Provisional Translation

Case Report from Audit Firm Inspection Results

（In Program Year 2020）

July 2020

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 ensuring 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 ensure 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 etc. of listed companies and other companies subject to audit by accounting auditors, investors and other market participants.

This Case Report has been updated to add the latest cases of inspections and redesigned to make the background to audit deficiencies identifies via inspections as understandable as possible, following previous years' editions 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 "2020 Monitoring Report". Please also refer to this report.

Please submit any comments or requests regarding this Case Report to the dedicated e-mail address below.
Office of Monitoring and Inspection, Secretariat of the Certified Public Accountants and Auditing Oversight Board
iiu.cpaaob@fsa.go.jp

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 CPAAOB inspections classify audit deficiencies as either significant deficiencies or deficiencies, but this Case Report will draw no distinction between the two, listing those deficiencies that comport to the purposes of this Case Report.
(3) 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.
(4) 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.
(5) 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.
(6) In cases where there are multiple criteria for identifying the deficiencies, the principal provision is quoted.

2. Main Characteristics of the 2020 Edition

(1) In "I. Operations Management Environment (Root Cause Analysis)", a new figure has been posted, along with explanations and examples on the process for analyzing root causes.
(2) In "II. Quality Control Environment", a new figure has been posted, along with expanded examples of issues with the quality control environment with regard to the conclusion of new audit contracts, the education/training of audit teams, the supervision of assistants to professional staffs, etc.
(3) In "III. Individual Audit Engagements", descriptions of deficiencies and points to note have been included in sections such as "1. The Auditor's Responsibilities Relating to Fraud in Financial Statement Audits", "4. Auditing Accounting Estimates" and "5. Group Audit" to reflect the fact that accounting fraud at listed companies and accounting issues at overseas group companies continue to attract public attention.
(4) A NEW mark has been placed at the start of examples newly added to the current program year's Case Report.

(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, Deloitte Touche Tohmatsu LLC, Ernst & Young ShinNihon LLC, and PricewaterhouseCoopers Aarata LLC.
Second-tier audit firm	An audit firm whose business scale is second only to large-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
CPAAOB	Certified Public Accountants and Auditing Oversight Board
JICPA	Japanese Institute of Certified Public Accountants
Quality control (QC) review	Quality control review performed by the JICPA under Article 46-9-2 of the Certified Public Accountants Act and Article 77 of the JICPA Rules
Audit Firm Governance Code	Refers to the Principles for Effective Management of Audit Firms, published by the FSA in March 2017
Audit team	Persons engaged in the provision of audit services, and comprises an engagement partner and assistants to the engagement partner
Engagement partner	The person responsible for conducting the audit, who is a CPA with responsibility for the audit services and their provision as well as the audit report issued
Assistants to engagement partner	Members of an audit team other than the engagement partner

[Contents]

Responses Expected of Audit Firms

1. Ensuring the Reliability of Audits

Recent years have seen the powers of audit and supervisory board members, audit and supervisory boards, audit committee members, and audit committees (below, "corporate auditors, etc.") strengthened and corporate governance codes introduced. Developments such as these have helped enhance corporate governance environments, but incidents of fraud continue to occur both in Japan and overseas and a growing number of listed companies have acknowledged providing timely disclosure of inappropriate accounting. Given these circumstances, a considerable number of them are likely to have issues pointed out to them by auditors. To further ensure the reliability of audits, it is therefore necessary for each audit firm to continue 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 be mindful of striving in practice to ensure and improve the quality of their audits, considering not only whether their engagements and systems formally comply with standards but also whether they are applying appropriate professional skepticism to identify fraudulent accounting and whether they are focusing at all times on audited companies' business risks to assess and address the risks of material misstatement.

If deficiencies are identified in individual audit engagements or the system of quality control, the audit firm should not only remedy the deficiencies but also analyze the root causes before making improvements.

This Case Report also includes examples of "observed effective efforts" by audit firms that might serve as guides for improvement, and we ask that you find these informative.

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, the improvement of the system of quality control should not only be an issue for the CEO or PICOQC, but rather a corporate responsibility to be fulfilled voluntarily by the partners and employees of an audit firm. It is important, through such organized improvements, to foster a climate that emphasizes the quality of audits.

The "Principles for Effective Management of Audit Firms" ("The Audit Firm Governance Code") covering the management of audit firms was issued in March 2017. In light of the fact that some audit firms, particularly large-sized audit firms, are already establishing/strengthening governance environments to ensure and improve audit quality, the CPAAOB will continue inspecting whether the governance environment established and/or strengthened by each audit firm based on the Code is effective.

3. Accurately Discerning Deficiencies and Analyzing Causes

One prerequisite for appropriately analyzing root causes is accurately identifying deficiencies and precisely discerning their direct causes. If these direct causes cannot be precisely discerned, then the root causes cannot be suitably analyzed and the responses taken will also prove unsuitable.

We should bear in mind that when suitable audit documentation on key audit matters has not been prepared, for example, the problem in the vast majority of cases is not simply a lack of documentation but also a failure to perform the necessary audit procedures. If the prepared audit documentation does not satisfy the requirements stipulated in Auditing Standards Committee Statement No. 230, paragraph 7, it is necessary to carefully discern whether this is due to the necessary audit procedures not having been implemented without playing it down as simply a problem of documentation. If the necessary audit procedures have not been carried out, the reasons for this must be further analyzed and efforts made to improve. To ensure that necessary audit procedures are implemented on the audit frontline, the skills of the audit team must be enhanced through classroom education/training and superiors need to commit to providing guidance on a day-to-day basis to the assistants to engagement partners who supervise the audit frontline, review audit documentation, review and periodic inspection, etc.

4. Responding to Issues According to Size

There is wide variation in the sizes of audit firms, with some having just a few personnel while others have headcounts that run into the thousands. There are also differences in operations management environments. Because of these factors, it is important to continuously inspect whether the quality control environment established by the audit firm is appropriate in view of the size of the firm and the operations management environment.

The following characteristics have been identified as problems relating to the size of the audit firm, so each audit firm should refer to them and take appropriate action based on their size.

[Large-sized audit firms]

We can see that large-sized audit firms are working in an organized manner on improvements toward higher quality, such as rebuilding their governance environments through, for example, 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 different levels and 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. As a means of addressing this, a trend that has been seen recently is to shift the maintenance and improvement of quality control to business units, which are closer to the audit frontline. While such initiatives are likely to be effective to some extent, attention needs to be given to ensuring that the quality control department accurately and continuously finds out about the characteristics of the engagements handled by each business unit so as to ensure the effectiveness of the measures instituted by business units.

[Second-tier audit firms]

Regarding second-tier audit firms, some of them have been moving to establish structures that allow for organized action with regard to the firm's quality control, but their headquarters organization remains weak. Furthermore, the quality control environment is sometimes inadequate as a result of a limited numbers of quality control personnel and insufficient awareness concerning quality control among the CEO and PICOQC. Another problem is that at firms that are expanding the range of operations they perform, the establishment of an audit performance environment has not kept pace with, for example, the undertaking of new audit contracts. Furthermore, business administration at second-tier audit firms is characterized by inadequate post-merger management integration and heavy reliance on part-time professional staff in the performance of audit engagements.

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 foreign 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 lack the resources for developing systems of quality control. Because of this, while they are addressing deficiencies identified in external inspections, this action is often superficial, being based on treating the symptoms rather than tackling the causes. Some audit firms are also not making an effort on a day-to-day basis to improve audit quality and followed the previous audit procedures on the grounds that no major problem had occurred in the past.

There are also some small and medium-sized audit firms that prioritize expanding the range of services they offer, and there have consequently been instances of inadequate and inappropriate risk assessments and risk-related audit procedures in which such firms have concluded contracts in the belief that the risks in concluding new audit contracts (hereinafter, the risks in concluding or renewing such contracts will be termed "contract risks") had been appropriately assessed even though due consideration had not been given to the fraud risks posed by listed companies with high audit risk.

To Directors, Company Auditors etc., Investors and Other Stakeholders

The relationship between the directors/company auditors of a business audited company and an accounting auditor are being streamlined through the recent revision of the Companies Act and related regulations such as the Corporate Governance Code. Meanwhile, incidents such as fraudulent accounting by listed companies and accounting issues related to overseas group companies continue to be seen.

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 accounting 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 accounting 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 accounting auditors, and that companies' proper financial information is disclosed on a continuous basis by securing proper auditing.

In particular, audit reports from the term ending March 2021 (early application from the term ended 2020) will list "key audit matters" (hereinafter, "KAM") to improve the transparency of audits conducted by auditors and boost the information value of audit reports. This can be expected to further enhance collaboration/communication between auditors and company auditors as well as discussions with management, and lead to more effective audits.

In view of such matters, this Case Report describes examples of deficiencies identified in the CPAAOB's inspections, which include the most recent cases of accounting fraud and matters pertaining to collaboration with accounting auditors, company auditors, etc., in the most easily comprehensible manner possible from the perspective of providing directors and company auditors, etc., at listed companies as well as investors with reference information on audits. This Report also describes observed effective cases of improvement efforts by audit firms. We thus hope that this Report will be used as a reference for the appropriate evaluation of accounting auditors.

I. Operations Management Environment
(Root Cause Analysis)

1. Operations Management Environment and Root Cause Analysis

(1) Necessity of Root Cause Analysis

With regard to audit firms that the CPAAOB conducted inspections of, it has been recognized that when a deficiency was detected in a review conducted by the JICPA in accordance with Article 46-9-2 of the Certified Public Accountants Act and Article 77 of the JICPA Rules (below, "QC review)" or periodic inspection, quite a few audit firms only took cosmetic improvement measures, without fully identifying the cause.

Deficiencies identified in inspections are discovered within the scope of investigations. It is likely that the audit firms have other undiscovered deficiencies arising from the same root causes. Moreover, even if measures are implemented to address the direct causes of the deficiencies, they will only be effective temporarily, and similar deficiencies will occur again. 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 symptom-treating 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.

When performing root cause analysis, it is important to accurately identify what are assumed to be the direct causes. The direct causes of deficiencies do not only reside the knowledge, attitudes, or experience of those who carried out the acts. It is therefore essential to identify them after obtaining an adequate understanding of factors such as the a situation with the audit team and the business conditions of the audited company, and to then analyze the root causes in view of the direct causes.

In recent years, with regard to deficiencies at large audit firms relating to individual audit engagements identified through external inspections and periodic inspections, the firms not only identify and communicate the inadequacies in audit procedures and audit evidence, but also incorporate action to analyze their root causes into their quality control environment.

For example, the quality control department etc. acts voluntarily to conduct interviews with and questionnaire surveys of the audit team in which the deficiency was identified in order to find out the details of the direct causes of the deficiency, after which it analyzes whether these direct causes were the result of the firm's operations management environment or quality control environment, and then reflects its findings in the improvements to be made.

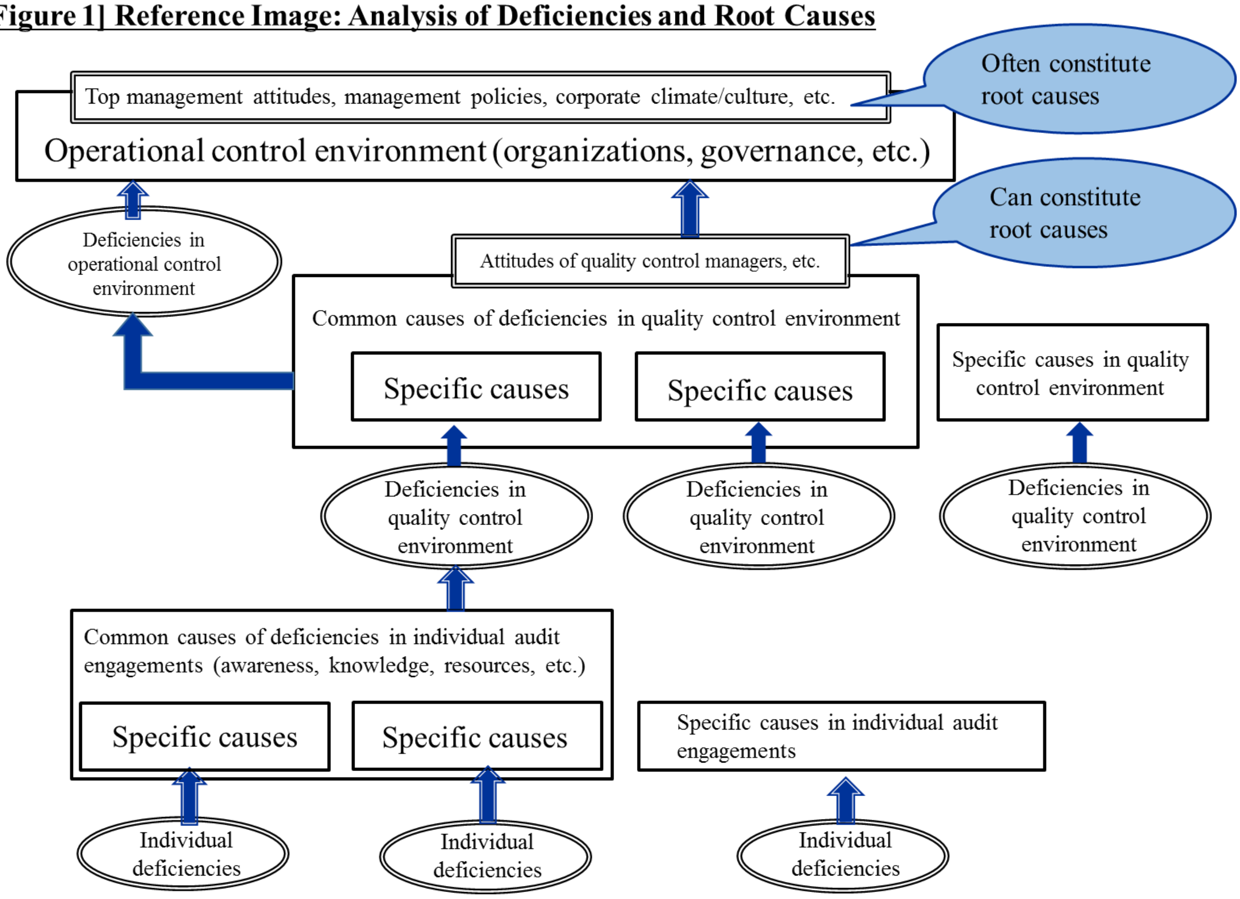
(2) Root Cause Analysis

When performing root cause analysis, it is important to accurately identify what are assumed to be the direct causes. The direct causes of deficiencies do not reside solely in the knowledge, attitudes, or experience of those who carried out the acts. It is therefore essential to identify these direct causes after obtaining an adequate understanding of factors such as the engagement team's circumstances and the business conditions of the audited company, and to then analyze the root causes in view of these direct causes.

Direct causes include "specific causes" that can be identified for individual deficiencies and "common causes" in which the specific cause identified is common to multiple deficiencies, and examining causes stemming from common causes often ties into root cause analysis.

In past inspections, this root cause was frequently related to the operations management environment as manifested in the attitudes and management policies of top managers, the governance environment and the organizational climate. Accordingly, attention must be paid to the effectiveness of the operations management environment (see [Figure 1]). At times, the attitude of the person in charge of quality control (PICOQC) or some other aspect of the quality control environment constitutes the root cause.

[Figure 1] Reference Image: Analysis of Deficiencies and Root Causes



The following are examples of root cause analysis in which the CPAAOB's inspections analyzed the direct causes of deficiencies, investigated the root causes and discovered the root causes within the operations management and quality control environments.

[Large-sized audit firms]

[Case 1]

Multiple deficiencies, some of which were significant, with some individual audit engagements subject to investigation were identified at an audit firm.

The direct causes of these deficiencies included the fact that in an audit area etc. in which the engagement partner was convinced that there were no problems with accounting treatment at an audited company as a result of data obtained from the company and consultations conducted with them in advance, the engagement partner did not demonstrate professional skepticism, and therefore instructions, supervision, and review of the audit frontline were inadequate. Not only that,but assistants to engagement partner did not possess the level of understanding required under audit standards.

In light of this situation, further investigations into the root cause determined that the root cause lay in the quality control environment in that the audit firm did not institute efforts to ensure and improve audit quality rapidly enough as it sought to step up its hiring of audit teams through mid-career recruitment and other approaches to deal with an increase in audit engagements, as evidenced by the fact that the skill level of audit teams as a whole had not been raised to an adequate degree despite progress made in improving quality control on the audit frontline.

[Case 2]

Multiple significant deficiencies with some individual audit engagements subject to investigation were identified at an audit firm. These concerned, for example, the failure to establish and implement in-depth audit procedures relating to fraud risk.

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. Recognized as a common cause of the deficiencies in the quality control environment was the audit division’s failure, as a consequence of inadequate internal/external cooperation, to ascertain these circumstances surrounding engagement teams as well as changes in the circumstances of audited companies, which in turn resulted in inadequate support being provided for high-risk audit engagements.

Further investigations into the causes discovered the root cause lay in the operations management environment, in that division managers were assigned responsibility for quality control at this audit firm and the division managers’ overly broad scope of responsibility for quality control made it difficult for them to respond flexibly to individual audit engagements.

[Second-tier audit firms]

[Case 1]

A significant deficiency with the quality control environment pertaining to the conclusion of new audit contracts was identified at an audit firm.The significant deficiencies in the quality control environment stemmed from the attitude of the PICOQC, who was aware that the regulations governing acceptance and continuance of audit engagements did not fit reality but left things as they were without making any revisions.

Further investigations into the causes discovered that the root causes lay in the operations management and quality control environments in that the chief executive officer (CEO) and other executives knew that the rules pertaining to the conclusion of new audit contracts did not fit reality but tolerated them because there had been no serious problems with business administration theretofore, and otherwise demonstrated a lack of awareness of the need to properly assess contract risks.

[Case 2]

Multiple significant deficiencies with some individual audit engagements subject to investigation were identified at an audit firm. These concerned, for example, substantive procedures for revenue and procedures for responding to fraud risk. These deficiencies were occurring frequently at a specific regional office.

The common cause for these deficiencies in individual audit engagements turned out to be that the engagement partners had not effectively reviewed audit documentation, instead following same audit procedures from the past years because no major issue had arisen in audit engagements theretofore. The common cause for this deficiency in individual audit engagements lay in the quality control environment in that the CEO had believed having a mechanism in place to convey decisions made by the head office to regional offices was in and of itself sufficient and he had no intent of revise the practice of regional offices administering these decisions independently, and in that the CEO and the PICOQC followed past practices because no major issues had arisen theretofore in key matters noted with regard to business administration and quality control at the audit firm by outside organizations.

Further investigations into the root cause determined that it lay in the operations management environment. More specifically, the audit firm had undergone repeated mergers but the headquarters organization remained fragile and the regional offices established by separate entities were permitted to run their businesses in their own ways, with hardly any exchanges of personnel taking place.

[Small and medium-sized audit firms]

[Case 1]

NEW

Deficiencies were identified in the quality control environment at this audit firm, and numerous significant deficiencies were also discovered with individual audit engagements.

The deficiencies in the individual audit engagements were due to a common cause of the engagement teams not sufficiently understanding the levels required by auditing standards pertaining to fraud risks and group audits. The common cause of the deficiencies in individual audit engagements lay in the quality control environment in that the PICOQC did not sufficiently understand the level of quality control system demanded by the quality control standards and thus was not aware of the need to establish and administer a suitable quality control system, while the CEO believed that that the audit procedures to be implemented would be of a sufficient level if audit documentation systems, templates, etc., were suitably established and that issues could be addressed to a certain degree using quality control methods similar to those employed before the merger even though the office had expanded in scale because of the merger.

Further analysis of the root causes discovered that they lay in the operations management environment. Specifically, they found that the CEO had not sufficiently understood the appropriate levels demanded of operations management and quality control environments in keeping with the office's expanded post-merger scale and that he lacked awareness of the need to rapidly institute organizational improvements in the operations management and quality control environments.

[Case 2]

NEW

Deficiencies were identified in an audit firm's quality control environment, and numerous significant deficiencies were also discovered in the individual audit engagements.

The deficiencies in individual audit engagements were due to the common causes of the engagement partners and the assistants to the engagement partners not sufficiently understanding the levels demanded by the audit standards with regard to identifying fraud risks, impairing fixed assets, etc., and the audit documentation having been insufficiently reviewed by the engagement partners. The common causes of the deficiencies in the individual audit engagements lay in a common cause for deficiencies in the quality control environment, i.e., the CEO and the PICOQC were not sufficiently aware of the need to construct an organizational quality control environment, believing that, if partners were assigned to specific operations, these partners would suitably carry out their respective assignments.

Further analysis of the root cause discovered that it lay in the operations management environment. Specifically, the CEO and the PICOQC were able to ascertain the skills of individual partners because the audit firm comprises a small number of partners, and they were convinced both that the partners were utilizing their abilities with a sufficient understanding of the levels demanded by the audit standards, and that the absence of any significant issues pointed out in previous quality control reviews meant that the minimum quality control environment needed for an audit firm of this scale had been established.

As the above cases show, an analysis of the causes of deficiencies revealed that they stem from issues with the audit firm's operations management and quality control environments, and it is important to upgrade these environments in order to fundamentally improve these deficiencies.
Although audit firms, and large-sized audit firms in particular, are currently working to establish and strengthen their organizational administration in accordance with the Audit Firm Governance Code, they ought to give adequate attention to ensuring their effectiveness and endeavoring to contribute to ensuring and improving audit quality.

2. Specific Examples of Root Causes

The following are specific examples of root causes identified in inspections, including root causes in the operations management environment as described in "1. Operations Management Environment and Root Cause Analysis".
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 ensure and improve audit quality.

[Large-sized audit firms]

While large-sized audit firms have established quality control structures, there are problems with the effectiveness of their operation.
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, we found that at large-sized audit firms there were deficiencies such as a lack of leadership, including with respect to the management's awareness of quality control, and problems with initiatives by divisions etc.
In recent years, large-sized audit firms, in a bid to address these deficiencies, have, under the leadership of the management, been taking steps to improve audit quality, with the measures being implemented by PICOQCs, quality control departments, etc. Furthermore, to ensure that these quality improvement initiatives are implemented on a sustained basis, they tend to be shifting responsibility for quality control from head-office quality control departments to divisions etc., which are closer to the audit frontline, and

that this has proved somewhat effective. As a result, divisions etc. are playing a greater role in voluntarily improving quality and propagating an improvement-oriented mindset among engagement team members. However, the management and quality control departments etc. are prioritizing the autonomy of each division with regard to initiatives for improving audit quality, and just leaving such initiatives in the hands of the divisions.There are cases where problems such an insufficient understanding of the actual situation of each division and an insufficient verification of whether the improvement measures are being appropriately carried out are occurring. As a result, the management and quality control departments etc. need to find out properly about the action being taken in each division and pay attention to how effective it is.

The following are specific examples of root causes at large-sized audit firms identified so far by the CPAAOB:

- Although firms are determining important audit areas at each level of the organization and formulating and implementing improvement measures in a prioritized and focused way, there was inadequate recognition of the need for departments in charge of quality control to find out whether measures to improve quality in audit were being implemented effectively. As a result, confirmation by departments in charge of quality control of the type of monitoring of audit engagements being performed by audit divisions was inadequate.
- Although the number of professional staff is increasing as a result of firms stepping up recruitment, including of mid-career personnel, to cope with business expansion, the overall skill level of audit teams has not been improved sufficiently, and efforts to ensure and improve quality on the audit frontline are not being made to an adequate degree. (With regard to this example, also refer to [Large-sized audit firms] [Case 1] on p.9)
- 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 outside the division and information from engagement partners inside the division are not being sufficiently utilized by audit divisions, 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 2] on p.9)

[Second-tier audit firms]

Looking at second-tier audit firms, we find that while the firms are indeed moving forward with the establishment of quality control environments, the establishment of headquarters organizations has, on the whole, been insufficient. Furthermore, top management's awareness of quality control is not keeping

pace with the expansion in their firms operations. On the other hand, the firms differ in terms of how they were established, their operations management environments, and their size, so the root causes of problems differ from firm to firm.
As a result, each firm needs to move quickly to make effective improvements after analyzing root causes in ways that adequately reflect trends with their own operations, their operations management environments, and so on.

The following are specific examples of root causes identified so far by the CPAAOB:

- Audit engagements had expanded due in part to mergers and the conclusion of audit contracts with high-risk audited companies, but the CEO and other executives deemed that there had been no major issues with business administration theretofore and, despite knowing that the rules governing the conclusion of new audit contracts did not fit reality, tolerated these shortcomings out of a lack of awareness of the need to suitably assess contract risks (with regard to this example, also refer to [Second-tier audit firms][Case 1] on p.10).
- Operations are performed independently at each regional office. Specifically, matters such as the mobilization 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 2] on p.10)
- NEW Given that previous CPAAOB inspections had noted that a high percentage of partners engaged in concurrent business placed a heavy burden on full-time partners, the CEO was systematically working to make partners and other personnel full-time in the hope that doing so would improve quality control operations, and he lacked awareness of the need to implement measures directly tied to quality control operations.
- NEW With operations expanding, the CEO believed that audit documentation could be reviewed by engagement partners and the assistants to the engagement partner supervised and guided by enhancing the progress management of audit engagements, and he was convinced that, if he instructed engagement partners as well as assistants to the engagement partner carrying out reviews to provide supervision and guidance through the review of audit documentation, etc., the various personnel responsible for these tasks would suitably perform them. Accordingly, he lacked awareness of the need to verify the degree to which quality control measures were conveyed and

instilled as well as their effectiveness and, trusting that the steps taken by these personnel alone would maintain and improve the quality of audit engagements, he did not develop a system for monitoring this.

[Small and medium-sized audit firms]

Small and medium-sized audit firms come in various sizes and forms, and levels of establishment and implementation of quality control structures also differ from firm to firm. However, their organizations are relatively small, and they all face the difficulty of providing audit teams with organized assistance in areas such as quality control. A key characteristic of them, therefore, is that business administration and levels of quality control depend to a large degree on the abilities of individuals that belong to the audit firm, including the CEO, and the relationship between the personnel and the firm.
Because of this, low awareness of and involvement in quality control by the CEO often affect the quality control climate throughout the audit firm, so it is important for the CEO to demonstrate leadership in quality control.
The root causes of deficiencies identified in the CPAAOB's inspections of small and medium-sized audit firms can be broadly categorized into the following two types:

▪ Cases relating to inadequate awareness of quality control among CEOs and PICOQCs
▪ Cases resulting from the background to the establishment of the audit firm or changes in the management environment within the audit firm due to mergers etc.

(1) Cases relating to inadequate awareness of quality control among CEOs and PICOQCs

NEW
- The CEO did not recognize the need to organizationally ensure the quality of audits as the top corporate manager, and he did not exercise leadership in constructing an effective quality control system tailored to the current status of the audit firm's audit engagements. In addition, engagement partners other than the CEO left business administration of the audit firm and development and operation of a quality control system to the CEO, not recognizing the need for them to be involved in this and failing to adequately fulfill their responsibilities as engagement partners.

NEW
- The CEO gave top priority to releasing an unqualified opinion by the audit report submission deadline and did not exercise proper care as a professional specialist, not recognizing the need for the audit firm to fulfill the roles and responsibilities expected of it by society in guaranteeing the reliability of financial statements. Other engagement partners, including the PICOQC, shared the CEO's thinking and placed no checks on other engagement partners, including the CEO.
- The audit firm has not established an environment for performing organized audits commensurate with audit risks. For example, it had not secured enough human resources to perform proper audits.
- 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 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 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 significant 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.
- 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.
- 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.

(2) Cases resulting from the background to the establishment of the audit firm or changes in the management environment within the audit firm due to mergers etc.

NEW

- The CEO did not sufficiently understand the levels required of the operations management and quality control environments for the audit firm’s expanded post-merger scale, and he believed that post-merger quality control at the audit firm could be handled to a certain degree using the management methods employed before the merger. Accordingly, he did not recognize the need to respond rapidly in developing organizational operations management and quality control environments (with regard to this case, refer also to [Small and medium-sized audit firms] [Case 1] on p.11).
- The audit firm comprises two audit departments, and each department’s audit engagements, finances, and personnel are controlled independently by the representative partner (head) of the audit department. The representative partner of each audit department is typically appointed by the previous representative partner, and an organizational climate exists in which priority is placed on

the independence of each audit department. The audit firm has designated the CEO as the person with the ultimate responsibility in quality control, but the CEO has not set forth a central policy aimed at integrating quality control, and has not demonstrated sufficient leadership in establishing an effective headquarters organization.

- 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.
- The audit firm had increased its audit engagements of listed and other companies, and the audit engagement risk continued to climb. However, the CEO lacked a stance of conducting suitable risk assessments of audited companies and companies with which new audit contracts had been concluded, and did not otherwise exercise leadership as a quality control manager in constructing a quality control environment.
- The number of audit engagements had increased every fiscal year and new audit contracts had recently been concluded with high-risk listed companies but, because the full-time audit teams comprise only a small number of partners and the audit firm is relying on part-time professional staff as well to serve as assistants to engagement partners, the partners are exclusively engaged in the audit engagements for which they are each responsible and hence not sufficiently involved in quality control operations.

NEW

- The CEO and the PICOQC were able to ascertain the skills of individual partners because the audit firm comprises a small number of partners, and they were convinced that the partners were fully utilizing their abilities. Given that no significant matters had been pointed out in quality control reviews conducted theretofore, they believed that the minimum quality control environment needed for an audit firm of this scale had been established. Accordingly, they did not sufficiently recognize the need to construct an organizational quality control environment (with regard to this case, refer also to [Small and medium-sized audit firms] [Case 2] on p.11).

3. Response to the Audit Firm Governance Code

<Expected response>

The Audit Firm Governance Code, which was published in March 2017, was formulated with the organizational administration of large-sized audit firms, which have numbers of personnel and handle the audits of listed companies etc., in mind. In response to the Governance Code, large-sized audit firms are required to establish effective management bodies and administer their operations in an organized manner in order to improve audit quality. Furthermore, there are no obstacles to the Audit Firm Governance Code also being adopted voluntarily by audit firms other than large-sized audit firms, and each audit firm must respond voluntarily in light of its own characteristics etc.

<Responses based on size>

As of July 1, 2020, all large-sized audit firms and second-tier audit firms as well as eight comparatively large small and medium-sized audit firms had announced adoption.

Regarding the five principles of the Audit Firm Governance Code, application of them by firms based on size is as follows: Large-sized audit firms and second-tier audit firms have declared that they will apply all the principles. However, many second-tier audit firms have not made statements concerning involvement by third parties with independence (below, "independent third parties") to perform supervision/evaluation functions within their organizational environments (Principle 3). Furthermore, compared with those from large-sized audit firms, external explanations concerning organizational structures and quality control structures for ensuring transparency (Principle 5) tend to be simplified. In addition, few small and medium-sized audit firms, despite having adopted the Audit Firm Governance Code, are applying all of the principles, with supervision/evaluation functions within organizational environments (Principle 3) and ensuring transparency (Principle 5) often being dropped.

<Responses to supervision/evaluation functions within organizational environments (Principle 3)>

Large-sized audit firms are pressing ahead with adding independent third parties as outside members of existing supervision/evaluation bodies, establishing independent bodies such as public-interest committees to monitor the organizational administration of the audit firm from a public-interest point of view, and so on. With these initiatives, it is important that third parties are provided with the information they need concerning important decisions and business administration at the audit firm, and that opinions are sought from the independent third parties whenever necessary.

For these reasons, some firms are moving to provide necessary information to independent third parties by allowing independent third parties to attend meetings of management bodies, including those of group firms, or establishing secretariats to assist the independent third parties. Furthermore, some are providing opportunities for independent third parties to periodically exchange opinions with the CEO etc. There are also cases of firms taking action to enhance effectiveness increasing the proportion of members of committees etc. who are independent third parties.

In addition, second-tier audit firms have appointed independent third parties as members of bodies for supervising/evaluating business execution bodies, yet some of them have not clarified how these independent third parties are appointed period of their role and the powers that they have been given.

II. Quality Control Environment

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 environment 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 Environment”, 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.

Relationship between quality control environment and individual audit engagements

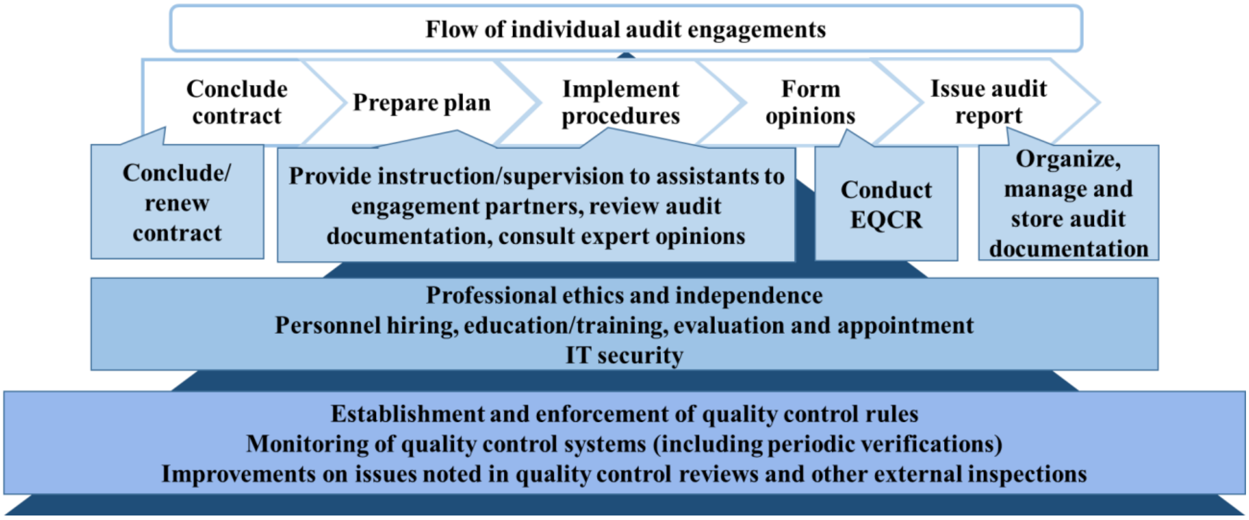
The Quality Control Standards for Audits and Quality Control Standards Committee Statements stipulate the quality control environment required, and these have had a major impact on the quality of individual audit engagements through the establishment and administration of quality control systems. The quality control environment contains elements pertaining to individual audit engagement processes and elements related to matters other than individual audit engagement processes.

The elements pertaining to individual audit engagement processes include assessments of contract risks, the supervision and review of audit documentation by engagement partners, the consultation of expert opinions, and EQCR, while among the elements not pertaining to individual audit engagement processes are professional ethics and independence and the hiring, education and training of human resources.

To ensure these systems function properly, audit firms establish and enforce rules on quality control and monitor quality control systems (including periodic inspections), and make improvements regarding issues noted in quality control reviews and other external inspections.

The quality of individual audit engagements can be reasonably ensured when the aforementioned quality control environment functions comprehensively and effectively in keeping with the scale and characteristics of each audit firm (see [Figure 2]).

[Figure 2] Reference Image: Relationship between Quality Control Environment and Individual Audit Engagements



<u>Analysis of deficiencies that occurred</u>

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

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 in which deficiencies continue to be identified in divisions, engagement teams, etc., because these divisions, engagement teams, etc., do not have an adequate understanding, and hence do not sufficiently disseminate, the purposes of measures formulated to improve deficiencies, with the result being that the anticipated effects of the improvement measures are not achieved.

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 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.There were also cases in which the PICOQC thought that partners would suitably handle matters if informed through training, etc., and otherwise did not sufficiently recognize the need to verify the effectiveness of quality control measures.

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 of effective efforts having been made to strengthen the 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.

Note that when such efforts are made, it is essential to pay adequate attention to their effectiveness, so it is important for the CEO and the PICOQC to be actively committed.

<u>Expected response</u>

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, after which each engagement team then responds through the revision of audit procedures based on the risks of each audited company. Efforts are being made to further instill improvement efforts by relocating quality control organizations from the head office to divisions closer to the audit frontline.

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, cases have been noted in which cooperation between the head office and divisions was inadequate, as well as cases in which efforts to make operational improvements have not been sufficiently introduced at divisions and regional offices that rarely exchange personnel with other divisions, etc., and that thus retain personnel long-term.

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 and 16)

Case 2: Verification of improvement

NEW

①The Quality Control Headquarters issued instructions to the persons responsible for monitoring at each division to monitor the implementation of audit procedures for audit engagements deemed high-risk via monitoring while communicating with engagement teams.

However, the Quality Control Headquarters did not clearly indicate to each division's monitoring personnel the level of procedures to be implemented, and the persons responsible for audit quality control at the divisions did not sufficiently perform their function of providing consultations for monitoring personnel.

Accordingly, the monitoring personnel decided due to time constraints that detail review of working paper could be safely left to the engagement quality control reviewer, and they thus did not undertake careful monitoring based on audit documentation.

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

② 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 due to reasons such as handover, with a 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 accounting issues and the temporary project of another engagement, 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 and 16)

Case 3: Gathering of audit risk information

Quality control division is encouraging improvements to be made in responses to risks by sending a questionnaire concerning audit risks pertaining to audited companies to audit teams, and is gathering information on audit risks with individual audit engagements. It is also providing audit teams with instructions as necessary based on the information it has gathered.

However, the environment is such that the same information is gathered from audit teams regardless of the degree of audit risk. Information that reflects risk levels is not being collected.

(Quality Control Standards Committee Statement No. 1, paragraphs 15 and 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 form (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 ensuring and improving the quality of the audit that each engagement team implements, resulting in the failure to detect and prevent audit deficiencies.

Change of auditors at listed companies has been increasing in recent years.In concluding new audit contracts with listed companies and other large firms, due consideration needs to be given to the time for auditing, the audit team's human resources, the level of audit fees, etc., to rationally ensure audit quality.

Therefore, the CPAAOB inspections not only evaluate anticipated risks from the conclusion and renewal of audit contracts (below, "engagement undertaking risk") 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.

(Observed effective efforts)

There were cases such as the following of effective efforts having been made:

The QC partners in the audit division confirm the views of the EQC reviewer concerning risks of material misstatement with audit engagements identified during the term by engagement partners, and inform quality control review headquarters of areas deemed to be high risk. Furthermore, quality control review headquarters examines audit teams' responses to risks, and demands that audit teams undergo headquarters quality control reviews as necessary. Because this process is performed twice a year on a continuous basis, quality control review headquarters is able to act swiftly in responding to listed-company audit engagements in high-risk areas.

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. Specifically, in the process of performing audits, the progress of audits and important matters need to be grasped through the review of audit documentation and discussions within the audit team. It is also necessary to form opinions at the final stage of the audit based on the audit evidence described in audit documentation.

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 their 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 operational improvements 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: Supervision of audit engagements and review of audit documentation

NEW ①The engagement partners were convinced that there was no problem with adopting the same audit responses as the previous fiscal year because there had been no significant changes in conditions at the audited company and that assistants to the engagement partners had been suitably performing procedures, so they did not provide instructions/supervision to the assistants to the engagement partners to ensure that the audit procedures were properly performed and they did not suitably review the audit documentation for the audit procedures performed by the assistants to the engagement partners in the belief that sufficient and sufficient appropriate audit evidence had been obtained on the identified risks of material misstatement.

(Quality Control Standards Committee Statement No. 1, paragraph 31; Auditing Standards Committee Statement No. 220, paragraphs 14, 15 and 16)

②Engagement partners, in advance discussions with an audit company with regard to areas in which it was deemed that there were no problems with the action being taken by the audited company, did not give instructions to assistants to engagement partners concerning specific audit procedures, and did not perform an appropriate review of audit documentation.

(Quality Control Standards Committee Statement No. 1, paragraph 31; Auditing Standards Committee Statement No. 220, paragraphs 14, 15, and16)

③At 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 assistants to 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 14, 15, and16)

《Points to Note》

To suitably perform audit engagements within a limited time frame such as that for year-end audits, engagement partners must issue concrete instructions to the assistants to engagement partners and supervise their performance as appropriate.

The content, timing and scope of the audit documentation to be reviewed must also be suitably planned if engagement partners, etc., are to suitably review the audit documentation.

Case 2: Securing effective review

NEW ①The EQC reviewer assumed that fraud risks had been suitably identified because the engagement team had aimed, in identifying fraud risks pertaining to revenue recognition, to clarify the risks by focusing on characteristic points in understanding corporate environments.

Accordingly, neither the audit documentation relating to the key audit judgments s made by the engagement team in identifying fraud risks pertaining to revenue recognition nor the audit documentation relating to their conclusions were sufficiently examined.

(Quality Control Standards Committee Statement No. 1, paragraphs 36 and 37; Auditing Standards Committee Statement No. 220, paragraphs 19 and 20)

②EQC 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, and A41; Auditing Standards Committee Statement No. 220, paragraphs 19 and 20)

Case 3: Effectiveness of periodic inspections

①Although 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)

②The engagement team performed additional audit procedures as corrective measures against the deficiency identified in the periodic inspections. 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 and 51)

《Points to Note》

It must be noted that, as with other reviews, it is necessary in EQC reviews and periodic inspections to assess whether the explanations offered by the engagement team are sufficiently and properly supported

by audit evidence by examining audit documentation and not just depending on oral communication.

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. Initiatives to Improve Performance Improvement Initiatives

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:

- Although the PICOQC, etc, recognized the need to analyze the underlying causes for the items noted in the recommendations for improvements, he went no further than analyzing the direct specific causes, and did not sufficiently understand the necessity of, or the analysis methods for, analyzing the root causes to be found in the quality control and operations management environments;
- 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 effective efforts were observed 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 EQC review system;
- The identified deficiencies were understood and the improvement measures were disseminated through discussions in each engagement team; and.
- An expert committee was set up for each discussion point, the members (inclusive of assistants to engagement partners) analyzed causes and discussed improvement measures, and an environment to provide feedback on findings to the firm's quality control division was constructed.

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

NEW

①In addition to having the CEO provide direction to the members of the engagement team as a means of improving points noted in the quality control review, the audit firm made it obligatory for engagement partners to conduct self-inspections using checklists containing the points noted, and arranged for EQC reviewers to confirm these inspection results when conducting their year-end EQC review.

However, inadequate analysis of the root causes meant the checklist encouraged direct responses only to the points noted, and the improvement responses taken were not sufficient to prevent similar deficiencies stemming from the same cause.

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

②The audit firm had not prescribed in its quality control regulations the role of the quality control committee in connection with responding to global reviews. As a result, the PICOQC did not believe it to be their personal responsibility to respond to issues pointed out in global reviews, and therefore did not consider what course of action to take.
(Quality Control Standards Committee Statement No. 1, paragraphs 15 and 16)

③With regard to issues highlighted in quality control reviews, the audit firm analyzes them, identifies their causes, and formulates improvement plans.
However, among the causes identified, the PICOQC formulated improvement plans with respect to some of them only.
(Quality Control Standards Committee Statement No. 1, paragraphs 15 and 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 professional staff, only a postal mail describing the deficiencies was sent.
(Quality Control Standards Committee Statement No. 1, paragraphs 15 and 16)

Case 3: Verification of improvement

①Ahead of a merger, the audit firm with the aim of finding out about the audit quality control system employed by the audit firm it was to merge with, held meetings with the PIOCQC at the audit firm it was to merge with, examined the results of its inspections by the CPAAOB, and so on.
However, the PICOQC, while aware that the audit firm that was the object of the merger had had numerous deficiencies point out during CPAAOB inspections etc., did not adequately assess whether the quality level of the firm was acceptable. For example, they did not specifically identify and analyze the nature and causes of the deficiencies.
(Quality Control Standards Committee Statement No. 1, paragraphs 15 and 16)

②The audit firm prepared a checklist of recommended improvements to be made in response to issues pointed out in quality control reviews etc., had engagement partners perform self-inspections using the checklist, and had the quality control division confirm that the self-inspections were being performed.
However, the confirmation performed by the quality control division only involved determining whether engagement partners had conducted checks, and did not adequately confirm whether the improvements made by audit teams were appropriate.

(Quality Control Standards Committee Statement No. 1, paragraphs 15 and 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/Implementation of Internal Rules and Compliance with Laws, Regulations, and Professional Standards

(1) Establishment/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 professional staff) and other personnel without fail, and ensures their familiarization with the rules, for example, by verbally explaining them as needed; and
- Whether the PICOQC or equivalent ensures compliance with the internal rules, for example, by having professional staff identify the status of compliance in a timely manner, as needed.

Outline of inspection results

In the establishment and implementation of internal rules, as shown in the case example section below, some firms did not establish internal rules related to organizational structure, independence, the provision of non-audit services, etc.. 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, that the audit firms adopted the template of the "Audit Quality Management Rules" that are provided by the Japanese Institute of Certified Public Accountants (below, "JICPA") as their internal rules without customizing them to their actual operation, and that they believed that did not need to be revised as no problems had occurred in the past.

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 and 16)

Case 2: Establishment of articles of incorporation and organizational rules

The CEO believed that the audit firm had not experienced any problems with administration since it had been established as a result of a merger in the past, so they did not investigate whether rules needed to be established or whether the statements in the current rules adequately took into account the size, circumstances, etc. of the firm. As a result, the articles of incorporation only prescribed "important matters pertaining to the operations of the audit firm" as matters requiring deliberation and resolution at a general meeting of partners," and rules etc. did not give specific examples or guidelines concerning "important matters."

Furthermore, there were no organizational rules, and there were no provisions concerning the relationships of organizations involved in quality control, such as the quality control division and quality control review division, nor were there provisions concerning the purposes, roles, positioning, etc. of important meetings.

(Quality Control Standards Committee Statement No. 1, paragraphs 17 and 18)

Case 3: Implementation of internal rules (conclusion of non-audit service contracts)

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 and 16)

Case 4: Implementation of internal rules (consultation)

NEW

Although quality control rules had been established, the CEO put no concrete structure in place for implementing fundamental policies and procedures on the consultation, including the matters requiring consultation and the procedures for carrying out such consultations.

(Quality Control Standards Committee Statement No. 1, paragraph 33; Auditing Standards Committee Statement No. 220, paragraphs 17 and F17-2)

《**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.

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

<u>Points of focus</u>

A variety of restrictions and obligations, etc., are imposed on certified public accountants and audit firms by the Certified Public Accountants Act (below, "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.

<u>Outline of inspection results</u>

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.

<u>Expected response</u>

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: Prohibition on competitive work by partners

NEW

Specific partners of the audit firm are carrying out operations (audit engagements) at their own

individual offices that fall within the scope of the audit firm's operations, having continued to do so since before they were appointed as partners of the audit firm, in violation of the Act that prohibits competitive work by partners. The audit firm also overlooked the fact that these partners are in violation of this Act.
(Article 34-14, paragraph 2 of the Act; Quality Control Standards Committee Statement No. 1, paragraph 19)

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; Ordinance for Enforcement of the Certified Pubilic Accountants Act, Article 25, Article 38, paragraphs 1 and 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.
(Article 34-5 of the Act)

《Points to Note》

Other deficiencies noted were that the internal rules did not stipulate the procedures for ascertaining whether operations that compete with the audit firm are being carried out as well as specific approval procedures for competitive work, that notices of changes to the articles of incorporation had not been filed by the statutory filing deadline, and that approval for conflict-of-interest transactions had not been given.

(3) Information Security

<u>**Points of focus**</u>

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; and
- ▶ Whether an information security manager ensures compliance with internal information security rules, for example, by continually monitoring whether professional staff (including part-time professional 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 professional 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;
- ▪ Managers, etc., responsible for information management do not properly understand their own professional responsibilities, and are not establishing rules suited to the actual use of information equipment at the audit firm;and
- ▪ 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; and
- The firm required all members to submit a "security policy compliance report," but some members failed to submit this report.

(Article 27 of the Act; Quality Control Standards Committee Statement No. 1, paragraphs 15 and 16; JICPA IT Committee Practical Guideline No. 4, III 1, IV 2, and5)

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.

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

Case 3: Handling of personal information

NEW

The audit firm has stipulated in its quality control rules the need to be mindful of laws and ordinances pertaining to the protection of personal information, and instructed audit teams to anonymize personal information obtained in the course of implementing audits if it is listed on audit documentation.

However, the CEO had not sufficiently established a posture on the protection of personal information, e.g., he had not specifically stipulated how personal information that might be obtained in the course of conducting audits was to be handled and how personal information obtained was to be managed, with the result being that personal information from some audit engagements was stored without being anonymized and personal information protection has not been thorough.

(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 professional staff 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.

In addition, there is a case in which an Internet server service provided by a major Internet-related company was being used as a file server in the absence of rules setting out necessary security measures for using the Internet server service in operations. It should be noted that the status of security measures should be examined when periodically evaluating service providers.

(4) 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” provided by the JICPA 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;and
- 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: 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.

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

《Points to Note》

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

- **The “Rules for Preventing Insider Trading” prohibit transactions involving specified securities etc. of business partners, and the “Code of Conduct and Ethics” prohibit excessive entertainment and gifts, but that is all. No comprehensive rules have been established;**
- **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.**

3. 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 fee dependency, 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; and
- 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, the deficiencies identified include the procedures for confirming independence stipulated in internal rules and elsewhere are merely being examined formally and not being implemented properly, as seen in audit firms that too easily conclude there are no problems regarding independence and that fail to carry out these procedures comprehensively even when they do implement them.

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 incharge.

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.Audit firms should carefully consider actual conditions when determining what if any degree of collusion impedes independence.

Case 1: Independence confirmation procedures for professional staff

Engagement partners had insufficient understanding of the firm’s quality control rules, and apart from audit team members involved in important operations, they mistakenly believed that it was unnecessary to confirm independence. As a result, independence confirmation procedures were not performed with respect to multiple assistants to engagement partners.

(Quality Control Standards Committee Statement No. 1, paragraph 20; Auditing Standards Committee Statement No. 220, paragraph 10))

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 conclusion of a new audit contract. 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 fee dependency

NEW

The fees received from an audited company accounted for more than 15% of the audit firm's total fees for two consecutive years, so the audit firm as a safeguard requested a CPA not a member ofthe audit firm to conduct a review after expressing the audit opinion. The audit fees from the audited company and the total audit fees from that company's consolidated subsidiaries were included in the numerator when calculating the degree of fee dependency from the audited company.
However, the audit firm had not established standards for determining "cases in which fees account for a certain percentage" and "cases in which the fees significantly exceed 15%" in its Interpretive Guidance for Professional Ethics, and had not considered whether these cases applied to the audited company. The audit firm had also not made assessments of related companies, etc., in keeping with the Interpretive Guidance for Professional Ethics, and had not considered whether there were any related companies, etc., that should be taken into consideration when calculating the degree of fee dependency.
(Guideline for Independence, Section 1, paragraphs 27, 220 and 222; Interpretive Guidance for Professional Ethics Q1 and Q13)

Case 6: Involvement period of engagement partners

NEW

The CEO of this audit firm was involved as an engagement partner in the audit engagements of a specific listed company and, during an interval period after having been replaced through rotation, he met alone with the top executive and the auditor of an foreign subsidiary that is a significant component of the company, communicating on key audit issues such as significant risks.
However, the PICOQC at this audit firm did not carry out an examination despite the fact that, because the foreig subsidiary that the CEO visited was a significant component, the engagement in which the CEO was involved constituted audit-related engagements prohibited during interval periods under the Act and very likely violated the Act.
(Article 34-11-3 of the Act; Ordinance for Enforcement of the Certified Public Accountants Act Article 9.3; Quality Control Standards Committee Statement No. 1, paragraphs 20 and 24)

4. 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 engagement 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 risks, including questions regarding the integrity of the top management of the audited company (note that it interviewing managers is an effective way of assessing their integrity);
- 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 risks;
- Whether the audit firm retains professional staff having sufficient knowledge, experience, capabilities and competence required to deal with the specified engagement 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 specific procedures for assessing engagement risks have been established, and whether engagement risks have been appropriately assessed;

- Whether identified engagement risks have been properly reflected in the audit plans for individual audit engagements;
- 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; and
- Whether engagement risks are being assessed and approvals within the audit firm are being conferred in a timely and appropriate manner.

<u>Outline of inspection results</u>

Among the deficiencies identified were that, although accepting and continuing audit contracts are core management decisions at audit firms, information on the integrity of the client, risk information ascertained about the audited companies and other information obtained by the (prospective) engagement partners was not shared with persons authorized to approve the acceptance and continuance of engagements (partners' meetings, etc.) and proper risk assessments were not carried out, and that insufficient consideration was given to the audit resources needed to conclude a contract.

Causes for the deficiencies:

- The prospective engagement partners gave greater priority to quickly concluding audit contracts and quickly getting started on the engagementthan to carrying out careful risk assessments and resolving issues in a timely and appropriate manner;
- 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 assessengagement aceeptance risks based on facts found in a preliminary audit or information provided by the predecessor auditor; and
- When discussing a proposed engagement, the partners did not recognize how important it was for the audit firm to assess the risks associated with the proposed engagement based on information gathered by the predecessor auditor, and the partners other than the prospective engagement partner 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 of the engagement acceptance to carefully determine the status of internal control relating to prevention of fraud. Under such circumstances, the prospective engagement partner not only obtained information from internal personnel such as the management, but also gathered detailed and objective information in order to corroborate the management's insists, 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

Bearing in mind that decisions on the acceptance and continuance of audit engagements are core management decisions at audit firms, audit firms in carrying out the procedures for assessing engagement risks, etc., must identify engagement risks based on the integrity of the client and the information obtained on risks and other aspects of the audited companies, examine the response measures taken as an audit firm to address these, and then verify the design and operation of policies and procedures for acceptance and continuance of audit engagements from the perspective of whether a new engagement has been approved.

Note that in recent years there have been many cases of audited companies switching their auditors from large-sized audit firms to mid-tier audit firms or small and medium-sized audit firms. In particular, if the background etc. to the replacement of auditors indicates that the audit engagement risk associated with the audited company is high, more caution needs to be exercised.

Case 1: Risk assessment procedures when accepting new audit engagements

NEW ①The audit firm in its “Audit Quality Management Rules” stipulated that audit engagements are to be accepted only when the integrity of the client has been examined and there are no significant issues that would adversely impact the acceptance of an engagement.

The prospective engagement partner assessed the integrity of management in a meeting with the administrative director.

However, the prospective engagement partner did not include information for assessing the integrity of the director in his memorandum on his meeting minutes and did not carry out the assessment procedures. The prospective engagement partner also did not assess the integrity of executives other than the administrative director or of key shareholders, company auditors, etc.

(Quality Control Standards Committee Statement No. 1, paragraphs 25, 26, F26-2, and 27; Auditing Standards Committee Statement No. 220, paragraphs 11, F11-2, and 12)

NEW ②The engagement team had determined that there were events or conditions that might cast significant doubt on the going concern assumption, as the audited company had been posting operating losses continuously and had violated the financial covenants of a commitment line contract concluded with a correspondent financial institution.

However, the engagement partner did not deem these circumstances or situations risks that should be considered in continuing the audit engagement. The partners’ meeting that has a role in approving the continuation of audit engagements approved the continuation of the audit engagement without sufficiently confirming with the engagement partner the events or conditions that might cast significant doubt on the going concern assumption.

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

Committee Statement No. 220, paragraph 11)

③The “Policies and Procedures for the Conclusion of New Contracts” established by the audit firm had just been copied from Quality Control Standards Committee Statement No. 1 (Quality Control at Audit Firms) and Auditing Standards Committee Statement No. 220 (Quality Control at Audit Firms), with specific procedures not having been established.

Furthermore, the prospective engagement partner did not take appropriate action. For example, they did not identify the fact that the accounting of the audited company was mainly performed by a single individual, which constituted a vulnerability in the accounting system, as an engagement risk. Moreover, even though they identified the fact that the company they were considering accepting the engagement from had committed fraud in the past, they accepted the appointment before the process of considering what to do had been completed.

(Quality Control Standards Committee Statement No. 1, paragraphs 14, 25, 26, and F26-2; Auditing Standards Committee Statement No. 220, paragraphs 11, and F11-2)

④Despite planning to rely on the audit results from the auditor of an foreign 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 component auditor had not been confirmed. Furthermore, even though materials attached to the request to approve the engagement stated that the auditor of the foreign 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)

Case 2: Risk assessment procedures when continuing audit engagements

NEW

This audit firm required approval by the partners’ meeting to accept or continue audit engagements. Although it was recognized at the time that the audit opinion was expressed that audit risks could rise because the engagement partner was unable to obtain sufficient information from the audited company on the preparation of financial statements, etc., including the records and documents needed in order to express an audit opinion, the engagement partner received approval from the partners’ meeting for continuing audit engagements in the next fiscal year without disclosing this concern to the partners’ meeting.

(Quality Control Standards Committee Statement No. 1, paragraphs 25 and 26; Auditing Standards Committee Statement No. 220, paragraph 11, and No. 260, paragraph 16)

《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. There were also cases where appointments as accounting auditor were accepted based on the belief that if, even after accepting the appointment, the results of performing the necessary engagement risk assessment procedures revealed problems, the acceptance could be easily withdrawn.

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.

It should be remembered that the methods for obtaining information on the integrity of participants must be examined with reference to the following from Quality Control Standards Committee Statement No. 1, paragraph A17.

- **Communication with persons, etc., who are currently providing, or who have provided in the past, accounting- and audit-related operations as a professional expert to the counterparty**
- **Questions for persons within the audit firm, and for third parties such as financial institutions, legal experts, and other companies within the counterparty's industry**
- **Background investigation using databases, etc., inside and outside the audit firm**

Case 3: Ensuring the necessary audit days

NEW

In estimating the expected audit days for the purpose of accepting new audit engagement, the prospective engagement partner did not consider if the expected audit days were adequate in comparison with predecessor auditor's audit days. The prospective engagement partner also did not report to the basis of its estimation- to the partners' meeting, the body that approves the acceptanceof audit engagement.

Despite the fact that the audit fee estimate presented by the prospective engagement partner was substantially lower than the audit fees charged by the predecessor auditor, the partners' meeting overlooked the fact that the prospective engagement partner had not sufficiently considered whether the expected audit days were adequate in comparison with predecessor's audit days.

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

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 and 26; Auditing Standards

Committee Statement No. 220, paragraph 11)

《Points to Note》

In addition to the above, there were cases in which, despite it being recognized when assessing contract risks in continuing audit contracts that management had not provided necessary information during the previous year's audit, the integrity of management of the audited company was not considered based on indications of inappropriate limitaionin the scope of work, such as restrictions on the scope of audit, and cases in which the integrity of managaement of the audited company was not considered based on responses being taken to address the disclosures of significant deficiencies, even though it was determined that there were significant deficiencies in entity level controls and process level controls

It should be noted that decisions on accepting or countinuing audit contracts should only be made after identifying engagement risks on the basis of information ascertained and considering response measures to these risks.

Case 5: Risk assessment procedures when accepting amendment audit engagement

A restatement audit engagement-coverring multiple fiscal yearsa was accepted shortly before the audit report deadline and, despite the difficulty of borrowing audit documentation from the predecessor auditor and evaluating the adequacy of the predecessor auditor's audit procedures, the time and human resources needed for the audit were not sufficiently analyzed in accepting the engagement

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

《Points to Note》

Recent years have seen more than a few instances of listed companies being prompted by the discovery of inappropriate accounting treatments to submit amendment reports of annual securities reports and, as is the case with ordinary financial statement audits, appropriate quality control of amendment audits must be ensured from the decision on whether to accept an engagement until submission of the audit report. When amendments of financial statements covering multiple fiscal years are anticipated, compared to ordidary audit engagement, it must be noted that the auditor may need more time to obtain sufficient appropriate audit evidence, making it more likely that the audit will not be completed per the initial planned audit schedule.

(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 auditor with useful information that can be used when the prospective 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 prospective 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 audit opinion, whether the predecessor auditor provides such information to the successor auditor;
- Whether the prospective 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 prospective 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; and
- Whether in cases where the conclusion of audit contract has been canceled or an existing contract has been terminated in response to illegal conduct, the predecessor auditor, pursuant to a request from the prospective auditor, provides the prospective auditor with all facts and information concerning confirmed and suspected illegal conduct that the predecessor auditor deems that the prospective auditor needs to know prior to determining whether an audit engagement can be accepted.

<u>Outline of inspection results</u>

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 prospective auditor in a sufficient and accurate matter.

In addition, the prospective 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 needs to be properly conveyed. In particular, important audit-related matters such as fraud risk, should be fully and clearly communicated from the predecessor engagement team to the successor engagement team.

Case: Inquiries, etc., to the predecessor auditor

The prospective engagement partner accepted a new audit engagement for a fund from the predecessor auditor of this audited company.

The person in charge of the fund had run a similar fund in the past, and the prospective engagement partner had accepted an audit engagement from them at that time. Furthermore, when inquiries were made during the handover of the similar fund, important matters were not conveyed by the predecessor auditor.

Accordingly, the (prospective) engagement partner determined that it was not necessary to make inquiries to the predecessor auditor again and he thus did not make inquiries to the predecessor auditor regarding a fund that was considering to accept the audit engagement.

(Auditing Standards Committee Statement No. 900, paragraph 9)

《Points to Note》

In addition to the above, there have been cases in which a sharp increase in the number of new audit contracts following the business expansion has meant that consideration pertaining to handover the audit engagements in accordance with rules established by the audit office were not carried out by the deadline. 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.

5. Recruitment, Education and Training; Evaluation and Assignment

(1) Recruitment, Education and Training

Points of focus

During its inspections, the CPAAOB investigates, from the following perspectives, whether the audit firm has established and is following policies and procedures concerning the recruitment of audit team members:

- Whether specific policies and procedures concerning recruitment have been established, and whether they are being properly implemented as prescribed.

Furthermore, 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; and
- 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, when recruiting professional staff, emphasis was placed on the administration of the audit division rather than the administration of the audit firm as a whole, so recruitment was sometimes unsuited to the audit firm as a whole.

Furthermore, deficiencies in education and training for professional staff were observed, with some firms not providing effective training programs and others failing to provide opportunities for education and training in areas that require special knowledge, such as the auditing of financial institutions.

Causes of the deficiencies included a lack of awareness of the need to establish an education and training system for the firm as a whole. There were cases, for example, of 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.

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 ensure 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, when recruiting professional staff, need to make appropriate estimates of the number of personnel they require in light of factors such as the current workload, the number of new audit engagements expected to be accepted, and the number of professional staff expected to leave the firm in the future.

Furthermore, when providing education and training for professional staff audit firms must maintain and improve the competence and capabilities of their audit teams (including part-time and unqualified audit team members). 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: Recruitment of staff

Due to the circumstances surrounding its establishment, the audit firm is divided into two divisions, and in one of the divisions insufficient time is made available for audit documentation review, engagement quality control review, and quality-control-related tasks, as engagement partners are busy with performing audit procedures for the accounts they are in charge of. Despite this situation, the CEO makes decisions regarding the hiring of professional staff based on the P/L of each division, and is failing to optimize recruitment for the firm as a whole.

(Quality Control Standards Committee Statement No. 1, paragraphs 17, 28, and A20)

Case 2: Effectiveness of training

NEW

①The audit firm has stipulated that a partner designated as an instructor will decide on the contents of training, and has not required that training be tailored to partners' and assistants' level of understanding of audit standards. In particular, the audit firm has not established an education/training environment that would make it possible to conduct audits in line with the fraud risks at the audited company, as indicated by the fact that the training stipulated in Auditing Standards Committee Statement No. 240 ("The Auditor's responsibilities Relating to Fraud in an Audit of Financial Statements") was not being adequately conducted.

(Quality Control Standards Committee Statement No. 1, paragraphs 28 and F28-2)

②Training conducted by the division in charge of quality control involves nothing more than showing a DVD of issues that have been identified, and does not reflect the causes of issues identified during quality control reviews or problems discovered through reviews by engagement partners and engagement quality control reviews conducted by the division in charge of engagement quality control reviews.

(Quality Control Standards Committee Statement No. 1, paragraphs 28, A21, and A22)

Case 3: Education and training of part-time professional staff

The PICOQC and the person in charge of training believed that because most of the part-time staff had experience of audits at large-sized audit firms, there were no problems with their ability, and therefore did not provide training on audit standards.

(Quality Control Standards Committee Statement No. 1, paragraphs 28, A21,and A22)

《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 an education and training fully considered on audit experience, the audit engagements, and audit standards that were newly introduced;**
- **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; and**
- **Audit firms did not follow up on personnel who had been absent from training sessions.**

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 audit teams 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:

- How 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 audit team members based on competence and capabilities as professional ,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 professional staff 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

The audit firm has established guidelines as a procedure for evaluating partners and reflecting their evaluations in their compensation, and prescribes that compensation be determined following discussions among the representative partners based on comments from evaluators and the results of personnel evaluations.

However, the person in charge of engagement quality control review and the PICOQC did not perform evaluations of each partner in the area of quality control, and therefore contributions to improving quality control were not taken into account.

Furthermore, while the guidelines prescribe that discussions among the representative partner should take place for the purpose of determining the compensation of each partner based on their evaluations, it was not made clear what should actually be discussed, and discussions did not even occur.

(Quality Control Standards Committee Statement No. 1, paragraphs 17, 28, A20, and A24)

Case 2: Evaluation of part-time professional staff

NEW

All partners at the audit firm were to carry out evaluations of part-time professional staff and, based on the results of these evaluations by partners, to decide through discussions at the partners' meeting the compensation of part-time professional staff engaged in audits.

However, the CEO and the PICOQC had not made clear the specific assessment items, the assessment methods and the quality control items to be emphasized in making assessments when

deciding on the compensation of non-full-time workers, and had not developed an effective environment for assessing non-full-time workers.
(Quality Control Standards Committee Statement No. 1, paragraphs 28, 29 and 30)

《Points to Note》

In addition to the above, there are cases involving the evaluations of engagement partners in which the audit firm have not engaged in sufficient monitoring of the audit engagements in which these partners are involved, despite concerns having been identified about these persons' quality control capabilities, etc. Although internal rules on quality control stipulate that the compensation of the professional staff is to be decided by the partners' meeting, deficiencies in the administration of the partners' meeting have been identified, among them being decisions made by the CEO or others instead of by the partners' meeting.
There have also been cases in which personnel evaluations of part-time professional staff engaged in audits were conducted in the same way as for full-time professional staff but the results of these personnel evaluations were not sufficiently reflected in promotions/demotions and the composition of engagement teams out of concern that harsh treatment of part-time professional staffmight lead to the resignation of, which would impede audit engagements.
Evaluation, compensation, promotion, etc., are vivid illustrations of the CEO's management policies, and they also have a major impact on an audit firm's climate. The importance of this must be given due consideration when seeking to formulate appropriate policies and procedures and implement them.

(3) Assignment

Points of focus

When assigning professional staff to audit engagements, audit firms must select audit practitioners 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 with the required competence and capabilities are assigned to individual audit engagements;
- Whether, when assigning audit practitioners (including engagement partners), sufficient examinations are made for each audit practitioners regarding the time that can be spent on assigned audit engagements, understanding professional standards and laws, practical experience, abilities, etc.; and
- Whether, if a merger etc. has occurred, audit teams members (including engagement partners) are being appropriately assigned, regardless of their affiliation prior to the merger, from the standpoint of forming appropriate engagement teams for the audit firm as a whole.

Outline of inspection results

Deficiencies were observed in assignments, 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 audit practitioners competence/capabilities and experience, or the performance capability of the audit firm as a whole; and
- 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 audit practitioners 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. Note that if a merger etc. has occurred, an integrated response is required for the audit firm as a whole.

Case 1: Assignment of engagement partner

①The 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 and 30)

②With 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 evaluation required for the assignment of engagement partners. As a result, he/she did not perform an evaluation to confirm whether engagement partners had the 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 and 29)

③When appointing engagement partners, the CEO of the audit firm is supposed to take into account not only restrictions on the number of years of involvement, but also factors such as the level of difficulty of the results of audit engagement and quality-related personnel evaluations.

However, even though factors such as the size of business and degree of internationalization of companies audited by each audit division and the periods of engagement of each partner differed, the CEO appointed engagement partners for each audit division, which had been independent audit firms prior to the merger, and did not consider audit risk for the firm as a whole and whether enough time could be secured to complete engagements.
(Quality Control Standards Committee Statement No. 1, paragraphs 17, 30, A26, and A27)

Case 2: Composition of engagement team

①Engagement partners, when assigning audit assistants to each engagement team, did not consider whether the staff 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 and 30)

②The 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)

6. Audit Documentation

(1) Preparation of Audit Documentation and Supervision/Review by Superior

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 of audit documentation and supervision/review by superiors from the following perspectives:

- Whether the audit firm has prescribed the information and techniques required for audits and informed audit teams of them;
- Whether engagement partners, during the process of conducting an audit, properly supervise the audit engagement by monitoring the progress of the audit engagement, finding out about important matters, etc. through the review of audit documentation and discussions with engagement teams;
- Whether professional staff prepare audit documentation in such a way to sufficiently describe the types of audit procedures performed in accordance with the auditing standards generally accepted in Japan, the nature, the timing and scope 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; and
- 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 of audit documentation and supervision/review by superiors, 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 sfficiently 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 supervise assistants to engagement partners or 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; and
- The engagement partner did not sufficiently understand audit procedures through review of audit documentation and obtained oral explanation or equivalent from the assistants to the engagement partner.

(Observed effective efforts)

The following case constitutes an effective effort observed at an audit firm.

The audit firm has divided up audit engagement processes granularly into detailed work tasks and documented the content, timing, workload, persons in charge, etc., of each work task, making it possible to carefully manage the progress of audit engagements by engagement partners, and it is conducting suitable and timely reviews of audit documentation as well as providing supervision and guidance to assistants to engagement partners.

Expected response

Some firms did not prepare audit documentation so that the audit procedures performed 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; and
- 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 engagement partner believed that experienced auditors would be able to adequately understand what had been examined by providing serial numbers for documents filed and check marks indicating whether procedures had been followed. Because of this, with regard to audit documentation relating to the evaluation of internal control, even though documents obtained from the audited company had been filed, there was no appropriate description of audit procedures performed with respect to the documents. Furthermore, with regard to audit documentation concerning the use of real-estate appraisal documents, the documentation contained conclusions related to the audit procedures but did not contain appropriate descriptions of 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 and 8)

Case 2: Review of audit documentation

NEW

①The engagement partner himself prepared audit documentation and reviewed audit documentation prepared by other engagement partners and assistants to engagement partners.

Because preparing the audit documentation for which he was responsible was time-consuming and sufficient time had not been allotted him for reviewing audit documentation, however, the engagement partner did not adequately confirm if other engagement partners and assistants to engagement partners had carried out suitable audit procedures in dealing with risks and if they had obtained sufficient appropriate audit evidence.

(Quality Control Standards Committee Statement No. 1, paragraphs 31 and A31; Auditing Standards Committee Statement No. 220, paragraphs 15 and 16)

②Engagement 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 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 and 16)

Case 3: Instructions to and supervision of assistants to engagement partner

The engagement partner believed that because the part-time professional staff that performed procedures had audit experience at a large-sized audit firm, they must have carried out the required procedures, and even though audit procedures covering accounts such as sales, which are important audit items, had been assigned to the part-time professional staff, the engagement partner overlooked the fact that the part-time professional staff had failed to perform certain substantive procedures with respect to sales. In this way, the engagement partner did not give adequate instructions and provide adequate supervision to assistants to the engagement partner.

(Quality Control Standards Committee Statement No. 1, paragraphs 31 and A30)

《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 assistants to engagement partners, 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 assistants to engagement partners conform to the current audit standards.

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

<u>Points of focus</u>

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; and
- Whether the audit firm secures the confidentiality, safe custody, integrity, accessibility, and retrievability 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

NEW

①The audit firm set out policies and procedures for the final assembly of audit files in its quality control rules and stipulated a deadline by which the final assembly of the audit files had to be completed.

However, the CEO and the PICOQC did not confirm if the final assembly of the audit files had been completed by the deadline set by the engagement partner.

(Quality Control Standards Committee Statement No. 1, paragraph 44)

②Because audit teams were not adequately aware that all audit documentation needed to be stored in files, they did not allow enough days in their schedules for the final assembly of audit documentation, and communication concerning the assembly of audit documentation was also insufficient. Furthermore, the quality control division had not standardized procedures for the final assembly of audit documentation, and had not prepared prescribed forms etc. Because of this, final assembly of audit documentation was not performed. For example, details of tasks performed were just left saved on the PCs of audit team members.

(Quality Control Standards Committee Statement No. 1, paragraph 44; Auditing Standards Committee Statement No. 230, paragraph 13)

《Points to Note》

In addition to the above, there are cases in which audit firms had not set out specific provisions on such matters as procedures and persons responsible for the final assembly of audit files, cases in which only the audited companies' names, the fiscal years and the total number of audit files were managed, with the contents of audit documentation stored in the audit files left unknown, and cases in which audit documentation had not been suitablycarried forword , despite the fact that the suitability of the audited company's accounting policies had been examined in previous fiscal years in individual audit engagements.

7. 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; and
- Whether it has been appropriately documented that the procedures required by the audit firm's EQCR policies have been implemented, that the EQCR was completed before date of the auditor's report, and that there were no items deemed improper among the significant audit judgements made by the engagement team and among the conclusions it reached.

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 EQC 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/she 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; and
- 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)

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

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.

<u>Expected response</u>

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)

Case 2: Ensuring the effectiveness of EQCR

NEW

①The EQC reviewer and the members of the review board selected by the collegial system read over the EQCR request form prepared by the engagement team and confirmed the audit procedures carried out and the audited company's assertions via an oral explanation from the engagement team and, determining thereby that the engagement team had obtained sufficient appropriate audit evidence, they did not sufficiently review the audit documentation themselves. The EQCR division manager also did not carefully ensure that the EQC reviewer and the members of the review board had reviewed the audit documentation relating to the significant judgement and conclusions made when conducting the EQCR.

(Quality Control Standards Committee Statement No. 1, paragraphs 36, 37 and A41; Auditing Standards Committee Statement No. 220, paragraphs 19 and 20)

NEW

②The EQC reviewer received an explanation on significant audit matters from the engagement partner prior to the EQCR for formulating the auditor's report and, believing that there were no issues that needed to be pointed out to the engagement team upon completion of these discussions, he relied excessively on the engagement partner's explanation. Accordingly, the EQC reviewer did not fully review audit documentation whether the engagement team had obtained sufficient appropriate audit evidence and made appropriate judgments, and did not consider the significant audit judgments made.

(Quality Control Standards Committee Statement No. 1, paragraphs 36 and 37; Auditing Standards Committee Statement No. 220, paragraphs 18, 19, and 20)

③The audit firm had not established an effective environment for quality control reviews. For example, the firm had the bulk of EQC reviews performed by specific EQC reviewers, so some EQC reviewers became pressed for time in conducting their EQC reviews, and they did not confirm that sufficient appropriate audit evidence had been obtained relating to important judgements made by audit teams.

(Quality Control Standards Committee Statement No. 1, paragraphs 36 and 37; Auditing Standards Committee Statement No. 220, paragraphs 19 and 20)

《Points to Note》

The EQC reviewer needs to ensure not only whether the accounting processes were suitable but also whether sufficient appropriate audit evidence was obtained, and to make objective evaluations by reviewing audit documentation and making records of the explanations offered by the engagement team.

Sending the necessary audit documentation ahead of time and other such steps are particularly necessary when a head office EQC reviewer located remotely, etc., carries out reviews of regional offices via a videoconferencing system, etc.

The audit firm must also ensure that, even if it consigns an EQCR to a CPA outside the audit firm, the steps required to be taken are the same as those when selecting a EQC reviewer from within the audit firm.

8. 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 ensuring and improving 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.

Furthermore, to confirm that an appropriate and adequate QC system has been established and is being implemented effectively, it is essential to accept statements of objection and doubt concerning violations of laws, regulations, and professional standards as well as breaches etc. of the QC system from inside and outside the audit firm. It is also necessary to conduct investigations based on this information, to take appropriate corrective action, as required, in the same way as in the case of deficiencies identified during day-to-day monitoring and evaluations of the QC system.

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; and
- 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 audit teams and inspecting audit documentation, not only by formal inspection using the checklist, etc.;
- Whether the audit firm selects target engagements 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; and

- Whether the audit firm analyzes the deficiencies identified as a result of inspections, and communicates the result of the analysis throughout the firm.

Statements of objection and doubt are investigated from the following perspectives:

- Whether an appropriate system for a statements of objection and doubt has been established;
- Whether statements of objection and doubt that have been received are properly investigated; and
- Whether appropriate corrective action is taken in response to the results of investigations of statements of objection and doubt.

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

The audit firm is required to establish and operate a system that adequately performs the inherent monitoring functions of a systeme of quality control, i.e., that enables issues with the system of quality control to be discovered/ascertained by the audit firm itself and corrective measures to be put in place voluntarily.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 qualified 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.

Furthermore, a system for ensuring that statements of objection and doubt are received in a timely fashion and that investigations are conducted as necessary needs to be established and implemented. For example, a system for receiving reports from whistleblowers both inside and outside the audit firm could be established.

Case 1: Effectiveness of ongoing monitoring

NEW ①The manager responsible for ongoing monitoring of the quality control system monitored among other things compliance with policies and procedures for the acceptance and continuance of client relationships.

This manager was also supposed to use an ongoing monitoring checklist to confirm the items checked in advance by the CEO and read over any relevant materials, etc., deemed necessary to peruse.

However, the manager responsible for ongoing monitoring only checked on the existence of relevant rules, etc., based on the checklist and did not confirm the rules' provisions and so did not carry out effective ongoing monitoring, as evidenced by his failure to discover during his ongoing monitoring any deficiencies in the establishment and enforcement of internal rules, etc.

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

Case 2: Effectiveness of periodic inspection

NEW ①The audit firm stipulated in its "Audit Quality Management Rules" that only persons not involved in conducting or reviewing audit engagements subject to inspection were to be selected to carry out periodic inspection. However, the PICOQC selected a partner who had served as an assistant to engagement partners for audit engagements subject to inspection because he thought this partner would be able to carry out the inspection efficiently.

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

NEW ②The person responsible for periodic inspection carried out periodic inspection of audit engagements based on a periodic inspection checklist, but he focused primarily on inspecting the suitability of the accounting processes and disclosures and did not inspect these in terms of the sufficient appropriate evidence. He also carried out inspections mostly through interviews with engagement teams and did not carry out objective inspections by review the audit documentation.

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

③The partner in charge of periodic inspections merely provided inspection assistants with checklists for conducting periodic inspections, failing to inform them of specific points to focus on, for example. Furthermore, despite the fact the deficiencies detected were almost all related to documentation, and that no deficiencies concerning, for example, the adequacy and appropriateness of audit procedures, were identified, the PICOQC did not evaluate the effectiveness of the periodic inspections.

(Quality Control Standards Committee Statement No. 1, paragraphs 47 and 48)

④The PICOQC just post a list of deficiencies detected during periodic inspections and the improvement measures required on a noticeboard in the office, so these matters were not communicated adequately. Furthermore, the descriptions of the required improvement measures only covered the procedures that needed to be followed to address the identified deficiencies. They were not based on the causes of the deficiencies.

Furthermore, confirmation of the status of improvements was limited to operations subject to periodic inspections, and the status of improvements with operations not subject to periodic inspections was therefore not confirmed.
(Quality Control Standards Committee Statement No. 1, paragraphs 49 and 50)

《Points to Note》

In addition to the above, there were deficiencies in persons being selected to carry out periodic inspection without consideration for their abilities with regard to audit quality, in a system being implemented that tended to lead to collusion, e.g., a majority of partners were selected as partners to carry out periodic inspection and carried out inspection among themselves, and in selecting inspection operations, e.g., the audit engagements of specific engagement partners were not targeted for 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 person in charge of periodic inspections.
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.

Case 3: Statements of objection and doubt

Even though the representative partners were receiving information about fraud at audited companies via a hotline, they did not inform the PICOQC of the information they had obtained.
Furthermore, even though the "Audit Quality Management Rules" stated that engagement partners in charge of audited companies should report how they investigated information received from inside and outside the firm to the division in charge of quality control in writing, they did not make such reports.
(Quality Control Standards Committee Statement No. 1, paragraph F54-2)

9. Cooperation with Company Auditors

(1) Cooperation between Accounting Auditors and Company Auditors

Points of focus

Accounting 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.

Given the importance of the aforementioned collaboration between the accounting auditors and company auditors, in CPAAOB inspections, policies on communication with company auditors, and on responses when fraud, etc., is discovered, have been suitably stipulated, and inspection of this implementation system is conducted from the following perspectives:

- Have suitable provisions been stipulated requiring timely communication with company auditors, and the sharing of necessary information when planning audits, when conducting them and when reporting audit results to enhance each other's audits?;
- Has a system been put in place whereby basic forms and samples are prepared and suitable explanations of the results of CPAAOB inspections and the results of quality control reviews made in writing to audited companies?;and
- Have policies and procedures been suitably stipulated to ensure compliance by assigned specialist personnel with guidelines on dealing with violations of law?

Inspection of communications with company auditors are carried out from the following perspectives:

- Is communication clearly being carried out with company auditors, on the auditor's responsibilities pertaining to the audit, the scope of the planned audit, and an overview of its timing? ;
- Are explanations of the results of CPAAOB inspections and quality control reviews being suitably provided in writing to audited companies? ;
- Is information on audits being properly obtained from company auditors? ;
- Are important issues pertinent to the responsibilities of the company auditors overseeing the financial reporting process that are discovered during audits being conveyed in a timely manner to company auditors, etc.?;and
- Are accounting auditors and company auditors cooperating and engaging in effective two-way communication?

Outline of inspection results

The need for collaboration between accounting auditors and company auditors has been widely accepted among the personnel involved, an environment for communication between these auditors has been established and maintained, and regular communication is being encouraged, despite disparities in the depth of the collaboration itself.

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 the QC review from the JICPA, but they did not communicate the results of the QC 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."

Auditing Standards Committee Statement No. 260 ("Communication with Company Auditors) revised in February 2019 specifically seeks to enhance communication on particularly important matters when conducting audits, and it concretely manifests provisions on communication with company auditors, e.g., specifically describing the details to be conveyed to company auditors, regarding the results of quality control reviews and CPAAOB inspections and disciplinary actions taken by regulatory authorities and JICPA, as well as the methods by which this information is to be conveyed, as part of explanations of the establishment and administration of accounting auditors' quality control systems (Note 1, Note 2).

Accounting auditors need to improve the effectiveness of audits through information sharing with company auditors about every stage of the audit – from the drafting of an audit plan to the implementation of audit procedures and the formation of an auditor's opinion – and circumstances identified in the process, exchange views on audit quality control issues highlighted in the results of CPAAOB inspections and quality control reviews, and actively promote collaboration with company auditors. This collaboration will help ensure and improve audit quality as well as enhance/strengthen corporate governance at audited companies.

The Revised Accounting Standards of 2018 required that key audit matters ("KAM") be included in auditor's reports. KAM are to be determined from among those matters discussed between accounting auditors and company auditors and the introduction of KAM has made in-depth communication between accounting auditors and company auditors all the more important.

Furthermore, Auditing Standards Committee Statement No. 701 ("Reporting on KAM in Accounting Auditors' Audit Reports") released in February 2019 stipulated that auditors are to communicate with company auditors, on KAM, while the Auditing Standards Committee Statement No. 260 ("Communications with Company Auditors") was revised in February 2019 to address KAM. It is thus necessary to understand these standards as well.

Audit firms need to build systems to support engagement teams so that engagement teams can suitably pursue effective two-way communication with company auditors.

(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 1: Cooperation with company auditors

NEW

① The engagement partner did not sufficiently understand the audit standards pertaining to communication with company auditors and thus did not convey to company auditors the details of and the steps taken in response to the “Quality Control Review Report” and the “Follow-up Review Report” received from JICPA, which is information that is very useful for company auditors when selecting accounting auditors.
(Quality Control Standards Committee Statement No. 1, paragraphs 25 and 26; Auditing Standards Committee Statements No. 220, paragraph 11, and No. 260, paragraphs 16 and A31)

② Although an engagement partner identified risks of material misstatement due to fraud when formulating the audit plan, in light of the situation with the conduct of the audit during the term, they deemed that there was no risk of material misstatement due to fraud, and altered the audit plan. However, the engagement partner was not adequately aware of the importance of properly informing corporate auditors etc. of the risks of material misstatement due to fraud that they had identified, and provided them with details of the risk assessment before the alteration of the audit plan.
(Auditing Standards Committee Statement No. 260, paragraphs 13, 20, and 22)

Case 2: Notifications to company auditors

NEW

The auditor from a component of an audited company belonging to the same network as the engagement team and the audit firm provided audit and non-audit services to the audited company and components of the audited company. The engagement team in its explanation of the implemented audit plan to company auditors presented an estimate for audit fees for the target audit period.

However, he did not notify company auditors in writing of the finalized amount of audit fees for the target audit period for the audit firm and domestic/overseas network firms or of information on fees for non-audit services.

(Auditing Standards Committee Statement No. 260, paragraphs 15 and 18)

《Points to Note》

In addition to the above, deficiencies were noted in that significant risks were only listed by item name in the audit plan, with no explanation offered to company auditors of the specifics of these items or the reasons they were identified, and in that communication with company auditors, etc., had not been perused on the scope of the planned internal control audit or on overall audit timing.

Auditors needs to ensure that communication must be maintained with company auditors on the scope of the planned audit, the overall timing, the nature of significant risks and the reasons they were identified.

When communicating verbally with company auditors, auditors must ensure to note in the audit documentation when, with whom, and on what topics this communication took place.

(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 of the Financial Instruments and Exchange Act, below "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)

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

Thoroughgoing efforts are being made to familiarize partners, etc., e.g., examples of notifications to be sent to company auditors of audited companies when facts indicative of a non compliance have been discovered are being presented.

Additionally, as a result of the audit firm having provided notice to an audited company in accordance with FIEA Article 193-3 about matters that could adversely impact the legitimacy of financial documents, the audited company receiving this notification revised its quarterly report and sought to reinforce its systems for suitable 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.

A support system for engagement teams must also be developed to allow these teams to suitably consult expert opinions, etc., when making audit judgments about fraud or non compliance.

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 examples of identified deficiencies that parallels Auditing Standards Committee Statements, and it begins by introducing "The Auditor's Responsibilities Relating to Fraud in Financial Statement Audits" not only because standards naturally require careful responses when dealing with fraud risks in audits but also because, as seen in recent incidents, accounting fraud has been garnering attention from society at large.

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 relevance of further audit procedures to audit risk and the sufficiency and appropriateness of audit evidence;
- Lack of an attitude of professional skepticism required of an auditor; and
- Insufficient knowledge of audit standards and the Auditing Standards Committee Statement.

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

(Reference case) Extent of test of details—Case where the sufficiency and appropriateness of audit evidence 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)

As the above example shows, there are many cases where it is not clear whether sufficient appropriate audit evidences were obtained from audit procedures performed by engagement teams. These deficiencies resulted from the fact that engagement teams did not sufficiently consider audit procedures and audit evidence 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.

When performing audit procedures, it is required under audit standards to develop and perform procedures in response 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.

(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's insists, 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 accounting treatment, due to a lack of professional skepticism. Similarly, at some audit firms there were cases where sufficient appropriate audit evidence was not obtained 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) Group audits – example of required matters not being addressed

Although the component auditor did not describe in his report the scope and timing of the audit procedures he had performed relating to significant risks as well as the specific audit procedures by which he had concluded that there were no abnormal journal entries made, etc., the group engagement team concluded that the work of the component auditor was appropriate even though it had not reviewed audit documentation, etc. to ascertain or examine specific audit procedures.

(Auditing Standards Committee Statement No. 600, paragraphs 30, 41 and 43)

In the above cases, deficiencies were noted in that the following audit procedures required of the group engagement team had not been carried out:

- The group engagement team should have evaluated the appropriateness of futher audit procedures performed by the component auditor to address significant risks pertaining to group financial statements
- The matters reported by the component auditor should have been evaluated assessed

(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 group audit and substantive analytic procedures described as an example, there tend to be many deficiencies due to the non-performance of requirements in areas such as those below:

- 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. 240, No.540);
- Audit procedures for transactions with related parties (Auditing Standards Committee Statement No. 550);
- Using the work of internal auditors (Auditing Standards Committee Statement No. 610); and
- Using the work of an auditor’s expert (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 ensure and improve 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. 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 suspected material misstatement due to fraud exists; and
- Whether the engagement team communicates with company auditors who supervise the execution of duties by directors, if it determines that suspected 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 suspected 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)

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

- The audited company ran a manufacturing business and had multiple regional sales subsidiaries. These sales subsidiaries only sold products purchased from the parent company to customers, and they used a sales management system shared in common with the parent company to recognize revenue.

  Because of the commonality in revenue types and transaction formats between the parent company and its sales subsidiaries, the group engagement team conducted a centralized risk assessment and proposed risk-related audit procedures to address fraud risks pertaining to revenue recognition by the audited corporate group inclusive of the parent company and key sales subsidiaries that constitute key components.
- 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 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 fraudulent accounting.
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 due to fraud 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 respond 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 suspected material misstatement due to fraud exists. If auditors identify the suspected 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) Discussion among 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.

Besides the above example, there were also deficiencies resulting from a lack of adequate consideration. For example, an engagement team identified fraud risk at an audited company, but due to a poor understanding of the company and its environment, it overlooked other methods that could be used to commit fraud besides the ones it had identified.

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, paragraph 14)

《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

NEW ①The engagement team had ascertained that the audited company’s revenues comprise multiple businesses: sales of goods, service revenues and real estate business.

However, the engagement team focused on fraud risks in revenue recognition as a whole, and did not assess the kinds of fraud risk occur to the various revenue transaction formats. In addition, the engagement team did not have an understanding of the relevant internal controls, despite fraud risks pertaining to service revenues having been identified.

(Auditing Standards Committee Statement No. 240, paragraphs 25 and 26)

NEW ②The engagement team identified fraud risks pertaining to revenue recognition for revenues from individual contracts exceeding a prescribed amount in view of their impact on the audited company's business performance at an audited company running an advertising business.

However, the engagement team did not sufficiently examine the rationality for determining the existence of fraud risks based on a specific amount rather than the type of revenue, etc.

(Auditing Standards Committee Statement No. 240, paragraphs 25 and 46)

《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.In particular, when the audited company operates multiple businesses within its consolidated group, it is necessary to identify and assess fraud risks for each type of revenue and transaction.Furthermore, if a risk of material misstatement due to fraud has been identified, the company's internal controls, including control activities relating to this risk, must be understood.

Note that cases were seen where it was concluded, with respect to the presumption that there was fraud risk in revenue recognition, and without adequate investigation, that the circumstances were not such that presumption could be easily applied to revenue recognition. However, if revenue recognition is not to be identified as a fraud risk, it is necessary that adequate consideration be given and that the reasons for rebutting fraud risk be presented in the audit documentation.

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

NEW ①The engagement team conducted journal entry tests as audit procedures to address management override.

However, the procedures implemented by the engagement team did not constitute a reasonable examination for the following reasons:

a) "Abnormal" and "exceptional" journal entries were set as extraction conditions, but specific extraction conditions were not defined because the fraud risk factors at the audited company had not been examined and fraud scenarios based on these examinations had not been specified, and the engagement team did not consider whether the risk of management override had been addressed by examining these extracted journal entries.

b) Journal entries above a certain amount were extracted as "large numbers of jounal entries ", but no consideration was given to whether extracting journal entries exceeding a certain amount was a suitable procedure for identifying material misstatements due to fraud.

c) For some of the journal entries extracted based on the above extraction conditions, it was determined by checking the details listed in the extracted journal entries only that there were no irregularities; no consideration was given to whether a more detailed test was needed.

(Auditing Standards Committee Statement No. 240, paragraph 31)

②In 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 design 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.

Furthermore, the engagement team also needs to obtain sufficient appropriate audit evidence with respect to the completeness of journal data used for journal entry testing.

Case 2: Business rationale for significant transactions

①The 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)

②When 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 sales of non-current 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; No. 315, paragraph 10)

《Points to Note》

Indicators that may suggest that significant transactions that are outside the normal course of business for the audited company, or that otherwise appear to be unusual, may have been entered into to engage in fraudulent financial reporting or to conceal misappropriation of assets include（Auditing Standards Committee Statement No. 240, paragraph A46）：

- **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; and**
- **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, and as result of assessing them it discovers circumstances that indicate material misstatement due to fraud, 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 suspected 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

①With regard to revenue recognition, the engagement team identified a risk of material misstatement due to fraud. Based on its understanding of the audited company's environment, it anticipated fraud risk scenarios for specific methods of fraud, and design 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)

NEW

②The engagement team identified a risk of material misstatement due to fraud in the cutoff of revenue, extracted samples from sales transactions one week before and after the period end, and cross-checked these against shipping slips, receipts, etc.

However, the engagement team did not examine whether extracting samples from the transactions one week before and after the last day of the period was a sufficient audit procedure for addressing the fraud risks.

(Auditing Standards Committee Statement No. 240, paragraph 29)

③Depending 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 designed an audit plan to investigate important construction projects by performing 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, the team did not obtain sufficient appropriate audit evidence for addressing fraud risk.
(Auditing Standards Committee Statement No. 240, paragraph 29)

④The 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 and 31; No. 330, paragraph 20)

⑤Bill and hold sales, which were prohibited by the audited company's internal rules, were identified at the audited company through direct whistle-blowing to the engagement team. The audited company insisted that the sales transactions in question were realized by the year-end since the inventory related to the sales transactions had already been shipped by the year-end.
Against this argument, the engagement team conducted unannounced inspection 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 respond to fraud risksthat were necessary for this matter, such as tests based on evidence including shipment slips, if the See above comment 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)

⑥With 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 any accounts 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 cutoff 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)

⑦The 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 did not obtain audit evidence for the whole revenue that was more relevant or reliable for the risk of fictious revenue recognition.

(Auditing Standards Committee Statement No. 240, paragraph 29; No. 330, paragraphs 5 and 20)

⑧The audited company was engaged in the sale of expendable office supplies and applied a shipping basis as its standard for revenue recognition but, in keeping with an industry-specific business practice, it posted sales revenues for unshipped goods in some transactions.

The audit team recognized that the contract conditions for sold inventory awaiting shipment were not clear, that the company had no choice in relation to its customers but to hold the goods in storage and that holding periods were quite protracted for some customers.

However, the audit team only received the explanation from the audited company that such tansactions had been regular practice for quite some time and the trade recievables had been collected under the same conditions as shipping sales transactions, so the audit team did not consider from the perspective of fraud risk whether these transactions were carried out at the request of purchasers for economically rational reasons. The audit team also did not sufficiently examine sales recording requirements had been satisfied, such as whether the audited company charged customers for storage and toransport fees.

(Auditing Standards Committee Statement No. 240, paragraph 31)

《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; and**

- **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

①In examining a loan that may be relevant to a related party, the engagement team directly confirmed with the original borrower and considered the valuation of the assets 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; No. 550, paragraph 22)

②During the current term, the audited company rehired employees that it had transferred to a specific group company in the past, but also concluded new contracts with these employees that would see them dispatched to the same group company. By doing this, the audited company booked large profits. The engagement team identified these contracts as unusual transactions, and identified them as constituting circumstances indicating signs of material misstatement due to fraud. As a result of inquiring about the matter with directors of the audited company, the team was told that the company would generally not be taking similar actions in the future, but that such action might be taken on an emergency basis to prevent a company in the corporate group from falling into a crisis situation.

However, the engagement team did not adequately consider the economic rationality of these unusual transactions.

(Auditing Standards Committee Statement No. 240, paragraphs F11- 2, 32-2, and F35-2)

《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 circumstances that indicate the possibility of a 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 treatment:

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 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 and 4; 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 suspected material misstatements due to fraud.

Case 2: Evaluation of identified misstatement due to fraud during the audit

The engagement team had received a report from the directors of the audited company about the fact that an employee of a consolidated subsidiary of the audited company had misappropriated assets. The team received an explanation of the circumstances of this fraud, revised the audit plan, and performed additional audit procedures.

However, the engagement team did not adequately consider the results of the audited company's investigations, and did not obtain a complete picture of the impact of the fraud on the financial statements. Furthermore, the team did not adequately consider the impact of the fraud on the audit of internal controls or the need to correct information on the financial statements.

(Auditing Standards Committee Statement No. 240, paragraph F35-2)

《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 suspected 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 suspected 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 detecting fraud relating to that responsibility, inform the appropriate level of management of such matters on a timely basis. 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 nature, timing and extent of the audit procedures required to complete the audit. The team also needs to demand that management take appropriate measures to correct problems.

2. 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; and
- ▶ 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 design 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 assistants to engagement partner 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 assessed risks and procedures in the audit plan developed by using audit tools.

Other deficiencies identified include determining that there were no irregularities by analyzing increases/decreases despite a risk of material misstatement having been identified and thus not carrying out substantive procedures, and overlooking the fact that notes about important transactions with related parties were missing due to a lack of recognition of any particular risks, despite the fact that risk assessments for audited company that engage in various and numerous transactions with see above must be carried out more carefully than usual from the perspective of comprehensively ascertaining the transactions with thesee above.

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 need, in audit plans, to link material misstatement risks and details of the procedures responsive to the assessed risks (the nature, timing and extent of the procedures).

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; and**
- **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

NEW

①The audited company owned fixed assets such as facilities at shops run by consolidated subsidiaries, and received facility usage fees in compensation for the use of these facilities, etc., by the consolidated subsidiaries. The audited company posted these facility usage fees as sales, but posted expenses such as depreciation for these facilities as selling, general and administrative expenses.
However, the engagement team did not examine the suitability of the audited company not posting as the cost of sales such expenses as depreciation for these facilities that corresponds to the facility usage fees that count as sales.
(Auditing Standards Committee Statement No. 315, paragraph 10)

②The audited company operates multiple businesses including online retailing. The engagement team identified a risk of material misstatement in existence and completeness assertions for sales by all the audited company's businesses.
However, the engagement team did not perform procedures to understand the internal controls for the bricks-and-mortar retailing business, even though sales from the business far exceeded the performance materiality.
(Auditing Standards Committee Statement No. 315, paragraph 10 and 12)

《Points to Note》

As shown in the aforementioned examples of deficiencies identified, there are the case that the engagement team did not assess the audited company accounting policies and the case that the engagement team did not understand the internal control of the important business which the audited company engaged in other than its mainstay business. The engagement team needs to assess, by understanding the audited company and its environment, whether the company's accounting policies are suitable for that business and whether it conforms to the applicable financial reporting framework and to the accounting policies applicable in the industry to which the company belongs. Because there are cases that fraudulent financial reporting is made in businesses other than the audited company's main business, when identifying and assessing the risk of material misstatement at the assertion-level, the engagement team needs to consider the types of transactions and relevant internal controls differences between each businesses.
In addition, there are also cases in which the engagement team had an understanding of the businesses of each significant components in the group audit but not of businesses or distribution channels at a group level, as well as cases in which the risks of material misstatement were not identified and assessed for each type of transaction, despite the possibility of differences arising in effective procedures and the nature of audit evidence that ought to be obtained due to differences in the types of transactions even within the same account, since the risks of material misstatement had not been examined for each operational process.

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 cutoffs 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)

《Points to Note》

In identifying and assessing the risks of material misstatement, engagement teams need to exercise professional skepticism to gain a sufficient understanding of the company and its environment and thereby assess the risks. In doing so, engagement teams need to remember to carefully identify and assess these risks by such means as referencing this Case Report and Audit recommendations issued by the JICPA, etc.. Engagement teams also need to ensure its examinations are adequate because risks of material misstatement are often identified in unusual and important transactions, transactions with related parties, accounting estimates that rely to a great degree on the subjective judgment of manager, etc.

Case 3: 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

①The engagement team identified material misstatement risks with respect to prepaid expenses as well as salaries and allowances, and deemed that such risks were low. Furthermore, with regard to prepaid expenses, it performed a comparative analysis with the figures for the previous term, while with regard to salaries and allowances, it analyzed the causes of increases in the amounts booked, personnel expenses per employee, etc.

However, the engagement team did not perform substantive procedures, instead only performing analytical procedures such as comparing accounts for the previous term.

(Auditing Standards Committee Statement No. 330, paragraph 17)

②The 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》

As in the above examples of deficiencies identified, the deficiencies have been detected many times that substantive procedures were not implemented because no irregularities were identified in the increase / decrease analysis, even though the risk of material misstatement was identified in risk assessment.

In designing audit procedures responsive to the assessed risks of material misstatement, auditors need to take into account the particular characteristics if the relevant class of transactions, account balance or disclosure, ect., as well as relevant internal controls, and design audit procedures that ensure that sufficient appropriate audit evidence suited to the assessed risks of material misstatement at the assertion level can be obtained.

In particular, it must be remembered that more relevant, reliable,and voluminous audit evidence must be obtained when there are risks of material misstatement due to fraud than when fraud risks have not been identified in this assertion.

There are also instances in which auditors do not identify all of the risks of material misstatement or in which there are inherent limitations to internal control, including management override, so it should be remembered that substantive procedures must be designed and implemented for important transaction types, Account balances, disclosure, etc., regardless of the degree of the assessed risks of material misstatement.

Case 2: Adequacy of presentation and disclosure

NEW

① The audited company has leased Property A and Property B to outside parties. In these circumstances, the audited company has made Property A subject to disclosure as investment and rental property and set down its market value in the notes at the assessed value of the real property for property tax purposes, but Property B has not been made subject to disclosure.

However, the engagement team did not examine the propriety of deeming Property A as a less important property under accounting standards and stipulating its market value to be not the amount calculated using real estate appraisal standards but instead the assessed value of the real property for property tax purposes, and it did not examine the propriety of Property B not being listed in the notes under investment and rental property.

(Auditing Standards Committee Statements No. 330, paragraph 23, and No. 500, paragraph 5; ASBJ Guidance No. 23, paragraphs 11 and 13)

NEW

②The audited company had completed a business combination through acquisition and gave a outline of this business combination in the notes. The accounting standards require that an estimated amount of impact on the consolidated income statement for the period at the start of which the business combination is expected to be completed as well as the calculation methods for this estimate and the key presumptions in this calculation process be disclosed, but the audited company only posted that it was difficult to calculate an estimate and it omitted see above of the estimate, etc.

However, the engagement team did not examine whether it was difficult to calculate an estimate, and did not consider whether the audited company omitting an notes on the estimate, etc., because of difficulties in calculating the estimate conformed to the accounting standards' requirements.

(Auditing Standards Committee Statement No. 330, paragraph 23; ASBJ Guidance No. 21, paragraph 49)

《Points to Note》

Other than the above, deficiencies in audit procedures for presentation and disclosure included a case where the engagement team did not examine whether this fair value 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, a case where the engagement team did not examine the reasonableness of the presentation category of asset retirement expenses stemming from asset retirement obligations, 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 8, 9, and 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 design 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: Consideration of identified misstatements

The engagement team discovered overstating in this period of accrued revenue for the previous period, and handled it as an unmodified misstatement.

However, the engagement team did not examine the impact that this misstatement would have on the internal control audit, and did not consider whether it was necessary to describe this in the management representation as “an uncorrectede misstatement identified this fiscal year having an impact on the balances of previous fiscal years”.

(Auditing Standards Committee Statements No. 315, paragraph 15, and No. 450, paragraph 13)

《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 due to the information system and procedures responsive to assessed risks

Case 1: Formulation of a plan for auditing IT use

NEW

①For a subsidiary that had been identified as a significant component because of its individual financial significance and because of the risk of fraud in its revenue recognition, the group engagement team did not use component auditor but instead carried out the audit procedures itself. However, the group engagement team did not carry out audit procedures aimed at obtaining information on hardware configurations and other IT infrastructure for the sales system used by this subsidiary that would be necessary to understand the environment for IT use. The group engagement team also did not carry out audit procedures aimed at understanding controls for IT as a whole and did not verify how this subsidiary dealt with risks connected with IT.

(Auditing Standards Committee Statement No. 315, paragraphs 17 and 20; IT Committee Practical

Guidance No. 6, paragraph 4)

②The 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, paragraph 20; Audit and Assurance Practice Committee Statement No. 82, paragraph 144, IT Committee Practical Guidance No. 6, paragraph 29)

Case 2: Evaluating of deficiencies in overall control of IT

NEW

The audited company identified and assessed controls on program changes as part of general IT controls for logistics system. The company stipulated that information system work request forms, program test plans, transition plan to production environment, etc., must be prepared and approved at each stage – from detailed system design to testing to transition to a full-scale environment – as controls on program changes.

The engagement team identified deficiencies in these controls because the aforementioned necessary documentation was not prepared at each stage of these controls, but it concluded that IT controls were on the whole effective by identifying and assessing the preparation of information system development management charts and email approval as alternative controls.

However, the engagement team overlooked the fact that the information covered under control activities in which deficiencies had been identified was not listed in the information system development management chart to be prepared for managing progress in program development. The engagement team also did not confirm the specific operational methods for leaving traces of email approval and otherwise did not obtain sufficient appropriate audit evidence relating to the effectiveness of general IT controls.

(Audit and Assurance Practice Committee Statement No. 82, paragraph 185; IT Committee Practical Guidance No. 6, paragraph 46)

《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.

3. Audit Evidence

Points of focus

Auditors should assess information obtained as audit evidence considering its relevance and reliability. The CPAAOB inspects whether audit procedures designed by the engagement team are properly performed and whether sufficient appropriate audit evidence to draw reasonable conclusions on which to base the auditor's opinion is obtained 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; and
- 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 program 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;
- Audit evidence was not obtained on all of the specific items selected when sampling was carried out by selecting specific items;
- When testing items selected by specific sampling, the engagement team did not examine whether it was necessary to obtain additional audit evidence for the remainder of the population; and

- 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 “1. 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 appropriate audit evidence 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 “2. Risk Assessment and Response to Assessed Risks”).

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. Assistants to engagement partners 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 as a result of performing audit procedures through the review of audit documentation.

(1) Matters common to audit evidence

Case 1: Sufficient appropriate audit evidence

NEW

①The audited company newly obtained shares. When examining the suitability of the acquisition process for these shares, the engagement team only checked the request for approval prepared by the audited company with regard to the appropriateness of the acquisition price for the shares and it did not assess the reliavility of the evidence.

(Auditing Standards Committee Statement No. 500, paragraph 6)

②As 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)

③As 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)

④With regard to sales by significant components, the engagement team claimed to have identified significant risks and to have performed tests of detail, which constitute substantive procedures, at the same time as performing procedures to assess implementation of internal controls (dual-purpose test).
However, as procedures to assess implementation of internal controls, the engagement team just stated in the audit documentation that it had checked whether approvals had been given and the consistency of different types of evidence. Information on amounts investigated was not included, and substantive procedures had not been performed.
(Auditing Standards Committee Statement No. 330, paragraph 17; No. 500, paragraph 6)

《Points to Note》

In addition to the above examples, there are cases in which substantive procedures and tests of the operating effectiveness of controls are implemented for only part of the audit coverage period.
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, 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.

In addition, 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. Furthermore, when implementing tests of the operating effectiveness of controls to be performed coccurrently with substantive procedures (dual-purpose tests), the engagement team must remember to evaluate whether procedures designed to obtain sufficient appropriate audit evidence satisfying the purposes of the respective audit procedures have been designed and implemented.

Case 2: Work of management's experts

NEW

When accepting transfer of a business, the audited company requested a business value assessment from an individual CPA and decided on the business transfer price on the basis of the appraisal price derived from this business value assessment.

However, the engagement team did not ecaluate the CPA's competence, capability and objectivity, believing that there would be no problem with the reliability of the business value assessment even in the absence of a detailed examination as long as the expert used by the corporate managers was a CPA. The engagement team also did not verify the significant assumptions and methods adopted for, and the source data used in, this business value assessment, and it did not evaluate the appropriateness of the management's expert's work.

(Auditing Standards Committee Statement No. 500, paragraph 7)

《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 3: Reliability of information prepared by audited companies

①In 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)

②The 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 4: Timing of substantive procedures (procedures for remaining period)

① 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)

②The 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; 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 cutoff date set before the balance-sheet date, additional substantive procedures should be performed for the period from a cutoff 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

NEW

The engagement team identified fraud risks in order-made software sales transactions that applied the percentage-of-completion method, and sent out and collected confirmation forms on the agreement amounts for these transactions as a procedure responding to assessed risks.

However, the engagement team did not sufficiently evaluatewhether the results of the confirmation procedures provided relevant and reliable and it evidence, even though the returned confirmation form was signed/sealed by an individual who was not a representative.

(Auditing Standards Committee Statement No. 505, paragraphs 9 and 15)

《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.

Especially, 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, 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.

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 examination cash receipts.

However, among the amounts confirmed with respect to major business partners from which responses had not been received, 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 more than 80% of balances exceeding the materiality threshold, which should have been confirmed.

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

《Points to Note》

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

NEW

①The engagement team sent out a confirmation form as part of its procedures for auditing the audited company's accounts receivable. The reply the engagement team received noted a confirmation disparity attributable to differences in the timing of receiving inspections, and the engagement team conducted a cross-check with the accounts receivable ledger, an internal document, on the amount of this discrepancy. However, the accounts receivable ledger is itself accounting balance information so it naturally matched. Accordingly, the engagement team did not obtain sufficient appropriate audit evidence on the confirmation discrepancy.

(Auditing Standards Committee Statement No. 505, paragraphs 13 and 15)

②The engagement team performed balance confirmation procedures as part of its substantive procedures for receivables, and if there was an exception in relation to confirmation, it performed an investigation 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, paragraph 13)

③With 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.

Case 4: Evaluation of reply received

NEW

The engagement team checked the balance of the audited company’s externally stored inventory by selecting those storage destinations with the highest inventory balances as specific items.
However, the engagement team only collated a portion of the inventory details attached to the collected confirmation form with the inventory quantities on the audited company's books and did not obtain audit evidence for all selected specific items.
(Auditing Standards Committee Statements No. 500, paragraph 5, and No. 505, paragraph 15)

《Points to Note》

As in the above cases, there are cases where audit evidence has not been obtained for the entire confirmed amount even though the balance has been confirmed as a specific item due to the importance of the amount. With regard to the main examples of audit sampling, refer to "(4) Audit sampling and testing specific items".

(3) Substantive analytical procedures

Case 1: Performming substantive analytical procedures

①The engagement team performed substantive analytical procedure for sales, estimating auditor’s expectation for sales by dividing the cost of sales for the current term by the cost rate for the previous term.

However, with costs predicted to have decreased as a result of an increase in capacity utilization during the current term, the team did not consider whether it was appropriate to use the previous term’s cost rate to make the expectation. Furthermore, the expectation for sales was computed by aggregating the sales for two divisions even though the cost rate for each division was different, but the team did not consider whether it was appropriate to make the expectations through aggregation.

(Auditing Standards Committee Statement No. 520, paragraph 4)

NEW

②The engagement team carried out substantive analytical procedures for the audited company’s labor costs. Specifically, the engagement team subdivided the recorded amounts for each account, which provide a breakdown of labor costs, into categories –cost of products manufactured, R&D expenses, and selling, general and administrative expenses other than R&D expenses – and then calculated estimates based on the assumption that the ratio of each category to total labor costs had not changed from the previous term.

However, the engagement team did not ascertain the number of personnel in R&D organizations and non-R&D back-office organizations in the previous and current terms. Accordingly, the appropriateness of the assumption that the ratio of R&D expenses and selling, general and administrative expenses other than R&D expenses to the recorded amounts of each account into which personnel expenses are subdivided remained unchanged from the previous fiscal year was not sufficiently evalated.

(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

NEW

①The engagement team identified risks of material misstatement for the occurrence of the sales of the audited company, whose fiscal year ends in March. As a risk response procedure for these, 200 samples were extracted from the population of annual sales transactions and detailed tests conducted. The detailed tests consisted of procedures conducted as dual-purpose tests alongside operation evaluation procedures for internal controls as well as procedures conducted as cutoff tests before the end of the fiscal year. A breakdown of the extracted samples shows 150 samples from April to October, one sample from November to February, and 49 samples in March.

However, the engagement team did not fully examine whether the sampling method was an effective extraction method suited to the purposes of audit procedures, as shown by its failure to consider the rationality of extracting a single sample for the period November to February, given that one characteristic of the audited company's business was that a great number of sales were recorded in winter.

(Auditing Standards Committee Statements No. 500, paragraphs 5 and 9, and No. 530, paragraphs 5, 6 and 14)

②As a test of detail for cost of sales, the engagement team randomly selected at least two samples from each month, and compared them with delivery notes.

However, when making the comparisons, the team did not consider whether at least two samples from each month was sufficient as a test of detail.

(Auditing Standards Committee Statement No. 500, paragraph 5; No. 530 paragraphs 5 and 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.

With audit sampling, samples should be selected 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.

Case 3: Evaluation of audit sampling results

NEW

As an audit procedure for accounts receivable, the engagement team used customer-specific accounts receivable balances as the population, carried out confirmation procedures by sampling, and estimated the misstatement amount.

However, the engagement team evaluated the misstatement amount using materiality for the financial misstatement as a whole, even though the Auditing Standards Committee Statement stipulates that an amount equal to or less than performance materiality is to be used as a tolerable misstatement.

(Auditing Standards Committee Statements No. 505, paragraph 13, and No. 530, paragraphs 3 and A3)

《Points to Note》

Auditor need to determine the tolerable misstatement in using audit sampling from detailed tests. In determining see above, auditors must consider the risk of that the aggregate of individually immaterial misstatements may cause the finantial statements to be materially misstated and the possibility of undetected misstatements, and must remember that the amount is to tha same amount or an amount nower than performance materiality.

(5) Related parties

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

NEW

The engagement team obtained a list of related parties prepared by the audited company and used it to ascertain the related parties identified by the audited company.

Because the list of related parties bore the seal of the director in charge of accounting, the engagement team believed that obtaining this list meant that it had obtained sufficient audit evidence of the completeness of related parties, but it did not have an understanding of the process underlying the creation of the list of related parties.

(Auditing Standards Committee Statement No. 550, paragraphs 12 and 13)

《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; and**
- **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 "1. The Auditor's Responsibilities Relating to Fraud in Financial Statement Audits".

Case 2: Identification of significant related party transactions outside the audited company's normal course of business

NEW

The audited company received an order for building materials from a customer and ordered the building materials from Company A, which operated a construction contracting business not directly related to building materials and which was a company privately owned by the audited company's president. Company A received the order and placed an order with Company B, which also handled building materials and was also a privately-owned company of the audited company's president.

The engagement team recognized the need to confirm the business rationale of the transaction, which wasthe related party transaction assessed as a significant risk, and checked that the profit margin arising from the transaction was not abnormal.

However, the engagement team did not consider the rationality of the audited company placing an order not directly with Company B but instead through Company A, which operated a construction contracting business not directly related to building materials. In addition, the engagement team did not confirm whether a contract had been signed between the audited company and Company A and did not ascertain the specific transaction conditions (methods for bearing risk, methods for determining the purchase price, settlement conditions, etc.).

(Auditing Standards Committee Statement No. 550, paragraph 22)

《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: Evaluatin of management's assessment of going concern assumptions

NEW

The audited company violated the financial covenants of its commitment line contract with correspondent financial institutions by recording a loss. The audited company determined that its violation of the financial covenants constituted a situation raising significant doubts about its going concern assumptions, so it formulated a financial plan to resolve the situation and engaged in discussions with its correspondent financial institutions on an exemption from the application of the financial covenants of the commitment line contract. All the financial institutions agreed not to invoke acceleration clauses as a result, and the audited company decided that there was no material uncertainty regarding its going concern assumptions and that it was not necessary to make a note in its financial statements.

Given these circumstances, the engagement team held a meeting with the management of the audited company and verbally confirmed that, although the company had violated the financial covenants, it had obtained agreement from its correspondent financial institutions to defer the invocation of acceleration clauses.

However, the engagement team did not obtain a copy of the audited company's financial plan and did not examine its feasibility. In addition, in considering management's efforts to obtain agreement from the correspondent financial institutions not to invoke acceleration clauses, the engagement team did not consider whether asking questions of the audited company was sufficient.

(Auditing Standards Committee Statement No. 570, paragraphs 11 and 15)

《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.

In addition, the engagement team needs to comprehensively evaluate the circumstances of the audited

company and to consider based on concrete audit evidence whether management's plans for future actions in relation to its going concern assessment were effective and feasible.

(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 (Refer to Auditing Standards Committee Statement No. 560, paragraph 6) :

- **Understanding the procedures performed by the management to identify subsequent events;**
- **Inquiries with the management;**
- **Inspection of the minutes of board of directors meetings; and**
- **Review of the latest subsequent monthly financial statements, if available.**

Case 2: Examination of facts learned by an auditor after financial statements were released

NEW

The audited company corrected comparative information in the notes on consolidated tax effect accounting for the current period without submitting a corrected securities report on the notes for the previous period regarding the errors in the notes on consolidated tax effect accounting for the previous period that were recognized in the current period.
Thinking it unnecessary to submit a corrected securities report because the revised content of the comparative information did not affect the consolidated balance sheet and consolidated income statement, however, the engagement team did not consider the necessity of correcting the notes regarding consolidated tax effect accounting.
(Auditing Standards Committee Statements No. 560, paragraph 13, and No. 710, paragraph 7)

《Points to Note》

if, after the date of the auditor's report but before the date the financial statements are issued, a fact becomes known to the auditor that, had it been known to the auditor at the date of the auditor's report, may have caused the auditor to amend the auditor's report, the auditor shall implement the following procedures (Auditing Standards Committee Statement No. 560, paragraph 13):

- **Discuss the matter with management**
- **Determine if financial statement revisions or disclosures in financial statements are required**
- **If the financial statements need to be revised or there need to be disclosures in the financial statements, ask management how they plan to handle the matter in the financial statements.**

Case 3: Consolidated journal entry

NEW

①The audited company amended the financial statements of a consolidated subsidiary due to material discrepancies in accounting records relating to transactions between consolidated companies resulting from the difference between the closing date for the consolidated subsidiary and the consolidated closing date. The engagement team confirmed that the audited company had amended its financial statements using the same debit and credit accounts as in the previous period.
Although the engagement team identified risks of material misstatement in the amendments and the amended amount had increased significantly from the previous year, the engagement team did not sufficiently verify the evidence for amending the financial statements and the appropriateness of the amount.
(Auditing Standards Committee Statement No. 600, paragraphs 16 and 36)

②The 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 "5. Group Audit."

4. 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; and
- 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

There are still many cases in which a lack of professional skepticism by the engagement team in auditing accounting estimates leads the engagement team to be content with understanding management's assumption and the accounting processes and not objectively evaluate management's insists on, for instance, the appropriateness of inventory valuation rules, the impairment of fixed assets, and the recoverability of deferred tax assets that determines the feasibility of the business plan used in making accounting estimates, and not carry out procedures for verifying the rationality of these insists.
Further, required audit procedures were often not performed, due to the lack of understanding of requirements under Auditing Standards Committee Statement No. 540.

(Observed effective efforts)

The following case can be cited as an effective effort observed to improve procedures for auditing accounting estimates.
The engagement team unambiguously communicates to management at the audit planning stage its policy of not accepting management’s assumption that are not clearly supported when examining the audited company's business plan.

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

NEW ①In its concert event business, the audited company prepared provisional sales applications whenever the fiscal year ended during a concert period featuring multiple performances whose total sales had not been finalized, and once the prescribed approval had been received, the provisional sales for the performances concluded were recorded.

The engagement team identified significant risks due to uncertainties in the audited company's estimated sales, obtained the provisional sales application prepared by the audited company for the provisional sales recorded at the end of the fiscal year, and confirmed whether it has been approved. In addition, by confirming that there was no major disparity between the finalized amount and the estimated amount of the provisional sales that were finalized while closing out the books for the fiscal year, the engagement team deemed that it had obtained sufficient appropriate audit evidence on the accounting estimates.

However, the engagement team had not evaluated the rationality of the key assumptions used by management for the provisional sales, such as unit price estimates per performance.

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

NEW ②The audited company posted the summer bonus to be paid the next fiscal year in its bonus reserves at the end of the fiscal year, calculating it by multiplying the total basic salary by the number of months of bonus and a performance coefficient. The engagement team confirmed with regard to the year-end balance of bonus reserves that the number of people eligible as of the end of the fiscal year had decreased and that the performance coefficient had increased since the previous period.

However, the procedures performed by the engagement team included the following deficiencies:

- Despite being aware that the basic salary, performance coefficient, etc., were still not being used to determine the amount of bonus payments, the engagement team did not examine the appropriateness of the audited company multiplying the total basic salary by the performance coefficient for the previous year in calculating the bonus reserves.
- The engagement team did not consider the disparity in amounts when it was known by the date of the audit report required under the Companies Act that a significant disparity had arisen between the recorded amount of bonus reserves and the actual amount paid out.

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

《Points to Note》

Other than the examples 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 (Auditing Standards Committee Statement No. 540, paragraph 14):

- **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;**
- **The reasonableness of management's material assumptions; and**
- **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.**

③The 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 management's assumptions to project business performance for an identical period.

(Auditing Standards Committee Statement No. 500, paragraph 10; 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 non-consolidated 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 management's accounting estimates

①The audited company booked an allowance for bad debts based on past default rates to prepare for losses due to debt default. Specifically, it categorized claims as either (1) those for which no more than one year had passed since they fell into arrears or (2) those for which more than one year but no more than three years had passed since they fell into arrears, and then calculated the allowance for bad debts using the three-year-average default rate computed as follows for each of the categories (1) and (2).

With regard to (1), it computed the past default rate using the balance of receivables as the denominator and the amount of defaults in the following year as the numerator, while with regard to (2), it computed the past default rate using the balance of receivables as the denominator and the amount of defaults in the following two years as the numerator. Furthermore, the audited company re-categorized receivables for which three years had passed since they fell into arrears as bankruptcy/rehabilitation receivables, and booked an allowance for bad debts for the entire amount of the bankruptcy/rehabilitation receivables.

However, the engagement team did not adequately consider whether the above-mentioned period categories and default-rate calculations, which the audited company used to estimate future losses from defaults on receivables, were consistent with actual losses by the audited company incurred as a result of defaults.

NEW ②The audited company had adopted a method whereby it posted an allowance for doubtful accounts using a reserve ratio of 50% or 100%, depending on the uncollected period of loans, in calculating the allowance for doubtful accounts for some loans of concern.

The engagement team understood that the recoverability of debts of concern depended on the debtor's solvency, but it only verified the results of a debt retention investigation conducted by the audited company as well as changes in the allowance for doubtful accounts. The engagement team did not fully examine whether the method adopted by the audited company of setting uniform allowance rates according to the period receivables had been unrecovered was appropriate.

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

《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 (Refer to Auditing Standards Committee Statement No. 540, paragraph A68):

- **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; and**
- **Examination of management's review and approval for accounting estimates.**

Case 3: Review of prior period accounting estimates

With regard to provisions for handling product complaints, the engagement team chose to compare the accounting estimate, which had been booked as a product warranty provision in the previous year, with the actual amount for one of many cases subject to provisions, on the grounds that the same calculation method was used.

However, the team only investigated one case, and did not examine whether it was possible to identify and assess risks of material misstatement relating to accounting estimates in the current year just by investigating one case.

(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

NEW

①When evaluating the book value an insolvent subsidiary, the audited company did not impair the subsidiary's shares because it expected the real value of the subsidiary's shares to recover to the acquisition price within five years.

Given that the subsidiary's business plan showed a significant increase expected in sales and profits from the next fiscal year onward, the engagement team deemed the audited company's judgment to be valid because it had obtained answers to the questions it had asked of the subsidiary's management and because it had ascertained that the latest sales were in an uptrend.

However, the engagement team did not fully examine the rationality of the subsidiary's business plan, as illustrated by the engagement team not obtaining audit evidence for the management's assumption that the uptrends in sales and profits would continue from the next fiscal year onward.

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

②With regard to a fixed asset that was showing signs of having impaired, the audited company deemed that recognition of an impairment loss was unnecessary as the total amount of pre-discounted cash flow projected in the five-year business plan was higher than the book value of the fixed assets. The engagement team also determined that this judgment was reasonable.
However, with regard to the business plan, which forecast that operating profit would rise at a pace of 1.7 times a year, the engagement team just accepted the audited company's explanation that the target for the first year was feasible and that sales would increase as the market was growing. They therefore deemed that the projections in the business plan for the second and subsequent years were reasonable, and did not consider the feasibility of achieving the targets set forth in the business plan.
(Auditing Standards Committee Statement No. 540, paragraph 12)

《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

In its verification procedures for the valuation of loans to and receivables from a consolidated subsidiary whose liabilities were in excess of assets, the engagement team took into account unrealized gains on land owned by the consolidated subsidiary, and deemed that booking a provision for bad debts was unnecessary. However, it did not adequately consider the feasibility of selling the land, which was at the center of the assessment of recoverability.

(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)

①When 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 A Co. was covered by B Co., 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)

②In its self-assessment, an audited financial institution accepted that although C Co. 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 C Co.’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)

《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 how management makes accounting estimates

NEW ①Setting the life cycle of the goods and products it handled at two years, the audited company fully written down of book value of goods and products purchased or manufactured two years earlier as a valuation loss.

However, the engagement team only sought to ascertain the accounting policy of the audited company, and did not consider whether the two-year life cycle period and the calculation method for write-downs were rational in view of the audited company's actual circumstances.

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

NEW ②The audited company extracted sales transactions that were in the loss in the fourth quarter, and calculated the valuation loss of each product by multiplying the year-end balance of each product involved in these transactions by the actual total loss ratio in the fourth quarter. In addition, the audited company had posted a loss on the disposal of materials and work in process during the period, so deemed it unnecessary to post a valuation loss for materials and work in process.

The engagement team recalculated the data prepared by the audited company to calculate valuation loss for these products and, by ascertaining the disposition of materials and work in process by reading over the requests for approval, determined that the valuation of inventories was appropriate. However, the engagement team did not consider the reasons for the audited company not including materials and work in process as well as products that did not generate sales in the fourth quarter in its inventory valuation. In addition, the engagement team did not consider the rationality of not considering direct sales cost estimates when calculating the valuation loss of the products.

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

《Points to Note》

In addition to the above examples, there were cases in which the engagement team did not examine whether the retention period established by the audited company to define long-term retention was in line with the audited company's actual circumstances, cases in which the engagement team did not consider the reasons the audited company had posted a certain percentage of the book value in accordance with the retention period as a valuation loss, and cases in which the engagement team did not sufficiently examine the reliability of the valuation loss calculation data prepared by the audited company.

Also, audited companies have inventories with special characteristics, such as real estate inventories 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

Even though the audited company, which is in the clothing retail business, decides whether to open or close stores based on the profitability of each store, it does not group its long-lived assets in units of stores. Instead, it groups them in brand units, which are larger.

However, the engagement team did not consider whether stores constituted the smallest unit that generates cash flow or whether the cash flow generated by each store is mutually dependent on other stores, and it did not obtain sufficient appropriate audit evidence concerning the reasonableness of grouping.

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

《Points to Note》

In addition to the above examples, there are cases in which the engagement team overlooked deviations of asset groupings from actual circumstances, cases in which the engagement team did not examine the appropriateness of the grouping classification of shared assets, cases in which the engagement team did not examine the appropriateness of using the same groupings for non-consolidated and consolidated financial statements without any review in circumstances in which sales stores and factory equipment were leased to consolidated subsidiaries and classifications for management accounting and units for investment decision-making were set for multiple consolidated companies, and cases in which the engagement team only checked on the profits/losses or cash flow generated from operating activities calculated by the audited company and on the status of idle assets without examining the appropriateness and completeness of the identification of cash-generating units. There are also cases in which, when the impairment loss of fixed assets after a change in grouping was not recognized, the engagement team did not exercise professional skepticism and sufficiently examine whether this change might have been an indication of fraud, and cases in which the engagement team did not fully examine the reasonableness of a change in a grouping in light of accounting standards, etc., when impairment has not been recognized in a given cash-generating unit because of a regrouping of fixed assets traditionally belonging to a single cash-generating unit into multiple generating units.

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

NEW ①As to new stores in business less than two years from the beginning of the fiscal year following their opening, the audited company determined that operating losses incurred or likely to be incurred on a continuous basis would be excluded from the assessment of indications of impairment, except that some significant change in the environment exisits, because its new stores tend to suffer operating losses immediately after opening due to the nature of the business.

However, when examining the company's assessment of the indications of impairment for the new stores, the engagement team did not consider whether the new store's operating losses represented a significant downward deviation from the business plan formulated when the store was opened, although there are stores for which impairment losses are recognised just after their first two years in business.

(Auditing Standards Committee Statements No. 315, paragraph 10, and No. 540, paragraphs 12 and 14)

②A Co., a consolidated subsidiary of the audited company, has booked an operating loss, meaning that A Co.'s operating performance was far worse than had been projected in the business plan formulated at the time of A Co's establishment.

However, the engagement team deemed that the judgement of the audited company, namely that A Co. had only just been established and that there were therefore no indications of impairment of long-lived assets, was reasonable.

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

《Points to Note》

In addition to the above examples, there are cases in which head office expenses are not properly allocated to individual assets or cash-generating units in calculating the profit and loss flowing from operating activities, cases in which the assessment of indications of impairment were not performed using the profit/loss flowing from operating activities when the profit/loss flowing from operating activities and the cash flow flowing from operating activities were both known, and cases in which assessment of indications of impairment were made using estimated figures calculated before the end of the fiscal year and not actual year-end figures even though the actual year-end figures were significantly worse than the estimates. With these in mind, the engagement team needs 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

NEW

According to the budgets of the individual stores used by the audited company for the assessment of the recognition of impairment losses, higher sales and operating income were expected due to an increase in sales driven by sales promotion activities and reduced expenses driven by personnel structure reform. To examine the reasonableness of the budgets of individual stores, the engagement team confirmed that there were plans for sales promotion activities and personnel structure reform by inquries to the audited company and inspections of relevant materials.

However, the engagement team only confirmed that there were plans to carry out promotional activities and revamp the personnel structure, and it did not obtain audit evidence that specifically supported the reasonableness of the budgets. In addition, the engagement team did not sufficiently examine the feasibility of stores achieving their budgets, as exemplified by the team not taking into account the budget achievement rates for each store even though the companywide budget achievement rate for operating income was about 70%, with actual figures falling far below budgets, and the budget achievement rate had been incorporated into the budget used for the consideration of the recoverability of deferred tax assets.

(Auditing Standards Committee Statement No. 540, paragraphs 8, 11, 12 and 14)

《Points to Note》

In addition to the above examples, there are cases in which the engagement team did not examine the process for determining the main asset of each cash-generating unit or the reasonableness of remaining economic life of the main asset, the bases for the period of future cash flow projection, cases in which capital investment and repair costs to maintain present condition were not included in future cash flows, cases in which post-tax discount rates were used even though future cash flow figures were pre-tax figures, and cases in which the recognition of impairment loss was determined on the basis of profit/loss flowing from operating activities rather than undiscounted future cash flows.

In addition, there are cases involving the use of real estate appraisal reports in which the engagement team did not examine the appropriateness of continuing to use real estate appraisal reports obtained in previous year's audit as audit evidence for the current fiscal year, cases in which real estate appraisal reports were used without evaluating the capabilities, competence and objectivity of the real estate appraiser used by the management, and cases in which the engagement team did not examine the reasonableness of not deducting the estimated disposal cost from the real estate appraisal value in calculating the net selling value.

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 insists 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 and 12; ASBJ Guidance 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》

In addition to the above examples, there are cases in which the business plan formulated at the time of acquisition did not proceed as expected and the profit/loss results were significantly lower than the business plan formulated at the time of acquisition, leading to a revision of the business plan and the recognition of an impairment loss of the difference between the recoverable value and the book value of goodwill. However, engagement team did not examine each type of revenue, or only examined some types of revenue, when considering the revised business plan, and on the whole did not sufficiently examine the feasibility of the revised business plan. When considering goodwill, careful consideration must be given to the reasonableness of the relevant business plan. Regarding this point, see 《Points to Note》 in "Case 1: Reasonableness of management's assumptions" and "Case 4: Evaluation of reasonableness of business plan" under "(1) Matters common to auditing accounting estimates" above.

(7) Recoverability of deferred tax assets

Case 1: Review of company classification

①A 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 ASBJ Guidance No. 26 "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)

② When considering categories under ASBJ Guidance No. 26 "Implementation Guidance on Recoverability of Deferred Tax Assets" for domestic consolidated subsidiaries, the engagement team deemed that the basic data prepared by the audited company was reasonable.

However, with regard to domestic consolidated subsidiaries that had been deemed to be Category 2 by the audited company, the team investigated the reasonableness of the classification for some of the subsidiaries, but in the case of other companies, it did not consider the reasonableness of the classification, and did not even consider whether more detailed investigation was required.

(Auditing Standards Committee Statement No. 540, paragraphs 11, 12, and 17)

《Points to Note》

In relation to the company classification specified in the ASBJ Guidance No. 26 "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

Based on ASBJ Guidance No. 26 "Implementation Guidance on Recoverability of Deferred Tax Assets," the audited company and its subsidiary deemed that the companies were Category 3, and predicted that a pretax profit would be booked from the following term onwards. However, because the estimate for total future taxable income was negative, it did not book deferred tax assets for either of the companies.

Regarding the estimate for the total future taxable income of both companies, the engagement team acquired an understanding of the companies and their environment with respect to the decision not to book deferred tax assets, and as a result of performing an investigation based on the business plans for the two companies and the scheduling of end-of-term temporary differences that would be added/subtracted in the future, the team concluded that the judgement of the audited company and its subsidiary was reasonable.

However, the engagement team did not quantitatively examine the level of future taxable income before adjustment for temporary differences etc., which needed to be considered when determining recoverability of deferred tax assets.

(Auditing Standards Committee Statement No. 540, paragraphs 11 and 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 before adjustment for temporary differences etc. backed by its earnings capability, the business plan, a basis for taxable income before adjustment for temporary differences etc., 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

NEW

The audited company booked the full aount of an allowance for doubtful accounts for loans etc. to its poorly performing subsidiaries. The audited company determined that the deferred tax assets relating to the deductible temporary difference of the allowance for doubutful accounts were recoverable because they planned to waive their receivables in the future. The engagement team obtained a confirmation letter in the name of the representative director stating that the receivables would be waived at some unspecified point in the future for the liquidation or rehabilitation of the subsidiary, and therefore assessed that the audited company's accounting procedures for posting deferred tax assets relating to the allowance for doubtful accounts to be appropriate.

However, the engagement team did not examine the reasonableness of the management assumption that the debt waiver would take place based on the facts that the representative director's stated that the debt waiver would take place at some unspecified time and additional loans had been made in the current fiscal year.

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

《Points to Note》

In addition to the above examples, 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.

In addition, in examining the deferred dax liabilities arising from undistributed profits of subsidiaries, there are cases in which the engagement team did not sufficiently examine the audited company's policy of not having subsidiaries pay dividends as a rule, and cases in which the engagement team did not sufficiently verify whether the dividend policy of foreign subsidiaries had been officially approved by an authorized decision-making body, etc.

Case 4: Review of the impact of business combinations

NEW

The audited company classified its consolidated subsidiary Company A as Category 4 in ASBJ Guidance No. 26 because Company A had significant tax loss. In addition, the audited company planned to merge with Company A in the next fiscal year and, considering based on post-merger taxable income that the tax loss could be utilized , recognized deferred tax assets corresponding to this loss.

In examining the recoverability of the deferred tax assets, however, the engagement team overlooked that this accounting treatment did not comply with ASBJ Guidance No.10, which stipulates that the impact of the business combination cannot be taken into account until the actual business combination takes place and the impact must be reflected from the fiscal year in which the business combination takes place.

(Auditing Standards Committee Statement No. 540, paragraphs 11 and 12; ASBJ Guidance No. 10, paragraph 75)

《Points to Note》

As pointed out in the examples above, the recoverability of deferred tax assets is judged by taxable income before the addition/subtraction of temporary differences based on the profitability of the acquiring company, and it is important to note that the impact of the business combination is to be reflected after the fiscal year in which the business combination takes place.

(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 provided by the audited company for 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, a new store and a closed store, described above were unusual, and that the previous calculation method was appropriate for other stores.

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

5. Group Audit

<u>Points of focus</u>

Recent fraud cases identified at domestic and foreign 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 individually 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; and
- ▶ 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.

<u>Outline of inspection results</u>

There are many instances in group audits in which the group engagement team places excessive trust in work to be performed by component auditors and involves in group engagement team without evaluating whether the group engagement team will be able to be involved in the work of those component auditors. In addition, there are cases in which performing risk assessment was insufficient, e.g., qualitative aspects were not considered when selecting significant components, cases in which communication with component auditors was insufficient, as exemplified by not properly communicating risks to the component auditors, and cases in which the identification of significant risks of material misstatement of group financial statements and the further audit procedures for addressing such risks were not sufficiently considered.

(Observed effective efforts)

The following is an example of an effective effort aimed at ensuring and improving group audit quality.

- ▪ The quality control department prepares a list of discussion points to advance understanding of the group audit and implementation of the necessary measures. More specifically, the group engagement team makes clear what should be done in the group audit by making available materials that describe in detail issues pertaining to group audits – tasks to be performed throughout the year, methods for preparing audit documentation, methods for communicating with component auditors, etc. – and the responses thereto.

- 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 the group engagement team 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 foreign affiliate companies.The group engagement team uses this checklist to improve its understanding of the audited company's financial reporting processes and risk management environment for new foreign affiliated companies.

Expected response

The group engagement team is required to evaluate the work of the component auditors it uses, always bearing in mind that responsibility for issuing appropriate audit reports in audit engagements of group financial statements lies with the auditor offering the position statement.

Group audit requires the group engagement team to sufficiently communicate with the component auditors about the types,timing and scope 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.

In particular, when there are significant foreign components, the group engagement team is required to ascertain the circumstances of key business locations overseas, communicate sufficiently with component auditors, and then appropriately identify the 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 ensure and improve the quality of group audit.

In the case where the foreign component auditors are arranged in a multi-layered and complex structure, especially when involving an foreign 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 foreign component auditors, evaluation of reports prepared by the foreign component auditors, and understanding of the audited company's management control over new affiliate companies added through acquisition, etc.

Case 1: Significant components

①When selecting significant components of individual financial importance within the group, the group engagement team determined that components where any one of total assets, retained earnings, sales, or pretax profit accounted for more than 15% of the simple total for all consolidated companies would be regarded as components of individual financial importance. However, because the team did not take into account figures after the elimination of intragroup transactions, it did not adequately consider whether components generating around 25% of consolidated sales constituted significant components of individual financial importance.

(Auditing Standards Committee Statement No. 600, paragraphs 8, 16, and A5)

NEW

②The group engagement team did not consider the following, despite the fact that foreign subsidiaries Company A and Company B had operating losses for both the previous fiscal year and the current fiscal year, even while Company A and Company B, neither deemed a significant component, hold fixed assets that exceed the materiality for the group financial statements as a whole.

a) The group engagement team heard from the component auditor only that there was no risk of impairment of long-lived assets and, without obtaining sufficient information about the companies and their corporate environments such as Company A's future business plan, it determined that the financial statements of these components did not include significant risks.

b) Although the group engagement team had not sufficiently evaluated cost-cutting elements, the key factors for improving profit/loss, when evaluating Company B's business plan for posting operating profits in the next fiscal year, the group engagement team determined that this component's financial statements did not include significant risks.

(Auditing Standards Committee Statement No. 600, paragraphs 8 and 17)

③The 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: Understanding the Component Auditor

NEW

The group engagement team sent audit instructions to the auditor of a foreign subsidiary that is a significant component, and asked him to perform an audit of the reporting package prepared by the component based on Japanese generally accepted accounting principles and submitted to the audited company.

However, the group engagement team did not consider whether the auditor was knowledgeable of Japanese generally accepted accounting principles, despite the component auditor being located overseas.

(Auditing Standards Committee Statement No. 600, paragraph 18)

《Points to Note》

The group engagement team should keep in mind that, when asking a component auditor to perform work related to the component's financial information, it should determine if there are any issues pertaining to the component auditor's independence, whether he has the skills of a professional expert, and whether it can involve itself in the work of a component auditor.

Case 3: Materiality

NEW

The group engagement team uniformly applied the upper limits given in the audit manual in determining the component materiality, and decided that the component materiality for all components were to be slightly below the materiality for the group financial statements as a whole. Although employee fraud had been uncovered in the previous fiscal year at a subsidiary that was a significant component of the audited company, the group engagement team did not consider whether it was necessary to set a different component materiality in keeping with the circumstances of individual components, including those where fraud had been identified.

(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 4: Deciding audit tasks regarding the financial information of components

Regarding procedures for responding to the significant risk regarding foreign subsidiaries of the audited company, the group engagement team made a request to the auditors of components in the form of an instruction letter, and received reports from them.

However, in its instructions to the auditors of components, the group engagement team gave instructions not for audit procedures, but instead for agreed-upon procedures, and did not perform audit procedures for significant risks or obtain sufficient appropriate audit evidence.

(Auditing Standards Committee Statement No. 600, paragraphs 17, 25, and 26)

《Points to Note》

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

Case 5: Involvement in tasks undertaken by component auditors

NEW

The group engagement team identified fraud risks and other significant risks in estimating the total cost of construction on a percentage-of-completion basis at components of the audited company's consolidated group, and requested the components' auditors to perform procedures to respond to fraud risk-related audit procedures for estimating total construction cost.

However, the group engagement team did not obtain from the component auditor the information on its planned audit procedures to respond to the identified fraud risks and therefore did not evaluate their appropriateness. In addition, the group engagement team did not take into consideration that the further audit procedures to be performed by the component auditors to respond to the identified fraud risks were only reviews and that the component auditors did not report on assessments of the effectiveness of internal controls in addressing significant risks.

(Auditing Standards Committee Statement No. 600, paragraphs 30 and 41)

《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 6: Communication with component auditors

NEW

①The group engagement team requested the auditor of an foreign subsidiary that was a significant component to perform work on the financial information of a component. Because the audited company as the parent company put a great deal of pressure on this component to achieve its budget, the group engagement team identified a risk of the component improperly recognizing non-existent sales as revenue.

However, the group engagement team did not communicate to the component's auditor that it had identified this risk of the component improperly recognizing non-existent sales as revenue.

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

NEW ②The group engagement team understood that the audited company and an foreign subsidiary that was a significant component both recognized revenues based on an acceptance inspection standard because installation work was involved when selling products, and it identified a risk of fraud in product sales of pretending to have conducted acceptance inspections and then recognizing revenue.

However, the group engagement team communicated the component auditors only that there was a significant risk of material misstatement due to fraud in revenue recognition, but did not specifically communicate the risk of fraud identified with respect to the acceptance standard.

(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 Group engagement teams 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 7: Evaluation of audit results communicated from component auditors

NEW ①When issuing instructions to a component auditor, the group engagement team requested that procedures be performted to address identified significant risks, and it received a report at the end of the fiscal year to the effect that the component auditor had performed the procedures to address the significant risks, that no exceptions had been detected and that interviews had been conducted with key managers on the management override of internal controls.

However, the group engagement team did not confirm that some of the audit procedures planned by the component auditor had in fact been performed. Although the year-end report did not describe the scope and timing of audit procedures performed by the component auditor for significant risks or specific audit procedures that concluded that there had been no abnormal journal entries, the

group engagement team concluded that the component auditor’s work was appropriate, even though it had not ascertained/examined specific audit procedures by reviewing audit documentation, etc.
(Auditing Standards Committee Statement No. 600, paragraphs 18, 30, 41, 43, A31, and A59)

NEW ②The group engagement team received a report from the auditor of a significant component in an interview held while conducting an on-site visit that no abnormalities had been uncovered during journal entry testing. In addition, the group engagement team received a response to its audit instructions stating that there were no matters to report regarding journal entry testing.

However, the group engagement team did not ascertain the specific risk scenarios and implementation results by which the component auditor had concluded that there were no matters to report regarding journal entry testing, and the group engagement team did not evaluate the sufficiency and appropriateness of the procedures performed by the component auditor.

In addition, the group engagement team received a response to its audit instructions from the auditor of the significant component stating that the bank confirmation form had not been returned, but it did not thereafter obtain sufficient appropriate audit evidence on the audit procedures the auditor had performed and on his conclusions.

(Auditing Standards Committee Statement No. 600, paragraphs 41 and 43)

《Points to Note》

The group engagement team should evaluate the matters reported by the component auditor and, if it determines that the work of the component auditor has been insufficient, should decide on additional procedures to be performed by the group engagement team and on whether these additional procedures will be performed by the component auditor or by the group engagement team.

Case 8: Sufficiency and appropriateness of audit evidence obtained

NEW The group engagement team in its audit instructions to the auditor of Company A, a significant component, made it known that it had identified the likely significant risks of material misstatement of the group financial statements– a risk of improper revenue recognition by the component and a risk of management override of controls – and presented the auditor with a summary of further audit procedures to be performed.

The audit results report materials prepared by the component auditor and received by the group engagement team did not describe the audit procedures performed for these significant risks of material misstatement of the group financial statements and the results thereof, but the group engagement team nevertheless claimed to have confirmed the implementation and results of these procedures through oral communication with the component auditor.

However, the group engagement team did not describe in the audit documentation what had been confirmed in oral communication with the component auditor, and it did not evaluate whether sufficient appropriate audit evidence had been obtained from the work of the component auditor.

(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 evidence obtained for significant risks. 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 9: Consolidation process

NEW

①The group engagement team understood that the component auditor at a significant US subsidiary accounting for the majority of the audited company's consolidated sales was auditing consolidated financial statements based on US GAAP. In addition, the group engagement team had a policy of relying on the results of audits conducted by this component auditor for the subsidiary's consolidated settlement figures audited by the component auditor, and verifying for itself the figures not audited by the component auditor.

Despite the fact that the component auditor had not audited the year-end balance of inventory assets purchased by the subsidiary from the audited company that formed the basis for eliminating unrealized gains or other consolidated package figures prepared by the subsidiary, the group engagement team had no plans on how to verify these and did not in fact verify them.

(Auditing Standards Committee Statement No. 600, paragraphs 23, 32 and 33)

②The audited company prepared its consolidated financial statements based on IFRS (International Financial Reporting Standards). Furthermore, the audited company's foreign components followed local accounting standards when preparing their own financial statements. The audited company then included certain accounts in its consolidated financial statements without adjusting their accounting treatment to IFRS. The group engagement team found out from the component auditors that different accounting treatment was required under the local accounting standards and IFRS regarding these accounts.

However, the group engagement team did not adequately consider the need to adjust the accounting treatment based on accounting standards employed by the components to accounting treatment based on IFRS, which was employed for the consolidated financial statements.

(Auditing Standards Committee Statement No. 600, paragraph 34)

《Points to Note》

The group engagement team should keep in mind that the need to understand overall group control and consolidation processes, to draw up plans covering the types, timing and scope of risk-related audit procedures to address risks of material misstatement in group financial statements arising from the

consolidation process, and to implement these same plans.

6. Using the work of Auditor's 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

In using the work of others such as auditor's expert, there are cases in which the engagement team had overly trusted the result of the work of other and relied on it without sufficient evaluation.

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

Engagement teams should always keep in mind that they are responsible for issuing appropriate audit reports of the financial statement audits, and they should therefore evaluate the adequacy of the experts' work they intend to use.

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 appropriate audit evidence conforming to the audit purpose.

Case 1: Agreement with auditor's experts

With regard to some real estate inventories for sale that had been valued by the audited company based on real estate appraisal, the engagement team requested a review of the real-estate appraisal report from an internal expert.

However, the engagement team did not give appropriate instructions to the selected expert by clarifying the specific tasks requested, including the nature, scope and objectives, 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 and 12)

《Points to Note》

When using the work of an expert in a field of experties other than accounting or auditing, the engagement team shall not leave matters entirely to the expert but instead shall agree with the expert on the scope of that expert work, must evaluate the competence, capabilities and objectivity of the expert, and must evaluate the adequacy of the expert’s work for the auditor’s purposes.

For the requirements applicable when engagement teams undertake consultation on difficult or contentious matters of accounting or auditing, the engagement teams shall refer to paragraph 17 of Auditing Standards Committee Statement No. 220 (“Quality Control in Audit Engagements”). 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 “3. Audit Evidence”.

7. Audit of Internal Control over Financial Reporting

Points of focus

CPAAOB performs inspections of audit of internal control over financial reporting 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; and
- Whether the engagement team examines the impact on interneal control audit 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

An auditor shall form and express its opinion based on the audit evidence obtained, on whether internal control report prepared by management present fairly, in all material respects, the evaluation results of the effectiveness of internal controls in accordance with generally accepted standards for the assessment of internal controls.

To that end, in consideration of materiality, auditors should adequately understand management's design and operation status of internal contorol as well as assessment results and should carry out financial statement audit and internal control audit in an integrated manner from the perspective of effective and efficient conducting of both 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

NEW ①In examining the process-level controls of significant business locations or units included in the scope of assessment, the engagement team judged that the assessment scope of prosess-level controls determined by management was appropriate, based on the fact that sales after elimination of inter-company transactions related to the business processes included in the assessment scope of internal controls reached approximately two-thirds of the total sales on a consolidation basis.

Despite the fact that components' business processes associated with significant risks of the group financial statements were not included in the assessment scope of internal controls, however, the engagement team did not examine the reasonableness of the assessment scope determined by the audited company.

(Audit and Assurance Practice Committee Statement No. 82, paragraph 112)

NEW ②Despite having identified risks of the valuation of goodwill and inventories as significant risks, the engagement team did not examine the reasonableness of which management did not include business processes associated with the significant risks in the assessment scope for its internal control audit.

(Audit 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 are included in business processes involved in the preparation of accounts that are substantially related to the company's business objectives for significant business locations or units, but

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

①In 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; Audit and Assurance Practice Committee Statement No. 82, paragraphs 153 and 154)

②In 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.
(Audit and Assurance Practice Committee Statement No. 82, paragraphs 153 and 158)

Case 2: Assessment of design and operation of internal control

NEW

①The engagement team judged the assessment scope of company-level internal controls determined by the audited company to be appropriate, and it examined the appropriateness of assessment results of design and operation of company-level internal controls by the audited company.
However, the engagement team examined the appropriateness of the assessment of company-level internal controls only at the audited company and its subsidiaries selected as significant business locations or units, and it did not examine the appropriateness of the assessment results of company-level controls of the other subsidiaries included in the management assessment.
(Standards for Management Assessment and Audit concerning Internal Control Over Financial Reporting III. 4.(1))

②As part of its sales management process, the audited company performed master registration and processed orders received, shipments, cash collection, receivables settlement, etc. through their core computer system, which was interfaced with the accounting system once a month to allow the accounting of sales, accounts receivable, etc. to be performed.
However, the engagement team did not consider whether automated business processing control of the interface linking the core system with the accounting system needed to be included in the audit of internal controls.

(Audit Standards Committee Statement No. 315, paragraph 17; IT Committee Practical Guideline No. 6, paragraph 31; Practice Standards for Management Assessment and Audit concerning Internal Control over Financial Reporting III. 3 (4))

③With regard to internal controls relating to sales, the engagement team believed, based on audits in past years, that it had understood the internal controls for reflecting automatic journal entries in the accounting system based on transaction information entered into the sales management system. However, even though the team was aware that the relevant internal control program had been changed, it did not consider the impact of the change on the audit for the current year.
(Audit Standards Committee Statement No. 315, paragraph 8; IT Committee Practical Guideline No. 6, paragraph 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.In examining the assessment results of internal controls, attention must be paid to the change in business activities and earnings structure of the audited company, etc., without being excessivly influenced by the audit experiences of past years.

For points to note when performing a dual-purpose test, refer to "3. Audit Evidence (1) Matters common to audit evidence".

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

①The engagement team planned to perform the financial statements audit and the internal controls audit in an integrated fashion, but with regard to company-level internal controls and business-process internal controls relating to financial reporting process not relating to the preparation of the securities report (financial statements) , the team had not completed its assessment of the design and operation of these internal controls on the date of the Companies Act audit report.
(Auditing Standards Committee Statement No. 300, paragraph 8; No. 330, paragraphs 5, 6, 10, and 25; Audit and Assurance Practice Committee Statement No. 82, paragraph 27)

NEW ②The engagement team assessed process-level controls by obtaining management assessment result verified using the transactions in the first quarter as samples. In assessing the resut, the engagement team asked questions and inspected relevant documents of managment samples, and obtained the documents from the audited company confirming any material changes to internal controls after the year-end closing date. Considering the above, the engagement team assessed the status of design and operation of process-level controls as effective.

However, the engagement team did not examine what additional procedures should be perfomed for the rest of the fiscal year in order to assess whether the evaluation results of internal controls verified using the transcations in the first quarter as samples remained effective as of the year-end closing date.

(Auditing Standards Committee Statement No. 330, paragraph 11; Audit and Assurance Practice Committee Statement No. 82, paragraph 160)

《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 should preferably perform procedures for assessing operation prior to performing important substantive procedures. The same can be said for the assessment of the effectiveness of the company-level controls and IT general controls that support the process-level controls as well as the subject controls.

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.See Auditing Standards Committee Statement No. 330, paragraph A32 for the relevant factors in obtaining additional audit evidence for performing roll-forward procedures.

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) Assessment of Deficiencies

Case 1: Assessment of deficiencies in design and operation of internal control

With regard to the audited company's IT system for receiving and placing orders and its cost accounting system, the engagement team discovered that management functions such as the setting of IDs and passwords for each user were absent, and deemed this to be a deficiency in IT general controls.

However, the team did not consider the impact of this deficiency in IT general controls on IT application controls and the audit of financial statements.

(Auditing Standards Committee Statement No. 315, paragraph 30; IT Committee Practical Guideline No. 6, paragraph 53)

Case 2: Determination of material weaknesses

NEW

The engagement team identified numerous deficiencies from the process-level controls over financial closing and reporting process during the substantive testing of the financial statement audit, and also identified multiple disclosure errors in the securities report for the previous fiscal year caused by internal control deficiencies. Although these deficiencies had not been remediated as of the year-end closing date because the engagement team had identified these deficiencies after that day, the engagement team concluded by holding meetings with the internal audit department of the audited company that these did not constitute material weakness.

However, the engagement team did not examine specifically how management had assessed the deficiencies, and it did not consider from the viewpoint of financial and qualitative impacts whether these deficiencies constituted material weakness individually or in combination.

(Auditing Standards Committee Statement No. 330, paragraph 16; Audit and Assurance Practice Committee Statement No. 82, paragraphs 187 and 205)

Case 3: Assessment of internal control over misstatement

NEW

Regarding misstatements related to inventories discovered in the course of financial statement audit of a component, the engagement team considered reasonable the component auditor's assessment that those were not significant deficiencies because: the misstatements had been corrected; the misstatements were not deedmed as significant although these were caused by the deficiencies in internal controls; and the component's management had immediately taken remedial actions of deficiencies.

However, the evaluation procedures for deficiencies carried out by the engagement team included the following deficiencies.

- The internal controls that had deficiencies were not specified.
- The account items affected by the deficiencies and the likelihood of occurrence of the deficiencies were not examined to determine whether the deficiencies were deemed as a material weakness.
- The details of the remadeial actions taken by the component's management were not understood.
- It was not confirmed how these deficiencies had been assessed in the management assessment.

(Auditing Standards Committee Statement No. 265, paragraphs 6 and 7; Audit and Assurance Practice Committee Statement No. 82, paragraph 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 the work of internal auditors

Case: Extent of using the work of internal auditors

The engagement team partially employed audit results from internal auditors concerning the audited company's IT general controls for its accounting system and construction system, which were core systems (controls relating to program and data access controls, program modification, program development, and computer operation).

However, when deciding whether the work performed by the internal auditors was appropriate in light of the objectives of the financial statements audit, the team did not consider objectivity. Furthermore, the team did not conduct investigations to determine whether specific tasks performed by the internal auditors were appropriate in light of the audit objectives.

(Auditing Standards Committee Statement No. 610, paragraphs 11 and 19)

《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.

When using the work of internal auditors, etc., the engagement team must remember to examine: the degree of risk addressed by the internal controls intended to be used; the nature and importance of the internal controls; the operation status of the internal controls; the degree of judgment necessary to evaluate the operation; and the quality of the work of the internal auditors, etc.

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