Provisional Translation

# Case Report from Audit Firm Inspection Results

（In Program Year 2021）

July 2021

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 audit quality 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 (Case Report)), 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 Case 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 Case Report and organize information exchanges by conducting briefings at regional chapters of the Japanese Institute of Certified Public Accountants (JICPA) and seminars 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 "2021 Monitoring Report". Please also refer to this report.

In order to further ensure the reliability of audits, audit firms should review individual audit engagements and quality control systems in reference to examples of deficiencies and causes of the deficiencies described in this Case Report. In particular, small and medium-sized audit firms should make effective use of the Case Report in training programs, for example, in order to voluntarily improve audit quality.

Please submit any comments or requests regarding this Case Report to the dedicated e-mail address below.
Monitoring and Inspection Division, 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 Case Report

(1) Although this Case Report is a compilation of relatively new cases of deficiencies that were identified in the inspections, it 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 Case 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 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 be included in matters that should have been noted by audit firms and engagement teams, or may be included in 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.

(7) New example cases adopted in the 2021 edition of the Case Report are preceded by the mark.

NEW

2. Main Characteristics of the 2021 Edition

(1) In "I. Operations Management Environment (Root Cause Analysis)," the numbers of examples of root cause analysis conducted by the CPAAOB and examples of root causes have been increased in light of the importance of such analysis.

(2) In "II. Quality Control Environment," the number of examples of issues related to the quality control environment has been increased with regard to the conclusion of new audit contracts, the education/training of audit teams, evaluation of partners, and appointment of engagement partners, etc. In particular, in order to contribute to improvements at small and medium-sized audit firms, the number of examples of observed effective efforts has been increased. A new item, "Impact of COVID-19 on Audit Engagements and Response," has been added, describing the expected response, among other matters.

(3) In "III. Individual Audit Engagements," descriptions of identified deficiencies and points to note have been expanded in sections such as "1. The Auditor's Responsibilities Relating to Fraud in Financial Statement Audits," "4. Auditing Accounting Estimates," and "5. Group Audit" in light of the fact that

accounting fraud at listed companies and accounting issues at overseas group companies continue to attract public attention. In particular, in order to contribute to improvements at small and medium-sized audit firms, the number of examples of observed effective efforts has been increased. The size of audit firms is indicated in order to clarify whether individual example cases concern deficiencies at large-sized, second-tier, or small and medium-sized audit firms.

(4) In "IV. Others," a new item, "Notification of inspection results," has been introduced in order to provide explicit explanations about such matters as the contents of and how to treat notifications of CPAAOB inspection results that are based on root cause analysis.

(Definitions of terms)

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

| | |
|---|---|
| Act | Certified Public Accountants 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.<br>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.<br>In this Case Report, this refers 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 Financial Services Agency (FSA) in March 2017 |
| Audit team | Persons engaged in the provision of audit services, and comprises (an) engagement partner(s) and assistants to the engagement partner(s) |
| Engagement partner | The person responsible for conducting audits, 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

In recent years, the powers of Audit and Supervisory Board Members, Audit and Supervisory Boards, Audit Committee Members, and Audit Committees (hereinafter referred to as "company auditors, etc.") have been strengthened, corporate governance codes are introduced, and these developments have helped enhance corporate governance environments. However, incidents of fraud continue to occur both in Japan and overseas and a number of listed companies have announced inappropriate accounting practices and other misconduct through the timely disclosure procedure. Meanwhile, there are concerns that fraud risks at companies may grow as a result of the downturn of the global economy and social structure changes due to the impact of COVID-19.

It is therefore necessary for each audit firm to continue to verify its individual audit engagements and quality control systems 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 audit 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 risk of material misstatement.

If deficiencies are identified in individual audit engagements or quality control systems, 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 quality control systems should not only be an issue for the CEO and PICOQC, but rather a firm 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 audit quality.

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 their 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 Audit Firm Governance 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 appropriate audit work papers on material audit matters has not been prepared, for example, the issue in the vast majority of cases is not simply a lack of documentation but a failure to perform the necessary audit procedures. If the prepared audit work papers do 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 an issue of documentation. If the necessary audit procedures have not been carried out, the reasons for this must be further analyzed and efforts must be made to improve. To ensure that necessary audit procedures are implemented, 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 through supervising the audit practices, reviewing audit work papers, performing engagement quality reviews and conducting periodic inspection, etc.

## 4. Responding to Issues According to Firm 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 check 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 issues 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, aduit 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 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 firms' 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 audit divisions, 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 understands the characteristics of the engagements handled by each audit division so as to ensure the effectiveness of the measures instituted by audit divisions.

**[Second-tier audit firms]**

Second-tier audit firms have been improving their organizational structures so that they can take systematic actions with regard to quality control, but their headquarter organizations are still weaker than large-sized audit firms. In addition, the quality control environment of some firms is inadequate as a result of limited manpower assigned to quality control and also insufficient awareness of CEOs and PICOQCs concerning quality control. Another issue is that at firms expanding their operations, an audit operational environment has not been developed to serve new audit contracts in a timely manner. Furthermore, regarding operations management, some audit firms heavily rely on part-time stqaff performing audit procedures and some have quality control issues at regional offices.

Moreover, second-tier audit firms need to improve their ability to conduct audits for large listed companies, especially leading global group audits, including communications with their overseas network firms.

**[Small and medium-sized audit firms]**

As a result of lack of awareness of the importance of quality control among the CEOs and PICOQCs, small and medium-sized audit firms fail to proactively address matters of quality control. In addition, they lack the resources for developing quality control systems. Because of these, while they are addressing deficiencies identified in external inspections, this remedial 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 issue had occurred in the past.

Some small and medium-sized audit firms prioritize expanding their operations and have concluded new contracts in the belief that risks of new audit contracts (hereinafter, "contract risks," including risks for renewing contracts) had been appropriately assessed even though due consideration had not been given to fraud risks of listed companies with high audit risk. As a result, instances of inadequate and inappropriate risk assessments and corresponding audit procedures are found.

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

The relationship between directors/company auditors of a audited companies and accounting auditors has been 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 preparation of financial statements and the design and operation of internal controls. Furthermore, from the perspective of investor protection and securing reliability of the capital market, directors and company auditors are strongly expected to appropriately evaluate and select accounting auditors, who provide assurance as to fairness 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, including shareholders of audited companies, that the directors and company auditors of audited companies appropriately evaluate and select accounting auditors, and that the companies' financial information is properly disclosed on a continuous basis by securing proper auditing.

In particular, effective from the fiscal year ended March 31, 2021, "key audit matters" (hereinafter referred to as "KAM") are required to disclose in order to improve transparency of audits conducted by accounting auditors and increase information value of audit reports. More effective audits are expected to further enhance collaboration and communication between accounting auditors and company auditors, etc. as well as discussions with management, leading 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 between accounting auditors and company auditors, etc., in the most easily comprehensible manner from the perspective of providing directors and company auditors, etc., of listed and other companies as well as investors with reference information on audits. This Case Report also describes observed effective cases of improvement efforts by audit firms. We thus hope that this Case Report would be helpful 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 (below, “the Act”) and Article 77 of the JICPA Rules (below, “QC review”) or periodic inspection, at least some audit firms only took superficial improvement measures, without fully identifying the causes.

Deficiencies identified in inspections are detected within the scope of investigations. It is likely that the audit firms have other undetected deficiencies arising from the same root causes. Moreover, even if the measures are implemented only to address the direct causes of the deficiencies, they may be effective temporarily, and similar deficiencies may 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 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 relating to individual audit engagements identified through external inspections, etc. and periodic inspections, large-sized audit firms not only identify and communicate the deficiencies 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 deficiencies were identified in order to find out the details of the direct causes of the deficiencies, after which the department 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.

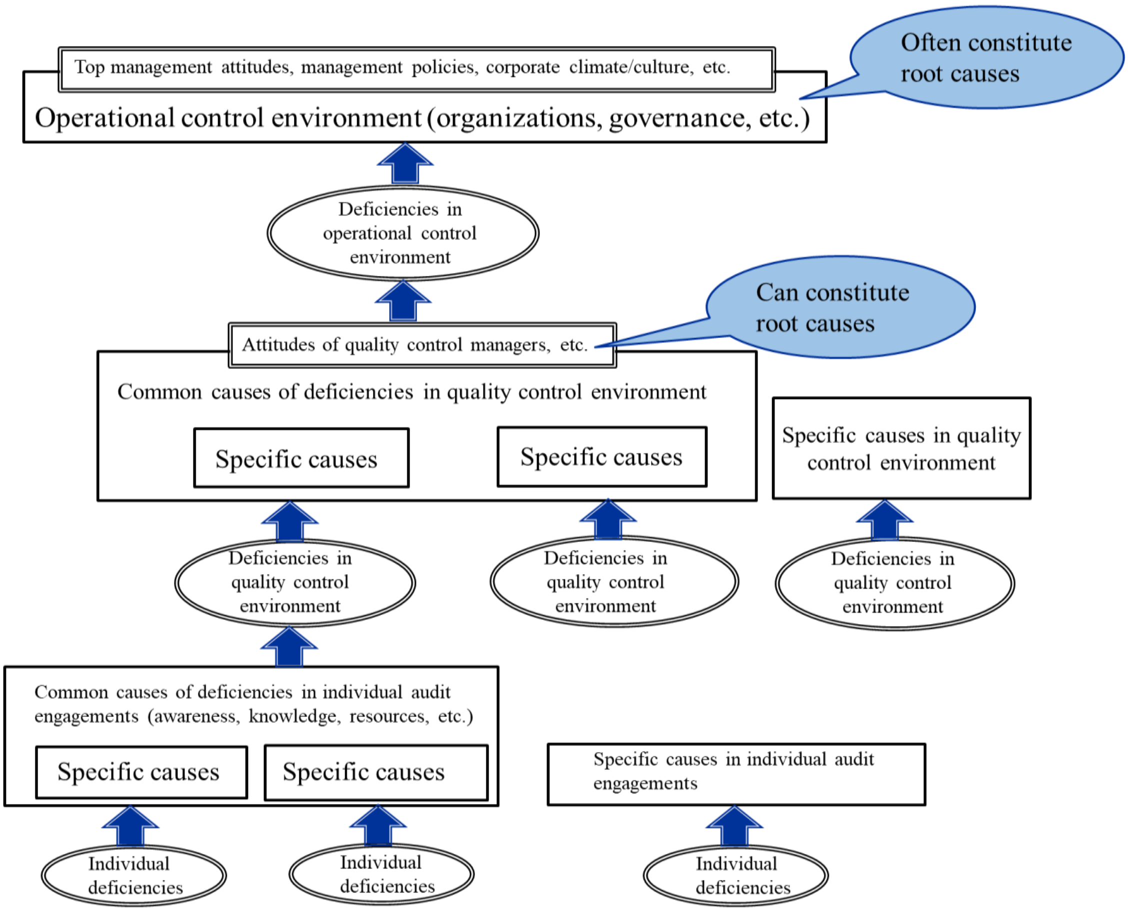
**(2) Root Cause Analysis**

When conducting root cause analysis, it is first and foremost important to accurately identify the direct causes of deficiencies. Rather than ascribing the direct causes merely to the knowledge, attitudes, or experiences of individual persons involved, it is essential to identify the direct causes after sufficiently understanding engagement team's circumstances and the business conditions of audited companies, among other factors, and conduct a further analysis to explore the root causes in light of the identified direct causes.

Direct causes include "specific causes," which are identified with regard to individual deficiencies, and "common causes," which are common to multiple deficiencies. Further examining the underlying causes of common causes often helps to identify the root causes.

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

【Figure 1】 **Reference Image: Analysis of Deficiencies and Root Causes**




The following are examples of root cause analysis in which the CPAAOB 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]**

At the audit firm, multiple deficiencies, including significant ones, were identified with regard to some individual audit engagements subject to inspection.

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 issues with accounting treatment at an audited company as a result of examinations of documents obtained from the company and discussions with it in advance, the engagement partner did not demonstrate professional skepticism, and therefore instructions, supervision, and review in the audit fieldwork were inadequate. The direct causes also included the fact that 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]**

NEW

At the audit firm, multiple deficiencies, including significant ones, were identified with regard to some individual audit engagements subject to inspection.

The direct causes of those deficiencies included a lack of commitment by engagement partners and their assistants to carefully consider whether adequate audit procedures were performed in areas other than those with higher risk of material misstatement, incuding significant risks. In addition, at the audit and quality control divisions, there was a common cause of the deficiencies in the quality control environment, which was a lack of understanding as to which engagement teams needed organizational support and which audited companies were facing higher risks.

Further analysis of the root causes ascribed the above deficiencies to the quality control environment. For example, the audit firm assumed that developing a system to monitor individual audit engagements and communicating quality control measures to engagement teams would be sufficient to improve audit quality. As a result, adequate verification was not conducted as to how the extent to which quality control measures had taken hold and how effective they were.

**[Case 3]**

NEW

At the audit firm, multiple deficiencies, including significant ones, were identified with regard to individual audit engagements subject to inspection.

The direct causes of those deficiencies included the assumption among engagement partners and their assistants that it was sufficient to examine material audit matters, such as accounting estimates, based only on the understanding of nature of audited companies' business and past business performance trends and that it was not necessary to examine quantitative supporting data. There were also common causes related to the deficiencies in the quality control environment at individual divisions and departments of the headquarters involved in quality control, including: a lack of efforts to ensure that the level of audit procedures required by the current audit standards are penetrated throughout the firm; and a lack of efforts to encourage engagement partners to be proactively involved in the audit engagements that they are in charge of.

Further analysis of the root causes ascribed the above deficiencies to the quality control environment. For example, the audit firm assumed that appropriately identifying material risks faced by audited companies and repeatedly communicating the importance of conducting risk-focused audits to engagement teams would be sufficient to improve audit quality. As a result, adequate verification was not conducted as to the extent to which quality control measures had taken hold and how effective they were.

**[Second-tier audit firms]**

**[Case 1]**

Significant deficiencies 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 rules 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 root causes discovered that the causes lay in the operations management and quality control environments in that the chief executive officer (CEO) and other executives acknowledged that the rules pertaining to the conclusion of new audit contracts did not fit reality but tolerated them because there had been no serious issues with business operations 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 inspections were identified at an audit firm. These concerned, for example, substantive procedures for revenue and procedures for responding to fraud risk. Many of these deficiencies were identified 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 work papers, instead followed same audit procedures from the past years because no major issues had arisen in audit engagements theretofore. The common cause for these deficiencies 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 revising 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.

**[Case 3]**

NEW

At the audit firm, multiple deficiencies were identified with regard to all individual audit engagements subject to inspection. Many significant deficiencies, including significant ones, were identified in individual audit engagements at particular regional offices.

Those deficiencies in the individual audit engagements had common causes, including a lack of understanding among engagement partners and their assistants of the level of audit procedures required by the current audit standards, including lack of professional skepticism with regard to response to fraud risks and accounting estimates; and lack of awareness of the need to review risk assessment and risk-related audit procedures every fiscal year due to the assumption that merely following the audit procedures performed in the previous fiscal year would be sufficient. The deficiencies in the individual audit engagements at particular regional offices also had a common cause, which was lack of awareness among some engagement partners of the need to give instructions to and supervise engagement teams and of the need to conduct in-depth review due to the assumption that audit procedures were being properly performed by other engagement partners concurrently serving as the chief auditors.

The common causes of those deficiencies in the individual audit engagements are ascribable to the quality control environment. For example, the PICOQC lacked awareness of the need to emphasize the need for cooperation between the quality control and audit divisions under the belief that the audit division should play the leading role in ensuring that improvement measures take hold in audit fieldwork. The common cause of the deficiencies in the individual audit engagements at particular regional offices are also ascribable to the quality control environment. Specifically, there was lack of awareness on the part of the manager in charge of the audit division about the need for support from the audit division due to the assumption that engagement teams could be appropriately organized if engagement partners were appropriately assigned.

Further analysis of the root causes ascribed the above deficiencies to the operations management environment. For example, in some cases, the CEO, when planning and implementing measures to improve audit quality, refrained from exercising strong leadership and placed emphasis on the independence of the quality control and audit divisions. As a result, there was lack of awareness of the need to quickly make improvements. Furthermore, the executive management team also respected the independence of the quality control and audit divisions and lacked awareness about the need for strong cooperation between those two divisions. In other examples, although the executive management team was aware of audit quality issuesat some regional offices, it assumed that the regional offices would be able to make improvements on their own. As a result, there was lack of awareness of the need to actively support the regional offices.

**[Small and medium-sized audit firms]**

**[Case 1]**

NEW

At the audit firm, deficiencies were identified with regard to the quality control environment. In addition, many deficiencies, including significant ones, were identified with regard to individual audit engagements subject to inspection.

The deficiencies in the individual audit engagements had common causes, including: a lack of understanding among engagement partners and their assistants of the assessment of and response to fraud risks and the level of audits concerning accounting estimates required by the current audit standards; and a lack of professional skepticism, such as willingness to challengemanagement's assertions. The common causes of deficiencies in the individual audit engagements are ascribable to the quality control environment. For example, the CEO and the PICOQC did not understand the level of in-depth analysis of causes necessary for preventing deficiencies similar to the ones detected in the quality control reviews, etc. In addition, the CEO and the PICOQC assumed that merely using JICPA's various audit tools by the audit teams would ensure a certain quality level of audits.

Further analysis of the root causes ascribed the above deficiencies to the operations management environment. For example, the CEO and PICOQC were not aware of a lack of understanding among all audit team members, including themselves, of the purposes of the current audit standards and of the levels of quality control and audit procedures required by the standards. In other example cases, the CEO and PICOQC assumed that there was no issue with the current management of their audit firm, and as a result, they were not aware of the need to develop an organized quality control environment.

**[Case 2]**

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 3]**

NEW

Although the audit firm is small, its audit division has comprised two departments since its foundation, with audit engagements and financial and personnel affairs of each department independently managed. This has resulted in the development of an organizational climate that gives precedence to the independence of each department. Furthermore, only engagement partners work on a full-time basis, while all assistants to engagement partners are certified public accountants and substantially all work as part-time staff.

Under these circumstances, at the audit firm, multiple deficiencies, including significant ones, were identified with regard to the quality control environment. In addition, many deficiencies, including significant ones, were identified with regard to individual audit engagements subject to inspection. The deficiencies in the individual audit engagements had common causes, including: a lack of understanding among engagement partners and their assistants of the level of audits required by the audit standards; a lack of professional skepticism, such as willingness to challenge management's assertions; lack of sense of belonging to the firm and of awareness of the need to maintain and improve the quality level of audits among assistants to engagement partners, who substantially work as part-time staff. The common causes of the deficiencies in the individual audit engagements are ascribable to the quality control environment. For example, the CEO and the PICOQC did not understand the level of in-depth analysis of causes necessary for preventing deficiencies similar to the ones detected in the quality control review, etc. and placed too much trust in engagement partners and their assistants had sufficient capabilities given their extensive practical experiences.

Further analysis of root causes ascribed the above deficiencies to the operations management environment. For example, the CEO and the PICOQC were not aware of a lack of understanding among all audit team members, including themselves, of the purposes of the current audit standards and of the levels of quality control and audit procedures required by the standards. In other example cases, the CEO and PICOQC assumed that there was no issue with the current organizational structure that had been maintained since the firm's foundation, since no serious deficiencies had been detected in past quality control reviews, etc. As a result, they were not aware of the need to achieve integrated operations management, including integrating the two departments, or the need to develop an organized audit operational environment, including employing more full-time assistants to engagement partners.

As mentioned above, many of the root causes of deficiencies are ascribable to the operations management and quality control environments, and it is important to improve those environments in order to fundamentally remediate deficiencies.

Audit firms, large-sized ones in particular, are currently making efforts to establish and strengthen organizational operations in accordance with the Audit Firm Governance Code. They should give due consideration to the effectiveness of those efforts so that the efforts can contribute to ensuring and improving audit quality.

**(3) Specific Examples of Root Causes**

The following are specific examples of root causes identified in inspections, including those mentioned in 1. (2) Root Cause Analysis.

To remediate deficiencies, it will be necessary for audit firms to tacke fundamental issues that affect the firm as a whole, such as issues relating to its operations management environment and to ensure and improve audit quality with reference to these examples.

**[Large-sized audit firms]**

While large-sized audit firms have established quality control environment, there are issues with the effectiveness of their operation.

Since large-sized audit firms have several thousands of employees, they usually have multiple audit divisions, consisting of several hundreds of staff managed by a division manager, etc., and multiple offices, including some regional offices.

Under such circumstances, in order to improve the quality control level across the entire organization, it is necessary not only for firms to design the organization and procedures of a quality control environment, but also for the management, including the CEO, to demonstrate strong leadership, and for each division to instill the improvement measures into the engagement teams. At large-sized audit firms, however, deficiencies such as lack of leadership, including with respect to the management's awareness of quality control, and issues 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. As a result, divisions etc. are playing a greater role in voluntarily improving audit quality and penetrating an quality-oriented mindset among engagement team members.

However, as the management and the quality control departments, etc. give precedence to the independence of each business division with regard to efforts to improve audit quality, they are leaving those efforts entirely in the hands of individual business divisions or neglecting to ensure sufficient communication with the divisions. As a result, issues occurred, including an insufficient understanding of the actual situation of each business division and an inadequate verification as to whether improvement measures are being appropriately implemented. Therefore, the management and quality control departments etc. need to appropriately identify the efforts being made in each business division and sufficiently examine the extent to which improvement measures have taken hold and how effective they are.

The following are specific examples of root causes of deficiencies at large-sized audit firms identified so far through the CPAAOB’s inspections:

- Although the number of audit team members, including those hired as mid-career personnel, is increasing as a result of firms stepping up recruitment in order to cope with business expansion, the overall skill level of audit teams has not improved sufficiently. However, efforts to improve and maintain audit quality made in audit fieldwork are not sufficient. (With regard to root cause analysis regarding this example, also refer to [Large-sized audit firms] [Case 1] on p. 9).
- NEW The audit firm assumed that it could appropriately identify engagement teams that need organizational support and audited companies with higher risks by developing and operating a system to monitor individual audit engagements in addition to revising the method for assessing risks related to audit engagements and organizing audit teams in accordance with the identified risks. The audit firm also assumed that communicating the need to conduct appropriate risk assessment and planning and performing audit procedures corresponding to identified risks would induce engagement teams, etc. to take appropriate responses in accordance with the risk levels. As a result, adequate verification was not conducted as to the extent to which quality control measures had taken hold and how effective they were. (With regard to root cause analysis regarding this example, also refer to [Large-sized audit firms] [Case 2] on p. 9).
- NEW The audit firm assumed that repeatedly communicating the need to appropriately identify material risks faced by audited companies and conduct risk-focused audits through sending messages and training would enable engagement teams, etc. to appropriately understand the level of audit procedures required by the current audit standards and take actions accordingly. Moreover, it assumed that communicating to engagement partners the importance of proactive involvement in the audit engagements that they are in charge of would induce them to appropriately perform their role. As a result, adequate verification was not conducted as to the extent to which quality control measures had taken hold and how effective they were. (With regard to root cause analysis regarding this example, also refer to [Large-sized audit firms] [Case 3] on p. 9).
- NEW The audit firm established a quality control committee in each business division and made continuous efforts to ensure that measures to improve audit quality would take hold in audit fieldwork. However, due to a lack of sufficient communication between the executive management team/the quality control department and individual business divisions, some quality control measures were inconsistent with the purposes and objectives of those efforts. As a result, adequate

verification was not conducted as to the extent to which quality control measures had taken hold and how effective they were.

**[Second-tier audit firms]**

Second-tier audit firms are proceeding with the development of the quality control environment. However, generally speaking, the headquarters functions have not been sufficiently strengthened. Furthermore, top managements' awareness about quality control has not matched the firms' expanded operations. In addition, some firms are heavily dependent on part-time staff in the performance of audit engagements, while others are facing audit quality issues at particular regional offices. On the other hand, founding history, operations management environments and size of operations are different firm by firm, so the root causes of issues differ from firm to firm.
As a result, each firm needs to analyze root causes and accelerate effective improvements in considerations with trends of its own operations, their operations management environments, and so on.

The following are specific examples of root causes of deficiencies at second-tier audit firms identified so far through the CPAAOB's inspections:

- The number of audit engagements had increased due in part to mergers with other firms and the conclusion of audit contracts with high-risk audited companies. However, the CEO and other executives lacked awareness of the need to suitably assess contract risks, despite knowing that the rules governing the conclusion of new audit contracts did not fit reality, and tolerated these shortcomings, as there had been no major issues with business administration theretofore out of a lack of. (With regard to root cause analysis regarding this example, also refer to [Second-tier audit firms] [Case 1] on p.11)
- Operations are performed independently at each regional office. Specifically, matters such as the organization of engagement teams, the determination of partners' compensation, periodic inspections, and engagement quality control reviews are determined and implemented under an independent operations management environment. Furthermore, exchange of partners and their assistants among different regional offices has been hardly made. 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 has not been effective, so the steps being taken are inadequate to ensure integrated business administration. (With regard to root cause analysis regarding this example, also refer to [Second-tier audit firms] [Case 2] on p.11)

NEW
- The CEO placed emphasis on the need to foster personnel responsible for maintaining and improving audit quality when planning and implementing measures to improve audit quality.

Moreover, since becoming the representative of the audit firm, the CEO had refrained from exercising overly strong leadership and placed emphasis on the independence of activities of the quality control and audit divisions. As a result, there was a lack of awareness of the need to accelerate the improvements.

The executive management team assumed that cooperation between the quality control and audit divisions would be ensured by sorting out and sharing issues through discussions at executive management meetings and respected the independence of each division, in order to take steps to improve audit quality. As a result, there was lack of awareness of the need for strong cooperation between these two divisions. Furthermore, although the executive management team was aware of audit quality issues at some particular regional offices, it assumed that the regional offices would be able to make improvements on their own. As a result, there was a lack of awareness of the need to actively support regional offices, for example by allocating the human resources necessary for making improvements. (With regard to root cause analysis regarding this example, also refer to [Second-tier audit firms] [Case 3] on p.11)

- Given that previous CPAAOB inspections detected that a high percentage of partners engaged in concurrent businesses placed a heavy burden on full-time partners, the CEO was systematically working to make partners and other personnel full-timers and assumedthat would improve quality control operations. However, he lacked awareness of the need to implement measures directly tied to quality control operations.

NEW

- While the audit firm was increasing the number of partners and professional staff members amid the recent rapid expansion of its operations, the CEO and the executive management team lacked awareness of the need to ascertain the sufficiency and effectiveness of measures to strengthen the headquarters functions and improve the quality control environment. For example, they failed to sufficiently understand the shortage of manpower allocated to individual offices of the headquaters and the lack of understanding among audit team members of the level of audits required by the current audit standards and assumed that measures to strengthen the headquarters functions and improve the quality control environment could be appropriately implemented by the individual managers in charge.
- With operations expanding, the CEO believed that engagement partners would appropriately review the audit work papers, supervise and guide the assistants to the engagement partners by enhancing the progress management of audit engagements. He was also convinced that, once he instructed engagement partners and assistants to the engagement partners carrying out reviews to supervise and guide through the review of audit work papers, etc., each personnel would appropriately respond. Accordingly, he lacked awareness of the need to verify the extent to which quality control measures were conveyed and instilled as well as their effectiveness and, he failed to develop a system for monitoring these matters trusting each personnel to take steps to maintatin and improve the quality of audit engagements.

**[Small and medium-sized audit firms]**

Small and medium-sized audit firms come in various sizes and have different founding history, and levels of establishment and implementation of quality control envirionment also differ from firm to firm. However, their organizations are relatively small, and they all face the difficulty of providing audit teams with organizational support in areas such as quality control. A key characteristic of the firm, therefore, is that business administration and quality control levels, in many cases, are highly dependent on the abilities of individuals that belong to the audit firm, including the CEOs, and the relationship between the individuals and the firm.

Because of this, low awareness of and involvement in quality control by the CEOs often affect the quality control climate throughout the audit firms, so it is important for the CEOs to demonstrate leadership in quality control. One characteristic trend identified in recent inspections is that the CEOs and the PICOQCs were "not aware of a lack of understanding among all audit team members, including themselves, of the current audit standards and the levels of quality control and audit procedures required by the standards." Another is that the CEOs and the PICOQCs "did not understand the level of in-depth analysis of causes necessary for preventing deficiencies similar to the ones detected in the quality control reviews, etc."

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 three types:

・Cases related to a lack of awareness about quality control among CEOs and PICOQCs.
・Cases ascribable to changes in audit firms' management environment, such as mergers etc.
・Cases ascribable to audit firms' organizational climate

**(1) Cases related to a lack of awareness about quality control among CEOs and PICOQCs**

NEW

- As the CEO and the PICOQC did not understand the level of in-depth analysis of causes necessary for preventing deficiencies similar to the ones identified in quality control reviews, etc., they merely implemented superficial improvement measures without conducting adequate analysis of causes of the identified deficiencies and assumed that a certain level of audit quality could be ensured only if audit teams used JICPA's various audit tools. Furthermore, the CEO and the PICOQC were not aware of a lack of understanding among all audit team members, including themselves, of the purposes of the current audit standards and the levels of quality control and audit procedures required by the standards. In addition, as they assumed that there was no issue with the current operations of their firm, they were not aware of the need to develop an organized quality control environment. (With regard to root cause analysis regarding this example, also refer to [Small and medium-sized audit firms] [Case 1] on p.13)
- The CEO did not recognize the need to organizationally ensure the quality of audits as the top management, 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 failed to fulfill their responsibilities to leave business administration of the audit firm and development and operation of a quality control system to the CEO and not to recognize the need for their involvement in these operations.

- The CEO gave top priority to releasing unqualified opinions until the filing due dates of the audit reports and did not exercise due care as a professional specialist. He also did not recognize the need to fulfill the roles and responsibilities as an audit firm expected by society in providing assurance to the reliability of financial statements. Other engagement partners, including the PICOQC, shared the CEO's thoughts and failed to check other engagement partners, including the CEO.
- The CEO and the PICOQC lacked 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 and the professional skills of professional staff, even though the most recent quality control review had identified relevant significant deficiencies. He had partners with insufficient understanding and knowledge of the quality levels required under current audit standards serve as engagement partners or engagement quality control reviewers (EQCRs) 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 engagement teams avoided audit failures by fully addressing material matters identified bythe engagement teams. 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 ascribable to changes in audit firms' management environment, such as mergers etc.**

- The CEO did not sufficiently understand the required levels of the operations management and quality control environments suited to the audit firm's expanded size after the merger and assumed 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, the CEO lacked awareness of the need to take prompt action to develop organized operations management and quality control environments. (With regard to root cause analysis regarding this example, also refer to [Small and medium-sized audit firms] [Case 2] on p.13)

- As the audit firm increased its audit engagements of listed and other companies, the audit engagement risk had been rising. However, the CEO failed to exercise leadership as a quality control manager in developing a quality control environment, as indicated by a lack of commitment to conduct appropriate risk assessment of continuous and newly contracted audited companies.
- The number of audit engagements had increased every fiscal year and new audit contracts had recently been concluded with high-risk listed companies. However, only a small number of partners are serving as full-time audit team members, and the audit firm was dependent on part-time staff as assistants to engagement partners. As a result, the partners were preoccupied with the audit engagements that they are in charge of and failed to sufficiently involve themselves in quality control operation.

**(3) Cases ascribable to audit firms' organizational climate**

NEW

- Although the audit firm is small, its audit division has comprised two departments since its foundation, with audit engagements and financial and personnel affairs of each department independently managed. This has resulted in the development of an organizational climate that gives precedence to the independence of each department. Furthermore, only engagement partners work on a full-time basis, while all assistants to engagement partners are certified public accountants and substantially all work as part-time staff.

  Under these circumstances, the CEO and the PICOQC were not aware of a lack of understanding among all audit team members, including themselves, of the purposes of the current audit standards and the levels of quality control and audit procedures required by the current audit standards. Moreover, they assumed that there was no issue with the current organizational structure that had been maintained since the firm's foundation, since no serious deficiencies had been detected in past quality control reviews, etc. As a result, they were not aware of the need to achieve integrated operations management, including integrating the two departments within the audit division, or the need to develop an organized audit operational environment, including employing more full-time assistants to engagement partners. (With regard to root cause analysis regarding this example, also refer to [Small and medium-sized audit firms] [Case 3] on p.14)

NEW

- The audit firm, which comprises a small number of partners and their assistants who have little experience of audit engagement at other audit firms, has maintained the management environment that has continued since its foundation. For many years, the firm has mainly audited several listed companies, and as a result, the ratio of fees received from those audited listed companies to the firm's overall revenue (fee dependency) is high.

  Under these circumstances, the CEO, who concurrently serves as PICOQC, had placed top priority on maintaining the relationships with audited companies that had continued since before the firm's foundation and assumed that there was no issue with the performed audits and the firm's management because no changes had been made to the composition of audited companies. In addition, the CEO/PICOQC was not aware of the need to place emphasis on audit quality and the required qualifications for certified public accountants, such as professional ethics and independence. He was also not aware of the need to develop organized operations management and quality control environments. Moreover, as the autocratic management of the firm by the CEO/PICOQC had become entrenched, other partners were not aware of the need to perform their duties.

- The audit firm comprises two audit departments, and each department's audit engagements, and financial and personnel affairs are managed independently by the representative partner, head of each department. The organizational climate, which prioritizes independence of each audit department, has been fostered, such that the representative partner of each audit department is in effect appointed by the previous representative partner. The audit firm has designated the CEO as the person with the ultimate responsibility for quality control, but the CEO has not set forth a policy for achieving integrated quality control or 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. 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 was established by partners who were colleagues at a large-sized audit firm. As the audit firm is comprised of a small number of partners, the CEO and PICOQC have a grasp of the capabilities of individual partners and are assuming that the partners are exercising their capabilities. In addition, since no significant deficiency has been pointed out to the audit firm in quality control reviews so far conducted, perception of the CEO and PICOQC is that the necessary minimum quality control environment appropriate to the size of the audit firm has been developed. Accordingly, they were not sufficiently aware of the need to develop an organized quality control environment.

## 2. 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 Audit Firm 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, 2021, all large-sized audit firms and second-tier audit firms as well as eight comparatively larger small and medium-sized audit firms had announced adoption.

Application of the five principles of the Audit Firm Governance Code by audit firms by size is as follows: Large-sized audit firms and second-tier audit firms are applying all the principles. However, few small and medium-sized audit firms are applying all the principles. In particular, some small and medium-sized audit firms are refraining from applying the principles for supervision/evaluation functions within organizational environments (Principle 3) and ensuring transparency (Principle 5).

**<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 operations of the audit firms from a public interest point of view, and so on. With these initiatives, it is important that third parties are provided with necessary information 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 providing necessary information to independent third parties by allowing the 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.

Following the publication of the Audit Firm Governance Code, second-tier audit firms have established independent bodies, such as public interest committees, whose members include independent third-party persons, as supervision/evaluation bodies. However, second-tier audit firms, with the exception of some firms, have not established nomination, compensation and audit subcommittees, etc., and as a result, the involvement of third-party persons in each of the nomination, compensation and audit processes is limited compared with the situation at large-sized audit firms. While some second-tier audit firms take care to ensure the provision of necessary information to third-party persons by granting them the authority to attend meetings of management bodies, others have not established any authority necessary for third-party persons to proactively obtain information.

Five of the eight small and medium-sized audit firms have not established supervision/evaluation bodies on the grounds that their small size enables the exercise of mutual checks between partners. However, some of the firms that have not established supervision/evaluation bodies allow independent third-party persons to attend operations management meetings. Many small and medium-sized audit firms have not clarified the specific procedures for each of the nomination, compensation and audit processes.

**<Responses to ensuring transparency (Principle 5)>**

With regard to the status of application of each principle of the Audit Firm Governance Code and efforts to improve audit quality, large-sized audit firms publish and disclose on their websites reports on quality control, etc. on an annual basis. Reports on quality control, etc. provide detailed explanations about matters such as organizational structures, human resource development, and the firms' networks. In recent years, explanations about audit quality indicators (AQI) and effective use of IT have also been expanded. Some firms disclose the results of responses to the challenges recognized in the previous fiscal year, and the challenges which they plan to address in the next fiscal year, while others disclose the status of attendance in management meetings, etc. by third-party persons. In reports on quality control etc. published in the fiscal year 2020, explanations were provided about preparations for the application of KAM and responses to COVID-19.

With regard to exchange of opinions with capital market participants, etc. about efforts to improve audit quality, large-sized audit firms have already been making such efforts as conducting audit quality surveys and creating opportunities for dialogue with audited companies' chief financial officers (CFOs) and company auditors, etc. Currently, they are striving to create opportunities for dialogue with a broader range of capital market participants, etc., for example by holding meetings for exchange of opinions with institutional investors and analysts, involving independent third-party persons.

Second-tier audit firms publish and disclose on their websites reports on quality control, etc. focusing mainly on explaining organizational structures and quality control. In many cases, descriptions in reports on quality control, etc. are more concise than the descriptions in large-sized audit firms' reports, and explanations about audit quality indicators (AQI) and systematic human resource development, including human resource development programs and training curriculums, are insufficient in some cases. On the other hand, some firms disclose staff members' assessment of the current status of efforts to improve audit quality, including the results of internal questionnaire surveys concerning quality control.

With regard to exchange of opinions with capital market participants, etc. about efforts to improve audit quality, some firms conduct audit quality surveys with audited companies' CFOs, company auditors, etc. In some cases, second-tier audit firms exchange opinions with capital market participants, etc. at discussion forums for investors held by JICPA and exchanges instead of holding meetings for exchange of opinions on their own.

Four of the eight small and medium-sized audit firms, which have announced the adoption of the Audit Firm Governance Code, publish reports on quality control, etc. The firms that do not publish such reports merely provide concise explanations about the status of application of the Audit Firm Governance Code on their websites. Many firms' reports on quality control, etc. or explanations provided on websites are more concise in terms of the number of description items and the contents of descriptions than reports or explanations provided by second-tier audit firms. In some cases, no explanations are provided about specific organizational structures.

With regard to exchange of opinions with capital market participants, etc. about efforts to improve audit quality, many of the small and medium-sized audit firms that have announced the adoption of the Audi

Firm Governance Code merely have engagement teams exchange opinions with audited companies' CFOs and company auditors, etc.

# 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 “Second-tier, 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**

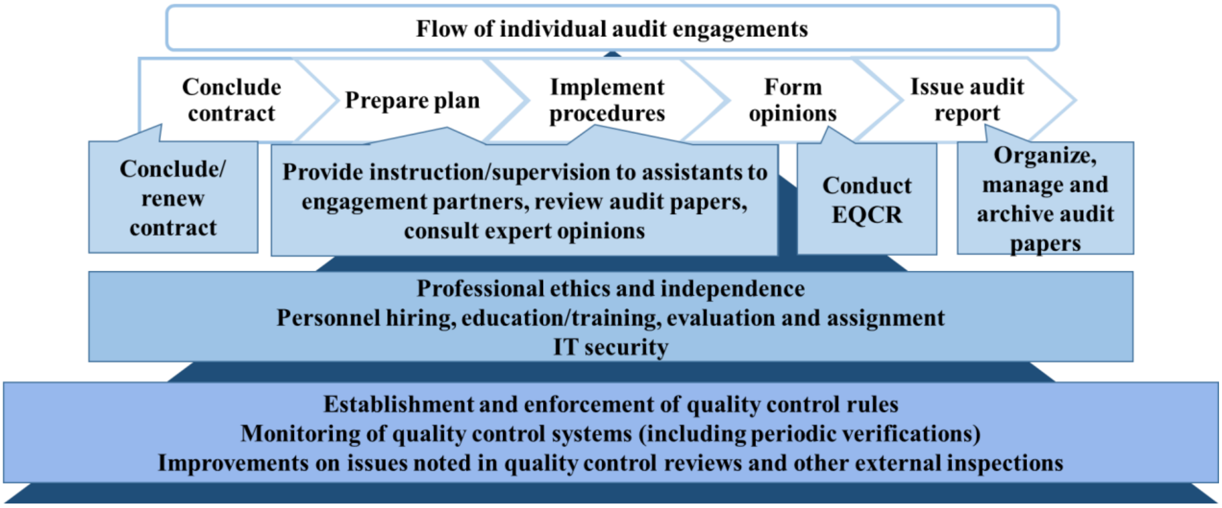
The Quality Control Standards for Audits and Quality Control Standards Committee Statements stipulate the quality control environment required, and these have had a major impact on the quality of individual audit engagements through the establishment and administration of quality control systems. The 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 work papers 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 work papers, engamgent quality control reviews and periodic inspections.

Furthermore, with regard to deficiencies in individual audit engagements that were identified by the CPAAOB inspections and quality control reviews in the past, adequate verification was not conducted as to the extent to which improvement measures had taken hold and how effective they were. As a result, the same or similar deficiencies have been identified in other individual audit engagements. In such cases, it may be deemed that efforts to improve quality control operations are insufficient.

For example, there are cases in which deficiencies have been identified in divisions, engagement teams, etc., because these divisions, engagement teams, etc., do not adequately understand, 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 have been identified in a broad range of areas in terms of both the development and operation of the quality control system. In addition,

as at large-sized audit firms, inspections of individual audit engagements found cases where deficiencies, which had been identified in the past by the CPAAOB inspections and quality control reviews, etc., were not appropriately remediated. In many of those cases, the causes of the deficiencies were deemed to be ascribable to the quality control system. For example, there were many cases where the quality control system was not appropriately developed or operated due to lack of awareness and knowledge of quality control operations on the part of the CEOs and the PICOQCs or where the CEOs and the PICOQCs did not sufficiently understand the level and method of in-depth analysis of causes necessary for preventing deficiencies similar to the ones detected in the quality control reviews, etc. There were also cases where deficiencies occurred because of a failure to allocate sufficient business resources to the development and operation of the quality control system, which directly affects audit quality, or where the PICOQCs were not aware of the need to verify the effectiveness of quality control measures due to the assumption that partners would appropriately handle matters of quality control if informed of the need for the abovementioned activities through training, etc.
One cause of deficiencies that is unique to second-tier audit firms is the failure to strengthen the headquarters functions or otherwise improve quality control system functions sufficiently to suit the expansion of the size of the firms through merger or acceptance of new audit engagements. For example, there were cases in which, although persons in charge of each of the functions of the quality control system, including the EQC reviews and education/training, were appointed, they could not identify and remediate the deficiencies that are inherent in quality control operations and individual audit engagements due to a lack of sufficient manpower assigned to individual offices of the headquarters.

**(Observed effective efforts)**
There were cases such as the following of effective efforts having been made to strengthen the quality control of the firm as a whole:
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 actively commit.

**Expected response**
Based on the primary purpose of a quality control system, which is to reasonably ensure the quality of audit engagements, all audit firms are required to establish such a system effectively and efficiently, depending on the size and characteristics of each audit firm, so that the QC system can effectively work in individual audit engagements. Specifically, the CEO and PICOQC of audit firms should understand the purpose and

importance of the quality control system, and take the initiative in ensuring that each professional in a firm understands that the primary purpose of the QC system is to spread measures to improve the quality of audit throughout the entire organization, and monitors its effects at all times.

The content and scope of quality control policies and procedures stipulated by an audit firm are affected by various factors, such as the size and composition of professionals at the firm, the characteristics of management, and whether the firm belongs to a global network. In light of this, the CEO and PICOQC of audit firms should establish appropriate QC environment according to the size and characteristics of their firm and appropriately maintain the system by reviewing it as needed.

**[Large-sized Audit Firms]**

**1. Initiatives to Improve Performance**

**Points of focus**

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

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

**Outline of inspection results**

At large-sized audit firms, remediation measures for deficiencies identified in the CPAAOB inspections and QC reviews may be planned under the initiative of the QC division at the headquarters, and disseminate them to engagement teams through training and notifications, 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 revealed that organized improvement measures were not necessarily sufficient at different levels within the firm, including divisions and partners. For example, cases have been noted in which cooperation between the head office and divisions was inadequate or in which efforts to make operational improvements had not sufficiently taken hold at divisions and regional offices where the lineup of staff rarely changes due to a lack of exchange of personnel with other divisions, etc. Other cases noted included ones where there was a lack of organizational support from the head office and divisions for taking actions in important areas of audits where no significant changes in the situation were noted.

**<u>Expected response</u>**

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 firms should respond to any deficiency together with division managers, based on the understanding of quality control in the entire firms, instead of response only by limited divisions, such as the QC division. Thus, the expected effects can be achieved. The CEOs 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 PICOQCs are 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 by themselves but to provide appropriate instructions and urge professional staff under their management to make appropriate responses.

Furthermore, the CEOs and PICOQCs, together with department managers, etc., should establish an effective system to monitor improvement and promptly take appropriate remedial actions when it has been recognized as a result of verification that improvement measures have not sufficiently taken hold or are not sufficiently effective.

In carrying out measures to improve operations at large-sized audit firms, close attention should be paid so that the measures are not be superficial, such as by giving uniform instructions for improving deficiencies throughout the entire firms. For this purpose, it is necessary to carry out moderated and effective measures, such as by fully analyzing the tendency and causes of the identified deficiencies to identify the target areas for operational 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: Establishment of environment to improve operations**

The Quality Control Headquarters issued instructions to the persons responsible for monitoring at each division to monitor the performance of audit procedures based on audit work papers for audit engagements deemed high-risk 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 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 workpapers could be left to the engagement quality control reviewer, and the personnel thus did not undertake careful monitoring based on audit work papers.
(Quality Control Standards Committee Statement No. 1, paragraphs 15 and 16)

**Case 2: Verification of improvement**

NEW ①The audit firm asserted that, in light of the results of past external inspections and information on audited companies provided by the quality control division, the audit division periodically identified engagement teams that needed organizational support and took remedial measures as necessary.
However, although the audit and quality control divisions supported engagement teams facing significant changes in the situation, such as the occurrence of fraud and they were focusing on responses to the significant changes in the situation, they lacked the viewpoint of comprehensively considering the need to provide organizational support to engagement teams with regard to the handling of important audit areas other than those where the situation is changing significantly.
(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, the partner 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 could not be expected by, for example, assigning more employees to the engagement team.
(Quality Control Standards Committee Statement No. 1, paragraphs 15 and 16)

NEW ③The audit firm informs its staff of the result of past external inspections through training. Divisions and departments at the head office that are involved in quality control are strengthening efforts to ensure the intensive performance of audit procedures in audit areas that they have properly recognized as important.
However, there is a lack of efforts to ensure that engagement partners appropriately give instructions

and conduct supervision and reviews in order to prevent the inadequacy of procedures due to a lack of understanding of the level of audit procedures required by the current audit standards with regard to response to fraud risks and accounting estimates.

(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)

## 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 environment is developed, there are deficiencies in the effectiveness of QC environment including its operation.

Therefore, the CPAAOB examines 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 firms established and operated have failed to lead to ensuring and improving the audit quality 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. As the number of companies aiming for IPO is trending upward, the number of new audit contracts pursuant to Article 193-2 of the Financial Instruments and Exchange Act is rising. In concluding new audit contracts with large companies, including listed ones, and new audit contracts pursuant to Article 193-2 of the Financial Instruments and Exchange Act, due consideration should be given to the time for auditing, audit teams' human resources, the level of audit fees, etc., in order to rationally ensure audit quality.

Therefore, the CPAAOB not only evaluates anticipated risks from the conclusion and renewal of audit contracts (below, "engagement undertaking risk") but also verifies whether the time for auditing and human resources as well as the level of audit fees are fully examined to ascertain whether the audit quality 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 work papers, EQC reviews and periodic inspections. Specifically, there were many cases where the engagement partners or equivalent who review audit work papers, the EQC reviewer and the persons 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 teams, 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 reviewers concerning risks of material misstatement with audit engagements identified during the terms 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 understood through the review of audit work papers 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 work papers.
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 work papers to ascertain that there were no issues 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 work papers**

①The engagement partners were convinced that there was no issue 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 the partners 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 appropriately review the audit work papers for the audit procedures performed by the assistants to the engagement partners in the belief that 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 audited company with regard to areas in which it was deemed that there were no issues 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 work papers.
(Quality Control Standards Committee Statement No. 1, paragraph 31; Auditing Standards Committee Statement No. 220, paragraphs 14, 15, and16)

NEW ③Engagement partners did not give instructions for appropriately performing audit procedures since they assumed that their assistants had sufficient experiences and capabilities. In addition, engagement partners did not conduct appropriate reviews of audit work papersas they assumed that reviews conducted by their assistants were sufficient.
(Quality Control Standards Committee Statement No. 1, paragraphs 31, 32, and A31; Auditing Standards Committee Statement No. 220, paragraphs 14, 15, and 16)

**《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 work papers to be reviewed must also be suitably planned if engagement partners, etc., are to appropriately review the audit work papers.**

**Case 2: Securing effective review**

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 work papers relating to the key audit judgments made by the engagement team in identifying fraud risks pertaining to revenue recognition nor the audit work papers relating to their conclusions were sufficiently examined by the EQC reviewer.

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

NEW ②As EQC reviewers focused mainly on checking information presented in review documents prepared by engagement teams, they lacked awareness of the need to conduct a review based on audit work papers as to whether those teams planned and performed appropriate risk assessment procedures relevant to risks.

As a result, EQC reviewers failed to point out deficiencies concerning procedures related to response to fraud risks in their reviews.

(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**

Although reviewers for periodic inspections confirmed the existence of audit work papers 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, paragraph 47)

**《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 work papers 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.**

**Case 4: Appropriate participation in continuing professional education (CPE) programs**

NEW With regard to the continuing professional education (hereinafter referred to as "CPE") that is mandatory under the Act, the audit firm was not aware that staff could concurrently participate in multiple training programs through the firm's internal e-learning system. The audit firm did not assume that CPAs affiliated with the firm would inappropriately participate in CPE programs, which are intended to enable CPAs to improve skills and capabilities required by laws and regulations. As a result, the audit firm did not take adequate measures to prevent inappropriate participation in training programs, such as cultivating the sense of ethics necessary required for CPAs and monitoring the training status. As some partners and other staff members inappropriately acquired CPE credits through concurrent participation in multiple CPE programs, they failed to meet the necessary number of credits.

(Quality Control Standards Committee Statement No. 1, paragraph 28)

**Case 5: Communication with company auditors, etc.**

NEW

A component auditor of an audited company who belongs to the same network as the audit firm provided audit and non-audit services to the component of the audited company.

However, assistants to engagement partners lacked understanding of the audit standards, while engagement partners did not sufficiently review the summary report of the audit results submitted to the Audit & Supervisory Board. As a result, information on fees related to those services was not provided in writing to the audited company's Audit & Supervisory Board Members.

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

**《Points to Note》**

**It should be noted that when the audited company is a listed company, the engagement team and the network firm should make written communication with company auditors, etc. as to compliance with professional ethics rules regarding independence.**

**[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;
- The audit firm had not established environment to effectively monitor the improvement of deficiencies; and
- The audit firm had insufficient manpower at divisions that implement improvement measures compared with its size.

Furthermore, in many cases, engagement partners responsible for reviewing audit documentation, EQC reviewers, and persons in charge of periodic inspections completed their work by merely reviewing audit documentation and implementing checklists as a matter of formality because they did not sufficiently understand the purpose of their own operations. In addition, the audit firm left the acquisition of audit engagement knowledge to the discretion of audit team members themselves instead of proactively maintaining and improving the aptitude and capabilities of the staff. Therefore, audit teams did not sufficiently understand the audit standards and matters required by the standards, including the Auditing Standards Committee Statement. As a result, in many cases, the same or similar deficiencies that were inherent in individual audit engagements were not identified, nor were operational improvements made in other engagements.

**(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 root 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 ①The audit firm instructed engagement teams to take corrective actions based on a checklist listing the deficiencies identified in quality control reviews, the cause of them and improvement measures, and partners in charge of the EQC review checked what actions were taken by the teams.

However, although the CEO and the PICOQC were aware of the need to analyze the root causes of the deficiencies identified, they did not sufficiently understand the necessary depth and method of the analysis of the root cause. As a result, sufficient improvements were not made in order to prevent the occurrence of similar deficiencies ascribable to the same causes.

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

②The audit firm's quality control rules do not prescribe the quality control committee's role regarding response to the matters identified in global reviews. As a result, the PICOQC assumed that it was not his/her own responsibility to respond to them, and therefore he/she did not consider what course of action to take.
(Quality Control Standards Committee Statement No. 1, paragraphs 15 and 16)

NEW

③With regard to the root causes of the deficiencies identified in the CPAAOB inspection, the audit firm recognized engagement partners' insufficient involvement in audit work and implemented improvement measures in which engagement partners take the initiative in identifying and assessing audit risks. Moreover, the quality control division checked through periodic verification how much the improvement measures had taken hold. In addition, the CEO continuously communicated the importance of engagement partners' involvement through communication with staff members.
However, due to a shortage of the manpower at the quality control division necessary for continuing those improvement measures and ensuring that they take hold, corrective actions taken in relation to the deficiencies identified were insufficient. Moreover, as engagement partners placed excessive trust in the formats of audit documentation revised in response to quality control reviews, awareness about the need for engagement partners' involvement in audit work did not sufficiently improve.
(Quality Control Standards Committee Statement No. 1, paragraphs 31, A30, and A31; Auditing Standards Committee Statement No. 220, paragraphs 14, 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 revisions of 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.

As for the causes of those deficiencies, there were cases in which there was a lack of sufficient understanding of the laws, regulations and standards applicable to audit firms and cases in which audit firms adopted the template of quality control rules ("Audit Quality Management Rules") provided by the JICPA without making any modification in accordance with the audit firm's actual circumstances. There were also cases in which audit firms assumed that it was unnecessary to revise the rules because no problem had occurred in the past.

**(Observed effective efforts)**

The following is an example of observed effective efforts made by an audit firm.

The audit firm promoted understanding of the relationship between the audit manual and the Auditing Standards Committee Statement by noting the requirements indicated in relevant statements with respect to each provision of the audit manual. Using the audit manual, the audit firm provides education on the level of audit responses required by the audit standards.

**<u>Expected response</u>**

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 (statements of objection and doubt)**

NEW

The CEO did not sufficiently understand the quality control standards. As a result, the audit firm did not develop an appropriate environment in which to operate a whistleblower system. For example, although the audit firm prescribed the policy and procedures related to statements of objection and doubt under the quality control rules, it did not establish any contact point through which whistleblowers inside and outside the firm may provide information. In addition, the firm did not inform all partners and other staff members of the presence of the whistleblower system.

(Quality Control Standards Committee Statement No. 1, paragraphs 54, F54-2, and 58)

**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)**

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

**Points of focus**

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

**Outline of inspection results**

From the perspective of compliance with laws, regulations and professional standards, some audit firms had deficiencies related to legal compliance, including a lack of internal rules regarding the non-competing obligation by partners, lack of qualifications to become an audit partner required for development of operational control structure, 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 qualifications to become an audit partner required for development of operational control structure. In addition, some deficiencies occurred in relation to the rotation of senior engagement team members.
Causes of the deficiencies listed above include: the PICOQC or equivalent did not fully understand the applicable laws, regulations and professional standards or did not appoint practitioners to take charge of

the confirmation of regulatory compliance of each task that requires such confirmation, and did not establish a clear and concrete workflow for confirmation.

**Expected response**

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

**Case 1: Prohibition on competitive work by partners**

A certain partner affiliated with the audit firm had continued to provide services (audit services) that fall within the scope of the firm's engagements at his/her own audit office since before becoming a partner of the firm in violation of the Act, which prohibits engagement in competitive work by partners. The audit firm overlooked the fact that this partner was violating the 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)

**Case 4: Rotation of major engagement team members**

NEW

With regard to long-preiod involvement in audit work, the audit firm's quality control rules require that senior engagement team members (engagement partners, EQC reviewers, and other engagement team members responsible for making important decisions and judgments related to important matters of audit engagement) be replaced at intervals of seven years with regard to audit engagements for "large companies, etc." as defined under the Act and at intervals of 10 years with regard to audit engagements related to companies other than "large companies, etc."

However, the CEO, who concurrently serves as the PICOQC, did not sufficiently understand laws and regulations related to independence. As a result, when partners performing audit engagements for large companies, etc. as assistants to engagement partners were involved in the audit work for a longer period of time than engagement partners, the CEO/PICOQC did not consider whether those partners were equivalent to other engagement team members responsible for making important decisions and judgments related to important matters of audit engagement. Moreover, some engagement partners were violating the firm's policy concerning long-term involvement in audit engagements for companies other than large companies, etc. that was prescribed by the internal rules by continuing to be involved for more than 10 years.

(The Act, Article 24-3; Ordinance for Enforcement of the Certified Public Accountants Act, Article 9, paragraph 3; Guideline for Independence, Section 1, paragraph 139; Quality Control Standards Committee Statement No. 1, paragraph 24)

**《Points to Note》**

**Other deficiencies noted included: a failure to develop internal rules that prescribe the specific procedures for checking whether operations that compete with the audit firm are being performed and for granting approval regarding competitive work; a failure to submit notices of changes to the articles of incorporation by the statutory submission deadline; and a failure to perform the approval procedures regarding transactions that may involve conflicts of interest.**

### (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, the deficiencies identified included: a failure to appropriately implement measures to prevent information leakage; a failure to establish internal rules on the use of internet server services for operation; a failure to appropriately apply rules on information security to part-time staff; and a failure to appropriately anonymize personal information described in audit documentation.

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;
- Because priority was placed on executing tests of internal controls and substantive procedures, personal information related to audit procedures was not anonymized; and
- As managers responsible for information management did not sufficiently understand or were not sufficiently aware of the importance of information security, they were not aware of the need to appropriately develop information security systems.

**(Observed effective efforts)**

The following are examples of observed effective efforts made by audit firms.

To reduce the risk of information leakage due to the loss of personal computers, the audit firm introduced a virtual desktop interface (VDI) using thin client terminals and used an external cloud storage service for exchange of data with audited companies (through the method of creating individual dedicated sites accessible only by engagement team members and audited companies within the storage account). When the external cloud storage service was introduced, the audit firm identified risks associated with its introduction and implemented its own new management measures as necessary with regard to risks not addressed by the external service provider.

**Expected response**

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

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

**Case 1: Establishment and operation of internal information security rules**

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

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

・Stored data were not classified according to their crisis level; no backup or encrypted data were created for stored data; no ID codes or passwords were assigned to professional staff to protect critical electronic data from unauthorized access;

・The firm required all members to submit a "security policy compliance report," but some members failed to submit this report; and

・The audit firm did not inform all partners and other staff of various rules, including the basic policy for information security. The audit firm did not provide periodic education/training concerning information security, either.

(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**

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 has developed and implemented an environment to appropriately and aptly collect the necessary information, including a list of audited firms, for judging whether persons subject to confirmation of independence are complying with the rules on independence when performing the confirmation procedure;
- 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 included: a failure to appropriately perform the procedure for confirming independence as prescribed under internal rules, with the conclusion on independence reached after only a perfunctory consideration; a failure to cover a comprehensive range of factors in the independence confirmation procedure; and a failure to develop rules in accordance with the revisions of laws, regulations, etc. concerning independence.

As for the causes of the deficiencies, in some cases, the PICOQC, etc. did not determine specific procedures for confirming independence (including the method for collecting the most up-to-date information on audited companies' consolidated subsidiaries, etc.) and the specific period of implementation or appoint the person in charge of the confirmation procedure. In other cases, the management of implementation was left entirely to the discretion of some particular persons in charge.

**Expected response**

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

NEW

As the audit firm did not sufficiently understand laws and regulations concerning independence, it used a checklist for confirming independence that did not appropriately reflect the revisions of the JICPA's Guideline for Independence. As a result, it did not perform a confirmation procedure adapted to the expansion of the scope of persons subject to regulation on independence beyond "major partners, etc. in charge" to include "persons in charge" in general. In addition, the audit firm did not define "persons in charge" who are subject to regulation on independence under its quality control rules, and this means a failure to develop quality control rules in accordance with the revisions of the Guideline for Independence.

(Quality Control Standards Committee Statement No. 1, paragraphs 20 and 21; Guideline for Independence, Section 1, paragraphs 150 and 150-4)

**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 to comprehensively identify and assess situations and relationships that could harm independence. As a result, when the tax accounting firm concluded new contracts with audited companies, the audit firm's 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**

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**

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)

**Case 7: Maintaining professional ethics and independence**

NEW

The audit firm has continuously received from audited companies "special audit fees," which were not deemed to be equivalent to consideration for audit services, apart from audit fees prescribed under audit contracts, and it has continuously given product coupons to audited companies' executives.

The abovementioned "special audit fees" are deemed to be equivalent to "special economic profits" under the Act. As a result, the audit firm is providing audit services to "a company or any other person in which the audit corporation has a substantial interest," a practice prohibited under the same act. As for the provision of product coupons by the audit firm, the firm is providing "gifts that are beyond the limits that are tolerable under social norms" to clients receiving assurance services, a practice that is prohibited under the Code of Ethics that has been established by the JICPA.

(Act, Articles 1-2 and 34-11; Order for Enforcement of the Certified Public Accountants Act, Articles 7 and 15; JICPA Rules, Article 50 and 52; Code of Ethics, Articles 13 and 26, note 22; Guideline for Independence, Section 1, paragraph 230)

## 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.

**Outline of inspection results**

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. Other deficiencies included a failure to conduct appropriate risk assessment despite having identified situations in which there was significant doubt about the going concern assumptions and transactions the business rationale of which was in doubt.

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 assess engagement 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 are examples 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.

- The audit firm established a division dedicated to IPO within the head office organization in order to develop an environment to enable companies aiming for IPO to receive appropriate audit services. The dedicated IPO division is responsible for exercising functions such as serving as a contact point for requests for consultation from companies aiming for IPO, ensuring audit quality by supporting engagement teams, and preparing and implementing training programs for personnel responsible for IPO-related audit.

**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.

As the number of companies aiming for IPO is trending upward, the number of new contracts pursuant to Article 193-2 of the Financial Instruments and Exchange Act is rising. On the other hand, it is important to maintain audit quality in order to ensure appropriate disclosure of financial reports by companies aiming for IPO. Therefore, when concluding new contracts for audits related to IPO, it is necessary to carefully consider whether audits of appropriate quality can be implemented.

Companies subject to consideration regarding the conclusion of new contracts for audits related to IPO often face challenges in terms of developing internal control and management systems, and therefore, attention should be paid to the following points in particular.

- Carefully evaluate the integrity of audited companies' management.
- Consider whether or not it is possible to conduct audits suited to audited companies' contract risks by securing the necessary and appropriate amount of audit manpower and time.
- Secure audit team members possessing the knowledge, experience and capabilities, necessary for conducting audits, including expertise regarding IPO-related operations.

Moreover, from the viewpoint of developing a system to continuously provide IPO-related audits, it is necessary to develop an organizational system that makes it possible to train personnel responsible for IPO-related audit and to and to collect and accumulate knowledge and knowhow regarding IPO-related operations and to improve quality control.

**Case 1: Risk assessment procedures when accepting new audit engagements**

NEW

①The prospective engagement partner judged the contract risk to be low based on information obtained through an interview with the previous auditor, and this judgment was deemed to be valid and the conclusion of an audit contract was approved at a partners' meeting.

However, although there was a situation raising significant doubt about the going concern assumptions, the prospective engagement partner merely asked the previous auditor about his/her recognition of the situation and failed to perform the risk assessment procedures, such as considering the integrity of the management through a meeting and conducting interviews concerning business plans.

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

NEW

②The prospective engagement partner underwent a review related to the conclusion of a new audit contract based on the audit firm's rules when he/she concluded a new audit contract.

However, although a new audited company conducted business transfer transactions which required careful consideration of business rationale, the prospective engagement partner did not sufficiently consider the business rationale of those transactions or the integrity of the management. The partner in charge of the EQC review was not aware of the need to conduct an in-depth review of the conclusion of a new audit contract and therefore overlooked the above situation and approved the audit contract.

(Quality Control Standards Committee Statement No. 1, paragraphs 25, 26, and F26-2)

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)

**《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 audit firm it was to merge with in the past years including audit procedures for details of a material asset and liability items that the audited company recorded, although they understood important matters regarding these accounts 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 the client must be examined with reference to the following from Quality Control Standards Committee Statement No. 1, paragraph A17.**

- **Communications with existing or previous providers of professional accountancy services to the client in accordance with relevant ethical requirements, and discussion with other third parties**
- **Inquiry of other firm personnel or third parties such as bankers, legal counsel and industry peers**
- **Background searches of relevant databases**

### Case 2: Risk assessment procedures at the time of renewal of audit contracts

①The audit firm requires approval by a partners' meeting when concluding or renewing audit contracts.
The engagement partner was unable to obtain from audited companies sufficient information related to the preparation of financial statements, including records and documents necessary for expressing audit opinions. As a result, despite being aware of the possibility that audit risks might be high when expressing an audit opinion, the engagement partner received approval for the renewal of the audit contract in the next fiscal year without reporting that possibility to a 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)

② An audited company violated the financial covenants of its commitment line contract with correspondent financial institutions by continuously recording an operating loss, and the engagement team determined that this fact constituted an incident or situation raising significant doubt about the going concern assumptions.

However, the engagement partner did not regard the above incident/situation as a risk that should be taken into consideration at the time of renewal of an audit contract. 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)

**《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 a limitation on the scope of the 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 was a Material Weakness 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 3: Ensuring the necessary audit days**

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 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 financing statement audits must be ensured from the decision on whether to accept an engagement until submission of the audit report. When corrections of financial statements covering multiple fiscal years are anticipated, it is necessary to carefully consider the adequacy of the planned number of audit days because the auditor may need more time to obtain sufficient and appropriate audit evidence than in cases of normal audit engagement.**

**(2) Communication with the predecessor auditor**

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

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.

**Outline of inspection results**

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

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

**Expected response**

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

Other deficiencies included a failure to have staff members who have not participated in mandatory training programs to do so within the period prescribed by each audit firm despite having identified those persons.

The causes of those deficiencies included a lack of commitment to establishing an appropriate education and training system. For example, in some cases, the PICOQC, etc. depended entirely on engagement partners' instructions and supervision in audit field work in encouraging staff members to acquire engagement-related knowledge. In other cases, the PICOQC was not aware of the need to check whether staff members have participated in mandatory training programs.

There were also cases in which audit firms lacked commitment to maintaining and improving audit quality by ensuring that all audit team members have a certain level of engagement-related knowledge, as they left the improvement of skills to the discretion of individual engagement team members, including part-time staff.

**(Observed effective efforts)**

The following is an example of observed effective efforts made by an audit firm.

The audit firm has set the required number of credits at four per year, higher than the necessary minimum of two credits per year prescribed by the JICPA, under its rules on training, as it believes that learning widely about examples of fraud at other audited companies helps to enhance the ability to detect fraud given the limited number of audit engagements performed for listed companies by the audit firm, etc.

**Expected response**

Audit firms, when recruiting audit staff, should appropriately estimate the necessary number of personnel in light of factors such as the current audit workload, the number of new audit contracts expected to be concluded, and the number of staff members expected to leave the firm in the future.

Furthermore, when providing education and training for audit teams, firms must maintain and improve the skills of engagement team members (including part-time and non-qualified engagement team members) by accurately identifying the areas of audit where they lack sufficient understanding and by preparing and implementing training programs that give due consideration to their respective knowledge, skills and experiences. Moreover, it is necessary to implement effective measures to ensure staff members' participation in mandatory training programs, such as conducting follow-up checks as to whether they have appropriately participated in the mandatory training programs designated by each audit firm. It is also important to enhance the effectiveness of education and training through reviews of audit documentation, etc. so that knowledge and perspectives acquired through training programs can be fully put to use 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's quality control rules stipulate that opportunities for necessary training and appropriate opportunities for fraud-related education and exercises should be provided to all professional staff members. Its anti-insider trading rules obligate all partners and other staff members to participate in the training program concerning anti-insider trading efforts designated by the audit firm.

However, although an accounting fraud case has occurred at an audited company, the audit firm has not provided opportunities for fraud-related training and exercises by implementing fraud-related training on its own, and so on.. Moreover, the audit firm has not designated a training program concerning anti-insider trading efforts in which partners and other staff members should participate as prescribed by its anti-insider trading rules.

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

NEW

②In principle, the audit firm leaves training to voluntary efforts by audit team members. With regard to the revisions of the audit standards and points to note that take account of the deficiencies identified in the JICPA's quality control reviews, the firm holds a group training session once or twice each year.

However, the CEO, despite being aware that the causes of the deficiencies identified in the most recent quality control review was a lack of understanding among engagement team members on the audit standards, placed excessive trust in the possession by audit team members, such as engagement partners and their assistants, of sufficient skills based on their abundance of experience and failed to prepare and implement appropriate training programs for rectifying the lack of understanding about audit standards.

(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 conduct follow-up checks on the status of training with regard to persons who have not participated in mandatory training programs.**

**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

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

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.

<u>**Outline of inspection results**</u>

Some audit firms did not evaluate audit team members based on professional skills (quality control-related skills in particular) and compliance with professional ethics.

As for the background factors of the above deficiency, at some audit firms, the CEO evaluated audit team members and determined their compensation based on subjective evaluation. There were also audit firms which assumed that the quality of audit engagements did not significantly differ from partner to partner or which believed that it was important not to differentiate between partners in terms of evaluation.

**(Observed effective efforts)**

The following is an example of observed effective efforts made by an audit firm.

As a way of placing emphasis on audit quality, the audit firm adopted as many as 12 evaluation items related to quality control, including the level of understanding of audit procedures and accounting standards, among all 17 evaluation items of partners set by the firm.

**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 partners**

NEW

The audit firm evaluates partners based on the table of personnel evaluation prescribed by the operational rules on personnel evaluation. Personnel evaluation is conducted on a five-grade scale with respect to each evaluation item. Overall evaluation is conducted based on the total points calculated according to the weightings assigned to the evaluation items. The audit firm proclaims to reflect its emphasis on the quality of audit engagements in personnel evaluation by giving higher weightings to the evaluation items related to the quality. Compensation plans for partners prepared by the CEO based on the results of personnel evaluation are determined subject to consultation at a partners' meeting.

However, actually, the audit firm did not give consideration to audit quality when evaluating partners. For example, its evaluation assigned the same points and the same grade to each and every partner with respect to every evaluation item for two straight fiscal years.

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

**Case 3: Evaluation of part-time professional staff**

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. In some cases, deficiencies regarding the management of partners' meetings were identified. For example, there was a case in which the CEO made the decision instead of leaving the decision to a partners' meeting, although internal rules on quality control stipulate that the compensation for audit team members should be decided at a partners' meeting. Another deficiency identified was a failure to set clear standards regarding the relationship between the results of evaluation of factors that should be considered in the evaluation of partners and the evaluation categories concerning the base salary and the payment terms of evaluation-based compensation.**

**There were also cases in which, although part-time audit staff were subject to the same standard of personnel evaluation as full-time staff, the results of the personnel evaluation of part-time audit staff were not sufficiently reflected in promotions/demotions or the composition of engagement teams out of concern that part-time staff might quit their jobs if treated strictly, a situation that could 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;
- Audit firms appoint engagement partners mainly based on which audit department the partners belong to, without due consideration for their quality control skills;
- 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.

**(Observed effective efforts)**

The following is an example of observed effective efforts made by an audit firm.
Following a merger, the audit firm has appointed partners in charge of individual audit engagements in a way that ensures that, after the expiry of each rotation period, each engagement partner and the partner in charge of the EQC review is replaced by a person who was affiliated with a different pre-merger audit firm.

**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**

NEW

①When appointing engagement partners, the audit firm did not identify the appointees' workload and level of involvement in each audit engagement. This means that the firm failed to conduct appropriate monitoring as to whether sufficient time was secured for engagement partners to perform their duties.

(Quality Control Standards Committee Statement No. 1, paragraphs 29 and A26)

NEW

②Although the audit firm is small, the audit division has comprised two departments since its foundation, with audit engagements and personnel affairs managed independently by the two departments. As a result, engagement partners are appointed mainly on the basis of which of the two departments the partners belong to, with no regard for the evaluation of the appointees' quality control skills.

(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:

- As the CEO and the PICOQC place excessive trust in engagement partners, they assume that if the quality control policy and procedures are prescribed by the quality control rules, the partners will appropriately give instructions to and supervise their assistants and other staff;
- 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**

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**

NEW

Engagement partners placed excessive trust in their assistants, and as a result, regarding the performance of audit procedures suited to audit risks in the current fiscal year, they merely instructed the assistants to perform the same audit procedures as the ones performed in the previous fiscal year while giving no other specific instructions.

In addition, because of the excessive trust placed in their assistants, when reviewing audit documentation, engagement partners did not check whether the procedures performed with regard to important judgments concerning the audit of accounting estimates and the results thereof had been appropriately recorded or whether sufficient and appropriate audit evidence had been obtained.

(Quality Control Standards Committee Statement No. 1, paragraphs 31, A30, and A31; Auditing Standards Committee Statement No. 220, paragraphs 14, 15, and 16)

**《Points to Note》**

**Engagement partners should understand that they are required to appropriately assess audit procedures that were performed through review of audit documentation, concerning the relevance of audit procedures performed by 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.

**(Observed effective efforts)**

The following is an example of observed effective efforts made by an audit firm.

The audit firm converted audit documentation into an electronic format using audit software available in the market in light of its own resources from the viewpoint of ensuring the confidentiality, safe custody, information integrity, accessibility, and retrievability of audit documentation.

**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**

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;
- Although the audit firm did not have a sufficient number of partners or other staff members with sufficient knowledge and experience to perform the EQC review, the PICOQC did not examine whether persons with sufficient qualifications to serve as EQC reviewers had been hired or fostered. In addition, due to excessive trust placed in the EQC reviewer, there was a lack of awareness of the need to develop an adequate review environment;
- The EQC reviewer merely examined the same deficiencies as the ones identified in the CPAAOB inspections or the quality control reviews while neglecting to examine the responses to those deficiencies;
- 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. In addition, the EQC reviewer lacked commitment to critically considering engagement teams' opinions.

**(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.

**Expected response**

When reviewing the audit planning, the EQC reviewer should review the risk assessment conducted and risk-related audit procedures planned by engagement teams from an objective standpoint while taking into account not only audited companies' business activities and business performance trends but also business risks related to their business objectives and strategies.

In addition, when reviewing the forming of audit opinions, the EQC reviewer should not only discuss matters important for the forming of opinions with engagement partners but also review audit documentation related to important judgments in order to examine whether the conclusions reached by engagement teams are supported by sufficient and appropriate audit evidence. At small and medium-sized audit firms in particular, partners who serve as EQC reviewers are usually very busy because the firms are operated by a small number of partners. As a result, in some cases, as partners placed priority on their own audit engagements, it became difficult for them to conduct appropriate reviews. Therefore, audit firms are required to take actions to enhance the review environment after reaffirming the importance of the review of audit engagements.

**Case 1: Eligibility of the EQC reviewer**

NEW

The audit firm's quality control rules stipulate that a person appointed to the post of EQC reviewer must have more than five years of practical audit experience after becoming qualified as a certified public accountant. However, while the firm was facing a shortage of persons with such practical audit experience, it placed the top priority on complying with the legally mandated rotation rules. As a result, with regard to audit engagements related to all large-sized companies, etc., the firm appointed a partner with less than five years of experience after becoming qualified as a certified public accountant as an EQC reviewer without considering the appointee's eligibility.

(Quality Control Standards Committee Statement No. 1, paragraph 38)

**Case 2: Ensuring the effectiveness of EQCR**

①The EQC reviewer and members of the review board selected by the collegial system did not sufficiently review audit documentation. In the case of the EQC reviewer, the reason for failing to conduct a sufficient review was that he/she did not adequately understand the need to objectively consider key audit judgments based on audit documentation. In the case of the members of the review board, the reason was that, because they assumed that the EQC reviewer had sufficiently reviewed audit documentation, they determined that engagement teams had obtained sufficient and appropriate audit evidence as a result of reading the EQC review request form prepared by the teams and checking the audit procedures performed and audited companies' assertions based on oral explanations from the teams. Moreover, the EQC review division manager did not take steps to make sure that the EQC reviewer and members of the review board reviewed audit documentation relating to important judgements and conclusions when conducting the EQC review due to the assumption that they had considered the key audit judgements based on audit documentation.

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

NEW

②The audit firm's checklist requires engagement teams to be subjected to review by an opinion review board comprised of partners belonging to the EQC review division in "cases where priority matters are described in an audit report" and "cases where there is suspicion of a material misstatement due to fraud," for example. However, the firm did not implement measures to

ascertain that the review had been appropriately conducted, such as requiring the submission of checklists to partners in charge of the EQC review and making sure that those partners examine the contents of the checklists. As a result, the firm failed to detect and prevent the occurrence of cases in which engagement teams were not subjected to review by the opinion review board.
(Quality Control Standards Committee Statement No. 1, paragraphs 36 and 37)

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 in advance 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 were some cases where the persons responsible for implementing ongoing monitoring and periodic inspection (including external persons responsible for those activities) conducted reviews based on checklists, etc. merely as a matter of formality and in which the PICOQC did not give those persons pre-inspection instructions or conduct post-inspection monitoring of them. There were also many deficiencies concerning the operation of the quality control system, such as a failure to appropriately detect deficiencies regarding individual audit engagements in periodic inspections because the person in charge of inspection merely received explanations from engagement teams and failed to spend sufficient time on inspections.

The primary cause of those deficiencies was the audit firm's failure to allocate sufficient time and manpower to inspections due to a lack of sufficient understanding of the importance of monitoring the quality control system.

**(Observed effective efforts)**

The following is an example of observed effective efforts made by an audit firm.

From the viewpoint of securing audit quality, the audit firm selects operations subject to periodic inspection so that each engagement partner's work is inspected at a frequency of around twice every three years.

**Expected response**

Audit firms are required to develop and operate an organizational system that adequately performs the primary function of quality control monitoring, which is to enable audit firms themselves to discover and understand problems related to the quality control system and voluntarily implement corrective measures. Specifically, audit firms should give due consideration to the need to carefully select individual audit engagements and identify the necessary inspection items in light of the economic environment, the business condition of audited companies, and the results of the previous CPAAOB inspection or the quality control review. They also need to ensure that qualified persons responsible for implementing periodic inspections conduct appropriate inspections, rather than merely conducting perfunctory inspections based on the checklist, and to develop an environment to check the adequacy of the corrective measures taken against the deficiencies identified through inspections.

It should also be kept in mind that even when a CPA from outside the audit firm has been appointed as the person responsible for implementing periodic inspections, it is necessary to check whether the primary monitoring function is sufficiently exercised, just as it is when a person within the audit firm has been appointed to that post.

Furthermore, it is necessary to develop and operate a system to ensure that statements of objection and doubt are recognized in a timely fashion, with appropriate investigations conducted as necessary. For example, one possible way to do that is to establish a system for receiving information from whistleblowers inside and outside the audit firm.

**Case 1: Effectiveness of ongoing monitoring**

The 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 ①When conducting inspections, the persons responsible for implementing periodic inspections merely conducted perfunctory checks based on the checklist without setting forth specific viewpoints of inspection. In addition, the persons did not spend sufficient time on those checks. This means a failure to conduct in-depth inspection from the viewpoint of whether engagement teams obtained sufficient and appropriate audit evidence. Moreover, despite being aware that the time spent on inspections was short compared with the volume of the checklist used in the inspections and that the number of deficiencies identified was small relative to the number of deficiencies identified in the quality control review, etc., the PICOQC did not evaluate the effectiveness of periodic inspections. In addition, the PICOQC did not develop an environment to ensure the implementation of effective periodic inspections, for example by increasing the number of persons responsible for implementing periodic inspections.

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

NEW ②Although the persons responsible for implementing periodic inspections periodically implemented

such inspections based on the checklist, they merely received explanations from audit teams and failed to implement sufficient inspections based on audit documentation due to the assumption that there was no matter that could pose a significant problem.
(Quality Control Standards Committee Statement No. 1, paragraph 47)

③ The 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.**
**Other deficiencies included a failure to develop an effective system to monitor the quality control system. For example, the monitoring of the quality control system was conducted solely by the CEO in some cases, while the frequency of inspection of audit engagements subject to periodic inspection was too low in other cases.**
**It is important to analyze the deficiencies identified in the quality control 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) Communication 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**

As the need for collaboration between accounting auditors and company auditors has been widely accepted among relevant persons, efforts have been made to develop and maintain an environment to

facilitate communication between them. As a result, periodic communication has been promoted, although the depth of collaboration may vary case by case.
Audit firms are following the principle of reporting the results of the CPAAOB inspection or the quality control review to company auditors in writing in a timely manner. On the other hand, as shown in the example case section below, there were some cases in which communication was inadequate due to a lack of understanding of the items requiring communication or in which audit firms, despite having received notification of the results of the quality control review from the JICPA, did not communicate the results to company auditors.

**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 on the CPAAOB's website)

(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: Communication with company auditors**

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)

②Although 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)

NEW ③Regarding significant risks, engagement teams did not conduct sufficient communication with audited companies' audit committees. For example, in briefing papers on audit and quality review plans submitted to the audit committees, engagement teams merely listed significant risks, item by

item, without providing explanations about the specifics of those items or the reasons why they had been identified.
(Auditing Standards Committee Statement No. 260, paragraph 13)

NEW ④ Engagement teams did not conduct sufficient communication with audited companies' audit committees. For example, they did not report to the audit committees the overview of internal control audits, including the responsibilities of auditors related to such audits, the scope of planned audits, and the timing of implementation. In addition, they did not report the results of internal control audits before submitting audit reports based on the Financial Instruments and Exchange Act.
(Audit and Assurance Practice Committee Statement No. 82, paragraphs 44-2 and 46)

**Case 2: Notifications to company auditors**

NEW Engagement teams did not appropriately prepare written explanations regarding the audit results. As a result, they failed to provide to audited companies' audit committees' information on fees for non-audit services related to the audit coverage period, which is required to be communicated in writing to company auditors.
(Auditing Standards Committee Statement No. 260, paragraphs 15 and 18)

**《Points to Note》**

**Auditors need 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

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

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). 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.

**<u>Outline of inspection results</u>**

**(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 Financial Instruments and Exchange Act 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 Financial Instruments and Exchange Act.
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.

**Impact of COVID-19 on Audit Engagements and Response**

**Points of focus**

Due to the rapid COVID-19 pandemic from around March 2020 in Japan, account book-closing work has been delayed, mainly at companies that close account books in March. Accordingly, with regard to audit engagements, constraints on the implementation of audits have arisen in a broad range of activities, including observing inventory checks, checking account balances, and conducting group audits related to foreign subsidiaries, raising concerns about delays in audit engagements and the impact on audit opinions. In the field of "audits related to accounting estimates," it has become difficult to make projections regarding the timing of the containment of COVID-19, among other factors.

Under these circumstance, since March 2020, the JICPA has published notices on audit considerations related to COVID-19, while the Accounting Standards Board of Japan published notices on the impact of COVID-19 on accounting estimates and the approach to the impact.

In the CPAAOB's inspections, verification is conducted with regard to audit responses to COVID-19 from the following viewpoints in light of the abovementioned circumstances.

- ▶ Whether the audit firm has developed appropriate operations management and quality control environments, for example by reorganizing the audit implementation system.
- ▶ Whether the audit firm is appropriately dealing with the impact on audit procedures and other elements of individual audit engagements in reference to the notices on audit considerations published by the JICPA.

**Outline of inspection results**

Concerning the operations management environment, there were cases in which the CEO informed staff members of the basic policy for responding to the COVID-19 pandemic, such as protecting staff members from infection risk and conscientiously performing the firm's social missions, and cases in which support was provided with regard to working arrangements and the development of a remote work environment.

Concerning the quality control environment, there were cases in which the quality control division informed staff members of the notices on audit considerations published by the JICPA in light of the impact of COVID-19 and cases in which the quality control division identified audit-related challenges faced by engagement teams and new risks detected, provided guidance on how to respond to those challenges and risks, and supported engagement teams as necessary. Some audit firms made audit responses in light of the guidance on audit implementation that had been provided by global networks with which they were in partnership.

In individual audit engagements, the following responses were made in light of the notices on audit considerations published by the JICPA.

- A case in which an audit firm revised the audit schedule and changed the date of submission of an audit report in order to deal with delays in the progress in the account book-closing work of audited companies' groups, including foreign components.

- A case in which an audit firm remotely observed inventory checks using a video camera because of the restrictions on the entry of auditors into audited companies' factories and other facilities.
- A case in which regarding the balance of claims payable by business clients from which written replies could not be obtained at the time of balance checking, replies obtained via email were used as audit evidence as an alternative measure.
- A case in which an audit firm, when conducting group audits, increased the frequency of communication with component auditors and audited companies' top management in light of the restrictions on work done by component auditors.
- A case in which audit reference materials were provided by an audited company to an audit firm in the PDF format because of the restrictions on on-site audits of audited companies and in which the audit firm ascertained the authenticity of the audit reference materials later, when an on-site audit was conducted, by checking them against the original data.
- A case in which an audit firm, when conducting an audit of accounting estimates, considered requiring appropriate disclosure of additional information in light of the possible impact on financial statements of the assumptions set by the top management with regard to the timing of containment of COVID-19.

As for individual audit engagements, there were cases in which audit firms did not check consistency between the assumption regarding the timing of containment of COVID-19 adopted by the top management in the estimate of future cash flow when considering the impairment of fixed assets and the timing of containment of COVID-19 indicated in additional information when those two timings were different.

**Expected response**

With regard to the operations management environment, it is important to formulate a basic policy for responding to COVID-19 that gives consideration to protecting staff members from infection risk and fulfilling the audit firm's social missions at the same time and to inform all staff members of the basic policy. Moreover, it is necessary to determine a policy on working arrangements for staff members adapted to the level of the COVID-19 pandemic (e.g. decisions on the percentage of staff members working in the office and on whether or not to permit business trips) and to develop infrastructure for efficiently conducting audits, such as introducing a web conference system, in order to enable the remote work arrangement, which has taken hold under the COVID-19 pandemic, to function effectively.

As for the quality control environment, it is essential to inform all audit firms' staff members, in an appropriate and timely manner, of the notices on considerations published by the JICPA and the Accounting Standards Board of Japan in light of the impact of COVID-19. The quality control division, etc. should collect information from engagement teams with regard to audit risks and constraints on audit implementation that have arisen at audited companies and provide organized support as necessary.

With regard to individual audit engagements, it is necessary to obtain sufficient and appropriate audit evidence after identifying, in a timely manner, the impact of the COVID-19 pandemic on audited companies' business activities and business performance and the presence or absence of constraints on audit implementation, giving consideration to the presence or absence of changes in internal control due to the expansion of telework, and appropriately evaluating audit risks. In particular, in the field of "audits related to accounting estimates," while it is not appropriate to tolerate top management's overly optimistic estimates, it is necessary to keep in mind that it is also not appropriate to make overly pessimistic projections disconnected from reality and judge the top management's accounting estimates as material misstatements. It is also necessary to give consideration to the need to take more care than usual to engage in communication with audited companies' top management and company auditors, etc. in an appropriate and timely manner.

# 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," lists example cases of identified deficiencies in accordance with the structure of the Auditing Standards Committee Statement. In particular, the section begins with "The Auditor's Responsibilities Relating to Fraud in Financial Statement Audits" not only because the Fraud Risk Response Standard requires careful response when addressing fraud risks in audits but also because, as seen in recent incidents, accounting fraud has been attracting attention from society at large. For the same reasons, the number of example cases has been increased.

Furthermore, with regard to "Audit of Internal Control over Financial Reporting," which is subject to audit standards different from the ones that are applicable to audits of financial statements, example cases and other items, including specifics related to the "use of internal audits" (Auditing Standards Committee Statement No. 610), are described in a separate sub-section. The number of example cases has also been increased.

As in "II. Quality Control Environment," each subsection describes the "points to note" in performing audit procedures as a reference, in addition to the "points of focus" in inspection and example cases of identified deficiencies.

**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)").

Reflecting the situation surrounding engagement teams and audited companies, various factors were cited as the causes of deficiencies. In recent cases, the following three causes were identified 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 inadequate consideration of the relevance of risk-related audit procedures to audit risk and the sufficiency and appropriateness of audit evidence**

Auditors are required to identify and assess the risk of a material misstatement based on their understanding of companies and business environments and to design and perform procedures for addressing the assessed risk of material misstatement. However, many cases were observed in which it could not be ascertained that sufficient and appropriate audit evidence had been obtained through the audit procedures. This deficiency resulted from the fact that engagement teams did not adequately consider the audit procedures and audit evidence at the following two stages:

1) Risk assessment at the audit planning stage

In some cases, the auditors did not plan audit procedures for addressing risks that should in principle have been assumed at the assertion level (refer to "1. The Auditor's Responsibilities Relating to Fraud in Financial Statement Audits"(2) and "2. Risk Assessment and Response to Assessed Risks"(2)) due to the insufficiency of their own risk assessment.

There were also many cases in which although risks were appropriately identified, sufficient and appropriate audit evidence was not obtained because risk-related audit procedures performed under a detailed audit plan were not sufficiently relevant to the specifics of the identified risks (refer to "1. The Auditor's Responsibilities Relating to Fraud in Financial Statement Audits"(3) and "2. Risk Assessment and Response to Assessed Risks"(3)).

When performing audit procedures, auditors are required under the audit standards to design and perform procedures to address the risks identified through risk assessment. Specifically, the nature, timing and extent of specific risk-related audit procedures should be determined based on the professional judgment of engagement teams in view of the situation of audited companies. In particular, it is required that risk-related audit procedures at the assertion level be designed under a detailed audit plan.

2) 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. In principle, whether sufficient and appropriate audit evidence has been obtained should be checked through means such as a review by superiors, but there were cases in which the obtained audit evidence was not sufficiently evaluated (refer to "1. The Auditor's Responsibilities Relating to Fraud in Financial Statement Audits"(3) and "3. Audit Evidence")

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

**(2) Lack of an attitude of professional skepticism required of an auditor**

Auditors are required to make professional judgments and maintain professional skepticism throughout the processes of planning and performing audits. However, there were cases in which, although the auditors understood the management's assumptions and accounting treatments, they failed to perform the procedures for verifying the reasonableness of the management's assertions regarding the feasibility of business plans used in accounting estimates based on objective evaluation due to a lack of professional skepticism (refer to "4. Auditing Accounting Estimates" (1)). There were also some cases in which the auditors failed to obtain sufficient and appropriate evidence because they overlooked the risk of a material misstatement due to a lack of professional skepticism (refer to "4. Auditing Accounting Estimates" (7)).

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) Insufficient knowledge of audit standards and the Auditing Standards Committee Statement**

As described below, there were many cases of deficiencies due to a lack of knowledge concerning the matters required by the audit standards and the Auditing Standards Committee Statement.

- Cases in which the specific procedures to be performed by component auditors in order to address significant risks related to group financial statements were not identified or examined in group audits (refer to "5. Group Audit," Case 5), in which the appropriateness of risk-related audit procedures was not evaluated (refer to "5. Group Audit," Case 9), or in which the matters reported by component auditors were not evaluated (refer to "5. Group Audit," Case 9).
- Cases in which the reliability of basic data was not evaluated in the substantive analytical procedures (refer to "3. Audit Evidence" (3)), or in which sufficient and appropriate evidence was not obtained when the difference between the booked value and the estimated value was larger than the tolerable level of difference (refer to "3. Audit Evidence" (3)).
- Cases in which transactions which were recorded in journal entries through different methods were treated as a single population in audit sampling with no consideration given to the characteristics of the population (refer to "3. Audit Evidence" (4)), or in which transactions conducted between January and March that were included in the sample population of transactions in a relevant year were not given a sampling opportunity (refer to "3. Audit Evidence" (1)).
- Cases in which the accuracy and completeness of the basic data were not examined in accounting estimates (refer to "4. Auditing Accounting Estimates" (2)), or in which accounting estimates in the previous fiscal year were not examined (refer to "4. Auditing Accounting Estimates" (1)).
- Cases in which whether the objectivity of internal auditors was sufficient and the audit work done was appropriate in light of the purposes of the audit when internal audit was used (refer to "7. Audit of Internal Control over Financial Reporting" (4)).
- Cases in which experts' competence, capabilities and objectivity and the work done by them were not evaluated when experts' work was used (rfefer to "6. Using the Work of Auditor's experts").

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.

**<u>Expected response</u>**

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 material misstatement due to fraud; and whether the engagement team places emphasis on where and how material misstatement due to fraud may occur in financial statements, including how fraud is committed, without assuming the reliability and integrity of the audited company's top management, directors, and company auditors;
- Whether the engagement team evaluates whether the information obtained from other performed risk assessment procedures and related activities indicates the presence of fraud risk factors and takes such risks, if any, into account when identifying and assessing the risk of a material misstatement due to fraud at two levels, i.e. the financial statement level and the assertion level; whether the engagement team makes judgements as to which types of revenue, sales transactions or assertions may give rise to fraud risks; and, when making such judgments, whether the engagement team conducts sufficient consideration in light of the audited companies' business processes, without easily assuming that fraud risks are limited to areas where particularly high risks are considered to exist;
- 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.

**<u>Outline of inspection results</u>**

There were cases of significant deficiencies regarding audit procedures related to fraud risks in the audit of financial statements. For example, in some cases, the engagement team overlooked indications of fraud, although the risk of a material misstatement due to fraud could have been identified at the stages of audit design and performance. In other cases, the audit team determined a misstatement to be due to error without sufficient examination although the situation raised suspicions about the management's possible involvement in fraud.

Other cases were also observed in which: the engagement team failed to assess the risk of a material misstatement due to fraud in view of changes at the audited company; the engagement team identified the risk of a material misstatement due to fraud only in areas where particularly high risks were considered to exist and determined without due consideration that there was no risk of a material misstatement due to fraud in other areas; the engagement team did not examine the presence or absence of risk of a material misstatement due to fraud with regard to items other than revenue recognition; the engagement team did not sufficiently perform risk-related audit procedures, although it identified the risk of a material misstatement due to fraud with regard to revenue recognition; the engagement team performed only perfunctory risk-related audit procedures in order to address risks related to management override; the engagement team did not carefully assess fraud risks, although it identified transactions with related parties 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 required 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 risk of a material misstatement due to fraud.

In particular, all auditors must recognize anew that the reliability of audit has once again been called into question following recent cases of fraudulent accounting.

Therefore, when preparing audit plans, 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 may be used for fraud, obtain information through interviews with managers and other employees, and carefully examine whether the information obtained indicates the presence of fraud risk factors through discussions within the engagement team.

Furthermore, auditors should consider identified fraud risk factors and identify and assess the risk of a material misstatement due to fraud at two levels, i.e. at the level of the financial statement as a whole, and at the assertion level. When identifying and assessing fraud risks related to revenue recognition, auditors should consider where and how material misstatements due to fraud may occur in financial statements in light of their understanding of the audited company and its business processes, without easily assuming that fraud risks are limited to areas where particularly high risks are considered to exist.

In responding to the assessed risk of a material misstatement due to fraud, auditors should always keep in mind the possibility that a material misstatement due to fraud could occur and prepare general responses appropriate to the risk of a material misstatement due to fraud at the level of the financial statement as a whole and audit procedures for addressing the risk of a material misstatement at the assertion level.

In performing the procedures to address the risk of a material misstatement due to fraud, auditors should keep in mind that they are required to obtain more relevant and stronger audit evidence in greater quantity with regard to assertions regarding the identified fraud risks than with regard to assertions over which no fraud risk has been identified.

If auditors have identified circumstances that indicate the possibility of a material misstatement due to fraud during the process of audit performance, they should make inquiries of and ask for explanations from the management, and they should perform additional audit procedures in order to determine whether the suspected material misstatement due to fraud exists. In cases where there are suspicions about a possible material misstatement due to fraud, such as when the management's explanations are considered to be not reasonable, it is necessary to keep in mind the need to modify their risk assessment and designed risk-related audit procedures and perform audit procedures that are specifically relevant to

| |
|---|
| the type of fraud that may be assumed. |

**(1) Discussion among the engagement team, risk assessment procedures, and related activities**

**Case: Understanding of fraud cases at audited companies and the industries to which they belong**

NEW

The audited company engages in construction business and applies the percentage-of-completion method to the booking of sales. As a fraud risk scenario, the engagement team considered possible fraud due to the manipulation of the total construction cost and the progress in construction as of the date of the account book closing.

However, the engagement team did not consider the need to identify risks related to the "fraudulent practice of indicating the cost of a construction project as the cost of another project," many cases which have been published as examples of fraud, in discussions within the team.

In addition, although the engagement team identified cases of such fraud in past fiscal years during the process of auditing at the end of each fiscal year, it did not consider the need to review its risk assessment.

(Auditing Standards Committee Statement No. 240, paragraphs 14, F15-2, and No. 330, paragraph 24) [Second-tier, and small and medium-sized audit firms]

**《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.**

**There were also cases in which the discussion held within the engagement team was merely perfunctory. For example, the risks indicated by example cases of fraud thus far published were not discussed in relation to audited companies. In some cases, as inquiries asked of the management about fraud and communication with the management and company auditors were merely perfunctory, the engagement team failed to reflect the information obtained through those processes in its risk assessment.**

**(2) Identifying and assessing risk of material misstatement due to fraud**

**Case: Identifying and assessing fraud risks in revenue recognition**

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

NEW

②The audited company engages mainly in the business of selling digital multifunction office equipment. When examining fraud risks related to sales of digital multifunction office equipment, the engagement team judged that the situation did not require the estimation of risk of a material misstatement due to fraud and noted this judgement in audit documentation because the per-transaction sales value in this business was low and below the benchmark of materiality.
However, the engagement team did not consider specific scenarios of fraud with regard to the types of transactions and assertions, since it judged that it was unnecessary to identify the risk of a material misstatement due to fraud only because the per-transaction sales value is low relative to the benchmark of materiality.
(Auditing Standards Committee Statement No. 240, paragraph 25) [Second-tier, and small and medium-sized audit firms]

NEW

③When examining fraud risks related to the revenue recognition of the audited company, which closes its annual account book in March, the engagement team assumed that the period during which fraudulent booking of sales might occur was limited to March on the grounds that fraudulent booking of sales in and before February could be found during the budget management process, as the company was conducting budget management on a monthly basis.
However, the engagement team failed to sufficiently examine fraud risks related to sales booked by the audited company in and before February. For example, it did not check the accuracy of budget management.
(Auditing Standards Committee Statement No. 240, paragraph 25) [Second-tier, and small and medium-sized audit firms]

NEW

④The engagement team identified the "risk of employees engaging in the practice of early sales booking by booking sales regarding transactions that do not meet the booking requirements" given the possibility that employees of the audited company might commit fraud in order to achieve the budgeted sales figure because of the severe order-receiving situation.
However, the engagement team did not sufficiently examine the risk of a material misstatement due to fraud related to revenue recognition. For example, the engagement team did not identify the risk of fraud being committed by the management merely because of the assumption that the management was strict about rules and that their sense of values was not such that they would justify fraud, nor did it take into account motivations and opportunities for the management to commit fraud.

(Auditing Standards Committee Statement No. 240, paragraph 25) [Second-tier, and small and medium-sized audit firms]

NEW ⑤The audited company engages in wholesale sales of beverages and retail sales using vending machines. Regarding wholesales sales, the engagement team identified the risk of sales being overstated through a fraudulent practice. On the other hand, regarding sales through vending machines, which account for around 40% of the audited company's overall sales, although the engagement team recognized the presence of a possible motivation for overstating sales, it did not identify the risk of a material misstatement due to fraud for the following reasons: that it was difficult to commit fraud to overstate sales to a large degree given the need to book a large number of small-value cash sales transactions; and that if sales were overstated to a large degree, the anomaly could be easily detected through audit procedures.

However, the engagement team did not sufficiently examine the risk of a material misstatement due to fraud related to sales through vending machines. For example, it did not take into account the possibility of the management falsifying financial data.

(Auditing Standards Committee Statement No. 240, paragraph 25) [Large-sized audit firms]

NEW ⑥The audited company is operating a large chain of drugstores and pharmacies.

With regard to sales at drugstores and pharmacies, the engagement team identified the risk of sales being illegally booked without going through the enterprise system through the direct entry of fictitious sales data into the accounting system. On the other hand, sales booked through the enterprise system represented sales of products to general customers and were comprised of small-value transactions, and the journal entry of sales was automatically implemented based on sales data recorded by store registers incorporating the point of sales system (POS registers), leaving little room for human intervention. Therefore, the engagement team did not identify fraud risks. It should be noted that when evaluating the status of development of internal control over store sales, the engagement team recognized the possibility that sales data recorded by POS registers might be modified during the process of being booked in the accounting system via the enterprise system.

However, when identifying and assessing the risk of a material misstatement due to fraud related to revenue recognition, the engagement team did not consider the possibility of fraud being committed through the modification of sales data booked via the enterprise system.

(Auditing Standards Committee Statement No. 240, paragraph 25) [Second-tier, and small and medium-sized audit firms]

**《Points to Note》**

**As shown in the above example case section, many cases were observed in which: although the audited company engaged in multiple businesses, the engagement team did not identify and assess fraud risks in accordance with those businesses' respective types of revenue and transactions; in which the engagement**

**team identified fraud risks only in areas where higher risks were considered to exist (e.g., fraud committed during a limited period of time, such as March, or fraud committed by employees), while assuming the absence of fraud risks in other areas without conducting sufficient examination in light of possible motivations and opportunities for committing fraud.**

**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. When making such judgment, it is necessary to pay attention to the following points.**

- **When the audited company engages in multiple businesses within the consolidated group, it is necessary to identify and assess fraud risks in accordance with those businesses' respective types of revenue and transactions.**
- **When considering fraud risk scenarios, it is necessary to examine where in the financial statement and how a material misstatement due to fraud may occur based on an understanding of the audited company and its business processes.**
- **When the risk of material misstatement due to fraud has been identified, it is necessary to understand the audited company's internal control, including control activities related to the identified risk.**
- **When fraud risks related to revenue recognition have not been identified, it is necessary to conduct sufficient examination and to describe the reason for judging that there is no fraud risk in audit documentation.**
- **It is essential to identify and assess the risk of a material misstatement due to fraud at two levels, i.e. at the level of the financial statement as a whole and at the assertion level, after sufficiently examining risks related to management override.**

### (3) Response to assessed risk of material misstatement due to fraud

#### Case 1: Journal entries test

①In 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) [Second-tier, and small and medium-sized audit firms]

NEW ②The engagement team conducted journal entry tests as an audit procedure to address management override. As it assumed that the room for fraud was small with regard to automatic journal entries, the engagement team focused its inspection on manual journal entries.

However, the engagement team did not consider the option of excluding automatic journal entries from journal entry tests despite being aware of the following facts: that the audited company was automatically entering data and making corrections to journal entries using proprietary IDs that enabled direct modifications of data and programs; and that the audited company was inputting automatic journal entries into the accounting system while modifying data registered with the operation system.

(Auditing Standards Committee Statement No. 240, paragraph 31) [Second-tier, and small and medium-sized audit firms]

**《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

①With regard to the cause of discrepancies that arose during the process of checking the balance of accounts receivables related to the audited company's sales transactions with a leasing company, the engagement team received a reply from the leasing company stating that accounts payable would not be recorded until the starting date of the relevant lease agreement with end users, which was more than a year later than the date of the leasing company's acceptance of goods.

However, the engagement team did not examine the validity of the occurrence of sales and the period attribution, including the reasonableness of the transactions and the contract terms pertaining to them.

(Auditing Standards Committee Statement No. 240, paragraphs 22 and 31) [Large-sized audit firms]

②The audited company engages in the sale of expendable office supplies and is adopting a shipping basis as its standard for revenue recognition, but, in keeping with an industry-specific business practice, it books sales regarding some transactions before shipment.

The engagement team was aware that the contract terms were unclear with regard to inventory in custody, namely goods before shipment for which sales had been booked, that the company had no choice but to hold them in custody out of consideration for its relationship with customers, and that the period of custody was long with regard to some customers.

However, the engagement team merely received explanations from the audited company to the effect that such transactions had been conducted as a customary practice and that payments were made under the same terms as those regarding ordinary transactions for which sales were booked after shipment and failed to consider, from the viewpoint of addressing fraud risks, whether those transactions were based on the economically rational needs of purchasers. The engagement team also failed to sufficiently examine whether those transactions met the requirements for booking of sales in terms of the treatment of storage and transportation charges, among other factors.

(Auditing Standards Committee Statement No. 240, paragraph 31) [Second-tier, and small and medium-sized audit firms]

**《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) [Second-tier, and small and medium-sized audit firms]

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

NEW

③The audited company engages in construction business and applies the percentage-of-completion method to the booking of sales.

Regarding projects to which the percentage-of-completion method was applied, the engagement team assumed the following fraud risk scenarios because of the pressure to achieve budget targets: (i) that the management would increase the profit/loss ratio by fraudulently understating the total estimated cost; and (ii) that employees would overstate the rate of progress by booking fictitious costs.

To identify projects in which there was the possibility that either of the above scenarios could come true, the engagement team selected (i) projects in which the profit/loss ratio was higher at the end of the fiscal year than at the end of the third quarter and (ii) projects in which the rate of progress was higher at the end of the fiscal year than at the end of the third quarter, checked the validity of the reasons given for the increases by inquiring with the audited company and by reading the company's internal documents, and ultimately concluded that there was no project in which fraud might have been committed.

However, the procedures performed by the engagement team were not relevant to the assumed fraud risks. For example, although the risk of the management or employees committing fraud due to the pressure to achieve budget targets was assumed, the engagement team did not take into account the status of achievement of budget targets when selecting projects involving the possibility of fraud. In addition, when checking the validity of the reasons given for the increases in the profit/loss ratio and the rate of progress in the selected projects, the engagement team merely identified the reasons by inquiring with the audited company and by reading the company's internal documents but did not examine relevant external evidence. As a result, the procedures performed by the engagement team were not sufficient to conclude that there was no project in which fraud might have been committed.

(Auditing Standards Committee Statement No. 240, paragraph 29) [Large-sized audit firms]

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, paragraph F35-2) [Second-tier, and small and medium-sized audit firms]

NEW ⑤ The audited company engages in the business of manufacturing measurement and control equipment, mainly electricity meters, and applies the arrival of shipment standard to the booking of sales.

With regard to the period attribution of sales at the audited company, the engagement team identified the risk of a material misstatement due to fraud, and citing the possibility of the company deliberately manipulating the timing of booking of sales around the end of the term, it selected

samples from among sales data booked around the end of the term and conducted a detailed test.
However, when examining the period attribution of sales, the engagement team merely checked sales data against order sheets but did not perform substantive procedures to obtain stronger audit evidence, such as checking sales data against customers' acknowledgements of receipt that confirm the fact of arrival of shipment.
(Auditing Standards Committee Statement No. 240, paragraph 29) [Second-tier, and small and medium-sized audit firms]

NEW ⑥With regard to revenue recognition concerning the audited company's wholesale business, the engagement team identified the risk that, when entering order receipt information, they might deliberately enter earlier requested dates of delivery than those indicated in order sheets for the purpose of moving forward to the current fiscal year the timing of the booking of sales transactions that shipment was scheduled for the next fiscal year.
To address the above fraud risk, the engagement team performed procedures to evaluate the exercise of internal control related to the order-receiving process.
However, when performing the procedures to evaluate the exercise of internal control related to the order-receiving process, the engagement team designed and performed procedures under which the sample population size and the degree of use of internal auditors' work were similar to the ones under the procedures to be performed in cases where fraud risks had not been identified. As a result, the engagement team did not obtain stronger audit evidence or a larger quantity of evidence, as required in cases where fraud risks had been identified.
(Auditing Standards Committee Statement No. 240, paragraph 29, and No. 330, paragraph 7) [Large-sized audit firms]

**《Points to Note》**

**There were many cases related to risk assessment regarding revenue recognition and risk-related audit procedures. For example, in one case, the engagement team did not perform sufficient risk-related audit procedures due to the failure to sufficiently perform risk assessment regarding revenue recognition based on an understanding of the audited company's business and its business environment, including its type of business and the characteristics of its sales transactions, and due to the failure to develop appropriate audit procedures. In another case, the engagement team did not perform sufficient risk-related audit procedures due to the failure to conduct specific deliberations on what risks existed with regard to each assertion and to develop appropriate audit procedures despite having identified the risk of material misstatement due to fraud. In some cases, although the engagement team assumed fraud risk scenarios, it did not conduct sufficient examination, as it concluded that the assumed fraud risks had not materialized after merely performing analytical procedures, such as comparison with the previous term, for example. In other cases, the engagement team merely cross-checked books against evidence as a matter of formality and overlooked an abnormal profit ratio and terms of contracts that were inconsistent with reality. There were also cases**

**in which the engagement team, when examining the estimated total cost under the percentage-of-completion method, merely inquired with the management and cross-checked books against internal management data 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) [Second-tier, and small and medium-sized audit firms]

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) [Large-sized audit firms]

**《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, F35-2) [Second-tier, and small and medium-sized audit firms]

**《Points to Note》**

**In the case above, the auditors did not exercise the professional skepticism that is 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.**

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

NEW

The audited company established an investigative committee headed by an external auditor and conducted an in-house investigation because it was found during the inventory-taking process that fictitious inventories due to fraudulent cost transfer were booked.

As a result of the investigation, the investigative committee concluded that Division A implemented the fraudulent cost transfer under the initiative of the head of the division. As for the method of fraud, the investigative committee determined that Division A had instructed the order-placing division to place an order with a construction number different from the original number.

In order to identify transactions affected by the cost transfer, the investigative committee selected transactions worth 100,000 yen or higher from among the acceptance data and checked the construction numbers indicated in the quotation against the construction number at the time of order placement, and it determined that fraudulent cost transfer occurred in cases where the two numbers were different.

Moreover, regarding divisions other than Division A, the investigative committee also conducted a similar investigation with respect to transactions worth 3 million yen or higher and confirmed that there was no case of fraudulent cost transfer.

Regarding the completeness of the investigation's coverage of transactions affected by fraudulent cost transfer, the engagement team read the report prepared by the investigative committee and determined that the committee's investigation method was appropriate.

However, the engagement team did not check the completeness of the acceptance data when considering whether the investigative committee had exhaustively selected transactions affected by fraudulent cost.

Moreover, when examining the presence or absence of fraudulent cost transfer at divisions other than Division A, the engagement team did not consider the reasonableness of subjecting only transactions worth 3 million yen or higher to investigation or the possibility that cost transfer might have been implemented through a similar method at other consolidated subsidiaries.

(Auditing Standards Committee Statement No. 240, paragraph F35-2) [Second-tier, and small and medium-sized audit firms]

**《Points to Note》**

**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**

With regard to risk assessment and response to the assessed risks, there were many cases in which the engagement team did not appropriately design and perform risk-related audit procedures as a result of the failure to makeappropriate risk assessment.

For example, there were cases in which: the engagement team did not assess the audited company's accounting policy; the engagement team did not understand and assess internal control concerning important businesses; or the engagement team did not understand and assess the internal control of service organizations over important business processes. There were also cases in which: deficiencies occurred with regard to the nature, timing and extent of substantive procedures performed at the end of the term as a result of the failure to appropriately consider revising the audit plan when the audited company's business environment and financial results deteriorated, or when misstatements were identified over the course of the audit process; or deficiencies occurred with respect to the operations assessment procedures and substantive procedures due to the failure to design appropriate audit procedures to address the assessed risks.

Moreover, there were still engagement partners and assistants to engagement partners who did not fully understand the concept of a risk-based approach. As a result, 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 cases of deficiency included ones in which: the engagement team did not perform substantive procedures despite having identified the risk of material misstatement on the grounds that the analysis of changes in accounting found no irregularities; or the absence of notes regarding important transactions with related parties was overlooked at an audited company engaging in a large volume of various types of transactions with relevant parties due to a lack of particular awareness about risks even though risk assessment should have been conducted more carefully than usual from the viewpoint of exhaustively identifying transactions with related parties. There were also cases in which: the effects of the identified misstatement on the results of the evaluation of internal control and on the substantive procedures were not considered; the engagement team lacked sufficient understanding of the overview of the audited company's information systems and of the company's general IT controls.

**(Observed effective efforts)**
The following is an example of observed effective efforts made by an audit firm.
The audited company is not only actively engaging in corporate acquisitions in order to achieve business growth but is also eagerly starting new businesses. With regard to new businesses, the company expects long-term growth in some cases and earns profits by selling businesses that started to show commercial promise. In addition, the company opts for business closure or selloff immediately once it has judged that it is difficult to continue operating new businesses. This reflects the significant effects that the management's decisions and judgments have had on the company's financial statements.
The engagement team understands the above situation and has requested to have a meeting with the management each month. In the meeting, the engagement team strives to grasp changes in the company's situation and in its business environment in an appropriate and timely manner by checking the management's present assessment of the results of corporate acquisitions and new businesses and by receiving detailed explanations about the matters determined by and reported to the board of directors directly from the management.

**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) [Second-tier, and small and medium-sized audit firms]

**《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) [Second-tier, and small and medium-sized audit firms]

**《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 engages in the business of processing raw materials into products at its own factories and selling them. Of the manufacturing costs, processing expense is booked as a period cost without cost calculation, with only raw material cost booked as an inventory item through costing.

However, the engagement team did not assess or examine the effects of the inconsistency between the audited company's policy concerning the manufacturing costs and inventory, and the cost calculation standard.

(Cost Accounting Standards, Chapter 1.6 (1); Auditing Standards Committee Statement No. 315, paragraph 10) [Second-tier, and small and medium-sized audit firms]

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

《**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 interim period 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 overstate its profits, and identified as fraud risks in overstatement of sales and software (excessive capitalization of expenses).

owever, while the engagement team identified fraud risks regarding sales and software, it did not consider the need to identify the risk of misstatement in completeness and cutoff assertions for cost, despite assuming that the audited company might fraudulently overstate its profits.

(Auditing Standards Committee Statement No. 315, paragraph 25) [Large-sized audit firms]

《**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) [Second-tier, and small and medium-sized audit firms]

**《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) [Large-sized audit firms]

NEW

②The engagement team identified the risk of material misstatement related to the existence of the audited company's inventory and the valuation of inventory.

However, the engagement team did not examine the accuracy of the assessed unit prices concerning the closing balances with regard to finished goods, work in process, raw materials, and merchandise. Nor did it obtain sufficient and appropriate audit evidence with regard to the existence of work in process and raw materials.

(Auditing Standards Committee Statement No. 330, paragraph 17) (Second-tier, and small and medium-sized audit firms)

**《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**

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

NEW

② The engagement team identified the risk of material misstatement with regard to segment information.

However, the engagement team did not evaluate whether segment information conformed to the accounting standards concerning segment information, etc. Moreover, it merely checked segment information against the basic reference materials prepared by the audited company and failed to perform sufficient substantive procedures.

(Auditing Standards Committee Statement No. 330, paragraphs 17 and 23 and No. 501, paragraph 12) (Second-tier, and small and medium-sized audit firms) [Second-tier, and small and medium-sized audit firms]

**《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.**

**As shown in the above case example section, there were also several cases in which the engagement team did not design and perform audit procedures to evaluate whether segment information displayed and disclosed by the audited company conformed to the accounting standards, etc. Engagement teams should keep in mind that they should obtain sufficient and appropriate audit evidence concerning segment information through the following procedures (Auditing Standards Committee Statement No. 501, paragraph 12).**

**・Obtain an understanding of the methods used by management determining segment information.**

**・Where appropriate, evaluate whether such methods are likely to result in disclosure in accordance with the applicable financial reporting framework.**

**・Perform analytical procedures or other audit procedures in the circumstances.**

**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

NEW

The audited company outsourced the administration and investment of plan assetsto multiple life insurance companies and trust banks. In this situation, the engagement team lacked sufficient understanding of the services provided by them, the importance of those services, and the effects of those services on the audited company's internal controls related to audit. As a result, the engagement team did not identify and assess the risk of material misstatement related to plan assets. (Auditing Standards Committee Statement No. 402, paragraphs 8 to 10) [Second-tier, and small and medium-sized audit firms]

**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) [Second-tier, and small and medium-sized audit firms]

**《Points to Note》**

**In addition to the above cases of deficiency, there were cases in which, although the management of inventory, including shipment and acceptance of goods, was outsourced to a warehousing company, the engagement team lacked sufficient understanding of the services provided by the service organization and relevant internal controls.**

**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**

NEW

The engagement team ascertained that the understatement of loss on valuation of shares of subsidiaries and associates in the 'non-consolidated nd consolidated financial statement for the prior period, which were included in comparative information, was recognized in the current period and that the uncorrected misstatement in the previous fiscal year was corrected in the current term.

However, the engagement team did not examine the effect of the misstatement in the previous fiscal year on audit of internal control over financial reporting. In addition, it did not include "uncorrected misstatement included in comparative information" or "effect of the undermining of comparative information as a result of correction made in the figures for the current term" among the matters to be confirmed in the management representation letter for confirmation. Moreover, the engagement team did not report to the board of auditors the effect of the uncorrected misstatement related to past fiscal years on the relevant classes of transactions, account balances, or disclosures, and the non-consolidated and consolidated financial statement as a whole.

(Auditing Standards Committee Statement No. 265, paragraph 6, and No. 450, paragraphs 5 and 10; Audit and Assurance Practice Committee Statement No. 82, paragraphs 188 and 195) [Second-tier, and small and medium-sized audit firms]

**《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 included in comparative information or (2) 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**

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

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

**Case 2: Evaluating of deficiencies in overall control of IT**

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

**《Points to Note》**

**In addition to the above example cases, there were also cases in which the engagement team lacked sufficient understanding of the specifics of programs related to cost calculation and information systems using IT, including the method of generating master data used by the programs, when evaluating the development of business processes for cost calculation.**

**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.”

**(Observed effective efforts)**
The following is an example of observed effective efforts made by an audit firm.
The engagement team reviewed audit plans before the end of each term, and the results of the review are shared at a meeting held before the end of the term and attended by all team members. At that meeting, the engagement team checks once again each of the audit procedures planned to be performed in term-end audits with regard to each material accounts, and the engagement partner conducts a detailed review of the specifics of the audit procedures before the performance of term-end 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**

①The audit evidence for the risk of material misstatement

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

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

(Auditing Standards Committee Statement No. 500, paragraph 5) [Large-sized audit firms]

NEW ②Dual-purpose test

The engagement team claimed to have performed dual-purpose tests doubling as substantive procedures in the form of examination of 25 sample cases conducted as atest of controls related to raw material cost included in manufacturing costs.

However, the engagement team merely stated in audit documentation the fact of having checked the presence or absence of approval as a test of controls, but information on monetary value was not covered by the examination, while substantive procedures were not performed. In addition, the engagement team did not fully examine the sufficiency of the 25 sample cases randomly selected, nor did it design and perform substantive procedures for the period between January and March, which was not covered by the test of controls.

(Auditing Standards Committee Statement No. 500, paragraphs 5 and 9, and No. 530, paragraphs 6 to 8) [Second-tier, and small and medium-sized audit firms]

NEW ③Observation of physical inventory-taking

Although the engagement team observed physical inventory-taking, it merely observed inventory-taking procedures and performed test counts but failed to perform the procedures to check the completeness of the on-site records of inventory-taking and the accuracy of cutoff of shipping and receipt. As a result, the engagement team did not obtain sufficient and appropriate audit evidence regarding the completeness and accuracy of the records of inventory-taking.

(Auditing Standards Committee Statement No. 500, paragraph 5 and No. 501, paragraph 3) [Large-sized audit firms]

④Revisions of non-consolidated financial statements in the consolidation process

The audited company corrected the financial statement 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 corrected the financial statement using the same debit and credit accounts as those used in the previous term. Although the engagement team identified the risk of material misstatement in the corrected statement and recognized that the corrected amount represented a significant increase from the previous fiscal year, it did not sufficiently examine the validity of the reason for the correction and the corrected amount.

(Auditing Standards Committee Statement No. 600, paragraphs 16 and 36) [Large-sized audit firms]

⑤Consolidation journal entry

The engagement team identified the risk of material misstatement regarding the accounting treatment of capital consolidation. However, due to the following deficiencies of the audit procedures performed by it, the engagement team did not evaluate whether the audit evidence obtained was sufficient and appropriate for examining the risk of material misstatement.

a) With regard to journal entries concerning the amortization of goodwill, the engagement team merely reviewed documents prepared by the audited company and failed to perform substantive procedures.

b) With regard to journal entries concerning the equity method of accounting, the engagement team merely made comparisons with the previous term and failed to perform substantive procedures with respect to the booked amounts.

c) With regard to journal entries concerning full market value valuation associated with the evaluation of assets and liabilities at the time of business combination, the engagement team compared the total journalized amount of deferred tax assets/liabilities with the figure for the previous term and recognized a significant decrease. However, it concluded that "nothing unusual was found with journal entries" and failed to consider whether additional procedures were necessary.

(Auditing Standards Committee Statement No. 330, paragraph 17, No. 600, paragraphs 32 and 33) [Second-tier, and small and medium-sized audit firms]

**《Points to Note》**

**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.**

**There were also cases in which: when examining consolidated journal entries, the engagement team merely made comparisons with the previous term's figures and read documents prepared by the audited company while not performing substantive procedures; or, due to a lack of a sufficient understanding of the audited company and its business environment at the group level, the engagement team did not examine whether**

**unrealized profits were fully eliminated even though complex intra-group transactions had occurred. Engagement teams should keep in mind that appropriately understanding corporate groups, including evaluating capital relationships, substantial control, and influence, is prerequisite for the audit of consolidated financial statements. For information on example cases related to consolidated financial statements, also refer to "5. Group Audit."**

**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 some cases, although the engagement team performed multiple audit procedures, it did not consider whether the audit evidence obtained through the audit procedures designed under the audit plan was sufficient in terms of quality and quantity, with the result that sufficient audit evidence to keep the level of audit risk low on the whole was not obtained.**

**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 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: Information used as audit evidence**

NEW

①Relevance and reliability of information

The audited company engages in the business of providing economic information to customers. It prepares and updates the list of customers based on written applications for subscriptions and notices of cancellation that indicate fixed monthly fees and books sales on a monthly basis based on the list of customers.

Although the engagement team selected samples from the list of customers as a substantive procedure concerning the occurrence of sales, it merely checked sales data against written applications received at the start of transactions and failed to consider the need to obtain audit evidence for ascertaining that the contracts for those transactions were still in effect by verifying the fact of payment, for example.

(Auditing Standards Committee Statement No. 500, paragraph 6) [Large-sized audit firms]

②Work of management's experts

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

NEW ③Reliability of information prepared by companies
Based on data for item-by-item unit book prices, quantity, book value, dates of final loading, final unit sale prices, and estimated direct cost of sales of inventory, the audited company booked (i) valuation losses on inventory based on the net sales unit price, which represents the final sales unit price minus the estimated direct cost of sales and (ii) valuation losses based on the period of time passed since the date of final loading.
However, although the engagement team examined the completeness of the abovementioned data, it did not examine the accuracy of item-by-item unit book prices, quantity, book value, dates of final loading, final unit sale prices, or estimated direct cost of sales of inventory.
(Auditing Standards Committee Statement No. 500, paragraph 8) [Second-tier, and small and medium-sized audited companies]

**《Points to Note》**

**When designing and performing audit procedures, auditors should keep in mind that they should take into account the relevance and reliability of information used as audit evidence.**
**In addition, when using information prepared by experts (e.g., pension actuaries, real estate appraisers, and attorneys) employed by the management as audit evidence, auditors should keep in mind that they should evaluate the competence, capabilities and objectivity of the experts, to understand the experts' work, and to evaluate the adequacy of the experts' work used as audit evidence in light of relevant assertions.**
**Meanwhile, audited companies often make accounting estimates based on information prepared by themselves, including reference data regarding valuation losses that lists book values and net sales prices by inventory and reference data regarding indications of impairment that lists book values of fixed assets and operating profits/losses by asset group, and data regarding estimated construction profits/losses by construction project and the balance of construction-in-progress expenditures under the percentage-of-completion method, and reference data regarding construction loss provisions. There are still many cases in which information prepared by audited companies as the basis of accounting estimates is used as audit evidence in the audit of accounting estimates without its accuracy and completeness being verified. When performing audit procedures using information prepared by audited companies, engagement teams must obtain audit evidence concerning the accuracy and completeness of the information and sufficiently examine the reliability of the information obtained by evaluating whether the information is sufficiently accurate and detailed.**

**Case 3: Timing and coverage of substantive procedures**

NEW

①Procedures for the remaining period

The engagement team checked the balance of accounts payable as of the end of February as a substantive procedure regarding accounts payable. However, although changes that exceeded the materiality for the financial misstatement as a whole had occurred in the balance with respect to multiple suppliers, the engagement team merely vouched one arbitrarily selected transaction with each supplier in March and failed to design and perform sufficient substantive procedures for the remaining period.

(Auditing Standards Committee Statement No. 330, paragraphs 5 and 21) [Second-tier, and small and medium-sized audit firms]

NEW

②Changes in inventory between the date of physical inventory-taking and the closing date of the term

The audited company adopted physical inventory cycle counting, with different reference dates before the term end applied to inventory taking at different business locations.

The engagement team selected multiple locations for observation of physical inventory taking and performed audit procedures with respect to changes in inventory at some of those locations between the date of physical inventory taking and the closing date of the term.

However, the engagement team did not identify the balance of inventory as of the date of physical inventory taking or the changes in the balance between the date of physical inventory taking and the closing date of the term at locations not covered by the examination of changes in the balance of inventory. As a result, it did not design and perform audit procedures to obtain sufficient and appropriate audit evidence with regard to changes in the balance of inventory between the date of physical inventory taking and the closing date of the term.

(Auditing Standards Committee Statement No. 330, paragraph 21, and No. 501, paragraph 4) [Second-tier, and small and medium-sized audit firms]

NEW

③Examination throughout the period under audit

The engagement team identified significant risks concerning the completed construction amount and performed substantive procedures with regard to samples selected from among the data for the period from April to December. However, it did not design and perform substantive procedures for the period from January to March.

(Auditing Standards Committee Statement No. 500, paragraph 9, and No. 530, paragraph 7) [Second-tier, and small and medium-sized audit firms]

**《Points to Note》**

**It should be kept in mind that, when performing substantive procedures with regard to balance sheet items with a date before the closing date of the term as the reference date, it is necessary to perform additional substantive procedures for the remaining period in order to provide rational grounds for an extended**

**application of the results of the performed substantive procedures to the remaining period.**

**It should also be kept in mind that, when using samples for performing substantive procedures with regard to income statement items, it is necessary to select the samples through a method that provides a selection opportunity to all sampling units during the period under audit because the entire data for the whole of that period becomes the sample population.**

### (2) External Confirmation

### Case 1: Reliability of responses to confirmation request

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

**《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) [Second-tier, and small and medium-sized audit firms]

《**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**

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

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) [Large-sized audit firms]

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) [Large-sized audit firms]

**《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 identified the risk of material misstatement in the existence of inventory, and regarding the audited company's externally stored inventories, it requested confirmation from all entities entrusted with storing those inventories as to inventory balances

However, the engagement team cross-checked only the inventory balance data provided by the entities from which replies to the inquiry were collected against the system data and neglected to do such cross-checking with regard to the inventories stored by other entities. As a result, the engagement team did not obtain audit evidence concerning the existence of inventory.

(Auditing Standards Committee Statement No. 505, paragraph 15) [Second-tier, and small and medium-sized audit firms]

**《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) [Second-tier, and small and medium-sized audit firms]

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

**《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) [Second-tier, and small and medium-sized audit firms]

**《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**

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 6, 7 and 14) [Second-tier, and small and medium-sized audit firms]

NEW

②The audited company engages in retail business and enters daily sales data into the sales reporting system. While data on sales at stores using POS registers is transmitted and entered on a daily basis, data entry regarding sales at stores not using POS registers is conducted manually based on daily reports from the stores.

As an audit procedure regarding the appropriateness of the cutoff of sales, the engagement team cross-checked data transmitted from POS registers against data entered into the sales reporting system with regard to one sample case.

However, the engagement team did not consider the appropriateness of including stores using POS registers and stores not using such registers in the same sample population within distinguishing between those stores despite the difference in the method of booking sales.

(Auditing Standards Committee Statement No. 530, paragraph 5) [Second-tier, and small and medium-sized audit firms]

**《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: Selecting specific items

NEW

The engagement team identified the risk of material misstatement related to the existence of accounts receivable and the occurrence of cost of sales, and general and administrative expenses and performed tests of details over a certain amount as responses to audit risk.

owever, although all of the remainders of the population reagarding the abovementioned detailed test were above performance materiality, the engagement team merely conducted comparison with the previous term with regard to those remainders or performed other analytical procedures but failed to consider whether or not additional substantive procedures were necessary.

(Auditing Standards Committee Statement No. 500, paragraphs 9 and A55) [Second-tier, and small and medium-sized audit firms]

**《Points to Note》**

**As the above case shows, numerous deficiencies are still being observed. These include the failure to consider whether additional procedures should be considered for the remaining part of the population after**

**some selected items in the population have been tested.**

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

### (5) Related parties

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

The 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) [Second-tier, and small and medium-sized audit firms]

**《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**

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

**《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**

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

**《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) Subsequent events

#### Case 1: Examination of events that occurred between the date of the financial statements and the date of the auditor's report

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

《**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 excessively eliminated the amount of deferred tax assets by mistake with regard to the journal entry of the eliminations of intercompany balances when preparing a consolidated financial statement based on the Companies Act.

The engagement team expressed an unqualified opinion in the auditor's report based on the Companies Act while overlooking the excessive elimination. However, later, when the consolidated financial statement was published, the engagement team identified the excessive elimination and submitted the auditor's report regarding a corrected financial statement.

Still, when preparing the corrected auditor's report, the engagement team did not consider whether the error overlooked in the pre-correction auditor's report should be included as a matter for emphasis or as other matter.

(Auditing Standards Committee Statement No. 560, paragraph 15) [Second-tier, and small and medium-sized audit firms]

《**Points to Note**》

**In addition to the above example cases, 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.**

## 4. Auditing Accounting Estimates

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

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.

**<u>Outline of inspection results</u>**

There are 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.

**<u>Expected response</u>**

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.

With regard to the impact of COVID-19 on the audit of accounting estimates and how to respond to the impact, refer to "II. Quality Control Environment: Impact of COVID-19 on Audit Engagements and Response."

**(1) Matters common to auditing accounting estimates**

**Case 1: Reasonableness of management's assumptions**

NEW

①The audited company engages in manufacturing business on a global scale. Although it has consistently booked operating profits in consolidated financial statements, it has continued to book operating losses in non-consolidated financial statements. The audited company judged that it was unnecessary to recognize impairment losses related to fixed assets in non-consolidated financial statements because the amount of undiscounted future cash flow that was estimated based on a short-term management plan exceeded the book value of the fixed assets.

The engagement team judged through inquiries with the management that the management's assumption that revenue would expand in the future was rational to some degree given the company's policy of reducing fixed costs and the sales results in the current term.

However, with regard to the short-term management plan, the engagement team merely inquired with the audited company and checked the sales results, while failing to examine the reasonableness of the plan based on specific evidence.

(Auditing Standards Committee Statement No. 540, paragraph 12) [Large-sized audit firms]

NEW

②With regard to retained inventory that had been removed from the operating cycle process, the audited company reflected a profitability decline in its accounting through the method of regularly lowering book value. Regarding the evaluation of some inventory at the end of the current fiscal year, the audited company asserted that those assets were not retained inventory that had been removed from the operating cycle process despite the absence of medium- and long-term sales plans and the small amount of shipped inventory over past years. The reasons given for the assertion were that those retained assets had not physically deteriorated and that sales activity was continuing.

Although the engagement team was aware of the sluggish sales results in the past years with regard to some inventory, it merely ascertained through inquiries that sales activity was continuing and failed to sufficiently examine the appropriateness of the audited company's judgment that those assets were not retained inventory that had been removed from the operating cycle process and those assets' future sales potential.

(Auditing Standards Committee Statement No. 540, paragraph 12) [Second-tier, and small and medium-sized audit firms]

NEW

③With regard to a new subsidiary established in the previous fiscal year, the audited company was considering whether or not loss on valuation of shares of subsidiaries and associates should be booked because the subsidiary was insolvent in the current fiscal year. As a result, the audited company judged that it was possible to restore net assets to the acquisition value within five years based on a future plan and refrained from booking valuation losses.

The engagement team determined that the audited company's judgment that it was unnecessary to book valuation losses was appropriate on the grounds that the subsidiary's business performance would become more stable as a result of the accumulation of knowhow given the stability of the market even though its business was unlikely to immediately get on track because it had to first cultivate customers.

However, regarding the future plan for the audited company's subsidiary, the engagement team merely conducted a qualitative evaluation and failed to examine the reasonableness of quantitative specifics.

(Auditing Standards Committee Statement No. 540, paragraph 12) [Second-tier, and small and medium-sized audit firms]

**《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.**

**When examining accounting estimates, including the evaluation of investments in and loans to subsidiaries and associates, impairment of fixed assets and recoverability of deferred tax assets, engagement teams often evaluate the reasonableness and other aspects of business plans prepared by the management. However, there were many cases in which the engagement team did not sufficiently and appropriately examine the reasonableness of the business plan from a critical standpoint as professionals. For example, the engagement team evaluated the business plan qualitatively only through interviews with the management without checking the details of the business plan based on concrete evidence. Engagement teams should keep in mind that they should carefully consider business plans. For example, they should examine the consistency between business plans and the business environments as understood by themselves, compare the plans with past actual results, check specific measures that form the basis of numerical projections contained in the plans, such as revenue growth and cost reduction, and examine the feasibility of the measures.**

**In particular, when significant risk has occurred with regard to accounting estimates, engagement teams 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.**

### Case 2: Review of the method of management's accounting estimates

①The 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) [Large-sized audit firms]

NEW

②Regarding directly operated stores, the audited company had the policy of estimating the projected amount of original state restoration cost that may occur at the time of closure based on leasing contracts and booking asset retirement obligations with respect to stores for which the projected amount is higher than a certain level.

The engagement team judged that the audited company's policy concerning the booking of asset retirement obligations was appropriate on the grounds that booking such obligations with respect to all stores would not be realistic and that it was possible to overstate the amount of such obligations because, despite the obligation for original state restoration, whether or not original state restoration work is necessary is determined depending on the situation of the lessor at the time of closure and on how negotiations go and because in the past, original state restoration cost did not occur in some cases.

However, the engagement team did not examine the reasonableness of the audited company's assertion that it was sufficient to book asset retirement obligations only with respect to stores for which the projected amount of cost is higher than a certain level.

(Auditing Standards Committee Statement No. 540, paragraph 11) [Second-tier, and small and medium-sized audit firms]

**《Points to Note》**

**With regard to accounting estimation methods applied by the management, it is necessary to evaluate the**

**following points: whether the management appropriately applied the requirements of the accounting standards related to the accounting estimate; whether the methods for making accounting estimate are appropriate in light of the purpose of the accounting standards; whether the method for making accounting estimate has been applied consistently; and, whether changes, if any, in accounting estimates or in the method for making them from the prior period are appropriate in the circumstances at the time.**

**Furthermore, engagement teams should keep in mind that, testing how management made the accounting estimate may involvethe 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) [Second-tier, and small and medium-sized audit firms]

**《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.**

### (2) Evaluation of shares in subsidiaries and associates

**Case 1: Examination of recoverability**

When evaluating the book value of shares in an insolvent subsidiary, the audited company did not account for impairment of those shares because it expected their net asset value would recover to the acquisition value within five years.

Sales and profits were projected to increase significantly under the subsidiary's business plan for the next year and beyond. Under these circumstances, the engagement team determined that the audited company's judgment was appropriate because it had obtained replies to its inquiries with the subsidiary's management and because it recognized a growth trend in recent sales.

However, the engagement team did not obtain audit evidence concerning the management's assumption that the growth trend in sales and profits would continue in the next year and beyond. As a result, it did not sufficiently examine the reasonableness of the subsidiary's business plan.

(Auditing Standards Committee Statement No. 540, paragraph 12) [Second-tier, and small and medium-sized audit firms]

**Case 2: Reliability of basic data**

NEW

The audited company estimated and booked provision for loss on liquidation of subsidiaries and associates based on the amount of excess debts in a consolidated subsidiary's non-consolidated financial statement. However, as impairment losses that should be booked in the consolidated subsidiary's non-consolidated financial statement was booked in consolidation journal entries, the estimation of those loss provisions was adjusted so as to reflect the consolidation journal entries in the amount of excess debts in the consolidated subsidiary's non-consolidated financial statement.

However, the engagement team did not examine the accuracy of the amount of excess debts after the reflection of the consolidated journal entries in the amount of excess debts in the non-consolidated financial statement.

(Auditing Standards Committee Statement No. 540, paragraph 12) [Second-tier, and small and medium-sized audit firms]

**《Points to Note》**

**In addition to the above example cases, there were cases in which the engagement team did not quantitatively examine the reasonableness of the management's assumption that business performance would become more stable even though a subsidiary established in the previous fiscal year was insolvent (refer to (1) Matters common to auditing accounting estimates, Case 1③), or in which the engagement team**

**did not examine the reasonableness of the audited company's judgment regarding the evaluation of shares in a subsidiary with poor business performance although the value of the shares, which was estimated to be able to recover in roughly five years based on the subsidiary's business plan, failed to reach the book value and remained at around 50% of the book value.**

**When the net asset value of shares in subsidiaries and associates whose market value is considered to be very difficult to be identified has fallen by around 50% compared with the acquisition value, it is necessary to assume that the net asset has declined significantly and book a reasonable amount of impairment losses. The same treatment of asset impairment is applicable to the evaluation of shares in recently acquired subsidiaries and associates, and therefore, it is necessary to carefully examine the possibility of a decline in the net asset, including examining the discrepancy between the initial business plan and the actual results.**

### (3) Valuation of receivables

### Case 1: Review of recognition and measurement

The 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.

(Auditing Standards Committee Statement No. 540, paragraph 7 and 14) [Large-sized audit firms]

**《Points to Note》**

**In addition to the above example cases, there were cases in which the engagement team did not sufficiently examine the reasonableness of the estimation method of setting a uniform allowance rate according to the period during which receivables had remained unrecovered (refer to (1) Matters common to auditing accounting estimates, Case 2 ①), or in which, regarding assets scheduled to be seized, the engagement team did not examine the reasonableness of the amount of assets that the audited company asserted could**

**be recovered. When evaluating debt claims in cases where some assets are planned to be seized, it is necessary not only to identify the assets to be seized but also to sufficiently examine the feasibility of seizure and the estimated amount of assets that may be disposed of.**

**As for the method of evaluating receivables with default possibility, if it is difficult to obtain data that helps judge the debtor's ability to pay, one example option is using a simplified method of provisioning 50% of the balance of receivables after the deduction of the estimated disposal value of the collateral in the term that the receivables are determined for the first time to have a default possibility. With regard to individually material receivables with default possibility, it should be kept in mind that it is necessary to obtain as much data as possible and to sufficiently examine whether the audited company conducted an appropriate estimation at the time of evaluation.**

**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)[Large-sized audit firms]

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

**《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.**

### (4) Inventory valuation

### Case: Examination of how management makes accounting estimates

Setting 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) [Second-tier, and small and medium-sized audit firms]

**《Points to Note》**

**In addition to the above example cases, there were cases in which: the engagement team did not sufficiently examine the reasonableness of the management's assumption that it was unnecessary to book valuation losses on retained inventory whose sales results were sluggish because those assets had not physically deteriorated and that sales activity was continuing (refer to (1) Matters common to auditing accounting estimates, Case 1 ②); the engagement team did not examine the reasonableness of the audited company's assumption that with regard to current sales products and inventories held for the purpose of maintenance, valuation losses would not occur because they would not be sold at prices below their book values; the engagement team did not consider whether the long period of retention as defined by the audited company reflects the company's actual circumstances; the engagement team did not examine the reasonableness of the audited company's applying a uniform valuation loss rate to retained inventory according to the period of retention; or the engagement team did not sufficiently examine the reliability of calculation data**

**regarding valuation losses 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) [Large-sized audit firms]

**《Points to Note》**

**In addition to the above example cases, there were cases in which: the engagement team overlooked the discrepancy between the asset grouping and the reality; the engagement team did not examine the appropriateness of the classification of shared assets; or the engagement team merely checked the amount of profits/losses or cash flow generated from operating activities that was calculated by the audited company and the status of idle assets and failed to examine the appropriateness and completeness of the asset grouping. 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

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. 540, paragraphs 12 and 14) [Large-sized audit firms]

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

NEW

③The audited company judged the presence or absence of indications of impairment based on profits/losses after the distribution of head office costs and costs related to shared assets by asset class (hereinafter referred to as "profits/losses for judgement").

However, with regard to profits/losses for judgment, which form the basis for making judgment on indications of impairment, the engagement team did not examine the accuracy of the calculation of distribution of head office costs and costs related to shared assets.

(Auditing Standards Committee Statement No. 500, paragraph 8) [Large-sized audit firms]

**《Points to Note》**

**In addition to the above examples, there were cases in which: the engagement team did not assess indications of impairment using profits/losses generated from operating activities when it had identified both those profits/losses and cash flow generated from operating activities; or the engagement team assessed indications of impairment based on the estimated figures before the end of the term and neglected to conduct assessment based on the actual figures at the end of the term although it recognized a significant deterioration in the actual figures compared with the estimated figures. With those cases in mind, engagement teams need to carefully examine 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**

With regard to fixed assets showing indications of impairment, the audited company judged that it was unnecessary to recognize impairment losses because the total amount of undiscounted future cash flows based on a five-year business plan was higher than the book value of those fixed assets, and the engagement team also determined that this judgment was appropriate.

However, regarding the business plan, which projected annual growth of 70% in operating profit, the engagement team merely received the audited company's explanations about the possibility of achieving the growth target in the first year and about the expectations of a sales expansion in a growing market, and it failed to sufficiently examine the feasibility of the business plan as it judged that the portions of the plan that concern the second year and later were rational based on those explanations.

(Auditing Standards Committee Statement No. 540, paragraph 12) [Second-tier, and small and medium-sized audit firms]

**《Points to Note》**

**In addition to the above examples, there were cases in which: the engagement team merely inquired with the audited company about the business plan that formed the basis of the calculation of future cashflows and failed to examine the reasonableness of the plan based on specific supporting data ((refer to (1) Matters common to auditing accounting estimates, Case 1, ①); the engagement team did not examine the reasonableness of the process of determining the main asset of each asset group and the remaining economic life of the main asset, which form the basis of the estimation period of future cash flow; capital investment and repair costs necessary for maintaining the present value were not included in future cashflows; after-tax discount rates were used even though future cash flows were pre-tax figures; the recognition of impairment losses was assessed on the basis of profits/losses generated 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 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.

(Auditing Standards Committee Statement No. 540, paragraphs 11 and 12) [Second-tier, and small and medium-sized audit firms]

**《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.**

### Case 2: Indications of goodwill impairment

NEW

①Although a consolidated subsidiary for which goodwill was recognized recorded operating loss after amortization of goodwill in the current fiscal year, the engagement team judged that the audited company's assertion that there were no indications of impairment was appropriate because the subsidiary had recorded operating profit in the previous fiscal year.

However, the engagement team did not sufficiently examine the presence or absence of indications of impairment. For example, it did not compare the business plan at the time of the acquisition of shares in the subsidiary with the actual results.

(Auditing Standards Committee Statement No. 540, paragraphs 11 and 12) [Large-sized audit firms]

NEW

②When the audited company conducted a corporate acquisition during the current term, it adopted the closing date of the term as the deemed date of acquisition and booked a large amount of goodwill in addition to incorporating the acquired company's consolidated balance sheet into its own accounting. When the audited company acquired shares in the acquired company, it prepared an investigative report concerning the calculation of share value while receiving support from external experts and conducted the corporate acquisition transaction at a price within the evaluated share price range indicated in the report.

When examining the corporate acquisition value, the engagement team ascertained by reading the report that the acquisition value was within the evaluated share price range, and it also ascertained by reading the minutes of meetings of the audited company's board of directors' meetings that this transaction had been approved by the board of directors. The engagement team cross-checked the corporate acquisition value against the contract on the transfer of shares related to the share acquisition.

However, although goodwill accounted for a significant portion of the acquisition value, the engagement team did not sufficiently examine indications of the impairment of the goodwill. For example, it did not verify the reasonableness of the acquired company's future business plan that was used for the calculation based on the DCF method that was described in the report on share value.

(Auditing Standards Committee Statement No. 540, paragraph 12) [Large-sized audit firms]

**《Points to Note》**

**As can be seen from the above examples, if the value allocated to goodwill and other intangible assets is relatively high, it may be determined that there is an indication of impairment in the year of the business combination as well. Therefore, if a large amount of goodwill has occurred, engagement teams should also sufficiently examine whether there are indications of impairment in the year of occurrence of goodwill.**

**In addition to the above examples, there were cases in which the engagement team did not sufficiently examine the feasibility of business plans. For example, in one such case, a business plan formulated at the time of acquisition failed to proceed as expected and the actual profit/loss figure fell significantly short of the target under the business plan, and as a result the business plan was revised and the difference between the recoverable value based on the revised business plan and the book value of goodwill was booked as impairment loss. However, when reviewing the revised business plan, the engagement team did not examine the revenues by type and examined only some portions of the revenues. Moreover, there were cases in which the engagement team did not sufficiently examine the inconsistency in the management's assumptions regarding accounting treatments. For example, in one such case, although the audited company booked impairment losses related to shares in a subsidiary in the non-consolidated financial statement, the engagement team did not examine the impairment of the corresponding goodwill on a consolidated basis. Engagement teams should keep in mind the need to evaluate from a broad perspective whether the identified events have been comprehensively reflected in accounting.**

**(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) [Large-sized audit firms]

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

**《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**

①Based 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) [Large-sized audit firms]

②The audited company used the next year's budget for assessing the recoverability of deferred tax assets and the impairment of fixed assets. The audited company did not book deferred tax assets because it was doubtful whether the budget target could be achieved, while it determined that it was unnecessary to recognize impairment losses on fixed assets on the grounds that the budget target could be achieved. As a result, inconsistency arose in the management's judgments regarding accounting estimates.

However, the engagement team did not examine the reasonableness of the presence of inconsistency in the management's assumption as indicated by the use of different assessments of the business performance projection for an identical term.

(Auditing Standards Committee Statement No. 500, paragraph 10; No. 540, paragraphs 12 and 20) [Second-tier, and small and medium-sized audit firms]

**《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.**

**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

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

**《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**

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

**《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**

NEW

The audited company outsourced the calculation of retirement benefit obligations to an external pension actuary and booked prepaid pension costs and provision for retirement benefits based on the calculation results presented by the pension actuary.

The engagement team sent a confirmation related to the calculation results of retirement benefit obligations to the pension actuary and ascertained that the response to the confirmation request was consistent with the retirement benefit obligations booked.

However, the engagement team did not examine the accuracy and completeness of the data related to employees and beneficiaries which formed the basis of the calculation of retirement benefit obligations and which was provided by the audited company to the pension actuary.

(Auditing Standards Committee Statement No. 540, paragraph 12) [Second-tier, and small and medium-sized audit firms]

**《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: Review of accounting estimates in the previous fiscal year

NEW

The audited company booked asset retirement obligations concerning stores that it operated based on the estimated amount of original state restoration cost that might occur, which had remained unchanged since those obligations were booked for the first time. However, in the current fiscal year, the amount of original state restoration cost due to store closures exceeded the amount of asset retirement obligations concerning those stores, resulting in a performance difference being incurred as an expense. In addition, in past years, a performance difference had continued to be incurred as an expense.

However, despite the continuous occurrence of a performance difference at the audited company, the engagement team did not conduct a comparative analysis of the estimated amount of asset retirement obligations regarding closed stores that was booked in the previous fiscal year and the finalized amount. As a result, the engagement team did not sufficiently consider whether or not it was necessary to revise the amount of asset retirement obligations concerning other stores.

(Auditing Standards Committee Statement No. 540, paragraph 8) [Second-tier, and small and medium-sized audit firms]

### 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)
[Second-tier, and small and medium-sized audit firms]

**《Points to Note》**

**In addition to the above example cases, there were cases in which the engagement team did not sufficiently examine the reasonableness of the estimation method of booking asset retirement obligations only regarding stores for which the estimated amount of original state restoration cost was higher than a certain level (refer to (1) Matters common to auditing accounting estimates, Case 2, ②).**
**Even if the amount of asset retirement obligations cannot be fixed due to a lack of clarity over the timing of fulfillment of the obligations and method of retirement, it is deemed that the amount of asset retirement obligations can be reasonably estimated provided that it is possible to obtain information necessary for reasonably estimating the range of the timing and probability of fulfillment of asset retirement obligations. Cases in which the amount of asset retirement obligations cannot be reasonably estimated are limited to those in which reasonably calculating the future is impossible even if the best estimation is conducted in light of all evidence available as of the account closing date. Therefore, engagement teams should keep in mind that, when audited companies assert that they cannot reasonably estimate the amount of asset retirement obligations, it is necessary to carefully examine the reasonableness of the assertion, including the possibility of obtaining information that may be used for estimating the amount.**

### (10) Others

### Case 1: Provisions for loss on a received construction order

NEW

The audited company concluded contracts for construction orders, to which the right to place an additional order as well as an initial order was attached. In the current term, the construction for the initial order was completed and the right to place an additional order was exercised, with construction scheduled to start in the next term or later. The audited company booked losses because higher than-expected construction cost occurred with respect to the initial order, and it also booked provisions for losses on a received construction order because losses were projected to occur in the future with respect to the additional order as well.
When estimating the amount of provisions for losses on a received construction order related to the additional order, the audited company calculated construction revenue based on the order price under the contract and construction cost based on the actual cost incurred with respect to the initial order.
Regarding the estimation of construction cost for the additional order, the engagement team compared the actual cost for the initial order and the estimated cost for the additional order with regard to each major cost item and recognized a decrease in the estimated cost for the additional order compared with the actual cost for the initial order. The engagement team verified the reasonableness of the reason for the decrease by making inquiries and reading relevant data.

However, the engagement team merely identified the presence of expenses that occurred with respect to the initial order but did not occur with respect to the additional order and a cost reduction expected to be made through increased proficiency as factors of the decrease in construction cost and failed to examine whether the estimated cost was reasonably reduced based on concrete evidence.
(Auditing Standards Committee Statement No. 540, paragraph 14) [Large-sized audit firms]

**《Points to Note》**

**In addition to the above example cases, there were cases in which, although losses were booked in the current fiscal year with regard to construction contracts for which provisions for construction losses were not booked in the previous fiscal year, the engagement team did not take into account the impact of the booking of those losses on the management's estimates, or in which the engagement team did not consider whether the management's assumption regarding the projection period of loss occurrence reflects reality.**
**The engagement team should keep in mind that they should obtain sufficient and appropriate audit evidence through the following procedures: appropriately identifying events which are expected to lead to the occurrence of expenses or losses in the future while taking into account the estimation uncertainty related to construction contracts; examining the reasonableness of basic data related to the management's estimates and the management's assumptions; and examining accounting estimates in the previous fiscal year.**

**Case 2: Provision for bonuses**

The audited company booked the summer bonus to be paid in the next business year as provision for bonuses at the end of the year, with the bonus amount calculated by multiplying the total basic salaries by the number of months of bonus and by a performance coefficient. Regarding the term-end balance of provision for bonusess, the engagement team ascertained that the number of people eligible for the bonus at the end of the term had decreased and the performance coefficient had increased compared with the figures in the previous year.
However, the procedures performed by the engagement team included the following deficiencies:

- Despite being aware that the basic salary, performance coefficient, etc. continued not to be used to determine the amount of bonus payments, the engagement team did not examine whether it was appropriate for the audited company to calculate the amount of provision for bonuses by multiplying the total basic salary by the previous fiscal year's performance coefficient.
- Although it became known before the date of the auditor's report required under the Companies Act that there was a large discrepancy between the amount of provision for bonuses booked and the actual amount of payments, the engagement team did not examine the discrepancy.

(Auditing Standards Committee Statement No. 540, paragraphs 11 and 12) [Second-tier, and small and medium-sized audit firms]

## 5. Group Audit

**Points of focus**

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.

**Outline of inspection results**

With regard to group audits, there were many cases in which the group engagement team placed excessive trust in the results of audits conducted by auditors of components and used them without sufficient evaluation. There were also cases in which: the group engagement team assessed the individual financial significance based only on financial indicators regarding sales when identifying important components; the group engagement team did not conduct sufficient risk assessment, as exemplified by a failure to take into account qualitative factors, including the possibility that components have significant risks related to group financial statements; communication with component auditors was insufficient, as exemplified by a failure to appropriately communicate risks to them; or the group engagement team did not sufficiently consider whether the identification of significant risks related to group financial statements and the audited procedures to deal with those risks were adequate.

**(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.

**<u>Expected response</u>**

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.

Regarding the impact of COVID-19 on group audits and response to the impact, refer to "II. Quality Control Environment: Impact of COVID-19 on Audit Engagements and Response."

**Case 1: Significant components**

NEW

①The engagement team identified the audited company and the components that account for more than 15% of the company's sales after elimination of intragroup transactions as components of individual financial significance.

However, as the engagement team took into account sales after the elimination of intragroup transactions as the sole indicator when identifying components of individual financial significance, it failed to sufficiently consider whether domestic manufacturing subsidiaries such as one that accounted for 29% of the pre-tax profits before elimination of intragroup transactions and one that accounted for 19% of the cost of sales after elimination of intragroup transactions were equivalent to components of individual financial significance.

(Auditing Standards Committee Statement No. 600, paragraphs 8, 16, and 17) [Second-tier, and small and medium-sized audit firms]

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

《**Points to Note**》

**When determining important components, it is necessary to take into account financial indicators used for assessing individual financial significance, not only sales but also other items such as assets, liabilities, cash flow or profits indicated in group financial statements, depending on the group's characteristics and circumstances. It is also necessary to make judgements in accordance with the specific characteristics and circumstances of components. For example, in addition to individual financial significance, qualitative significance, such as the possibility that compontents have significant risks related to group financial statements, should also be taken into account.**

### Case 2: Understanding the Component Auditor

NEW

The engagement team sent a letter of inquiry concerning quality control to the auditors of foreign components that had not been identified as important components and requested a reply, in addition to requesting a report concerning the results of the audits and subsequent events, in order to understand those auditors.

However, the engagement team did not sufficiently perform the procedures to understand component auditors. For example, it did not obtain a reply to the letter of inquiry concerning quality control from multiple component auditors whom it asked to perform audits for the first time in the current fiscal year.

(Auditing Standards Committee Statement No. 600, paragraph 18) [Second-tier, and small and medium-sized audit firms]

《**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 the component auditor has the skills of a professional expert, and whether it can involve itself in the work of the component auditor. When consigning the audit of financial statements prepared based on the Japanese accounting standards to the auditors of foreign components, it is necessary to consider whether those auditors have the knowledge necessary for performing audits.**

### Case 3: Materiality

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

**《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. In addition to the above example cases, there were cases in which the engagement team did not evaluate the appropriateness of the performance materiality, as exemplified by a failure to request component auditors to report on theperformance materiality that they had determined.**

### 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 audit instructions, and received reports from them.

However, the group engagement team instructed the component auditors to perform agreed-upon procedures rather than audit procedures and failed to examine whether the agreed-upon procedures were sufficient as audit procedures to deal with the significant risks. As a result, it did not obtain sufficient and appropriate audit evidence with regard to the significant risks.

(Auditing Standards Committee Statement No. 600, paragraphs 17, 25, and 26) [Second-tier, and small and medium-sized audit firms]

**《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

①The 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) [Large-sized audit firms]

NEW ②With regard to Company A, its consolidated subsidiaries, and Company B, all of which were among important components of individual financial significance, the engagement team requested the component auditors to audit those components. In addition, the engagement team sent to the component auditors letters of inquiry concerning the accounting policies and audit plans for individual components and evaluated the appropriateness of the procedures to deal with significant risks by checking the replies to the letters of inquiry.
However, although the engagement team obtained replies to the letters of inquiry from the component auditors, it did not hold discussions with them about the components' business activities and fraud risks. As a result, its involvement in the risk assessment conducted by the component auditors was insufficient.
(Auditing Standards Committee Statement No. 600, paragraph 29) [Second-tier, and small and medium-sized audit firms]

**《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: Consolidation process**

NEW ①With regard to financial information included in the consolidation reporting package prepared by important components, the engagement team had the policy of relying on the results of audits performed by component auditors for the examination of specified account balances concerning significant risks related to the group financial statements, while examining other information on its own.
However, with regard to the following financial information of quantitative materiality that the engagement team had decided to examine on its own, it merely ascertained the absence of abnormal changes through trend analysis and other means, and failed to perform substantive procedures.

・ The term-end balance of inventory assets purchased by the components from the consolidated group companies, which form the basis of journal entries concerning the elimination of unrealized profits/losses on inventory assets.

- The detailed data on changes in the balance of the components' tangible fixed assets, which form the basis of "expenditure due to the acquisition of tangible fixed assets" subject to disclosure in the consolidated cash flow statement.

(Auditing Standards Committee Statement No. 600, paragraphs 23 and 32) [Second-tier, and small and medium-sized audit firms]

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 incorporated the foreign components' certain accounts into its consolidated financial statement without adjusting accounting treatments to conform to IFRS. The component auditors reported that different accounting treatments were required under the local accounting standards and IFRS with regard to certain accounts.

However, the group engagement team did not sufficiently consider whether it was necessary to adjust accounting treatments based on the accounting standards adopted by the components to conform to IFRS, which was adopted for the consolidated financial statements.

(Auditing Standards Committee Statement No. 600, paragraph 34) [Large-sized audit firms]

**《Points to Note》**

**The group engagement team should keep in mind that they should understand the overall group control and consolidation processes and to design the type, timing and scope of audit procedures to address the risk of material misstatement in group financial statements that may arise from the consolidation processes and perform the procedures.**

### Case 7: Subsequent events

NEW

The engagement team requested the auditors of multiple foreign components to prepare and submit reports on subsequent events.

However, as of the date of the auditor's report based on the Companies Act, the engagement team did not receive a report on subsequent events from any of those auditors, and as a result, it did not perform planned procedures.

(Auditing Standards Committee Statement No. 600, paragraph 37) [Second-tier, and small and medium-sized audit firms]

**《Points to Note》**

**Group engagement teams and component auditors need to perform procedures designed in order to identify events which may occur between the term end of the components' financial information and the date of the auditor's report on the group financial statements and which may require a revision of the group financial statements or may become subject to disclosure in the group financial statements.**

**Case 8: Communication with component auditors**

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

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

**《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 auditors. Furthermore, group engagement teams must request 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 shown above, there were cases in which the group engagement team did not appropriately inform component auditors of risks. There were also cases in which: even though component auditors reported significant risks to the group engagement team, the team did not sufficiently examine those risks; the timing of obtaining information, including audit plans, from component auditors was late; or the group engagement team merely presented a list of affiliated companies to component auditors and did not present a list of related parties identified by the audited company, including executives. Group engagement teams need to engage in effective two-way communication with component auditors.**

**Case 9: Sufficiency and appropriateness of audit evidence obtained**

NEW ①The group engagement team sent written instructions for performing audit procedures to the auditors of multiple important foreign components and received reports on the audit results from them.

However, the procedures performed by the engagement team were insufficient in the following respects:

A. Although the group engagement team received reports on significant risks that it did not identify (the evaluation of inventory assets, accuracy of tax calculation, appropriateness of disclosure, and going concern assumptions) from some component auditors, it did not reconsider significant risks related to the consolidated financial statements through discussions with them.

B. Despite the circumstances described below, the group engagement team concluded that the work of component auditors was appropriate and failed to examine the sufficiency and appropriateness of the procedures performed by them.

- The engagement team did not receive from some auditors reports on the details of procedures to address fraud risks related to revenue recognition and the audit results.
- The engagement team received from some auditors reports on the results of audit procedures performed in order to address management override risk after the date of the auditor's report based on the Financial Instruments and Exchange Act.
- The engagement team did not receive from some auditors reports on the results of journal entry tests implemented as an audit procedure to address management override risk.

(Auditing Standards Committee Statement No. 600, paragraphs 30, 41, and 43) [Second-tier, and small and medium-sized audit firms]

②In an interview held with the auditors of a significant component while conducting an on-site visit, the group engagement team was informed that they had not identified any abnormalities 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 by which the component auditor had concluded that there were no matters to report regarding journal entry testing and the implementation results, 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 obtain sufficient appropriate audit evidence on the audit procedures the component auditor had subsequently performed and on the conclusion of the procedures.

(Auditing Standards Committee Statement No. 600, paragraphs 41 and 43) [Large-sized audit firms]

NEW

③The engagement team instructed the auditors of important components to implement audits and used the audit results. However, although the engagement team received from the component auditors the reports on the presence of deficiencies of internal control that had been identified as a result of the evaluation of internal control audits, it did not evaluate those deficiencies. It also failed to consider whether or not additional procedures were necessary.

(Auditing Standards Committee Statement No. 600, paragraph 41) [Second-tier, and small and medium-sized audit firms]

NEW

④The engagement team instructed the auditors of multiple important foreign components to implement audits of each component's financial information, and in the term-end audit, it received from them the auditors' report on whether or not each component's financial information conformed to the policies and instructions included in the audited company's group accounting manual in all important respects.

However, the engagement team did not understand the audited company's group accounting manual and failed to appropriately evaluate the opinions of the auditors of individual components when forming the basis for expressing its own opinion regarding the consolidated financial statements.

(Auditing Standards Committee Statement No. 600, paragraphs 16 and 43) [Second-tier, and small and medium-sized audit firms]

**《Points to Note》**

**Group engagement teams should evaluate whether or not sufficient and appropriate audit evidence has been obtained through the audit procedures performed with regard to the consolidation processes and the work done by themselves and component auditors with regard to financial information concerning the components in order to form the basis for expressing opinions regarding group financial statements.**

**However, as shown in the above, there were cases in which: the group engagement team did not receive reports on the results of the audit procedures performed by component auditors in a timely manner; the group engagement team merely obtained information on the results of audit procedures from component auditors and failed to appropriately evaluate the sufficiency and appropriateness of the audit evidence obtained with regard to significant risks; or although deficiencies regarding components' internal control were identified, the group engagement team did not evaluate them. 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.**

## 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: Competence, capabilities and objectivity of auditor's expert**

NEW

The engagement team used the auditor's expert to evaluate retirement benefit obligations and service cost calculated by the audited company, but it did not sufficiently understand the external expert's area of expertise and evaluate the external expert's competence, capabilities or objectivity. (Auditing Standards Committee Statement No. 620, paragraphs 8 and 9) [Second-tier, and small and medium-sized audit firms]

**Case 2: 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) [Large-sized audit firms]

**《Points to Note》**

**When using the work of auditor's experts in areas of expertise other than accounting and auditing, engagement teams should not leave matters entirely to them but should determine the scope of work for which their services are used, evaluate their competence, capabilities and objectivity and assess whether their work is appropriate in light of auditing purposes.**
**In addition to the above cases, there were also cases in which, although the evaluation method adopted by an expert was different from the one designated by the engagement team, the team did not examine the appropriateness of the work done by the expert.**
**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 Financial Instruments and Exchange Act 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 important accounts of significant relevance to operational objectives**

The audited company (a labor-intensive consulting firm) considered sales, accounts receivable, and inventories as important 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) [Second-tier, and small and medium-sized audit firms]

《**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

With regard to the impairment process for fixed assets at subsidiaries that had been identified as a significant risk related to the group financial statements, the engagement team did not examine whether there was a reasonable reason for the audited company not to subject the process to internal control evaluation.

(Audit and Assurance Practice Committee Statement No. 82, paragraph 112) [Second-tier, and small and medium-sized audit firms]

《**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) [Second-tier, and small and medium-sized audit firms]

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

**Case 2: Assessment of design and operation of internal control**

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

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

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

**《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**

NEW

①With regard to the company-level control and other business processes, the engagement team performed roll-forward procedures before the date of the auditor's report based on the Financial Instruments and Exchange Act, but as of the date of the auditor's report based on the Companies Act, it had not yet completed those procedures.
(Audit and Assurance Practice Committee Statement No. 82, paragraph 46; Auditing Standards Committee Statement No. 330, paragraphs 11 and 25 and No. 402, paragraph 16 [Second-tier, and small and medium-sized audit firms]

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

**《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)) [Second-tier, and small and medium-sized audit firms]

**《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) [Second-tier, and small and medium-sized audit firms]

**Case 2: Determination of material weaknesses**

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

**Case 3: Assessment of internal control over misstatement**

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

**《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) [Large-sized audit firms]

**《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.**

# IV. Others

**Notification of inspection results**

(1) Letter of notification of inspection results

The notification of the results of the CPAAOB inspection is made through the provision of a document (a letter of notification of inspection results) to the CEO of the inspected audit firm.

The main items of the letter of notification of inspection results are as follows:

| |
|---|
| 1. Matters of particular note<br>2. Viewpoints of inspection<br>3. Status of measures to ensure appropriateness of implementation of business processes designed by the audit firm in order to maintain and improve the quality control environment (quality control environment)<br>4. Status of implementation of audit engagements (individual audit engagements) |

(2) Specifics described in "Matters of particular note"

Of the items of the letter of notification of inspection results, "Matters of particular note" sorts out deficiencies which have been identified in inspection and which are considered to be important. This is comprised of three items, i.e., operations management environment, quality control environment, and individual audit engagements, with an overall assessment to be given according to the statuses of the three items. An overall assessment of the inspected audit firm's business administration is described at the beginning of "Matters of particular note" in the letter of notification of inspection results, as shown below.

In "(1) Operations management environment" of "Matters of particular note," the root causes analyzed by the CPAAOB (refer to "I. Operations Management Environment, 1. Operations Management Environment and Root Cause Analysis") with regard to deficiencies identified in inspection are described. In addition, the direction of future improvement considered by the CPAAOB is indicated in the case of some audit firms.

| |
|---|
| 1. Matters of particular note<br><br>As a result of the inspection of the audit firm, with regard to the business administration of the firm, it is deemed, within the scope of the inspection, that …, as described below.<br><br>(1) Operations management environment<br>… (issues related to governance and business administration are described)<br><br>(2) Quality control environment<br>… (deficiencies and other matters related to the quality control system are described)<br><br>(3) Individual audit engagements<br>… (deficiencies and other matters related to audit engagement are described) |

The presentation of overall assessment started with inspections launched in Program Year 2016 in order to accurately convey the CPAAOB's assessment to audit firms and help corporate auditors, etc. of audited companies to which inspection results are disclosed by the audit firms appropriately understand the audit firms' level of quality control.

(3) Grades of overall assessment

Overall assessment is presented in the following five grades based on the statuses of the inspected audit firm's operations management environment, quality control environment, and individual audit engagements.

**"Good (Overall assessment grade: 1)"**

The grade that is given in cases where business administration is considered to be good, such as when few deficiencies have been identified with regard to the statuses of the operations management environment, quality control environment, and individual audit engagements.

**"Generally good despite the presence of some points requiring improvement (Overall assessment grade: 2)"**

The grade that is given in cases where business administration is considered to be generally good despite the presence of some points requiring improvement, such as when no serious problem has been identified although some deficiencies have been identified with regard to the statuses of the operations management environment, quality control environment, or individual audit engagements.

**"Not good due to the presence of significant points requiring improvement (Overall assessment grade: 3)"**

The grade that is given in cases where business administration is not considered to be good, such as when there are significant problems that require improvement with regard to the statuses of the operations management environment, quality control environment, or individual audit engagements.

**"Not good and requiring prompt improvement in the status of the operations management environment, etc. (Overall assessment grade: 4)"**

The grade that is given in cases where business administration is considered to be not good and to require particularly prompt improvement.

**"Considerably inadequate (Overall assessment grade: 5)"**

The grade that is given in cases where serious deficiencies have been identified with regard to the statuses of the quality control environment and individual audit engagements and where voluntary improvement is not expected to be made.

It should be noted that the CPAAOB requires the submission of reports from audit firms to which the assessment grade "Not good and requiring prompt improvement in the status of the operations management environment, etc." has been given at the same time as the notification of the inspection results and urges them to make prompt improvement. With regard to audit firms to which the assessment grade "Considerably inadequate" has been given, the CPAAOB recommends that the Commissioner of the Financial Services Agency should take administrative actions or implement other measures.

(*) The wordings of the above assessment grades are those used on the occasions of inspections launched in Program Year 2021 (as for the wordings of the assessment grades in Program Year 2020 and earlier, refer to the "Monitoring Report" in relevant years).

(4) Communicating "Matters of particular note" to corporate auditors, etc. of audited companies

Audit firms are required to communicate "Matters of particular note" described in the letter of notification of inspection results and the audit firms' handling of those matters to corporate auditors, etc. of all audited companies (Auditing Standards Committee Statement No. 260, paragraphs 16 and A31-2). In addition, audit firms are required to communicate the specifics of deficiencies identified in the inspection of audit engagements and the audit firms' handling of the deficiencies to corporate auditors, etc. of the audited companies related to the selected audit engagements in the inspection.

From the viewpoint of accurately communicating inspection results, the CPAAOB has asked audit firms to communicate "Matters of particular note" without any modification to corporate auditors, etc. of audited firms, starting with inspections launched in Program Year 2016.

Moreover, from the viewpoint of helping corporate auditors, etc. of audited companies understand the level of their audit firms' business administration through comparison with other audit firms in terms of inspection results, the CPAAOB publishes data on the distribution of overall assessment grades in the "Monitoring Report."

(5) Regarding treatment of inspection results, etc.

When inspected audit firms disclose the contents of the letter of notification of inspection results to third-party entities, they need to obtain prior consent from the CPAAOB. Recently, there have been many cases in which an audit firm applied with the CPAAOB for prior consent to disclosure of inspection results, etc. based on a request from an audited company's directors, from corporate auditors and directors (including outside directors) of the audited company's parent company, or from a company that may potentially be audited (e.g., a company considering appointing an accounting auditor).

However, considering that corporate auditors, etc. of audited companies utilize inspection results and communication with audit firms will be promoted, prior consent is not required in the case of (4) above.

It is desirable that the results of the CPAAOB inspection, etc. be used not only by corporate auditors, etc. of audited companies but also by directors, etc. of audited companies and by companies that may potentially be audited in order to check the statuses of the design and operation of accounting auditors' quality control systems.

Certified Public Accountants and Auditing Oversight Board

https://www.fsa.go.jp/cpaaob/english/index.html