between audit divisions, quality control divisions, etc. with the aim of maintaining and improving quality control throughout the firm.

However, because of cooperation between divisions within the firm was inadequate, when considering making changes to the composition of an engagement team involved in a high-risk audit engagement, the division in charge failed to communicate adequately with the engagement partner, who had been assigned from another division, and therefore failed to grasp this engagement partner's situation, such as how many audit engagements he/she was involved with, whether he/she had a heavy workload, etc. Although other divisions were aware of heavily loaded information about this engagement partner, it was not being shared with other divisions.

Furthermore, the audit divisions and quality control divisions were not sharing information with each other about material changes in audit engagements, the audit divisions were unaware of

increased risk of audit engagements, and therefore did not consider the needs of additional supports for these audit engagements.
(Quality Control Standards Committee Statement No. 1, paragraphs 15–16)

Case 2: Verification of improvement

The audit firm changes its engagement partners engaged in audit engagements with many deficiencies identified in the CPAAOB inspections, in order to limit the number of audited companies they are in charge of. However, an engagement partner that was subject to the limitation of the number of audited companies in charge was retained in a certain individual audit engagement due to reasons such as handover, with an engagement partner to be newly engaged in the engagement supplementing the roles of the above engagement partner.

However, the new engagement partner was held up by a temporary project of another engagement and could not be involved in the above engaged as initially planned. Therefore, the engagement team has not been able to fully respond to the accounting issues of the audited company.

Furthermore, although the new engagement partner initially reported to the division manager of the audit firm about the temporary project of another engagement and accounting issues, he/she did not make subsequent reports on an ongoing basis.

Moreover, the division manager failed to respond to the situation where full involvement of the new engagement partner cannot be expected by, for example, assigning more employees to the engagement team.

(Quality Control Standards Committee Statement No. 1, paragraphs 15–16)

Case 3: Progress of remediation plan

Quality control division is endeavoring to remediate deficiencies pointed out in previous CPAAOB inspections and QC reviews by making team members aware of them through training, revising the format of audit documentation, and so on. Also, audit divisions have established quality control committee to enhance the audit quality at the field site.

However, re-forming audit team members consciousness, such as planning/executing the audit procedures reflecting the charge in the business environment of audited companies and understanding in the levels of audit procedures to be executed in each situation was not enough.

As a result, similar deficiencies related to accounting estimates and the investigation of related-party transactions were repeated from the past.

(Quality Control Standards Committee Statement No. 1, paragraphs 15–16)

《Points to note》

When taking measures to improve operations by changing team members, attention must be paid to check whether the personnel change has yielded the expected effects.

In addition to the above, even though the initiative of improvement was not effective, the QC division and other departments did not carry out monitoring or other actions and not verify the improvement status for each engagement team. Then, it can be said that the CPAAOB inspection was made before appropriate improvement guidance could be provided. This led to the identification of cases of an "unimproved" situation. It is important to enhance the system of quality controls such as EQC reviews and periodic inspections. In addition, audit divisions close to field site could design and exercise their own expeditions monitoring system is thinkable.

2. Operation of the Quality Control System

Points of focus

At large-sized audit firms, although deficiencies related to the design of a QC system have seldom been identified in recent years, there are still deficiencies identified in individual audit engagements. The CPAAOB believes that, although the format (organization and procedures) of QC systems is developed, there are deficiencies in the effectiveness of QC systems including their operation.

Therefore, the CPAAOB inspections examine the existence of operational deficiencies of the QC system related to individual audit engagements from the perspective of whether the QC system that the audit firm established has failed to lead to the maintenance and improvement of the quality of the audit that each engagement team implements, resulting in the failure to identify and prevent audit deficiencies.

Change of auditors at listed companies has been increasing in recent years. In undertaking new audit engagements of large companies such as listed companies, it is necessary to fully examine the time needed for auditing, the human resources such as professional staff and the level of audit fees in order to reasonably ensure the quality of audit.

Therefore, the CPAAOB inspections not only evaluate the risk of undertaking audit engagements but also verify whether the time for auditing and human resources as well as the level of audit fees are fully examined to ascertain whether the quality of audit is reasonably ensured.

Outline of inspection results

In terms of the operation of QC systems, the CPAAOB has identified many deficiencies in areas such as reviews of audit documentation, EQC reviews and periodic inspections. Specifically, there were many cases where the engagement partners or equivalent who review audit documentation, the EQC reviewer and the person in charge of periodic inspections had not fully understood the changes in the environment surrounding audited companies, the circumstance of the audited companies, or the audit procedures performed by the engagement team, and failed to detect the deficiencies of individual audit engagements.

The CPAAOB has pointed out as the causes of such deficiencies that, although there were differences in awareness of audit quality and abilities of quality control among partners such as engagement partners and EQC reviewers, the QC department could not fully understand the differences or assign the appropriate engagement partners and EQC reviewers, and, in addition, the engagement teams did not proactively consider how to ensure audit quality as they relied on manuals and the headquarters' instructions.

Expected response

Engagement partners should understand that they are responsible for supervising engagement team members, considering their competency and experience, and leading them to conduct audit engagements sufficiently and appropriately, and should proactively engage in every phase from audit planning

through the forming of opinions.
Furthermore, EQC reviewers should confirm that audit engagements have been conducted sufficiently and appropriately, for example, by reviewing audit procedures and audit evidence related to significant matters described in the audit documentation to ascertain that there were no problems in the process of forming opinions.
The CEO and PICOQC should then establish environment where the engagement partners conducting reviews and EQC reviewers can appropriately carry out operations.
Specifically, audit firms should assign appropriate engagement partners and EQC reviewers, considering each partner's awareness of required audit quality, abilities in QC and audit risk based on the audited company's corporate environment. In addition, if a deficiency in audit improvement caused by an engagement partner has been detected, for example, the audit firm should re-evaluate the ability in QC of the engagement partner and appropriately allocate resources based on the ability and provide re-training to engagement partners.
Large-sized audit firms utilize contents such as electronic audit documentation systems, in which audit procedures are described, and checklists that are used in EQC reviews and periodic inspections in order to perform audits and related operations effectively and efficiently. In addition, they have established consultation and council systems at the headquarters, where difficult audit issues are discussed and advice or solutions are provided. While such a system is useful in maintaining audit quality at a certain level throughout the audit firm, it might lower the awareness of engagement teams to proactively consider audit quality.
The CEO and engagement teams, including engagement partners, should endeavor to appropriately conduct audit engagements by fully understanding the benefits and limitations of a system such as the above.

Case 1: Review of audit documentation and supervision of audit engagements

- Engagement partners only ascertained matters that were identified in past periodic inspections or matters that it assumed would be identified in the future, as they were strongly conscious of the results of periodic inspections, without conducting reviews to ascertain whether the risk evaluation procedures performed by audit assistants or substantive procedures were performed appropriately in light of the business environment of the audited company; therefore, they could not detect deficiencies in accounting estimate auditing through reviews.
  (Quality Control Standards Committee Statement No. 1, paragraph 31; Auditing Standards Committee Statement No. 220, paragraphs 15–16)

- Engagement partners assumed that partners and professional staff who work with engagement partners had sufficient auditing experience and skills in areas other than important audit areas, and that the degree of the risks of misstatement was relatively low. Therefore, they did not give

sufficient directions to professional staff who work with engagement partners appropriately to perform audit procedures and did not conduct sufficient reviews or supervision to ascertain whether the audit procedures performed by partners and professional staff who work with engagement partners sufficiently met the audit levels required by the audit standards.
(Quality Control Standards Committee Statement No. 1, paragraph 31; Auditing Standards Committee Statement No. 220, paragraphs 15–16)

- At the time they planned audits, engagement partners lacked awareness of the need to consider effective audit procedures each term in the light of the situation in audited companies. Because of this, they did not give effective instructions to partners and professional staff who work with engagement partners concerning the design of audit procedures correspond to the risk of material misstatements. Furthermore, at the completion of audits, they did not perform in-depth reviews for the purpose of ascertaining whether sufficient appropriate audit evidence had been obtained.
(Quality Control Standards Committee Statement No. 1, paragraph 31; Auditing Standards Committee Statement No. 220, paragraphs 15–16)

《Points to Note》

In a limited time frame, such as year-end audits, it is required to appropriately plan the content, timing and scope of the review of audit documentation for engagement partners or equivalent to conduct appropriate reviews and direct engagement teams through reviews. It is also required to give specific directions and supervision to partners and professional staff who work with engagement partners.

Case 2: Securing effective review

- The EQC reviewer assumed, through daily communication with the engagement team, that the audit procedures performed by the engagement team were sufficient and appropriate. Therefore, the EQC reviewer did not conduct sufficient reviews of audit documentation concerning important audit judgments made by engagement teams and their conclusion, by ascertaining whether the engagement teams' explanations for important audit areas, such as audit procedures for significant risks, were supported by sufficient appropriate audit evidence.
(Auditing Standards Committee Statement No. 220, paragraphs 19–20)

- EQC reviewers did not conduct adequate engagement quality control reviews from an objective standpoint. For example, EQC reviewers mainly checked the information presented in audit summary memos prepared by engagement teams, and omitting reviews of important items in management letters or in financial statements. Furthermore, they lacked awareness of the need for skepticism in engagement quality control reviews. For example, they did not adequately examine the content of audit documentation, instead relying on oral explanations from the

engagement teams. Moreover, because they were pressed for time to perform important engagement quality control reviews, they did not conduct appropriate engagement quality control reviews in other areas.
As a result, they not only failed to identify deficiencies in accounting estimates and audit procedures for fraud risks, but also overlooked the fact that the content of management letters was inconsistent with the audit results.
(Quality Control Standards Committee Statement No. 1, paragraphs 36, 37, A41; Auditing Standards Committee Statement No. 220, paragraphs 19–20)

Case 3: Effectiveness of periodic inspections

- Although reviewers for periodic inspections confirmed the existence of audit documentation using a checklist, they lacked awareness of the need to conduct in-depth reviews concerning the adequacy of further audit procedures performed by engagement teams. Because of this, deficiencies concerning accounting estimates and related-party transactions were not discovered.
  (Quality Control Standards Committee Statement No. 1, paragraphs 47)

- The audit firm positioned the global review as its principle procedures for periodic inspection. In the global review, mainly the constituents of overseas member firms focused on priority items from the unique perspective of the global review within a limited period of time.
  However, since the audit firm did not fully consider such nature of the global review, it could not ensure the effectiveness of periodic inspection, nor could it fully respond to matters required under audit standards for periodic inspection.
  (Quality Control Standards Committee Statement No. 1, paragraphs 50–51)

- The engagement team performed additional audit procedures as corrective measures against the deficiency identified in the cyclic inspection. The QC department did not sufficiently monitor the audit documentation to ascertain whether the judgments made by the engagement team for these additional audit procedures were supported by sufficient appropriate audit evidence, since it did not understand the need to critically evaluate important judgments made by the engagement team.
  (Quality Control Standards Committee Statement No. 1, paragraphs 50–51)

《Points to Note》

It should be noted that EQC reviews and periodic inspections are required to evaluate the content of the engagement teams explanations objectively based on documents, through examination of audit documentation.

It should also be noted that with regard to audit firms positioning the global review as the center of

periodic inspection, whether the global review conducts inspections that correspond to requirements under Japan's audit standards should be ascertained, and if it is suspected that it does not, it should be ascertained whether it is necessary to take some kind of supplementary measures.

［Second-tier Audit Firms and Small and Medium-sized Audit Firms］

1. Operation Control Structure

(1) Initiatives to Improve Performance

Points of Focus

The CPAAOB performs inspections based on QC review reports, in principle. The CPAAOB inspection focuses on the status of improvement of deficiencies identified in the previous CPAAOB inspection or QC review. Specifically, the CPAAOB ascertains the status of cause analysis of past identified deficiencies as well as the status of measures to improve operations, such as those based on the cause analysis, and also ascertains the effectiveness of operational improvement of the audit firm through inspections of individual audit engagements. Furthermore, in the case where measures to improve operations are deemed problematic, the CPAAOB seeks to identify the service management environment issues that might be the cause of such insufficiency.

Outline of inspection results

As shown in the case example section below, in some audit firms, initiatives to improve the deficiencies identified in the QC review were not fully implemented, and in more than one deficiency, no improvement measures were made or the improvement was insufficient.

Possible causes of the identified deficiencies include the following:

- The PICOQC merely carried out measures as a formality, such as simply disseminating information on the deficiencies through training and only instructing to respond to the items included in the checklist for improvement related to identified deficiencies, without considering why the matter was identified as a deficiency in the QC review;
- The audit firm lacked the attitude of seeking improvement in all audit engagements; and
- The audit firm had not established environment to effectively monitor the improvement of deficiencies.

Furthermore, engagement partners that review the audit documentation, the EQC reviewer and the person in charge of periodic inspection or the equivalent did not fully understand the purpose of their functions and completed their work by reviewing audit documentation and implementing checklists merely as a formality. They also relied on the engagement practitioners for the development of knowledge required for audit engagement. The audit firm did not proactively seek to maintain and improve the aptitude of professional staff or develop their capabilities. Therefore, professional staff including partners often did not fully understand the matters required under the audit standards and standards of audit of the Auditing Standards Committee Statement or equivalent. All of this led to the inability to detect the same or similar deficiencies that were inherent in individual audit engagements, and thus to make any improvement.

(Observed effective efforts)

The following responses were made at an audit firm where many deficiencies were identified in the QC review:

- The CEO directly ascertained the improvement of deficiencies in all audit engagements.
- A system that enables an early detection of audit issues was established, such as the implementation of a preliminary EQR review system.
- The identified deficiencies were understood and the improvement measures were disseminated through discussions in each engagement team.

Expected response

The audit firm must fully understand to what range and nature a deficiency should be improved, considering the reason why it was identified as a problem in the CPAAOB inspection or the QC review. Based on the results of that examination, the firm should develop and implement appropriate improvement measures for the identified deficiency. At the development stage of improvement measures, it is important that improvements of the identified deficiency are not developed as a mere formality, but that the cause of the deficiency is analyzed before effective improvement measures are formulated to eliminate the cause. At the implementation stage of the improvement measures, it is important that the contents of the measures are correctly understood throughout the organization. The firm should not only examine the individual audit engagement where the deficiency was identified, but also check whether other individual audit engagements had the same or similar situations as the identified deficiency, and fully examine whether the improvement measures developed have been properly implemented. Thus, the firm must take measures to improve all audit engagements undertaken by the firm.

Case 1: Establishment and implementation of specific procedures for improvement

- With the aim of addressing deficiencies identified in the QC review, the PICOQC of an audit firm reported the recommendations for improvement in the QC review at the partners' meeting, and instructed engagement partners to communicate them to each engagement team. The PICOQC also prepared a checklist of recommendations, and used it in order to have engagement partners conduct self-inspections. Furthermore, EQC reviewers confirm that these self-inspections were performed.

  However, since the instructions and recommendations checklist were limited to items and accounts which were directly identified, they did not constitute improvement measures based on adequate analysis of causes.

  (Quality Control Standards Committee Statement No. 1, paragraphs 15–16)

- The audit firm prepared a checklist for deficiencies found in QC reviews and their improvement measures, while engagement partners, EQC reviewer, and PICOQC confirmed the improvement status using the checklist.
  However, the contents of most of the improvement measures merely responded to the wording of the identified deficiencies as a formality, for example, “Evaluate whether management’s assumptions are reasonable and record it in the audit documentation” against the following deficiency: “Management’s assumption of the estimate is not examined.”
  (Quality Control Standards Committee Statement No. 1, paragraphs 15–16)

Case 2: Communication of specific policies and procedures for improvement

There were cases where the specific policies and procedures for improvement were not fully communicated within the organization. For example, in the checklist designed for periodic inspection, the PICOQC included deficiencies identified in the QC review and improvement plans for them. However, the PICOQC did not explain to other members in the firm the reasons of the deficiencies and the purpose of the improvement plans. For part-time employees, only a postal mail describing the deficiencies was sent.
(Quality Control Standards Committee Statement No. 1, paragraphs 15–16)

Case 3: Verification of improvement

The CEO disseminated the improvement measures for the deficiencies identified in the QC review and monitored the improvement status through periodic inspection, but did not verify the improvements for operations that were not subject to periodic inspection.
(Quality Control Standards Committee Statement No. 1, paragraphs 15–16)

《Points to Note》

The above example cases indicate that the same or similar deficiencies as the deficiencies identified in the past CPAAOB inspections and QC reviews were found. These cases were occasioned by merely taking improvement measures as a formality, such as simply communicating the details of the matters to be improved or using improvement checklists without identifying the root cause of the deficiencies and resolving or improving the causes. Therefore, the PICOQC should note that it is necessary not only to communicate to the engagement teams the details of the identified deficiencies but also to examine instructions in order to specifically reflect the issues into audit procedures. In addition, when using the improvement checklist or equivalent, it should be noted that the PICOQC and engagement partners need to inspect the improvement status in light of why the matter was identified as a deficiency as well as the scope of procedures that should be improved.

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

Points of focus

The CPAAOB inspects audit firms for the status of establishment, dissemination, and implementation of internal rules, from the following perspectives:

- Whether the audit firm has internal rules in place to reasonably ensure audit quality, taking into consideration the size and operations of their audit firm;
- Whether the audit firm works to ensure the adequacy of the internal rules, for example, by sufficiently confirming consistency between the rules when establishing or revising them, or by revising the internal rules according to revised laws, regulations, and professional standards, as needed;
- Whether the PICOQC or equivalent distributes copies of the internal rules to professional staff (including part-time staff) and other personnel without fail, and ensures their familiarization with the rules, for example, by verbally explaining them as needed;
- Whether the PICOQC or equivalent ensures compliance with the internal rules, for example, by having professional staff or other staff monitor the status of compliance in a timely manner, as needed.

Outline of inspection results

In the establishment, dissemination and implementation of internal rules, as shown in the case example section below, some firms did not establish internal rules related to independence and non-audit services. Some other firms did not follow internal rules related to contract management.

Some of the reasons for such deficiencies were that the members of the audit firms did not understand the laws and standards that are applied to audit firms, and that the audit firms adopted the template of the "Audit Quality Control Regulations" that are provided by the JICPA as their internal rules without customizing them to their actual operation.

Expected response

Audit firms need to reconfirm that their internal rules are in compliance with the applicable laws and standards and are adequate considering the actual operational conditions of the firms. Based on this reconfirmation, they should perform sufficient examination and review as to whether their operations are performed in accordance with the internal rules. They also need to establish service management environment concerning the appropriate establishment, dissemination, and implementation of internal rules, for example, by establishing a workflow in accordance with the actual conditions of the individual firm.

Case 1: Establishment of internal rules related to independence

- The PICOQC of an audit firm stipulated in the firm's internal rules that even if fees received from a single client accounted for 15% of the firm's total revenues for two consecutive years, if it fell to less than 15% in the third year, the firm could avoid the application of the Safeguard. This rule did not correctly reflect the "Guideline for Independence."
(Quality Control Standards Committee Statement No. 1, paragraphs 15–16)

- The PICOQC of an audit firm only stipulated the prohibition of trading of regulated securities of clients in the internal rules "Regulations for Preventing Insider Trading," and prohibited the provision of excessive entertainment and gifts to clients in the internal rules "Code of Conduct." The firm did not establish internal rules that comprehensively secured the independence of the firm.
(Quality Control Standards Committee Statement No. 1, paragraphs 15–16)

Case 2: Implementation of internal rules

Although the CEO and PICOQC stipulated in the "Contract Management Regulations" that the conclusion of a contract shall be notified to all partners and an inquiry of the contract details be requested when entering into a non-audit service contract with a client, neither notification nor inquiry was carried out when the majority of the non-audit service contracts were concluded.
(Quality Control Standards Committee Statement No. 1, paragraphs 15–16)

《Points to Note》

The number of identified deficiencies in establishing rules, such as the non-existence thereof, has decreased due to the enhancement of templates provided by the JICPA or equivalent. However, since the templates were used without being customized to the audit firm's actual operation, and the internal rules did not suit the actual situation of the firm, the rules were not actually followed at some firms. Therefore, it is vital to check periodically whether or not there are any discrepancies between the internal rules developed by the audit firm and the actual status of operation.

In addition to cases described here, deficiencies in the operation of the Partners' Meeting have been identified, such as the compensation of professionals being decided by the CEO instead of the partners' meeting, although the internal rules on quality control stipulate that the compensation of professionals be decided at the partners' meeting.

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

Points of focus

A variety of restrictions and obligations, etc., are imposed on certified public accountants and audit firms by the Act and other laws, regulations, and professional standards, from the perspective of ensuring appropriate operations. The CPAAOB, therefore, inspects the status of compliance with applicable laws, regulations, and professional standards, and the status of the establishment and implementation of the service management environment to ensure such compliance.

Outline of inspection results

From the perspective of compliance with laws, regulations and professional standards, some audit firms had deficiencies related to legal compliance, including a lack of internal rules regarding the non-competing obligation by partners, lack of partners' qualifications required for operational control, and a discrepancy between matters described in the articles of incorporation as the purpose of the audit firm and the firm's actual operation. In particular, multiple deficiencies were identified in the satisfaction of partners' qualifications required for operational control.

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

Expected response

An audit firm should establish appropriate operation control structure to ensure compliance with laws, regulations, and professional standards by identifying those operations where it is required to check the status of compliance with laws, regulations, and professional standards, and by assigning persons to be responsible for the identification work.

Case 1: Non-compete obligation by partners

The audit firm did not have internal rules that set forth procedures to check that each partner's individual firms did not compete with the business of the audit firm and detailed procedures to approve such competing transactions.

(Quality Control Standards Committee Statement No. 1, paragraphs 15–16)

Case 2: Satisfaction of requirements for partner

An audit firm did not satisfy the requirement that the majority of partners have been engaged in audit certification services for three years or more after being registered as certified CPAs. Despite this situation, the CEO did not take necessary improvement measures. Moreover, in the business report, the firm incorrectly included three partners who had less than three years of audit certification experience in the number of those with at least three years of experience after being registered as CPAs.

(the Act, Article 34-13, paragraph 1, Article 34-16, paragraph 2; the Ordinance, Article 25, Article 38, paragraphs 1–2; Quality Control Standards Committee Statement No. 1, paragraph 28)

Case 3: The objective described in the audit firm's articles of incorporation and implemented operations

Although this audit firm limited the firm's objective described in its articles of incorporation to the audit or attestation services for financial documents (operation described in Article 2, paragraph 1 of the Act), it provided the service of preparation of comfort letters, which was the service of compiling financial documents, examining or planning financial matters, or being consulted on financial matters (operation described in Article 2, paragraph 2 of the Act). Thus, the actual scope of operations did not comply with the articles of incorporation.

(Quality Control Standards Committee Statement No. 1, paragraph 31; Article 34-5 of the Act)

《Points to Note》

Other deficiencies have been identified such as the failure to submit a notification of changes to the articles of incorporation by the submission due date.

(4) Information Security

Points of focus

Professional staff, in the course of their daily duties, often carries paper documents and personal computers that contain or store confidential information of audited companies. They also use e-mail to communicate with the contact persons of the audited companies. Audit firms also store electronic audit documentation and electronic data before compilation in servers installed in and outside their offices. Therefore, audit firms are required to establish and operate information security systems that fully and appropriately meet the sensitive needs of the IT environment, etc.

In consideration of the above, the CPAAOB inspects audit firms for the status of establishment of information security systems, from the following perspectives:

- Whether the audit firm properly assesses information leakage risks, for example, by analyzing the type of information, etc., held by the audit firms;
- Whether the audit firm has security policies and other internal information security rules in proper operation in accordance with such risks;
- Whether an information security manager ensures compliance with internal information security rules, for example, by continually monitoring whether professional staff (including part-time staff)

and other personnel observe the internal rules.

Outline of inspection results

As shown in the case example section below, some audit firms did not appropriately carry out any measures to prevent information leakage as specified in their internal information security rules, while others did not establish internal rules to properly control the use of Internet server services for the firm's operation.

Causes of the identified deficiencies:

- The information security manager or equivalent established internal information security rules only as a formality, leaving the application of the rules to professional staff (including part-time staff) who use computers and other information devices.
- The information security manager or equivalent did not implement any measures to keep track of the operational status of the internal information security rules at their audit firms, placing too much reliance on such professional staff being compliant with the internal rules.
- The information security manager or equivalent did not establish internal rules appropriate for the information devices actually used in the firm.
- Because priority was placed on executing tests of internal controls and substantive procedures, personal information related to audit procedures was not anonymized.

Expected response

Although the opportunity to obtain extensive electronic data has increased due to the progress of digitization of confidential information of audited companies, many deficiencies for information security are still identified. Audit firms should fully understand the serious and adverse effects that information leakage would impose on the operation of the firm, and carry out the establishment and operation of appropriate information security systems in accordance with how information devices are being used at each audit firm.

Note that the leakage of data as a result of external unauthorized access and external attacks bringing down the IT systems constitute a management risk for audit firms, and that it is therefore necessary to ensure that cybersecurity is strengthened in conjunction with the developments in IT.

Case 1: Establishment and operation of internal information security rules

The information security manager of an audit firm did not fully understand the level and scope of information security measures required. He or she thus established a security policy and other internal rules, and performed information security checks just as a formality. As a result, the following deficiencies were observed.

- A security policy to prevent information leakage was in place. However, no policy or procedures for action to take in the event of information leakage were established.

- Stored data were not classified according to their crisis level; no backup or encrypted data were created for stored data; no ID codes or passwords were assigned to professional staff to protect critical electronic data from unauthorized access.
- The firm required all members to submit a "security policy compliance report," but some members failed to submit this report.

(Quality Control Standards Committee Statement No. 1, paragraphs 15–16; Article 27 of the Act; JICPA IT Committee Practical Guideline No. 4, III 1, IV 2, 5 and 10)

Case 2: Operation of internal information security rules for part-time professional staff

The PICOQC of the audit firm had stipulated in the "Information Security Regulations" to monitor remaining data related to audit engagements on personal PCs when a part-time professional staff used his/her personal PC for audit engagements. However, the PICOQC merely used the "Checklist on Information Security" as a formality and did not actually ascertain whether there was remaining audit engagement data on the PC.

(Quality Control Standards Committee Statement No. 1, paragraphs 15–16; Article 27 of the Act; JICPA IT Committee Practical Guideline No. 4, IV 2 and 5, and V 2)

Case 3: Security in using Internet servers for operations

An audit firm uses an Internet server service provided by a leading Internet service provider. The firm has not established internal security rules for the use of an Internet server service for the firm's operations. Because of the lack of such internal rules, when the firm performed regular assessment of the service provider, the firm did not check whether the service provider took measures to prevent unauthorized access, whether the service provider used subcontractors for providing services, or other security-related matters of the service provider.

(JICPA Code of Ethics, Article 6, paragraphs 1 and 3, JICPA IT Committee Practical Guideline, No.4, III 3, IV 2 and 3)

Case 4: Handling of personal information

As part of its security policies, the audit firm has formulated an information management policy and provides internal training to point the keys of personal information handling.

However, the audit firm was not ensuring compliance with the information management policy it had established in the areas of testing internal controls and substantive procedures relating to the personnel expenses. For example, payroll information such as names and salaries and pay slips were stored without anonymization in audit documentation.

(Quality Control Standards Committee Statement No. 1, paragraph 45; Auditing Standards Committee Statement No. 220, paragraph 7)

《**Points to Note**》

It should be noted that, as described in Case 2, when a part-time employee uses his/her personal PC for audit engagements and work as well as a full-time employee, it is necessary to take the same level of security measures for a full-time employee.

(5) Prevention of Insider Trading

Points of focus

If a CPA, who holds the important social mission of ensuring the reliability of the capital markets, partakes in insider trading using the insider information of an enterprise acquired in the course of business, trust in CPA audit may be seriously damaged.

In addition, not only will the CPA involved in insider trading be held liable, but also such involvement can seriously damage trust in the audit firm to which the CPA belongs. Each audit firm is therefore required to constantly take effective measures to prevent any of its members from participating in insider trading.

In consideration of the above, the CPAAOB inspects audit firms regarding the status of establishment and operation of an anti-insider trading system, from the following perspectives:

- ▶ Whether the audit firm has internal rules in place that provide for effective procedures to prevent any of their members from participating in insider trading, and makes these procedures known to their members;
- ▶ Whether the audit firm appropriately takes the anti-insider trading measures set forth in its internal rules, and, whenever necessary, carries out monitoring, including confirmation of regulated securities transactions by its members.

Outline of inspection results

As shown in the case example section below, we observed cases where internal rules were prepared by using the template “Rules for Preventing Insider Trading” as a guide, but such rules were not followed.

Causes of identified deficiencies:

- ・The anti-insider trading manager or equivalent did not comprehensively understand the anti-insider trading measures to be performed under the internal rules;
- ・The anti-insider trading manager or equivalent did not confirm whether members were actually compliant with the anti-insider trading rules, having too much confidence that members were appropriately observing the relevant rules.

Expected response

Audit firms should understand that negative effects of insider trading on capital markets are generally known and take even more effective measures to prevent such trading.

Specifically, audit firms should take necessary responses such as carefully studying “Q&A Concerning

Insider Trading" issued by the JICPA (September 2, 2008) and other relevant documents, re-examining the conditions of establishment, dissemination, and implementation of the rules for preventing insider trading, and considering whether the strengthening of systems to prevent insider trading is required.

Case 1: Implementing training to prevent insider trading

The PICOQC and the partner in charge of training of an audit firm only carried out training to prevent insider trading once in the past. Although regulations concerning insider trading were subsequently revised, after which new partners joined or new audit assistants were hired, no training to prevent insider trading nor surveys of the status of participation in training to prevent insider trading were conducted.

(Quality Control Standards Committee Statement No. 1, paragraph 15 and 19; Article 26 of the Act)

Case 2: Submission of written pledges regarding anti-insider trading

The PICOQC requires the submission of a written pledge to comply with the "Rules for Preventing Insider Trading," which prohibits all members from buying/selling regulated securities issued by the audited companies to which services are provided. However, the written pledge was only required to be submitted at the time of hiring, and besides, any anti-insider trading measures such as monitoring all members for trading of regulated securities were not carried out subsequently.

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

《Points to Note》

In addition to the above cases, the following examples of deficiencies were identified in the operation of internal rules for preventing insider trading;

- **Although it is specified in the "Rules for Preventing Insider Trading" that a list of audited companies to which services are provided shall be distributed to members in order to provide a warning about insider trading, the anti-insider trading manager did not distribute a list of audited companies to which services are provided; and**
- **Although members were instructed to submit written pledges to not buy/sell regulated securities issued by the audited companies to which services are provided, in accordance with the "Rules for Preventing Insider Trading," written pledges from certain members who should submit the pledges have not been obtained, because the status of submission has not been confirmed.**

2. Professional Ethics and Independence

Points of Focus

In order for the audits performed by CPAs to be viewed as trustworthy by related parties, it is important that auditors maintain a fair and impartial attitude, not represent any special interests, 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, the CPAAOB inspects the professional ethics and independence of an audit firm from the following perspectives:

- Whether the audit firm obtains, at least once a year, a confirmation letter concerning compliance with policies and procedures for the maintenance of independence from all persons required to maintain independence; and whether appropriate verification procedures are used according to the classifications of such applicable persons;
- Whether the audit firm performs the independence confirmation procedures set forth in its internal rules before acceptance and continuance of audit engagements, and when issuing the auditor's report, appropriately confirms that there was no change in the status of independence;
- Whether the audit firm carries out independence confirmation procedures after providing those subject thereto with the latest correct information on the subsidiaries, etc., of the audited company;
- Whether the audit firm establishes and communicates policies and specific procedures to ensure the observance of professional ethics, such as no dependence on a single income source, employment restrictions, and restrictions on gift-giving and entertainment, and whether the audit firm instructs the professional staff to follow these policies and procedures; and whether the professional staff follow the policies and procedures for the observance of professional ethics stipulated in the internal rules of the firm;
- Whether the audit firm establishes and implements policies and procedures related to engagements associated with long periods of time to ensure compliance with the legal requirement of rotation.

Outline of inspection results

As shown in the case example section below, there were identified deficiencies, such as not properly implementing the independence confirmation procedures specified in their internal rules or otherwise, and even if the procedures were implemented, the implementation was not comprehensive.

Causes of the deficiencies include: the PICOQC or the equivalent did not establish specific procedures (including but not limited to how to gather the latest information on consolidated subsidiaries, etc., of the audited company) and period of independence confirmation, and did not appoint a practitioner in charge thereof, and the management of the implementation status was left entirely to certain staff in charge.

Expected response

Audit firms need to establish environment as soon as possible to implement comprehensive procedures to confirm their independence in a timely and sufficient manner in order to ensure the reliability of audits, since many deficiencies are still identified in matters concerning professional ethics and independence.

Case 1: Independence confirmation procedures for professional staff

The partner in charge of independence confirmation left the sending and submission management of the written confirmations concerning compliance with the policies and procedures for retaining independence, entirely to a certain general affairs staff, and did not confirm the status of submission. As a result, written confirmations were not obtained from certain professional staff.

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

Case 2: Confirmation procedures for accepting new engagements

The policy and procedures for retaining independence that were established by the audit firm required that a written confirmation of the auditor's independence, or equivalent, be obtained from all professionals of the audit firm before the acceptance of an engagement. However, the PICOQC obtained the written confirmations only from the engagement partners and audit assistants who were to engage in the new engagements, and did not obtain them from other partners or professionals.

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

Case 3: Incomplete list of audited companies

Partly due to the fact that the PICOQC did not take measures to centrally collect the most recent information about audited companies, etc., and reflect such information in the "List of Audited companies" distributed at the time of annual independence confirmation, some audited companies were omitted from the "List of Audited companies" distributed at the time of the independence confirmation procedures.

(Quality Control Standards Committee Statement No. 1, paragraphs 20, 21 and 23)

Case 4: Environment for obtaining information about group firms

With regard to non-assurance engagements for audited companies performed by a tax accounting firm which is a member of the audit firm's group, the audit firm had not established an environment for comprehensively assessing the identified situations and relationships that could harm independence. As a result, when the tax accounting firm concluded new contracts with audited companies, failure to perform required verification and approval procedures were not discovered or prevented in advance.

(Quality Control Standards Committee Statement No. 1, paragraphs 20 and 21)

Case 5: Calculation of dependence on income from a single audited company

The CEO and the PICOQC incorrectly interpreted the provisions in the JICPA Guideline for Independence and other independence-related rules. When calculating the percentage of compensation received from one single audited company to judge the necessity of the Safeguard, revenues which should not have been included were included in the total revenues of the firm (denominator), such as the revenues of a real estate lease company at which a partner of the firm served as a representative director and the revenues of a tax accounting firm that were not attributable to a partner who worked concurrently for the tax accounting firm.

(Guideline for Independence, paragraphs 220 and 222, Guideline for Interpreting Professional Ethics Q13)

Case 6: Length of engagement by engagement partners

The PICOQC assigned a back-office employee to prepare the document used for determining the rotation of engagement partners. The PICOQC also assumed that each partner checked the lengths of his/her individual audit engagements. The PICOQC did not check the accuracy of the document prepared by the back-office employee. As a result, the PICOQC could not detect that the document prepared for engagement rotation contained incorrect lengths of audit engagements of some engagement partners.

(Quality Control Standards Committee Statement No. 1, paragraphs 20 and 24)

3. Acceptance and Continuance of Engagements

(1) Assessment of Risk Associated with Acceptance and Continuance of Engagements

Points of focus

In order to reasonably ensure audit quality, in principle, audit firms need to carefully assess the potential risks involved in the acceptance and continuance of engagements (hereinafter "engagement acceptance risks"), by collecting information regarding the integrity, etc., of the audited company involved from a wide range of sources, prior to the acceptance or continuance of engagements. If insufficient consideration is given to the process of risk assessment regarding the conditions of audited companies, or if a judgment as to whether audit engagement should be accepted, etc., is made based on an incorrect understanding of the audit performance system, it might result in a situation where auditors cannot fully execute their responsibilities. It is, therefore, evidently required that careful judgment based on properly collected, sufficient information is carried out in accepting or continuing audit engagements.

Therefore, before acceptance and continuance of engagements, audit firms must consider the following matters:

- ▸ Whether there are engagement acceptance risks, including questions regarding the integrity of the top management of the audited company;
- ▸ Whether it is possible for the audit firm to allocate the necessary and appropriate personnel and time, and to perform audit procedures according to engagement acceptance risks;
- ▸ Whether the audit firm retains professional staff having sufficient knowledge, experience, capabilities and competence required to deal with the specified engagement acceptance risks appropriately; and
- ▸ Whether the audit firm could comply with regulations related to professional ethics

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

The audit firm should establish policies and procedures for the acceptance and continuance of audit engagements, which include the evaluation of risks relating to the acceptance and continuance of the audit engagement considering the risks of fraud. The policies and procedures should also require that the adequacy of the evaluation be reviewed by an appropriate department or person outside the engagement team, according to the degree of risk upon acceptance or continuation of engagements.

In consideration of the above, the CPAAOB conducts investigations from the following perspectives concerning the acceptance and continuance of engagements at audit firms:

- ▸ Whether engagement acceptance risks have been appropriately assessed,
- ▸ Whether identified engagement acceptance risks have been properly reflected in the audit plans for

individual audit engagements, and

- Whether, when the audit performance system is being put together, adequate consideration is given to whether the audit firm has the aptitude, ability, and human resources necessary to perform the new audit engagement.

Outline of inspection results

The acceptance and continuance of audit engagements should be an essential issue in an audit firm's managerial judgment. In reality, as shown in the case example section below, deficiencies were identified in internal procedures relating to the acceptance and continuance of audit engagements. For example, information on an audited company obtained by the partner who would take charge of the engagement for the audited company was not shared with the approvers of the acceptance/continuance of engagements (such as the Partners' Meeting). Thus, they did not perform an appropriate risk assessment. In another case, insufficient consideration was given to whether the audit firm possessed the audit resources required to accept an engagement.

Causes for the deficiencies:

- The prospective engagement partner prioritized quick acceptance and quick commencement of the engagement rather than performing careful risk assessment and taking timely and appropriate actions for any identified problems.
- The prospective engagement partner did not have sufficient experience to make appropriate decisions regarding management fraud, audit of internal control, accounting estimates or other matters. Therefore, the engagement partner failed to properly identify and assess risks related to accepting the engagement based on facts found in a preliminary audit or information provided by the predecessor auditor.
- When discussing a proposed engagement, the partners did not recognize how important it was to assess the risk associated with the proposed engagement based on information gathered by the predecessor auditor, and other partners were reluctant to express critical opinions as to whether or not the engagement should be accepted.

(Observed effective efforts)

The following is an example of an effective effort observed in an audit firm.

Since the company from which the acceptance of engagement was being considered was a high-risk company where sales fraud had been identified in the previous fiscal year, it was necessary in risk evaluation upon acceptance to carefully determine the status of internal control relating to prevention of fraud. Under such circumstances, the partner in charge of new engagement acceptance not only obtained information from internal personnel such as the management, but also gathered detailed and objective information in order to corroborate the assertions of the management, such as by interviewing external experts who were directly involved in the fraud prevention measures of the company, in order to fully understand the internal systems and progress related to the actual establishment of internal control.

Expected response

Decisions on the acceptance and continuance of audit engagements are essential matters in an audit firm's management. Fully recognizing this, audit firms need to re-examine what policies and procedures for acceptance and continuance of audit engagements are established and how they are operated. Regarding the risk assessment at the time of acceptance or continuance of an engagement, re-examination should be made about the policy and procedures as well as their implementation and operating effectiveness, from the viewpoints such as whether the decision of acceptance was made by identifying engagement acceptance risks based on collected information, and considering measures to manage such risks.

Case 1: Approval in Partners' Meeting

- Whether an audit engagement could be accepted or not was to be decided at the Partners' Meeting. However, the information materials to be presented to the Partners' Meeting were selected only by the prospective engagement partner at his or her sole discretion. As a result, the acceptance of engagements was decided and approved without communicating to the Partners' Meeting information necessary and sufficient for making the right decision.
  (Quality Control Standards Committee Statement No. 1, paragraph 25)

Case 2: Risk assessment procedures when concluding a new audit contract

- The prospective new audited company is in a state that may cast significant doubt on the audited company's ability to continue as a going concern, such as recording net loss and negative operating cash flows for several years. Nevertheless, the audited company did not disclose the footnote information regarding a going concern assumption on the grounds of financial support from its president.
  Under such circumstances, the prospective engagement partner obtained from the predecessor auditor a copy of a financial support letter by the president upon the acceptance of the engagement. However, the engagement partner did not fully perform risk assessment procedures, such as verifying the feasibility of the financial support described in the letter by checking the financial status of the president.
  (Quality Control Standards Committee Statement No. 1, paragraphs 25–26; Auditing Standards Committee Statement No. 220, paragraph 11)

- The prospective engagement partner obtained information from the predecessor that would raise questions on the integrity of the top management. Nevertheless, this prospective engagement partner did not assess the impact of this information on the prospective engagement, and did not plan specific measures to reduce the risks expected from the acceptance of such an engagement to a tolerable level, either.

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

- Despite planning to rely on the audit results from the auditor of an overseas significant component, the prospective engagement partner asked the PICOQC to approve the engagement on the grounds that no issues with group audits had been identified, even though the independence of the auditor concerned had not been confirmed. Furthermore, even though materials attached to the request to approve the engagement stated that the auditor of the overseas significant component was scheduled to be changed, the PICQCC approved the engagement without investigating whether the prospective engagement partner had confirmed the independence of the incoming auditor.
  (Auditing Standards Committee Statement No. 600, paragraphs 11, 19, A11, and A37)

《Points to Note》

In addition to the above, there were cases where engagements were approved before the audit firm had completed required procedures such as obtaining answers from predecessor auditors in response to inquiries.

Furthermore, in the case of a merger with another audit firm, some audit firms did not fully consider the adequacy of audit procedures performed by the acquirer in the past years including audit procedures for the incurrence of a material asset and liability items that the audited company recorded, although they understood important matters that should be examined upon acceptance of the audit engagements. It should be noted that when audit firms merge, appropriate risk assessment procedures need to be performed once required procedures such as audit engagement acceptance procedures have been completed.

Case 3: Risk assessment procedures when accepting a revision audit contract

The acceptance of a revision audit engagement covering multiple terms was just prior to the deadline for the audit report, so it was difficult to borrow audit documentation from the predecessor auditor to assess the adequacy of the audit procedures performed by the predecessor auditor and to carry out additional audit procedures. Despite this, the audit time and audit personnel required for the acceptance of this engagement had not been sufficiently analyzed.

(Quality Control Standards Committee Statement No. 1, paragraphs 25 and 26; Auditing Standards Committee Statement No. 220, paragraph 11)

《Points to Note》

In the case above, the audit firm concluded a contract with a high risk company for a revision audit covering multiple terms just a few days prior to the deadline for the audit report. Furthermore because the accounting periods covered by the revised report included a considerable number of audit periods

that had been handled by the predecessor auditor, it was going to be extremely difficult, given the short space of time available, to assess the adequacy of the audit procedures performed by the predecessor auditor and for the audit firm concerned to perform the necessary additional procedures. Despite this situation, no investigation was conducted into whether there was adequate time and audit personnel available to accept the engagement.

In recent years, there have been several cases of listed companies submitting revised reports such as annual securities reports as a result of the discovery of inappropriate accounting treatment, and as is the case with normal audits of financial statements, with revision audits it is also essential to perform appropriate quality control from deciding whether to conclude the contract to the submission of the auditor's report. If it is expected that financial statements covering multiple terms will need to be revised, it is possible that it will take more time for the auditor to obtain sufficient appropriate audit evidence than is the case with normal audit engagements. Audit firms must therefore pay attention to the fact that it is highly likely that it will be impossible to complete the audit in accordance with the initial timetable.

Case 4: Risk assessment procedures when continuing an engagement

Although the audited company carried out several transactions, which the engagement team should carefully examine the business rationality of, such as subscription to a third-party allocation of shares by a company that is unrelated to the audited company's business and conducting significant transactions with related parties, the engagement partner did not perform assessment of contract risk in light of these events.

(Quality Control Standards Committee Statement No. 1, paragraphs 25–26; Auditing Standards Committee Statement No. 220, paragraph 11)

《Points to Note》

In addition to the above, some firms did not examine the integrity of the top management of audited companies from the perspective of responses to indications of inappropriate restrictions to the extent of audit and significant internal control deficiencies over financial reporting, although they had identified that information necessary for audits was not provided by the top management and that there were material weaknesses concerning company-level controls and process-level controls.

Audit firms must pay attention, not only when accepting a new engagement but also when continuing an existing contract, to whether the acceptance of engagements is decided after identifying engagement acceptance risks and considering actions for the risks based on information that was obtained.

Case 5: Availability of human resources

Upon acceptance of a new engagement, the CEO did not consider whether there was environment including sufficient time and human resources, in order to carry out procedures for high risk engagement.

(Quality Control Standards Committee Statement No. 1, paragraphs 25–26)

(2) Communications between Predecessor and Successor Auditors

Points of focus

In cases where auditors change, the information collected and obtained by the predecessor auditor in the course of performing audit engagements in the past is extremely important. The predecessor audit firm and the prospective incoming audit firm should follow appropriate procedures to hand over the engagement from the predecessor auditor to the incoming auditor so that the prospective auditor can obtain the information necessary to determine whether it can accept the proposed audit engagement and useful information for the performance of the audit.

In consideration of the above, the CPAAOB inspects whether an audit firm uses appropriate procedures for handing over an audit engagement to another audit firm, mainly from the following perspectives:

- Whether the predecessor auditor communicates in a timely and adequate manner in order to provide the prospective incoming auditor with useful information that can be used when the successor auditor makes a judgment as to whether the audit engagement should be accepted and when the successor auditor conducts an audit.
- Whether the predecessor auditor responds honestly and clearly to inquiries made by the successor auditor. Especially in the case where the predecessor auditor is aware of information or circumstances concerning significant material misstatements in the financial statements that affected or could affect the auditor's opinion, whether the predecessor auditor provides such information to the successor auditor;
- Whether the prospective incoming auditor makes inquiries required under the audit standards to the predecessor auditor, including the reason for the replacement of the audit firm, and the status of measures against fraud risks, to determine whether or not to accept the engagement;
- Whether the incoming auditor and the predecessor auditor respectively create and store detailed records of the processes performed for the handover of the engagement;
- Whether the audit firm confirms that the handover is properly conducted, by having the engagement team report the status of the communication to an appropriate department or a person who does not belong to the engagement team.

Outline of inspection results

As shown in the case examples below, deficiencies were observed in some audit firms regarding communication with the predecessor auditor, including failure to make appropriate inquiries.

Causes of the deficiencies include: the partner who would take charge of the engagement prioritized quick acceptance and quick commencement of the audit engagement rather than performing careful risk assessment, solving any identified problems or performing procedures required by the audit firm in an adequate and timely fashion.

Expected response

The predecessor auditor needs to understand that it is essential to provide information relating to the audit risks of the audited company, etc., obtained in the course of performing audit engagements to the successor auditor in a sufficient and accurate matter.

In addition, the successor auditor needs to establish a system in which the information relating to audit risks of the audited company, etc., obtained from the predecessor auditor in the process of communications between auditors, etc., which should be properly documented and fully used in the audit.

Similarly, when an engagement is handed over within the same audit firm, information related to audit risks should be fully and clearly communicated from the predecessor engagement team to the successor engagement team.

Case: Inquiries, etc., to the predecessor auditor

In an audit firm, a new audit engagement with a fund audited company was proposed. The prospective engagement partner did not make inquiries of the predecessor auditor of this audited company. The prospective engagement partner assumed that no additional inquiries were necessary because the engagement partners and the predecessor auditor of the fund audited company were the same as those of another fund audited company that had been handed over in the past, and because the predecessor auditor did not notify the firm of significant information upon the handover of the engagement from the other fund audited company in the past.

(Auditing Standards Committee Statement No. 900, paragraphs 8–9)

《Points to Note》

In addition to the above, some firms did not carry out examinations in accordance with the engagement rules established by the audit firm before the due date when being handed over audit contracts, due to the significant increase in new engagements following an expansion of operations.

Furthermore, it was revealed ex-post facto at some firms that the application of accounting policies was inappropriate as a result of being handed over audit engagements without fully examining the appropriateness of the accounting policies of the audited company, on the grounds that the predecessor auditor was a large-sized audit firm. Therefore, it should be noted that it is necessary to maintain a cautious stance upon handover and to not rely too much on the predecessor auditor.

4. Education and Training, Evaluation and Assignment

(1) Education and Training

Points 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. The CPAAOB inspects education and training provided at each audit firm from the following perspectives:

- Whether the audit firm develops and provides education/training programs that fully take into account the knowledge, experience, competence and capabilities of the professional staff;
- Whether the audit firm provides education/training programs designed to maintain and improve the audit competence and capabilities of the professional staff; this may include, for example, accurately identifying areas where professional staff tend to have less understanding and providing training focusing on these areas;
- Whether the engagement partner provides direction and supervision to professional staff so that they can fully utilize and exercise the knowledge and awareness acquired in the training in audit field work.

Outline of inspection results

As shown in the case examples below, deficiencies in education and training were observed. Some firms did not establish proper education/training systems. The training programs provided by those firms were not effective in the specific steps of procedures necessary for important audit items, such as the audit of fraud in financial statements and the audit of accounting estimates.

Furthermore, some firms failed to provide opportunities for education and training in areas that require special knowledge, such as the auditing of financial institutions.

Causes of the deficiencies include: the PICOQC or equivalent entirely entrusted the training of professional staff, including providing engagement-related knowledge, to the engagement partner(s) who provided direction and supervision in the field work. However, sufficient education and training were not carried out, as the engagement partner or equivalent did not give sufficient direction and supervision to audit assistants, such as timely and appropriate review of audit documentation prepared by the engagement team.

Several audit firms thought it was sufficient to rely on the voluntary efforts of part-time professional staff to improve their capabilities, and thus lacked awareness of the need to maintain and improve audit quality by ensuring that the audit firm as a whole maintained an appropriate level of knowledge, etc., of audit engagements.

Expected response

Audit firms must maintain and improve the competence and capabilities of their professional staff including engagement partners and part-time professional staff. The efforts may include accurately understanding in which areas the professional staff do not have sufficient knowledge, and developing and implementing education/training programs based on this understanding as well as fully taking into account the knowledge, experience and current competence and capabilities of the individual professional staff. It is also important to enhance the effectiveness of education and training through reviews of audit documentation, etc., so that the advice and awareness obtained during training programs can be put into practice in audit field work.

Case 1: Effectiveness of training

- Even though past CPAAOB inspections have revealed that partners and staff lack knowledge of audit procedures, the PICOQC has not established an education/training environment for enhancing audit quality, instead leaving the maintenance and improvement of knowledge and competence up to the individuals themselves.
  (Quality Control Standards Committee Statement No. 1, paragraph 28)

- The PICOQC provided training within the firm once a month mainly for their members. However, the PICOQC did not conduct internal training for special knowledge, such as the auditing of financial institutions or give sufficient instructions to participate in outside training. As a result, education/training environment that would enable auditing for the risks of the audited companies was not established.
  (Quality Control Standards Committee Statement No. 1, paragraph 28)

- The PICOQC only carried out training using the CD-ROM produced by the JICPA on the grounds that there was no time to plan training programs. Neither did the PICOQC follow up on absentees nor establish appropriate environment to implementing education and training.
  (Quality Control Standards Committee Statement No. 1, paragraph 28)

Case 2: Education and training of part-time members

The audit firm's quality control rules prescribe part-time audit assistants as "professionals" who are required for education and training. However, the PICOQC did not provide part-time audit assistants assigned to major audit engagements with the training, including outside seminars, necessary to perform their duties, or take other measures to educate and train them.
(Quality Control Standards Committee Statement No. 1, paragraph 28)

《Points to Note》

In addition to the above, example cases of deficiencies include the following:

- **Audit firms did not provide professional staff with opportunities to maintain and improve the knowledge, competence/capabilities. They only monitored the achievement status of practitioners'**

CPE (continuing professional education) enrollment obligations, and did not develop/provide an education and training fully considered on audit experience, the audit engagements, and audit standards that were newly introduced; and

- **Audit firms did not continuously conduct education and training to improve the audit quality control capabilities for engagement partners. It resulted in many deficiencies identified in certain individual audit engagements.**

In many audit firms, where deficiencies were identified in individual audit engagements, there was insufficient understanding of audit standards resulting from deficiencies in the education/training for professional staff. Audit firms are required to maintain and improve the competence/capabilities of professionals, including engagement partners, through education and training in order to properly perform audit engagements.

(2) Evaluation, Compensation, and Promotion

Points of focus

Audit firms are expected to design appropriate policies and procedures for compensation, performance evaluation, and promotion of personnel that places a high priority on audit quality. The CPAAOB inspects the conditions of establishment and implementation of procedures for the evaluation, compensation, and promotion of professional staff, from the following perspectives:

- Whether the audit firm reflects the attitude of placing high priority on audit quality in the policies and procedures relating to personnel affairs;
- Whether the audit firm has designed and properly followed its policies and procedures for performance evaluation, compensation and promotion of personnel with which the competence and capabilities of professional staff (especially those of quality control) and their professional ethics are fairly evaluated and appropriately rewarded.

Outline of inspection results

Audit firms did not evaluate professional staff or equivalent based on professional competence and capabilities, particularly those of quality control, and compliance with professional ethics.

The above deficiency resulted from evaluation and compensation for professional staff being determined based on the subjective evaluation of them by the CEO. In some audit firms, an evaluator of partners assumed that there was no significant difference in the quality of the audit performance between the partners.

Expected response

Audit firms need to establish and implement policies and procedures for personnel evaluation, in order to maintain and enhance their professional competence and capabilities, particularly those of quality control, and compliance with professional ethics of members, taking into consideration the size,

personnel structure and other relevant factors of the audit firm.
In addition, audit firms should properly evaluate professionals improving and maintaining their competence and capabilities as well as complying with professional ethics, and appropriately reflect the results of the evaluation in compensation, promotion, and composition of engagement teams, in order to fully reward such efforts.

Case 1: Policies and procedures for evaluating professional staff

Some audit firms did not establish policies and procedures for the evaluation of professional staff and did not take into consideration the quality of their audit performance in evaluation.
(Quality Control Standards Committee Statement No. 1, paragraphs 15 and 28)

Case 2: Evaluation of part-time employees

Evaluation of part-time employees engaged in audits was conducted in the same way as for full-time employees. However, the audit firm was concerned that part-time employees would leave the firm if their evaluation was severe, leading to difficulties in audit engagements. As a result, the audit firm did not fully reflect the results of personnel evaluation in the promotion/demotion and composition of engagement teams.
(Quality Control Standards Committee Statement No. 1, paragraphs 15 and 17)

《Points to Note》

In addition to the above cases, although audit firms identified engagement partners with insufficient quality control capabilities in their evaluation, the firm did not sufficiently monitor audit engagements in which these partners were involved.
Evaluation, compensation, and promotion directly reflect management policies of a representative of firms and have a large impact on the culture of the audit firm. It is necessary to develop and operate appropriate policies and procedures with full consideration of the importance of matters.

(3) Assignment

<u>Points of focus</u>
When assigning professional staff (including engagement partners) to audit engagements, audit firms must select persons who have the knowledge, competence/capabilities and experience necessary to properly perform the audits, considering the business and characteristics of the audited companies, and who can take sufficient time for the assigned engagements.
In consideration of the above, in the inspections, the CPAAOB reviews the assignment of professional staff to engagements, including their appropriateness, from the following perspectives:

- Whether the audit firm has assignment policies and procedures to ensure that professional staff, including engagement partners, with the required competence and capabilities are assigned to individual audit engagements;
- Whether, when assigning professional staff (including engagement partners), sufficient examinations are made for each professional staff regarding the time that can be spent on assigned audit engagements, understanding professional standards and laws, practical experience, abilities, etc.

Outline of inspection results

Deficiencies were observed in personnel assignment, including cases where the assignment of an engagement partner and the composition of an engagement team were not appropriately conducted based on audit risks. Causes for the identified deficiencies were as follows:

- The audit firm failed to appropriately conduct risk assessment for audited companies, or compose an engagement team based on risk assessment;
- The audit firm gave priority to acquiring new audit engagements without due consideration to the professional staff' competence/capabilities and experience, or the performance capability of the audit firm as a whole;
- The audit firm did not correctly understand the QC competence of engagement partners and how much time they could spend on audit engagements.

Expected response

Audit firms need to assign professional staff who have the professional knowledge, practical experience, and abilities, etc., required in accordance with the size, risk and business of audited companies, and to establish a system for properly carrying out engagements to ensure that the engagement team can spend sufficient time on audit engagements, for example, by monitoring the work load.

Case 1: Assignment of engagement partner

- The CEO assigned a partner, who was busy with his/her own private practice and who could not spend enough time on the audit engagement, as an engagement partner, although he knows the partner's situation.
  (Quality Control Standards Committee Statement No. 1, paragraphs 29–30)

- With regard to the assignment of engagement partners, the rules of the audit firm specify that the Partners' Meeting must confirm that they possess the aptitude and competence to perform their duties as engagement partners. However, the person in charge of appointment believed that just observing the day-to-day work performance of partners was sufficient to constitute the assessment required for the assignment of engagement partners. As a result, he/she did not

perform an assessment to confirm whether engagement partners had the proper aptitude and competence required when submitting a proposed rotation plan for engagement partners to the Partners' Meeting.
(Quality Control Standards Committee Statement No. 1, paragraphs 28-29)

Case 2: Composition of engagement team

- Engagement partners, when assigning audit assistants to each engagement team, did not consider whether the persons assigned had sufficient knowledge and experience necessary to perform audit engagements in accordance with the professional standards and applicable laws and regulations.
(Quality Control Standards Committee Statement No. 1, paragraphs 29-30)

- The PICOQC was aware of issues in the composition of engagement teams in certain audit engagements of a regional office but relied on the regional office for audit responses, including composition of engagement teams. This led to insufficient monitoring by the audit division in head office for the composition of engagement teams at the regional office, such as failing to instruct improvement.
(Quality Control Standards Committee Statement No. 1, paragraphs 15, 29, and 30)

5. Audit Documentation

(1) Preparation and Review of Audit Documentation

Points of focus

Audit documentation provides evidence to show that an auditor has obtained the basis for issuing an auditor's report and that the auditor has conducted the audit in accordance with the auditing standards generally accepted in Japan. Thus, the audit documentation serves as evidence to directly and specifically demonstrate the audit procedures performed by the auditor.

On the other hand, especially in the case of audit procedures concerning significant or material matters, if the procedures performed were not recorded in the audit documentation, evidence other than the audit documentation (for example, oral explanations by an engagement team member who performed the procedures) cannot serve as solid and reliable evidence of the work performed by the auditor, or its conclusion. Auditors, as professionals, must pay full attention to this matter.

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

- ▶ Whether professional staff prepare audit documentation in such a way to sufficiently describe the status of compliance with the auditing standards generally accepted in Japan, the nature, the timing and scope of implementation of audit procedures, the grounds for judgments, the conclusions reached, and other information;
- ▶ Whether more experienced members of the audit team appropriately review the audit documentation prepared by less experienced members;
- ▶ Whether the engagement partner reviews the audit documentation and has discussions with the engagement team to confirm that sufficient appropriate audit evidence has been obtained to support the reached conclusions and audit opinion.

Outline of inspection results

Deficiencies in lack of audit documentation, which means that engagement teams did not perform appropriate audit procedures, were identified in many audit firms. In the preparation and review of audit documentation, audit procedures performed by engagement teams and the basis for auditor's conclusion were not documented. Furthermore, as a result of the failure of the engagement partner to review from the perspective of whether the audit procedures performed were sufficiently and appropriately documented, deficiencies in audit documentation were identified.

Causes for the identified deficiencies were as follows:

- ・ The professional staff did not fully understand the important role of the audit documentation when performing quality control related services in the audit firm and providing explanation of audits to others.
- ・ Engagement partners did not consider the need to review audit documentation and left the audit

procedures to audit assistants because they misunderstood that there was a shared awareness among the engagement team of the audited company issues and audit procedures to be performed, since the partner always accompanied on site audits and understood the situation.

- The engagement partner did not sufficiently understand audit procedures through inspection of audit documentation and obtained oral explanation or equivalent from the audit assistants.

Expected response

Some firms did not prepare audit documentation so that the audit procedures taken for individual audit engagements could be clearly identified. There were also many cases where the processes to reach an important conclusion could not be understood from the audit documentation. The firms in which these deficiencies were found should strictly instruct the professional staff to follow the following processes:

- All procedures should be recorded clearly in the audit documentation, while confirming their adequacy and completeness;
- Professional staff must check that the audit procedures are consistent with the audit plan that was established, and describe the audit procedures performed, the results of the audit procedures and the audit evidence obtained in the audit documentation. In addition, the audit documentation must also include the conclusions reached as well as the professional judgments and the basis for reaching those conclusions.

Engagement partners must realize that their review of audit documentation is a good opportunity to educate and train professional staff with communicating the level of audit procedures to be performed for individual audit engagements as well as the required level of audit documentation, including the conclusions reached by professional staff and the basis for reaching those conclusions. Keeping this in mind, it is important for engagement partners to fully verify whether the conclusions reached by the engagement team are supported by the obtained audit evidence, and instruct or supervise the team as necessary.

Case 1: Preparation of audit documentation

The audit documentation only included the information material obtained from the audited company and did not include a description of audit procedures performed. The documentation contained conclusions related to the audit procedures but did not contain the purpose of the examination, records of the processes used to reach the conclusions, and what items were examined.

(Auditing Standards Committee Statement No. 230, paragraphs 7–8)

Case 2: Review of audit documentation

- ▸ Although engagement partners reviewed audit working papers to verify whether there were any accounting issues, they did not fully ascertain through their reviews whether appropriate audit

procedures were performed for the risks identified, or whether sufficient appropriate audit evidences were obtained for items of accounting estimates, since they lacked awareness of the need to ensure the sufficient appropriate audit evidences obtained and the sufficiency of documentation at the working papers.
(Quality Control Standards Committee Statement No. 1, paragraphs 31 and A31; Auditing Standards Committee Statement No. 220, paragraphs 15–16)

- Engagement partners did not verify that an understanding of procedures required under current audit standards and an understanding of the recent business situation at audited companies had been reflected in audit plans. Their verification of the adequacy of statements in audit evidence and engagement documentation was also insufficient. Furthermore, because partners and professional staff who work with engagement partners had experience of audit work at large-sized audit firms and had spent many years working on current audit engagements, and because there was low awareness of the need for partners to check the engagement documentation produced by other partners, a critical stance was lacking. As a result, reviews of audit documentation were inadequate. For example, audit procedures to appropriately deal with risks were not performed and sufficient appropriate audit evidence was not obtained.
  (Quality Control Standards Committee Statement No. 1, paragraphs 31, A30, and A31; Auditing Standards Committee Statement No. 220, paragraphs 15-16)

《Points to Note》

Engagement partners should understand that they are required to appropriately assess audit procedures that were performed through review of audit documentation, concerning the relevance of audit procedures performed by professional staff, and whether the conclusion that was reached was supported by sufficient appropriate audit evidence.
In particular, there are cases where those responsible for reviews focused on examining the appropriateness of accounting by the audited company and neglected to ascertain whether the audit procedures performed met the levels required under audit standards. It is important in reviews to re-examine whether the levels of audit procedures performed by professional staff conform to the current audit standards.

(2) Final assembly of audit files and control and retention of audit documentation

Points of focus
After the date of the auditor's report, and within the due period, the audit firm should assemble the audit documentation within the audit file, and complete the administrative procedures for the final assembly of the audit file. The audit firm should pay sufficient attention to the final assembly of the audit file and the control and retention of the audit documentation.

In consideration of the above, the CPAAOB inspects audit firms for final assembly of the audit file and control and retention of the audit documentation from the following perspectives:

- Whether the audit firm has established appropriate policies and procedures for the final assembly of the audit file;
- Whether the audit firm completed the final assembly of the audit file by the due date, by appropriately applying the policies and procedures mentioned above;
- Whether the audit firm ensures the traceability of any correction made after the final registration of the audit documentation and the reason and process for the correction, from the perspective of reliability of audit documentation;
- Whether the audit firm has policies and procedures properly in place for audit documentation to ensure that confidentiality, safe custody, integrity, accessibility, and retrievability are properly established and implemented;
- Whether the audit firm secures the confidentiality, safe custody and integrity of audit documentation by appropriately applying the policies and procedures mentioned above.

Outline of inspection results

In the control of audit documentation, audit firms had not established specific procedures for the completion of audit files and the retention of audit documentation. Some firms registered audit documents as the final assembly despite the fact that they had not completed important audit procedures, while some firms did not control audit documentation in a register. Cases of identified deficiencies include the following: lack of awareness in the control of audit documentation, as well as the lack of the professional staff understanding of the importance of audit documentation when carrying out quality control related services at the audit firm and when explaining audits to others.

Expected response

Audit firms need to ensure the confidentiality, safe custody, integrity, accessibility, and retrievability of audit documentation.

In order for the above to occur, each audit firm must once again recognize the importance of the control and retention of audit documentation and re-examine the condition of the final assembly of the audit file and the control and retention of the audit documentation, under the initiative of controllers such as the PICOQC. Audit firms must also ensure the completion of the final assembly of the audit file after the date of the auditor's report and within the due period, and implement all possible measures to prevent loss of audit evidence, leakage of confidential information, or any other damage, resulting from the loss of or damage to audit documentation.

Case: Final assembly of the audit file

The PICOQC did not monitor if the assembly of the audit documentation for annual audits and

quarterly reviews were completed within the due period determined by the audit firm.
(Quality Control Standards Committee Statement No. 1, paragraph 44)

《Points to Note》

In addition to the above cases, audit firms did not establish specific procedures, the person in charge, and other related matters regarding the final assembly of audit files, while other firms only controlled the name of the audited company, fiscal year and the total number of audit files, and did not keep track of the content of the audit documentation.

6. Engagement Quality Control Review

Points of focus

In principle, audit firms should establish policies and procedures for reviews in order to objectively evaluate the audit procedures performed, and the significant audit judgments and opinions made by the engagement teams for all audit engagements.

The CPAAOB inspects the appropriateness of review performed by the EQC reviewer from the following perspectives:

- ▸ Whether a person with the necessary experience and ability to perform the duties is appointed as the EQC reviewer, and whether they maintain objectivity and independence;
- ▸ Whether the EQC reviewer reviews at an appropriate time for the planning of an audit, significant audit judgments, and expressions of audit opinion;
- ▸ Regarding significant judgments and audit opinions made by the engagement team, whether the EQC reviewer discusses with the engagement partner, reviews audit documentation, evaluates audit opinions, and reviews the appropriateness of financial statements and the draft of audit report, etc.;
- ▸ Whether the EQC reviewer examines the appropriateness of the evaluation of the engagement team members' independence, the necessity of consultation with experts and the conclusion reached, and whether the important judgments made by the engagement team were supported by sufficient appropriate audit evidence, by reviewing the audit documentation.

Outline of inspection results

There were cases of deficiencies in the adequacy of EQC reviewers, where an EQC reviewer with abilities corresponding to the audit risk was not appointed. Ineffectiveness of the review process was also observed in many cases of deficiencies, for example, the EQC reviewer did not fully review the appropriateness and sufficiency of the audit evidence and its judgment process related to significant matters, from a viewpoint that the EQC reviewer evaluates objectively; the EQC reviewer could not find deficiencies in the important audit procedures in individual audit engagements. Furthermore, there were also many cases where deficiencies were identified in the operation of reviews as a result of analyzing the cause of deficiencies of individual audit engagements.

Causes of the identified deficiencies include the following issues:

- ・Due to reasons such as limitations in the personnel composition of the audit firm, an EQC reviewer with sufficient knowledge and experience corresponding to the audit risk as well as having spent enough time on reviews, was not assigned;
- ・In an audit firm where a small number of partners operate the business, the EQC reviewer did not spend sufficient time for the review because the EQC reviewer had to give priority to the audit engagements he was in charge of;
- ・Despite the fact that the firm did not have a sufficient number of partners and members having

sufficient knowledge and experience to perform the review, the PICOQC did not examine whether persons qualified as an EQC reviewer have been recruited or developed;

・Although the EQC reviewer paid attention to responding to deficiencies identified in the CPAAOB inspections and QC reviews, he/she merely examined the same matters as the deficiencies and did not review the situation of responses to similar matters.

・As the engagement team did not pass on to the EQC reviewer (including in cases entrusted to an external EQC reviewer), in writing or by any other appropriate means, information regarding the condition of the audited company and the description of significant matters, the engagement team and the EQC reviewer did not share the recognition of risk and other audit matters.

・The EQC reviewer assumed, from the daily communications with the engagement team, that the audit procedures performed by the team were sufficient and appropriate. Thus, the EQC reviewer did not examine the important judgments made by the engagement team and the sufficiency and appropriateness of their audit procedures through audit documentation;

(Observed effective efforts)

Besides the normal opinion engagement quality control review, the audit firm carried out preliminary engagement quality control reviews concerning important accounting estimates, such as the recoverability of deferred tax assets, at an early stage during the end-of-term audit, when plenty of time was available. As a result, engagement quality control reviews were not performed when staff were busy with formulating an opinion. This meant that they could take their time and conduct an in-depth engagement quality control review.

Expected response

When reviewing the audit planning, the EQC reviewer needs to review the risk assessment procedure performed by the engagement team and further audit procedures planned by the engagement team from objective standpoints, by taking into account not only the business activities and changes of business performance of the audited company, but also the business risk related to the business objectives and strategies of the audited company.

In addition, when reviewing the forming of the audit opinion, the EQC reviewer needs to undertake a review through not only discussing significant matters for forming the audit opinion with the engagement partner but also reviewing the audit documentation related to significant judgment to confirm that the conclusions made by the engagement team were supported by sufficient appropriate audit evidence. Especially at small and medium-sized audit firms, partners who also fulfilled the role of EQC reviewer were usually quite busy because the firms were operated by a small number of partners. Consequently, there were some cases in which those firms found it difficult to undertake reviews appropriately. Therefore, audit firms are required to take action to enhance and strengthen their EQCR environment after reaffirming the importance of the EQCR of audit engagements.

Case 1: Eligibility of the EQC reviewer

- Partners who did not have sufficient reviewing capability were appointed as EQC reviewers, since the CEO and PICOQC did not take any measures to improve the capability of EQC reviewers other than training and did not inspect their eligibility.
  (Quality Control Standards Committee Statement No. 1, paragraph 38)

- The audit firm did not establish environment that ensured effective reviews. For example, since more review duties were assigned to a specific EQC reviewer than to other EQC reviewers, that EQC reviewer could not spend sufficient time on each review and thus did not check the appropriateness of the extent of the audit procedures for significant audit risks.
  (Quality Control Standards Committee Statement No. 1, paragraph 38)

Case 2: Securing effective review

- Reviews of audit engagements were conducted under a council system of all representative partners at the review committee held once a month. Reviews were carried out verbally based on the submitted review documentation, and were completed without examining audit working papers related to material judgments on significant risks. Accounting issues were mainly discussed at the committee and they did not sufficiently discuss whether sufficient appropriate audit evidence was obtained.
  (Quality Control Standards Committee Statement No. 1, paragraphs 34, 36, and 37; Auditing Standards Committee Statement No. 220, paragraphs 18–20)

- The EGC reviewer, when conducting preliminary engagement quality control reviews aimed at addressing fraud risk, reviews whether there were any suspected material misstatements resulting from fraud.
  However, based on his/her impressions from meeting with management of the audited company at other times, he/she believed that management was not involved in fraud, and accepted that opinion of the engagement team while being unable to point out that the fraudulent investigation report submitted at the time of the engagement quality control review contained statements casting doubt on the explanations provided by management.
  (Quality Control Standards Committee Statement No. 1, paragraphs 36 37, FA40-2 and A41; Auditing Standards Committee Statement No. 220, paragraphs 19–20)

Case 3: Follow-up of deficiencies found in the EQC review

With regard to material deficiencies identified in the review, the EQC reviewer only received explanations from the engagement team about additional procedures and the final audit judgments made by the engagement team after the review, but did not verify the appropriateness and sufficiency of such additional procedures by inspection of the audit documentation. Thus, the audit firm did not perform effective reviews.

(Quality Control Standards Committee Statement No. 1, paragraphs 41–43)

《Points to Note》

It must be noted that even when an audit firm entrusted an external CPA to perform EQC reviews, the external CPA is expected to produce the same response as when a person within the audit firm is appointed as the EQC reviewer.

The EQC reviewer must pay attention to the fact that he/she is required to objectively evaluate the contents of the explanations by the engagement team with records and by carrying out examinations through audit documentation.

In particular, where EQC reviewer at the headquarters reviews audit engagements performed by a regional office through a video conference, necessary audit working papers have to be submitted to the EQC reviewer in advance.

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

Points of focus

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

In consideration of the above, the CPAAOB inspects whether monitoring of the QC system is effectively functioning from the following perspectives, in view of the importance of functions of QC system monitoring:

- Whether the audit firm assigns as the person responsible for the monitoring of the system of quality control a person with sufficient and appropriate experience for the role, and vests the assigned person with sufficient authority;
- Whether the audit firm appropriately grasps the status related to the establishment of a quality control system and has an inspection environment in place to identify quality control problems closely;
- Whether the audit firm evaluates the impact of deficiencies identified in the process of ongoing monitoring, and takes appropriate improvement measures in accordance with the results of such evaluation.

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

- Whether the audit firm ensures that the person in charge of periodic inspections performed in-depth inspections to confirm whether the audit evidence was sufficient and appropriate, for example, by making inquiries of the professional staff, etc., and inspecting audit documentation, not only by formal inspection using the checklist, etc.;
- Whether the audit firm selects target duties for periodic inspections by fully taking into account deficiencies in the audit procedures identified during the QC review, the CPAAOB's inspection or other occasions;
- Whether the audit firm evaluates the impact of deficiencies identified as a result of inspections, instructs the relevant engagement partner to take improvement measures, and checks that the measures taken were appropriate;
- Whether the audit firm analyzes the deficiencies identified as a result of inspections, and communicates the result of the analysis throughout the firm.

Outline of inspection results

As shown in the case example section below, there are cases where practitioners responsible for ongoing

monitoring and periodic inspection (including external practitioners) merely performed reviews with checklists, etc., and the PICOQC did not provide practitioners with instructions prior to the inspection or did not conduct monitoring of them after the inspection. There are also many QC system operational deficiencies where the audit firm was not able to appropriately identify deficiencies in individual audit engagements through periodic inspections.
The primary causes of these deficiencies include the lack of appropriate understanding of QC system monitoring at the audit firm, as well as the failure to ensure sufficient time and resources as a result.

Expected response
Audit firms are required to establish and maintain a system in which the primary function of monitoring the system of QC (i.e., voluntarily identifying, understanding, and correcting problems) can be fully exercised. Specifically, audit firms should fully keep in mind that they need to carefully select individual audit engagements and identify inspection items by taking into account the economic environment, the business condition of the audited company, and results of the last CPAAOB inspection and QC review; and they also need to have eligible periodic inspection practitioners perform inspections in addition to formal inspections conducted according to the checklist and to establish environment to confirm the adequacy of the improvement measures taken for deficiencies found by the inspection.

Case 1: Effectiveness of ongoing monitoring

- The PICOQC only operated an annual ongoing monitoring by using the checklist indicated as the JICPA's template as a formality. The PICOQC did not perform an effective ongoing monitoring, such as confirming related internal rules and documents.
  (Quality Control Standards Committee Statement No. 1, paragraph 47)

- The person in charge of ongoing monitoring entrusted all inspections to an office staff member and did not give to the office staff members specific instructions about ongoing monitoring. The checklist used by the office staff member for ongoing monitoring only indicated conclusions. The person in charge of ongoing monitoring did not check what procedures were taken by the office staff member for the ongoing monitoring. Thus, the firm's ongoing monitoring did not work effectively.
  (Quality Control Standards Committee Statement No. 1, paragraph 47)

Case 2: Effectiveness of periodic inspections

- The person in charge of periodic inspections performed inspections without an adequate understanding of the levels required under current audit standards. Furthermore, the CEO neglected to establish a structure for ensuring the effectiveness of periodic inspections. For example, he/she did not secure appropriate personnel and time for inspections based on the

scale and importance of the targeted inspection. As a result, insufficient time was spent on the inspection even though the audit engagement was large.
(Quality Control Standards Committee Statement No. 1, paragraph 47)

- The person in charge of periodic inspections lacked skepticism when inspecting audit procedures performed by engagement teams. As a result, adequate inspections from the point of view of determining whether engagement teams had performed sufficient audit procedures for making judgments were not performed. Because of this, only superficial deficiencies such as a lack of audit documentation were identified. Furthermore, the PICOQC and the partner in charge of periodic inspections believed that there would be no problems with audit quality control as long as periodic inspections were performed before the start of the year-end audit for the following fiscal year. As a result, they performed periodic inspections immediately before the year-end audit and measures to address deficiencies discovered during the periodic inspections could not be included in the audit plan for the following fiscal year.
(Quality Control Standards Committee Statement No. 1, paragraphs 47-50)

- The PICOQC had acknowledged that improvement recommendation items were identified at a QC review for an individual audit engagement, for which no deficiencies were found at a periodic inspection performed prior to the QC review. However, the PICOQC did not re-evaluate the effectiveness of the periodic inspections.
(Quality Control Standards Committee Statement No. 1, paragraph 47)

《Points to Note》

In addition to the above, there were deficiencies in the selection of inspection, such as the audit engagements of certain engagement partners not being subject to periodic inspection.

It should be noted that even when an external CPA was appointed as the person in charge of periodic inspections, the external CPA expected the same response as when a person within the audit firm is appointed as the EQC reviewer.

It is important to analyze the deficiencies identified in a QC review, and re-evaluate whether periodic inspections were effectively performed to ascertain whether the identified deficiencies could have been prevented or noted beforehand.

8. Cooperation with Company Auditors

(1) Cooperation between Independent Auditors and Company Auditors

Points of focus

Independent auditors and company auditors are obligated to ensure the appropriateness of financial statements under the Companies Act and applicable laws. To perform this obligation, it is important that they cooperate by sharing information identified during audits at an appropriate time, as well as by actively exchanging information and opinions, where, for example, company auditors should evaluate the status of QC of audits undertaken by accounting auditors.

In consideration of the importance of cooperation between accounting auditors and company auditors as mentioned above, the CPAAOB inspects the status of such cooperation.

Outline of inspection results

The necessity of cooperation between independent auditors and company auditors has been recognized in general. Regular communications between them are conducted, though the depth of cooperation varied.

It is our understanding that audit firms report results of the CPAAOB inspection and QC review to company auditors in writing as determined on a timely manner. On the other hand, as shown in the case example section below, there were some cases where communication was inadequate, and some cases where audit firms received notification of the results of a special review from the JICPA, but they did not communicate the results of the special review with company auditors, since there were no particular identified deficiencies.

Expected response

The necessity and importance of cooperation between accounting auditors and company auditors has been recently emphasized again in response to the occurrence of fraudulent corporate financial reporting cases. The audit standards state, “the auditor must ensure appropriate cooperation, through consultation or otherwise, with company auditors at each stage of the audit.”

Audit firms and company auditors of the audited company should improve the effectiveness of the audit by sharing audit-related information with each other, including development of the audit plan and implementation of audit procedures, the progress of the audit at each stage of forming the auditors’ opinions, and the conditions of the audited company discovered in the course the audit. They should also actively promote cooperation with each other through exchange of opinions on audit quality issues based on the results of the CPAAOB inspection and the QC review. It is believed that this cooperation will contribute to securing and enhancing audit quality, and in turn improve and strengthen the corporate governance of the audited company.

Audit firms must also establish a system to support engagement teams so as to promote appropriate communication between the engagement teams and company auditors of the audited company.

It should be noted that the Auditing Standards Committee Statement No. 260 “Communication with Company auditors,” revised in May 2015, stipulates that when performing an audit of an audited company, the audit firm should keep close communication with company auditors in the audited company regarding particularly important matters, and specifies matters that should be communicated to company auditors, including the content and method of communication to company auditors concerning the results of the QC review or the CPAAOB inspection as part of explanations made by the accounting auditor regarding the establishment and operation of a quality control system (Notes 1 and 2).

(Note 1) Disclosure of the results of the CPAAOB inspection to a third party needs the advance approval of the CPAAOB, in principle. However, no advance approval of the CPAAOB is necessary if the disclosure is made to those charged with the governance or equivalent of the audited company and the disclosed information is “whether or not there were deficiencies in the establishment or operation of the quality control system of the audit firm and the outline of such deficiencies” or “whether or not there were deficiencies related to the engagement for the audited company and the outline of such deficiencies.”

(Please refer to “III. Handling of Inspection Results” in the “Basic Policy for Inspections Performed by the Certified Public Accountants and Auditing Oversight Board” published by the CPAAOB in April 2015.)

(Note 2) In principle, any disclosure, including whether or not the audit firm received the CPAAOB’s inspection, is not permitted during the inspection.

Case: Cooperation with company auditors

When communicating the results of a QC review, the prospective engagement partner for a new audit engagement did so by preparing communication material for the board of company auditors by amending cases from the past when an unqualified conclusion had been obtained. As a result, the prospective engagement partner only informed the board of company auditors of the fact that a qualified conclusion had been issued and the titles of each item subject to qualification. Therefore, sufficient information concerning the design and operation of the system of quality control was not conveyed in writing. For example, whether improvement recommendations had been made and the response of the audit firm was not communicated.

(Quality Control Standards Committee Statement No. 260, paragraphs 15-2 and A22-3)

(2) Response to Detection of Fraud/ Non-Compliance

Points of focus

In the event of discovering any fact that may affect ensuring the appropriateness of financial statements of the audited company, the auditor must notify company auditors thereof so as to encourage the audited company to implement voluntary corrective action (see Article 193-3, FIEA). In light of the important role played by such notice for ensuring the appropriateness of financial statements, the CPAAOB inspects the status of how the audit firm responded to the detection of fraud or non-compliance.

Outline of inspection results

(Observed effective efforts)

Some effective efforts observed in our inspections were: when regulations regarding responses to detected facts such as legal violations were introduced under FIEA, some audit firms ensured all partners understood them by, for example, showing to partners and employees cases of how to notify those charged with the governance of the audited company in the case of the detection of facts such as an illegal act.

In addition, there were cases where the audit firm notified the audited company under Article 193-3 of FIEA of a matter deemed to affect the appropriateness of its financial statements, and the notification led to the audited company's correction of its quarterly report and strengthening of its organizational structure aiming at implementing appropriate disclosure.

Expected response

It should be kept in mind that in the event of identifying any deficiency during an audit that may affect the appropriateness of financial statements, audit firms should respond to such deficiency by requiring audited companies to make corrections, including reviewing whether to give notice under Article 193-3 of FIEA.

Furthermore, it is necessary for audit firms to develop a system to support engagement teams so that the engagement teams' responses to consultation can be carried out appropriately.

Ⅲ. Individual Audit Engagements

Audit Engagement Performance

Summary

Examples of deficiencies in individual audit engagements identified during the CPAAOB's inspections broadly cover audit planning through to the formulating of Auditor's Opinions.
This section, "III. Individual audit engagements," explains those deficiencies with a composition similar to the Auditing Standards Committee Statements.
However, this part also contains separate items that introduce fraud in financial statement audits, for which cautious responses are required under the Fraud Risk Response Standard and to which attention is paid due to recent accounting fraud scandals. In addition, accounting estimates, in which many deficiencies are continuously identified, are separately introduced.
Furthermore, audits of internal control over financial reporting, in which different audit standards are applied from those applied for audits of financial statements, are introduced in a separate item, including contents of the use of internal audits (Auditing Standards Committee Statement No. 610).
Each item describes the Points of Focus in inspection, etc., along with examples of identified deficiencies, and Points to Note in performing audit procedures are appended for reference.

Analysis of deficiencies

Deficiencies identified in individual audit engagements result from lack of requirements of audit standards or standards of the Auditing Standards Committee Statement ("requirement(s)").
Causes of the deficiencies include various factors that are remotely due to engagement teams and the environment surrounding audited companies. However, in recent cases the following three causes were found relatively frequently:

- Insufficient consideration for the relevance and sufficiency of audit procedures
- Lack of an attitude of professional skepticism required of an auditor
- Insufficient knowledge of audit standards and the Auditing Standards Committee Statement

(1) Cases of deficiency due to insufficient consideration for the appropriateness and sufficiency of audit procedures

(Reference case) Extent of test of details—Case where the appropriateness and sufficiency of audit procedures were not evaluated

The engagement team evaluated that there was a risk of material misstatement due to fraud for the occurrence of sales in a significant component, and identified revenue recognition as a significant risk. During the period, the team performed a dual-purpose test for operation evaluation procedures of internal controls concerning the sales process and substantive procedures, and tested them with internal vouchers of shipment. Apart from the above procedures, the team tested dozens of items with the vouchers for the three months prior to the balance sheet date.

However, the engagement team did not evaluate whether the audit evidences obtained from the audit procedures were sufficient and appropriate for the risk of material misstatement due to fraud. (Auditing Standards Committee Statement No. 240, paragraphs 29 and F32-3)
When performing audit procedures, it is required under audit standards to develop and perform procedures to responses to the identified audit risks based on risk assessment. The nature, timing and extent of specific procedures responding to audit risks are determined based on the professional judgment of the engagement team, in light of the situation of the audited company. In particular, it is required that procedures in response to assessed risks at the assertion level are formulated in a detailed audit plan.
However, there are many cases where it is not clear whether sufficient appropriate audit evidences were obtained from audit procedures performed by engagement teams. This resulted from that engagement teams did not sufficiently consider audit procedures at the following two stages:

・ Risk assessment at the audit planning stage

  Auditors did not appropriately plan the responses to audit risk at the assertion level, since risk assessment by the auditors was insufficient in itself.

  Furthermore, there were many cases where sufficient appropriate audit evidences were not obtained since the responses to audit risks considered at a detailed audit plan were not appropriate to the identified risks, although the risks were appropriately identified.

・ Evaluation of obtained audit evidences

  Auditor have to conclude whether sufficient appropriate audit evidences have been obtained. If not, he/she needs to perform additional audit procedures. Auditors shall ascertain whether sufficient appropriate audit evidences have been obtained through reviews of working papers, there are cases where such obtained audit evidences were not sufficiently evaluated.

  With regard to risks of material misstatement at the assertion level, auditors shall note that they are required to obtain competent and strong audit evidences, or more evidences if any, comparing cases where no risk of fraud is identified for the assertion.

(2) Cases of deficiency due to the lack of a professional skepticism that an auditor should have

(Reference case) Audit of accounting estimates—Case where the audit firm only understood accounting estimates argued by the audited company but did not perform audit procedures that should have been performed in response to the argument.

The audited company accounts for deferred tax assets, excluding the future deductible amount that is collected over a period of more than five years based on profit plans that assume that the profit before income taxes’ budget for the next fiscal year continues for the next five years.
However, the engagement team did not consider the feasibility of management’s assumption that the same amount of profit before income taxes would be generated from the second year until the fifth year, despite

comparing the profit plan with the amount in the budget that was submitted to the Board of Directors when considering the collectability of deferred tax assets. (Auditing Standards Committee Statement No. 540, paragraph 12)

In this case, a deficiency in audit procedures was identified since the argument of management, such as the feasibility of the business plan that was used in accounting estimates, was not evaluated objectively and procedures to verify the rationality of the argument were not performed, even though the engagement team understood the management's assumption and the adequacy of accounting, due to a lack of professional skepticism. Similarly, at some audit firms there were cases where audit procedures were deemed insufficient since a material misstatement risk was overlooked due to the lack of professional skepticism.
Apart from the above cases, there were cases where, although journal entry tests were performed as responses to audit risk related to management override, and certain journal entries were selected, auditors did not note irregular items in the selected journal entries and did not verify their adequacy. Auditors need to pay attention to the possibility of material misstatement due to fraud and retain a professional skepticism throughout the entire audit process, regardless of the auditors' past experience concerning the reliability and sincerity of management, directors and company auditors.

(3) Cases of deficiency due to insufficient knowledge of the requirements

(Reference case) Substantive analytical procedures—Case of failure to respond to requirements

The engagement team mentioned that they performed substantive analytical procedures for account balances over performance materiality including sales, cost of sales, and selling, general and administrative expenses. However, the team did not set the acceptable level of difference between expectation and actual amounts, and thus did not satisfy the requirements of substantive analytical procedures. (Auditing Standards Committee Statement No. 520, paragraph 4)

In the above cases, the following requirements, which are required when adopting substantive analytical procedures, were not met. Therefore, a deficiency of failure to perform substantive procedures was identified.

- Develop the expectation of booked amounts or ratios and evaluate whether the expectation is sufficiently precise to identify a misstatement that, individually or when aggregated with other misstatements, may cause the financial statements to be materially misstated.
- Determine the acceptable level for differences of booked amounts from expectation without further investigation.

When performing audit procedures, if the engagement team does not fully understand the requirements, and requirements are not satisfied in the audit procedures performed, the purpose of audit cannot be achieved with the performed procedures and it results in a deficiency at audit procedures.

In addition to substantive analytic procedures described as an example, there tend to be many deficiencies due to the non-performance of requirements in areas such as confirmation procedures (Auditing Standards Committee Statement No. 505), development and implementation of audit sampling (Auditing Standards Committee Statement No. 530), management bias in accounting estimates (Auditing Standards Committee Statement No. 540, paragraph 20), audit procedures for transactions with related parties (Auditing Standards Committee Statement No. 550), audit procedures on group audits (Auditing Standards Committee Statement No. 600), using the work of Internal Auditor's (Auditing Standards Committee Statement No. 610), and using the work of an auditor's expert of experts (Auditing Standards Committee Statement No. 620).

Expected response

Engagement teams are required to exert professional skepticism in all audit aspects, as well as to update and expand the required knowledge such as audit standards. Upon this, it is necessary to respond to individual audit engagements from the perspective of whether sufficient audit plans are developed for misstatement risks, and whether the audit procedures planned are performed according to the requirements of standards of audit, such as the Auditing Standards Committee Statement, in order to reasonably reduce audit risk to a low level.

There continue to be many cases where engagement teams argue "deficiency in audit documentation" when identifying deficiencies in individual audit engagements. This argument means that the team actually performed audit procedures but neglected to document them.

In this regard, unless the argument by the engagement team is objectively proven by audit documentation, etc., it cannot be determined that the audit procedures were completed before issuance of the audit opinion. Therefore, close attention should be paid so that such cases are treated the same as when audit procedures were not performed.

Audit firms are required to maintain and enhance the quality of individual audit engagements through QC systems to prevent the occurrence of deficiencies that were identified in individual audit engagements.

In order for the penetration and establishment of measures over an entire firm, it may need to establish environment that monitors each engagement team's understanding of improvement measures, as well as the operation status of improvement measures by each engagement team. Upon the improvement of audit engagements, the use of existing systems including periodic inspections and QC reviews is also effective, instead of additional new QC systems. Each audit firm is required to try effective and efficient improvement for audit quality in a way that suits the feature of each firm.

Regardless of the size of the audit firm, some deficiencies in individual audit engagements are caused by engagement partners with an insufficient understanding of the concept of the risk-based approach. In this case, it is necessary to note that appropriate responses as an audit firm are required, such as re-education of partners and appropriate assignment.

According to the Auditing Standards Committee Statement No. 260, etc., deficiencies in individual audit engagements identified by the CPAAOB's inspections need to be explained to those in charge of governance of the audited company that was subject to the inspection. Therefore, each engagement team needs to strive for appropriate understanding of the deficiencies so that it can explain the deficiencies that were identified in the inspection to the audited company.

Once again, it is necessary for not only the engagement teams of the individual audit engagements that were subject to inspection but also other engagement teams to refer to the deficiencies identified in the CPAAOB’s inspections, QC reviews, and periodic inspections within the firm during their own audit engagements and examine/review such deficiencies in a timely manner.

1. Risk Assessment and Response to Assessed Risks

Points of focus

The CPAAOB performs inspections of risk assessment and response to assessed risks from the following perspectives:

- Whether the engagement team performs appropriate identification and assessment of the risks of material misstatement in the financial statements as a whole and at the assertion level when it develops an audit plan, considering the audited company and its environment, business risks and internal control of the audited company, instead of merely completing templates provided by the audit firm or the JICPA;
- Whether the engagement team makes appropriate judgment, when it identifies significant risks, in light of matters that are required by the Auditing Standards Committee Statement to be taken into account; and whether the team understands internal control relevant to significant risks;
- Whether the engagement team develops an overall response required by the Auditing Standards Committee Statement in accordance with the assessed risks of material misstatement in the financial statements as a whole, and plans the nature, timing, and extent of procedures in response to the audit risks, taking into account the materiality, in accordance with the assessed risks of material misstatement at the assertion level;
- Whether the engagement team makes appropriate responses, when a misstatement is identified as the audit progresses, such as judging whether it is necessary to revise the overall audit strategy and detailed audit plans, and evaluating the impact of the uncorrected misstatement;
- Whether the engagement team develops an audit plan suited to the contractor and IT use status considering the influence of the contractor and IT used by the audited company for the audit.

Outline of inspection results

There were many cases in assessing risks and responding to assessed risks where the engagement team did not appropriately develop and perform procedures responding to assessed risks because the engagement team did not carry out an appropriate assessment of risks.

For example, there were cases where a deficiency was identified in the nature, timing, and extent of year-end substantive procedures due to inappropriate revision of the audit plan when the business environment or performance of the audited company was deteriorated during the term, or a misstatement was identified in conjunction with the performance of the audit. There were also cases where a deficiency was identified in the tests of controls and substantive procedures since the engagement team did not plan appropriate audit procedures in response to assessed risks.

Moreover, there were still engagement partners and audit assistants who did not fully understand the concept of a risk-based approach. Therefore, there were several cases where the engagement team merely completed templates, such as the “audit tool” and the “documentation sample forms” provided by the audit firm or the JICPA, and did not perform appropriate risk assessment. There were also cases

where the nature, timing and extent of the procedures actually taken in response to the assessed risks did not respond to the risks since the engagement team did not examine the adequacy of the procedures in the audit plan developed by using audit tools.
In addition, at audited companies with many related party transactions of various types, there were cases where notes on financial statements for significant related party transactions were omitted since no particular risk was identified, although the risk must be carefully assessed from the perspective of completeness of related party transactions.

Expected response
Professional staff should note that they must pay due attention and exercise professional skepticism in fully understanding the audited company and its environment as well as assessing risk through such understanding, and carefully identify and assess audit risks, referring to this Case Report and the Audit Proposals issued by the JICPA. In addition, when developing responses to audit risk, they should carefully consider whether the procedures respond to the assessed risks and whether the procedures enable sufficient appropriate audit evidence to be obtained, including not only the types of procedure, but also the timing and the extent of the procedures. In order to do so, they should make sure sufficient hours are spent for not only substantive procedures but also for the audit plans.
Furthermore, some professional staff still do not recognize the importance of audit planning and have no understanding of the theoretical background that the material misstatement risks and the details of the procedures responsive to the assessed risks, i.e., the nature, timing and extent of the procedures, can be connected with audit planning.
Engagement teams must reconfirm the concept of the risk-based approach and the positioning of the audit plan in the current audit, and review the audit plan that they developed, according to the situation.
Once again, an audit firm where deficiencies were identified in risk assessment and responses to the assessed risks must consider appropriate responses, such as re-educating professional staff who have failed to catch up with the current audit standards and responding in terms of the personnel allocation of engagement teams.

(1) Audit planning

Case 1: Detailed audit planning

The engagement team did not establish a detailed audit plan for accounts receivable related to the collectability of credits and allowance for doubtful accounts, although they identified the collectability of credits owned by the audited company's subsidiary as a significant risk.
(Auditing Standards Committee Statement No. 300, paragraph 8)

《Points to Note》

As deficiencies in audit planning, there were cases where the engagement team only followed audit

procedures in the past as a formality and did not appropriately develop a detailed audit plan such as the nature of audit procedures that should be performed by engagement team members.

The engagement team shall carefully consider the timing and extent of audit procedures responsive to the assessed risks of material misstatement, as well as the nature of audit procedures, regarding whether the developed audit procedures correspond to the assessed risks and whether sufficient appropriate audit evidence has been obtained from those audit procedures.

In addition, an appropriate audit plan enables the following matters to be achieved. Therefore, it is important to consider these matters at the planning stage.

- **Appropriate attention to significant areas of audit**
- **Identification and solution of potential issues in a timely manner**
- **Conduct of an effective and efficient audit work through appropriate management of audit engagements**
- **Selection of engagement team members with appropriate competence and suitability to address risks, and allocation of the appropriate assignment to those team members**
- **Appropriate instructions to and supervision of team members, and reviews of working papers**
- **Cooperation with component auditors and experts as necessary**

Case 2: Changes to planning decisions during the course of the audit

In the audit plan developed at the beginning of the fiscal year, the engagement team designed and performed substantive procedures for each material class of transactions, account balance, and disclosure, based on figures from the financial statements for the previous fiscal year.

However, the engagement team did not consider the necessity to revise the audit plan, such as re-assessment of materiality, although there were changes in the business environment and worsening of the business performance of the audited company during the fiscal year.

(Auditing Standards Committee Statement No. 300, paragraph 9)

《Points to Note》

In addition to the examples of identified deficiencies mentioned above, there was a case where an engagement team did not consider whether their audit plan should be revised including risk assessment and materiality when events, which the engagement team did not expect, occurred, such as changes in business activities due to the reorganization of the audited company, the occurrence of fraud cases, significant overdue receivables and slow-moving inventories. If an engagement team obtains information, which significantly differs from original information used at the planning stage, the team should consider whether the plan should be revised.

(2) Identification and assessment of the risk of material misstatement through understanding the audited company and its environment

Case 1: Understanding the audited company and its environment, including the audited company's

internal control

The audited company conducted the sale of machinery as its main business as well as various other businesses, and sales of businesses other than the main business (below, “other sales”) accounted for 10% of consolidated sales.

The engagement team identified other sales as a risk of material misstatement.

However, the engagement team did not perform procedures to understand the transaction flows for the businesses of other sales and the processes for generating their accounting records, even though sales from multiple businesses included in other sales that far exceeded the performance materiality,.

(Auditing Standards Committee Statement No. 315, paragraph 17)

《Points to Note》

As shown in the above example, there were cases where the engagement team did not understand the internal controls even though the audited company was engaged in significant businesses besides its main business. Fraudulent financial reporting may generate in businesses other than the main business. It is essential to take into account differences in terms of the types of transactions and related internal controls between businesses when identifying and assessing the risk of material misstatements at the assertion level,.

There were also cases where businesses and distribution channels at the group level were not understood as part of group audits even though businesses of individual significant components were understood,.

In addition to the above, the engagement team did not examine the risk of material misstatement by business process. As a result, differences in the types of transactions recorded in the same account may lead to differences in effective audit procedures or the nature of audit evidence. However, there were cases where the risk of material misstatement by types of transactions was not identified and assessed.

Case 2: Identifying and assessing the risks of material misstatement

An audited company engaged in information and telecommunications business was listed during the term and revised its earnings forecasts downward in multiple times before the end of the term.

Given this situation, the engagement team determined that the audited company was under pressure to manipulate its higher profits, and identified as fraud risks in overstatement of sales and software (excessive capitalization of expenses).

However, the engagement team identified fraud risks in sales and software, but did not consider not to identify risks of misstatement in assertions concerning completeness and cut-offs of expenses, even though the engagement team predicted that the audited company would fraudulently overstate its profits,.

(Auditing Standards Committee Statement No. 315, paragraph 25)

Case 3: Identifying and assessing significant transactions with consolidated subsidiaries

The audited company received a sales order from its consolidated subsidiary for the construction of a power plant to be used by the subsidiary for its power generation business. With regard to the transaction, its sales and costs were recorded in the same amount on the audited company's non-consolidated financial statements. Although professional staff documented that the audited company was involved in the power plant construction as an agent of the construction contract, the engagement team did not examine the reasonableness of recording the sales on a gross basis instead of a net basis.

In addition, sales for the transaction were subject to notes on related parties in the financial statements, which stated that the transactions terms "are determined negotiations on the price based on market condition." However, the engagement team did not examine the adequacy of this statement, although the construction contract had unusual transaction terms, which the same amount of the construction costs incurred at the audited company was charged to the consolidated subsidiary that was the contractee.

(Auditing Standards Committee Statement No. 550, paragraphs 23–24)

《Points to Note》

The engagement team shall note that they need to identify and assess the risks of material misstatement through an understanding of the audited company and its environment, considering unusual significant transactions, related party transactions and matters dependent on management's judgments.

Furthermore, through an understanding of the audited company and its environment, the engagement team shall ensure that it assesses whether the audited company's accounting policies are appropriate for its business, comply with the applied financial reporting framework, and are consistent with accounting policies that are adopted in the industry to which the audited company belongs.

Case 4: Understanding of the audited company's internal controls related to significant risks

One of the audited company's main businesses was to earn revenue through providing its customers with rights to use its intellectual property.

The engagement team considered the business included risks to record sales based on fictitious contracts and sales in advance, and identified them as significant risks.

However, the engagement team did not perform the procedures to understand what sort of control activities were performed to address the above-mentioned significant risks although the engagement team understood the overview of transactions relating to the business.

(Auditing Standards Committee Statement No. 315, paragraph 28)

《Points to Note》

In terms of identified significant risks, an auditor must understand the internal controls, including control activities relating to the risk. Further, when relying on internal controls to address significant

risks, an auditor is required to perform tests of operating effectiveness of related controls during the audit for the current year.

(3) The auditor's responses to assessed risks

Case 1: Audit procedures for risks of material misstatements

The engagement team designed and implemented an audit sampling method, using the population of the last month's sales in order to verify the accounts receivable balance at the year-end.

However, 14 of the 18 samples selected by the engagement team had been settled prior to the year-end, which were not included in the accounts receivable balance at the year-end. As a result, the engagement team did not design its audit procedures to obtain sufficient appropriate audit evidence with regard to the existence of accounts receivable at the year-end.

(Auditing Standards Committee Statement No. 330, paragraphs 5 and 17, No. 500, paragraph 5)

《Points to Note》

When planning audit procedures responsive to assessed risk, auditors shall plan audit procedures to obtain sufficient appropriate audit evidences corresponding to the material misstatement risks at the assessed assertion level, considering the nature of related class of transactions, account balance and disclosure, and the relevant internal controls.

In particular, auditors shall note that they are required to obtain audit evidences, which are more compete or appropriate, for risks of material misstatement due to fraud, than in cases where no risk of fraud is identified for the assertion.

Engagement teams shall also note that they need to plan and perform substantive procedures for a significant class of transactions, account balance and disclosure regardless of the assessment of material misstatement risks, because they may not identify all risks of material misstatement and there are inherent limitations of an audit including management override on internal controls.

Case 2: Adequacy of presentation and disclosure

- The audited company amortized the retirement expenses in SG&A expenses on the incomes statement, which had been capitalized at the recognition of asset retirement obligations relating to leased property. Also, the audited company recorded an extraordinary loss of the difference between the balance of asset retirement expense obligations and the relocation expenses incurred during the year.

  However, the engagement team did not examine the reasonableness of the P/L category with regard to audited company`s booking an extraordinary loss, even though the accounting standards principally require the difference to be booked in the same category as the retirement expenses related to the asset retirement obligations.

  (Auditing Standards Committee Statement No. 330, paragraphs 23, and Corporate

Accounting Standards No. 18, paragraph 15)

- The audited company summarized related party transactions at a list and disclosed transactions that exceeded a certain level of materiality as notes in the consolidated financial statements, in accordance with Corporate Accounting Standards Implementation Guidance No. 13. However, the engagement team overlooked the fact that the transactions were not included in the list of related party transactions, regardless of that the team could note related party transactions, such as transactions guaranteed by directors.
  In addition, as for transactions with companies owned by an equivalent to a director, the engagement team overlooked the fact that significant related party transactions were not disclosed at the notes. It was because that "case where the related party is a corporation" was applied to determine the materiality in the disclosure of notes for related parties, instead of "case where the related party is an individual," which is stipulated in Corporate Accounting Standards Implementation Guidance No. 13.

(Auditing Standards Committee Statement No. 550, paragraphs 14, 16, and 20; Corporate Accounting Standards No. 13, paragraph 10; Corporate Accounting Standards Implementation Guidance No. 13, paragraphs 8, 9, and 16)

《Points to Note》

Other than the above, deficiencies in disclosure included a case where the engagement team did not examine whether this calculation method was actually based on real-estate appraisal standards even though the notes to leased property disclosed that an amount calculated by the audited company in accordance with real-estate appraisal standards was the fair value, yet, and a case where the engagement team did not notice an error in the presentation on a cash flow statement.

Engagement teams should plan and perform audit procedures to examine whether the overall presentation of financial statements, including related disclosures, complies with the applicable financial reporting framework. They shall note that disclosure of related parties, in particular, needs to provide appropriate information so that users of financial statements can understand the impact of transactions between companies and related parties or the existence of related parties on financial statements.

(4) Audit considerations relating to an audited company using a service organization

Case 1: Obtaining an understanding of the services provided by a service organization, including internal control

The audited company used an external warehouse to manage its inventories, including shipment and acceptance as the Service Organization.

Under such circumstances, the engagement team did not understand how the audited company used the operations of the warehouse, which is the service organization. Moreover, in understanding internal controls relevant to audit, the engagement team did not assess the design

of the audited company's internal controls relevant to the services provided by the warehouse and the application of the controls to the service.
(Auditing Standards Committee Statement No. 402, paragraphs 9–10)

Case 2: Audit evidence regarding the effectiveness of internal controls in the service organization

The audited company uses a network system developed by a service organization as an IT system for its important business operation processes. The audited company had obtained the auditor's report on a description of the service organization's system, the suitability of the design of controls, the application of the controls to the service, and the operating effectiveness of controls.

However, the engagement team only inspected this report obtained by the audited company and did not perform assessment of the service, such as assessment of the adequacy of the assessment procedures taken by the auditor of the service organization.
(Auditing Standards Committee Statement No. 402, paragraph 16)

《Points to Note》

If the audited company uses the services of one or more service organizations, the engagement team shall understand how the audited company uses the services provided by a service organization in the audited company's operations. Meanwhile, when understanding the internal control related to auditing, the engagement team shall assess the development status and operating effectiveness of relevant controls at the audited company that relate to the services provided by the service organization. Note that these are required to be performed not only in financial statement audits but also in audits of internal control over financial reporting.

Since the migration of systems to the cloud has been progressing recently, audit firms must often judge which of the audited company (user entity) and the service organization is responsible for the internal control over the underlying operations for the financial reporting, depending on the contents and the mode of service that the service organization provides for the audited company. Audit firms need to fully understand the contents of services provided by service organizations and their importance, and their impact on the internal control over financial reporting.

(5) Evaluation of misstatements identified during the audit

Case 1: Examination of identified misstatements during the audit

During an audit engagement for a financial institution, the engagement team identified the overstatement of accrued revenue for the previous year was recognized in the current year, and treated it as an uncorrected misstatement.

However, the engagement team did not consider how the misstatement affected the internal control audit. Further engagement team did not consider whether it was necessary to describe the misstatement in the written representation as an "uncorrected misstatement identified in the current fiscal year that could affect earnings for past fiscal years."

(Auditing Standards Committee Statement No. 450, paragraphs 4, 5, 13, A4)

Case 2: Evaluating the effect of uncorrected misstatements

The audited company included a prior year`s adjustment in non-operating expenses and did not restate its financial statements retrospectively. The engagement team did not examine the reasonableness of the above accounting since the amount of the prior-year adjustment was less than materiality and the team lacked awareness of the need to carefully examine treatments in audits. Therefore, the team did not examine the adequacy of retrospectively recognizing the adjustment as profit of the current year. In addition, they did not ask the audited company to state the items at a summary of unadjusted misstatement, which was attached to the written representation.

(Auditing Standards Committee Statement No. 450, paragraph 13; and Corporate Accounting Standards No. 24, paragraphs 21 and 35)

《Points to Note》

There were numerous cases where auditors did not examine the results of evaluating internal control and the impact on substantive procedures although auditors shall judge whether the overall audit strategy or detailed audit plans should be revised when the nature and circumstance of the identified misstatements may indicate the possibility of other misstatements, and there is possibility that the aggregation of other misstatements might become a material misstatement.

Moreover, auditors need to determine whether identified misstatements would be material, either individually or in aggregate, if they are not corrected. However, there were cases where auditors did not evaluate the impact of uncorrected misstatements of past fiscal years on the financial statements as a whole.

Note that it is necessary to state in the list of uncorrected misstatements attached to the written representation (1) uncorrected misstatements for the current term, (2) uncorrected misstatements included in comparative information, or (3) effect of comparative information as a result of correction (or elimination) of the figures for the current term, when auditors discovered uncorrected misstatements for the prior years, and management determined that they were not material and have corrected (or eliminated) them in the current term.

(6) Identifying and assessing the risks of material misstatement for the information system and procedures responsive to assessed risks

Case: Development of an audit plan for the use of IT systems

- The engagement team only inquired if there were significant changes from the previous year in its understanding of the general structure of IT use in mission-critical systems for sales and purchase operations, and did not perform procedures for understanding the stability of information systems, the overview of IT infrastructure and the degree of IT use, etc.

Moreover, the engagement team did not consider whether they should use an IT specialist although there was no one on the team who had sufficient knowledge of IT.

(Auditing Standards Committee Statement No. 315, paragraphs 17 and 20; IT Committee Practical Guidelines No. 6, paragraph 4)

- The audited company identified the application controls of information technology relating to sales processes included restrictions to non-registered customers' usage in the sales management system and the issuance of vouchers prior to shipping registration, and evaluated the design and operating effectiveness of the key aspect of the controls.

  The engagement team evaluated sales processes, and determined that application controls in information technology that should be examined as part of financial statement audits and internal control audits were absent, and only examined the design and operating effectiveness of manual internal controls.

  However, the engagement team did not understand how the audited company dealt with IT-related risks, and did examine whether it was possible for only manual internal controls other than the application controls in information technology to prevent and detect risks of misstatement on a timely basis.

  (Auditing Standards Committee Statement No. 315, paragraphs 20; Audit and Assurance Practice Committee Report No. 82, paragraph 144)

《Points to Note》

Business enterprises use information systems for their business operations. Through understanding the status, characteristics and operation of the information systems of the audited company, the engagement team can properly identify and assess the risks of material misstatements resulting from those systems. There were some cases in which the audit firm judged that the potential material misstatement risk was low without understanding the general structure of those IT systems. When developing an audit plan, audit firms should understand the IT-related environment of the audited company, and identify IT systems that should be included in the assessment for risks of material misstatement.

Moreover, when understanding the general structure of IT systems of an audited company at a group audit, auditors shall be careful not to omit significant components. In addition, auditors need to develop an appropriate audit plan by considering how the accounting policies and the control environment of the audited company, including the year-end closing process, are reflected in or associated with the IT systems.

Furthermore, when using various lists generated by the audited company's information system for the tests of controls or substantive procedures, the engagement team shall evaluate the accuracy and completeness of the information. Depending on the degree of IT use by the audited company, the

engagement team may need the support of IT specialists and incur considerable time to complete the audit. Therefore, the engagement team should note that it needs to develop an audit plan for the above procedures at an early phase.

2. Audit Evidence

Points of focus

Auditors should assess information obtained as audit evidence considering its relevance and reliability. The CPAAOB inspects whether the engagement team has designed and performed audit procedures to obtain sufficient appropriate audit evidence to draw reasonable conclusions on which to base the auditor's opinion from the following perspectives:

- ▶ Whether the engagement team obtains appropriate audit evidence responsive to the assessed risks of material misstatement at the assertion level, rather than only focusing on the quantitative sufficiency of audit evidence;
- ▶ Whether the engagement team performs further in-depth responses to audit risk to reduce audit risk to an acceptably low level for significant risks;
- ▶ Whether the engagement team performs appropriate audit procedures in individual situations as tests of controls and substantive procedures;
- ▶ Whether the engagement team assesses whether the information prepared by the audited company and information prepared by the management's experts is sufficiently reliable.

Outline of inspection results

The following examples of identified deficiencies, as pointed out in past years, are also frequent in the current year:

- ・The engagement team did not assess whether the audit evidence obtained through the audit procedures was adequate to identify risks of misstatement.
- ・The engagement team identified significant risks but did not perform substantive procedures that responded individually to the risks.
- ・The engagement team identified inconsistencies and irregularities with other audit evidence but did not determine the necessity of additional audit procedures.
- ・The procedures performed by the engagement team as substantive analytical procedures did not meet the requirements for substantive procedures since the engagement team only performed annual comparisons and monthly fluctuation analyses, and they did not assess the reliability of the data used by the auditor to estimate booked amounts and ratios, and whether the engagement team's estimate was precise enough to identify misstatements which could lead material misstatements.
- ・In sampling for audit procedures, the engagement team did not examine whether the sample size it had determined was adequate to keep sampling risk at a tolerably low level.
- ・When testing items selected by specific sampling, the engagement team did not examine whether it was necessary to obtain additional audit evidence for the remaining part of the population.
- ・When using information prepared by the audited company, the engagement team did not evaluate whether the information had sufficient reliability for audit purposes.

For more information in responses to audit risk for revenue recognition, also see items (2) "Identifying and assessing the risks of material misstatement due to fraud" and (3) "Response to assessed the risks of material misstatement due to fraud" in "6. The Auditor's Responsibilities Relating to Fraud in Financial Statement Audits."

Expected response

The engagement team needs to assess appropriately whether they have obtained sufficient audit evidence relevant to the purposes of audit procedures to respond to identified risks. Particularly, for significant risks, the engagement team shall perform substantive procedures individually.

Many examples of identified deficiencies in relation to obtaining sufficient appropriate audit evidence resulted from the engagement team's failure to appropriately perform risk assessment and response to audit risk, and the team's lack of in-depth understanding of the audited company's business for the fiscal year subject to audit (See paragraph titled "Expected response," in "1. Risk Assessment and Response to Assessed Risks" in Chapter III).

In many other cases, the engagement team appropriately performed risk assessment and designed audit procedures to respond to the assessed risk but the engagement partners neither gave specific directions nor exercised specific supervision. Professional staff therefore performed only conventional audit procedures, leading to a lack of organic coordination between the audit plan and actual audit procedures. Thus, when auditing the audited company, the engagement team should, through the audit period, gain a deep understanding of the audited company and its business environment and sufficiently discuss the risk assessment and audit procedures to be performed. The engagement team should also comprehensively evaluate the sufficiency and appropriateness of audit evidence obtained through the review of audit documentation.

(1) Matters common to audit evidence

Case 1: Sufficient appropriate audit evidence (sufficiency of audit evidence)

- In the assessment of the effectiveness of internal controls concerning the completeness of sales rebates that were identified as a significant risk, the engagement team used the results of assessment related to internal control that was performed by the internal auditors of the audited company, whose fiscal year-end is March 31. The internal auditors selected sampling items from the period subsequent to September at their assessment because there was a change in control activities relating to sales rebates in September.

  However, the engagement team did not plan and perform additional tests of effectiveness of internal controls as an assessment of internal controls in financial statement audits, although the period from April to August was not subject to tests of effectiveness of internal controls for a financial statement audit.

  (Auditing Standards Committee Statement No. 330, paragraph A19; and No. 500, paragraph

9)

- As for the occurrence and accuracy of sales with credit cards, the engagement team performed confirmation procedures for several of the balances of accounts receivable as of the balance sheet date, and vouched all unconfirmed accounts to the reports that the audited company obtained from credit card companies.
  Audit evidences of the credit sales obtained from the confirmation procedures were for the sales in the latter half of the year-end month. However, the engagement team did not consider the necessity of additional substantive procedures for the credit sales related to the period between the beginning of year and the first half of the year-end month, which is not subject to examination.
  (Auditing Standards Committee Statement No. 500, paragraph 9; and No. 530, paragraph 7)

《Points to Note》

As in the above example case of a deficiency, there were cases where tests of effectiveness of internal controls and substantive procedures were performed only for part of the period subject to audit, as well as cases where substantive procedures were not planned and performed for selling, general, and administrative expenses identified as a risk of material misstatement.

When performing tests of effectiveness of internal controls and substantive procedures, auditors are required to determine the period that should be subject to audit procedures in consideration of account balances and assertions. In audit procedures for the occurrence and accuracy related to items in the statement of income, in particular, auditors should note that the items audited over the entire period are subject to the procedures, in general. Furthermore, as in the above case, auditors should note that periods that should be subject to tests of effectiveness of internal controls for financial statement audits differ from period for audit of internal control over financial reporting, in the case where there was a change in internal control activities during the period.

In addition, generally, inquiries without other procedures neither proves that there is no risks of material misstatement at the assertion level, nor obtains sufficient audit evidences as to the effectiveness of internal controls; however, there were cases where the engagement team completed audit procedures by inquiries only. The engagement team needs to perform procedures responsive to assessed risks to corroborate the evidence obtained through inquiry. That applies not only to audit procedures for significant risks but also to audit procedures responsive to audit risk.

Auditors plan substantive analytical procedures, tests of details, or a combination of both as audit procedures for assessed risk, depending on the conditions, but the degree of required responses to audit risks differs depending on the significance of assessed risk.

In one case, the engagement team performed multiple audit procedures, yet the quantitative or qualitative appropriateness of audit evidences was not verified through the planned audit procedures. As a result, it was considered that the team did not obtain sufficient audit evidence to reduce the overall audit risk to a

low level.

The engagement team should not perform planned audit procedures for formality, but comprehensively assess the events identified during the audit and the sufficiency as well as the appropriateness of audit evidence obtained through multiple audit procedures.

Case 2: Sufficient appropriate audit evidence—appropriateness of audit evidence

- As audit procedures for completeness of liabilities related to purchase and selling, general and administrative expenses (excluding personnel expenses and depreciation), the engagement team vouched with records at bank accounts related to payments made in the period between the following day of the balance sheet date and 10 days later with supporting documents.

  However, although the cutoff date of payments of liabilities at the audited company was usually at month-end and they were paid at the following month-end, the engagement team did not plan and perform audit procedures for obtaining sufficient appropriate audit evidence on the completeness of liabilities. They needed to examine expanding the period of deposit payment records subject to verification, and verifying whether there were any invoices received on and after the date of the financial statements that should have been recorded as liabilities.

  (Auditing Standards Committee Statement No. 500, paragraph 5)

- In verifying the accuracy of inventory, the engagement team observed a physical inventory as part of its substantive audit procedures.

  The engagement team verified the accuracy of the closing balance recorded in the inventory listings through tracing the quantity confirmed at the physical inventory to that on the inventory listings.

  However, the engagement team did not perform audit procedures to obtain sufficient appropriate audit evidence to verify the accuracy of the unit prices of the closing balance.

  (Auditing Standards Committee Statement No. 330, paragraph 17; and No. 500, paragraph 8)

- In verifying manufacturing expenses and SG&A expenses, the engagement team performed to test some selected items in the population using the audit sampling.

  However, the following deficiencies were identified in the audit procedures performed by the engagement team:

  a) The engagement team understood the internal controls, and determined that many items recorded in manufacturing expenses and SG&A expenses were booked through the other accounts payable account. The team therefore extracted samples from the population of the recognition amounts of other accounts payable. However, it did not examine whether all manufacturing expenses and SG&A expenses were included in the population.

b) The samples extracted by the engagement team included transactions that were not directly related to manufacturing expenses and SG&A expenses, such as “construction in progress” “other financing expenses” and “miscellaneous charges.” However, the team did not consider whether it was appropriate for those samples to be subject to the audit procedures.

(Auditing Standards Committee Statement No. 530, paragraphs 5, 6, and 9)

《Points to Note》

Other than the cases where the engagement team did not obtain audit evidence relevant to the audit purpose, such as above, there were a number of cases where the engagement team, despite the identified fraud risk, often did not obtain appropriate audit evidence relevant to the assessed risks at the assertion level. For example, the team completed audit procedures only by verifying easily available audit evidence such as the internal vouchers of the audited company. The team needs to evaluate the reliability and relevance of audit evidence when planning and executing audit procedures.

When a test of operating effectiveness of internal controls was also used as a substantive procedure (dual-purpose test), the engagement team did not consider the effectiveness of such test as a substantive procedure. When planning and performing tests of effectiveness of controls and substantive procedures, engagement teams have to consider whether procedures to obtain sufficient appropriate audit evidences, which achieve the relevant audit objectives, are planned and performed.

Case 3: Work of management’s experts

When determining whether to recognize impairment loss on long-lived assets, the audited company obtained a real estate appraisal report prepared by an external real estate appraiser for the net realizable value.

However, in assessing the appraisal report, the engagement team failed to examine the competence, capabilities and objectivity of the expert used by management. Further, although the audited company used a real estate appraisal report obtained in prior years for certain assets, the engagement team did not examine whether the basic data (rent, discount rate, etc.) was still appropriate for the current year.

(Auditing Standards Committee Statement No. 500, paragraph 7; and No. 540, paragraph 12)

《Points to Note》

When using the work of the management’s experts (including pension actuary, real estate appraiser, etc.), the auditor needs to evaluate the competence, capabilities and objectivity of such experts, and understand the expert’s work, paying attention to evaluating the adequacy of the expert’s work used as audit evidence in light of related assertions.

Case 4: Reliability of information prepared by audited companies

- To perform a test of details for the occurrence of sales, the engagement team extracted random samples from annual sales data obtained from the audited company, and verified them to audit evidences.
  However, the engagement team did not examine the completeness of annual sales data obtained for the population of sampling from the audited company, such as comparing the data with the sales recorded in the financial statements.
  (Auditing Standards Committee Statement No. 500, paragraph 8 and A49, and No. 530, paragraph A5)

- In the verification of consolidated journal entries related to the elimination of unrealized profit on inventories, the engagement team checked the inventory quantities and profit ratio with information prepared by each division of the audited company.
  However, the engagement team did not obtain audit evidence on the accuracy and completeness of the information, and did not assess the reliability thereof.
  (Auditing Standards Committee Statement No. 500, paragraph 8)

- In examination of the valuation of inventories, the engagement team used the information prepared by the audited company (details of sales transactions for identifying inventories whose profitability had declined).
  However, the engagement team did not examine the completeness of the sales transactions, and did not evaluate whether the information was sufficiently reliable for the auditor's purposes, while the engagement team investigated the accuracy of the information.
  (Auditing Standards Committee Statement No. 500, paragraph 8)

- The engagement team examined to select the site observations, assess whether to recognize the construction loss provision, and investigate incomplete transfers from construction-in-progress expenditures to completed-construction costs, using the P/L data by construction projects prepared by the audited company.
  However, the engagement team did not evaluate whether the P/L data by construction projects and the construction-in-progress expenditures were appropriately aggregated, although the engagement team verified the reliability of the data through verifying that the total annual completed-construction amounts and completed-construction costs for all construction projects was consistent with the general ledger.
  (Auditing Standards Committee Statement No. 500, paragraph 8)

《Points to Note》

As shown in the above case, it is essential to verify whether the data obtained from an audited company

was consistent with the financial statements, such as verifying the completeness of the data population, when extracting samples from data obtained from an audited company.

Further, as part of the audit of accounting estimates, numerous cases were observed in which the information prepared by an audited company was used as an audit evidence without its accuracy and completeness being verified. When using the information obtained from an audited company as an audit evidence, the engagement team should thoroughly examine the reliability of such information, including the information produced by information systems.

Case 5: Timing of substantive procedures (procedures for remaining period)

- When verifying the balances of loans and deposits at an audited financial institution, the engagement team performed a dual-purpose test of both substantive procedures and operating effectiveness of controls to verify transactions during the term until February. However, the team only performed the analytical procedures for its risk assessment, but did not plan and perform the substantive procedures to verify the remaining period.
  (Auditing Standards Committee Statement No. 330, paragraphs 17 and 21)

- The audited company was in the retail business, and from the middle to the end of the closing month, it performed a physical inventory at several dozen stores.
  The engagement team selected two stores and observed the inventories being taken, and planned and performed roll-forward procedures from the date of the physical inventory up to the date of the financial statements.
  However, the engagement team failed to obtain sufficient appropriate audit evidence to verify the balance of inventory on the date of the financial statements since the engagement team's audit procedures included the following deficiencies:
  a) The engagement team only identified the changes in inventory from the date of the physical inventory to the date of the financial statements for the stores observed, and did not perform its substantive procedures for the transactions that led to the changes.
  b) Any audit procedures were not planned or performed for the stores not observed,.
  (Auditing Standards Committee Statement No. 330, paragraph 21, No. 500, paragraph 5, and No. 501, paragraph 4)

《Points to Note》

It should be kept in mind that in the case where substantive procedures were performed as of a cut-off date set before the balance-sheet date, additional substantive procedures should be performed for the period from a cut-off date to the balance sheet date to reasonably support the use of audit conclusions of the substantive procedures to cover the remaining period.

(2) External Confirmation

Case 1: Reliability of responses to confirmation request

With regard to a confirmation of receivables and payables not replied from an affiliated company, the engagement team requested, via the audited company, the affiliated company to reply to the confirmation, and then obtain the confirmation via the audited company.

However, the engagement team did not perform additional procedures although they had not directly obtained the confirmation.

(Auditing Standards Committee Statement No. 505, paragraphs 5 and 9)

《Points to Note》

External confirmation procedures generally provide strong audit evidence to auditors. However, if auditors have suspicion of the reliability of the replies, such as receipt of the replies via facsimile, email or obtaining the replies via an audited company, it is necessary to perform an audit procedure to ascertain the reliability of the replies and mitigate the risks of manipulation and fraud.

Case 2: Alternative audit procedures

- In confirming the outstanding balances of accounts receivable as of the balance sheet date, the engagement team conducted alternative procedures for confirmations not replied through verification of the collection.

  However, the engagement team only verified the collection of receivables through several collections made in the following month of the balance sheet date but did not examine balances of more than 80% of the amounts, which should have been confirmed.

  (Auditing Standards Committee Statement No. 505, paragraphs 5, 9, 11–13, and A11)

- In confirming the outstanding balance of receivables and payables, the engagement team received replies from certain companies that did not indicate any specific outstanding balances.

  However, the engagement team did not perform necessary audit procedures including resending the confirmation letters or conducting alternative procedures.

  (Auditing Standards Committee Statement No. 505, paragraph 11)

《Points to Note》

External confirmation is an audit procedure that generally provides persuasive evidence. Therefore, if an engagement team is unable to obtain responses to its confirmation requests, it needs to perform alternative audit procedures. At the same time, the team should carefully evaluate whether the audit evidence obtained through alternative procedures is adequate and appropriate in view of the risks of material misstatement.

Case 3: Exception in relation to confirmation

- The engagement team performed balance confirmation procedures as part of its substantive procedures concerning receivables, and if there was an exception in relation to confirmation, it performed substantive procedures with respect to the amount of the difference.
  However, performing a balance confirmation for an important business partner, the engagement team discovered that the amount in the response from the business partner included a large difference in an item called “money retained” (the amount of the other party’s obligation was excessively high). However, the team did not identify what “money retained” referred to, and excluded it from its investigations. It therefore did not obtain sufficient appropriate audit evidence with respect to the difference.
  (Auditing Standards Committee Statement No. 505, paragraphs 11 and 13)

- With regard to land and buildings, the audited company included a note concerning pledged assets on the grounds that a revolving mortgage had been established when the money was borrowed from financial institutions.
  With respect to the fixed tangible assets for which the revolving mortgage had been established, the engagement team compared the description of the assets on the collateral statement with the engagement documentation for the previous year’s audit, compared the amount with that in the fixed-asset ledger, perused examination records, minutes from meetings of the directors, and the approval circulars at the time the loan was taken out in order to investigate changes in the collateral.
  However, when the engagement team asked the three financial institutions that had provided the revolving mortgage to confirm the balance, two of them responded that there was no collateral property, while the other did not make a clear statement as to whether there was collateral property. Despite this, the team did not consider the need for additional procedures such as make inquiries with the financial institutions or resending the balance confirmation requests.
  (Auditing Standards Committee Statement No. 505, paragraphs 13 and 15)

《Points to Note》

Exceptions arising from replies to external confirmation might indicate misstatements in financial statements or potential misstatements. Based on this, the engagement team should investigate the differences between the confirmed and stated amounts, and obtain corroborative audit evidence such as specific supporting documents.

If the engagement team determines whether the exceptions corresponds to a misstatement as a result of cause analysis of exceptions, and identifies a misstatement, the team also needs to evaluate the effectiveness of internal control and its impact on the financial statements.

(3) Substantive analytical procedures

Case 1: Identified deficiencies in substantive analytical procedures

- In performing substantive analytical procedures for cost of goods sold (COGS), the engagement team assumed the following factors in developing the expectation of COGS of a restaurant business as a whole:
  a) The COGS margin of the audited company is constant, excluding the impact of price fluctuation.
  b) Price fluctuation that affects the audited company coincides with the simple average of the rate of price changes of food and alcohol of the consumer price index published by the Statistics Bureau of the Ministry of Internal Affairs and Communications.

  However, the engagement team did not examine whether the methodology to develop the expectation with the above factors was appropriate, in spite of the fact that the audited company operated a variety of stores such as restaurants, *izakayas* (Japanese-style pubs), and cafes, as well as the scrap and build each year.
  (Auditing Standards Committee Statement No. 520, paragraph 4)

- In the substantive analytical procedures for sales rebates of the audited company, the engagement team assumed that there was no significant fluctuation in the ratio of rebates to sales, and calculated the expectation of rebates by multiplying current year's sales by the rebate ratio during the previous period.
  However, although the rebate contracts differed between customers and sales to each customer fluctuated every year, the engagement team did not examine the appropriateness of the above assumption by obtaining specific supporting information such as review of revisions to the rebate contracts by each customer.
  (Auditing Standards Committee Statement No. 520, paragraph 4)

《Points to Note》

There continue to be cases where the engagement team selected substantive analytical procedures as substantive procedures, but, for example, only performed annual comparisons that did not meet the requirements of substantive analytical procedures.

It should be noted that in some cases, substantive analytical procedures met requirements stipulated in the audit standards, but examinations as to the reliability of the data and the accuracy of the expected value, which were necessary to reduce the audit risk to a minimum acceptable level, were not performed. For example, the engagement team used the actual previous period results and financial forecast as expectations without a rational reason when performing such procedures. The engagement team should consider the nature and relevance of information sufficiently, and that any difference of recorded amounts from expectation may turn out to be a material misstatement.

Case 2: Investigation of results of substantive analytical procedures

In substantive analytical procedures for personnel expenses (salary, miscellaneous wages, allocated labor expenses), the engagement team identified that a difference between the amounts recorded in manufactured costs and the expectation of the auditor exceeded the acceptable difference. However, they simply assumed that the difference resulted from internal assistance provided from the sales and control division to the manufacturing division to respond to unpredicted sales orders without obtaining sufficient appropriate audit evidences relating to the difference, such as documents to support the assumption that the internal assistance actually occurred.
(Auditing Standards Committee Statement No. 520, paragraph 6)

《Points to Note》

In some cases, the engagement team only performed an inquiry to obtain qualitative reasons regarding the nature of differences when investigating the differences between the amounts recorded on financial statements and the auditor's expectation. The team did not perform a quantitative investigation and analysis by each cause and did not obtain specific audit evidence to support the qualitative reasons. In substantive analytical procedures, the engagement team needs to investigate differences from expectations and reasons for inconsistencies with other related information considering that the differences subject to further investigations may turn out to be material misstatements.

(4) Audit sampling and testing specific items

Case 1: Planning of audit sampling

- In the substantive procedures for revenue of the audited company, the engagement team selected samples from the last business day of the two selected months (August and January) of the relevant period.
  However, the team did not consider whether the way of sampling above could provide a reasonable basis for conclusion about the entire population.
  (Auditing Standards Committee Statement No. 530, paragraphs 5 and 7)

- With no internal rules of audit sampling, the engagement team selected 25 or more samples in the test of details for account items (sales, accounts receivable, etc.) that are highly related to the business objectives of the audited company in the audit of internal control over financial reporting, and a few number of samples for other account items.
  However, the engagement team did not consider whether these numbers of samples could provide a reasonable basis for conclusion about the entire population.
  (Auditing Standards Committee Statement No. 530, paragraphs 5–6)

- The engagement team's audit procedures for valuing securities held by the audited financial institution involved comparing the stated market prices with external evidence. Among securities with market prices, the prices of all shares, investment trusts, and foreign bonds were compared, but in the case of domestic bonds, sampling was performed. This involved taking one sample for each type of bond (government bonds, municipal bonds, government-guaranteed bonds, public-corporation bonds and public-project bonds), for a total of five samples.

However, the engagement team did not consider whether the sample size for domestic bonds was adequate to keep sampling risk at a tolerably low level.

(Auditing Standards Committee Statement No. 530, paragraphs 6)

《Points to Note》

When designing audit sampling, the engagement team needs to consider the purposes of audit and the most suitable combination of audit procedures to achieve those purposes, in consideration of the characteristics of the population from which samples are to be selected.

In deciding the number of samples, it is necessary to note that the way of determination thereof for tests of operating effectiveness of internal control differs from that for tests of details, in general. Therefore, when using the number of samples, which was for the tests of controls, also for the tests of details as in the above example case, it is necessary to examine whether the number of samples is sufficient for tests of details. Audit sampling should be performed in a way that provides opportunities for all items within the population to be selected; therefore, it is necessary to pay attention to the completeness of the population for selection.

Note that if misstatements are discovered in some selected items in a population using sampling, it is necessary to estimate the total amount of misstatement in the population as a whole.

Case 2: Testing some selected items in a population

With regard to dividend income, SG&A expenses, etc., which had been identified as important transaction types, the engagement team performed substantive procedures for those transactions performed during the term that exceeded a certain amount.

However, even though the remaining components for the above-mentioned substantive procedures of the population all exceeded performance materiality, the engagement team did not consider whether additional substantive procedures needed to be performed.

(Auditing Standards Committee Statement No. 500, paragraphs 9 and A55)

《Points to Note》

As the above case shows, numerous deficiencies are still being observed. These include the failure to consider whether additional procedures should be considered for the remaining part of the population after some selected items in the population have been tested.

Testing some selected items in a population, which involves extracting specific items from transaction types or account balances, is an effective method for obtaining audit evidence, as it allows for the examination of atypical transactions, high-risk items, and monetary materiality, as well as the acquisition of information about the nature of transactions. Unlike audit sampling, however, it needs to be kept in mind that audit evidence is not provided concerning the remaining part of the population, namely the components of the population that are not extracted as samples.

(5) Related parties

Case 1: Understanding the audited company's related party relationships and transactions

The audited company engaged in transactions with major shareholders and companies related to them. These included loans, debt guarantees, and receipt of rent and consulting fees, and the audited company provided a note stating that these transactions were conducted under the same terms as arm's length transactions.

However, the only substantive procedures for related party transactions performed by the engagement team were comparing disclosures with documents prepared by the audited company. The team did not perform audit procedures to determine the relationships with the related parties, the completeness of transactions, the accuracy of transaction amounts, and whether the transactions were conducted under the same terms as arm's length transactions.

(Auditing Standards Committee Statement No. 550, paragraphs 19 and 23)

《Points to Note》

As the above case shows, there were cases where the engagement team did not examine related parties and transactions with related parties completely. If the management has implemented an internal control for identifying related party transactions and approving significant transactions, the engagement team needs to understand the internal control and perform other appropriate risk assessment procedures as deemed appropriate.

Further, the following examples of failure are found for the disclosure of related party transactions:

- **The audited company did not appropriately disclose the terms and conditions while the audited company provided non-interest bearing loans and guarantee without any charge;**
- **The engagement team did not sufficiently examine the terms and conditions of transactions that were disclosed as arm's length transactions.**

The engagement team should carefully evaluate whether identified relationships with related parties and related party transactions have been properly accounted for and disclosed in accordance with the applicable financial reporting framework.

For information on cases related to identification and assessment of the risks of material misstatement and audit procedures responsive to the assessed risk regarding related party transactions, including the consideration of fraud risk required in the Auditing Standards Committee Statement No. 240, also see "6. The Auditor's Responsibilities Relating to Fraud in Financial Statement Audits."

Case 2: Identification and assessment of the risks of material misstatement associated with related party transactions

The audited company was lending money to the company representative director, and details of this were included in related party information. Furthermore, the company's rules on loans to directors stated that the term of the loan should generally not be longer than one year. However, the company representative director was repaying and then reborrowing the same amount each year.

Even though the engagement team recognized related party transactions as a significant risk, they did no more than find out about the loan and obtain a summary of its purpose. They did not delve deeper by, for example, engaging in discussions with the company's management or communicating with company auditors to ascertain specifics about what the money was being used for, when it would be repaid, and whether there was even an intention to repay it.

(Auditing Standards Committee Statement No. 550, paragraphs 22 and 26)

《Points to Note》

Related party transactions sometimes carry higher risks of material misstatement of financial statements than third party transactions. Therefore, as a precondition for audit procedures, the engagement team needs to comprehensively understand the audited company's related parties and its relationships with them. The engagement team needs to be aware that if it discovers significant transactions with related parties outside the audited company's normal course of business, it must treat them as a significant risk. Furthermore, with regard to significant transactions with related parties outside the audited company's normal course of business, the engagement team needs to carefully consider not only whether they have been disclosed, but also whether their business rationality, or lack thereof, points to the possibility that they have been conducted for the purpose of producing fraudulent financial statements, and whether the transaction terms are consistent with the explanations by management.

(6) Going concern

Case : Identification of any events or conditions that may cast significant doubt on the audited company's ability to continue as a going concern

Despite severe business conditions that resulted in continuing operating losses and negative operating cash flow, and difficulties in financing as evidenced by multiple financial institutions' refusal to provide loans, the audited company mentioned that neither an event nor a condition which might cast significant doubt on the going concern assumption had occurred, maintaining that these losses had arisen from restructuring business operations.

However, the engagement team did not examine the reasonableness of the audited company's argument.

(Auditing Standards Committee Statement No. 570, paragraphs 9 and 11)

《**Points to Note**》

Early signs of significant events or conditions that may damage the continuity of business operations are likely to appear in business activities, so the engagement team should carefully ascertain any events or conditions that would cast significant doubt on the going concern assumption. Furthermore, when there are events or conditions that might cast significant doubt on the going concern assumption of the audited company, the engagement team should consider the potential need to revise the evaluation as to the risks of material misstatement and nature, timing and scope of further audit procedures.

Besides the above, in one case, the engagement team did not examine the audited company's financing plan specifically for the feasibility of financing. In other cases, the engagement team did not sufficiently examine, on a consolidated basis, factors having a significant impact on the going concern assumption, including subsidiaries' additional financing needs. The engagement team needs to evaluate the audited company's financial position comprehensively based on specific audit evidence and the effectiveness and feasibility of the measures taken by management in relation to the assessment of the audited company's ability to continue as a going concern.

(7) Other

Case 1: Subsequent events

The audited company executed an agreement to extend the due date of the significant loan that was approximately 20% of the audited company's total assets, and publicly disclosed the information.

However, the engagement team failed to consider whether the due date extension was a subsequent event that would require revisions in the audited company's financial statements or affect the audited company's financial statements in the following year and thereafter.

(Auditing Standards Committee Statement No. 560, paragraph 7)

《**Points to Note**》

In many cases, engagement teams performed audit procedures related to subsequent events only by making inquiries with the management. The engagement teams need to perform audit procedures regarding subsequent events for the period between the balance-sheet date and the date of the auditor's report, including at least:

(1) Understanding the procedures performed by the management to identify subsequent events;

(2) Inquiries with the management;

(3) Inspection of the minutes of board of directors meetings;

(4) Review of the latest subsequent monthly financial statements, if available.

Case 2: Risk of litigation

The engagement team did not examine the potential loss that might be incurred by the audited company, despite the audited company's lawyer's comments at a confirmation letter about the

existence of “matters that may give rise to filing for litigation or claim for compensation, correction, assessment or imposition, or equivalent matters to the same effects.”
(Audit Committee Statement No. 73, paragraph 3)

《Points to Note》

In the case of confirmation with the attorney, the engagement team needs to confirm the facts that caused the litigation or claim, when it arose or how long it continued, its status and the likelihood of losses arising therefrom, and an estimate of expected loss.

Additionally, in the case where the payment of compensation due to litigation, etc., is likely to impact the audited company’s financial statements materially, the engagement team should examine the appropriateness and effectiveness of the audited company’s litigation risk management framework.

Note: On February 19, 2018, Auditing Standards Committee Statement No. 73, “Practical Guidelines on the Assessment of Structures for Managing Risks Associated with Litigation and Confirmation with Attorneys” were revised to Auditing and Assurance Committee Practical Guidelines No. 73, “Practical Guidelines on Inquiry Letters to Advising Attorneys Concerning Litigation,” and have been applied to audits for accounting years starting on or after April 1, 2018. They may also be applied to accounting years starting prior to that date.

Case 3: Consolidated adjusting entries

The engagement team identified risks of material misstatements in accounting treatment for capital consolidation. However, the accounting procedures performed by the engagement team had the following deficiencies, and the team did not assess whether the audit evidence it obtained was adequate and appropriate for the risk of material misstatements.

a) With regard to the journal entries of amortization of goodwill, the engagement team only reviewed documents prepared by the audited company, and did not perform substantive procedures.

b) With regard to the journal entries of the equity method of accounting, the engagement team only made comparisons with the previous term, and did not perform substantive procedures with respect to the booked amounts.

c) With regard to the journal entries of market value valuation, the engagement team compared the total journalized amount of deferred tax assets/liabilities with the figure for the previous term, and discovered that it had decreased significantly. Yet despite this, it concluded that “nothing unusual was found with journal entries,” and did not consider whether additional procedures were necessary.

(Auditing Standards Committee Statement No. 330, paragraphs 6, 17, and 25, No. 500, paragraph 10)

《Points to Note》

As can be seen from the case above, there was a case where the engagement team, in its examination of consolidated adjusting entries, only made comparisons with the previous term and reviewed documents prepared by the audited company, and did not perform substantive procedures.

In addition to the above, there were also cases where the engagement team lacked an understanding of the company and its environment at the group level, which is essential for assessing risk relating to consolidated financial statements, and even though complex intra-group transactions had occurred, the team did not examine completeness concerning the elimination of unrealized profit. When auditing consolidated financial statements, engagement teams need to realize that they must have a proper understanding of the corporate group, including assessments of capital relationships, effective control, and levels of influence.

For information on typical cases related to consolidated financial statements, also see "4. Group Audit."

3. Auditing Accounting Estimates

Points of focus

The CPAAOB inspects audit firms regarding auditing accounting estimates from the following perspectives:

- Whether, considering the degree of estimation uncertainty, the engagement team appropriately identifies and assesses the risks of material misstatement in the accounting estimates, and performs appropriate audit procedures to address such risks, particularly considering the reasonableness of management's assumptions;
- Whether the engagement team identifies any indication of possible management bias, considering the risks of material misstatement due to fraud, and performs further audit procedures responsive to the management bias if any;
- Whether, in the case that the engagement team identifies significant risks in accounting estimates, the engagement team performs an evaluation required under Auditing Standards Committee Statement No. 540, paragraph 14 in addition to the planned audit procedure.

Outline of inspection results

In auditing accounting estimates, there were still many cases where the engagement team only understood management's assumptions and accounting approaches but due to the lack of professional skepticism, did not objectively evaluate management's arguments regarding the appropriateness of inventory assessment rules and achievability of its business plan that the audited company's accounting estimates were based upon, thereby failing to examine the reasonableness of the management's arguments adequately.

Further, required audit procedures were often not performed, due to the lack of understanding of requirements under Auditing Standards Committee Statement No. 540.

Expected response

Accounting estimates are accompanied by uncertainty, and the risks of material misstatement associated with them depend on the degree of the uncertainty. Thus, auditors should examine the estimation uncertainty—including the nature and method of accounting estimates, associated internal control, indications of management bias—and should identify and assess the risks of material misstatement.

Auditors should also perform appropriate audit procedures relevant to the risk of identified and evaluated material misstatements, and verify the reasonableness of the management's estimates from a critical standpoint as professionals.

(1) Matters common to auditing accounting estimates

Case 1: Reasonableness of management's assumptions

- The audited company calculated its allowance for doubtful accounts based on the rank of allowance for doubtful accounts and allowance rate for each customer in accordance with calculation standards that it had established itself.
  The engagement team identified the appropriateness of the amount of allowance for doubtful accounts booked as a significant risk, and recalculated the allowance to confirm that it had been calculated in accordance with the calculation standards.
  However, the engagement team did not consider whether the rank of allowance for doubtful accounts for each customer was consistent with the calculation standards, not whether the allowance rates prescribed in the calculation standards constituted assumptions that would allow the allowance for doubtful accounts to be reasonably estimated.
  (Auditing Standards Committee Statement No. 540, paragraphs 12 and 14)

- The audited company prepared as its internal rules and operated evaluation principle to provide one third of the initial carrying amount of inventory, which was determined to be slow-moving and/or obsolete, per year as valuation loss over three years.
  Two companies that became consolidated subsidiaries during the current year due to acquisition had different sales channels from those of the parent company, but adopted the same evaluation principle as that of the parent.
  Under such circumstances, the engagement team did not examine whether the principle was reasonable and in line with the actual situation of declining profitability of the inventory.
  (Auditing Standards Committee Statement No. 315, paragraph 10; and No. 540, paragraphs 7 and 11)

《Points to Note》

Other than the allowance for doubtful accounts and assessment of inventory assets above, it is necessary to also review the grouping of impairment of long-lived assets to determine whether the rules set by management match the actual situation of the company and whether the rules that were considered in prior fiscal years still match the actual state of the company when there were changes in the company or the environment surrounding the company. However, there are some cases where the engagement team accepted such management's assumptions without examining them in detail, and simply checked whether the estimate amount was calculated in accordance with management's assumptions.

Particularly, when a significant risk is identified in accounting estimates, the engagement team must evaluate the following.

(1) The methodology taken by management to consider an alternative assumption/result and their

reasons for not using such alternative assumption/result; or the process of examining the estimation uncertainty in the case that management did not consider an alternative assumption/result;

(2) The reasonableness of management's material assumptions;

(3) Management's intent and capability to abide by their principles, in terms of the reasonableness of the management's material assumptions or the appropriateness of the applied reporting framework.

- The audited company used the next year's budget to assess both the recoverability of deferred tax assets and the impairment of long-lived assets. The audited company did not account for any deferred tax assets because of the uncertainty of the budget, while they considered it unnecessary to recognize the impairment loss of long-lived assets as the budget was likely to be certain. Therefore, the management's judgment on accounting estimates was inconsistent.
  However, in examining accounting estimates, the engagement team did not verify the reasonableness of applying inconsistent assumptions to project business performance for an identical period.
  (Auditing Standards Committee Statement No. 500, paragraph 10; and No. 540, paragraphs 12 and 20)

《Points to Note》

Other than the examples above, there were cases where the engagement team did not sufficiently consider the inconsistency in management's assumptions among accounts. For example, although the audited company accounted for impairment loss on its subsidiary's shares in individual financial statements, the equivalent goodwill recognized in its consolidated financial statements was not written off. The engagement team should comprehensively evaluate the consistency of events they understood.

Case 2: Review of the method of accounting estimation

The audited company was in the construction business, and provided warranties of between two and ten years for completed properties. It booked the estimated expenses associated with these warranties as an allowance for warranties on completed construction. Specifically, it multiplied the past rate of warranty exercise by the sales for the current year to book the expenses expected to be incurred during the next year as an allowance.

However, the engagement team did not consider whether the amount booked as the allowance for warranties on completed construction was adequate in light of the periods of the warranties provided by the audited company.

(Auditing Standards Committee Statement No. 540, paragraphs 7 and 12)

《Points to Note》

The engagement team needs to verify the method of the management's accounting estimates by evaluating

whether the management's method for measurement is appropriate under certain circumstances and whether the management's assumptions are reasonable under the applicable accounting standards. Further, when reviewing the management's methods for accounting estimates, the engagement team should consider the following:

- **Examination as to the accuracy, completeness and relevance of the basic data used for accounting estimates, and whether the accounting estimates are made appropriately with the basic data and management's assumptions**
- **Examination as to the source of information, the relevance, and reliability of external data or information (including information from external experts used by management)**
- **Examination as to the consistency of information for accounting estimates and the recalculation thereof**
- **Examination of management's review and approval for accounting estimates**

Case 3: Review of prior period accounting estimates

With regard to the valuation of slow-moving inventory, which had been identified as a significant risk, the engagement team analyzed the actual amounts of accounting estimates made in prior period .

However, when performing the above-mentioned analysis, the engagement team did no more than confirm that the average sale price of each product was lower than the product cost after booking a valuation loss only in rare cases. It did not examine the appropriateness of the valuation rates for slow-moving inventory, which were 10% of the expected sale price in the case of ordinary products and 30% of the same in the case of special products.

(Auditing Standards Committee Statement No. 540, paragraph 8)

《Points to Note》

In some cases, when reviewing the audited company's accounting estimates, the engagement team only ascertained the amount of deviation between the value estimated in the previous period and the outcome in the current period and the reason therefor, and did not consider the background of the deviation in evaluating the management's estimate for the current period. The team needs to note that reviewing the accounting estimates for the previous period is required in order to identify possible management bias and evaluate the degree of the estimation uncertainty.

It should be noted that the existence of a difference between outcome of accounting estimate and estimated amounts in the previous year's financial statements does not necessarily indicate a misstatement in the previous year's financial statements. However, it is possible to make a reasonable basis that the audited company could estimate close to the actual amount, if management used certain information available when estimating, as well as information reasonably expected to be obtained or considered when preparing the financial statements. In such a case, the auditor needs to consider that the difference could increase misstatements in the previous year's financial statements.

Case 4: Evaluation of reasonableness of business plan

- The audited company has a large amount of outstanding receivable from the subsidiary that is in a negative equity position. The subsidiary predicted to turn to be profitable for the following period in its business plan partly because it merged another subsidiary of the audited company that is profitable (hereinafter referred to as the "merged company") and partly because it planned to change the conditions of transactions with the audited company effective from the following period. The audited company has not recorded allowance for doubtful accounts for the subsidiary on grounds of the expected recovery of profitability.
  However, the engagement team did not examine the achievability of the business plan, such as whether it was possible to continue to gain profits from the businesses that the subsidiary took over from the merged company, and the feasibility of changing the conditions of transactions with the audited company.
  (Auditing Standards Committee Statement No. 540, paragraph 12)

- With regard to a fixed asset that was showing signs of having impaired, the audited company prepared a business plan and made predictions for future cash flow. The result was that the total amount of future cash flow exceeded the book value of the fixed asset, and the company therefore decided that it was unnecessary to recognize an impairment loss.
  The engagement team interviewed management concerning the business plan, and assumed that the business plan would be achievable by the second year, and that the future cash flow in the second year would continue thereafter. It calculated the auditor's estimated amount based on these assumptions, and because that estimated amount exceeded the book value of the fixed asset, it decided that it was unnecessary to recognize an impairment loss.
  However, during its interview with management, the engagement team did no more than accept oral explanations of matters such as amounts with important customers from which orders were expected to be received by the second year. It did not obtain sufficient evidence concerning the feasibility of achieving the sales. Furthermore, it only considered sales, and did not examine the reasonableness of the expenses stated in the business plan.
  (Auditing Standards Committee Statement No. 540, paragraphs 12 and 14)

《Points to Note》

In examining accounting estimates, including the valuation of investments and loans for affiliated companies, impairment of long-lived assets and recoverability of deferred tax assets, the engagement team often evaluates the reasonableness and other aspects of the business plan prepared by management.

However, in many cases, the engagement team evaluated the plan qualitatively only through interviews with management without verification of the details of the business plan with supporting evidence. As such, the engagement team did not sufficiently or appropriately examine the reasonableness of the business plan from a critical standpoint as professionals. The engagement team should carefully consider

the business plan by examining the consistency between the plan and the business environment as understood by the engagement team, comparing it with past actual results, verifying specific measures that form the basis of figures contained in the plan such as increasing revenues and reducing costs, and examining their feasibility.

(2) Evaluation of shares of affiliate companies

Case: Examination of net asset value and recoverability

In valuing the shares of a non-performing subsidiary, the engagement team did not examine the reasonableness of the audited company's decision not to realize impairment on the shares, despite the fact that the audited company assumed that the value of the shares would recover to approximately 50% of the book value in five years based on the subsidiary's business plan.
(Auditing Standards Committee Statement No. 540, paragraph 12)

《Points to Note》

When the net asset value of shares of the audited company's affiliate company for which the market value is extremely difficult to estimate declines by more than 50% from the acquisition cost, the audited company is required to consider that the net asset value deteriorated substantially and recognize an appropriate amount of impairment loss. This treatment should also apply to the valuation of shares of affiliate companies shortly after establishment or acquisition, and the net asset value of the shares should be carefully considered in analyzing the difference between an affiliate company's performance and its business plan.

(3) Valuation of receivables

Case 1: Review of recognition and measurement

With regard to loan to a subsidiary whose financial condition had deteriorated, the audited company waived the debt in the current fiscal year, and booked the entire amount as an extraordinary loss. The engagement team deemed that this judgment by the audited company was reasonable.

However, at the end of the previous fiscal year, the subsidiary was already in a negative equity position, so there were problems with its financial situation. In addition, the subsidiary's financial statements carried a large amount of goodwill, for which an impairment loss was not booked on the basis of its future business plan.

During the previous year's audit, the engagement team deemed that it was unclear whether the excess profitability from the goodwill would continue, yet did not obtain concrete evidence concerning the reasonableness of the business plan, which forecast rapid growth. Furthermore, the engagement team accepted its claims that the booking of an allowance for doubtful accounts was unnecessary on the grounds that the team made inquiries to the audited company and that loan repayments had been made as contracted. It therefore did not obtain sufficient appropriate audit evidence concerning the appropriateness and timeliness of the valuation of the loan. (Auditing Standards Committee Statement No. 540, paragraph 12)

《Points to Note》

Besides the above, there were also cases where the engagement team did not consider the reasonableness of the amount of an asset that was expected to be subject to seizure that the audited company claimed could be recovered. If during the valuation of receivables, an asset is expected to be subject to seizure, it is not enough to just identify the asset concerned. It is also necessary to adequately consider the feasibility of seizure and the amount expected to be recovered from the disposal of the asset.

Additionally, if it is difficult to obtain data that helps judge the debtor's ability to pay, there is a simplified method of valuing receivables with default possibility by, for example, provisioning 50% of the balance net of the estimate disposal value of the collateral. As for individually material receivables with default possibility, it is necessary to obtain sufficient data to the extent possible and to sufficiently examine whether the receivables are appropriately estimated at the time of valuation.

Case 2: Self-assessment of loans (appropriateness of borrower category)

- When auditing a tier-2 regional bank, the engagement team did not examine the audited company's decision-making as to borrower category as follows:
  - a) While the engagement team considered that the "Reasonable and Highly Achievable Plan" prepared by a debtor was unachievable, the team agreed with the financial institution's decision to classify the debtor as category "requires attention." The engagement team did not perform audit procedures for the inconsistency above.
  - b) While recognizing that a debtor had substantially negative assets with an unrealized loss, the financial institution did not adjust the debtor's financial profile (including an adjustment based on the unrealized loss). However, the engagement team acknowledged the unrealized loss but did not examine the appropriateness of the financial institution's decision.
  - c) Despite the fact that a huge loss incurred by Company A was covered by Company B, the audited financial institution did not treat the two companies as a group in its self-assessment process. However, the engagement team did not examine the appropriateness of not treating the two companies as a single group and assign to a single borrower category or review the financial condition of the two companies as a borrower group.

  (Auditing Standards Committee Statement No. 540, paragraph 14)

- In its self-assessment, an audited financial institution accepted that although Company C had low net assets at the end of the term, if the assets of the owner-manager were taken into account, its solvency was adequate. It also predicted that it would earn sufficient profits in the future based on the business plan, and had no doubts about the collectability of the debt. It therefore categorized the company as a "normal borrower."

After examining the company's financial condition and business plan, the engagement team deemed that the debtor category was appropriate.

However, the engagement team noticed that Company C's inventory balance had been large in relation to its annual sales for at least the past five years, and that if it became clear that it was saddled with unsellable inventory, it would have negative equity. Despite this, the engagement team did not obtain additional audit evidence.

(Auditing Standards Committee Statement No. 540, paragraph 12)

《Points to Note》

In auditing a deposit-taking financial institution, it is often the case that the audited company's evaluation of loans is identified as a significant risk, and the audit plan is designed based on the internal controls. In that case, it is necessary to perform tests on the operating effectiveness of controls, in addition to substantive procedures. Re-performance, in addition to inspection of records and documents, is considered effective in the tests of operating effectiveness of controls regarding the allowance for doubtful accounts.

Extracting a borrower as a sample and re-performing self-assessment on it can cover both the tests of operating effectiveness and of details. However, it is important to fully consider that even when using identical information, procedures vary based on the purpose of these tests.

Case 3: Accuracy of loan loss ratio

In the examination of loan loss ratio, the engagement team did not take into account the accuracy or completeness of the beginning loan balance or the amount of loss for a calculation period prepared by the financial institution that is a cooperative financial institution.

(Auditing Standards Committee Statement No. 540, paragraph 12; and the Japanese Institute of Certified Public Accountants' Special Audit Committee for Banks and Other Financial Institutions Report No. 4, section IV, item 5)

《Points to Note》

Other than the example mentioned above, when auditing allowance for doubtful accounts, it is important to perform procedures to verify the sufficiency of allowance, considering any material changes in the creditworthiness of borrowers for the period from the balance sheet date to the date of the auditor's report.

(4) Inventory valuation

Case: Examination of information produced by the entity for the audit of accounting estimates

In its valuation of inventory, the audited company followed the following procedures: If the net selling value at the end of the term was lower than the carrying amount, the carrying amount was reduced to the net selling value. And if the inventory had been slow-moving for a long time, the carrying amount was written down on the basis of the defined rate according to the turn-over period during which it had not moved.

The engagement team verified the information of calculating valuation losses produced by the audited company to assess carrying amount reductions in connection with declines in the net selling value. It selected samples of the most recent selling prices and compared them with the evidence. However, because the evidence that the engagement team used for this comparison was not for the most recent transactions, there were many samples which were differences in amounts with the evidences. Despite this, the engagement team did not perceive the differences as problems and did not perform additional procedures.

Furthermore, with regard to the write-down in carrying amount for this slow-moving inventory, the audited company identified slow-moving inventory using an age table output from the production system (i.e. information produced by the entity). When verifying this age table for the inventory, the engagement team compared the final shipping dates with data for final shipping dates in the production system and compared total amount of the inventory with the amounts on the trial balance sheet. However, the engagement team did not evaluate the reliability of the data for final shipping dates in the production system. Furthermore, even though the engagement team just noted there were differences between the total amount of the inventory and the amounts on the trial balance sheet, they did not perform any additional procedures.

(Auditing Standards Committee Statement No. 500, paragraphs 5 and 8; No. 540, paragraph 12)

《Points to Note》

In addition to the examples above, there were some cases where the engagement team did not examine the reasonableness of the audited company's methodology for inventory valuation or the appropriateness of its approach for valuation loss calculation.

Also, audited companies have inventories with special characteristics, such as property for sale and development projects in progress, which are different in value and difficult to calculate an objective value for. It is necessary to keep in mind that these special inventories, in general, should not be excluded from the scope of reduction in book value due to a decline in profitability.

(5) Impairment of long-lived assets

Case 1: Review of cash-generating units

The audited company identifies stores as cash-generating units for impairment purposes, but in the third quarter, a specific store that was identified as a specified cash-generating unit was changed to corporate asset because its role and position was made clear.

However, the engagement team did not evaluate the reasonableness of changing it to a corporate asset, even though they had recognized that the store had been still generating its own cash flow. Furthermore, even though no significant change had occurred in the operation of the store during the fiscal year, the engagement team did not evaluate the appropriateness of the timing with regard to the changing of the cash-generating unit in the third quarter.

(Auditing Standards Committee Statement No. 540, paragraph 11)

《Points to Note》

Other than the case above, there were some cases where the engagement team overlooked the fact that the audited company's cash-generation unit deviated from the actual situation and where the engagement team did not consider the appropriateness of the grouping of corporate assets. In addition, in some cases where it was considered that long-lived assets were no longer impaired due to the change in cash-generating units, the engagement team did not appropriately examines the appropriateness of the change with professional skepticism from the perspective of whether they indicated signs of fraud.

Cash-generating units should, as a principle, be a unit generating cash flows generally independent of those of other assets or cash-generating units. Therefore, the engagement team should examine the appropriateness of the policy to determine cash-generating units when the audited company monitors operating performance in smaller units than the cash-generating units determined by the audited company.

Case 2: Review of indications of impairment

- In the review of the indications of impairment of long-lived assets of a subsidiary that had been loss making in past years, the audited company determined that there was no longer indication of impairment because the subsidiary generated a small amount of profits in the current year. However, the engagement team did not take into consideration other factors to identify indications of impairment of long-lived assets, such as a rapid decline in sales orders just before the end of the financial year.

  (Auditing Standards Committee Statement No. 540, paragraphs 11–12)

- The audited company was in the restaurant business, and had a certain criteria to identify indications whether long-lived assets may be impaired. The criteria were that the restaurant had been opened for at least two years, and the profits or cash flow generated from operating activities had been continuously negative. However, it had not criteria to identify indications of impairment of restaurants that had been open for less than two years (below, "new restaurants").

  The engagement team deemed that there were no problems with these criteria, after taking into account the nature of the business, namely that it normally takes new restaurants two or three years to start turning a profit. Furthermore, the engagement team reviewed minutes from meetings of the board of directors and checked the documents the sales performance of restaurants that had opened in the current year, and considered whether there had been any items about closing restaurants. In this way, the engagement team evaluated monitoring situation at the audited company and examined whether there were any indications of impairment at new restaurants.

However, even though some restaurants were actually closing in the second or third year after opening, the engagement team did not examine whether the negative profits or cash flow from the operating activities of new restaurants at the end of the term were far lower than the negative amounts anticipated in the business plan.

(Auditing Standards Committee Statement No. 540, paragraphs 7 and 11)

《Points to Note》

Other than the examples above, there was a case where the engagement team agreed to the audited company's argument that its deteriorated performance was unusual and temporary, without analysis of the cause. There was also a case where even though the market prices of land had dropped significantly, the engagement team did not judge that there were indications of impairment on the grounds that an impairment loss had already been booked in the past. Furthermore, there was a case where the audited company, in its calculation of earnings from operating activities, had not appropriately allocated head-office expenses to each asset and cash-generating unit. In light of these deficiencies, engagement teams need to carefully consider indications of impairment.

Further, as a principle, when an asset or a cash-generating unit becomes idle, it means a change that will reduce the recoverable amount of such asset or cash-generating unit significantly in the scope and method that the asset, etc., is used. Therefore, when examining the indications of impairment of idle assets, the engagement team needs to carefully examine the reasonableness of the amount of time that has passed since the assets became idle. For example, in the case where an asset just fell into the idle state, the engagement team should examine whether the duration can be treated as time necessary to determine the future use of the asset.

Case 3: Review of recognition and measurement of impairment

When the fair value of land falls by more than 50% of the carrying amount, the audited company recognizes the store as having an indication of impairment. In this situation, the audited company compares the previous year's and current year's figures for each P/L measure to estimate the growth rate. And then, the audited company prepares a business plan to estimate future cash flow on the basis of the assumption that the growth rate will remain the same throughout the period of estimation. After performing this procedure, the audited company decided that it was unnecessary to recognize an impairment loss on the grounds that the total future cash flow was higher than the carrying amount of the long-lived asset.

However, even though the engagement team had identified the impairment of long-lived assets as a significant risk and examined the appropriateness of the business plan, it did not perform any procedures other than confirm that the board of directors had approved the assumption that the growth rate would continue into the next term and beyond. It did not examine the appropriateness of the assumption itself based on business realities.

(Auditing Standards Committee Statement No. 540, paragraphs 14)

《Points to Note》

Other than the example above, there was a case where the audited company, in its projections of future cash flow, determined the period of projections for future cash flow without taking into account the remaining economic life of key assets within each cash-generating unit.

The audited company must largely rely on projected future cash flows to decide whether to recognize and measure impairment loss. Therefore, when verifying the management's assertion on the necessity to recognize impairment loss, the engagement team should note that it is necessary to carefully examine components of the projected future cash flows, including the remaining economic life used to calculate the utility value of assets, and the business plan that is the basis of projection, and the reasonableness of the business plan. Additionally, when the audited company adopted net selling value as the asset's recoverable value, the engagement team should carefully examine the basis of calculating the net selling value.

(6) Valuation of goodwill

Case 1: Review of amortization period and impairment of goodwill

For an acquisition completed in the current period, the audited company accounted for the difference between the net assets of the purchased company and the acquisition costs as goodwill.

In this regard, the engagement team ascertained that the amortization period of five years determined by the audited company was appropriate only on the basis that the period did not exceed 20 years. Therefore, the team did not examine the appropriateness of the goodwill amortization period by verification of the period during which the subject goodwill would remain effective and the reasonable period of return on the investment.

In addition, despite an accounting standard stipulating that a relatively large amount out of acquisition costs allocated as goodwill may indicate the possibility of goodwill impairment in the year of acquisition, the engagement team determined that there was no indication of impairment based on the operating profit generated by the acquired subsidiary on an unconsolidated basis without taking into account the goodwill amortization. As such, the engagement team failed to examine whether to take impairment loss in line with the accounting standard.

(Auditing Standards Committee Statement No. 540, paragraphs 11–12; Guidance on Accounting Standard No. 10, paragraph 77)

《**Points to Note**》

The acquirer must estimate a reasonable period as the goodwill amortization period for each business combination based on the expected duration that the goodwill will remain effective, while the accounting standard also allows reference to a reasonable period for the recovery of the investment as a basis for the calculation of the value of the business combination. With this understanding, the engagement team should pay attention to the necessity to verify the appropriateness of the amortization period applied by the audited company.

Furthermore, as can be seen from the above example, if the amounts allocated to goodwill and intangible assets other than goodwill are relatively high, this could be deemed an indication of impairment even in the year of the business combination. For this reason, if a large amount of goodwill has been booked, the engagement team needs to also give adequate consideration to whether there are indications of impairment in the year in which the goodwill arose.

Case 2: Indications of goodwill impairment

The engagement team acknowledged substantial changes in the business environment surrounding the audited company's consolidated subsidiary for which goodwill was recorded, such as the resignation of the president of the subsidiary at the acquisition and substantial underachievement of the subsidiary's earnings against the business plan. However, the engagement team did not adequately examine whether these circumstances should have been treated as indications of impairment.

(Auditing Standards Committee Statement No. 540, paragraphs 12 and 17)

《**Points to Note**》

Other than the example above, there was not only a situation where the actual performance of the business following its acquisition was lower than the targets in the business plan, but also a situation where the business plan itself had been revised downward following the acquisition, which formed the basis for the calculation of the value of the business when it was acquired. Even such situations, there were cases that indications of impairment were not considered.

(7) Recoverability of deferred tax assets

Case 1: Review of company classification

A consolidated subsidiary of the audited company booked a large tax loss in the current year. The audited company claimed that this was due to the impact of a drop in sales as a result of temporary factors, and that it would be easy for the audited company to reduce the management consulting fees which the audited company was receiving from the subsidiary.

Because of this, the audited company compared the total amount of taxable income of the audited company and the subsidiary with the amount of the tax loss, and classified the subsidiary as Category 2 in the Corporate Accounting Standards Implementation Guidance No. 26 "Revised

Implementation Guidance on Recoverability of Deferred Tax Assets" on the grounds that a "significant tax loss" had not arisen.

In response, the engagement team described in the audit documentation that the tax loss had arisen due to temporary causes and that the subsidiary was paying a large amount of management consulting fees to the audited company.

However, despite the fact that the taxable income for the next term as forecast in the subsidiary's business plan was smaller than the tax loss, the engagement team did not examine whether, for the current year, it met the criteria for stating that a "significant tax loss" had not occurred.

(Auditing Standards Committee Statement No. 540, paragraphs 7 and 11)

《Points to Note》

In relation to the company classification specified in the Corporate Accounting Standards Implementation Guidance No. 26 "Revised Implementation Guidance on Recoverability of Deferred Tax Assets", the engagement team needs to remain conservative and carefully check the company classification in light of relevant accounting standards.

Regarding "taxable income excluding that arising from temporary causes" for categories 2 and 3 in the Implementation Guidance, the engagement team needs to examine whether "that arising from temporary causes." was actually temporary or not with particularly careful manner.

Case 2: Estimation of taxable income

The audited company accounted for deferred tax assets in the amount derived by multiplying the expected taxable income for the following year based on income before taxes in the medium-term management plan by a certain ratio.

However, the engagement team simply confirmed that the deferred tax assets accounted for coincided with the calculation document without examining the achievability of income before taxes for the following year, the details of the amendment of final tax returns, and the adequacy of the ratio.

(Auditing Standards Committee Statement No. 540, paragraph 12)

《Points to Note》

In reviewing the recoverability of deferred tax assets, the engagement team often examines the reasonableness and other aspects of the business plan prepared by the audited company's management for estimation of taxable income. There are cases where the engagement team judges that the estimation is conservative and achievability is high based solely on the fact that management calculated the estimation by multiplying the business plan by achievement rates in past years, without critically reviewing the business plan itself. In this regard, see the points to keep in mind provided in "Case 1: Reasonableness of management's assumptions" and "Case 4: Evaluation of reasonableness of business plan" in "(1) Matters common to auditing accounting estimates."

If the audited company posts deferred tax assets based on the sufficiency of taxable income backed by its earnings capability, the business plan, a basis for taxable income, should in principle be approved by the board of directors. Further, in the case of material adjustments between the business plan and taxable income, the engagement team needs to perform audit procedures to secure the feasibility of taxable income, including verification of the reasonableness of adjustments from profits in the business plan to taxable income.

Case 3: Review of scheduling

For the valuation loss on shares of a subsidiary recorded in the past, the audited company estimated the timing of the reversal of the temporary difference, and concluded that the deferred tax asset associated with the valuation loss was recoverable.

However, the engagement team, in considering the recoverability of deferred tax assets, only ascertained the management's intention to sell the shares through discussions and a management representation letter, failing to examine the feasibility of the intended sale based on the fact that the audited company had not executed sales for a long time.

(Auditing Standards Committee Statement No. 540, paragraph 14)

《Points to Note》

In many cases, the engagement team did not appropriately or sufficiently examine the feasibility of the schedule for tax deduction of temporary difference in the future. For example, there is inconsistency between the assumption for valuation of securities and allowance for doubtful accounts and the planned period for tax deduction of relevant temporary differences in the future. The engagement team needs to exercise due care when examining the reasonableness of the schedule for tax deduction of deductible temporary differences arising from the valuation of investments in affiliated companies in particular, because complicated conditions such as organizational restructuring may often be involved.

(8) Retirement benefit obligations

Case: Reliability of basic data

The audited company outsourced the calculation of retirement benefit obligations to a pension actuary, an external expert, and booked allowance for retirement benefits based on the calculation result prepared by the actuary.

In examining the allowance for retirement benefits, the engagement team used as audit evidence the calculation results of the pension actuary that the management used.

However, the engagement team did not examine the accuracy and completeness of data of base salary, etc., of employees, which form the basis of the retirement benefit obligations calculation and which was prepared by the audited company to the pension actuary.

(Auditing Standards Committee Statement No. 540, paragraph 12)

《Points to Note》

When estimating retirement benefit obligations, it is necessary for auditors to examine the relevance, completeness, and accuracy of the basic data of the audited company upon using the service of the management's expert.

In addition, although actuarial assumptions such as the discount rate could influence the calculation results for retirement benefit obligations greatly, there were some cases where the engagement team failed to examine the reasonableness of actuarial assumptions. The engagement team should be aware of the importance of examining the appropriateness of the actuarial assumptions made by the audited company.

(9) Asset retirement obligations

Case 1: Methods of accounting estimates and review of previous period accounting estimates

The audited company multiplied an estimated price that it had employed in the past by the area of the property concerned to calculate the asset retirement obligations for stores. However, when estimating the asset retirement obligation for a new store that had opened in the previous year, the audited company used the amount of the written estimate obtained from a construction company to book the asset retirement obligation for the store because the amount of this written estimate was higher than the amount calculated using the previous method. Furthermore, the actual amount of expenditure associated with the closure of store in the previous year exceeded the asset retirement obligation that had been booked, resulting in a performance difference being incurred as an expense.

In response, the engagement team was told by the audited company that the reasons for the fact that the construction estimate for the new store and the expenditures associated with the store closure are different from the estimated amounts calculated by the previous method were that the building had a different structure and that a condition to clear the site of the old store had not been taken into account. The engagement team agreed on these explanations and deemed there to be no problem with the previous calculation method.

However, the engagement team did not give adequate consideration to the point that the circumstances of the just only two stores described above were unusual, and that the previous calculation method was appropriate for other stores.

(Auditing Standards Committee Statement No. 540, paragraphs 7-8)

Case 2: Appropriateness when reasonable estimates cannot be obtained

The audited company rents properties under restoration obligations, and of these, it booked asset retirement obligations for unprofitable stores for which impairment losses had been booked on the grounds that it is likely that the properties will be vacated when the terms of the leases expire, and that it is therefore possible to reasonably estimate the timing of the performance of restoration obligations. In the case of profitable stores and the company's head office, on the other hand, it does not book asset retirement obligations on the grounds that it is difficult to reasonably estimate the timing of the performance of restoration obligations because there are no current plans to close stores or relocate the head office. This is despite the fact that stores have been closed and the head office has been relocated in the past.

In response, the engagement team identified the completeness of asset retirement obligations as a significant risk, but it did not perform any procedures to verify in detail past performance of restoration obligations other than having the audited company's explanation that the reasons for closes in the past were that stores had been unprofitable or that the floor areas of the stores were small. Furthermore, the engagement team did not obtain sufficient appropriate audit evidence concerning the reasonableness of the audited company's claim that in the case of profitable stores and the head office, it was difficult to reasonably estimate the timing of the performance of restoration obligations.

(Auditing Standards Committee Statement No. 330, paragraph 20; No. 540, paragraphs 11-12)

《Points to Note》

Even though the amount of asset retirement obligations cannot be fixed due to the lack of clarity in timing and methods, asset retirement obligations should be recognized if information is available to reasonably estimate the timing and probability regarding the fulfillment of asset retirement obligations. Since cases where asset retirement obligations cannot be reasonably estimated are limited to cases where the amount cannot be reasonably estimated even though all evidence available as of the account closing date is taken into consideration and the best estimation is made, the engagement team should keep in mind that it should examine the reasonableness of the management's assertions including the possibility of obtaining information useful to estimate asset retirement obligations when the audited company asserts that asset retirement obligations cannot be reasonably estimated.

4. Group Audit

Points of focus

Recent fraud cases identified at domestic and overseas subsidiaries have increasingly drawn the attention of financial statement users. The CPAAOB inspects audit firms from the following perspectives.

- Whether the group engagement team appropriately assesses risks associated with the group financial statements and develops overall audit strategy and a detailed audit plan;
- Whether the group engagement team identifies significant components appropriately, including consideration of components with significant risks related to the group financial statements based on the nature and circumstance of each component, and does not simply make judgments based on whether the component is independently financially important;
- Whether the group engagement team appropriately understands the component auditors, gets involved in their procedures, and evaluates the appropriateness of such procedures performed;
- Whether the group engagement team appropriately communicates with the component auditors in situations that may influence the work of the component auditors during group audit, such as when a fraudulent material misstatement in relation to the group financial statements is identified;
- Whether the group engagement team evaluates the component auditors' reports, requests additional audit procedures if necessary, or performs the audit procedures, thereby obtaining sufficient appropriate audit evidence; and whether the engagement team, in response to the component auditors' reporting of an uncorrected misstatement, appropriately assesses the impact of such misstatement over the group financial statements.

Outline of inspection results

In identifying significant components in group audits, in one case, the group engagement team did not perform sufficient risk assessment by considering the qualitative aspect. In another case, the group engagement team did not sufficiently communicate with component auditors, or review the sufficiency of identification of significant risks related to group financial statements and audit procedures relevant to such risks.

(Observed effective efforts)

There was a case where the following efforts were made in maintaining and improving the quality of group audit.

A dedicated section was established within the audit business department to support and monitor engagement teams that conducted global group audits. Specifically, the dedicated section gathered information through questionnaire surveys of the engagement teams and interviews with group auditors with a significant component in emerging countries.

The PICOQC emphasized through training that it was necessary to consider not only quantitative

materiality such as value-based but also qualitative materiality, such as the existence of significant risk, when selecting significant components, in view of cases where a problem occurred in a component other than a significant component, resulting in revision of the financial statements.
The audit business department prepared, in cooperation with the advisory department, a checklist that summarized the key points in controlling overseas affiliate companies. The checklist enables the improvement of the financial reporting environment and risk control environment of new overseas affiliate companies of the audited company.

Expected response

In group audit, there were many cases where the engagement team excessively relied on the audit results of component auditors without adequately evaluating it. When auditing the audited company's financial statements and group financial statements, the auditor should evaluate the work of others, always keeping in mind that the ultimate responsibility to issue an appropriate audit report is on the group auditors that issue opinions of all the financial statements.
Group audit requires the group engagement team to sufficiently communicate with the component auditors about the scope and timing of audit procedures, as well as findings concerning the audit procedures performed for component financial information, and to obtain sufficient appropriate audit evidence about component financial information and consolidation processes so as to express opinions about whether the group financial statements have been prepared according to the applicable financial reporting framework. Therefore, the group engagement team needs to develop an appropriate audit plan and perform audit procedures, and needs to evaluate whether sufficient appropriate audit evidence has been obtained to gain a basis for opinion regarding group financial statements.
Particularly, when a significant component exists in overseas countries, the group engagement team is required to grasp the status of material overseas audited companies, and identify existing risks.
To perform group audit appropriately, the group engagement team, in addition to the knowledge and experience required for general audit practice, is required to be equipped with additional capability to cope with any situations, such as language skills to instruct the component auditors in overseas countries and knowledge of the accounting of specific countries.
To achieve the above, audit firms should carefully assign engagement partners and other professionals to maintain and improve the quality of group audit. Additionally, in the case where the overseas component auditors are arranged in a multi-layered and complex structure, especially when involving an overseas component auditor outside the group auditor's network, audit firms should develop frameworks to provide instructions and support in relation to the group engagement team's instructions to and supervision of the overseas component auditors, evaluation of reports prepared by the overseas component auditors, and understanding of the audited company's management control over new affiliate companies added through acquisition, etc.

Case 1: Significant components

- Given that the audited company's main business was manufacturing, the group engagement team identified the audited company's valuation of fixed assets as a significant risk in the group financial statements.
  However, in determining a significant component, the group engagement team did not consider components potentially involving the above significant risks at the group financial statements.
  (Auditing Standards Committee Statement No. 600, paragraph 8)

- The group engagement team did not assess the risk of material misstatements in the group financial statements by taking into account the qualitative materiality of fixed assets owned by foreign manufacturing subsidiaries and sales transactions by a sales subsidiary.
  (Auditing Standards Committee Statement No. 600, paragraph 17)

《Points to Note》

When determining significant components, the engagement team should consider the audited corporate group's characteristics and circumstances including qualitative materiality such as potential significant risks in the group financial statements, on top of the financial materiality of individual units.

Case 2: Materiality

The group engagement team set the materiality for significant components at the same level as, not lower than, the materiality for the group financial statements as a whole.
(Auditing Standards Committee Statement No. 600, paragraph 20)

《Points to Note》

To reduce the possibility that the total uncorrected and undiscovered misstatements in the group financial statements exceed group materiality to a minimum acceptable level, component materiality shall be set lower than group materiality. The group engagement team needs to sufficiently understand the audited company group and its business environment in deciding component materiality. If any change occurs in the business environment, the team needs to appropriately consider its effects and examine the adequacy of component materiality to perform appropriate audit procedures to response audit risks for each component.

Case 3: Deciding audit tasks regarding the financial information of components

- Regarding the financial information of components of individual financial significance to the group, the group engagement team failed to perform audit procedures based on the materiality of individual components. For example, the group engagement team did not perform substantive procedures on major accounts such as revenues,

(Auditing Standards Committee Statement No. 600, paragraph 25)

- The group engagement team did not conduct analytical procedures on non-significant components.
  (Auditing Standard Committee Statement No. 600, paragraph 27)

《Points to Note》

The group engagement team should consider whether audit tasks have been planned for both significant components and other components appropriately.

Case 4: Involvement in tasks undertaken by component auditors

The group engagement team identified the existence and cut-offs of sales as risks for material misstatements due to fraudulent group financial statements, and planned to address these risks by performing substantive procedures for unshipped sales involving direct transactions.

On the other hand, the auditor of an overseas subsidiary, which was a significant component, performed substantive procedures for sales by extracting and comparing with evidence transactions that exceeded performance materiality and transactions with new customers in the last month of the quarter. This auditor also conducted cut-off tests around the date of the financial statements.

However, the group engagement team did not adequately assess whether the audit procedures performed by the component auditor were appropriate for the purpose of addressing significant risk, including whether the audit procedures had been based on risk assessments for each sales channel and transaction type in the audited company's group.

(Auditing Standards Committee Statement No. 600, paragraphs 30 and 42)

《Points to Note》

With regard to significant risks in group financial statements, there was a case where the group engagement team did not get involved in the component auditor's risk assessments and did not assess the appropriateness of further audit procedures.

To address significant risks in group financial statements, the group engagement team needs to engage in appropriate communication with component auditors and assess the sufficiency and appropriateness of further audit procedures planned by the component auditors.

Case 5: Communication with component auditors

- The group engagement team sent audit instructions to significant component auditors and received related deliverables. However, the following deficiencies were identified in the audit procedures performed by the group engagement team:
  a) The group engagement team identified significant risks relating to fraudulent group

financial statements at the component (the risk of management override of internal controls and risks relating to sales), but did not inform the component auditor. As a result, audit procedures for addressing significant risks relating to fraudulent group financial statements were not followed.

b) The group engagement team asked for confirmation of the component auditor's independence, but did not inform the component auditor of the scope of independence to maintain.

(Auditing Standards Committee Statement No. 600, paragraphs 29 and 39)

- During the process of understanding the audited company's business environment, the group engagement team became aware that an overseas subsidiary that was significant component was operating the same type of construction business as the audited company.
  However, even though the group engagement team identified a fraud risk concerning percentage of completion method at the audited company, it did no more than inform the component auditor that this was a significant risk due to the risk of fraud in revenue recognition. It did not specifically inform the component auditor of the fraud risk concerning percentage of completion method.
  (Auditing Standards Committee Statement No. 600, paragraph 39)

《Points to Note》

Group engagement teams must inform component auditors of significant risks relating to group financial statements that would affect the work of the component auditor. Furthermore, group engagement teams must ask component auditors to inform them in a timely manner whether significant risks relating to group financial statements other than those communicated by the group engagement team exist and of the response to these risks.

However, as pointed out in the examples above, there were cases where the group auditor did not properly inform the component auditor of risks. There were also cases where even though the component auditor reported significant risks to the group engagement team, the group engagement team did not adequately evaluate these risks. Furthermore, there were cases where the timing of obtaining information such as the audit plan from the component auditor is late. Group engagement teams therefore need to have effective two-way communication with component auditors.

Case 6: Evaluation of audit results communicated from component auditors

- The group engagement team sent audit instructions to significant component auditors and received responses.
  However, with regard to uncorrected misstatements that were reported in the responses by the component auditor, the group engagement team had not decided whether it was necessary to review the related audit documentation prepared by the component auditor,

and did not request the component auditor to include the misstatement in the summary of uncorrected misstatements to be attached to the management representation letter. Furthermore, the group engagement team did not examine whether an internal control deficiency reported by the component auditor should be a material weakness, or whether it should be reported to the group's management.
(Auditing Standards Committee Statement No. 265, paragraph 7; No. 450, paragraph 13; and No. 600, paragraphs 41 and 45)

- The group engagement team sent audit instructions to the auditor of an overseas subsidiary, which was a significant component, and obtained a related deliverable.
  However, even though the group engagement team had received a report from the component auditor concerning "the absence of the accounting manager," related to a significant risk, it did not verify whether this matter should be treated as a deficiency in internal control. The group engagement team also did not decide whether it was necessary to review the relevant sections of the component auditor's audit documentation.
  (Auditing Standards Committee Statement No. 600, paragraph 41)

- The group engagement team sent audit instructions to significant component auditors and received related deliverables. However, the following deficiencies were identified in the audit procedures performed by the group engagement team:
  a) With regard to incomplete procedures described at the section of the report received from the component auditor, the report stated that five bank balance confirmation letters had not been collected , and the group engagement team understood this. However, the group engagement team did not assess the impact of these incomplete procedures on the audit of the group financial statements, and did not consider whether additional procedures were necessary.
  b) The group engagement team was informed by the component auditor that eight deficiencies were identified in an assessment of IT controls performed as part of its audit of internal controls. However, with regard to four deficiencies in internal control informed as described above, the group engagement team did not assess the impact on the audit of the group financial statements based on concrete evidence, and did not consider whether additional procedures were necessary.

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

Case 7: Sufficiency and appropriateness of audit evidence obtained

The group engagement team identified the risk of management override of internal controls as a significant risk in relation to the group financial statements, and requested the auditor of the relevant significant component to perform audit procedures relating to journal entry tests.

However, the group engagement team did not evaluate as to whether the component auditor had obtained sufficient appropriate audit evidence.
(Auditing Standards Committee Statement No. 600, paragraph 43)

《Points to Note》

As pointed out in the examples above, there were a number of cases where the group engagement team simply obtained information from the component auditors on the results of their audit procedures and did not evaluate regarding the sufficiency and appropriateness of audit procedures performed for significant risks. If a group engagement team deems that the work performed by a component auditor is inadequate, it must decide what kind of additional procedures the group engagement team should perform, or which of the component auditor or the group engagement team should perform these additional procedures.
Of note, even if the component auditor is in the same network as the group engagement team, the group engagement team still needs to evaluate the reports received from the component auditor.

Case 8: Consolidation process (accounting policies)

The audited company prepared its consolidated financial statements without adjusting the financial information of overseas components under local accounting standards to Japanese GAAP.
However, the group engagement team did not adequately check whether there was any account requiring adjustments due to differences in accounting standards.
(Auditing Standards Committee Statement No. 600, paragraph 34)

5. Making Use of Experts

Points of focus

The auditor may make use of experts to obtain sufficient appropriate audit evidence if the auditor needs expertise in areas other than accounting or auditing. The CPAAOB inspects whether the experts used by the engagement team are equipped with the necessary qualifications, competency and objectivity in light of the purposes of auditing financial statements and whether the auditor evaluates the appropriateness of the experts' work.

Outline of inspection results

There was a case where the engagement team did not sufficiently communicate with the experts on the scope and purpose of work to be used, or did not sufficiently assess the appropriateness of the work of experts used by the auditor.

Expected response

In using the work of others, there were many cases where the engagement team excessively relied on the work of others and did not adequately evaluate it. When auditing financial statements, the engagement team is required to evaluate the work of others, always keeping in mind that the ultimate responsibility for the audit opinions of the whole financial statements is on the group auditors.

When using expert services, the auditor should determine the necessity of use, assess the qualifications, competency and objectivity of the experts, and evaluate the appropriateness of the experts' work for audit purposes. In using the experts' work, the engagement team needs to sufficiently consult with the experts on the purpose and scope of work to be used, without leaving everything to the experts, in order to obtain sufficient audit evidence conforming to the audit purpose.

Case 1: Agreement with experts

In the valuation of real estate assets for sale that had been held for a long time as of the date of the financial statements, the audited company utilized valuation reports issued by a real estate appraiser.

In connection to this, the engagement team did not give appropriate instructions to the selected expert by clarifying the specific tasks requested, including the details, scope and purposes, and thus the engagement team and the expert were not in agreement with each other regarding their roles and responsibilities.

(Auditing Standards Committee Statements No. 620, paragraph 10)

Case 2: Evaluation of adequacy of experts used by the auditor

The engagement team identified the valuation of real estate inventory for sale as a fraud risk, and requested an expert to perform an assessment of it.

However, the engagement team did not examine the adequacy of the expert's work even though the expert did not use the methodology specified by the engagement team.

(Auditing Standards Committee Statement No. 620, paragraphs 11–12)

《Points to Note》

Before using experts' work, the engagement team needs to avoid relying entirely on their work, and to determine the scope of work to be used through consultation with the experts, assess their qualification, competency and objectivity, and evaluate the appropriateness of the experts' work for audit purposes.

For points to note in the case where audit evidence is based on the work of experts used by the audited company's management, refer to the section "2. Audit Evidence."

6. The Auditor's Responsibilities Relating to Fraud in Financial Statement Audits

Points of focus

Users of financial statements are increasingly paying more attention to fraud that may result in material misstatement on financial statements. Considering this, the CPAAOB inspects the auditor's response to fraud risks in financial statement audit from the following perspectives:

- Whether the engagement team maintains professional skepticism throughout the audit, and exercises such skepticism so as not to overlook any circumstances that indicate the possibility of a material misstatement due to fraud, when assessing the risks of material misstatement due to fraud, responding to such risks, and evaluating audit evidence that has been obtained;
- Whether the engagement team discusses the possibility of a material misstatement due to fraud; and places emphasis on where and how material misstatement due to fraud may exist, including how fraud is committed, without assuming reliability and integrity of the audited company's management, directors, and company auditors.
- Whether the engagement team evaluates whether the information obtained from other risk assessment procedures and related activities indicates that one or more fraud risk factors are present and takes them into account in identifying and assessing the risks of material misstatement due to fraud at two levels: the financial statement level and the assertion level;
- Whether the engagement team obtains audit evidence more relevant, reliable and/or quantity of audit evidence, for the risks of material misstatement due to fraud at the assessed assertion level than in cases where no risk of fraud has been identified;
- Whether the engagement team evaluates if a misstatement, in the case that one is identified, is indicative of fraud; recognizes that, when such misstatement is determined to be indicative of fraud, an instance of fraud is unlikely to be an isolated occurrence; and pays extra attention to the relationship with other aspects of the audit, particularly evaluating the reliability of statements by the management, and reviews and modifies its audit plan as needed after evaluating the implications of such misstatement;
- Whether the engagement team makes inquiries of and asks for explanations from the management when it identifies any circumstances that indicate the possibility of a material misstatement due to fraud during the audit, and performs additional audit procedures; and modifies its risk assessment and planned responses to audit risk to include audit procedures that are specifically responsive to the types of possible fraud if it determines that any suspicion of a material misstatement due to fraud exists;
- Whether the engagement team communicates with company auditors who supervise the execution of duties by directors, if it determines that a suspicion of material misstatements due to fraud exists or suspects fraud involving the management.

Outline of inspection results

There were cases of significant failures in audit procedures related to fraud risks in the financial statement audit such as: the engagement team overlooked indications of possible frauds although the risk of material misstatement due to fraud could have been identified in the planning and conducting stages of audit; and the engagement team determined the misstatement to be an error without skeptical consideration, although there was a suspicion of fraud involving the management.

We have also observed cases such as: the engagement team failed to assess risks of material misstatement due to fraud in view of changes at the audited company; the engagement team did not consider the risks of material misstatements due to fraud other than in revenue recognition; the engagement team did not sufficiently perform audit procedures to respond to the assessed risks although the team identified risks of material misstatement due to fraud in revenue recognition; the engagement team performed only perfunctory procedures for risks related to management override; the engagement team did not carefully assess fraud risks therein although the team identified related party transactions and unusual transactions.

（Observed effective efforts）

An audited company (private tutoring school), upon establishing preventive internal control over fictitious revenue recognition with no track record of classes, considered obtaining signatures from the students and their parents upon attending class as external evidence of the transactions, but was reluctant to do so on the grounds that it was bothering. Against this situation, the engagement team, saying that external evidence of the transaction was fundamental, convinced the audited company to appropriately develop the internal control.

Expected response

Conventionally, auditors have been expected to maintain professional skepticism. Since the Fraud Risk Response Standard emphasizes the maintenance and exercise of professional skepticism, auditors should pay attention to the fact that that they are expected to maintain professional skepticism in all processes of auditing and exercise it when examining the risks of material misstatement due to fraud.

In particular, all auditors must once again recognize that the reliability of audit has once again been called into question following the recent cases of accounting fraud.

Therefore, when planning, in order to examine if there are fraud risk factors, auditors are required to understand major fraud cases published as well as general and industry specific business practices that might be used for fraud, obtain information through interviews with managers and other employees, and carefully examine whether such information indicates the existence of fraud risk factors, through discussions within the engagement team.

Furthermore, auditors should consider identified fraud risk factors and identify and evaluate risks of material misstatement at two levels: the level of financial statements as a whole, and the assertion level.

In responding to risks of material misstatement due to fraud that they evaluated, auditors should always

keep in mind that there is a possibility that material misstatement due to fraud could occur, and draw up general responses to the risks of material misstatement due to fraud at the level of the entire financial statement and at the assertion level.
In implementing procedures to cope with the risks of material misstatement due to fraud, auditors should keep in mind that they are required to obtain audit evidence, which is more relevant or reliable, or greater in quantity, for assertions related to the identified risk of fraud than for other assertions for which no risk of fraud is identified.
If auditors identify any circumstances that indicate the possibilities of a material misstatement due to fraud during the course of audit, they should make inquiries of and ask for explanation from the management and should perform additional audit procedures to determine whether a suspicion of a material misstatement due to fraud exists. If auditors identify the suspicion of a material misstatement due to fraud in such case that the management explanations are not considered reasonable, it is necessary to note that they should modify their risk assessment and planned procedures responding to audit risks, and conduct audit procedures that are specifically responsive to the types of possible fraud.

(1) Discussions by the engagement team, risk assessment procedures, and related activities

Case 1: Understanding of fraud cases in an audited company and the industry to which such audited company belongs

The engagement team identified that a different form of transactions such as sale on consignment and sale as purchasing agent existed in the sales transactions of the audited company, which is in the wholesale business, and also identified business practices such as sales based on change of title of inventory.
However, the engagement team did not assess fraud risk factors based on this understanding of such business activities of the audited company and industry practices.
(Auditing Standards Committee Statement No. 240, paragraphs 11 and 25)

《Points to Note》

The engagement team needs to sufficiently perform risk assessment with an understanding of the audited company's nature of business, the industry-specific business practices, and previous fraud instances. The team then needs to develop an appropriate audit plan responsive to the identified risks related to the assertions, so as to perform sufficient and appropriate further audit procedures.
In addition, it is necessary to maintain and exercise professional skepticism in identifying fraud risk factors, including incentives or pressure to commit fraud, or events or situations which create opportunities to do so; as well as in assessing the risks of material misstatement due to fraud.

Case 2: Discussion within the engagement team

The engagement team did not discuss where risks of material misstatement by type of fraud existed on the financial statements, including the possibility of fraud that may occur in a relationship with a related party or in a transaction with a related party, and also did not share such information within the team.
(Auditing Standards Committee Statement No. 240, paragraphs 14, F15-2)

《Points to Note》

Other than the examples of deficiencies mentioned above, the engagement team only carried out discussions within the team routinely. The team often did not hold substantial discussions including the examination of possible risks in relation to the audited company in reference to published fraud cases. There were also some cases where the engagement team only directed fraud-related inquiries to the management or communicated with the management and company auditors routinely, and the information obtained was not reflected in the risk assessment.

(2) Identifying and assessing the risks of material misstatement due to fraud

Case : Identifying and assessing fraud risks in revenue recognition

- The audited company is engaged in the manufacture and sale of replacement components for manufacturing equipment, and from some customers, it receives orders for greater quantities than it expects to use during repairs, and retains the unused components for the next round of repairs. After performing risk assessment procedures concerning these bill-and-hold sale transactions at the time of preparing the audit plan, the engagement team deemed that such transactions are reasonable from a business point of view, examined the transaction terms and findings from past audits, and did not identify any significant risks requiring special investigation.
  However, in the process of verifying bill-and-hold sale transactions at the time of the term-end audit, the engagement team discovered that the reason given for bill-and-hold sale transactions differed from the reason that had been expected at the time of the audit plan, yet did not consider whether the risk assessment needed to be revised.
  (Auditing Standards Committee Statement No. 240, paragraph 25; No. 315, paragraph 30)

- The audited company is engaged in manufacturing. It sells products and provides maintenance services. The engagement team identified sales as a fraud risk, and envisaged the booking of fictitious sales through the use of acceptance inspection documentation lacking the customer's seal as a specific method for such fraud.
  However, the engagement team did not adequately consider where the risk of material misstatement due to fraud resided and how such fraud might be committed in connection

with the portion of the audited company’s sales coming from maintenance services for which no acceptance documentation had been issued.

(Auditing Standards Committee Statement No. 240, paragraphs 14 and 25)

《Points to Note》

When identifying and assessing the risks of material misstatement due to fraud, the engagement team shall, based on a presumption that there are risks of fraud in revenue recognition, evaluate which types of revenue, sales transactions or assertions give rise to such risks.

The engagement team shall keep in mind that it needs to identify and assess the risks of material misstatement due to fraud at two levels—at the level of the financial statements as a whole and at the assertion level—after sufficiently examining risks related to management override according to information and judgment the team has obtained.

(3) Response to assessed risk of material misstatement due to fraud

Case 1: Journal entries test

- The engagement team performed journal entry tests as one of the audit procedures for addressing the risk of management override, but it did not conduct reasonable examinations for the following:
  - a) The selection of journal entries for irregular accounts was stated as one of the criteria for the selection of journal entries, but no specific definition of “irregular” was determined, so the selection criteria were unclear.
  - b) There were several selection criteria, but results concerning some of them were not recorded.
  - c) With regard to the selected journal entries, the engagement team did no more than determine that there were no problems with the details of the journal entries, and did not consider the need to perform tests of detail.

  (Auditing Standards Committee Statement No. 240, paragraph 31)

- In its journal entry tests, the engagement team selected journal entries above a certain monetary amount (performance materiality amount) that contained specific keywords such as “CEO ” and then deemed that there were no relevant journal entries.

  However, the engagement team did not consider whether this procedure for discovering material misstatements due to fraud, which covered journal entries above the specific amount, was appropriate. Furthermore, it used only typical keywords as selection criteria, and did not assess the characteristics of inappropriate or atypical journal entries based on an understanding of the business environment in which the audited company was operating and the process the audited company used to make and revise journal entries. It also did not consider whether this approach was adequate to address the risk of management override.

(Auditing Standards Committee Statement No. 240, paragraph 31)

《Points to Note》

Other than the example mentioned above, there were many cases where suspicion arose over the exercise of professional skepticism. In one case, the engagement team did not perform procedures to address fraud risk with respect to journal entries selected for fraud risk on the grounds that these journal entries were deemed not to be problematic based on the team's understanding of the details of the journal entries. In another case, the engagement team only performed journal entry testing routinely without fully taking fraud risks into consideration with respect to procedures to respond to audit risks related to management override.

The engagement team shall keep in mind that it needs to formulate and implement effective audit procedures in response to the degree of said risks after understanding that management is in a position to falsify accounting records and prepare fraudulent financial statements by overriding effectively operated internal control.

Case 2: Business rationality of significant transactions

- The audited company transferred outsourcing costs to a third party, which were recorded as expenses during an interim period, to loan to the third party at year end because it was subsequently determined that the costs would be borne by the third party. However, although the engagement team identified the transactions as unusual transactions, the engagement team did not examine whether or not such transactions had business rationality.
  (Auditing Standards Committee Statement No. 240, paragraph 31)

- When selling machinery, a subsidiary of the audited company retained the book value of the asset on the balance sheet as an inventory and recorded revenue at the amount of the sales price, where the book value of the asset should normally be accounted for as "gain or loss on sale of fixed assets."
  However, in examining the appropriateness of the accounting treatment, the engagement team did not examine whether the transaction was a significant transaction that was outside the audited company's normal course of business or of an unusual nature, considering the auditor's understanding of the audited company or its environment and information obtained during the audit.
  (Auditing Standards Committee Statement No. 240, paragraph 31; and No. 315, paragraph 10)

- The audited company sells office supplies, and employs the shipping basis as the standard for revenue recognition, yet for some transactions, it booked sales of goods that had not yet been shipped as an industry-specific business practice.
  With respect to the withheld inventory corresponding to the unshipped sales, the engagement

team recognized that the contract terms were unclear, and that this was simply a case of storage that was unavoidable given the relationship with the customers. It also recognized that in the case of some customers, the period of storage was long.

However, the engagement team just accepted the explanation of the audited company that these transactions had been ongoing for some time and that payment was being received under similar terms to general sales transactions involving shipping. The team did not investigate, from the standpoint of addressing risk, whether the transactions were based on economically reasonable demands from the buyers. Furthermore, the team did not adequately consider whether factors such as responsibility for storage charges and shipping charges satisfied the requirements for booking sales.

(Auditing Standards Committee Statement No. 240, paragraph 31)

《Points to Note》

Significant transactions falling outside the audited company's ordinary transaction process or which can be deemed unusual may have been carried out to conduct fraudulent financial reporting or to conceal misappropriation of assets, indications include the following:

- **The form of such transactions appears extremely complex (e.g., transactions involve multiple audited companies within a consolidated group or multiple unrelated third parties);**
- **The management has not discussed the nature of and accounting for such transactions with company auditors of the audited company, and there is inadequate documentation;**
- **The management places more emphasis on the need for a particular accounting treatment than on the underlying economic reality of the transactions;**
- **Transactions that involve non-consolidated related parties, including special-purpose audited companies, have not been properly reviewed or approved by company auditors of the audited company;**
- **The transactions involve previously unidentified related parties or parties that do not have the substance or the financial strength to support the transactions without assistance from the audited company under audit.**

If the engagement team identifies any of the above mentioned indications in the course of the audit, the engagement team needs to ask the management for explanation and needs to keep in mind that the team should implement additional audit procedures in order to judge whether there are suspicions of material misstatement due to fraud.

Furthermore, there are some cases where, in conducting fraudulent accounting treatment, the audited company obscured accounting treatments by carrying out complicated transactions with several business partners. Therefore, in examining the business rationality of significant transactions, it is important for the engagement team to not only examine individual transactions but also assess and examine the entire picture of a series of related transactions by paying attention to the timing and conditions of such transactions.

Case 3: Response to fraud risks in revenue recognition

- With regard to revenue recognition, the engagement team identified material misstatements due to fraud as a risk. Based on its understanding of the audited company's environment, it anticipated fraud risk scenarios for specific methods of fraud, and formulated an audit plan to address these scenarios. Specifically, the engagement team envisaged such scenarios as the company having related parties make payments to the company for sales, booking fictitious sales, and then refunding the money and reversing the sales the following fiscal year.

  However, the engagement team did not adequately formulate or follow substantive procedures for directly addressing fraud risk. For example, the team did not conduct tests of detail focused on transactions with related parties. Compared to situations where fraud risk had not been identified, the engagement team did not obtain more appropriate or more convincing audit evidence.

  (Auditing Standards Committee Statement No. 240, paragraph 29; No. 330, paragraphs 5 and 20)

- The engagement team identified the appropriateness of cut-offs for merchandise sales as a fraud risk, and witnessed inventory taking and performed cut-off tests for sales transactions as procedures for addressing this risk.

  However, the engagement team only selected two business sites for attendance inventory taking. These were the site with the highest monetary materiality and one other site, which was selected after taking into account factors such as sites that had been visited by auditors in past years and regional bias. As a result, the considerations were inadequate as further audit procedures for addressing fraud risk.

  (Auditing Standards Committee Statement No. 240, paragraph 29; No. 330, paragraph 5)

- Depending on the type of construction project, the audited company booked sales based on either the completed-contract method or the percentage-of-completion method.

  With regard to the completed-contract method, the engagement team identified the "risk of reallocation of costs between projects as a means of understating cost of sales" as a fraud risk, and to identify fraudulent reallocations of cost of sales at the time of the end-of-term audit, the team followed analytical procedures for balances of work in progress, after which it deemed that there were no accounts that required detailed investigation. However, the analytical procedures performed by the engagement team involved the application of a uniform cost rate, even though the cost rates differed from project to project. Moreover, the team did not take into account the characteristics of the timing of the incurrence of project costs (e.g. the fact that few costs are incurred in the design phase of the first half of a project). As a result, the procedures lacked sufficient precision to identify material misstatements due to fraud.

Furthermore, with regard to the percentage-of-completion method, the engagement team identified the "risk of manipulation of rates of progress to meet budget targets as a means of overstating sales" as a fraud risk, and formulated an audit plan to investigate important construction projects using substantive procedures. However, the engagement team did not perform substantive procedures with respect to contracting costs, which were the main component of cost of sales, which provided the basis for the calculation of rates of progress. However, the team did not obtain sufficient appropriate audit evidence for addressing fraud risk.
(Auditing Standards Committee Statement No. 240, paragraph 29)

- The engagement team identified a very strong incentive at the audited company to expand its revenue and profits since the company was in the rapid growth stage. Under these circumstances, the team identified a fraud risk where sales transactions with unclear underlying economic rationale might occur. The team also identified more than one unusual sales transaction in the audited company's rapid increased sales.
  However, the engagement team did not examine the appropriateness of the selling price of raw material reselling transactions of the above sales transactions, as well as the reasonableness of recording bill and hold sales. In addition, the team did not examine the reasonableness of changes in collection terms regarding sale transactions of merchandise. Moreover, they did not assess whether the above transactions implied a possibility that they were carried out for fraudulent financial reporting purposes.
  (Auditing Standards Committee Statement No. 240, paragraphs 29, 31 and 34; and No. 330, paragraph 20)

- Bill and hold sales, which were prohibited by the audited company's internal rules, were identified at the audited company through direct whistleblowing to the engagement team. The audited company insisted that the sales transactions in question were realized by the year-end since the merchandise subject to the sales had already been shipped by the year-end.
  Against this argument, the engagement team conducted a short notice inspection of the storage site on the day following the year-end, in order to examine the audited company's argument that the deposited inventory was shipped by year-end, and confirmed that the inventory was removed and no physical items remained.
  However, the engagement team did not perform for fraud risks that were necessary for this matter, such as tests based on evidence including shipment slips, if the merchandise was delivered to the customer, and ascertaining whether similar sales existed, since they determined that their procedures above were sufficient as tests of the fact of shipment.
  (Auditing Standards Committee Statement No. 240, paragraph F35-2)

- With regard to the cause of exceptions noted in responses to confirmation request for accounts receivable from sales transactions to a leasing company, the engagement team received a reply from the leasing company stating that the cause of the exception was that no account payable would be recorded until the start date of the related lease agreement with the end users, which would be more than a year later than the date of leasing company's receipt.
  However, the engagement team did not examine reasonableness of the occurrence and cut-off assertions of the sales transactions, including the rationale of the transactions and the contract conditions pertaining to them.
  (Auditing Standards Committee Statement No. 240, paragraph 22)

- The engagement team identified, for the entire revenue of the audited company, the risk of fictitious revenues recognition as a risk of material misstatement due to fraud.
  The engagement team checked domestic transactions against copies of invoices and settlement notes, while checking export transactions against invoices.
  However, the documents were prepared by the audited company, and the engagement team did not obtain audit evidence that was more relevant or reliable for the risk of whole fictitious revenue recognition.
  (Auditing Standards Committee Statement No. 240, paragraph 29; and No. 330, paragraphs 5 and 20)

《Points to Note》

As with the examples of identified deficiencies mentioned above, there were deficiencies in procedures for risk assessment and procedures for responding to the assessed risk in relation to revenue recognition.

- **In one case, the engagement team did not sufficiently perform risk assessment on revenue recognition with an understanding of the audited company's business and its business environment, including its type of business and the characteristics of its sales transactions. The team therefore did not plan appropriate audit procedures.**
- **In another case, the engagement team identified risks of material misstatement due to fraud in revenue recognition but did not specifically identify the kinds of risk that existed in each assertion. The team, therefore, did not plan appropriate audit procedures and respond to audit risk.**

In addition, there were cases where the engagement team only routinely verified books against vouchers, overlooking an abnormal profit ratio and agreement details inconsistent with the realities. There was also a case where the engagement team, in its investigation of estimated total cost using the percentage-of-completion method, did no more than make inquiries of management and make comparisons with internal materials prepared by the audited company.

For revenue recognition, Auditing Standards Committee Statement No. 240, paragraph 25 stipulates "When identifying and assessing the risks of material misstatement due to fraud, the auditor shall, based on a presumption that there are risks of fraud in revenue recognition, evaluate which types of revenue,

revenue transactions or assertions give rise to such risks," while paragraph 29 prescribes "Auditors are required to obtain audit evidence, which is more relevant or reliable, or greater in quantity, for risk of material misstatement due to fraud at the assessed assertion level than in cases where no risk of fraud is identified for the assertion." Particular attention should be paid in implementing responses to audit risks.

Case 4: Response to fraud risks in transactions with related parties

In examining a loan that may be relevant to a related party, the engagement team directly confirmed with the original borrower and assessed the assets pledged by the borrower as collateral.

However, the team did not carry out audit procedures, such as obtaining a full understanding of the flow of capital and the reasonableness of the loan transaction with an eye to possible fraud, by taking into account the fact that the objective of the original loan was unclear.

(Auditing Standards Committee Statement No. 240, paragraphs F11- 2 and 31; and No. 550, paragraph 22)

《Points to Note》

According to Auditing Standards Committee Statement No. 550, paragraph 11, discussions within the engagement team "shall include specific consideration of the susceptibility of the financial statements to material misstatement due to fraud or error that could result from the audited company's related party relationships and transactions." In auditing related party transactions, the engagement team needs to consider the risks of material misstatement due to fraud.

In entrepreneurial companies in particular, owner-managers are often so strongly influential that internal control may not function over related party transactions. Understanding these characteristics of companies, the engagement team needs to obtain sufficient appropriate audit evidence in performing risk assessment procedures and responses to audit risk in connection with related party transactions.

(4) Evaluation of audit evidence

Case 1: Responses to situations that imply material misstatement due to fraud

- It was discovered that the audited company recognized revenue for a product, the payment for which had been made in advance but which had not been delivered to the customer. The engagement team interviewed the audited company's executive officer and obtained the following background to such accounting:
  a) An e-mail urging employees to achieve their monthly sales targets was sent to all employees from the representative director & president; and
  b) The specific instruction to record advance payments as revenue was notified to all stores by the manager in charge of stores in an e-mail sent;

However, the engagement team determined the misstatement as due to an error without fully evaluating whether a circumstance that indicated the possible material misstatement due to fraud, and did not perform examinations to comply with the Standard to Address Risks of Fraud in an Audit.

(Standard to Address Risks of Fraud in an Audit No. 1, paragraphs 1–4; its Appendix 2, paragraphs 3–4; and Auditing Standards Committee Statement No. 240, paragraph F11-2)

《Points to Note》

In the case above, the auditors did not exercise the professional skepticism that is assume expected of them even though there were strong indications of material misstatement due to fraud.

Other than the examples mentioned above, there were other cases where professional skepticism was not exercised. For example, even though the engagement team determined the booking of sales to be a circumstance that indicated a possible material misstatement due to fraud, the team did not investigate the inconsistencies between this circumstance and the explanations given by the management.

Auditors need to exercise professional skepticism and evaluate the audit evidence they have obtained to ensure that they do not overlook indications of material misstatement due to fraud. Furthermore, if the engagement team identifies indications of a material misstatement due to fraud, the team needs to perform additional audit procedures while exercising professional skepticism and making inquiries of and asking for explanation from the management in order to determine whether there are suspicions of material misstatement due to fraud.

Case 2: Evaluation of identified misstatement during the audit

During a branch audit the engagement team detected a misstatement in posted sales, and requested that the audited company revise it. However, the team did not assess whether the misstatement fell under an indication of fraud, including by reviewing similar transactions at other branches. In addition, the team did not perform additional audit procedures including examination of the quantitative impact on the whole audited company and control deficiencies, and as a result, overlooked misstatements at other branches.

(Auditing Standards Committee Statement No. 240, paragraph 34)

《Points to Note》

As in the examples of identified deficiencies mentioned above, there were deficiencies in procedures for fraud-related risks, including failure to sufficiently assess whether the misstatement identified during the audit fell under an indication of fraud, failure to assess the possibility of the identified misstatement occurring in the audited company as a whole, and failure to reconsider risk assessment if circumstances that may indicate the possibility of a material misstatement due to fraud were identified.

If the engagement team identifies the suspicion of a material misstatement due to fraud, the team needs to revise its planned risk assessment and responses to audit risks, and implement audit procedures that directly respond to the situation of possible fraud, including sufficient examination of the suspicion of material misstatement due to fraud, in order to obtain sufficient appropriate audit evidence regarding the

suspicion.

Furthermore, if the engagement team has identified fraud, or obtained information that indicates the possibility of fraud, the team must, in order to convey to the person responsible for preventing and uncovering fraud matters relating to that responsibility, inform the appropriate layer of management of such matters in a timely fashion. The team also needs to inform the company auditors of such matters. In addition, if the engagement team suspects that management are involved or are on suspicion of being involved in fraud, the team must report this to the company auditors and hold consultations with the company auditors concerning the type, timing, and scope of the audit procedures required to complete the audit. The team also needs to demand that management take appropriate measures to correct problems.

7. Audit of Internal Control over Financial Reporting

Points of focus

Auditors should express audit opinions based on evidence obtained by themselves as auditors, such as whether the internal control report assessed by the management was prepared to appropriately present the results of the assessment of internal control effectiveness in accordance with generally accepted internal control assessment standards.

Under these circumstances, the CPAAOB inspects audit firms regarding auditing internal control from the following perspectives:

- Whether the engagement team develops an audit plan in consideration of materiality, with an understanding—based on the audited company's business environment and business characteristics—of the design and operation of internal control and assessment thereof by the management;
- Whether the engagement team evaluates the way the management decides the scope of assessment as well as its reasonableness; and particularly in the case that the management prepares an internal control report that excluded some part of the transaction cycles that could not be assessed, the engagement team should examine the reasonableness of the management's exclusion of the scope and the effects of the exclusion on the financial statement audit;
- Whether the engagement team appropriately assesses the deficiencies identified by the management; especially in evaluating the degree of control deficiencies, does the team examine the potential impact of the deficiencies and the possibility of the occurrence of a material misstatement by taking into consideration the quantitative and qualitative effect on the overall internal control of the audited company;
- Whether, in the course of an internal control audit, the engagement team reports the deficiencies detected by the auditors to the appropriate person at an opportune time and examines the possibility of the deficiencies being a material weakness;
- Whether, if the engagement team has discovered a material weakness, the team reports this to the management and demands that the management corrects it, and examines progress made in correcting the deficiencies at an opportune time.
- Whether the engagement team examines the potential impact on the financial reporting by the misstatements found during the course of the financial statement audit.

Outline of inspection results

In some cases, the engagement team, without enough professional skepticism, relied on the results of the audited companies' internal control assessment, without evaluating the adequacy of the scope of internal control assessment, the internal auditors' ability and independence, the adequacy of samples, assessment scheme and so on.

Some engagement teams only responded in form to changes of the business environment of the audited company such as those of significant business locations or units because of acquisition and commencement of new business or other. Other engagement teams did not examine the appropriateness of management using the previous year's results of the evaluation for IT general controls. Other engagement teams did not examine whether the identified deficiencies could constitute material weakness. The other engagement teams did not obtain enough audit evidence to evaluate the remedial actions against the relevant material weakness.

Expected response

Auditors should sufficiently understand the design, the operation, and the assessment methodologies of the internal control so as to integrate internal control auditing and financial statement auditing considering materiality for effective and efficient audits.

Meanwhile, the purpose of the internal control reporting system under the FIEA is to ensure disclosure reliability through managements' assessment of their internal controls over financial reporting and by audits of their assessment. Therefore, auditors should lead the audited company to design internal controls based on the audited company's background, including its size and business structure.

To meet the expectations mentioned above, auditors need to examine the scope, timing and appropriateness of audit procedures to evaluate the adequacy of the scope of internal control assessment, the methodologies of internal control assessment, and the assessment of the significance of internal control deficiencies. They should not perform procedures uniformly and routinely without sufficient examination.

Careful assessment should be performed concerning whether sufficient appropriate audit evidence was obtained particularly on the audited company's business locations/units deemed to have relatively high risks, such as processes newly added to be assessed.

(1) Evaluation of the Scope of Assessment of Internal Control

Case 1: Selection of significant accounts

The audited company (a labor-intensive consulting firm) considered sales, accounts receivable, and inventories as accounts for the audited company's business objectives and included them in the scope of internal control assessment.

However, the engagement team did not assess whether personnel expenses, which were larger in amount than inventories according to the characteristics of the audited company's business, should be included in the scope of internal control assessment.

(Auditing and Assurance Practice Committee Statement No. 82, paragraphs 98 and 100)

《Points to Note》

"Important accounts for operational objective (three accounts: sales, accounts receivable and inventories)" are just examples, described in the Practice Standards for Management Assessment and Audit concerning

Internal Control over Financial Reporting. It is necessary to note that important accounts should be appropriately selected in consideration of the audited company's type of industry, business environment and business characteristics. In the event of changes in the audited company's business activities and profit structure, in particular, important accounts need to be carefully selected.
In addition to the above example case, net sales are often used as an indicator for selecting significant business locations or units. However, it must be noted that using a different or additional indicator may be more appropriate depending on the environment or nature of the business of the audited company.

Case 2: Identifying significant business processes

The engagement team identified the risk of appropriate evaluation of the shares of affiliate companies as a significant risk. However, the engagement team did not examine whether there was a rational reason for the exclusion of business processes associated with the significant risk from the scope of internal control assessment.
(Auditing and Assurance Practice Committee Statement No. 82, paragraph 112)

《Points to Note》

Business processes, related to the accounts with significant risks, should be usually selected for internal control assessment by the management because of their characteristics. If such business processes are not selected, the engagement team should note that they are requested to discuss again with the management regarding the management's method of deciding the scope of assessment as well as the basis of the decision, and carefully evaluate the reasonableness of the scope of assessment.
If the engagement team considers that the business processes selected by the management for assessment are not appropriate, the engagement team needs to request the management to take additional actions, including reconsidering the business processes to be assessed, in accordance with the degree of impact on financial reporting.
If some processes included in significant business locations or units are excluded from assessment because of their limited relevance to material businesses or operations and small impact on financial reporting, the engagement team should carefully evaluate the reason for their exclusion from assessment, etc.

(2) Evaluation of Assessment of Internal Control

Case 1: Sampling

- In assessing the operation of internal controls over revenue recognition, the engagement team used the audited company's tests of controls, but did not examine the appropriateness of the selection method and sample size the audited company had extracted.
  (Auditing Standards Committee Statement No. 500, paragraph 9; and Auditing and Assurance Practice Committee Statement No. 82, paragraph 153)

- In assessing the operation of internal controls over operational processes of significant business locations or units, the audited company selected samples only from certain months from the entire population that covered 12 months.

However, the engagement team did not examine whether the management's sample selection method has provided a reasonable basis for conclusion about the entire 12-month population. (Auditing and Assurance Practice Committee Statement No. 82, paragraphs 153 and 158)

Case 2: Assessment of design and operation of internal control

The engagement team identified the actual existence of and cut-offs for sales as a fraud risk, and evaluated the same sales processes covered by the internal controls that the audited company designed and assessed.

However, the engagement team failed to adequately examine whether the internal controls related to each assertion were designed to sufficiently mitigate the fraud risks identified by the auditors, that includes to examine whether the internal control was necessary for the audited company to verify the existence of newly registered customers, and whether internal controls were maintained to verify that the invoice information was consistent with the order information and the shipping information.

Furthermore, accounting treatment and booking of sales-process-related sales and accounts receivable was performed based on sales data interfaced from the sales system to the accounting system each month and the invoice data for the distributors.

However, the engagement team did not consider whether internal controls relating to this interface should be subject to investigation, and did not adequately understand and examine the design and operation of internal control relating to the accounting treatment and booking of sales and accounts receivable.

(Practice Standards for Management Assessment and Audit concerning Internal Control over Financial Reporting III. 3 (4); Standards for the Assessment Auditing Standards Committee Statement No. 500, paragraphs 5 and 6)

《Points to Note》

Other than the examples mentioned above, in some internal control evaluation, some engagement teams documented as audit evidence only the results of control activities, such as a signature on a document. With a sufficient understanding of Auditing Standards Committee Statement No. 230 ("Audit Documentation"), a team needs to document significant facts identified in the course of performing procedures and professional judgments, as well as the results of the procedures, in a manner that enables experienced auditors without involvement in the audit to understand the situation. Meanwhile, in evaluating the scope of internal control assessment, an engagement team also needs to pay attention to changes in the audited company's business activities and earnings structure, regardless of audit experience in the past years.

Furthermore, in implementing a detailed test and tests of controls for the same transaction as a

dual-purpose test, the engagement team needs to pay attention to whether it can take procedures that are suited to both purposes of the test, especially whether audit evidence obtained is appropriate for the assertion of account and internal control to be assessed.

It should also be noted that evaluation of the design and operating effectiveness of the financial reporting process must be carefully performed, since the process is one of the most important business processes concerning the reliability of financial reporting but its frequency is lower than other operational processes that are related to daily transactions.

Case 3: Timing of assessment procedures

In developing its plan for responding to financial statements audit risk, the engagement team planned to rely on the related effective internal controls. However, the team did not complete its evaluation on the design and operating effectiveness of IT general controls and operation-processing controls by the date of the auditor's report for the Companies Act.

(Auditing Standards Committee Statement No. 300, paragraph 8, No. 330, paragraphs 5, 6, and 10; Auditing and Assurance Practice Committee Statement No. 82, paragraph 27)

《Points to Note》

If the engagement team plans to rely on related internal controls that it assumes to be effective in deciding the nature, timing and extent of substantive procedures in the financial statement audit, it needs to assess the effectiveness of the company-level controls and IT general controls that support the process-level controls as well as the subject controls before performing important substantive procedures.

Furthermore, there was a case where the engagement team performed tests of internal controls during the term, and with regard to the period after that, performed roll-forward procedures after the date of the financial statements. However, the roll-forward procedures were not completed by the date of the auditor's report for the Companies Act.

Case 4: Management's use of assessment results of prior years

In management's assessment of IT general controls over sales systems used at significant business locations or units, the audited company used the results of prior years' assessment for certain internal controls.

However, the engagement team did not examine whether it was appropriate for the management to use the results of prior years' assessment, according to the Practice Standards for Management Assessment and Audit concerning Internal Control over Financial Reporting.

(Practice Standards for Management Assessment and Audit concerning Internal Control over Financial Reporting II. 3 (3) (v) D (Note))

《Points to Note》

When the management continuously uses the results of previous year's assessment of operating

effectiveness in assessing IT general control items, the engagement team should note that it is necessary to examine whether the items have particularly material impact on the reliability of financial reporting, whether there had been any material changes in effectiveness of the design from the previous year, whether the results of previous year's assessment of operation were effective, and whether operating effectiveness has been assessed once every several accounting periods

(3) Evaluation of Deficiencies

Case 1: Assessment of deficiencies in design and operation of internal control

- The audited company said it had remediated deficiencies in the business process pointed out by the engagement team by the end of the period.
  However, the engagement team did not obtain adequate audit evidence to prove that the deficiencies in the business process had been remediated by the end of the year.
  (Auditing and Assurance Practice Committee Statement No. 82, paragraph 216)

- The engagement team identified a deficiency in the program change management and the access privilege distribution of the audited company's management information system which is exposed to the risk of unintended commands being executed, since the proper system configuration was not established, and general users were able to issue direct commands.
  However, the engagement team did not examine how this deficiency in internal control involving IT could affect application controls in information technology or the assessment of information prepared by the company.
  (Auditing Standards Committee Statement No. 315, paragraph 17 and 20, IT Committee Implementation Guidelines No. 6, paragraph 53)

Case 2: Determination of material weaknesses

Regarding the results of internal control assessment by management, the engagement team obtained a list of matters to be remedied that was prepared by management, and understood that management assessed that there was no material weaknesses although there were deficiencies as of the year-end.
However, the engagement team did not examine the appropriateness of the results of assessment by the management concerning such control deficiencies.
(Auditing and Assurance Practice Committee Statement No. 82, paragraphs 210–211)

Case 3: Assessment of internal control over misstatement

The engagement team detected an overstatement of sales and cost of sales of the same amount and the audited company did not revise the financial statements since it did not have an impact on net profits. However, the engagement team did not examine whether the misstatement mentioned above was caused by control deficiency, nor did they consider the impact on the internal control assessments in the financial statement audit or confirm whether the audited company treated the matter as a deficiency in the management's assessment of the internal control reporting system.

(Auditing and Assurance Practice Committee Statement No. 82, paragraphs 43–44)

《Points to Note》

Deficiencies in the internal control can be classified into deficiencies in design and deficiencies in operating effectiveness. Deficiencies in design include the absence of internal control and failure of the existing internal control to fulfill the objectives of the internal control, while deficiencies in operating effectiveness consist of failure to perform the internal control as designed, the existence of many errors in performing internal control and a poor understanding of the nature and objectives of the internal control by the person who performs the internal control.

When finding a deficiency in internal control, the engagement team is required to: confirm which classification it falls under; take into account its quantitative and qualitative materiality and compensating control; calculate the potential quantitative impact of the deficiency discovered; and examine which accounts will be affected by such deficiency and to what extent, and the possibility of material misstatement. The team needs to pay attention to the fact that it is required to carefully judge if the deficiency found falls under material weaknesses.

Further, it should be noted that, if the misstatement identified by the auditor was due to ineffective internal control, it may imply the possibility of other misstatements.

(4) Use of Management Assessment

Case: Extent of using the work of internal auditors

The engagement team adopted an approach that relied on internal controls for significant risks identified in revenue recognition, and used the results of internal control assessment conducted by internal auditors of the audited company in its assessment of control effectiveness.

However, they did not examine the appropriateness of the assessment method, including the sufficiency of sample size examined by internal auditors.

(Auditing Standards Committee Statement No. 610, paragraph 9)

《Points to Note》

In many cases, engagement teams use the work performed by the audited company's internal auditors from the perspectives of effectiveness and efficiency. However, on such occasions, it is necessary to examine if the independence and professional skills of the internal auditors are maintained and if the quality of assessment by the internal auditors is high enough to be used as audit evidence.

In this case, the engagement team should keep in mind that it is necessary to examine the degree of risk corresponding to the internal control where the engagement team plans to use the work performed by the audited company's internal auditors, the nature and materiality of the internal control, the

operations of internal control, the degree of judgment necessary for assessing operations, and the quality of the work performed by the internal auditors.

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