II. Quality Control System

Implementation of Quality Control Operation

<u>Outline</u>

The CPAAOB inspects whether measures developed by audit firms to ensure adequate operations and maintenance/enhancement of the QC system are appropriate to the size and characteristics of the firm. Responses to requirements for QC systems under the audit standards vary from large-sized audit firms with several thousand members to relatively small-sized audit firms. Furthermore, many deficiencies identified thus far reflect the size and characteristics of each audit firm, and the background to the deficiency as well. Therefore, in "II. Quality Control System", examples of deficiencies identified in the CPAAOB inspections are categorized into "Large-sized audit firms" and "Mid-tier, and small and medium-sized audit firms". 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.

(Revision of Quality Control Standards Concerning Audits and Revision of Ethics Rules)

The revised Quality Control Standards will be applied to audits of financial statements for fiscal years or accounting periods starting on or after July 1, 2023 (for audit firms other than large-scale audit firms under the Certified Public Accountants Act, for fiscal years or accounting periods starting on or after July 1, 2024). The Ethics Rules, which were revised in July 2022, came into effect on April 1, 2023. This Case Report presents deficiencies in accordance with the provisions of Quality Control Standards Report No. 1 (Quality Control at Audit Firms). However, cases of deficiencies based on the revised Quality Control Standards Report and the revised Ethics Rules have not been identified. Therefore, it should be noted that the provisions on the basis of deficiencies presented in this Program Year are all pre-revision provisions.

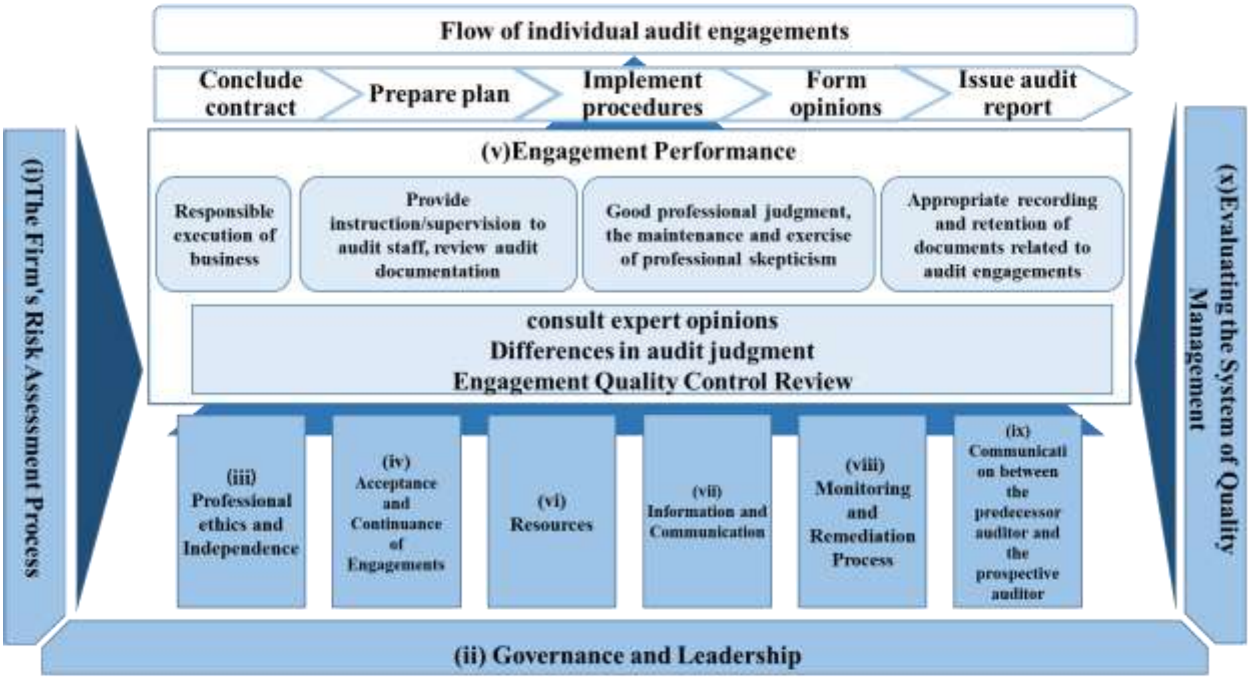
<u>Relationship between quality control system and individual audit engagements</u>

Regardless of the size of an audit firm, the purpose of establishing and operating a quality control system is to reasonably ensure the quality of audit engagements as an organization. The quality control system required is stipulated in the "Quality Control Standards for Audits" and the "Quality Control Standards Report," etc., and it has a significant impact on the quality of individual audit engagements through the establishment and operation of a quality control system. Some audit firms have established a quality control system only as a formality. In such cases, the system does not operate as expected, and thus does not function effectively in improving the quality of individual audit engagements.

The revised quality control standards define quality control system as follows: (i) The Firm's Risk Assessment Process, (ii) Governance and Leadership, (iii) Professional Ethics and Independence, (iv) Acceptance and Continuance of Engagements, (v) Engagement Performance, (vi) Resources, (vii) Information and Communication, (viii) Monitoring and Remediation Process, (ix) Communication between the predecessor auditor and the prospective auditor. The QC system of an audit firm must be evaluated at least once a year by setting a record date, and conclude whether the quality control system provides the audit firm with reasonable assurance that the objectives of the system are achieved ((x) Evaluating the System of Quality Management). (i) In order to enable audit firms to conduct quality control on their own initiative, audit firms are required to set quality objectives for each component of their quality control system, identify and assess quality risks that could hinder the achievement of the quality objectives, and define and implement policies or procedures to address the assessed quality risks. (ii) Governance and Leadership establish the environment underlying an audit firm's quality control system and have a significant impact on all other components of the quality control system of an audit firm. It should be noted that (ii) Governance and Leadership must also be included in the evaluation of (i) The Firm's Risk Assessment Process and (x) Evaluating the System of Quality Management. (v) Engagement Performance includes elements that have a direct impact on the quality of individual audit engagements, such as the direction and supervision of assistants by engagement partners, review of audit documentation, and review of audit engagements.

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

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



Analysis of deficiencies that occurred

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, engagement 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 whether 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, the objectives of measures designed to improve deficiencies were not fully understood by divisions and engagement teams, etc., and were not sufficiently permeated. As a result, the expected effects of improvement measures were not achieved, and similar deficiencies continued to be identified in individual audit engagements.

At Mid-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 establishment and implementation of the quality control system. In addition, same 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 deficiencies were deemed to be attributable to the quality control system. Specifically, there were many cases where the CEO and the PICOQC did not have sufficient awareness and knowledge of quality control operations and did not appropriately develop and operate a quality control system. There were also many cases where the CEO and the PICOQC did not have sufficient understanding of the depth and methods of cause analysis required to prevent the occurrence of similar deficiencies identified in quality control reviews, etc.

Specifically, although persons responsible for each function of the quality control system, such as EQC reviews and education / training, had been appointed, there were cases in which the deficiencies inherent in quality control and individual audit engagements had not been identified and corrected on their own due to insufficient human resources allocated to each office at 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 identify the issues to be considered 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 meetings 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 adequate awareness of 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 and implement such 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 aware the purpose and importance of the quality control system, take the initiative in ensuring that whole personnel in a firm understand the primary purpose of the QC system, disseminate measures to improve the quality of audit throughout the entire organization, and verify their effects at all times. In this regard, it should be noted that the revised QC standards also state that it is important for the CEO to have an awareness of organizationally ensuring audit quality and to demonstrate leadership toward the establishment of a quality control system.
Note that 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 personnel at the firm, the characteristics of the management of organization, and whether the firm belongs to a global network. In light of this, the CEO and PICOQC of audit firms should establish appropriate QC system according to the size and characteristics of their firm and appropriately maintain the system by revising it as needed.

(Reference)

Main provisions serving as the basis grounds for deficiencies identified in quality control operation and relevant points to be noted are as follows.

Item	Main provisions that serve as the basis for the Identification	Relevant Points to Note
1. Initiatives to Improve Operation	Quality Control Standards Statement No. 1 paragraphs 15, 16, 31	➢ For deficiencies identified in inspections, etc., has formulated and implemented specific improvement measures based on the root causes. ➢ Whether the proposed improvement measures have been disseminated throughout the organization. ➢ Whether the effects of the improvement measures have been verified.

Item	Main provisions that serve as the basis for the Identification	Relevant Points to Note
2.Establishment/Implementation of Internal Rules and Compliance with Laws, Regulations, and Professional Standards	Quality Control Standards Statement No. 1 paragraphs 15, 16, 17, 18	➢ Whether the audit firm has developed an organizational culture that ensures compliance with laws, regulations, and professional standards as well as internal rules. ➢ Whether the audit firm periodically checks whether there are any discrepancies between the internal rules it developed and their actual implementation. ➢ Whether the audit firm has developed a control system for appropriately recording and managing the CPA qualifications and actual working hours of partners and employees. ➢ Whether the audit firm has established security rules necessary for the use of Internet server services in the course of business, and whether it has considered security measures.
3. Professional Ethics and Independence	Quality Control Standards Statement No. 1 paragraphs 20, 21, 23, 24	➢ Whether the audit firm obtains confirmation letters concerning independence from all target persons at least once a year. ➢ Whether the audit firm conducts independence confirmation procedures when accepting or continuing audit engagements. ➢ Whether the audit firm has developed and implemented a control system for updating, in a timely and accurate manner, the list of regulated companies, which is necessary for the procedures to confirm.

Item	Main provisions that serve as the basis for the Identification	Relevant Points to Note
		➢ Whether the audit firm has established a policy and specific procedures concerning compliance with professional ethics, such as dependence on remuneration, restrictions on employment, confidentiality, and gift-giving and entertainment, and informed them to professional staff. ➢ Whether the audit firm has established policies and procedures to comply with the rotation system for engagement partners, etc.
4. Acceptance and Continuance of Engagements	Quality Control Standards Statement No. 1 paragraphs 25, 26 Auditing Standards Statement No. 900 Paragraphs 9, 13	➢ Whether specific procedures for evaluating contract risks have been established, and whether approval by the audit firm is made in a timely and appropriate manner. ➢ Whether the identified engagement risks have been appropriately reflected in the audit plans for individual audit engagements. ➢ Whether the audit firm examines whether it has sufficient human resources to implement newly accepted engagements. ➢ Whether the predecessor auditor provides information including information and circumstances relating to material misstatements in the financial statements in good faith and clearly in response to inquiries from the prospective auditor. ➢ Whether the prospective auditor makes inquiries of the predecessor auditor on matters required under auditing standards in order to determine whether or not to

Item	Main provisions that serve as the basis for the Identification	Relevant Points to Note
		accept the engagement.
5. Recruitment, Education and Training; Evaluation and Assignment	Quality Control Standards Statement No. 1 paragraphs 28, F28-2, 29, 30	➢ Whether the audit firm continually provides education and training aimed at improving its audit quality control capabilities, and provides follow-up to personnel who have not completed the mandatory training. ➢ Whether the audit firm has established policies and procedures to fairly evaluate the competence (especially competence related to quality control) of professional staff and their compliance with professional ethics with regard to evaluation, remuneration and promotion, and whether these policies and procedures are properly implemented. ➢ Whether the engagement team sufficiently evaluates the time, work experience, and capabilities, etc. that professional staff, including engagement partners, can secure to perform their duties when forming the engagement team;
6. Audit Documentation	Quality Control Standards Statement No. 1 paragraphs 31, 44 Auditing Standards Statement No. 220 Paragraphs 14, 15, 16	➢ Whether the engagement partner reviews the audit documentation and holds discussions with the engagement team to confirm that sufficient appropriate audit evidence has been obtained to support the conclusions and audit opinion. ➢ Whether the audit firm has appropriately developed policies and procedures for the final assembly of the audit file, and ensures that the final assembly of the audit file is completed by the deadline.

Item	Main provisions that serve as the basis for the Identification	Relevant Points to Note
		➢ Whether the audit firm has adequate policies and procedures in place to ensure the confidentiality, safe custody, integrity, accessibility, and retrievability of audit documentation.
7. Engagement Quality Control Review	Quality Control Standards Statement No. 1 paragraphs 36, 37, 38	➢ Whether a person with the necessary experience and skills, etc. and who maintains objectivity and independence has been appointed as the EQC reviewer. ➢ Whether the EQC reviewer examines, based on the audit documentation, whether the evaluation of independence, the necessity of consultation with experts and the conclusion reached, and the significant judgments made by the engagement team are supported by sufficient appropriate audit evidence.
8. Monitoring the Firm's Quality Control System	Quality Control Standards Statement No. 1 paragraph 47, 48, 49, 50	➢ Whether the audit firm appropriately grasps the status of establishment and implementation operation of the quality control system, and has established an inspection system to identify deficiencies. ➢ Whether the audit firm has had the person in charge of periodic inspection conduct an in-depth inspection of whether the audit evidence is sufficient and appropriate, by making inquiries of the professional staff and inspecting the audit documentation. ➢ Whether the audit firm evaluates the impact of deficiencies identified through ongoing monitoring and periodic inspections, instructs the relevant manager (s) to implement corrective

Item	Main provisions that serve as the basis for the Identification	Relevant Points to Note
		measures, and checks the appropriateness of the measures.
9. Cooperation with Company Auditors	Auditing Standards Statement No. 260 Paragraphs 13, 14, 15, 16, 22	➢ Whether the engagement team clearly communicates with the company auditors, etc. about the auditor's responsibilities related to the audit, an overview of the scope and timing of the planned audit including the nature and the reasons of identified significant risks. ➢ Whether the engagement team provides audited companies with appropriate written explanations about the results of the CPAAOB inspections and quality control reviews. ➢ Whether important audit findings are communicated to company auditors in a timely manner.

[Large-sized Audit Firms]

1. Efforts to Improve Operation

<u>Points of focus</u>

At large-sized audit firms, although a quality control environment has been developed as a formality, there may be some deficiencies in its operation. Therefore, the CPAAOB inspects, in a focused manner, whether effective, rather than a formality, efforts are being made to improve operations in response to deficiencies identified in the previous CPAAOB inspection and quality control review.

Specifically, the CPAAOB verifies the effectiveness of the firm's improvement efforts by checking the status of cause analysis of the deficiencies identified in the past and the status of the implementation of remediation based on it, and by examining individual audit engagements. In the case where issues are identified in the measures to improve operations, the CPAAOB examines the effectiveness of the remediation measures carried out by the firm through the process such as examining problems on the operation management system that are supposed to be the cause of issues.

<u>Outline of inspection results</u>

At large-sized audit firms, improvement measures for deficiencies identified in the CPAAOB inspections and quality control reviews are often drafted under the initiative of the quality control division etc. at the headquarters, and after being made known to each engagement team through training and notifications, each engagement team takes action, such as reviewing actual audit procedures according to the risks of each audited company. In addition, in order to further disseminate improvement measures, there is a tendency to establish a quality control environment not only at the headquarters but also at divisions closer to the audit frontline.

However, the CPAAOB inspection identified that organizational improvement measures were not necessarily sufficient at different levels within the firm, including divisions and partners. For example, cases 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 staff assignment is not flexible due to a lack of exchange of personnel with other divisions, etc. Furthermore, cases in which there were lacks of organizational support from the head office and audit service divisions concerning the response to the important audit areas where no significant change had occurred, were identified.

<u>Expected response</u>

Large-sized audit firms employ several thousand employees and have multiple offices, including regional ones. As a result, they usually have multiple divisions with several hundred employees. It is therefore important that measures taken at the headquarters are instilled throughout the entire organization as a means of improving operations. In order to achieve this, it is important to increase the understanding of quality control operations at the firm as a whole and to take action at the firm as a whole, including division managers, rather than having only limited departments, such as the quality control department, take action. In particular, the CEO needs to take the initiative in encouraging all members, especially engagement partners who are in a position to lead each engagement team, to make operational improvements so that the purpose of operational improvements reaches the entire organization. In addition, the PICOQC needs to plan and implement timely and appropriate measures under the direction of the CEO, and division managers need not only to make operational improvements themselves, but also to provide appropriate instructions and encourage professional staff under their umbrella to take appropriate actions.

Furthermore, the CEOs and PICOQCs, together with department heads, etc., should establish an effective system to monitor improvement and promptly take appropriate remedial actions in case a problem related to the status of dissemination or effectiveness of improvement measures has been recognized as a result of verification.

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

Case 1: Verification of the status of improvement

①In order to improve the deficiencies identified in the previous CPAAOB inspection, the audit firm implemented measures such as familiarization training for partners and professional staff. In addition, through training for monitoring personnel, the audit firm worked to ensure thorough monitoring by communicating points to be noted for each of the major items subject to monitoring. However, the quality control headquarters did not fully explain the information related to audit risks identified when selecting audit engagements to be monitored to some of the persons in charge of monitoring, and did not examine in detail the reports from some of the persons in charge of monitoring. As a result, **the situation where the engagement team did not appropriately performed audit procedures was not adequately identified during the monitoring process**.
(Quality Control Standards Statement No. 1, paragraphs 15 and 16)

NEW

②The audit firm conducted audit monitoring of significant audit areas, mainly accounting estimates, as one of the improvement measures against deficiencies identified in external inspections. However, the department in charge of these measures **did not adequately confirm whether the procedures to respond to audit risks, which had been planned at the time of audit planning through audit monitoring, had been implemented without fail**, and the effectiveness of audit

monitoring was not ensured in some audit engagements.
(Quality Control Standards Statement No. 1, paragraphs 15 and 16)

Case 2: Collection of audit risk information

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

However, in effect, **such collection is conducted as collecting same information throughout all audit engagements regardless of the degree of audit risk. Consequently, information corresponding to risks is not being collected**.

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

2. Operation of the Quality Control System

Points of focus

At large-sized audit firms, although deficiencies in the design of a QC system have seldom been identified in recent years, deficiencies continue to be identified in individual audit engagements. The CPAAOB believes that the cause of these deficiencies lies in the operational aspects of the quality control system, although the form (organization and procedures) has been developed.

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 implemented has 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.

In recent years, the number of auditor changes at listed companies and the number of newly listed domestic companies have remained at high levels. In concluding new audit contracts with large companies, including listed ones, and new audit contracts pursuant to Article 193-2-1 of the Financial Instruments and Exchange Act, sufficient 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 inspects noting that whether audit firms sufficiently consider the time for auditing ,manpower and the level of audit fees with the viewpoint that verifies reasonableness of the evaluation of risks from the conclusion and renewal of audit contracts (below, "engagement undertaking risk") as well as the audit quality .

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 partner etc. conducting reviews, the EQC reviewer, and the person in charge of periodic inspections did not fully understand the changes in the environment surrounding the audited company and the audited company's circumstances, or the audit procedures performed by the engagement team, and therefore did not identify any deficiencies in individual audit engagements.

Causes of these deficiencies include: a disparity in awareness of audit quality and abilities related to quality control among partners, such as engagement partners and EQC reviewers; the QC department not being able to fully grasp the disparity; as a result, appropriate engagement partners and EQC reviewers were not assigned; and engagement teams not proactively taking action to ensure audit quality, such as not consulting the head office for expert opinions in a timely manner.

(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 course of audit 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 promptly in addressing high-risk areas in listed-company audit engagements.

Expected response

Engagement partners need to be aware that they are responsible for directing, supervising, and guiding engagement team members so that they can perform audit engagements sufficiently and appropriately, taking into account the abilities and experience of engagement team members, and to be proactively involved from the audit planning stage through the formation of audit opinions. Specifically, engagement partners need to accurately understand the progress of audits and important matters through appropriate direction and supervision of assistants to engagement partners in the audit process, conduct in-depth reviews of audit documentation, and confirm that sufficient appropriate audit evidence is obtained prior to expressing audit opinions.

Furthermore, the EQC reviewer needs to spend sufficient time to examine whether audit engagements are sufficiently and appropriately performed, such as by objectively evaluating audit procedures and audit evidence included in audit documentation for important matters and confirming that there are no problems with the process of forming audit opinions.

To this end, the CEO and the PICOQC need to establish an environment in which engagement partners conducting reviews and EQC reviewers can appropriately perform engagements.

Specifically, engagement partners should assign appropriate engagement partners and EQC reviewers, etc. based on an understanding of each partner's awareness of audit quality, abilities in quality control, and audit risks based on the audited company's corporate environment. For example, if deficiencies in the implementation of operational improvements attributable to engagement partners are detected, the audit firm as a whole should re-evaluate the abilities of engagement partners in quality control, appropriately allocate engagement partners based on abilities, and provide re-education to engagement partners.

Furthermore, large-sized audit firms utilize content such as electronic audit documentation that describes audit procedures and checklists used in EQC reviews and periodic inspections in order to conduct audits and related services effectively and efficiently. In addition, they have established a consultation function and a deliberation system in which difficult audit issues are discussed and advice / solutions are provided at the head office. Such systems are useful for achieving a certain level of audit quality throughout the firm, but they also reduce the awareness of engagement teams to proactively consider audit quality.

Engagement teams, including the CEO and engagement partners, need to make efforts to establish and operate a quality control system based on a full understanding of the benefits and limitations of such systems as described above.

Case 1: Supervision of audit engagements and review of audit work papers

NEW

① The engagement partner believed that, since there had been no significant changes in the circumstances of the audited company, it would be sufficient to carry out audit procedures similar to those of the previous fiscal year, or that appropriate procedures had been carried out by assistants to the engagement partner with sufficient experience. As a result, **the engagement partner did not give appropriate instructions to the assistants to the engagement partner regarding the audit procedures to be performed when disclosing financial statements, etc. and examining compliance with accounting standards, etc. for accounting treatment from previous fiscal years, and did not sufficiently review related audit documentation regarding the audit procedures performed by the assistants to the engagement partner**.
(Quality Control Standards Statement No. 1, paragraph 31; Auditing Standards Statement No. 220, paragraphs 14, 15 and 16)

②In an audit area where the engagement partners deemed the risk to be relatively low, based on their understanding of the company and business environment and their past audit experience, and in an audit area where the engagement partners were convinced from prior discussions, etc. with the audited company that there were no accounting issues, they thought that they should only confirm the correspondence between their assumption and the conclusion written in the audit work paper. Also, **they trusted their assistants to engagement partner excessively. Because of these issues, the engagement partners did not provide appropriate instructions/supervision and did not conduct reviews appropriately.**
(Quality Control Standards Statement No. 1, paragraph 31; Auditing Standards Statement No. 220, paragraphs 14, 15, and16)

《Points to Note》

To suitably perform audit engagements within a limited time frame such as that for year-end audits, engagement partners are required to provide concrete instructions to the assistants to engagement partner and supervise their performance appropriately.
The content, timing and scope of the audit work papers to be reviewed should also be suitably planned so that engagement partners, etc., appropriately review the audit work papers.

Case 2: Ensuring effective EQC review

NEW

①The EQC reviewer was convinced that the engagement team had appropriately developed the audit plan based on a sufficient understanding of the audited company's business, and **lacked awareness of critically examining the audit plan developed by the engagement team from an objective standpoint**.
As a result, EQC reviewers failed to point out deficiencies concerning procedures related to response to fraud risks in their reviews.

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

②**The quality control headquarters did not re-examine the eligibility of the EQC reviewer according to the risks of audit engagements in which material risk information was newly identified in the middle of the fiscal year**.
(Quality Control Standards Statement No. 1, Paragraph 38)

Case 3: Effectiveness of periodic inspections

NEW

①The personnel in charge of periodic inspections were **not aware of the need to include areas with a relatively high risk of material misstatements in the scope of inspection**, taking into account the areas the engagement team identified as priority audit items when determining the scope of inspection. In addition, the personnel were **not aware of the need to perform a critical inspection** of the engagement team's judgment on the items included in the scope of inspection and the audit procedures performed. As a result, the personnel in charge of periodic inspections were not able to identify any deficiencies related to the examination of accounting treatment associated with the application of the accounting standard for revenue recognition or the audit of accounting estimates.
(Quality Control Standards Statement No. 1, paragraph 47)

②**Although** persons in charge for periodic inspections **confirmed the existence of audit work papers corresponding to 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, they failed to conduct effective inspections. For example, deficiencies concerning accounting estimates and related-party transactions were not discovered.
(Quality Control Standards Statement No. 1, paragraph 47)

《Points to Note》

With regard to EQC reviews and periodic inspections, it should be noted that, as with reviews, it is necessary to objectively evaluate whether the explanations provided by the engagement team are supported by sufficient appropriate audit evidence, not only through oral communication but also through examination of audit documentation.

In addition, audit firms that position global reviews as the center of periodic inspections should check whether the global reviews exhaustively carry out inspections that correspond to the requirements under Japanese audit standards, and whether it is necessary to take any supplementary measures if there is a concern that they are not carrying out such inspections.

Case 4: Misstatements concerning qualifications as a certified public accountant in materials submitted outside of the firm;

①**The audit firm submitted to some audited companies audit contracts, audit plan statements, and audit results statements containing misstatements describing that persons who were not registered as CPAs engaged in audits of the audited companies were not registered as CPAs were not registered as CPAs were not registered as CPAs were not registered as CPAs as CPAs**. In addition, **the audit firm submitted an audit summary to the Director-General of the competent Local Finance Bureau containing an excessive number of CPAs or engagement hours**.

Furthermore, the audit firm provided incorrect information to an audited company concerning the number of CPAs that should be included in the "Composition of assistants to engagement partners" column of the securities report, and as a result, **the audited company overstated the number of CPAs in the securities report**.

(Quality Control Standards Statement No. 1, Paragraph 15; Auditing Standards Statement No. 220, Paragraph 7; Article 5, Paragraph 1 of the Cabinet Office Ordinance on Audit Certification of Financial Statements, etc.)

NEW

②We have issued business cards indicating that they are CPAs to persons who have passed the final test but have not yet been registered as CPAs or who have not passed the final test.

(Quality Control Standards Statement No. 1, Paragraph 15; Auditing Standards Statement No. 220, Paragraph 7; Article 48 of the Certified Public Accountants Act).

Case 5: Omission of registration of audited company information (large companies, etc.)

NEW

The audit firm's internal rules stipulate that audit and attestation services pertaining to entities with high social impact (hereinafter referred to as "PIEs") and entities equivalent to PIEs need to undergo additional EQC reviews. Furthermore, with regard to whether an audited company falls under a large company, etc., the audit firm manages this matter through a database that contains registration information of large companies, etc. and financial information of the audited company, including capital and total liabilities. The audit firm instructs each engagement team to enter and update this database at regular intervals every year. However, with regard to audit services pertaining to an unlisted audited company that is a 100% subsidiary of a listed audited company, the engagement partner overlooked the fact that the audited company was not registered as a large company, etc. in the database even though the audited company met the requirements for a large company, etc. In addition, the engagement partner did not undergo additional EQC reviews prescribed in the internal rules. In addition, the audit firm did not take sufficient measures necessary to prevent errors in data input into the database and the failure to register the audited company as a large company, etc., and failed to detect the failure to register the audited company as a large company, etc., in a timely manner.

(Quality Control Standards Statement No. 1, Paragraphs 15 and 34; Auditing Standards Statement No. 220, Paragraph 7).

《**Points to Note**》

Whether or not an audited company falls under a PIE has wide-ranging effects, such as having an impact on the maximum period of involvement of the partners in charge of audit engagements, etc. and on the scope of communication with company auditors, etc. Therefore, audit firms need to establish a control environment that prevents errors.

Case 6: Communication with company auditors, etc.

①A 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, the assistants to engagement partner 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 Statement No. 260, Paragraph 15 and 18)

NEW

②After issuing the Companies Act audit report, the engagement team explained the audit results of the Companies Act audits to the company auditors, etc. of the audited company.) The team explained the content of the draft of the management confirmation letter concerning the Companies Act audits. The team also explained the audit results again before issuing the Financial Instruments and Exchange Act audit report. b) The team explained the information on the fees paid to the audited company group for audit and non-audit services. However, the engagement team did not communicate with the company auditors, etc. regarding a) and b) above at the right time before issuing the Companies Act audit report.

(Auditing Standards Statement 260 Paragraph 14, 15 and 20)

《**Points to Note**》

Please refer to the Auditing Standards (Auditing Standards Report 260, etc.), which specifically describe matters required to be communicated with company auditors, etc. It should be noted that such communication needs to be conducted at a timely timing before the issuance of the audit report, and that if the audited company is a PIE, the scope of such communication will expand.

Case 7: Information Management

NEW

The audit firm has prescribed in its internal rules, etc. the appropriate handling of personal information, including that of customers and employees of business partner companies. These internal rules, etc. prescribe that personal information obtained from audited companies should be deleted, blacked out, or otherwise handled when preparing audit documentation, except in cases where personal identification is required. However, most of the individual audit engagements

subject to inspection by the CPAAOB involve audit documentation for which no measures, such as deletion or blackening, have been taken with respect to personally identifiable information. As a result, the audit firm has not been thorough in handling personal information protection.
(Quality Control Standards Statement No. 1, Paragraph 45; Auditing Standards Statement No. 220, Paragraph 7).

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

1. Efforts to Improve Operation

Points of focus

CPAAOB performs inspections based on QC review reports, in principle. CPAAOB inspections focuses on improvements of deficiencies identified in previous CPAAOB inspection or QC review. Specifically, CPAAOB ascertains cause analysis of deficiencies identified before as well as measures to improve operations, such as measure based on the cause analysis, and also ascertains 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, CPAAOB seeks to identify the operations management system issues that might be the cause of such insufficiency.

Outline of inspection results

As shown in the case example section below, at some audit firms, initiatives to improve the deficiencies identified in the QC review were not fully implemented, and over multiple deficiencies, improvement measures were not implemented or insufficient.

Possible causes of the above deem to be as follows:

Although PICOQC or equivalent 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 systems;

The audit firm lacked the attitude of seeking improvement throughout all audit engagements;

The audit firm had not established system to effectively monitor the improvement of deficiencies; and

The divisions had insufficient manpower to implement improvement measures correspond to the size of the audit firm.

Furthermore, there were many cases found which engagement partners responsible for reviewing audit documentation, EQC reviewers, and persons in charge of periodic inspections completed their work by superficially reviewing audit documentation and filling out checklists as a matter of formality because they did not sufficiently understand the purpose of their own roles. In addition, the audit firm left acquisition of knowledge related to audit to the discretion of audit team members themselves instead of proactively maintaining and improving the aptitude and capabilities of the staff. Therefore, engagement teams did not sufficiently understand the level of procedures required under audit standards such as the Audit Standards Statement. As a result, there were many cases found which the same or similar deficiencies in individual audit engagements were not found, or operational improvements by the audit firm were not made sufficiently.

(Observed effective efforts)

NEW

The followings are Examples of effective efforts:
Establishment of a cross-organizational project for audit quality improvement led by CEO.
CEO directly ascertained the improvement of deficiencies in all audit engagements;
Partners of quality control department monitor audit documentation before expressing audit opinion.
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
A system under which 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 conclusion was a provided to the firm’s quality control division, was constructed.

<u>Expected response</u>

Audit firms must fully understand to what range and nature a deficiency should be improved, considering the reason why it was identified as a problem in CPAAOB inspection or QC review. Based on these understandings, audit firms should develop and implement appropriate improvement measures for identified deficiencies. In this regard, it is important for CEO to take a leadership, and at the stage of formulating improvement measures, not only make formal improvements to deficiencies but also analyze root causes of the deficiencies and then formulate effective improvement measures to resolve the causes. At the implementation stage of the improvement measures, it is important to make the entire organization understand correctly details of the improvement measures. It is also necessary to check whether the same or similar deficiencies exist not only in the individual audit engagements where the deficiencies were identified, but also in other individual audit engagements, and to fully verify whether the improvement measures formulated by the audit firm are appropriately implemented, in order to improve the overall audit engagements conducted by the audit firm.

Case 1: Establishment and implementation of specific procedures for improvement

①The audit firm attributed the deficiencies identified in the quality control review to a) insufficient understanding of audit standards, b) insufficient understanding of the level required by audit standards, and c) lack of professional skepticism.
However, the audit firm **<u>did not perform an analysis of the root causes</u>** of a) to c).
(Quality Control Standards Statement No. 1, paragraphs 15 and 16)

②With 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 inspection 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 Statement No. 1, paragraphs 31, A30, and A31; Auditing Standards Statement No. 220, paragraphs 14, 15, and 16)

Case 2: Dissemination of specific policies and procedures for improvement

The PICOQC fails to disseminate specific policies and procedures for improvement thoroughly. For example, the PICOQC included deficiencies identified in the QC review and improvement plans in the checklist designed for periodic inspection. 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 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 to be merged with, held meetings with the PIOCQC of that firm, reviewed the results of inspections by the CPAAOB, and so on.
However, while the PICOQC was aware that the audit firm to be merged with had had numerous deficiencies pointed out during CPAAOB inspections etc., he/she **did not adequately assess whether the quality level of the firm was acceptable**. For example, he/she did not specifically understand and analyze the nature and causes of the deficiencies.
(Quality Control Standards Statement No. 1, paragraphs 15 and 16)

NEW

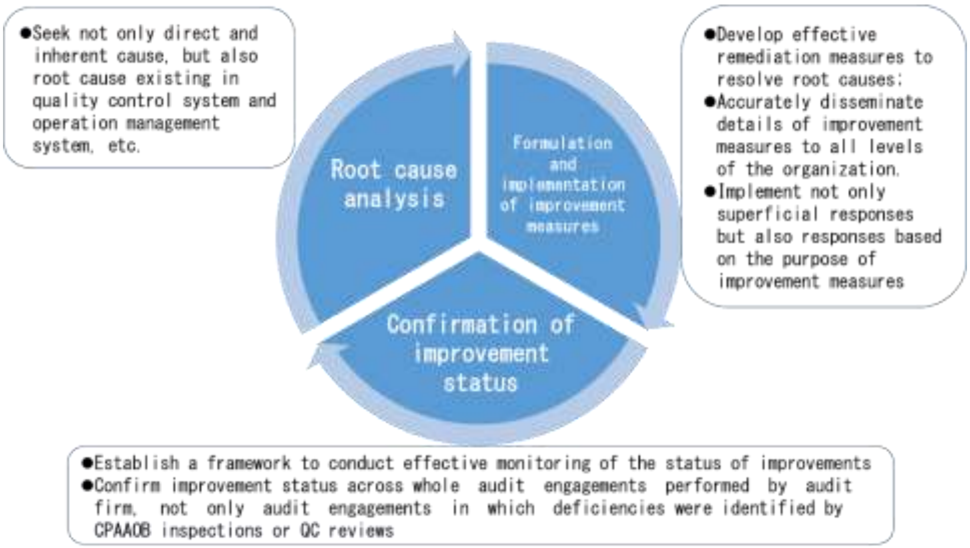
②The audit firm communicate points to attention of performing audit, which are based on deficiencies identified in external inspections, with the firm's personnel by training. The firm also prepared "Table for Identifying Deficiencies" that listed the deficiencies and had engagement partners perform self-check, and had EQC reviewers confirm results of the self-check. However, the engagement partners and the EQC **reviewer only confirmed items of self-check listed in the "Table for Identifying Deficiencies" as a formality, and did not perform in-depth reviews of deficiencies**.
Furthermore, the audit firm performed these self-check only for audit engagements of specific fiscal year-ends, and **did not perform self-check for audit engagements of the other fiscal year-ends.**

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

《**Points to Note**》

The aboves are examples of audit firms, which deficiencies identical or similar to the deficiencies identified in past CPAAOB inspections and QC reviews, were identified. This resulted from the implementation of formal improvement measures, such as simply communicating the deficiencies for improvement and using improvement checklists, without identifying the root causes of the deficiencies and resolving or improving them. Therefore, the PICOQC should keep in mind that it is necessary not only to communicate details of identified deficiencies to engagement teams, but also to consider specific instructions for improvement of audit procedures. In the case of using improvement checklists, PICOQC and engagement partners should monitor a status of the improvement in light of the meaning of the deficiencies and the scope of procedures to be improved based on the meaning. (Refer to [Figure 3])

［Figure 3］Reference image: Initiatives to improve operations



2. Establishment/Implementation of Internal Rules and Compliance with Laws, Regulations, and Professional Standards

(1) Establishment/Implementation of Internal Rules

Points of focus

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, sufficiently 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 PICOQC or equivalent communicates the internal rules to personnel (including part-time staff) and other personnel without omission, and ensures their familiarization with the rules, for example, by verbally explaining them as needed; and
- Whether PICOQC or equivalent verifies the status of compliance with internal rules, for example, timely understanding the status of compliance by personnel with the internal rules.

Outline of inspection results

Regarding the a design and operation of internal rules, as shown in the case example section below, there were deficiencies not only in the operation of internal rules but also in designs of them.

As for the causes of these 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 according to 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 Statement by noting the requirements indicated in relevant statements with respect to each provision of the audit manual. Using such audit manual, the audit firm provides education on the level of audit responses required by the audit standards.

Expected response

Audit firm should re-examine whether their internal rules comply with laws, regulations, and professional standards and are appropriate for their size and actual situation, and review and revise internal rules as necessary. Audit firm should also establish an operations management system for appropriate design, dissemination, and operation of internal rules, such as by establishing a workflow that is appropriate for the actual situation.

Case 1: Establishment of internal rules (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 new 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 Statement No. 1, paragraphs 17 and 18)

Case 2: Establishment of internal rules (Partners' meeting)

The audit firm has a partners' meeting consisting of all partners to make decisions on important matters relating to management and operations.

However, the audit firm did not have a system in place for appropriate operation of the partners' meeting. For example, **the audit firm did not specifically stipulate in writing the matters to be resolved by the partners' meeting and the method of resolution, and it did not keep a record of the process of deliberation and content of resolutions on matters though it asserted that such matters had been resolved by the partners' meeting**.

(Article 34-13 of the Certified Public Accountants Act)

Case 3: Dissemination of internal rules

NEW

An audit firm stipulated in its quality control regulations that "When these regulations are newly adopted or renewed, PICOQC shall document policies and procedures concerning quality control in these regulations, etc., distribute these regulations to personnel, and explain the content of these regulations, the purpose to be achieved, and the point that each individual is responsible for quality."

However, the audit firm **only kept various regulations, including quality control regulations, in**

a cabinet within their office, and PICOQC **did not distribute the quality control regulations, etc., to personnel**. Furthermore, PICOQC did not **fully inform personnel of the content and objectives to be achieved, etc., when new personnel were employed or quality control regulations, etc., were newly established or revised**.
(Quality Control Standards Statement No. 1, paragraphs 15 and 16)

Case 4: Operation of internal rules (retirement age rules)

NEW

An audit firm set the retirement age for partners at 65 in its retirement age regulations, but **the audit firm permitted its partners who had passed the retirement age to attend partners' meetings and keep their partner registration without adopting a resolution to extend the retirement age, so that the audit firm did not treat these partners in accordance with the regulations.**
(Quality Control Standards Statement No. 1, paragraph 15)

Case 5: Operation of internal rules (seeking expert opinions)

However, the audit firm did not establish specific procedures for obtaining expert opinions. For example, the audit firm **did not establish specific reporting procedures when the engagement team identified matters on which an expert opinion should be sought, and did not identify a person with appropriate expert knowledge and experience in or outside the firm**.
(Quality Control Standards Statement No. 1, paragraph 33, F33-2)

《Points to Note》

As the templates provided by JICPA and other bodies have been enhanced, the number of deficiencies in the design of rules, such as the absence of rules, has been decreasing. However, there are some operational problems where the templates are used without any modification, and the rules are not in accordance with the actual situation of the audit firm, and the rules are not actually functioning. 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 implementation.

In addition to the above, the following deficiencies were identified:

- **There is no contact channel for information related to fraud risk received from outside, and no specific system has been established to respond to information related to fraud risk from outside.**
- **The firm had failed to put in place a system for tallying and managing working hours of professional staff, which serve as the basis for developing audit plans.**
- **Regarding audit strategy to obtain audit evidence by conducting substantive procedure without conducting test of internal controls, the audit manual did not set out any guidelines on the requirements, nature, timing and extent of such substantive procedure.**
- **When concluding contracts for non-audit services, procedures prescribed in internal rules (notification to and proceedings of all personnel) were not performed.**

(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. CPAAOB, therefore, inspects the status of compliance with applicable laws, regulations, and professional standards, and the status of the establishment and implementation of the operation management system to ensure such compliance.

Outline of inspection results

From the perspective of compliance with laws, regulations, and professional standards, there were deficiencies in the rules for non-competition among partners, as well as in the rotation of key personnel in charge of audit engagements, inappropriate responses to inspections, and false statements regarding CPA qualifications.

Causes of the deficiencies listed above include: PICOQC or equivalent did not fully understand the applicable laws, regulations and professional standards or did not clearly and concretely stipulate practitioners and workflow regarding the tasks that necessitate verifying the status of compliance with laws, regulations and professional standards.

Expected response

An audit firm should be aware of their duties and responsibilities of certified public accountants at all times and should foster an organizational culture under which laws, regulations, and professional standards are observed. Moreover, an audit firm should establish an appropriate operations management system to ensure compliance with laws, regulations, and professional standards by identifying operations which necessitate checking the status of compliance with laws, regulations, and professional standards, and by assigning persons to be responsible for those operations.

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. In addition、 the audit firm overlooked the fact that this partner was violating the Act.

(Article 34-14, paragraph 2 of the Act; Quality Control Standards Statement No. 1, paragraph 19)

Case 2: Rotation of major engagement team members

With regard to long-period 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 equivalent or a longer period of time than engagement partners, the CEO/PICOQC did not consider whether such partners were 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 Statement No. 1, paragraph 24)

Case 3: Inappropriate response to inspection

The audit firm submitted the inspection-related documentation to inspectors as if it had been prepared in a timely manner even though some partners and staff members had prepared some documents relating to quality management system after cut-off date of inspection or they had prepared some audit documents relating to individual audit engagement and inserted into the audit final file which had been completed and assembled before.

(The Act, Articles 26, 28-3, and 34-14-3)

Case 4: Responding to QC reviews

NEW

PICOQC of this audit firm made statements to partners and employees **that could be interpreted as encouraging or permitting the addition, correction and update** of audit documentation relating to audit engagements subject to JICPA QC reviews during the period between the audit report date and the completion of the assembly of the final engagement files.

(Quality Control Standards Statement No. 1, paragraph 17, A4).

Case 5: Inputting working hours of professional staff

Professional staff at the audit firm input working hours into the attendance management system. However, at this audit firm, there were numerous cases in which the working hours of professional staff, including those on statutory holidays, were not input into the attendance management system. In addition, there were numerous cases in which the number of working hours listed in the audit summary was insufficient and in which working hours on statutory holidays were input as working hours on working days. Despite these cases, **corrective measures were not taken to ensure the accuracy of input working hours for all professional staff, and the working hours of professional staff were not appropriately managed**.

(Quality Control Standards Statement No. 1, Paragraph 15; Auditing Standards Statement No. 220, Paragraph 7; Article 5, Paragraph 1 of the Cabinet Office Ordinance on Audit Certification of Financial Statements, etc.)

Case 6: Misstatements concerning qualifications as a certified public accountant in materials submitted outside the firm

The audit firm submitted to some audited companies audit plan statements containing misstatement that an employees engaged in an audit of the audited company who were not registered as a CPAs was qualified as a CPAs.

In addition, **the audit firm issued business cards to persons who had not yet been registered as CPAs, stating that they were CPAs**.

(Quality Control Standards Statement No. 1, Paragraph 15; Auditing Standards Statement No. 220, Paragraph 7)

《Points to Note》

In addition to the above cases, the following deficiencies have been identified.

- **The requirement that the majority of partners have been engaged in audit and attestation services for three (3) years or more after being registered as a certified public accountant has not been met.**
- **Internal rules did not establish procedures for identifying whether or not services that compete with audit firms are being conducted, or specific approval procedures related to competitive work.**
- **There is a discrepancy between the purpose of the audit firm stated in the Articles of Incorporation and the actual content of the audit firm's business.**
- **Notification concerning an amendment to the Articles of Incorporation has not been submitted by the statutory submission deadline.**
- **Transactions involving conflicts of interest are not approved.**
- **The audit firm did not calculate and manage the actual work hours of partners and employees, and did not establish a system for appropriately preparing audit summaries.**
- **Approval procedures for contracts for services outsourced by affiliates of the audit firm were not carried out.**

(3) Information Security

Points of focus

Frim personnel routinely obtain confidential information of audited companies, etc., and carry around personal computers on which such information is stored. They also use e-mail to communicate with a person in charge at audited companies, etc., and store electronic audit documentation and electronic data before preparation of documentation at audit firms and on external servers. Therefore, audit firms are required to establish and implement information security systems that fully and appropriately meet the sensitive needs of the IT environment, etc.

In consideration of the above, CPAAOB inspects audit firms for the status of establishment and implementation 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, being too confident in professional staff’s compliance with the internal rules;

The person responsible for information management do not properly understand their own professional responsibilities, and do not establish rules suited to the actual use of information devices at the audit firm;

Forgetting to anonymize personal information.

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 enormous 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 implementation 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 aiming IT systems failure 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 implementation 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 Statement No. 1(Before amendment in July 2023), paragraphs 15 and 16; Quality Control Standards Statement No. 1 Practical Guidelines No. 1 III-1, IV-2, and 5)

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 check whether data related to audit engagements is remaining on part-time professional staff's own personal PCs when they use such PCs for audit engagements. However, the PICOQC **<u>merely used the "Checklist on Information Security" as a formality</u>** and did not actually ascertain whether there was remaining audit engagement data on the PC.

(Article 27 of the Act; Quality Control Standards Statement No. 1(Before amendment in July 2023), paragraphs 15 and 16; Quality Control Standards Statement No. 1 Practical Guidelines No. 1 IV-2, IV-5, and V-2)

Case 3: Handling of personal information

FREQUENT

In its Manual for Preparing Audit Documentation, the audit firm stipulated the following: a) In principle, vouchers containing personal information should not be stored as audit documentation; b) Measures should be taken to make it impossible to identify individuals when such vouchers are stored as audit documentation.

However, in audit documentation of multiple audit engagements at the audit firm, information that enables the identification of specific individuals, such as names, masking was not masked or other measures were not taken. **Therefore, <u>internal rules on the protection of personal information are not being appropriately implemented</u>**.

(Quality Control Standards Statement No. 1, paragraph 45; Auditing Standards 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 job-related use of 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

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

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 his/her work, 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 implementation 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.

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

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.

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

Audit firms should understand that the general public awareness of negative effects of insider trading on capital markets is increasing and take even more effective measures to prevent such trading.

Specifically, audit firms should take necessary responses sufficiently referring to "Q&A Concerning Insider Trading" issued by the JICPA (September 2, 2008) and other relevant documents, re-examine the status of establishment and implementation of the rules for preventing insider trading, and consider 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 Statement No. 1, paragraph 19)

《Points to Note》

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

- **The audit firm has not established internal rules comprehensively, only prohibiting transactions involving specified securities etc. of parties to which services are provided in The "Rules for Preventing Insider Trading" and prohibiting excessive entertainment and gifts in the "Code of Conduct and Ethics";**
- **Although it is specified in the "Rules for Preventing Insider Trading" that a list of 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 such 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 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 performed 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 designed and operated a control environment for updating, in a timely and accurate manner, the list of companies subject to regulations on independence, which is necessary for determining whether or not a party subject to the regulations complies with the provisions on independence when carrying out independence confirmation procedures;
- Whether the audit firm establishes and communicates policies and specific procedures to ensure the observance of professional ethics, such as fee dependency, employment restrictions, duty of confidentiality 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, some engagement teams merely performed a formality review of the independence confirmation procedures prescribed in internal rules, etc., and easily concluded that there were no problems with independence. Some engagement teams also did not perform independence confirmation procedures comprehensively. In addition, some engagement teams did not update their internal rules in accordance with amendments to laws and regulations concerning independence.

As for the causes of the deficiencies, in some cases, PICOQC, etc. did not determine specific procedures for confirming independence (include procedures for updating the list of independent regulated entities) and the specific period of implementation or appoint the person in charge of the confirmation procedure.

<u>Expected response</u>

Audit firms continue to have deficiencies in matters related to professional ethics and independence. Therefore, in order to ensure the reliability of audits, it is necessary to establish an appropriate operations management environment by complying with the basic principles of the "Code of Ethics" published by JICPA and applying the conceptual framework approach. In addition, it is necessary to carefully consider the actual situation when identifying, evaluating, and addressing factors that hinder independence. (Refer to [Figure 4])

[Figure 4] Conceptual framework approach

Case 1: Confirmation of independence in collegial review

NEW

As an independence confirmation procedure in a council review, the audit firm verbally confirmed the independence of prospective review committee members, and if no problem was found with their independence, the audit firm recorded in the "Confirmation of Independence" column of the "Review Request Form" that the independence confirmation procedure had been completed. However, the audit firm **<u>did not perform independence confirmation procedures for some prospective review committee members</u>**.

(Quality Control Standards Statement No. 1, paragraphs 20 and 38)

Case 2: Confirmation of independence when accepting new audit engagements

The audit firm performs procedures to confirm the independence of members who conduct a preliminary investigation of new audit engagement before conducting the preliminary investigation, and performs procedures to confirm the independence of other members of the engagement team before commencing audit engagements.

However, **<u>with regard to confirmation of independence, the audit firm did not establish internal rules setting out specific procedures such as who should be subject to the checks and when they should be implemented</u>**, so for some audit engagements, **<u>procedures to confirm independence before conducting a preliminary investigation or before starting audit</u>**

engagements were not performed.

(Quality Control Standards Statement No. 1, paragraph 20)

Case 3: Inadequate preparation of a list of regulated companies

When performing the procedure for confirming independence to a partners and other staff, the audit firm prepared a list of companies subject to regulation on independence and then appended this list to the independence checklist. However, the audit firm **neglected to include multiple companies subject to regulation on this list, as the firm had not checked the comprehensiveness of such list**. Furthermore, when performing the procedure for confirming independence, even though the responses obtained from partners and other staff contained oversights in the checks, the firm failed to adequately ascertain the reasons for this and thus failed to sufficiently confirm the status of compliance with rules regarding independence.

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

Case 4: System for obtaining information about group firms

The audit firm performed non-audit services (financial due diligence, etc.) entrusted to it by affiliated companies, etc. These services were outsourced by affiliated companies, etc.

However, **with regard to the acceptance of non-audit engagements by the audit firm, the audit firm did not establish policies and procedures for maintaining independence**, and did not establish specific procedures for: a) examination of whether concurrent provision of non-audit services constituted prohibited work, etc. (i.e., whether there was a capital relationship between the client of the non-audit services and the audited company, the nature of the non-audit services, etc.); b) examination of safeguards to be applied when providing non-audit services; c) approval by the engagement partner and PICOQC.

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

Case 5: Calculation of fee dependency

The fees received from a specific 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 who was not a member of the 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 judgements 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

After being involved as an engagement partner, CEO attended meetings to report audit results to representative directors etc. of some audited companies during periods when he / she was no longer involved as an engagement partner due to the number of years he / she had been continuously involved.

However, despite being aware of this fact, **the person in charge of independence did not examine whether CEO's attendance at the meeting to report audit results had a direct impact on the results of audit engagements or other matters from the perspective of independence**.

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

Case 7: Employment with client

NEW

With regard to the existence and materiality of factors hindering the independence of a former partner in charge of the audit engagements for an audited company and was scheduled to assume office as an officer of the audited company, the audit firm only checked whether audited financial statements had been issued for the period from the day on which the former partner resigned as an engagement partner in the audit engagement to the day on which he / she assumed office as an officer of the audited company. **It did not conduct an examination in light of whether the audit firm provided economic benefits, etc. to the former partner, whether the audit firm owed debts to the former partner, or whether the former partner had been involved in the professional services of the audit firm**.

(Guideline for Independence, Section 1, paragraph 135 and 139)

Case 8: Payment of commission for referral to assurance services

The audit firm paid to staff members a set percentage of the assurance service contract sum as an allowance by way of commission for referral to assurance services when the referral resulted in the conclusion of a contract. The firm also outsourced new customer cultivation and referral services to an external business partner and paid them commission for referral to assurance services. However, **the payment of such commission violates the Code of Ethics prohibiting payment of commission referral to assurance services**.

(Code of Ethics, Article 23)

《Points to Note》

In addition to the above, examples of deficiencies in professional ethics and independence include

the following:

・The firm included, in the denominator for calculating the fee dependency, the fees received by partners engaged in concurrent business from companies serving as part-time directors, but it did not consider whether it was appropriate to include such fees in the denominator as income for the audit firm.

・The firm had neither set out policies and procedures regarding the long-term involvement of engagement team members, nor prescribed standards for those subject to periodic rotation or when safeguards are required to defuse the situation that may create threats to independence.

Column

Safeguards regarding Fee Dependency

If fees received from clients for specific audit engagements account for a large proportion of the total income of the audit firm, etc. expressing an audit opinion (hereinafter referred to as "fee dependency"), concern about losing fees from such clients for audits and other engagements affects the level of self-interest of the auditor, which is a disincentive to independence (threats), and creates undue pressure; therefore, safeguards need to be considered and implemented to reduce the threats to an acceptable level .

<Calculation of fee dependency >

The calculation of fee dependency is described in Q. 410 - 5-4 of Practical Guidance No. 1 of the Code of Ethics, Q & A on Ethical Conduct (Practical Guidance), as follows; please refer to that guidance for further details.

$$\frac{\textbf{The total fees from an audit client and its related entities;}}{\textbf{Total fees of the audit firm, etc.}}$$

＜Safeguards for audit engagements as Public Interested Entities＞

When providing audit services to a client which is Public Interested Entity (PIE) (*), the audit firm shall apply the following safeguards (if it is determined that they can be safeguards) regarding fee dependency.

- When for each of two consecutive years fee dependency from the client represent or is likely to represent more than 15%: A review, which is similar to engagement quality review, performed by a professional accountant who is not a member of the firm expressing the opinion on the financial statements, prior to the audit opinion being issued on the second year's financial statements.
- When the circumstances described above continue for five consecutive years: The audit firm shall cease to be the auditor after the audit opinion for the fifth year is issued.

It should be noted that the amended Code of Ethics revises the rules on safeguards for fee dependency, and as a result, a review (periodic inspections or JICPA QC reviews) after expressing audit opinion is no longer accepted as safeguards for audit engagements as PIE.

(*)Public Interest Entity (PIE) is defined as "Large company etc." under the Certified Public Accountants Act and are additional entities treated as PIE by an audit firm.

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 an audit firm evaluates the risks insufficiently in the process of risk assessment regarding the conditions of audited companies, or if an audit firm make a judgment as to whether the acceptance and continuance of audit engagements should be accepted, etc., 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, audit firms need to pay attention to the following points, for example, when accepting or continuing audit engagements:

- Whether there are engagement risks, including questions regarding the integrity of the top management of the audited company (note that interviewing top management 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 or not audit firms comply with the relevant Rules on Professional Ethics and Independence.

In particular, when examining the integrity of the management of an audited company, it is necessary to obtain information that is considered to be necessary in each situation, and if problems are identified, it is necessary to carefully examine whether or not to accept or continue the audit engagement, and to document the conclusion appropriately.

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 inspections 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

The acceptance and continuance of audit engagements are core management decisions at audit firms. However, as shown in the case example section below, when accepting and continuing audit engagements, risk information such as the integrity of the audited company involved, which was obtained by the prospective engagement partner through a preliminary investigation and handover of audit engagements, was not shared among persons authorized to approve the acceptance or continuance of engagements (partners' meetings, etc.). As a result, appropriate risk assessment was not performed. In addition, insufficient consideration was given to the audit resources required to conclude engagements. 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 or the business rationale of transactions 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 engagement than 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 judgments regarding management fraud, internal control audits, accounting estimates, etc. As a result, engagement risk assessment based on facts identified through the preliminary investigation and handover of audit engagements, etc. was not performed appropriately.

When discussing with partners whether or not to accept an audit engagement, the audit firm did not understand the importance of conducting a risk assessment based on information etc. obtained from the predecessor auditor, and partners other than the prospective engagement partner did not critically consider audit engagements obtained by other partners.

(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.

In order to develop an environment in which companies intending to list can receive appropriate audits, the Company has established a dedicated department within the headquarters organization. This dedicated department has functions of providing consultation services to companies intending to list, ensuring audit quality by supporting engagement teams, and planning and conducting training to develop human resources who will be responsible for audits of companies preparing to be listed.

Expected response

Audit firms should pay sufficient attention to the fact that acceptance and continuance of audit engagements are core management decisions at audit firms. It is necessary to determine whether to accept or reject an audit engagement after identifying engagement risks and considering measures to address them as an audit firm, based on information obtained through a preliminary investigation or handover of audit engagements, such as the integrity of the audited company and risk information on the audited company.

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.

In addition, the number of new contracts for audits equivalent to the provisions of Article 193 - (2), Paragraph 1 of the Financial Instruments and Exchange Act for listed preparatory companies has increased to a considerable extent, and there are many listed preparatory companies that face challenges in internal controls and internal control environments. Therefore, when concluding new audit contracts with listed preparatory companies, it is necessary to carefully consider whether or not audits of appropriate quality can be conducted, while paying attention to the following points.

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 knowledge of initial listing related operations.

Furthermore, from the viewpoint of constructing a framework that can continuously provide audit services to listed companies, it will be necessary to train human resources who will be responsible for initial listing related operations, and accumulate and consolidate related knowledge and know-how.

Case 1: Risk assessment procedures when accepting new audit engagements

①The prospective engagement partner had assessed the contract risk as high after ascertaining that in previous audits, the submission of audit reports had been delayed due to vulnerabilities in the audited company's management systems relating to accounting, etc. After that, inquiring with the predecessor auditor and confirming that there were no problems with the integrity of key management of the company, the prospective engagement partner submitted the matter to partners meeting to discuss the advisability of acceptance of a new audit engagement.

However, the prospective engagement partner had not had a meeting with key management of the company and the partners meeting failed to adequately assess the integrity of key management of the company, it approved the new contract with the audited company based solely on the outcome of the inquiry made to the predecessor auditor.

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

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 acquisition 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 Statement No. 1, paragraphs 25, 26, and F26-2)

③Despite planning to rely on the audit results from the auditor of an foreign significant component, the prospective engagement partner requested 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 checking whether the prospective engagement partner had confirmed the independence of the incoming auditor.

(Auditing Standards 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.

It should be kept in mind that when an audit firm merges with another audit firm, the audit firm needs to

perform necessary procedures such as accepting audit engagements need to be completed and appropriate risk assessment procedures.

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 Statement No. 1(After revision), paragraph A69.

- **In the case of existing engagements, where applicable, information from current or past work or inquiries to other professional personnel who have undertaken other work for the engagement;**
- **In the case of a new client, inquiries to a person who is currently providing or has provided in the past accounting and audit-related services as a professional expert to the client in accordance with the provisions on professional ethics.**
- **Discussions with third parties, such as financial institutions, legal experts, and other companies in the same industry in which they are involved;**
- **Background checks using relevant databases (which may also fall under intellectual resources); in some cases, audit firms may use service providers to carry out background checks.**

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

The engagement team became aware of significant matters, including significant deficiency in internal controls, note about going concern assumption, and doubt about the business rationale of the transaction with a major shareholder. The engagement team assess the transactions of dubious rationality with the major shareholder as the circumstances that indicated the risk of material misstatement due to fraud.

However, when renewing the audit contract with the audited company, **the audit firm failed to sufficiently consider procedures to ensure audit quality, even though the firm was aware that these significant matters would cause significant difficulty in ensuring the quality of audit engagements**.

(Quality Control Standards Statement No. 1, paragraphs 24, 25, 26, and F26-2; Auditing Standards Statement No. 220, paragraph 11 and F11-2)

《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 from the viewpoint of inappropriate limitation in the scope of work, such as a limitation on the scope of the audit, and cases in which the integrity of management of the audited company was not considered based on responses being taken to address the disclosures of significant deficiencies in entity level controls and process level controls, even though such deficiencies were identified.

It should be noted that, not only on accepting but also on continuing audit contracts, decisions should only be made after identifying engagement risks on the basis of information ascertained and considering

response measures to address these risks.

Case 3: Securing audit resources

NEW

With regard to the continuance of audit engagements, the audit firm requires engagement partners to obtain approval from EQC reviewer after evaluating the degree of contract risk, taking into account such factors as the integrity of the audited company, audit implementation risks, and the need to secure audit resources.

However, when examining whether or not to continue the audit engagement, the engagement team estimated the planned audit hours for the current period audits as being at the same level as the planned audit hours for the previous period, even though the actual audit hours for the previous period far exceeded the planned audit hours. **The engagement team did not consider a specific method for significantly reducing the actual audit hours for the previous period, or the specific number of hours that could be reduced by such method, while maintaining high-quality audits**.

Furthermore, when approving the continuance of the audit engagement, EQC reviewer did not consider the reasonableness of the scheduled audit hours estimated by the engagement team, and did not adequately consider whether the continuance of the audit engagement was appropriate.

(Quality Control Standards Statement No. 1, paragraphs 25; Auditing Standards Statement No. 210, paragraph 9 and No. 220, paragraph 11 and A7)

Case 4: Risk assessment procedures when accepting amendment audit engagement

Since an amendment audit engagement-covering multiple fiscal years was accepted shortly before the audit report deadline, borrowing audit documentation from the predecessor auditor, evaluating the adequacy of the predecessor auditor’s audit procedures, and performing supplemental procedures as needed were difficult. Despite this fact, time and human resources needed for the audit were not sufficiently analyzed when accepting the engagement

(Quality Control Standards Statement No. 1, paragraphs 25 and 26; Auditing Standards 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 to submit amendment reports of annual securities reports and, as is the case with ordinary financial statement audits, appropriate quality control of amendment audits must be ensured from the decision on whether to accept an engagement until submission of the audit report. When 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 between the predecessor auditor and the prospective auditor

Points of focus

In cases where auditors change, the information 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 useful information to determine whether it can accept the proposed audit engagement and perform 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. In particular, in cases where information on material misstatements that have had or could have had an impact on the audit opinion is identified, whether such information is provided to the prospective auditor without omission;
- Whether the prospective auditor, in order to appropriately judge whether or not to accept an audit engagement, makes inquiries of the predecessor auditor on all matters required under the audit standards, such as reasons for the replacement of the audit firm and the status of responses to fraud risks;
- Whether the prospective auditor and the predecessor auditor mutually confirm and 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 handover 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 or suspicious 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

There were deficiencies in that inquiries to the predecessor auditor were not appropriately conducted, and that the predecessor auditor did not correctly convey to the prospective auditor the management's views on integrity.

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. There were also cases in which the PICOQC assumed that, if rules were put in place around the termination of audit contracts and the handover of audit engagements, the engagement team would comply with those rules and apply them appropriately.

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 clear and sufficient manner.

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: Provision of information to the prospective auditor

When handing over an audit engagement, the audit firm communicated to the prospective auditor its awareness that there were no particular problems with the integrity of the management.

However, although the engagement partner at the audit firm had, in the application to withdraw from the audit engagement prepared as part of the firm's internal procedure for withdrawing, explained that there were significant matters with the integrity of the management, the engagement partner **did not accurately communicate this awareness regarding the integrity of the management during the handover to the prospective auditor**. Furthermore, the quality control department at the audit firm had not established procedures for identifying discrepancies between the minutes of the audit engagement handover meeting and the application to withdraw from the audit engagement.

(Quality Control Standards Statement No. 1, paragraphs 27 and 60; Auditing Standards Statement No. 900, paragraph 13)

《Points to Note》

In addition to the above, there were cases where the prospective engagement partner did not ask questions to the predecessor auditor, and cases where, due to a sharp increase in new audit engagements accompanying business expansion, consideration in accordance with the internal rules developed by the audit firm was not completed by the deadline when taking over audit engagements.

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 the audit firm has specific policies and procedures concerning recruitment, and whether they are properly operated.

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 sufficiently 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.

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

The causes of these 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' direction 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 audit team members have a certain level of engagement-related knowledge as a whole, as they left the improvement of skills to the discretion of individual audit practitioner, 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 of training about fraud risk at 12 per year, higher than the necessary minimum of 6 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.
- At training sessions to inform personnel of deficiencies identified in CPAAOB inspections and QC reviews, the audit firm informed personnel of specific areas highlighted and areas where improvements were required by presenting as much of the content of the audit documentation as possible.
- Staff who have not taken the mandatory training courses designated by the audit firm are obliged to take a test concerning the course content so that the firm is able to check the extent of their knowledge of audit engagements and the like.
- The audit firm recognizes that part-time professional staff account for a high proportion of professional staff, and is strengthening its recruitment of full-time professional staff and converting part-time professional staff to full-time professional staff as improvement measures. In addition, the firm is giving careful consideration to renewing contracts with part-time professional staff who engaged in for fewer days.

Expected response

Audit firms, when recruiting assistants to engagement partner, 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 Statement No. 1, paragraphs 17, 28, and A20)

Case 2: Effectiveness of training

① The 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 audit team 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 Statement No. 1, paragraphs 28 and F28-2)

② The audit firm obliged all partners and professional staff members to earn at least 40 credits per year from continuing professional education (CPE) programs offered by the JICPA, and also held two periodic training sessions per year of its own, along with other ad hoc training courses as needed. However, although the PICOQC was aware that partners and professional staff members lacked an understanding of audit standards and of the level of procedures required under current audit standards, **they failed to prepare and implement training programs that took into account the causes, based on a sufficient analysis of deficiencies identified in QC reviews**.

(Quality Control Standards Statement No. 1, paragraphs 28 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 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 left the maintenance and improvement of knowledge, competence/capabilities to individual effort of each professional staff. They only monitored the achievement status of practitioners' CPE (continuing professional education, Currently Continuing Professional Development (CPD))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 cases, 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. There are also many cases where the cause of deficiencies in individual audit engagements lay in the education and training of audit teams.

(2) Evaluation, Compensation, and Promotion

Points of focus

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

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

Outline of inspection results

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

The reasons given for this deficiency include: evaluation of professional staff and determination of their remuneration were based on the CEO's subjective assessment; there were no major differences in the quality of audit engagements performed by professional staff; and it was important to ensure that there were no differences in evaluation among professional staff because the audit firm is a small organization.

(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 in order to evaluate 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’s efforts to improve and maintain their competence and capabilities as well as their compliance 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 partners

The audit firm stipulated that evaluations and compensation for partners were determined based on factors such as the length of the period since the appointment as a partner office, the quality control of audit engagements performed, and the partner's performance.

However, the audit firm did not establish specific evaluation standards for each evaluation item, nor did it clarify how each evaluation item would be reflected in partners' remuneration. As a result, the audit firm **did not have a system in which the evaluation of audit quality, etc. would be reflected in determining partners' remuneration**.

(Quality Control Standards Statement No. 1, Items 15, 17, 28, A5, A20, and A24)

Case 2: Evaluation of partners

NEW

At this audit firm, the CEO carried out evaluations of partners. Based on the performance of each partner, the CEO carried out individual evaluations of each partner on evaluation items such as "audit engagement," "audit quality," and "corporate management," and then carried out an overall evaluation on a three grade scale based on the results of the individual evaluations. In addition, as part of its policy for evaluating compensation based on overall evaluations, the CEO prepared a draft proposal for the following year's partner compensation based on each overall evaluation, and decided on the draft proposal for partner compensation after discussion at the partners' meeting. However, the process for evaluating partners and determining partner compensation at this audit firm was devised independently by the CEO, and the audit firm did not establish rules relating to this process or disseminate them to partners. In addition, the CEO **did not establish specific evaluation standards for each item in the individual evaluations, and all partners had the same evaluation results for the "audit quality" evaluation item**. Furthermore, the CEO did not clarify how the individual evaluations would be reflected in the overall evaluation, and thus evaluations of partners were not carried out in an effective manner.

(Quality Control Standards Statement No. 1, paragraphs 15, 16, 17, 28, A5, 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 clarified specific assessment items, the assessment methods and the quality control items to be emphasized in making assessment**s when deciding on the compensation of part-time professional staff, and had not developed an effective system for evaluating them.

(Quality Control Standards Statement No. 1, paragraphs 28, 29 and 30)

《Points to Note》

In addition to the above cases, the following deficiencies were identified in the evaluation of engagement partners.

- **Cases in which the audit firm's monitoring of the audit engagements for which a professional staff member was responsible was inadequate despite the fact that the professional staff member had been identified as having concerns about his / her quality control capabilities, etc.**
- **Cases in which the compensation of professional staff was determined by the CEO, etc. without being determined by the partners' meeting, although the internal rules on quality control stipulate that the compensation of professional staff members should be determined by the partners' meeting**
- **Cases in which clear standards were not established for the relationship between the evaluation results of factors to be considered in partner evaluation and the classification of base salary evaluation, as well as for the conditions for the payment of evaluation salary**

There were also cases in which, although part-time assistants to engagement partner were subject to the same standard of personnel evaluation as full-time staff, the results of the personnel evaluation of part-time assistants to engagement partner were not sufficiently reflected in promotions/demotions or the composition of engagement teams out of concern that audit engagements could be impeded because part-time staff might quit their jobs if treated strictly.

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 (including engagement partners)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 based on the actual status of 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 so that the firm is able to promote integrated operation.

- The audit firm ascertained the operational workload of each partner by means of a comparative analysis of actual engagement performance against the annual engagement plan drawn up by each partner, and revised assignment of responsibility if necessary.

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

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

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

②When accepting or continuing audit engagements, the audit firm identified audit engagements assessed as having high audit risk as high-risk audit engagements, and in consideration of the results of the risk assessment, determined the most suitable engagement partner and partner in charge of engagement quality control, and subject them to audit quality monitoring by the quality control division.

However, the audit firm **did not reconsider the assignment of engagement partners of some of the audit engagements selected as high-risk audit engagements from the perspective of identified audit risks, and did not select them as engagements subject to audit quality monitoring by the quality control division**.

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

Case 2: Composition of engagement team

Although the PICOQC was aware of issues in the composition of engagement teams in certain audit engagements of a regional office, he/she left audit responses including composition of engagement teams to regional office entirely and did not provide any instruction for improvement as headquarter audit division. **This led to insufficient monitoring by the audit division in head office for the**

composition of engagement teams at the regional office.

(Quality Control Standards Statement No. 1, paragraphs 15, 29, and 30)

Case 3: Assignment of IT auditors

NEW

With regard to the assignment of IT auditors for each engagement team, the individual responsible for IT had a policy of checking whether or not they were certified as "IT audit experts" as stipulated by the audit firm, and whether they had appropriate capabilities in light of the degree of complexity of IT in the audited company they are in charge of.

However, the procedures for assigning IT auditors at this audit firm were found to have the following deficiencies:

- The individual responsible for IT stated that when assigning IT auditors, the individual evaluated their expert knowledge and capabilities based on audit documentation prepared by the IT audit experts in past years and the engagement team's evaluation, but he **did not record the standards applied in this evaluation, as well as the evaluation process and results**.
- The IT audit division manager only monitored the effort of IT audits estimated by the engagement team with regard to the degree of complexity of IT at the engagement, and **did not perform an adequate evaluation based on the use of IT and the IT environment at the audited company**.

(Quality Control Standards Statement No. 1, paragraphs 30, and A27)

《Points to Note》

It is important for audit firms to conduct appropriate risk assessment in line with the actual situation of audited companies, and to compose engagement teams based on the results of such risk assessment. When forming an engagement team, the audit firm shall give due consideration to the quality control capabilities of engagement partners, and shall bear in mind that monitoring by the head office is important for ensuring audit quality.

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 generally accepted auditing standards. 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 and appropriately describe the types of audit procedures performed in accordance with generally accepted auditing standards , 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 and appropriate audit evidence has been obtained to support the reached conclusions and audit opinion.

Outline of inspection results

Concerning the preparation of audit documentation and supervision/review by superiors, many deficiencies, such as not documenting audit procedures performed by engagement teams and the basis for auditor's conclusion, were identified. Such deficiencies indicate that engagement teams did not perform appropriate audit procedures. . Furthermore, as a result of the failure of the engagement partner to review from the perspective of whether the audit procedures performed were appropriate and such procedures were sufficiently 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 review audit documentation and provide instructions to and supervise their assistants and other staff;
- The professional staff did not fully understand the important role of the audit documentation at the time when the audit firm conducts quality control related tasks or explains their audits to external parties;
- Engagement partners did not consider the need to supervise assistants 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 about audited company's 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 concluded his/her understanding by simply hearing oral explanation or equivalent from the assistants.

(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 instructions to assistants to engagement partners.
- ▸ By providing guidance about how to document the performed audit procedures and obtained audit evidence, the audit firm ensured that audit teams were informed of the level of audit procedures to be performed for individual audit engagements, as well as the required status of audit documentation, including the conclusions reached by practitioners and the basis for reaching their conclusions.

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. Therefore, audit firms should ensure that the professional staff is fully aware of the following items:

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 by audit practitioners as well as the basis of professional judgments for reaching such 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 status 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 instructor supervise the team as necessary.

Case 1: 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 Statement No. 1, paragraphs 31 and A31; Auditing Standards Statement No. 220, paragraphs 15 and 16)

②Engagement partners lacked their understanding of procedures required by current audit standards and did not have adequate stance to reflect an understanding of the business of the audited company in audit plans and to verify the sufficiency of audit evidence and audit documentation. Furthermore, engagement partners **were not sufficiently critical because their assistants to engagement partners had audit experience at large-sized audit firms and had been engaged in current audit engagements for a long time, and they were not aware of the need to mutually check the audit documentation prepared by other partners**. Therefore, engagement partners did not sufficiently confirm whether appropriate audit procedures corresponding to risks had been performed and did not sufficiently confirm whether sufficient appropriate audit evidence had been obtained by reviewing audit documentation, etc.
(Quality Control Standards Statement No. 1, paragraphs 31, A30, and A31; Auditing Standards Statement No. 220, paragraphs 15 and 16)

Case 2: Instructions to and supervision of assistants to engagement partner

Engagement partners did not sufficiently identify and assess fraud risks in accordance with the audited company's business and its business environment and did not sufficiently plan procedures to respond to audit risks, and did not appropriately instruct or supervise audit procedures performed by assistants to engagement partners. Engagement partners also **did not conduct in-depth reviews of audit documentation from the perspective of whether management's assertions about accounting estimates were critically examined and whether sufficient appropriate audit evidence commensurate with the identified risks of material misstatement had been obtained**. (Quality Control Standards Statement No. 1, paragraphs 31; Auditing Standards Statement No. 220, paragraphs 14, F14-2, 15, F15-2, and 16)

《Points to Note》

Engagement partners should note 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 were cases in which those in charge of reviews focused on examining the appropriateness of accounting treatment of the audited company and neglected to examine whether the audit procedures performed met the level required by audit standards, and cases in which appropriate reviews based on information obtained from the audited company were not performed. It is important in reviews to critically review whether the level of audit procedures performed by assistants to engagement partners is consistent with current audit standards.

(2) Assembly of final audit files and control and retention of audit documentation

Points of focus

After the date of the auditor's report, and within the due period, auditors 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 status of 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 so that confidentiality, safe custody, integrity, accessibility, and retrievability are ensured; 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.

<u>Outline of inspection results</u>

With regard to the management of audit documentation, audit firms have not yet established specific procedures for assembly of final audit file and the management of audit documentation. Some audit firms have already completed the assembly of final audit file before documentation of significant audit procedures had been completed. Some audit firms have not conducted bookkeeping of audit documentation. In addition, audit firms have not established or implemented policies and procedures for the removal of audit documentation and physical inventory. Furthermore, under the circumstances audit firms have introduced electronic audit documentation systems increasingly in recent years, because these systems are not being properly operated, the dates of preparation and review recorded electronic audit documentation are sometimes manipulated.

The main causes of the identified deficiencies included lack of awareness in the control of audit documentation, as well as the lack of understanding among professional staff regarding the importance of audit documentation at the time when the audit firm conducts quality control related tasks or explains their audit to external parties.

(Observed effective efforts)

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

- From the viewpoint of ensuring the confidentiality, safe custody, information integrity, accessibility, and retrievability of audit documentation, the audit firm converted audit documentation into an electronic format using audit software available in the market in light of its own resources.
- NEW The time required to complete assembly of final audit file is shorter than that required by audit standards, etc.

<u>Expected response</u>

Audit firms should set appropriate quality targets for the preservation and retention of audit documentation, taking into account factors such as the safe storage, integrity, accessibility or recoverability of underlying data, and controls over related technologies. Each audit firm should reaffirm the importance of the control and retention of audit documentation, and re-examine the final assembly of the audit file and the control and retention of audit documentation, under the initiative of the PICOQC, etc. It should ensure that the final assembly of the audit file is completed within an appropriate period after the date of the audit report, and take all possible measures to prevent the loss of audit documentation

and the leakage of confidential information.

Case 1: Assembly of final audit file

The audit firm established policies and procedures for the final assembly of the audit file and a deadline for completing the final assembly of the audit file in its quality control rules. In addition, if it became necessary to amend existing audit documentation or add new audit documentation after the deadline for completing the audit file documentation, the audit firm required to document (a) the specific reason for the amendment or addition, (b) the person who made the amendment or addition and the date of making the amendment or addition, and (c) the person who reviewed the amendment or addition and the date of reviewing, and developed a standard audit documentation format for this purpose.

However, the engagement partner **did not retain part of the audit documentation in the audit file, and even though some of the audit documentation had been amended after the deadline for completion of the documentation, the specific reasons for the need for amendments, etc. were not documented as prescribed**.

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

Case 2: The date of preparation and review of the electronic audit documentation;

NEW

The audit firm's quality control rules stipulate that the person who prepared the electronic audit documentation and the date of preparation, as well as the person who reviewed the electronic audit documentation and the date of review shall be clearly identified through prescribed electronic signature procedures. However, the PICOQC did not prohibit post-hoc correction of the actual date of preparation and date of review of the audit documentation to a date prior to the date of audit report on the electronic audit documentation system, and did not instruct retention of the edit history of the audit documentation on the electronic audit documentation system.

As a result, although audit documentation was prepared and reviewed after the date of audit report in some audit engagements, a deficiency was identified in that the date of preparation and date of review of audit documentation recorded on the electronic audit documentation system was corrected to a date prior to the date of audit report, and **no measures were taken to prevent post-hoc correction of the actual date of preparation and date of review of audit documentation**.

(Quality Control Standards Statement No. 1, paragraph 31, 45 and A52)

《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 properly carried forward , despite the fact that the adequacy of the audited company's accounting policies had been examined in previous fiscal years in individual audit engagements. In addition, in the process of promoting digitalization of audit documentation, it is necessary to pay attention to whether the electronic audit documentation system is appropriately established and operated in accordance with the quality control rules established by the audit firm.

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, the significant audit judgments and opinions made by the engagement teams throughout 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 the audit planning, significant audit judgments, and expressions of audit opinion in a timely manner;
- 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 examines 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 and 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 and conclusions made by the engagement team.

Outline of inspection results

There were cases of deficiencies in the qualifications of EQC reviewers, such as failure to appoint persons with abilities corresponding to audit risks, as well as cases where EQC reviewers did not objectively review the sufficiency and appropriateness of audit evidence for significant audit items or the judgment process, and thus failed to identify significant deficiencies in audit procedures. In addition, deficiencies in the operation of EQC reviews were often identified as a result of analyzing the causes of deficiencies in 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 putting a priority on 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, the PICOQC did not aware of the need to develop an adequate review system;

The EQC reviewer only verified the same matters as the deficiencies identified in the CPAAOB inspections and quality control reviews, etc., and did not verify the status of responses to the same matters similar to the deficiencies in the course of the EQC review;

- As the engagement team did not pass on to the EQC reviewer (including in cases outsourced to an external EQC reviewer), in writing or by any other appropriate means, information regarding the condition of the audited company and the consideration 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 work papers. In addition, the EQC reviewer lacked awareness to critically examining 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 the work of the engagement team and the EQC reviewer did not become hectic. As a result, engagement quality control reviews were performed with plenty of time and profound perspectives instead of being performed precipitously right before formulating audit opinions.

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 perspective 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, the engagement team should not only discuss significant matters for forming the audit opinion with the engagement partner, but also review the audit documentation to determine whether the conclusions of the engagement team are supported by sufficient appropriate audit evidence. In particular, at some small and medium-sized audit firms, partners who are EQC reviewers are usually extremely busy because they are engaged in business operations with a small number of partners, and because they give priority to their own audit engagements, it is difficult to conduct appropriate EQC reviews. For this reason, it is necessary to take actions to enhance and strengthen EQC reviews while reaffirming the importance of EQC reviews of audit engagements.

Case 1: Eligibility of the EQC reviewer

The audit firm's quality control policies stipulates 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 Statement No. 1, paragraph 38)

Case 2: Ensuring the effectiveness of EQCR

①Regarding EQC reviews, the audit firm stipulated in its quality control policy that if any material misstatements due to fraud emerged, the adequacy of the amended audit plan, and the sufficiency and appropriateness of audit evidence obtained should be reviewed at a partners' meeting. However, **a review at a partners' meeting was not carried out when conducting an audit on amended financial statements arising from a material misstatement due to fraud**.
(Quality Control Standards Statement No. 1, paragraphs 36 and 37)

②As only one person was in charge of conducting the EQC reviews for almost all of the audit firm's listed audited companies, he/she was unable to make sufficient time available for each review when several reviews coincided. Accordingly, **the EQC reviewer judged that understanding the engagement teams' explanation of key audit matters would be sufficient, and completed the review by concluding that there were no problems with the key judgments and conclusions of the engagement team, without sufficiently reviewing the relevant audit documentation**.
(Quality Control Standards Statement No. 1, paragraphs 36 and 37)

NEW

③**The EQC reviewer assumed that the engagement team had appropriately responded to important matters that had been discussed in ongoing communication with the engagement team**. Therefore, the EQC reviewer concluded that there were no problems with the important judgments and conclusions made by the engagement team without fully examining the related audit documentation with respect to the evaluation of and responses to fraud risk and significant risks and important judgments on significant accounting estimates made by the engagement team.

(Quality Control Standards Statement No. 1, paragraphs 36 and 37)

Case 3: Examination in the Financial Instruments and Exchange Act Audit

The engagement team did not inform the audited company that, at the time the audited company submitted its financial statements to EDINET, **the response to consultations from the department in charge and the review of audit engagements had not been completed, and the firm was not in a position to make an official expression of its opinion**; this led to the situation where the engagement team submitted the financial statements to EDINET that appeared as if the opinion had already been expressed, despite the fact that the EQC reviews had not been completed and the audited company's audit opinion was not yet expressed.

(Quality Control Standards Statement No. 1, paragraphs 14 and 41; Auditing Standards Statement No. 220, paragraphs 17)

《Points to Note》

The EQC reviewer needs to verify not only whether the accounting processes were suitable but also whether sufficient and appropriate audit evidence was obtained, and to make objective evaluations of engagement teams' explanations based on recorded facts by reviewing audit documentation.

In particular, with regard to audit engagements at regional offices, if the EQC reviewer at the headquarters, who is remotely located, conducts the EQCR via a videoconferencing system, etc., it is necessary to take actions such as sending the necessary audit documentation in advance..

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 assigning internal personnel to EQCR.

Furthermore, if the date of the audit report based on the Financial Instruments and Exchange Act is the same as the date on which the financial statements, etc. is submitted to EDINET, it is necessary to ensure sufficient communication with the audited company so that the financial statements, etc. is not submitted to EDINET before the examination is completed.

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 issues relating to the QC system and to remediate such issues. For this reason, audit firms are required 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 ongoing 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 a person with sufficient and appropriate experience as the person responsible for the monitoring of the system of quality control, and vests the assigned person with sufficient authority;
- Whether the audit firm sets up monitoring system which appropriately understands the status of the establishment and implementation of a quality control system and identifies deficiencies; 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 to audit teams and reviewing audit documentation, not only by superficial inspection using the checklist, etc.;
- Whether the audit firm selects target engagements for periodic inspections by sufficiently taking into account deficiencies in the audit procedures identified during the QC review, the CPAAOB's inspection or other occasions;
- Whether the audit firm analyzes the impact of deficiencies identified as a result of inspections, has the relevant engagement partner take improvement measures, and verifies the appropriateness of such measures; and

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

The CPAAOB inspects Statements of objection and doubt from the following perspectives:

- Whether an appropriate system for a statements of objection and doubt has been established;
- Whether proper investigation is conducted based on the accepted statements; 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 engagements subject to periodic inspection so that each engagement partner's work is inspected at a frequency of around twice every three years.
- NEW In order to detect quality control issues in audit engagements at an early stage and enable audit firms to take systematic action, audit firms select audit engagements to be monitored based on the results of analysis of published financial statements and timely disclosure information, and the content of audit documentation is checked by a monitoring staff separate from the EQC reviewer by the date of the audit report required under the Companies Act.

Expected response

Audit firms are required to establish and implement 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 system of quality control and voluntarily implement remediation 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 establish a system which ensures that qualified persons inspections conduct periodic inspections, rather than merely conducting superficial 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 establish and implement a system which enables 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 person responsible for ongoing monitoring of the quality control system only checked on the existence of relevant documents (rules, etc.) based on the ongoing monitoring checklist and the like, and **did not perform in-depth inspections of the content of the relevant documents**. As a consequence, the person failed to point out multiple deficiencies in the quality control system identified by CPAAOB inspections, including those relating to the establishment and implementation of internal rules.
(Quality Control Standards Statement No. 1, paragraph 47)

Case 2: Effectiveness of periodic inspection

①**The persons in charge of periodic inspections merely conducted superficial checks based on the checklist without setting forth specific viewpoints of inspection and did not spend sufficient time on those checks. This resulted in 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 and that the number of deficiencies identified was smaller than that 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 a system to ensure the implementation of effective periodic inspections, for example by increasing the number of persons in charge of periodic inspections.
(Quality Control Standards Statement No. 1, paragraphs 47 and 48)

② 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. **<u>They were not based on the causes of the deficiencies</u>**.

Furthermore, confirmation of the status of improvements was limited to engagements subject to periodic inspections, and the status of improvements with another engagements was not confirmed.

(Quality Control Standards Statement No. 1, paragraphs 49 and 50)

《Points to Note》

In addition to the above, there were cases where persons were selected to carry out periodic inspection without consideration for their abilities with regard to audit quality, where a system was being implemented in a manner leading to collusion, e.g., the majority of partners were selected to carry out periodic inspection and they carried out inspection among themselves, and where audit engagements of specific engagement partners were not targeted for periodic inspection.

Other cases included a failure to develop an effective system for monitoring the quality control. For example, the monitoring of the quality control system was conducted solely by the CEO in some cases, while the frequency of periodic inspection of each audit engagements was too low in other cases.

From the perspective of analyzing deficiencies identified in the quality control review and preventing / discovering the identified deficiencies in advance, it is important to evaluate again whether periodic inspections were not limited to formal confirmation of the existence of audit documentation based on checklists, but were implemented effectively.

Case 3: Statements of objection and doubt

①Even though the representative partners received information about fraud at an audited company via a hotline, they **<u>did not inform the PICOQC of the information they had obtained</u>**.

Furthermore, even though the “Audit Quality Management Rules” stipulated that engagement partners in charge of audited companies should report how they considered whistleblowing from internal and external parties to the division in charge of quality control in writing, they did not make such reports.

(Quality Control Standards Statement No. 1, paragraph F54-2)

②However, the audit firm did not set up a contact point for accepting information related to fraud risk received from outside the firm, and **<u>did not establish a specific system for responding to information related to fraud risk received from outside the firm</u>**.

(Quality Control Standards Statement No. 1, paragraph F54-2)

《Points to Note》

Audit firms need to establish well-defined whistle-blowing systems so that expert personnel can raise complaints and doubts without being subject to unfair treatment. Audit firms that conduct audit

engagements in compliance with the Standards for Responses to Fraud Risks of Listed Companies, etc. need to receive information relating to fraud risks provided to them by inside and outside audit firms.

It should be noted that it is necessary to take measures to ensure the effectiveness of these systems for internal and external reporting, including not only establishing contact points but also establishing a system that enables appropriate examination by the audit firm, and making professional staff aware of such systems.

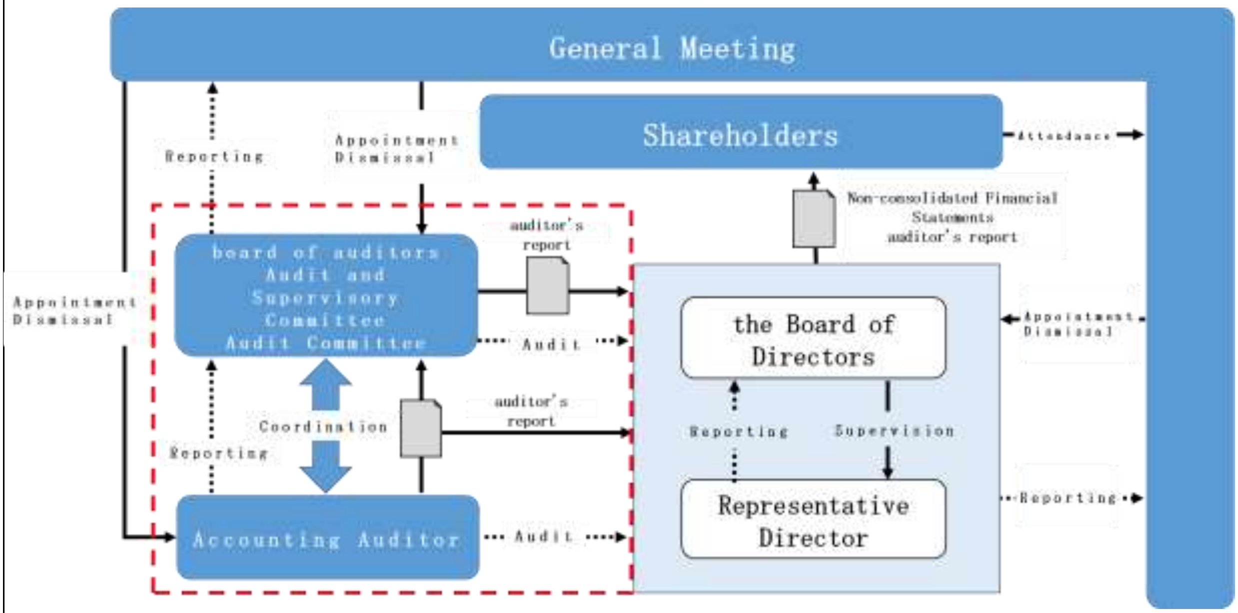
9. Cooperation with Company Auditors

(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 through actively exchanging information and opinions, for example, they should share information identified during audits in a timely manner, or company auditors should understand the status of QC of audits undertaken by accounting auditors. (Refer to [Figure 5])

［Figure 5］ Reference image: Relationship between Company Auditors and Accounting Auditors



Source: Prepared by the CPAAOB based on data published by the JICPA

In light of the importance of collaboration between accounting auditors and company auditors as described above, the CPAAOB inspects whether policies and procedures for communication with company auditors and responses when fraud, etc. is detected are appropriately established and implementation systems are developed and established from the following perspectives:

- Whether suitable provisions, requiring timely communication with company auditors at each phase of audits (planning, conducting, and reporting) and share of necessary information for enhancing both sides' audit work, have been stipulated;
- Whether a procedure in which, for example, basic forms and model sentences are prepared, has been put in place so that suitable explanations of the results of CPAAOB inspections and the results of quality control reviews are reported to audited companies in writing; and
- Whether the audit firm has properly established policies and procedures concerning responses to

non-compliance.

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

- Whether communication with company auditors concerning the accounting auditor's responsibilities, the scope of the planned audit, and an overview of its timing is clearly being carried out ;
- Whether explanations of the results of CPAAOB inspections and quality control reviews are suitably provided in writing to audited companies ;
- Whether information on audits is being properly obtained from company auditors ;
- Whether issues that are discovered during accounting audits and deemed to be important are conveyed in a timely manner to company auditors, etc. responsible for overseeing the financial reporting process; and
- Whether accounting auditors and company auditors cooperate and engage 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, due to a lack of understanding of the items requiring communication, there were some cases in which communication was inadequate 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 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 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 implementation 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 audit planning to the implementation of audit procedures and the formation of an auditor's opinion – and significant 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.
In addition, the 2018 revision of auditing standards and related revisions to the Auditing Standards Report required the inclusion of Key Audit Matters ("KAM") in audit 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.
Audit firms need to establish 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 implementation 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 is being inspected by the CPAAOB, is not permitted during the inspection.

Case: 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 contents of and the steps taken in response to the "Quality Control Review Report" and the "Follow-up Review Report" received from JICPA** that are very useful for company auditors when selecting accounting auditors.
(Auditing Standards Statement No. 260, paragraphs 16 and A31)

NEW

②The engagement team did not communicate sufficiently with the company auditors, as it failed to provide reports on the following matters:

- **Uncorrected misstatements which came to light after the issuance of the audit report on the Companies Act audit;**
- **The draft of the written representations by the auditor in an audit under the Financial Instruments and Exchange Act.**

(Auditing Standards Statement No. 260, paragraph 13 and 14; No. 600, paragraph 48; and No. 610, paragraph 16)

《Points to Note》

Auditor should keep in mind that they must communicate with company auditors on matters required in the Auditing Standards Report in a timely basis. For example, the timing of communication regarding the draft of the written representations and communication regarding independence should be determined based on measures that company auditors are expected to take. In addition, if there are any changes in the audit plan, such as changes in significant risks during the term, or any changes in matters communicated with company auditors, such as uncorrected misstatements discovered after the issuance of the Companies Act Audit Report, it is necessary to communicate with company auditors again in a timely manner. Furthermore, when conducting both Financial Instruments and Exchange Act audits and Companies Act audits of audited companies, the scope of audits and the date of the audit report differ. Therefore, even at the final stage of Financial Instruments and Exchange Act audits, it is necessary to communicate with company auditors on matters required in the Auditing Standards Report, such as draft management agreements and the results of internal control audits. It should be kept in mind that when communicating verbally with company auditors, the auditor must record in the audit documentation when, with whom, and on what topics the communication was conducted.

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

Points of focus

In the event of discovering any fact that may affect ensuring the appropriateness of financial statements (a fact such as a violation of laws and regulations) of the audited company, the auditor is obligated to 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 importance of such notice for ensuring the appropriateness of financial statements, the CPAAOB inspects the status of how the audit firm responded to the detection of fraud or non-compliance.

Outline of inspection results

(Observed effective efforts)

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

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

Additionally, as a result of the audit firm having provided notice to the entity in accordance with Financial Instruments and Exchange Act Article 193-3 about matters that could adversely impact the appropriateness of financial documents, the entity revised its Financial statements and sought to reinforce its systems for suitable disclosure.

Expected response

It should be kept in mind that in the event of detecting any deficiency during an audit that may affect the appropriateness of financial statements, audit firms should respond to such deficiency by facilitating audited companies to make corrections, including considering whether to give notice under Article 193-3 of Financial Instruments and Exchange Act.

A support system for engagement teams must also be established so that experts are able to provide appropriate opinions when audit judgments about fraud or non-compliance are made.

Please refer to "Practical Guidelines for Audits of Financial Statements Included in Amendment Reports" (revised in January 2023), Auditing Standards Statement 560, Practical Guidelines No. 2, published by the JICPA, for points to be noted in order for auditors to take appropriate actions in audits of amended financial statements included in amendment reports for financial statements, interim reports, and quarterly reports.