Ⅲ． Individual Audit Engagements

Audit Engagement Performance

Summary

Examples of deficiencies in individual audit engagements identified during the CPAAOB's inspections broadly cover audit planning through to the formulating of auditor's opinions.

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

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

Furthermore, cases that have continued to appear since being identified in previous program years and identified at multiple audited companies cases are presented with the mark: **FREQUENT**

Analysis of deficiencies

Deficiencies identified in individual audit engagements result from some form of failures of satisfying requirements of audit standards or standards of the Auditing Standards Statement ("requirement(s)").

Reflecting the situation surrounding engagement teams and audited companies, various factors were described as the causes of deficiencies. In recent cases, the following causes were identified relatively frequently:

・Insufficient consideration for suitability of further audit procedures to audit risk and the sufficiency and appropriateness of audit evidence;

・Lack of an attitude of professional skepticism required of an auditor; and

・Insufficient understanding of the level of procedures required by current audit standards and the Auditing Standards Statement.

(1) Cases of inadequate consideration of the suitability of risk-related audit procedures to audit risk and the sufficiency and appropriateness of audit evidence

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

1) Risk assessment at the audit planning stage

In some cases, the auditors did not plan audit procedures for addressing risks that should in principle have been assumed at the assertion level (refer to "1. The Auditor's Responsibilities Relating to Fraud in Financial Statement Audits"(2) and "2. Risk Assessment and Response to Assessed Risks"(2), and "5. Group Audit" Case 1) due to the insufficiency of their own risk assessment.

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

2) Evaluation of obtained audit evidences

Auditor have to conclude whether sufficient and appropriate audit evidences have been obtained. If not, he/she needs to perform additional audit procedures. In principle, whether sufficiency and appropriateness of obtained audit evidence should be checked through means such as a review by superiors, but there were cases in which the obtained audit evidence was not sufficiently evaluated (refer to "1. The Auditor's Responsibilities Relating to Fraud in Financial Statement Audits"(4) and "3. Audit Evidence")

With regard to risks of material misstatement at the assertion level, auditors should note that they are required to obtain more suitable and more attestable, or more audit evidences if any, compared to cases where no risk of fraud is identified.

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

Auditors should always strive to improve their professional skills and accumulate knowledge gained through practical experience as professional experts. They are also required to conduct audits with due care as professional experts and professional skepticism throughout the entire audit process. In this regard, there were cases in which, for examples, they failed to perform the procedures for verifying the reasonableness of the management's assertions such as the feasibility of business plans used in accounting estimates due to a lack of professional skepticism (refer to "4. Auditing Accounting Estimates).

Auditors need to continuously pay attention to the possibility of material misstatement due to fraud and retain a professional skepticism throughout the entire audit process, regardless of the auditors' past experience concerning the reliability and sincerity of management, directors and company auditors.

(3) Insufficient understanding of the level of procedures required by current audit standards and the Auditing Standards Statement.

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

- Cases in which the engagement team did not identify and assess fraud risks according to the types of revenue and transactions of the audited company (refer to "1. The Auditor’s Responsibilities Relating to Fraud in an Audit of Financial Statements " (2)), or did not perform sufficient audit procedures suited to fraud risks (refer to "1. The Auditor’s Responsibilities Relating to Fraud in an Audit of Financial Statements" (3))

- Cases in which substantive procedures were not performed for significant account balances (refer to "2. Risk Assessment and Response to Assessed Risks" (3)).
- Cases in which the reliability of basic data was not evaluated in the substantive analytical procedures (refer to "3. Audit Evidence" (3)), or in which sufficient and appropriate evidence was not obtained when the difference between the booked value and the estimated value was larger than the tolerable level of difference (refer to "3. Audit Evidence" (3)).
- Cases where the suitability and reliability (accuracy and completeness) of information used as audit evidence was not verified (refer to "3. Audit Evidence" (1))
- A case where accounting estimates for the previous fiscal year were not considered in evaluating management's estimates for the current fiscal year (refer to "4. Audit of Accounting Estimates"(4)), or a case where the reasonableness of management's assumptions and the reliability of basic data were not considered (refer to "4. Audit of Accounting Estimates"(4))
- Cases in which the specific procedures to be performed by component auditors in order to address significant risks related to group financial statements were not understood or considered in group audits (refer to "5. Group Audit," Case 4), in which the appropriateness of risk-related audit procedures was not evaluated (refer to "5. Group Audit," Case 8), or in which the matters reported by component auditors were not evaluated (refer to "5. Group Audit," Case 8).
- Cases where the necessity of Auditor's expert has not been considered (refer to "6. Using the Work of Auditor’s experts").
- Cases in which, in audits of internal controls over financial reporting, the adequacy of the scope of internal control was not examined (refer to "7. Audit of Internal Control over Financial Reporting" (1)) or in which the impact of the identified material misstatements on the audit of internal controls was not examined (refer to "7. Audit of Internal Control over Financial Reporting" (3)).
- Cases in which procedures not performed are listed as KAM (refer to "8. Key Audit Matters (KAM)").

If the engagement team does not sufficiently understand the level of procedures required by current audit standards and the Auditing Standards Statement, it will not be possible to obtain sufficient appropriate audit evidence from the audit procedures performed, leading to deficiencies in audit procedures.

Expected response

Engagement teams are required to sufficiently exert professional skepticism in all audit aspects, as well as to update and expand the required knowledge such as audit standards. Based on this, they necessitate to respond to individual audit engagements from the perspective of whether sufficient audit plans are formulated according to misstatement risks, and whether the audit procedures planned are performed

according to the requirements of standards of audit in order to reduce audit risk to a reasonably low level.
There continue to be many cases where engagement teams argue “deficiency in audit documentation” when identifying deficiencies in individual audit engagements. This argument means that the team actually performed audit procedures but neglected to document them.
In this regard, unless the argument by the engagement team is objectively proven by audit documentation, etc., it cannot be determined that the audit procedures were completed before issuance of the audit opinion. Therefore, close attention should be paid so that such cases are treated the same as when audit procedures were not performed.

Audit firms are required to ensure and improve the quality of individual audit engagements through QC systems to prevent the occurrence of deficiencies that were identified in individual audit engagements.
In order for the penetration and establishment of measures over an entire firm, it may need to establish a system that monitors each engagement team’s understanding of improvement measures, as well as the implementation status of improvement measures by each engagement team. When improving audit engagements, not only additionally establishing new quality control system, but also the use of existing systems including periodic inspections and QC reviews is effective. Each audit firm is required to take efforts for effective and efficient improvement for audit quality in a way that suits the characteristics of each firm.
Regardless of the size of the audit firm, some deficiencies in individual audit engagements are caused by engagement partners whose understanding of the concept of the risk-based approach are insufficient. In such case, it is necessary to note that audit firms are required to respond with organizational and adequate measures, such as re-education of partners and appropriate assignment.

According to the Auditing Standards Statement No. 260, etc., deficiencies in individual audit engagements identified by the CPAAOB's inspections need to be explained to those in charge of governance of the audited company that was subject to the inspection. Therefore, each engagement team needs to strive for exact understanding of the deficiencies so that it can explain the deficiencies that were identified in the inspection to the audited company.
Furthermore, it is necessary for not only the engagement teams that were subject to inspection but also other engagement teams to refer to the deficiencies identified in the CPAAOB’s inspections, QC reviews, and periodic inspections within the firm so that they are able to examine/review their audit work appropriately.

(Reference)
Regarding deficiencies identified in individual audit engagements, the provisions on criteria and points to note relating to frequently identified deficiencies are shown below.

Deficiency	Provisions Often Serving as Criteria for Identification	Relevant Points to Note
1. The Auditor's Responsibilities Relating to Fraud in Financial Statement Audits	Auditing Standards Statement No. 240, Paragraphs 25, 29, 31	➢ Whether the engagement team easily limits fraud risks. ➢ Whether the engagement team designs and implements adequate audit procedures suited to the identified fraud risks. ➢ Whether the engagement team performs procedures to respond to audit risks, such as verifying evidence, for all journal entries extracted in the journal entry test.
2. Risk Assessment and Response to Assessed Risks	Auditing Standards Statement No. 330, Paragraphs 17, 20	➢ Whether the engagement team plans the nature, timing, and extent of risk-related audit procedures, in accordance with the assessed risks of material misstatement at the assertion level. ➢ Whether the engagement team designs and implements substantive procedures for important transaction types, account balances, and notes, etc., regardless of the degree of the assessed risks of material misstatement.
3. Audit Evidence	Auditing Standards Statement No. 500, Paragraphs 5~8; No. 520, Paragraph 4, 6; No. 530, Paragraphs 7; No. 570, Paragraph 15	➢ Whether the engagement team confirms that it has obtained sufficient appropriate audit evidence for the purpose of each audit procedure for the dual-purpose test. ➢ Whether the engagement team evaluates the competence, capabilities and objectivity of experts employed by the management, and examines the appropriateness of the experts' work. ➢ Whether the engagement team examines the reliability of data prepared by the audited company. ➢ Whether, when performing substantive analytical procedures, the engagement team examines the reliability of the data, the accuracy of the expected values, and reason of any differences that exceed the acceptable level.

Deficiency	Provisions Often Serving as Criteria for Identification	Relevant Points to Note
		➢ Whether, when performing audit sampling, the engagement team examines the validity of the sample selection method and sample size. ➢ Whether the engagement team examines, based on specific audit evidence, whether the management's response measures relating to the assessment of the going concern assumption are effective and feasible.
4. Auditing Accounting Estimates	Auditing Standards Statement No. 540, Paragraphs 13, 21～23; No. 500, Paragraph 8	➢ Whether the engagement team examines the appropriateness of policies established by the audited company, such as inventory valuation rules and the grouping for impairment judgement of fixed assets. ➢ Whether the engagement team examines the reliability of data prepared by the audited company when audit of accounting estimates. ➢ Whether the engagement team examines the audited company's material assumptions, such as the feasibility of the business plan, based on concrete evidence. ➢ Whether the engagement team considers and evaluates all relevant audit evidence obtained in the course of the audit, including contradictory information. ➢ Whether the engagement team evaluates the appropriateness of the work of experts used by the management as audit evidence. ➢ Whether the engagement team examines whether expert skills and knowledge are necessary for the engagement team, including whether or not the use of auditor experts is necessary.
5. Group Audit	Auditing Standards Statement No. 600, Paragraphs 29, 30, 39, 40~42	➢ Whether the engagement team is appropriately involved in tasks undertaken by component auditors. ➢ Whether the engagement team comprehensively

Deficiency	Provisions Often Serving as Criteria for Identification	Relevant Points to Note
		communicates to component auditors the significant risks and related parties involved in the group financial statements. ➢ Whether the engagement team sufficiently evaluates the audit procedures performed by the component auditor in response to audit risks. ➢ Whether the engagement team has taken necessary additional actions as a group engagement team in response to the component auditor's report;
6. Using the Work of Auditor's Experts	Auditing Standards Statement No. 620, Paragraph 6	➢ Whether the engagement team examines the necessity of using the work of experts when specialized knowledge is required;
7. Audit of Internal Control over Financial Reporting	Auditing Standards Statement No. 265, Paragraph 6,7 No. 610, Paragraph 13, 14, 19 Auditing Standards for Internal Controls over Financial Reporting Statement No. 1, Paragraphs 97, 101, 112, 187	➢ Whether the engagement team examines consistency between the scope of risk assessment in financial statement and that of effectiveness evaluation of internal controls conducted by management. ➢ Whether the engagement team examines the impact on internal control audit of misstatements and internal control deficiencies identified in the course of the financial statement audit. ➢ Whether, in cases where the engagement team uses the work of internal auditors, the engagement team evaluates the objectivity and capabilities of the internal auditors and evaluates the appropriateness of the work to be used, and whether the scope of use of internal auditors is appropriately determined according to the degree of the risk of material misstatement;
8. Key Audit Matters (KAM)	Auditing Standards Statement No. 701, Paragraph 12	➢ Whether the engagement team performed the audit procedures described as an audit response to KAM.

1. The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements

Points of focus

Users of financial statements are increasingly paying more attention to fraud that may result in material misstatement of financial statements. Considering this, the CPAAOB inspects the auditor's response to fraud risks in an audit of financial statement from the following perspectives:

- Whether the engagement team maintains professional skepticism throughout the audit, and exercises such skepticism so as not to overlook any circumstances that indicate the possibility of a material misstatement due to fraud, when assessing the risks of material misstatement due to fraud, responding to such risks, and evaluating audit evidence that has been obtained;
- Whether the engagement team substantially discusses the possibility of material misstatement due to fraud; and whether the engagement team places emphasis on where and how material misstatement due to fraud may occur in financial statements, including how fraud is committed, without assuming the reliability and integrity of the audited company's top management, directors, and company auditors;
- Whether the engagement team evaluates whether the information obtained from other performed risk assessment procedures and related activities indicates the presence of fraud risk factors and takes such risks, if any, into account when identifying and assessing the risk of a material misstatement due to fraud at two levels, i.e. the financial statement level and the assertion level; whether the engagement team makes judgements as to which types of revenue, sales transactions or assertions may give rise to fraud risks; and, when making such judgments, whether the engagement team conducts sufficient consideration in light of the audited companies' business processes, without easily limiting areas where fraud risks are considered to exist;
- Whether the engagement team evaluates whether unusual or unexpected relationships identified through the performance of analytical procedures could indicate a risk of material misstatement due to fraud;
- Whether the engagement team obtains audit evidence more relevant, reliable and/or quantity of audit evidence, for the risks of material misstatement due to fraud at the assessed assertion level than in cases where no risk of fraud has been identified;
- Whether the engagement team evaluates if a misstatement, in the case that one is identified, is indicative of fraud; recognizes that, when such misstatement is determined to be indicative of fraud, an instance of fraud is unlikely to be an isolated occurrence; and pays extra attention to the relationship with other aspects of the audit, particularly evaluating the reliability of statements by the management, and reviews and modifies its audit plan as needed after evaluating the implications of such misstatement;
- Whether the engagement team makes inquiries of and asks for explanations from the management when it identifies any circumstances that indicate the possibility of a material misstatement due to fraud during the audit, and performs additional audit procedures; and modifies its risk assessment

and planned responses to audit risk to include audit procedures that are specifically responsive to the types of possible fraud if it determines that any suspected material misstatement due to fraud exists; and

- Whether the engagement team adequately communicates with company auditors who supervise the execution of duties by directors, if it determines that suspected material misstatements due to fraud exists or suspects fraud involving the management.

<u>Outline of inspection results</u>

As examples of deficiencies in audit procedures relating to fraud risks in financial statement audits, there were cases in which the engagement team did not sufficiently examine whether unusual or unexpected relationships identified through audit procedures could indicate the risk of material misstatement due to fraud.

Other cases were also observed in which: the engagement team failed to assess the risk of a material misstatement due to fraud in view of changes at the audited company; the engagement team identified the risk of a material misstatement due to fraud with regard to revenue recognition only in areas where particularly high risks were considered to exist and determined without due consideration that there was no risk of a material misstatement due to fraud in other areas; the engagement team did not sufficiently perform further audit procedures, although it identified the risk of a material misstatement due to fraud with regard to revenue recognition; the engagement team performed only perfunctory risk-related audit procedures in order to address risks related to management override; the engagement team did not carefully assess fraud risks with taking into account the possibility of fraud, although it identified significant and unusual transactions outside the normal course of business with related parties and unusual transactions.

In addition to the above cases, there were cases in which the engagement team assessed that the impact of the misstatement due to fraud on the financial statements was limited without fully examining the impact of the misstatement on the financial statements because it occurred on an isolated basis.

(Observed effective efforts)

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

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

  Because of the commonality in revenue types and transaction formats between the parent company and its sales subsidiaries, the group engagement team conducted a centralized risk assessment and proposed further audit procedures to address fraud risks pertaining to revenue recognition by the audited corporate group inclusive of the parent company and key sales subsidiaries that constitute significant components

NEW

・ In order to prevent the omission of fraud risks pertaining to revenue recognition, the audit firm develops a sample work paper within the firm in which all transaction types (business flows) are listed so that the total sales for each transaction type (business flow) matches the amount of sales recorded in the general ledger, and each transaction is examined what fraud risks should be identified.

Expected response

Conventionally, auditors have been required to maintain professional skepticism. Since the Fraud Risk Response Standard emphasizes the maintenance and exercise of professional skepticism, auditors should pay attention to the fact that they are expected to maintain professional skepticism in all processes of auditing and exercise it when examining the risk of a material misstatement due to fraud.
In particular, all auditors must recognize anew that the reliability of audit has once again been called into question following recent cases of fraudulent accounting.
Therefore, when preparing audit plans, in order to examine if there are fraud risk factors, auditors are required to understand major fraud cases published as well as general and industry-specific business practices that may be used for fraud, obtain information through interviews with managers and other employees, and carefully examine whether the information obtained indicates the presence of fraud risk factors through discussions within the engagement team.
Furthermore, auditors should consider identified fraud risk factors and identify and assess the risk of a material misstatement due to fraud at two levels, i.e. at the level of the financial statement as a whole, and at the assertion level. When identifying and assessing fraud risks related to revenue recognition, auditors should give due consideration where and how material misstatements due to fraud may occur in financial statements in light of their understanding of the audited company and its business processes, without easily limiting areas where fraud risks are considered to exist.
Auditors should always keep in mind the possibility that a material misstatement due to fraud could occur and prepare overall responses appropriate to the risk of a material misstatement due to fraud at the level of the financial statement as a whole and further audit procedures for addressing the risk of a material misstatement at the assertion level.
In performing the procedures to address the risk of a material misstatement due to fraud, auditors should keep in mind that they are required to obtain more relevant and stronger audit evidence in greater quantity with regard to assertions regarding the identified fraud risks than with regard to assertions over which no fraud risk has been identified.
If auditors have identified circumstances that indicate material misstatement due to fraud during the process of audit procedure, they should determine whether the assessment of the risks of material misstatement due to fraud is still appropriate. Furthermore, if auditors have identified circumstances that indicate the possibility of a material misstatement due to fraud, they should make inquiries of and ask for explanations from the management, and they should perform additional audit procedures in order to determine whether the suspected material misstatement due to fraud exists. In cases where there are

suspicions about a possible material misstatement due to fraud, such as when the management's explanations are considered to be not reasonable, it is necessary to keep in mind the need to modify their risk assessment and designed further audit procedures and perform audit procedures that are specifically relevant to the type of fraud that may be assumed.

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

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

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

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

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

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

《Points to Note》

Engagement teams should exercise professional skepticism to identify fraud risk factors, such as motivations or pressures to commit fraud, or events or conditions that provide opportunities to commit fraud, and assess the risks of material misstatement due to fraud, by identifying audited companies' transaction types, industry practices, and past fraud cases. To this end, it is important that engagement teams engage in substantive discussions, with the engagement partners providing leadership. In addition to the above examples of deficiencies, there were cases in which the engagement team's discussion of fraud risks was only a formality, and the engagement team did not substantially discuss the risks considered from fraud cases published to date in relation to the audited company's characteristics, such as industry type and governance. There were also cases in which the engagement team's communication with management and company auditors regarding fraud was only a formality, and the information obtained from the communication was not reflected in the risk assessment.

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

Case: Identifying and assessing fraud risks in revenue recognition

FREQUENT

①The audited company is engaged in business A and B. In both businesses, transactions for which the price per each transaction is relatively small account for the majority of all transactions.

However, in business B, transactions for which the price per transaction is high occur several times a year.

In light of these circumstances, the engagement team assessed that the transactions in Business B involving price of money per transaction had a high fraud risk, and planned and performed audit procedures such as cross-checking with cash-receipt vouchers and checking the status of system development, in addition to cross-checking with order and acceptance vouchers. In addition, the engagement team assessed that there was a fraud risk of fictitious recording in overall sales excluding transactions involving large price per transaction, and responded by expanding the number of transactions subject to detailed testing compared to cases where no fraud risk had been identified.

However, although the engagement team assessed that transactions with large price per transaction had high fraud risks, and that overall sales excluding such transactions also had fraud risks of fictitious sales, the engagement team **did not sufficiently consider these fraud risks from the perspective of specifically what kind of methods would be used to commit fraud**.

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

FREQUENT

②The audited company ran a home furnishings wholesale business. The engagement team identified the risk of fraudulent sales being booked in respect of transactions carried out using a miscellaneous account or new account that were not based on orders.

However, although the engagement team used transactions within a period of 10 business days before and after the closing date of the fiscal year as the sample population, based on the assumption that channel stuffing is generally more prone to taking place during this period, the team **did not examine whether the period in question was appropriate in light of the audited company's likelihood of fraud risks**. Moreover, regarding the risk of booking fraudulent sales using a miscellaneous account or new account, the engagement team **did not examine such matters as the specific individuals committing fraud or the means via which fraud might be committed, nor did the team fully examine which types of sales transactions or assertions may give rise to fraud risks**.

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

FREQUENT

③With regard to an audited company manufacturing and selling fire protection and extinguishing products, the engagement team found that the sales division manager was under pressure to meet budget targets, which increased its motivation to commit fraud in the last month of the fiscal year. The team also found that there were opportunities to commit fraud during the shipment suspension period, when false shipment orders from the sales division to the factory were unlikely to be detected.

Based on the consideration of these fraud risk factors, the engagement team assumed a fraud risk scenario in which "the sales division manager or his / her subordinate under his / her instructions records sales by giving false shipping instructions to the person in charge at the factory during the shipping suspension period for product sales transactions exceeding an amount that was clearly determined to be an insignificant misstatement." However, because there were no transactions exceeding an amount that was clearly determined to be an insignificant misstatement during the shipping suspension period, the team did not perform procedures to respond to the fraud risks. However, the engagement team **did not adequately consider the possibility of fraud in transactions that occurred before the period of suspending shipments at the year-end and in transactions below the amount of the apparently immaterial misstatement that occurred during the period of suspending shipments**.
(Auditing Standards Statement No. 240, paragraph 25, 46) [Mid-tier, and small and medium-sized audit firms]

NEW

FREQUENT

④In examining fraud risks associated with revenue recognition at an audited company that sells nursing care products and welfare equipment, the engagement team identified "motive and pressure" for sales personnel to perform fraud because they have pressure to meet sales targets, and also identified "fraud risk of sales personnel booking fictitious sales" based on examination of other fraud risk factors.
However, despite the engagement team **identifying "motive and pressure" for sales personnel to perform fraud, the engagement team did not understand the content of the sales targets set by the audited company. In addition, the engagement team did not sufficiently examine the risks of material misstatement due to fraud associated with revenue recognition, such as by not examining the existence of "motive and pressure" to perform fraud for persons other than sales personnel**.
(Auditing Standards Statement No. 240, paragraph 25) [Mid-tier, and small and medium-sized audit firms]

NEW

⑤Company A, a sub-subsidiary of the audited company, granted the right to use content, etc. (license) to its sub-subsidiary Company B, and received license fees as consideration. The engagement team performed analytical procedures and found that the turnover period for all receivables held by Company A had lengthened to 20 months. However, the engagement team only obtained an overview of the related transactions with respect to Company A's sales to Company B, and **did not adequately examine whether the prolonged turnover period indicated represented a risk of material misstatement due to fraud**.
(Auditing Standards Statement No. 240, paragraph 22) [Large-sized audit firms]

FREQUENT

⑥With regard to sales at drugstores and pharmacies, the engagement team identified the risk of sales being fraudulently booked without going through the enterprise system through the direct entry of fictitious sales data into the accounting system. On the other hand, sales booked through the enterprise system represented sales of products to general customers and were comprised of small-value transactions, and the journal entry of sales was automatically implemented based on sales data recorded by store registers incorporating the point of sales system (POS registers), leaving little room for human intervention. Therefore, the engagement team did not identify fraud risks. It should be noted that when evaluating the status of design of internal control over store sales, the engagement team recognized the possibility that sales data recorded by POS registers might be modified during the process of being booked in the accounting system via the enterprise system.

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

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

《Points to Note》

As shown in the above example deficiencies, many deficiencies were observed in which: the engagement team identified and assessed fraud risks without fully understanding the type of revenue, transaction types, and business processes leading to revenue recognition at the audited company; in which the engagement team identified fraud risks only in areas where higher risks were considered to exist (e.g., fraud committed during a limited period of time, such as the last month of the fiscal year, fraud committed by the use of a miscellaneous account or new account, or fraud committed by specific employees such as sales personnel), while assuming the absence of fraud risks in other areas without conducting sufficient evaluation for committing fraud.

When identifying and assessing the risks of material misstatement due to fraud, the engagement team shall, based on a presumption that there are risks of fraud in revenue recognition, evaluate which types of revenue, sales transactions or assertions give rise to such risks. When making such judgment, it is necessary to pay attention to the following points:

- **When the audited company engages in multiple businesses within the consolidated group, it is necessary to comprehensively identify and assess fraud risks in accordance with those businesses' respective types of revenue and transactions.**
- **When considering fraud risk scenarios, it is necessary to fully understand the business processes leading to revenue recognition, based on the understanding of the audited company and the business processes, and examine where and how material misstatement due to fraud may occur in the financial statements.**

- **When fraud risks related to revenue recognition have not been identified, it is necessary to conduct sufficient examination whether there are fraud risks in other areas and to describe the reason for judging that there is no fraud risk in audit documentation.**
- **It is essential to identify and assess the risk of a material misstatement due to fraud at two levels, i.e. at the level of the financial statement as a whole and at the assertion level, after sufficiently paying attention to risks related to management override.**

Auditors must always be aware of the possibility of material misstatement due to fraud, and maintain professional skepticism throughout the audit process. For example, if the engagement team identifies unusual or unexpected relationships through the performance of analytical procedures, it is important that the engagement team carefully consider whether these may indicate risks of material misstatement due to fraud.

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

Case 1: Response to fraud risks in revenue recognition

FREQUENT

①The audited company provided financial support services such as investments, loans, and debt guarantees for medical institutions, as well as services such as providing guidance on management, administration, and operation of medical institutions it supported.

The engagement team identified as a fraud risk relating to revenue recognition the possibility that the audited company could use its financial support services to influence the companies it supported and thereby receive unduly excessive compensation. In addition, from the perspective of evaluating the reasonableness of the amount of compensation for service agreements, the engagement team set the amount of compensation deemed appropriate by management at a reasonable amount, and performed procedures to compare this amount with the actual amount of compensation.

However, although the engagement team identified the possibility of receiving unduly excessive remuneration as a fraud risk, the engagement team set the amount of remuneration deemed appropriate by management as a reasonable amount of remuneration based only on its understanding in light of discussions with management. **<u>In evaluating the reasonableness of the amount of remuneration, the engagement team did not obtain audit evidence that was more relevant or more convincing than in cases where no fraud risk had been identified.</u>**

(Auditing Standards Statement No. 240, paragraph 29) [Mid-tier, and small and medium-sized audit firms]

NEW

FREQUENT

②The engagement team identified fraud risks related to revenue recognition for all direct sales transactions on the grounds that there were opportunities for sales personnel to falsify internal vouchers related to direct sales and to record fictitious sales. As a procedure to address this fraud risk, the engagement team performed a detailed test using the population of direct sales for the five business days before and after the year-end closing date. However, the engagement team **did not**

consider the appropriateness of including the five business days before and after the year-end closing date in the test.

(Auditing Standards Statement No. 240, paragraph 29) [Mid-tier, and small and medium-sized audit firms]

FREQUENT

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

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

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

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

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

④At an audited company whose main business was to manufacture and sell automated service equipment to game parlors, the engagement team identified fraud risks in sales of game machines and the like and assumed a fraud scenario involving fictitious and early booking of sales by means of the forgery of order forms and other supporting documents by sales staff, along with the falsification of shipments by moving products to a warehouse secured by the audited company.

When, amid this situation, the engagement team conducted journal entry tests as a procedure to address the aforementioned fraud risks, the team confirmed that for all 161 journal entries for the year relating to product sales, the journal entry data showed that the corresponding account was accounts receivable, the summary was sales of system equipment, and the booked date was the last day of the month. As a result, the team concluded that there were no inappropriate or atypical journal entries and no material misstatements due to fraud in respect of sales of game machines and the like. However, when the engagement team checked of the aforementioned journal entry data, the team did not plan and perform further audit procedures responsive to the identified fraud risks, as the team **did not take into account the fact there was a low possibility of being able to identify the forgery of supporting documents or falsification of shipments by inspecting only the journal entry data**.

(Auditing Standards Statement No. 240, paragraph29) [Mid-tier, and small and medium-sized audit firms]

NEW

FREQUENT

⑤ The audited company engages in the construction industry, and recognize revenue of short construction periods at the point in time when the performance obligation is satisfied. The engagement team identified the risk of sales being booked ahead of schedule in the month of the account closing (March) as a risk of material misstatement due to fraud, and performed voucher matching on a sample of construction contracts for which sales were booked in the month of the account closing. However, the engagement team only performed reconciliation with a copy of invoice issued by the audited company, which was internal evidence, and **did not perform procedures to obtain stronger or more audit evidence than in cases where no fraud risk had been identified**.

(Auditing Standards Statement No. 240, paragraph 29 and No. 330, paragraph 20) [Mid-tier, and small and medium-sized audit firms]

《Points to Note》

There were many cases in which the design of audit procedures was inadequate. For example, insufficient understanding of the audited company and its environment, such as the characteristics of the business sector and sales channels, was the cause of failure to design sufficient audit procedures. Another case was that the design of audit procedures was inadequate because the engagement team did not specifically examine the types of fraud risks involved in each assertion. There were also cases in which the engagement team assumed fraud risk scenarios but reached conclusions without obtaining sufficient audit evidence, such as concluding that the assumed fraud risks had not materialized by merely asking questions of the audited company and performing analytical procedures such as year-on-year comparisons. In addition, there were cases in which the engagement team merely performed a formal reconciliation between books and vouchers and overlooked abnormal profit ratios and contract details that did not match the reality. There were cases in which the engagement team only performed inquiries of the audited company and performed reconciliation with documents for internal management prepared by the audited company when verifying the estimated total costs on a percentage-of-completion basis. For revenue recognition, Auditing

Standards Statement No. 240, paragraph 25 stipulates "When identifying and assessing the risks of material misstatement due to fraud, the auditor shall, based on a presumption that there are risks of fraud in revenue recognition, evaluate which types of revenue, revenue transactions or assertions give rise to such risks," while paragraph 29 prescribes "Auditors are required to obtain audit evidence, which is more relevant or reliable, or greater in quantity, for risk of material misstatement due to fraud at the assessed assertion level than in cases where no risk of fraud is identified for the assertion." Auditors should pay particular attention to these requirements.

Case 2: Responses to significant transactions with related parties

NEW

①During the fiscal year under review, the audited company purchased from Mr. A, Representative Director and President, the shares of Company B for JPY 30 million, which Mr. A had purchased for JPY 30 million four years earlier, and recorded the acquisition as investment securities (the "Acquisition"). The engagement team determined that the Acquisition constituted a material transaction with a related party outside of the ordinary course of business. In addition, the engagement team reviewed the related agreement, the share price valuation report obtained by the audited company from an external expert, and the minutes of the Board of Directors meeting regarding the resolution approving the Acquisition. Based on these, the engagement team determined that there were no indications that the Acquisition was conducted for fraudulent financial reporting or to cover up the misappropriation of assets. However, the engagement team **did not examine the reasonableness of the fact that the acquisition price for the share acquisition transaction by Mr. A was the same as the acquisition price for the Acquisition, even though the Acquisition had been executed approximately four years after the share acquisition transaction by Mr. A, and did not sufficiently examine the Acquisition from the viewpoint of the possibility of the Acquisition being conducted to cover up the misappropriation of assets**.
(Auditing Standards Statement No.550, paragraph 22) [Mid-tier, and small and medium-sized audit firms]

②The audited company rehired employees that it had transferred to a specific group company in the past as employees of the audited company the current period, and also booked large profits by concluding a new contract to dispatch these employees to the group company. The engagement team identified unusual transactions involving these dispatch contracts that indicated indications of material misstatement due to fraud. As a result of questioning the directors of the audited company, the engagement team was told that similar actions would not be taken in the future in principle, but could be taken as an emergency measure to avoid a crisis at a company in the corporate group. However, the engagement team **did not adequately examine the economic rationality of these unusual transactions, etc**.
(Auditing Standards Statement No. 240, paragraphs F11-2, 32-2, F35-2) [Mid-tier, and small and

medium-sized audit firms]

《**Points to Note**》

Auditing Standards Statement No. 550, paragraph 11, provides that internal discussions "should consider the possibility of material misstatements being made in the financial statements due to fraud or error that may arise from the audited company's related party relationships and transactions." In addition, if the engagement team identifies significant related party transactions that are outside the audited company's normal course of business, the engagement team should review the contracts and other documents related to the transactions to assess whether: (i) the business rationality (or lack thereof) of the transactions suggests that the transactions were conducted for fraudulent purposes; (ii) the terms and conditions of the transactions are consistent with the audited company's explanations; and (iii) the transactions are appropriately processed and disclosed in accordance with the applicable financial reporting framework. The engagement team should also take note of the need to obtain audit evidence regarding the authorization and appropriate approval of the transactions. In evaluating the terms and conditions of transactions, if audit evidence obtained from outside experts, such as share valuation reports, is used, it should be noted that it is necessary to assess the appropriateness of significant assumptions, methods, and basic data used in the experts' work, depending on their significance. In particular, in owner-managed enterprises, owner-managers often exert strong influence, making it difficult for internal controls to function effectively in transactions with related parties. When performing audit procedures for transactions with related parties, the engagement team needs to obtain sufficient appropriate audit evidence, taking these characteristics into account.

(4) Addressing the risk of management override

Case 1: Journal Entry Test

NEW

①The engagement team identified the risks of management override for journal entries that met the following conditions, and selected them for journal entry testing:

(a) Unusual journal entries, such as liability / expense or liability / revenue, that would not normally occur;

(b) Journal entries ended with a run of identical numbers (zero) in the amount;

(c) Journal entries with specific words ("confidential," "president," "instructions," etc.) in the description column.

The engagement team performed detailed testing on 2 of the 48 journal entries selected under the conditions in (a) above and 5 of the 75 journal entries selected under the conditions in (b) above. The engagement team also did not perform detailed testing on all of the journal entries selected under the conditions in (c) above because the impact on profits and losses was deemed to be minimal. However, the engagement team only performed detailed testing on some of the selected journal entries and **did not perform comprehensive detailed testing on the selected journal entries**,

even though it identified the risks of management override for journal entries that met the conditions in (a) to (c) above.
(Auditing Standards Statement No. 240, paragraph 31) [Mid-tier, and small and medium-sized audit firms]

②When performing journal entry testing as a procedure to address the risk of management override, the engagement team excluded from the journal entry testing automated journal entries that were automatically generated by batch processing based on data in the business system, as there was little room for generating fraudulent journal entries.
However, **when excluding automated journal entries from the journal entry testing, the engagement team did not adequately consider the possibility of generating fraudulent automated journal entries due to inputting fraudulent data into the business system or directly correcting data using a privileged ID in the business system**.
(Auditing Standards Statement No. 240, paragraph 31) [Mid-tier, and small and medium-sized audit firms]

《Points to Note》

There were many cases where the engagement team did not exercise professional skepticism. For example, some engagement team easily concluded that extracted journal entries were not problematic and did not perform procedures to respond to audit risks, such as verifying evidence. Some engagement team also performed journal entry testing by merely setting extraction conditions without fully understanding the business processes for entering and adjusting journal entries.
The engagement team shall keep in mind that it needs to design and implement effective audit procedures after understanding that management is in a position to be able to falsify accounting records and prepare fraudulent financial statements by overriding internal control.
Furthermore, the engagement team also needs to obtain sufficient appropriate audit evidence with respect to the completeness of journal data used for journal entry testing.

Case 2: Business rationale for significant transactions

①The engagement team had determined that the transactions for the five accounts receivables of the audited company (whose fiscal year ended in March) were unusual because the receivables had become delinquent beyond the due date for payment and it was considering changing the collection conditions and collection methods. In addition, the engagement team received an explanation from the audited company regarding the recoverability of the above accounts receivable at the time of the first and second quarterly reviews for the current fiscal year. Subsequently, contrary to the explanation given at the time of the second quarterly review, the audited company explained to the engagement team that "all of the above accounts receivable were deposited in the accounts of customers in the audited company's name and recovered in November and December of the current fiscal year." Therefore, the engagement team confirmed that the receivables had been deposited in these accounts.

However, although the engagement team **determined that it was unusual for the audited company to repeatedly consider changing the collection conditions and collection method for the above trade receivables after sales were recorded , the engagement team did not consider whether this situation indicated the possibility of fraudulent financial reporting, for example, by not being aware of the reason for considering changing the payment conditions and payment method from those at the time of the transaction**.

(Auditing Standards Statement No. 240, paragraphs 11, F11-2 and 31) [Large-sized audit firms]

②The engagement team was aware that six outsourcing costs of the audited company (whose fiscal year ended in March) had not been paid for a long time. In addition, in February of the current fiscal year, the audited company explained to the team that it had "received a complaint from a customer about the delivered goods, and reduced or planned to reduce the outsourcing costs in consultation with the outsourced manufacturer of the delivered goods," and the team recognized that the reduction of each outsourcing cost had been accounted for as of March 31, the end of the current fiscal year.

With regard to the above claims, the engagement team received an explanation from the audited company that "Each claim was not significant in terms of the amount of money for all related sales transactions, and the business of the client was not hindered and the impact was not significant. Each claim could not be handled by the contractor, so it was accepted by the audited company and handled by the sales representative." The team also obtained and reviewed the related request for approval (approved between late January and early February of the current fiscal year) and the detailed report (prepared and confirmed on March 31, the end of the current fiscal year). The team also obtained a delivery slip that stated the amount after the reduction and confirmed whether the amount had been reduced and the amount.

However, the engagement team **did not fully understand the details of the claims made by customers and the reasons why outsources were unable to respond, and it did not obtain sufficient audit evidence to support the audited company's assertions. As such, the engagement team did not evaluate whether these reductions in outsourcing costs indicated the possibility that these reductions had been made for the purpose of producing fraudulent financial reports**.

(Auditing Standards Statement No. 240, paragraph 31; No. 550, paragraph 5) [Large-sized audit firms]

《Points to Note》

Indicators that may suggest that significant transactions that are outside the normal course of business for

the audited company, or that otherwise appear to be unusual, may have been entered into to engage in fraudulent financial reporting or to conceal misappropriation of assets include（Auditing Standards Statement No. 240, paragraph A46）:

- **The form of such transactions appears extremely complex (e.g., transactions involve multiple subsidiaries of audited companies within a consolidated group or multiple third parties not having usual trading relationships);**
- **The management has not discussed the nature of and accounting for such transactions with company auditors of the audited company, and there is inadequate documentation;**
- **The management places more emphasis on the need for a particular accounting treatment than on the underlying economic reality of the transactions;**
- **Transactions that involve non-consolidated related parties, including special-purpose companies, have not been properly reviewed or approved by company auditors of the audited company; and**
- **The transactions involve previously unidentified related parties or parties that do not have the substance or the financial strength to support the transactions without assistance from the audited company.**

If the engagement team identifies any of the above mentioned indications in the course of the audit, and as result of assessing them it discovers circumstances that indicate material misstatement due to fraud, the engagement team needs to ask the management for explanation and needs to keep in mind that the team should implement additional audit procedures in order to judge whether there are suspected material misstatement due to fraud.

Furthermore, there are some cases where, in conducting fraudulent accounting treatment, the audited company obscured accounting treatments by carrying out complicated transactions with several business partners. Therefore, in examining the business rationality of significant transactions, it is important for the engagement team to not only evaluate individual transactions but also assess and examine the entire picture of a series of related transactions by paying attention to the timing and conditions of such transactions.

(5) Evaluation of audit evidence

Case 1: Identifying misstatements and responses to circumstances that indicate the possibility of a material misstatement due to fraud

①The audited company reported to the engagement team that it had discovered that two employees in Division A had placed an oral order for construction work without permission. The internal investigation into this matter had not been completed by the date of the audit report, and the full picture of the situation had not been clarified as of the same date. However, the audited company interviewed its business partners concerning the construction work in which two employees were involved, and as a result, it identified the omission of expenses and inventory related to this matter. Under these situation where the internal investigation by the audited company had not completed before forming audit opinion, the engagement team interviewed the Director and CFO about this matter. As a result, the engagement team was able to confirm that the division where the oral order without prior consent was placed was limited to division A. In addition, given the scale of the construction work that the two employees were in charge of, the engagement team determined that it was unlikely that there would be an impact that exceeded the materiality threshold, and that the qualitative factors contributing to the fraud were not material. In addition, the above expenses and the amount of inventory not recorded were treated as an uncorrected misstatement.

However, **despite the fact that the whole picture of this matter was still unknown, the engagement team only asked questions of the CFO and did not sufficiently examine whether the uncorrected misstatement indicated signs of material misstatement due to fraud**.

(Auditing Standards Statement No. 240, paragraph 34, 35) [Mid-tier, and small and medium-sized audit firms]

②The audited company sold the land on which its head office and distribution center were located and the buildings on the sites to a company of which the audited company's shareholder, Shareholder A, was the representative director. The audited company booked the sale as gains on the sale of fixed assets.

When reviewing the contract of sale for the aforementioned real estate transaction and confirming that the proceeds from the sale had been received, the engagement team identified circumstances indicating material misstatement due to fraud, as the team identified the payment of a guarantee deposit not specified in the contract of sale and a discount equivalent to consumption tax.

However, the engagement team did not evaluate whether or not this equated to a significant risk, even though the team had identified the transaction as an unusual transaction and a significant transaction, and had also identified circumstances indicating material misstatement due to fraud. Moreover, although the engagement team had identified circumstances indicating material misstatement due to fraud, the team only communicated with the management and company auditors, and **did not plan and perform additional audit procedures in respect of the real estate transaction. Nor did the engagement team obtain sufficient and appropriate audit evidence relating to the question of whether the suspected material misstatement due to fraud existed.**

(Auditing Standards Statement No. 240, paragraph F11-2, F35-2; No. 315, paragraph 27) [Mid-tier, and small and medium-sized audit firms]

《Points to Note》

Auditors should note that if they identify a misstatement, they should assess whether the misstatement is an indication of fraud, especially if management may be involved, and reassess the impact on their assessment of the risks of material misstatement due to fraud and on the type, timing and extent of the audit procedures performed. In addition to the above, there were cases where the engagement team did not exercise professional skepticism under circumstances that indicated material misstatement due to fraud, such as (I) cases where the team conducted formal inquiries with the audited company, did not critically

examine the answers, and did not examine the contradictory explanations from the audited company, and (ii) cases where the team only obtained answers through inquiries and did not plan or perform additional audit procedures. There were also cases where the engagement team did not appropriately assess the impact of misstatements, such as (I) cases where the team identified misstatements in the audit process but did not sufficiently examine whether they were indications of fraud, and (ii) cases where the team determined that the misstatements identified were indications of fraud but did not pay attention to the relationship with other aspects of the audit.

Case 2: Suspected material misstatement due to fraud

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

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

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

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

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

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

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

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

《Points to Note》

If the engagement team identifies the suspected material misstatement due to fraud, the team needs to revise its planned risk assessment and further audit procedure, and implement audit procedures that directly respond to the situation of possible fraud, including sufficient evaluation of the suspected material misstatement due to fraud, in order to obtain sufficient appropriate audit evidence regarding the suspicion. Furthermore, if the engagement team has identified fraud, or obtained information that indicates the possibility of fraud, the team must, in order to convey to the person responsible for preventing and detecting fraud relating to that responsibility, inform the appropriate level of management of such matters on a timely basis. The team also needs to inform the company auditors of such matters. In addition, if the engagement team suspects that management are involved or are on suspicion of being involved in fraud, the team must report this to the company auditors and hold consultations with the company auditors concerning the nature, timing and extent of the audit procedures required to complete the audit. The team also needs to demand that management take appropriate measures to correct problems. Depending on the nature of the fraud, it may be necessary to report this to the regulatory authorities.

2. Risk Assessment and Response to Assessed Risks

Points of focus

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

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

Outline of inspection results

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

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

Moreover, there were still engagement partners and audit assistants who did not fully understand the concept of a risk-based approach. As a result, there were several cases where the engagement team merely completed templates, such as the “audit tool” and the “documentation sample forms” provided by the audit firm or the JICPA, and did not perform appropriate risk assessment. There were also cases where the nature, timing and extent of the procedures actually taken in response to the assessed risks did not respond to the risks since the engagement team did not evaluate the adequacy of the assessed risks and procedures in the audit plan developed by using audit tools.
In addition, there were cases in which the engagement team did not perform substantive procedures despite having identified the risk of material misstatement, cases in which the absence of notes regarding important transactions with related parties was overlooked at an audited company engaging in a large volume of various types of transactions with relevant parties, cases in which the effects of the identified misstatement on the results of the test of internal control and on the substantive procedures were not considered, cases in which the engagement team lacked sufficient understanding of the overview of the audited company's information systems and of the company's general IT controls, and cases in which the engagement team did not sufficiently examine the appropriateness of the financial statement presentation and notes

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

<u>Expected response</u>
Professional staff should pay due attention as professional experts and exercise professional skepticism. They should fully understand the audited company and its environment and assess risks through such understanding, and should carefully identify and assess risks by referring to this Case Report and the Audit Recommendations issued by the JICPA, based on a full understanding of the intent of Auditing Standards Report No.315, etc. In addition, when developing responses to audit risk, they should carefully

consider whether the procedures respond to the assessed risks and whether the procedures enable sufficient appropriate audit evidence to be obtained, including not only the types of procedure, but also the timing and the extent of the procedures. In order to do so, they should make sure sufficient hours are spent for not only substantive procedures but also for the audit plans.

Furthermore, some professional staff still do not recognize the importance of audit planning and have no understanding of the need, in audit plans, to link material misstatement risks and details of the procedures responsive to the assessed risks (the nature, timing and extent of the procedures).

Engagement teams must reconfirm the concept of the risk-based approach and the positioning of the audit plan in the current audit, and review the audit plan that they developed, according to the situation. Once again, an audit firm where deficiencies were identified in risk assessment and responses to the assessed risks must consider appropriate responses, such as re-educating professional staff who have failed to catch up with the current audit standards and responding in terms of the assignment of engagement teams.

(Revision of Auditing Standards Statement 315 "Identification and Assessment of the Risks of Material Misstatement")

Auditing Standards Statement No. 315, as amended in June 2021, requires separate assessment of inherent risk and control risk. Inherent risk assessment requires consideration of how and to what extent inherent risk factors (Characteristics of events or conditions that affect susceptibility to misstatement, whether due to fraud or error, of an assertion about a class of transactions, account balance or disclosure, before consideration of controls) affect susceptibility of related assertions to misstatement.

(1) Audit planning

Case 1: Materiality

The engagement team had selected net income before income taxes as the indicator to be used in deciding materiality in the previous fiscal year, but as a net loss was expected to be booked for the current fiscal year, due to the impact of COVID-19, the engagement team selected an average of net income before income taxes for the past three fiscal years as the indicator for the current fiscal year. As a result, the materiality for the current fiscal year was higher than the materiality for the previous fiscal year.

However, with regard to the audited company's full-year results for the current fiscal year, in examining the going concern assumptions and evaluating such matters as fixed assets, investments in and loans to subsidiaries and associates, and deferred tax assets due to the impact of COVID-19, the engagement team **did not conduct a full evaluation, including comparison with the previous fiscal year's materiality, when deciding on materiality, despite circumstances creating an increased audit risk**.

(Auditing Standards Statement No. 320, paragraph 9 and A2) [Mid-tier, and small and medium-sized audit firms]

《Points to Note》

In addition to the aforementioned cases, there were also cases in which indicators affecting economic decision-making by users of financial statements were not fully evaluated; for example, with regard to indicators used in deciding materiality, in a situation in which the audited company had booked fictitious profits in past years, the engagement team used sales and net assets—indicators that do not take profits into consideration—rather than types of profit and loss, such as net income before income taxes or operating profit.

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

The audited company, whose main business is to operate nail salons, included franchise sales in the sales account because they were insignificant in the previous term. On the other hand, in light of the increase of sales in the current period, the audited company accounted for them as a separate account, the franchise sales account.

When developing the audit plan at the beginning of the fiscal year, the engagement team identified risks of material misstatement at the assertion level using account balances at the end of the previous fiscal year, and determined that it was not necessary to revise the audit plan developed at the beginning of the fiscal year because there had been no material changes in the understanding of the company and its environment at the end of the fiscal year.

However, the engagement team **did not consider the need to revise the plan in light of changes in the audited company and its environment**. For example, the engagement team did not consider the need to identify risks of material misstatement even though the amount of franchise sales booked the current period exceeded the materiality threshold.

(Auditing Standards Statement No. 300, paragraph 9; No.315 (Before amendment in June 2021), paragraph 24 and 25) [Mid-tier, and small and medium-sized audit firms]

《Points to Note》

In addition, there were cases where the engagement team did not identify significant risks that the Auditing Standards Committee Statement required it to identify, such as risks assessed as material misstatement due to fraud and significant transactions with related parties outside the audited company's normal course of business (Auditing Standards Statement No. 315, paragraph. 11 (10) 2)).

Furthermore, there were cases where the engagement team only followed audit procedures for past years in a perfunctory way and did not appropriately prepare a detailed audit plan covering such matters as the nature, timing, and extent of audit procedures to be performed by engagement team members.

The engagement team shall carefully consider not only the nature of audit procedures, but also their timing and extent, to ascertain whether the established audit procedures respond to the assessed risks and whether sufficient and appropriate audit evidence can be obtained from those audit procedures.

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

Case 1: Understanding the audited company and its environment, including the audited company’s internal control

①The audited company mainly provided consulting, system development, and system maintenance services related to management and accounting. In revenue recognition from the services provided, the audited company adopted an accounting treatment in light of the 5-step model for revenue recognition (I) identifying contracts, ii) identifying performance obligations, iii) determining transaction prices, iv) allocating transaction prices, and v) recognizing revenue from satisfying performance obligations, as set forth in the Revenue Recognition Accounting Standard.

The engagement team understood the audited company's accounting treatment in the past fiscal years in light of these 5-step model. For "⑤ recognizing revenue from satisfying performance obligations," the team verified the appropriateness of the timing of satisfying performance obligations for each service type. The team also understood that there had been no significant changes in the audited company's business in the current fiscal year.

However, the engagement team **did not verify the appropriateness of the matters considered by the audited company in applying the above accounting treatment, based on actual contract details**.

(Auditing Standards Statement No. 315 (Before amendment in June 2021), paragraph 10) [Mid-tier, and small and medium-sized audit firms]

②The engagement team identified a risk of material misstatement in existence and completeness assertions for sales by all the audited company’s multiple businesses.

However, the engagement team **did not perform procedures to understand the internal controls for the bricks-and-mortar retailing business**, even though sales from the business far exceeded the performance materiality.

(Auditing Standards Statement No. 315 (Before amendment in June 2021), paragraph 10 and 12) [Mid-tier, and small and medium-sized audit firms]

NEW

③In valuing inventories (examining whether there has been a decline in profitability), the audited company deemed that the net selling value was the amount calculated by deducting the estimated costs necessary to make the sale from the average selling price for a certain period in the past for each product. If the net selling value was below the book value, the audited company determined that the profitability of the inventories had declined and recognized the difference as valuation losses on inventories in cost of sales.

However, the engagement team did not confirm whether the audited company had deducted the estimated costs necessary to make the sale from the average selling price when calculating the net selling value, and did not have a sufficient understanding of the audited company's inventory

valuation method (method for examining whether there was a decline in profitability).
(Auditing Standards Statement No. 315 (Before amendment in June 2021), paragraph 10) [Mid-tier, and small and medium-sized audit firms]

《**Points to Note**》

In recent years, there have been multiple cases in which the engagement team did not sufficiently assess the appropriateness of accounting policies adopted by audited companies in relation to the application of the "Accounting Standard for Revenue Recognition" (ASBJ Statement No. 29). The engagement team needs to assess whether the company's accounting policies are appropriate for the business, comply with the applicable financial reporting framework, and are consistent with accounting policies applied in the industry to which the company belongs, by understanding the entity and its environment. In addition, there are cases where fraudulent financial reporting is conducted in businesses other than the principal business. Therefore, when identifying and assessing the risks of material misstatement at the assertion level, the engagement team needs to take into account differences in the business environment and related internal controls of each business.

In other cases, the group engagement team did not comprehensively understand the businesses and distribution channels at the group level. There were also cases in which the group engagement team did not examine the risks of misstatement for each business process, and did not consider the possibility that effective audit procedures or audit evidence that should be obtained may differ due to differences in the types of transactions for the same account.

Case 2: Identifying and assessing the risks of material misstatement

An audited company engaged in information and telecommunications business was listed during the interim period and revised its earnings forecasts downward in multiple times before the end of the fiscal year. Given this situation, the engagement team determined that the audited company was under pressure to overstate its profits, and identified as fraud risks in overstatement of sales and software (excessive capitalization of expenses).

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

(Auditing Standards Statement No. 315 (Before amendment in June 2021), paragraph 25) [Large-sized audit firms]

《**Points to Note**》

In identifying and assessing the risks of material misstatement, the engagement team needs to exercise professional skepticism and sufficiently understand the audited company and its environment, and thereby perform risk assessment.

Case 3: Understanding of the audited company's internal controls related to significant risks

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

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

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

(Auditing Standards Statement No. 315 (Before amendment in June 2021), paragraph 28) [Mid-tier, and small and medium-sized audit firms]

《Points to Note》

In terms of identified significant risks, an auditor must understand the internal controls, including control activities relating to the risk. Further, when relying on internal controls to address significant risks, an auditor is required to perform tests of operating effectiveness of related controls during the audit for the current year.

It should also be noted that the definition of significant risks has been changed to the following in the revised Auditing Standards Statement No. 315 (refer to Figure 6).

(I) Risks of material misstatement assessed to exist in the areas of highest inherent risk based on the degree to which inherent risk factors affect a combination of the likelihood of a misstatement occurring and the magnitude of the potential misstatement (quantitative and qualitative impact)

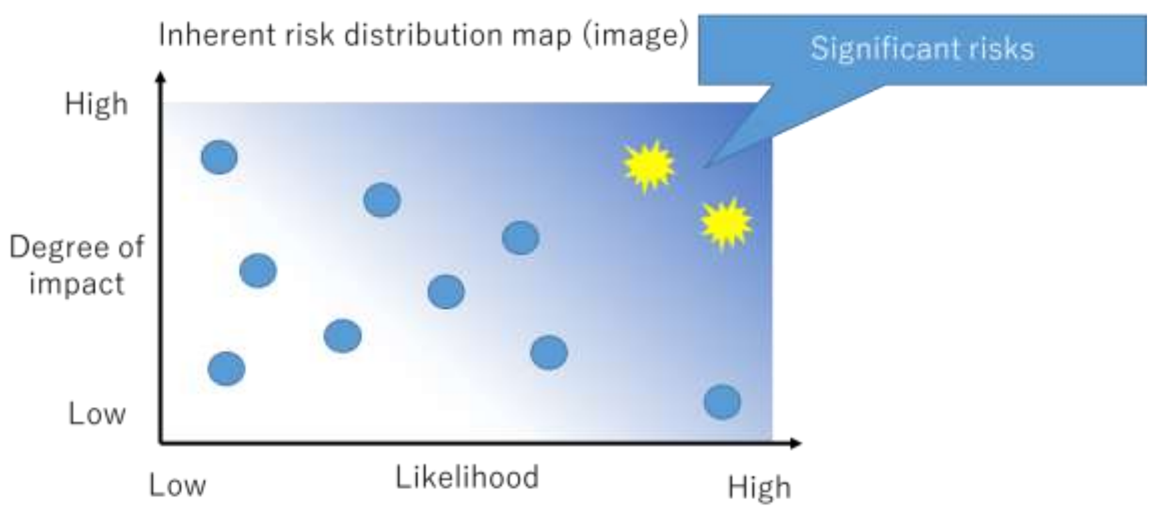
(ii) Risks of material misstatement that are determined to be treated as significant risks in accordance with the requirements of other audit standard reports

・Risks assessed as risks of material misstatement due to fraud.

・Risks related to management override of controls;

・Significant related party transactions outside the entity's normal course of business;

［Figure 6］Reference image: Distribution of inherent risk



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

(3) The auditor’s responses to assessed risks

Case 1: Audit procedures for risks of material misstatements

FREQUENT

①The engagement team identified risks of material misstatement with regard to sales of some businesses among sales reported by the audited company on its non-consolidated financial statements. Based on its understanding that the design and operation of internal controls for the sales of these businesses were effective, the engagement team performed confirmation procedures for confirmed the balance of receivables with the end of the previous month of the fiscal year end as the record date, and roll-forward procedures for the remaining period, as well as performed procedures to respond to fraud risks with respect to sales reported in the fiscal year end.

However, although the engagement team identified risks of material misstatement of sales for this business, the engagement team **did not perform substantive procedures for sales recorded before the month before the end of the fiscal year**.

(Auditing Standards Statement No. 330, paragraph 17 and No.500, paragraph 5) [Mid-tier, and small and medium-sized audit firms]

NEW

FREQUENT

②A consolidated subsidiary of the audited company had incurred early recognition of expenses due to cost transfer in the past. Therefore, as a measure to prevent recurrence, the consolidated subsidiary introduced the same production control system as that of the audited company, and thereafter, the content of cost transfer was required to be registered in the system, and was monitored by the control division of the audited company.

In the audit for the current fiscal year, the engagement team identified a risk that expenses would be recorded early due to cost transfer at the consolidated subsidiary (hereinafter referred to as "risk of early recording of expenses") as a significant risk. As a procedure for dealing with the risk, the engagement team confirms that the implementation of recurrence prevention measures has been ongoing since the previous fiscal year by asking questions to the person in charge of the General Administration Department of the consolidated subsidiary.

However, the engagement team **did not understand the internal controls related to the risk of early recording of expenses, which was a significant risk**. In addition, the engagement team **did not perform substantive procedures to address the risk, even though this risk had been identified as a significant risk**. Furthermore, the engagement team did not examine whether there were reasonable grounds for the audited company to exclude processes related to the risk of early recording of expenses, which was a significant risk, from the assessment of internal controls.

(Auditing Standards Statement No. 315 (Before amendment in June 2021), paragraph 28; No. 330, paragraph 20, Auditing Standards for Internal Controls over Financial Reporting Statement No. 1 , paragraph 112) [Mid-tier, and small and medium-sized audit firms]

③The audited company deemed that the company split was a transaction under common control and had each succeeding company succeed to the assets and liabilities attributable to the split company (the audited company) at the time of the company split at their book values.

Given these circumstances, the engagement team identified significant risks associated with the company split in light of the atypical nature of the transaction and the materiality of the amount involved, and performed the following procedures to address these risks.

・Inspection of the agreement concerning the company split;
・Checking compliance with relevant accounting standards;
・Check that the balance of the journal entries related to the company split is consistent between the split company and each succeeding company.
・Inspection of the trial balance prepared by the audited company with respect to the assets and liabilities succeeded to by each succeeding company;

However, **although the engagement team identified significant risks in the company split,** the engagement team **did not examine the consistency between the assets and liabilities succeeded to by each succeeding company in the company split and the business of each succeeding company**.

(Auditing Standards Statement No. 330, paragraph 20) [Mid-tier, and small and medium-sized audit firms]

《Points to Note》

As shown in the examples of deficiencies above, there were many cases in which audit procedures suited to the identified and assessed risks of material misstatement were not performed, as well as cases in which substantive procedures to address the assessed risks of material misstatement on an individual basis were not performed despite the assessed risks of material misstatement being determined to be significant risks. In designing audit procedures responsive to the assessed risks of material misstatement, auditors need to take into account the particular characteristics of the relevant classes of transactions, account balances, and disclosures, etc., as well as relevant internal controls, and design audit procedures that ensure that sufficient appropriate audit evidence suited to the assessed risks of material misstatement at the assertion level can be obtained.

It should be noted that substantive procedures must be designed and performed for material classes of transactions, account balances, and disclosures because auditors may not have identified all of the risks of material misstatement and internal controls have inherent limitations, including management override.

Case 2: Adequacy of presentation and disclosure

①While the audited company adopted the percentage-of-completion basis as its revenue recognition standard, it did not disclose important accounting estimates in the company's annual securities report.

Amid this situation, the engagement team understood that judgments by management influenced the estimate of the total cost of construction on a percentage-of-completion basis, and that estimates of such matters as the details of tasks, work-hours, and raw material prices entailed some uncertainty. However, **in judging the need for disclosures regarding important accounting estimates, the engagement team did not evaluate whether or not these were items that risked having a material impact on the financial statements of the audited company in the following fiscal year, nor did the team evaluate the size of the quantitative impact on the following fiscal year's financial statements or the likelihood of such an impact occurring**.
(Auditing Standards Statement No. 330, paragraph 23) [Mid-tier, and small and medium-sized audit firms]

②The engagement team identified the risk of material misstatement in the segment information disclosed by the audited company.
However, the engagement team **did not evaluate whether the segment information conformed to the accounting standards concerning segment information**, etc. Moreover, it merely checked segment information against the basic reference materials prepared by the audited company and failed to perform sufficient substantive procedures.
(Auditing Standards Statement No. 330, paragraphs 17 and 23 and No. 501, paragraph 12) [Mid-tier, and small and medium-sized audit firms) [Mid-tier, and small and medium-sized audit firms]

NEW

③The audited company additionally acquired the remaining equity interest in Company A the current period for cash, even though Company A was consolidated and the audited company held a majority interest in Company A.
However, **the engagement team overlooked the fact that the above-mentioned expenditures for additional acquisition were expenditures for acquisition of interests in subsidiaries that did not result in change in the scope of consolidation and should have been presented in the "Classification of cash flows from financing activities," but the audited company presented them in the "Classification of cash flows from investing activities."**
(Auditing Standards Statement No. 330, paragraph 23) [Large-sized audit firms]

《Points to Note》

There were numerous deficiencies in audit procedures for presentation and disclosure, including a case where the engagement team did not sufficiently verify the presentation and notes of the financial statements and overlooked material misstatement in the presentation of the consolidated statement of changes in net assets, notes on the consolidated statement of comprehensive income, notes on significant subsequent events, etc., a case where the engagement team did not plan and perform audit procedures to assess whether accounting standards, etc. were being followed in the notes on revenue recognition, and a case where the

engagement team did not examine the completeness of data used as the basis for calculating fair value in the notes on investment and leased properties. In addition, there were cases where the engagement team only provided a check mark as a formality and overlooked misstatements in audit procedures using the disclosure checklist.

Engagement teams should design and perform audit procedures to assess whether the overall presentation of the financial statements, including related disclosures, complies with the applicable financial reporting framework.

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

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

NEW

The audited company had introduced a point card system for sales promotion in Business A, and booked the points that were expected to be used in the future as contract liabilities at the end of the fiscal year. The audited company also entrusted the administration of point data used to calculate the amount of contract liabilities to an external administration firm.

When evaluating General IT controls over the systems of the external management company and the audited company that were related to the point data management business, the engagement team conducted interviews with the external management company via the audited company and reviewed the results of the responses.

However, when examining the balance of the contract liabilities and the supporting documents, the engagement team **did not identify the internal controls of the external service provider and the audited company that were related to the point data management business, evaluate the design, or make a judgment on implementation**.

(Auditing Standards Statement No. 402, paragraphs 8, 9; No. 500, paragraphs 8) [Mid-tier, and small and medium-sized audit firms]

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

The audited company used a network built by a company that was entrusted with the operation of IT systems for important business processes (hereinafter referred to as the "Contractor Company"). The audited company obtained the description of the Contractor Company's systems, and an assurance report on controls at the Contractor Company.

However, the engagement team only reviewed the report obtained by the audited company and **did not perform assessment of the services, such as the appropriateness of the assessment procedures performed by the auditor of the** Contractor Company.

(Auditing Standards Statement No. 402, paragraph 16) [Mid-tier, and small and medium-sized audit firms]

《Points to Note》

In addition to the above examples of deficiencies, there were cases in which the engagement team did not fully understand the operations and internal controls provided by the companies that were entrusted with the shipping and inspection of inventory, despite the fact that such operations were outsourced to warehouse operators.

In cases where an audited company outsources part of its operations, the engagement team must understand how the audited company uses the services of the service provider in its business operations. In understanding the internal controls related to the audit, the engagement team must evaluate designs and implementation of the audited company's internal controls, including the internal controls performed by the service provider. It should be noted that this applies not only to the financial statement audit but also to the audit of internal controls over financial reporting.

In recent years, due to the shift to cloud computing and other developments, depending on the content of services provided by the service organization, it may be difficult to determine whether the audited company (user entity) or the service organization has internal controls over the operations that form the basis of financial reporting. Auditors need to sufficiently understand the content and importance of the services provided by the service organization and their impact on the audited company's internal controls related to audit.

(5) Evaluation of misstatements identified during the audit

Case: Consideration of identified misstatements

①The engagement team ascertained that the understatement of loss on valuation of shares of subsidiaries and associates in the ’non-consolidated and consolidated financial statement for the prior period, which were included in comparative information, was recognized in the current period and that the uncorrected misstatement in the previous fiscal year was corrected in the current term. However, the engagement team <u>**did not evaluate the effect of the misstatement in the previous fiscal year on audit of internal control over financial reporting. In addition, it did not include "uncorrected misstatement included in comparative information" or "effect of the undermining of comparative information as a result of correction made in the figures for the current term" among the matters to be confirmed in the management representation letter for confirmation**</u>. Moreover, the engagement team did not report to the board of auditors the effect of the uncorrected misstatement related to past fiscal years on the relevant classes of transactions, account balances, or disclosures, and the non-consolidated and consolidated financial statement as a whole.

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

②The audited company disclosed the "amount of inventories recognized as expense" in the notes on inventories in the consolidated financial statement for the previous term and the current period.

In response, the engagement team stated in the audit documentation that the amount disclosed in the previous period was incorrect.

However, the engagement team did not sufficiently understand that comparative information was included as an integral part of the financial statements for the current fiscal year, so the team did not confirm the difference between the misstated amount and the amount that should have been stated, and **did not evaluate whether the misstatement was material as an uncorrected misstatement**.

(Auditing Standards Statement No. 300, paragraph 23, and No. 450, paragraphs 10) [Mid-tier, and small and medium-sized audit firms]

《Points to Note》

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

Moreover, auditors need to determine whether identified misstatements would be material, either individually or in aggregate, if they are not corrected. However, there were cases where auditors did not evaluate the impact of uncorrected misstatements of past fiscal years on the financial statements as a whole. Note that it is necessary to state in the list of uncorrected misstatements attached to the written representation (1) uncorrected misstatements included in comparative information or (2) effect of comparative information as a result of correction (or elimination) of the figures for the current term, when auditors discovered uncorrected misstatements for the prior years, and management determined that they were not material and have corrected (or eliminated) them in the current term.

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

Case 1: Formulation of a plan for auditing IT use

①With regard to general controls over IT systems used for construction management and financial management at a consolidated subsidiary of the audited company, the engagement team identified as a deficiency that there were no differences in the authority settings for each user and that all users were granted the same authority. Furthermore, although the engagement team determined that the deficiency was minor as a result of performing risk assessment procedures, the engagement team designed an audit plan and performed audit procedures on the assumption that it was impossible to rely on general controls over the IT systems. Specifically, as substantive procedures, the scope of detailed tests of construction sales by comparing vouchers was expanded.

However, the engagement team **did not identify in detail what risks would arise from the deficiencies in general controls related to the IT systems, did not appropriately assess the risks of material misstatement in light of the impact of the deficiencies, and did not consider the necessity of additional substantive procedures to address the risks**.

(Auditing Standards Statement No. 315 (Before amendment in June 2021), paragraphs 20 and 30) [Large-sized audit firms]

NEW

②In the sales process at Company A, a consolidated subsidiary of the audited company, order information was managed using a customer management system. The sales division prepared sales details based on the information in the customer management system, and the control division entered sales journal entries based on the sales details.

The engagement team identified the risk of early booking of sales at Company A as a fraud risk and evaluated the design and operation of internal controls related to Company A's sales process. The team determined that the customer management system was not directly related to the preparation of financial statements and did not include the customer management system in the assessment of general IT controls.

However, although the engagement team was aware that sales details had been prepared based on information from the customer management system and sales journal entries had been entered based on these sales details, the engagement team **did not consider whether the customer management system should be included in the assessment of general IT controls, and did not sufficiently examine the appropriateness of the scope of assessment.**

(Auditing Standards Statement No. 315 Before amendment in June 2021, paragraph 17) [Mid-tier, and small and medium-sized audit firms]

Case 2: Evaluating of deficiencies in General IT control

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

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

However, the engagement team overlooked the fact that the information covered under control activities in which deficiencies had been identified was not listed in the information system development management chart to be prepared for managing progress in program development.

The engagement team also did not confirm the specific operational methods for leaving traces of email approval and otherwise **did not obtain sufficient appropriate audit evidence relating to the effectiveness of general IT controls**.

(Audit and Assurance Practice Committee Statement No. 82, paragraph 185; IT Committee Practical Guidance No. 6, paragraph 46) [Mid-tier, and small and medium-sized audit firms]

《Points to Note》

In addition to the above examples of deficiencies, there were cases in which the engagement team lacked sufficient understanding of the content of automated application controls for cost accounting, the scope of related master data, and the use of IT in understanding the cost accounting business process.

Business enterprises use information systems for their business operations. Through understanding the status, characteristics and operation of the information systems of the audited company, the engagement team can properly identify and assess the risks of material misstatements due to those systems. There were some cases in which the engagement team judged that the potential risks of material misstatements were low without understanding the IT environment. When developing audit plans, the engagement team need to understand the IT environment of the audited company, and identify IT systems that should be included in the assessment for risks of material misstatement.

The group engagement team also need to develop appropriate audit plans by ensuring that they understand the IT environment at the group level, as well as how the entity's control environment, including applicable accounting policies and financial closing systems, is reflected in or related to IT systems.

Furthermore, when using various lists generated by the audited company's information system for the tests of controls or substantive procedures, the engagement team shall evaluate the accuracy and completeness of the information. Depending on the degree of IT use by the audited company, the engagement team may need the support of IT specialists and incur considerable time to complete the audit. Therefore, the engagement team should note that it needs to develop an audit plan for the above procedures at an early phase.

The revised Auditing Standards Report No.315 expands the scope of IT-related statements and includes in the appendix some considerations for understanding IT and for understanding IT general controls.

3. Audit Evidence

Points of focus

Auditors should consider the relevance and reliability of information used as audit evidence. The CPAAOB inspects whether audit procedures designed by the engagement team are properly performed and whether sufficient appropriate audit evidence to draw reasonable conclusions on which to base the auditor's opinion is obtained from the following perspectives:

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

Outline of inspection results

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

- The engagement team did not assess whether the audit evidence obtained through the audit procedures was adequate to identify risks of misstatement;
- The engagement team identified significant risks but did not perform substantive procedures that responded individually to the risks;
- The engagement team identified inconsistencies and irregularities with other audit evidence but did not determine the necessity of additional audit procedures;
- In substantive analytical procedures, the engagement team did not evaluate the reliability of the data used in the auditor's estimates of the booked amounts or ratios, and did not evaluate whether such estimates were sufficiently accurate to identify misstatements that could lead to material misstatements;
- In using audit sampling for audit procedures, the engagement team did not examine whether the sample size it had determined was adequate to reduce sampling risk to an acceptably low level;
- Audit evidence was not obtained on all of the specific items selected when sampling was carried out by selecting specific items;
- When testing specific items selected, the engagement team did not examine whether it was necessary to obtain additional audit evidence for the remaining balance; and
- When using information prepared by the audited company, the engagement team did not evaluate whether the information had sufficient reliability for audit purposes.

For more information in responses to audit risk for revenue recognition, also see items "(2) Identifying and assessing risks of material misstatement due to fraud" and "(3) Response to assessed risks of material misstatement due to fraud" in "1. The Auditor's Responsibilities Relating to Fraud in Financial Statement Audits."

(Observed effective efforts)

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

The engagement team reviewed audit plans before the end of each fiscal year, and the results of the review are shared at a meeting held before the end of the fiscal year and attended by all team members. At that meeting, the engagement team checks once again each of the audit procedures planned to be performed in year-end audits with regard to each material accounts, and the engagement partner conducts a detailed review of the specifics of the audit procedures before the performance of year-end audits.

<u>Expected response</u>

The engagement team needs to obtain sufficient appropriate audit evidence corresponding to the identified risks. In particular, the engagement team needs to keep in mind that it must perform substantive procedures to individually respond to significant risks.

Furthermore, many of the examples of deficiencies relating to audit evidence were caused by the engagement team's failure to appropriately perform risk assessment and design further audit procedures, as well as a lack of in-depth understanding of the audited company's business for the fiscal year subject to audit.

On the other hand, there were many cases where the engagement team appropriately performed risk assessment and designed further audit procedures, but staffs of the to engagement teams only performed conventional audit procedures because engagement partners, etc. did not provide specific instructions, supervision or review. Therefore, there were discrepancies between audit plans and actual audit procedures. For this reason, when conducting audits, the engagement teams are required to sufficiently discuss risk assessment and audit procedures to be performed throughout the engagement, and confirm the sufficiency and appropriateness of audit evidence actually obtained through reviews.

(1) Matters common to audit evidence

Case 1: Sufficient appropriate audit evidence

①The audit evidence corresponding to the risk of material misstatement

With regard to the fact that the audited company, which is engaged in the land sales business, recorded sales for land sales transactions as of the year-end closing date, the engagement team determined that there was no problem with the attribution of the period for the Transaction because, although the receipt of the sales proceeds and the registration of the transfer of ownership for the Transaction were both made after the year-end closing date, setting the date of transfer of ownership and the date of delivery on the year-end closing date was based on the buyer's request, and the parties concerned had agreed to it.

However, the engagement team **only confirmed the agreement between the parties that the delivery date would be the year-end closing date, and did not examine the reasonableness of the agreement or whether the delivery had actually occurred**.

(Auditing Standards Statement No. 330, paragraph 5) [Large-sized audit firms]

②Dual-purpose test

FREQUENT

The engagement team performed sample inspections of 25 cases as test of controls related to raw material costs included in the audited company's manufacturing costs. The team claimed to have performed these tests as dual-purpose tests that also served as substantive procedures.

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

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

③Observation of physical inventory counting

The engagement team attended the audited company's physical inventory count, but it did not obtain sufficient appropriate audit evidence concerning the completeness and accuracy of the physical inventory records. For example, the team only observed the inventory count procedures and performed test counts, and **it did not perform procedures to confirm the completeness of the physical inventory records or to confirm the accuracy of the closing process for inventory transactions**.

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

《Points to Note》

Generally, inquiries alone do not indicate that sufficient audit evidence has been obtained regarding responses to the risks of material misstatements or regarding the effectiveness of the operation of internal controls. However, there are cases where audit procedures have been completed only by inquiries. In audit procedures for responding to risks, as well as those for responding to significant risks, audit evidence obtained through inquiries needs to be specifically supported by audit procedures other than inquiries.

Depending on the circumstances, auditors may also design substantive analytical procedures, tests of detail, or a combination of these procedures to respond to audit risk. However, depending on the degree of risk

assessed, the extent of audit evidence required will vary.

In one case, the engagement team performed multiple audit procedures but did not examine whether the amount or quality of the audit evidence obtained was sufficient. As a result, the engagement team did not obtain sufficient audit evidence to reduce the overall audit risk to a low level.

Engagement teams should not perform designed audit procedures as a formality, but should comprehensively evaluate events identified in the audit process and the sufficiency and appropriateness of audit evidence obtained through other audit procedures. Engagement teams should also evaluate whether procedures designed to obtain sufficient appropriate audit evidence that satisfies the purpose of each audit procedure have been designed and performed when performing tests of the operation of internal controls concurrently with substantive procedures (dual-purpose tests).

Case 2: Information to be used as audit evidence

①Relevance and reliability of information

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

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

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

②Work of management's experts

FREQUENT

When evaluating the book value of shares in an insolvent subsidiary, the audited company obtained a real estate appraisal report for land and buildings owned by the subsidiary and calculated the net asset value of the shares, taking into account the market valuation of land and buildings.

Amid this situation, the engagement team evaluated the competence, capabilities and objectivity of the experts used by management to prepare the appraisal report, which is information used as audit evidence, and obtained an understanding of the experts' work before reviewing the appraisal report.

However, the engagement team **did not sufficiently evaluate the appropriateness of the appraisal report as audit evidence, as the team did not verify the calculation methods or the source data employed by the experts used by management**.

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

NEW

FREQUENT

③Reliability of information produced by companies (i)

In examining whether fixed assets were impaired, the audited company grouped its fixed assets by store and calculated operating profits / losses for each store, and determined that there were indications of impairment for the group of fixed assets that contained stores that had posted recurring losses in operating profits / losses by store over the past two fiscal years.

However, the engagement team **did not examine the accuracy of the operating profits / losses by store calculated by the audited company**.

(Auditing Standards Statement No. 500, paragraph 8) [Mid-tier, and small and medium-sized audited companies]

NEW

FREQUENT

④Reliability of information produced by companies (ii)

In order to examine the appropriateness of the audited company's inventory valuation, the engagement team confirmed the existence of slow-moving products based on the long-term inventory list prepared by the audited company.

However, when using this list, the engagement team **did not verify whether it accurately and exhaustively reflected the status of product retention**.

(Auditing Standards Statement No. 500, paragraph 8) [Mid-tier, and small and medium-sized audit firms]

《Points to Note》

When designing and performing audit procedures, auditors should keep in mind that they should take into account the relevance and reliability of information used as audit evidence.

In addition, when using information prepared by experts (e.g., pension actuaries, real estate appraisers, and attorneys) employed by the management as audit evidence, auditors should keep in mind that they should evaluate the competence, capabilities and objectivity of the experts, to understand the experts' work, and to evaluate the adequacy of the experts' work used as audit evidence in light of relevant assertions.

Meanwhile, audited companies often make accounting estimates based on information prepared by themselves, including reference data regarding valuation losses that lists book values and net sales value by inventory and reference data regarding indications of impairment that lists book values of fixed assets and operating profits/losses by asset group, and data regarding estimated construction profits/losses by construction project and the balance of construction-in-progress expenditures under the percentage-of-completion method, and reference data regarding construction loss provisions. There are still many cases in which information prepared by audited companies as the basis of accounting estimates is used as audit evidence in the audit of accounting estimates without its accuracy and completeness being verified. When performing audit procedures using information prepared by the audited company, the engagement team needs to obtain audit evidence on the accuracy and completeness of the information and fully examine the reliability of the information used.

Case 3: Timing of substantive procedures

NEW

①Performing substantive procedures at an interim date

As substantive procedures for accounts payable of the audited company (closed in March), the engagement team designed to perform external confirmation with the end of January as the record date and substantive procedures (roll-forward procedures) for increasing transactions and decreasing transactions during the remaining period (from February to March).

However, **when performing the roll-forward procedures, the engagement team did not perform substantive procedures for decreasing transactions of accounts payable, and did not perform sufficient substantive procedures for the remaining period**.

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

②Physical inventory counting is conducted on a day other than the balance sheet date.

The audited company adopted physical inventory cycle counting, with different interim count dates applied to inventory taking at different business locations.

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

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

(Auditing Standards Statement 501, paragraph 4) [Mid-tier, and small and medium-sized audit firms]

《Points to Note》

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

It should also be kept in mind that, when using audit sampling for substantive procedures with regard to income statement items, it is necessary to select items for the sample in such a way that each sampling unit in the population during the period has a chance of selection because the entire data for the whole of that period becomes the sampling population.

(2) External Confirmation

Case 1: Reliability of responses to confirmation request

The engagement team identified fraud risks in accounts receivable, recognizing that the audited company had receivables that had been in arrears for a long time beyond the payment deadline and that transaction agreements for these receivables had not yet been concluded. In addition, the engagement team e-mailed confirmation letters to the companies where the receivables had been in arrears to confirm their balances, collected them, and compared the e-mail address domain of the confirmed respondents with the website domain of the companies where the receivables had been confirmed.

However, the engagement team **did not consider the need for additional procedures even though there was a partial mismatch between the email address domain of the confirmed respondent and the website domain of the confirmed company**.

(Auditing Standards Statement No. 505, paragraphs 6) [Large-sized audit firms]

《Points to Note》

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

Case 2: Alternative audit procedures

With regard to the external confirmation of accounts receivable balances performed with the year-end closing date as the record date, the engagement team performed alternative procedures by verifying the status of payments to the audited company for parties to be confirmed that had not responded.

However, the engagement team only verified that of the amounts for major clients that had not yet responded, several collections had been made in the month following the year-end closing date, and **did not examine the fact that more than 80% of the balances that exceeded the materiality had not yet been answered**.

(Auditing Standards Statement No. 505, paragraph 11) [Mid-tier, and small and medium-sized audit firms]

《Points to Note》

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

Case 3: Exception in relation to confirmation

NEW

The engagement team reconciled the difference between the accounts payable answered by the confirmed party and the accounts receivable of the audited company.

However, **despite the fact that the response from the confirmed party was dated July, the engagement team did not examine the appropriateness of the management's explanation that the difference arose from transactions delivered in August**.

(Auditing Standards Statement No. 505, paragraphs 13) [Mid-tier, and small and medium-sized audit firms]

《Points to Note》

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

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

Case 4: Evaluation of reply received

The engagement team identified the risk of material misstatement in the existence of inventory, and regarding the inventories under the custody and control of a third party, it requested confirmation from all entities entrusted with storing those inventories as to inventory balances

However, the engagement team **reconciled only some of the inventory balance data provided by the third party to the system data and neglected to reconcile all of the inventory balance date on the confirmation responses from third party**. As a result, the engagement team did not obtain audit evidence concerning the existence of inventory.

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

《Points to Note》

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

(3) Substantive analytical procedures

Case 1: Developing expectation

FREQUENT

①For the audited company, which operated a payment agency business, the engagement team performed a substantive analytical procedure for cost of sales, developing expectation for cost of sales by multiplying sales for the current term by the cost of sales rate for the previous term.

However, the audit team **did not consider whether it was appropriate to calculate the developed expectation by multiplying by the cost of sales rate for the previous term, even though the cost of sales included costs arising from the settlement amount, costs arising from the number of settlements, costs arising separately without being linked to sales, and sales that did not give rise to cost of sales**.

(Auditing Standards Statement No. 520, paragraph 4) [Large-sized audit firms]

NEW

FREQUENT

②As substantive analytical procedures for payroll expenses recorded by the audited company, the engagement team calculated the auditor's developed expectation of payroll expenses recorded by the audited company based on the information it obtained from the audited company on payroll expenses per employee and salary increase rate.

However, the engagement team **did not examine the reliability of the salary increase rate, which was information obtained from the audited company**.

(Auditing Standards Statement No. 520, paragraph 4) [Mid-tier, and small and medium-sized audit firms]

《Points to Note》

There continue to be cases where the engagement team did not examine the reliability of data and accuracy of developed expectation required to reduce audit risk to an acceptably low level. For example, the engagement team used the results of the previous fiscal year or earnings forecasts as developed expectation without reasonable grounds when designing and performing substantive analytical procedures.

Case 2: Investigation of results of substantive analytical procedures

FREQUENT

In substantive analytical procedures for cost of sales, the engagement team identified that the difference between the expenditure items listed as cost of sales and the expectation of the auditor exceeded the acceptable difference.

However, **the engagement team only asked questions of the audited company about the reason for the difference and obtained the response, and did not obtain audit evidence to support the response from the audited company.**

(Auditing Standards Statement No. 520, paragraph 6) [Mid-tier, and small and medium-sized audit firms]

《Points to Note》

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

(4) Audit sampling and testing specific items

Case 1: Planning of audit sampling

FREQUENT

①The engagement team planned audit sampling as tests of details for the value of goods purchased by the audited company. The team performed dual-purpose tests doubling as substantive procedures in the form of cross-checking supporting documents for 25 cases to evaluate the operation of internal control in respect of the value of goods purchased between April and September, and cross-checked supporting documents for the value of goods purchased between March 16 and March 30 for 24 cases.

However, the engagement team **limited the period under the substantive procedures relating to the value of goods purchased and therefore did not select samples in a way each sampling unit in the population has a chance selection**.

(Auditing Standards Statement No. 530, paragraphs 7) [Mid-tier, and small and medium-sized audit firms]

NEW

②The engagement team carried out audit sampling using R & D expenses and expenses such as sales commissions and outsourcing expenses ("general expenses") as one population, which included various expenses such as payroll expenses and depreciation for the R & D division.

However, even though the engagement team **recognized that the characteristics of R & D expenses and general expenses were different, it did not examine the appropriateness of including them in one population**.

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

③In order to verify the audited company's sales, the engagement team cross-checked samples selected through audit sampling against relevant vouchers.

However, the engagement team could not compare some sales transactions in the sample with external evidence such as order forms and acceptance notifications because the audited company did not possess such evidence. Despite this situation, the engagement team **did not examine the appropriateness of audit evidence obtained through alternative procedures**.

(Auditing Standards Statement No. 530, paragraph 10) [Large-sized audit firms]

《Points to Note》

When designing audit sampling, the engagement team needs to consider the purposes to be achieved by the auditor and the optimal combination of audit procedures and evidence to achieve the purpose, taking into account the characteristics of the population from which test items are to be selected.

In deciding the number of samples, it is necessary to note that the way of determination thereof for tests of operating effectiveness of internal control differs from that for tests of details, in general. Therefore, when using the number of samples, which was for the tests of controls, also for the tests of details as in the above example case, it is necessary to examine whether the number of samples is sufficient for tests of details.

With audit sampling, samples should be selected in a way that provides opportunities for all items within the population to be selected; therefore, it is necessary to pay attention to the completeness of the population for selection.

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

Case 2: Selecting specific items

The engagement team identified risks of material misstatement (including in regard to existence and completeness) in respect of the cost of sales of the audited company (value of goods purchased) and performed cutoff tests using data for transactions near the closing date of the term and also performed balance confirmation procedures regarding accounts payable as of the closing date of the term.

However, the engagement team did not obtain sufficient and appropriate audit evidence regarding the cost of sales (value of goods purchased), as the team only performed tests of details for transactions near the closing date of the term that were subject to the cutoff and the accounts payable balances subject to confirmation procedures, and **did not perform tests of details in respect of the remaining transactions after these had been excluded**.

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

《Points to Note》

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

Testing some selected items in a population, which involves extracting specific items from transaction types or account balances, is an effective method for obtaining audit evidence, as it allows for the examination of atypical transactions, high-risk items, and monetary materiality, as well as the acquisition of information

about the nature of transactions. Unlike audit sampling, however, it needs to be kept in mind that audit evidence is not provided concerning the remaining part of the population, namely the components of the population that are not extracted as samples.

(5) Related parties

Case 1: Verification of reliability of questionnaire responses relating to related party transactions

NEW

The engagement team obtained "Questionnaire Responses" from directors and company auditors of the audited company in order to ascertain related party transactions. The engagement team also obtained from the Chairman of the Board a written response stating that there were no transactions that constituted related party transactions. The engagement team inspected the written responses to verify related party transactions. The engagement team also confirmed through inspecting the minutes of the Board of Directors that related party transactions were being conducted with the corporation represented by the Chairman of the Board.

However, the engagement team **did not sufficiently examine the reliability of the written responses even though the aforementioned related party transactions related to the Chairman of the Board were not included in the written responses**.

(Auditing Standards Statement No. 550, paragraphs 8) [Large-sized audit firms]

《Points to Note》

In addition to the above, the following examples of deficiencies were identified.

- **The engagement team did not sufficiently examine whether relationships with related parties and transactions with related parties were comprehensively identified;**
- **The engagement team overlooked the fact that the terms and conditions of related parties transactions were not appropriately disclosed when no interest-free loans or debt guarantee fees were paid.; and**
- **The engagement team did not sufficiently examine the terms and conditions of transactions that were disclosed as arm's length transactions**

The engagement team should carefully evaluate whether or not related party relationships and related party transactions are comprehensively identified and appropriately processed and disclosed in accordance with the applicable financial reporting framework.

For information on cases related to identification and assessment of the risks of material misstatement and audit procedures responsive to the assessed risk regarding related party transactions, including the consideration of fraud risk required in the Auditing Standards Statement No. 240, also see "1. The Auditor's Responsibilities Relating to Fraud in Financial Statement Audits".

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

With the aim of strengthening its revenue base, the audited company decided to enter a specific new business and acquired the business from a company with which the audited company had personal connections (the "Acquisition"). Under the business acquisition agreement, the audited company sold its products to only one customer and stored them in an external warehouse designated by that customer.

The engagement team determined that the transaction for the Acquisition, which was intended to enter a new business, was a significant transaction outside the audited company's normal course of business, and through interviews with the management, the engagement team obtained an understanding of the distribution channel for the Business and the economic rationale of the business model for the Business.

However, the engagement team **did not recognize that the customer to whom the products relating to the business were sold was a related party of the audited company and did not accurately understand the particularities of the business.** In addition, **regarding the reasonableness of the business acquisition, the engagement team did not critically examine and assess whether the business acquisition implied the possibility that the transaction had been carried out for fraudulent financial reporting or to conceal the misappropriation of assets**.

(Auditing Standards Statement No. 550, paragraph 22) [Mid-tier, and small and medium-sized audit firms]

《Points to Note》

Because related party transactions may carry higher risks of material misstatement than third party transactions, the engagement team should comprehensively understand the audited company's related parties and their relationships with them. The engagement team should also be aware that if it identifies any significant related party transactions outside the audited company's normal course of business, it must treat them as a significant risk.

Furthermore, with regard to significant transactions with related parties outside the audited company’s normal course of business, the engagement team needs to carefully consider not only whether they have been disclosed, but also whether their business rationality, or lack thereof, points to the possibility that they have been conducted for the purpose of producing fraudulent financial statements, and whether the transaction terms are consistent with the explanations by management.

(6) Going concern

Case: Evaluation of management's assessment of going concern assumptions

FREQUENT

Although there were events or conditions casting significant doubt on the going concern assumptions, such as a negative cash flow from sales activities, the audited company determined that there was no material uncertainty regarding its going concern assumptions, as the company had implemented cost reductions and other measures to eliminate the events or conditions in the doubt.

Amid this situation, the engagement team examined the consistency of the statement of cash receipts and disbursement prepared by the audited company with the budget and maximum credit line.

However, the engagement team **did not sufficiently examine the reliability of basic data in the budget prepared by the audited company, nor the evidence for the audited company's assumptions forming the basis for the preparation of the budget. Moreover, with regard to additional borrowing in the statement of cash receipts and disbursement, the engagement team did not conduct a detailed examination of the feasibility of additional borrowing in excess of the maximum credit line**.

(Auditing Standards Statement No. 570, paragraphs15) [Mid-tier, and small and medium-sized audit firms]

《Points to Note》

In addition to the above, there are cases where the engagement team did not examine whether there were additional facts or information concerning the going concern assumption when examining subsequent events.

Since the beginning of a significant event or circumstance that may undermine the continuity of business activities is likely to appear in business activities in advance, the engagement team needs to pay attention to audit evidence related to events or circumstances that may raise significant doubt on the entity's ability to continue as a going concern, and examine whether management's assessment of the existence of such events or circumstances is appropriate. Furthermore, when there are events or conditions that might cast significant doubt on the going concern assumption of the audited company, the engagement team should consider the potential need to revise the evaluation as to the risks of material misstatement and nature, timing and scope of further audit procedures.

In addition, the engagement team needs to comprehensively evaluate the circumstances of the audited company and to consider based on concrete audit evidence whether management's plans for future actions in relation to its going concern assessment were effective and feasible.

(7) Subsequent events

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

①The audited company executed an agreement to extend the due date of the significant loan that was approximately 20% of the audited company's total assets, and publicly disclosed the information.However, the engagement team **failed to consider whether the due date extension was a subsequent event that would require revisions in the audited company's financial statements or affect the audited company's financial statements in the following year and thereafter**.

(Auditing Standards Statement No. 560, paragraph 7) [Mid-tier, and small and medium-sized audit firms]

NEW ②The engagement team had designed to review minutes of the Board of Directors' and Audit & Supervisory Board's meetings held during the period from the day after the year-end closing date to the date of the audit report as one of the procedures to identify subsequent events at the audited company (closing date in March). However, the engagement team did not review the minutes of the Board of Directors' and Audit & Supervisory Board's meeting held in June because it was unable to obtain the minutes.

However, the engagement team **did not ask questions regarding matters discussed at the Board of Directors'** and Audit & Supervisory Board's **meeting, which should be conducted if the minutes could not be reviewed**.

(Auditing Standards Statement No. 560, paragraph 6) [Mid-tier, and small and medium-sized audit firms]

《Points to Note》

In many cases, engagement teams performed audit procedures related to subsequent events only by making inquiries with the management. The engagement teams need to perform audit procedures regarding subsequent events for the period between the balance-sheet date and the date of the auditor's report, including at least (Refer to Auditing Standards Statement No. 560, paragraph 6):

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

If after the date of the auditor's report but before the date the financial statements are issued, a fact becomes known to the auditor that, had it been known to the auditor at the date of the auditor's report, may have caused the auditor to amend the auditor's report, the auditor shall implement the following procedures (Auditing Standards Statement No. 560, paragraph 9):

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

4. Auditing Accounting Estimates

Points of focus

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

- Whether the engagement team appropriately exercises professional skepticism throughout the audit of accounting estimates;
- Whether the engagement team appropriately identifies and assesses the risks of material misstatement related to accounting estimates, by evaluating the extent to which estimates are affected by uncertainty and inherent risk factors (complexity, subjectivity or other inherent risk factors), as well as internal controls related to risks; and
- Whether the engagement team designs audit procedures suited to the assessed risks of material misstatement, and examines the appropriateness of the estimation methods, significant assumptions and data used by management in making accounting estimates, and assesses whether there are any signs of management bias.

Outline of inspection results

In a wide range of auditing accounting estimates, including the valuation of investments and loans to affiliated companies, impairment of fixed assets and goodwill, valuation of inventories, and recoverability of deferred tax assets, the following situations were frequently observed:

- Due to a lack of understanding of the requirements of Auditing Standards Report No. 540, risk assessment procedures such as consideration of the finalized amounts of accounting estimates for the past fiscal years and understanding of management's estimation methods were not appropriately performed.
- Due to a lack of understanding of the requirements under Auditing Standards Report No. 540 and due to a lack of professional skepticism, only qualitative assessments were performed by asking management questions about the business environment, etc. Procedures for examining the appropriateness of estimation methods, significant assumptions, and data used by management in making accounting estimates, such as the feasibility of business plans used in accounting estimates, were insufficient.

(Observed effective efforts)

The following case can be cited as an effective effort observed to improve procedures for auditing accounting estimates.

An audit firm developed and implemented a template corresponding to the requirements of Auditing Standards Statement 540. It provided training on Auditing Standards Statement 540 and used the template to demonstrate the extent of audit procedures to address risks according to the level of risk.

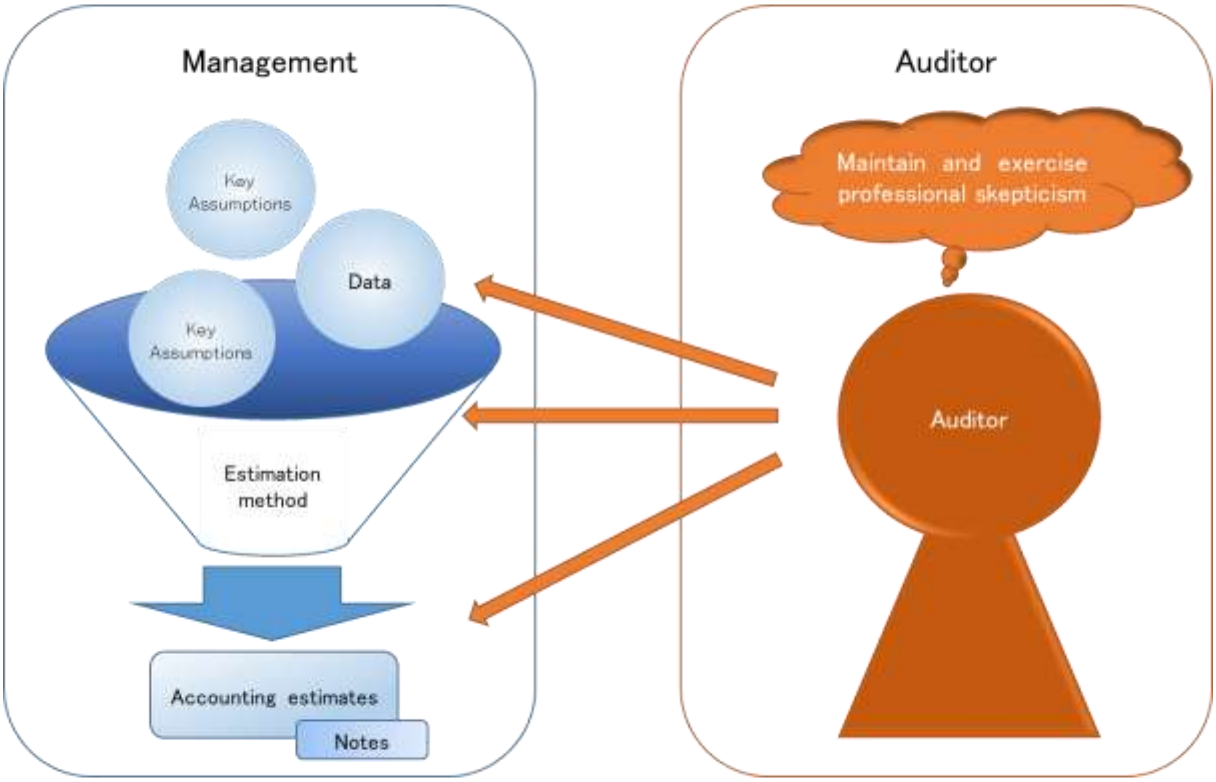
Expected response

It should be noted that the auditing accounting estimates has been significantly enhanced by the revision of Auditing Standards Statement 540 (Auditing Accounting Estimates). When assessing the risks of accounting estimates, auditors need to fully understand the company and its environment, the applicable financial reporting framework, the company's internal control system, etc., and evaluate inherent risk factors (such as the uncertainty, complexity and subjectivity of accounting estimates and other inherent risk factors) based on the review of the finalized amounts of accounting estimates for the past fiscal years.

Auditors should also note that in performing audit procedures for accounting estimates, auditors may examine how management made accounting estimates. Auditors should exercise professional skepticism and perform a critical review, considering all relevant audit evidence obtained, while noting indications of management bias against each of the estimation methods and significant assumptions and data used by management. In addition, they should fully examine the footnotes to the accounting estimates. (Refer to Figure 7)

Auditing Standards Statement 540 (Auditing of Accounting Estimates), which was revised in January 2021, is applicable to the audit of financial statements for the fiscal year ending March 31, 2023. Therefore, the provisions on the basis of deficiencies identified in the CPAAOB's inspection of the audit of financial statements for the fiscal years prior to March 2023 were not amended in January 2021

[Figure 7] How auditors examines accounting estimates made by management



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(1) Evaluation of shares in subsidiaries and affiliates

Case 1: Examination of Real Value in Valuation of Shares of Affiliated Companies

The audited company acquired additional shares of Company A, which it had invested in because of its high technical affinity with the audited company, in anticipation of excess profitability, and made it an equity method affiliate.

In valuing Company A's shares that had been recorded as shares of affiliated companies, the audited company examined whether there was any impairment of excess profitability by comparing the business plan at the time of the additional acquisition of Company A's shares with the actual results. Specifically, although Company A's actual profit for the fourth quarter was lower than planned, the cause was a delay in the progress of the business plan. Based on the business plan revised at the end of the fiscal year based on this cause, the Company determined that it was not necessary to write down the value of shares of subsidiaries and affiliates.

Amid this situation, the engagement team confirmed that the cause of actual performance of Company A falling below the plan was the lag, and, after examining the feasibility of the revised business plan, deemed the audited company's assertion that no write-down was required to be valid. However, **despite the fact that the revised business plan for Company A had been revised downward from the business plan at the time of the additional acquisition of Company A's shares, the engagement team did not adequately consider the impact of this situation on the excess profitability that it had initially anticipated**.

(Auditing Standards Statement No. 540 (Before amendment in January 2021), paragraph 11 and 12) [[Large-sized audit firms]

《Points to Note》

In addition to the above examples of deficiencies, there were cases where the engagement team did not consider the need for a write-down of shares held by the subsidiary in an insolvent subsidiary of its own, and thus did not appropriately value the net asset value of shares in the subsidiary.

When the real value of shares of a non-marketable affiliated company declines by 50% or more from their acquisition cost, unless the possibility of recovery is supported by sufficient evidence, the company is required to recognize a considerable impairment loss as a significant decline in the real value.

This treatment is also applied to the valuation of shares of newly established or recently acquired subsidiaries and affiliates.

In particular, in cases where excess profitability is anticipated, it is necessary to identify any deviation between the initial business plan and actual results in a timely manner and carefully examine whether there has been a significant decline in the real value.

Case 2: Consideration of recoverability of shares of subsidiaries and affiliates

NEW

FREQUENT

Although the real value of shares of Company B, a non-consolidated subsidiary, held by Company A, a consolidated subsidiary, fell below 50% of its book value, the audited company did not post a valuation loss on shares of subsidiaries and associates related to Company B's shares because, after examining the possibility of recovery based on Company B's business plan prepared by the audited company, it believed that it could recover with future income.

After examining Company B's business plan, the engagement team deemed that the audited company's judgment that the book value of Company B's shares could recover was reasonable.

However, the engagement team only confirmed that **the sales volume projections in Company B's business plan**, which formed the basis for Company B's future income, matched the sales volume projections for Company B in the audited company group's medium - to long-term plan approved by the board of directors of the audited company, and **did not examine the reasonableness of these sales volume projections**.

(Auditing Standards Statement No. 540, paragraphs 7) [Mid-tier, and small and medium-sized audit firms]

《Points to Note》

In addition to the above examples of deficiencies, there were cases in which the engagement team did not examine the reasonableness of the audited company's decision not to impair the value of shares of subsidiaries and affiliates despite the fact that the value of shares of subsidiaries and affiliates that were performing poorly had recovered by only about 50% of their book value in the final year of the business plan (five years) for these subsidiaries and affiliates.

There were multiple cases where the engagement team, as a professional expert, did not sufficiently and appropriately examine the appropriateness of the business plan's assumptions made by the management when evaluating the appropriateness of the business plan's assumptions for the valuation of shares of subsidiaries and affiliates, from a critical perspective. For example, the engagement team did not confirm the business plan based on concrete evidence, and only qualitatively evaluated the business plan by asking questions to the management.

With regard to business plans, engagement teams should understand the corporate environment, creation process, and related internal controls, compare them with finalized figures, and carefully examine the feasibility of the estimated figures incorporated into plans for earnings expansion, cost reduction, etc.

(2) Valuation of receivables

Case 1: Examination of calculation method for allowance for doubtful accounts

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

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

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

(Auditing Standards Statement No. 540 (Before amendment in January 2021), paragraph 7 and 14)

[Large-sized audit firms]

《Points to Note》

In addition to the above examples of deficiencies, there were cases in which the engagement team did not sufficiently examine the appropriateness of the estimation method of taking into account the uncertainties according to the period during which receivables were scheduled to be recovered, or in which, regarding assets scheduled to be seized, the engagement team did not examine the appropriateness of the amount of assets that the audited company asserted could be recovered. When evaluating debt claims in cases where some assets are planned to be seized, it is necessary not only to identify the assets to be seized but also to sufficiently examine the feasibility of seizure and the estimated amount of assets that may be disposed of. In addition, with regard to receivables with default risk, the engagement team should carefully examine whether the audited company adopted an appropriate method for calculating the estimated amount of bad debt (calculation method based on the financial condition evaluation method or the cash flow estimation method) at the time of valuation.

Case 2: Examination of reasonableness of management's assumptions

NEW

FREQUENT

Company A, which was established as a consolidated company, had net losses the current period in the previous two fiscal years and had liabilities in excess of assets. However, the audited company did not make an allowance for doubtful accounts for short-term loans to affiliated companies with regard to the balance of loans to Company A.

The engagement team determined that there was a high risk of material misstatement in the audited company's valuation of short-term loans receivable from affiliated companies.

The achievement status of Company A's business plan was confirmed by comparing the budget and actual performance for the target period in the "Basic Plan for Preparation of Quarterly Consolidated Financial Statements" (hereinafter referred to as the "Basic Plan")

However, the engagement team **did not examine the reasonableness of Company A's business plan, as it did not confirm the management's estimation method for sales, cost of sales, etc. in Company A's business plan**. In addition, the engagement team **did not examine the reasonableness of the fact that the audited company had not reviewed Company A's business plan** despite the fact that Company A's sales for the period under review were lower than those in Company A's business plan and that business progress was delayed.

(Auditing Standards Statement No. 540 (Before amendment in January 2021), paragraph 11 and 12)[Large-sized audit firms]

《Points to Note》

When evaluating the appropriateness of the management's business plan assumptions for the valuation of the audited company's receivables from affiliated companies, there were several cases where the engagement team did not sufficiently and appropriately examine the business plan from a critical perspective as a professional expert. For example, the engagement team did not confirm the business plan based on specific evidence and only qualitatively evaluated the business plan by asking questions to the management.

With regard to business plans, engagement teams should understand the corporate environment, production process, and related internal controls, compare them with finalized figures, and carefully examine the feasibility of the estimated figures incorporated into plans for earnings expansion, cost reduction, etc.

In addition, there were cases in which the engagement team did not consider the need for the parent company to bear the final burden of the amount of liabilities in excess of assets of a subsidiary of the audited company that had liabilities in excess of assets.

In principle, limited liability to shareholders is limited to the amount invested. However, as a parent company, it is necessary to note the need to provide for the amount of liabilities in excess of assets of the subsidiary in excess of the amount invested.

(3) Inventory valuation

Case1: Review of inventory valuation methods

With regard to the valuation of products and raw materials, the audited company had an accounting policy that the audited company write-down book values to zero due to decline in profitability, on the condition that the products, of which were expected to be hold for more than three years in the future, were unlikely to be sold (condition 1) and raw materials expected to be disposed of (condition 2). Also, the audited company determined that raw materials that were not subject to condition 2 would not have a decline in profitability, as such raw materials would not degrade physically and the audited company would need to hold a wide variety of raw materials.

The engagement team noted that the audited company evaluated products and raw materials in accordance with the above policy.

However, the engagement team **did not evaluate whether the aforementioned valuation method for products and raw materials of the audited company was appropriate to determine declines in the profitability of products and raw materials**.

(Auditing Standards Statement No. 540 (Before amendment in January 2021), paragraphs 7) [Mid-tier, and small and medium-sized audit firms]

Case2: Examination of reasonableness of management's assumptions;

NEW

With regard to the valuation of products and work in process relating to content such as video game software, if the net selling value (selling price at the end of the fiscal year minus the estimated additional manufacturing cost) was below the acquisition cost, the audited company had a policy of recognizing the difference as a valuation loss.

In calculating the selling price at the end of the fiscal year, the audited company assumed that the projected sales volume of each content would be at the same level as the actual sales volume of content deemed similar by the audited company.

In calculating the net selling value, the audited company did not deduct estimated direct sales expenses.

The engagement team identified the above assumption made by the audited company as a significant assumption, and also identified the risk of incorrect valuation of content-related products and work in process as a significant risk. As audit procedures to address this risk, the engagement team performed procedures such as inspecting calculation data prepared by the audited company, understanding the method of estimating selling prices and estimated additional manufacturing costs at the end of the fiscal year, and obtaining basic data.

Furthermore, the Company compares the actual sales volume of content sold the current period with the forecast sales volume for the previous fiscal year and discusses the difference.

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

- The engagement team did not examine the appropriateness of the audited company not deducting estimated direct sales expenses when calculating the net selling value.
- **Despite the existence of content in which actual sales volume in the current period fell short of the sales volume forecast for the previous fiscal year, the reasonableness of assumptions was not sufficiently examined. For example, the engagement team did not examine how management assessed the impact of uncertainties in accounting estimates on assumptions**;

- **In determining the selling price and estimated additional manufacturing cost at the end of the fiscal year, the engagement team did not examine the reasonableness of the estimation method used by management and the accuracy of the underlying data**.

(Auditing Standards Statement No. 540 (Before amendment in January 2021), paragraphs 11, 12, 14; ASBJ Statement No. 9, Paragraph 5) [Mid-tier, and small and medium-sized audit firms]

《Points to Note》

In addition to the above examples of deficiencies, there were cases in which the engagement team did not sufficiently consider the appropriateness of management's assumption that it would not be necessary to record valuation losses because slow-moving inventories with poor sales records had not deteriorated physically and remained in operation. There were also cases in which the engagement team did not consider the appropriateness of management's assumption that it would not record valuation losses because the audited company did not sell its existing products for sale or inventory held for maintenance at below book value. There were also cases in which the engagement team did not consider the appropriateness of the audited company recording valuation losses at a certain rate of book value according to the delay period. There were also cases where the engagement team did not sufficiently examine the reliability of valuation loss calculation data prepared by the audited company.

Among the inventories held by the audited company are inventories with special characteristics, such as those for which it is difficult to calculate an objective value, such as real estate for sale and development project expenditures.

It should be noted that inventories with such special characteristics cannot normally be excluded from the scope of write-downs based on decreased profitability, and that the necessity of using the work of experts needs to be considered when valuing significant inventories.

(4) Impairment of fixed assets

Case 1: Consideration of grouping of assets

In performing impairment tests of fixed assets in consolidated financial statements, the audited company grouped its bricks-and-mortar store assets on the basis of the organizational units responsible for businesses under a particular brand (hereinafter referred to as "brand units").

Amid this situation, the engagement team did not undertake any particular examination of the cash-generating units, as the audited company grouped its store assets on the basis of brand units every fiscal year and there had been no change during the current fiscal year.

However, the engagement team **did not examine the appropriateness of the audited company grouping its store assets on the basis of brand units**, even though the audited company published figures for the number of stores opened and closed in its monthly overview of sales and grouped those store assets on the basis of independent store units in those figures.

(Auditing Standards Statement No. 540 (Before amendment in January 2021), paragraphs 11)

[Large-sized audit firms]

《**Points to Note**》

In addition to the above examples of deficiencies, there were cases where the engagement team overlooked that the grouping of assets deviated from the actual situation, and did not examine the appropriateness of the classification of shared assets.

In addition, there are cases in which the engagement team did not consider whether the asset grouping rules it had considered in previous years would still be in line with the actual state of the company if the company or its surrounding environment changed.

On the other hand, there were cases where the engagement team did not exercise professional skepticism and sufficiently examine whether a change in impairment assessment before and after a change in grouping was an indication of fraud. There were also cases where the engagement team did not sufficiently examine the reasonableness of a change in grouping in light of accounting standards, etc. when impairment was not recognized for a certain asset group as a result of a change in grouping of fixed assets, which had been treated as a single asset group, into multiple asset groups.

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

Case 2: Review of Finalized Accounting Estimates for Prior Periods

Although consolidated company A of the audited company continued to record operating losses, in examining the recognition of impairment losses on fixed assets the current period, the engagement team determined that it was unnecessary to recognize impairment losses on fixed assets because undiscounted future cash flows based on the business plan exceeded the book value of fixed assets.

In addition, based on this business plan, the audited company anticipating expects Company A's fixed costs for the next fiscal year, personnel costs will be reduced through efforts to secure personnel and promote employee retention, and fixed costs other than personnel costs will also be reduced. As a result, overall fixed costs will decrease compared with the current period, and Company A will return to an operating profit.

The engagement team interviewed the management about the management's assumptions regarding Company A's fixed cost reductions in order to understand the management's assumptions.

With regard to personnel expenses, it is understood that the increase in personnel expenses the current period was due to temporary factors, and after comparing the planned figures for the next fiscal year in this business plan with the actual figures for the previous fiscal year, it has been determined that the management's assumptions are not unreasonable.

However, the engagement team did not have a specific understanding of the nature and reason for the difference between Company A's planned operating loss and actual operating loss in the current period and the fact that Company A had continued to post operating losses, even though Company A's actual operating loss was lower than planned. The engagement team also **did not assess the possibility of management bias in the audited company's management's estimate of fixed costs or the degree of uncertainty included in management's estimate**.

(Auditing Standards Statement No. 540(Before amendment in January 2021), paragraphs 7, 8, 12)

[Mid-tier, and small and medium-sized audit firms]

《Points to Note》

In some cases, when reviewing accounting estimates made by management, the engagement team only sought to ascertain the amount of deviation from estimates made in prior years and the actual results for the current year, as well as the reason for it, and did not take the findings into account in assessing the risk of management's estimates for the current year. The engagement team should bear in mind that the purpose of reviewing accounting estimates is to identify the possibility of management bias and to assess the degree of estimation uncertainty. A difference between the finalized accounting estimate and the amount recognized in the prior years' financial statements does not necessarily indicate a misstatement in the prior years' financial statements. However, there are cases where it can be reasonably assumed that an estimate that is close to the finalized amount could have been made if management used information available at the time of the prior year's estimate or information that management reasonably expects to obtain and take into account when preparing and presenting the prior years' financial statements. In such cases, the auditor should consider the possibility that the difference indicates a misstatement in the prior years' financial statements.

Case 3: Review of indications of impairment

NEW

FREQUENT

①With regard to the assessment of indications of impairment of store assets, the audited company did not allocate personnel expenses, advertising expenses, and other expenses related to head office employees "(hereinafter referred to as the "("head office expenses") to asset groups on the grounds that these expenses were unavoidable in maintaining head office functions and did not fall under indirect expenditures necessary for each asset group to generate future cash flows. The engagement team determined that the management's accounting policy of not allocating head office expenses to asset groups was acceptable from an audit perspective because head office expenses accounted for around 10% of total SG & A expenses.

However, the engagement team **did not sufficiently examine the appropriateness of management's determination that each item in head office expenses did not fall under expenditures that indirectly incurred by each asset group**, even though the team recognized that personnel expenses and advertising expenses related to head office employees included in head office expenses had the nature of expenses disbursed with the intention of managing the entire company, including stores, and maintaining and expanding store sales.

(Auditing Standards Statement No. 540, paragraphs 22; ASBJ Guidance No. 6, Paragraph 12) [Large-sized audit firms]

NEW

②When examining the impairment of fixed assets related to the hotel business, the audited company did not identify any indication of impairment in the hotel business asset group because operating income was expected for the next fiscal year based on the budget, although the hotel business had recorded operating losses for the last two consecutive fiscal years. The audited company expects operating revenue for the next fiscal year to recover to approximately 90% of the pre-COVID-19 level under the assumption that the number of guests will increase due to a decrease in the number of COVID-19 cases and a reduction in the scale of restrictions on activities and self-discipline. The engagement team performed the following procedures and determined that management's estimate of operating expenses for the hotel business for the next fiscal year was reasonable:

- Conducted a comparative analysis of the current period's budget and actual expenses to evaluate the accuracy of management's budget estimate.
- Conducted interviews with management to understand management's assumptions included in the estimate of operating expenses in the budget for the next fiscal year.
- Conducted a comparative analysis of operating expenses for previous fiscal years to evaluate the appropriateness of management's assumptions.

However, the engagement team **did not sufficiently examine the appropriateness of management's assumption that the budgeted operating expenses for the hotel business for the next fiscal year would be restrained compared to the increase in operating income, as evidenced by the fact that the engagement team did not check the data and documents that served as the basis for the restraint of operating expenses. This was despite the need for careful consideration of the hotel business's operating profit in the budget for the next fiscal year to assess whether there were any indications of impairment in the hotel business asset group**.

(Auditing Standards Statement No. 540, paragraphs 17, 21 23)Large-sized audit firms]

③As to new stores in business less than two years from the beginning of the fiscal year following their opening, the audited company determined that operating losses incurred or likely to be incurred on a continuous basis would be excluded from the assessment of indications of impairment, except that some significant change in the environment exists, because its new stores tend to suffer operating losses immediately after opening due to the nature of the business.

However, when examining the company’s assessment of the indications of impairment for the new stores, the engagement team **did not consider whether the new store’s operating losses represented a significant downward deviation from the business plan formulated when the**

store was opened, although there are stores for which impairment losses are recognized just after their first two years in business.
(Auditing Standards Statement No. 540 (Before amendment in January 2021), paragraphs 12 and 14) [Large-sized audit firms]

《Points to Note》

In addition to the above examples of deficiencies, there were cases in which the engagement team did not examine whether the change in the allocation standard for head office expenses was appropriate in light of changes in the circumstances of the audited company, cases in which the reliability of profit / loss information for each asset or asset group was not evaluated, cases in which the engagement team did not assess indications of impairment using profit / loss from operating activities when both profit / loss from operating activities and cash flow from operating activities were known, and cases in which the engagement team did not assess indications of impairment using actual figures at the end of the fiscal year even though the actual figures at the end of the fiscal year were significantly worse than expected after assessing indications of impairment using expected figures before the end of the fiscal year. The engagement team should keep in mind that, based on all available information, the engagement team should carefully examine indications of impairment. In addition, as a general rule, when an asset or asset group becomes idle, it falls under a change that significantly reduces the recoverable amount of the asset or asset group with respect to the scope or method of using the asset or asset group. Therefore, when examining indications of impairment, the engagement team needs to carefully examine the reasonableness of the period of idle status, such as whether the period of idle status falls under a period that is considered to be necessary to determine future use when the asset has hardly been used.

Case 4: Review of recognition and measurement of impairment

NEW

FREQUENT

①In examining the impairment of fixed assets within the consolidated group, the audited company determined that there were indications of impairment in Company A's asset groups, and as a result of examining the undiscounted future cash flows calculated for each asset group, it did not record an impairment loss.

The engagement team conducted a review based on undiscounted future cash flows for each asset group and found that the audited company's decision not to book impairment losses on Company A's fixed assets was reasonable.

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

・The engagement team did not examine the reasonableness of the fact that land was the audited company's main asset.

・**The engagement team did not examine the reasonableness of the audited company's assumption that the cash flow calculated based on the business plan for the fifth year**

would continue after the sixth year when estimating Company A's 20-year undiscounted future cash flow.

・**The reasonableness of Company A's capital investment amount was not examined**.

・The engagement team **did not examine the reasonableness of the audited company's estimates of sales volume and unit price to customers, which would have a significant impact on the calculation of some of the audited company's future cash flows**, out of the audited company's significant assumptions about Company A's sales.

・**Among the material assumptions regarding Company A's cost of sales, the reasonableness of the assumption that Company A's personnel expense ratio would decrease due to personnel reduction measures was not examined in light of the feasibility of reducing the specific number of personnel to be reduced and the amount of personnel expense reduction**.

(Auditing Standards Statement No. 540, paragraph 13, 21-23) [Mid-tier, and small and medium-sized audit firms]

NEW

②As the audited company continued to post operating losses, it decided to discontinue the asset group for Business A (the "Asset Group").The Company has determined that there are indications of impairment of fixed assets. In addition, the Company determined that it is not necessary to recognize an impairment loss for the asset group because the total undiscounted future cash flows expected over the remaining economic life of the major assets exceed the book value of the asset group.

The audited company disclosed the following information regarding its management policy, etc. for the next fiscal year and beyond.

(A)Announced management briefing materials indicate that the Company has a policy to consolidate domestic production bases related to Business A at the earliest possible time in the future;

(B)Announced management briefing materials indicate that the Company expects to incur extraordinary losses associated with the consolidation of domestic production bases as announced in (A) above;

(C)In the management briefing materials in (B) above and in "Section 2 [Business Overview] 2 [Views and Initiatives on Sustainability]" of the securities report, the management revised upward the target for the rate of reduction in greenhouse gas emissions for a certain period in the future, and as its main measures, the Company will reorganize its production system to improve production efficiency and stop the operation of existing facilities.

The engagement team received an explanation from the management that it would accelerate the reduction of existing facilities, that it expected specific plants to survive, and that it was considering whether to sell facilities at production bases other than these plants, in addition to converting them to other businesses and stopping them.

In addition, the engagement team recognized that the business budget and the estimate of undiscounted future cash flows that were used as the basis for the audited company's calculation of undiscounted future cash flows reflected the continuous decrease in sales volume of Business A, which was the background to the policy in (A) above.

However, the engagement team **<u>did not obtain specific information on the causes of the extraordinary losses mentioned in (B) above, and did not consider whether or not to recognize such extraordinary losses. In addition, the engagement team did not consider whether and to what extent the shutdown of existing facilities had an impact on the undiscounted future cash flow estimates mentioned in (C) above</u>**.

(Auditing Standards Statement No. 540, paragraphs 21, 22) [Large-sized audit firms]

NEW

FREQUENT

③Company A, a subsidiary of the audited company, incurred net losses from operating activities in Business B for two consecutive years. As a result, the audited company determined that there were indications of impairment of fixed assets held by Company A relating to Business B and measured impairment losses. In measuring the impairment loss, Company A obtained a "Real Estate Appraisal Report" for land and buildings and a "Report for Calculation of Net Selling Value of Movable Assets" for movable assets of machinery and equipment and certain structures. Company A purchased some structures, tools, furniture and fixtures, etc. (hereinafter referred to as "other structures, etc.") that were excluded from the valuation in the "Report on Calculation of Net Selling Value of Movables". However, since there are no significant fixed assets, the net selling value is the same as the book value. With regard to the valuation of fixed assets at Company A, the engagement team performed the following procedures for measuring impairment loss:

・Evaluation of the competence, capabilities, and objectivity of the experts used by the management, as well as consideration of the appropriateness of the calculation methods adopted by the experts and the basic data used by them

・Confirmation that no significant fixed assets are included in other structures, etc., based on the number of registrations in the fixed asset register and the book value per unit.

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

・The engagement team did not consider whether it was necessary for the engagement team to use the services of experts in measuring impairment losses on fixed assets related to Business B held by Company A, despite the fact that Company A required expert knowledge of real estate and movables valuation when measuring impairment losses on fixed assets.

・The engagement team **<u>did not examine the reasonableness of the management's assumption that the net selling value of other structures, etc. would be the same as the book value</u>**, despite the fact that the net selling value of the assets subject to valuation in the "real estate appraisal report" and the "report on calculation of net selling value of movables" had fallen below the book value.

(Auditing Standards Statement No. 540(Before amendment in January 2021), paragraph 12, 14; No.660, paragraph 6) [Mid-tier, and small and medium-sized audit firms]

《**Points to Note**》

In addition to the above deficiency cases, there are cases in which the engagement team did not examine the reasonableness of the remaining economic life of the asset, which serves as the basis for estimating future cash flows; cases in which capital investment and repair costs to maintain the present value were not included in future cash flows; cases in which a post-tax discount rate was used even though future cash flows were pre-tax figures; cases in which the appropriateness of the discount rate used was not examined; and cases in which impairment loss recognition was determined based on undiscounted future cash flows before allocation of head office expenses.

There were frequent cases where the engagement team did not sufficiently and appropriately examine the reasonableness of the business plan from a critical perspective as a professional expert. For example, the engagement team did not confirm the content of the business plan based on specific evidence and only qualitatively evaluated it by asking questions to the management, although the recognition and measurement of impairment loss largely depended on the estimate of future cash flows based on the business plan prepared by the management.

Therefore, when examining the management's assumptions regarding the necessity of impairment accounting, the engagement team needs to exercise professional skepticism and carefully examine the appropriateness of the estimation method, significant assumptions, and data used by the management, such as the remaining economic life used to calculate the value in use of assets, sales and operating expenses in the business plan that are the assumptions for the estimate, and components of future cash flows such as expenditures related to capital investment.

In examining future cash flows, it is also necessary to pay broad attention to consistency with non-financial information such as sustainability information.

Furthermore, with regard to the use of real estate appraisal reports in calculating the net selling value, there are cases in which the engagement team did not examine the appropriateness of continuing to use real estate appraisal reports obtained in previous fiscal years as audit evidence in the current fiscal year, cases in which real estate appraisal reports were used without evaluating the aptitude, ability, and objectivity of the real estate appraiser used by the management, and cases in which the engagement team did not examine the reasonableness of not deducting the expected disposal cost from the real estate appraisal value in calculating the net selling value.

The engagement team should carefully consider the basis for the net selling value calculation, including the use of real estate appraisal reports in determining the net selling value, as necessary for the work of the auditor's experts.

(5) Valuation of goodwill and identifiable intangible assets

Case 1: Review of amortization period of goodwill

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

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

(Auditing Standards Statement No. 540 (Before amendment in January 2021), paragraphs 11 and 12) [Mid-tier, and small and medium-sized audit firms]

《Points to Note》

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

Case 2: Impairment of goodwill

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

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

(Auditing Standards Statement No. 540 (Before amendment in January 2021), paragraphs 11 and 12) [Large-sized audit firms]

②The audited company did not recognize an impairment loss for the goodwill, which the audited company recognized in the business combination conducted in the current year, as the audited company deemed that the value in use calculated based on discounted future cash flows according to the business plan of the acquired company exceeded the book value of the cash-generating units, including goodwill as a result of an impairment test on the goodwill in accordance with International Financial Reporting Standards.

With regard to management's assumptions in the business plan of the acquired company used for estimating discounted future cash flows, the engagement team identified sales growth rate only as a significant assumption, and performed substantive procedures for sales growth rate.

However, the engagement team **<u>did not examine the reasonableness of assumptions other than</u>**

the sales growth rate, even though the business plan used for the audited company's impairment test assumed that the operating profit rate would continue to rise every period and that the number of employees hired would exceed the most recent actual number. In addition, while the engagement team **only compared the sales growth rate, which it identified as a significant assumption, with market forecasts in related fields published by an external organization and sales growth rates of other companies in the same industry, etc. it did not examine the reasonableness of sales growth factors specific to the acquired company (including the management's estimation method and basic data used), and did not sufficiently examine the reasonableness of assumptions used by the management**.

(Auditing Standards Statement No. 540 (Before amendment in January 2021), paragraph 7, 9 and 12) [Mid-tier, and small and medium-sized audit firms]

《Points to Note》

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

In addition to the above examples of deficiencies, there were cases in which the engagement team did not understand the management's assumptions, such as the breakdown of the amounts for each company in the group and the monetary impact of business measures, when evaluating the goodwill of a corporate group comprised of multiple consolidated subsidiaries. There were also cases in which the engagement team revised the business plan because the business plan at the time of acquisition did not progress as expected and the actual profit / loss fell significantly short of the business plan at the time of acquisition, and booked impairment loss for the difference between the recoverable amount based on the revised business plan and the book value of goodwill, but did not sufficiently examine the feasibility of the revised business plan.

Furthermore, there are cases in which the audited company did not consider additional amortization of goodwill in the corresponding consolidated financial statements even though it booked impairment losses on investments in subsidiaries in non-consolidated financial statements.

The engagement team should comprehensively evaluate whether the events identified in the audit process are comprehensively reflected in the accounting treatment.

Case 3: Consideration of identifiable intangibles (management's expert evaluation)

In identifying and valuing the intangible assets of a company that the audited company acquired during the fiscal year, the audited company obtained an intangible asset valuation report from an external expert that stated: a) only customer-related assets were identified as intangible assets; and b) Such customer-related assets are not recorded in the consolidated financial statements on the grounds that the amount of such customer-related assets is assessed to be insignificant;

The engagement team reviewed the intangible asset valuation report prepared by an external expert and confirmed that the amount of customer-related assets in the report was immaterial.

However, even though the engagement team used an intangible asset valuation report prepared by an external expert used by the management, the engagement team **did not understand the information used by the external expert to identify intangible assets or the method used by the external expert to value the identified customer-related assets, and did not examine the appropriateness of the report as audit evidence**.

(Auditing Standards Statement No. 500, paragraph 7; No. 540 (Before amendment in January 2021), paragraph 12) [Mid-tier, and small and medium-sized audit firms]

《Points to Note》

There were cases where the audited company did not sufficiently consider the necessity of accounting treatment to allocate the acquisition cost to identifiable intangible assets when acquiring a company.

The engagement team needs to carefully consider the accounting treatment for allocating acquisition costs to identifiable intangibles, including using such accounting treatment as may be necessary for the experts' work.

In addition, in fiscal years when there has been a change in auditor, if the balance at the beginning of the fiscal year includes important goodwill or intangible assets, engagement teams should keep in mind the need to understand the management's assumptions forming the basis of the allocation of acquisition costs, in order to identify and evaluate the risk of material misstatement in regard to goodwill, etc.

(6) Recoverability of deferred tax assets

Case 1: Review of company classification

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

Because of this, the audited company compared the total amount of taxable income of the audited company and the subsidiary with the amount of the tax loss, and classified the subsidiary as Category 2 in the ASBJ Guidance No. 26 “Implementation Guidance on Recoverability of Deferred Tax Assets” on the grounds that a “significant tax loss” had not arisen.

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

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

(Auditing Standards Statement No. 540 (Before amendment in January 2021), paragraphs 7 and 11) [Large-sized audit firms]

《Points to Note》

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

In particular, the engagement team needs to examine more careful consideration for the determination of "taxable income excluding that arising from temporary causes" in Category 2 or Category 3 of the said Guidance.

Case 2: Estimation of taxable income

NEW

FREQUENT

①The audited company determined that deferred tax assets fell under Category 3 of the Implementation Guidance on Recoverability of Deferred Tax Assets (ASBJ Guidance No. 26).

Deferred tax assets are recognized for estimated future taxable income for a reasonable and estimable period based on the Company's business plan.

The engagement team determined that all values in the business plan were based on significant assumptions and data.

In addition, the engagement team examined the expected future increase in sales resulting from each measure planned by the audited company against the current period performance, taking into account communication with management.

However, the engagement team did not examine that the above-mentioned expected increase in sales reflected the details of the store opening plan (including the status of securing land, etc.).

With regard to the amount of increase in sales at existing stores, the engagement team did not take into account factors such as an increase in the number of operating days due to a reduction in the number of New Year's holidays and the trend in daily sales at stores. As such, the engagement team **did not adequately consider each value in the business plan that it deemed to be significant assumptions and data.**

(Auditing Standards Statement No. 540, paragraph 13, 21-23) [Mid-tier, and small and medium-sized audit firms]

NEW

FREQUENT

②The audited company determined that deferred tax assets fell under Category 3 of ASBJ Guidance No. 26 "Implementation Guidance on Recoverability of Deferred Tax Assets" and that the future reasonably estimable period was one year. As a result of estimating taxable income using figures for the next fiscal year in the medium-term management plan, taxable income may decrease. As a result, the audited company did not record deferred tax assets related to tax loss carryforwards. On the other hand, the audited company deemed its five year medium-term management plan reasonable and did not take into account any additional decrease in profits when estimating future cash flows for determining impairment of fixed assets.

The engagement team deemed the audited company's judgment that the future reasonably estimable period was one year and the assumption that taxable income may decrease further to be reasonable. However, the engagement team deemed the audited company's five year medium-term management plan reasonable and did not take into account any additional decrease in profits for the plan when estimating future cash flows for determining impairment of fixed assets. On the other hand, the engagement team did not sufficiently examine the reasonableness of setting the future reasonably estimable period at one year and taking into account any additional decrease in profits for the plan when assessing the recoverability of deferred tax assets.

(Auditing Standards Statement No. 540 (Before amendment in January 2021), paragraphs 12) [Mid-tier, and small and medium-sized audit firms]

《Points to Note》

In examining the recoverability of deferred tax assets, the engagement team often examines the appropriateness of business plans prepared by management when estimating taxable income. However, there are cases in which the engagement team judges that the estimates are conservative and highly achievable based easily on the fact that management calculates estimates by multiplying business plans by past achievement rates, etc., and does not critically examine business plans themselves.

In addition, business plans that are the basis for estimating taxable income are, in principle, required to be approved by the Board of Directors, etc. It is also necessary to pay attention to the consistency with business plans used in other accounting estimates and the basis of their assumptions. Furthermore, if there is a significant adjustment in tax returns, the engagement team needs to perform sufficient audit procedures to confirm the feasibility of taxable income, such as confirming the reasonableness of adjustments from income in business plans to taxable income for tax purposes.

Case 3: Review of scheduling

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

However, the engagement team **did not examine the reasonableness of the management assumption that the debt waiver would take place based on the facts that the representative directors of the audited company had stated that they could not specify the timing of the debt waiver, and that additional loans had been made to the subsidiaries the current period**.

(Auditing Standards Statement No. 540 (Before amendment in January 2021), paragraph 12) [Mid-tier, and small and medium-sized audit firms]

《Points to Note》

In addition to the above examples of deficiencies, in many cases, the engagement team did not appropriately or sufficiently examine the feasibility of the schedule for tax deduction of temporary difference in the future. For example, there is inconsistency between the assumption for valuation of securities and allowance for doubtful accounts and the planned period for tax deduction of relevant temporary differences in the future. In particular, the engagement team needs to carefully examine the reasonableness of the timing of tax deduction for deductible temporary differences arising from the valuation of investments and loans for affiliated companies, including the need to use experts, since complex situations such as organizational restructuring are often involved.

In addition, in examining the tax effect on retained earnings on a consolidated basis, there were cases in which the engagement team did not sufficiently consider the audited company's policy that subsidiaries do not pay dividends in principle, and cases in which the engagement team did not sufficiently consider whether the dividend policy of a foreign subsidiary had been officially approved by a decision-making body, etc.

(7) Retirement benefit obligations

Case: Reliability of basic data

FREQUENT

The audited company provided the pension actuary engaged in the computation of retirement benefit obligations with the actuarial assumptions (discount rate, retirement rate, expected salary increase rate, etc.) and personnel data (salary, age, years of service, etc.) of each employee used in the computation of the retirement benefit obligations. The audited company booked provisions for retirement benefits in non-consolidated financial statements based on the computation results of the pension actuary.

The engagement team sent a confirmation letter concerning the computation results of retirement benefit obligations to the pension actuary, and confirmed that the amount in the reply on the confirmation letter matched the amount of retirement benefit obligations recognized by the audited company. In addition, the engagement team confirmed that the number of employees included in the pension actuary's computation matched the audited company's internal data.

However, the engagement team **did not examine the accuracy of the personnel data (salary, age,**

years of service, etc. of each employee) provided by the audited company to the pension actuary, and did not examine whether the assumptions used by the pension actuary in computing retirement benefit obligations conformed to the applicable financial reporting framework.
(Auditing Standards Statement No. 500, paragraph 8, and No. 540 (Before amendment in January 2021), paragraph 12) [Mid-tier, and small and medium-sized audit firms]

《Points to Note》

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

In addition, considering actuarial assumptions such as the discount rate could influence the computation results for retirement benefit obligations greatly, the engagement team should be aware of the importance of examining the appropriateness of the actuarial assumptions used by the audited company.

(8) Asset retirement obligations

Case 1: Look back review of accounting estimates in the previous fiscal year

Of the leased stores, the audited company booked asset retirement obligations for properties for which restoration obligations were contractually owed, at the amount calculated by multiplying the past unit price of restoration expenses per square meter leased by the number of square meters leased. The audited company re-estimated the cost of restoring stores that had been decided to close by the Board of Directors and booked additional asset retirement obligations. The audited company also reversed asset retirement obligations for stores that had already been closed on the grounds that the actual cost of restoring them to their original state fell short of the amount booked as asset retirement obligations.

The engagement team understood the method used by the audited company to estimate asset retirement obligations, and examined that the method had been applied consistently since the previous fiscal year. The engagement team also evaluated the design and operation of internal controls relating to asset retirement obligations, performed a detailed substantive test relating to the recording of asset retirement obligations relating to newly opened stores, and examined the appropriateness of the amount of asset retirement obligations recorded by the audited company.

However, the engagement team **did not evaluate the reason for discrepancy between the estimated amount of asset retirement obligations for the previous year and the actual amount fixed in the current year**, nor **the reason for difference between the estimated amount of asset retirement obligations for the previous year and the re-estimated amount made in the current year**.

Furthermore, the engagement team did not perform substantive procedures for the additional amount of asset retirement obligations booked relating to stores that the audited company had decided to close.

(Auditing Standards Statement No. 540 (Before amendment in January 2021), paragraph 8 and 11) [Mid-tier, and small and medium-sized audit firms]

Case 2: Appropriateness when reasonable estimates cannot be obtained

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

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

(Auditing Standards Statement No. 330, paragraph 20; No. 540 (Before amendment in January 2021), paragraphs 11 and 12) [Mid-tier, and small and medium-sized audit firms]

《Points to Note》

Even if the amount of asset retirement obligations is not determined because the timing of performaning restoration obligations or the method of retirement is unclear, asset retirement obligations can be reasonably estimated if information to reasonably estimate the scope and probability of the timing of performance is available. Cases in which asset retirement obligations cannot be reasonably estimated are limited to cases in which the amount cannot be reasonably estimated even after all evidence available as of the balance sheet date is taken into consideration to make the best estimate. Therefore, the engagement team should keep in mind that when an audited company asserts that asset retirement obligations cannot be reasonably estimated, the team is required to carefully consider the appropriateness of such assertion, including the availability of information used for estimating asset retirement obligations.

(9) Others

Case 1: Provisions for loss on order received

If a loss was forecast after comparing the value of a received order against the projected cost, the audited company would book provisions for loss on order received.

Amid this situation, the engagement team performed a risk assessment procedure focused on cases where the audited company had booked provisions for loss on order received at the end of the previous fiscal year by comparing the actual profit or loss realized during the current fiscal year against the provisions for loss on order received at the end of the previous fiscal year, and examined the difference. In respect of the provisions for loss on order received booked at the end of the current fiscal year, the engagement team observed the documents prepared by the audited company regarding the booking of provisions for loss on order received. Then, for an arbitrarily selected sample, the team vouched the projected cost with the revised cost projection data prepared by the audited company.

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

- Regarding cases where provisions for loss on order received had not been booked at the end of the previous fiscal year, the engagement team **did not sufficiently examine the completeness of the booking of provisions for loss on order received**, as the team did not examine whether or not there were any cases involving losses during the current fiscal year.
- Amid a situation in which there were cases of loss during the current fiscal year and even though there were other cases in which losses were expected for items with the same name and for the same customer, the engagement team merely vouched figures with the revised cost projection data prepared by the audited company, however, the team **did not examine the reasonableness of specific assumptions used by the audited company, nor did the team examine the realizability of cost reductions**.

(Auditing Standards Statement No. 540 (Before amendment in January 2021), paragraph 8 and 12)
[Mid-tier, and small and medium-sized audit firms]

Case 2: Consideration of estimates of total cost of construction on a percentage-of-completion basis

A consolidated subsidiary of the audited company applied the percentage-of-completion method as the basis for revenue recognition pertaining to software development for customers. Sales were calculated by multiplying total contract revenue by the progress rate (the ratio of actual incurred costs as of the balance sheet date to estimated total cost of construction).

As an audit procedure for revenue on a percentage-of-completion basis for this consolidated subsidiary, which is a significant component, the engagement team confirmed that the estimated total cost of construction used for calculating the progress rate matched the estimated total cost of construction estimated in advance in the document for the estimate prepared by the audited company. However, the engagement team **only examined that the estimated total cost of construction was**

consistent with the amount in the document for the estimate prepared by the audited company and examined the internal approval status, and did not obtain an understanding of the detailed estimation method used by the audited company.

(Auditing Standards Statement No. 540 (Before amendment in January 2021), paragraph 12) [Mid-tier, and small and medium-sized audit firms]

《Points to Note》

In addition to the above cases, there are cases in which a loss was recorded in the current year for a construction contract for which provision for loss on construction was not recorded in the previous year, but the impact of management's estimates on the valuation was not considered. There are also cases in which management's assumptions about the period for which losses are expected to be incurred were not examined.

The engagement team should note that it is necessary to obtain sufficient appropriate audit evidence by taking into account the uncertainty of estimates for construction contracts, appropriately identifying the events for which expenses or losses are expected to be incurred in the future by comparing the accounting estimates for the previous year with the actual values for the current year, and by examining the appropriateness of estimation methods used by management in making accounting estimates, significant assumptions, and data.

5. Group Audit

Points of focus

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

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

Outline of inspection results

There were many cases in which group engagement teams put too much reliance on the audit results of component auditors without sufficiently evaluating them; there were also cases in which group engagement teams did not sufficiently perform risk assessments, such as not considering the possibility that component's financial statements contain significant risks; there were also cases in which communication with component auditors was inadequate, such as not communicating clearly the audit procedures that component auditors should perform; there were also cases in which the group engagement teams did not consider whether audit procedures to address significant risks in group financial statements were adequate; and there were also cases in which the group engagement team did not perform audit procedures for the consolidation process or consolidated journal entries.

(Observed effective efforts)

The following is examples of effective efforts aimed at ensuring and improving group audit quality.

- The quality control department prepares a list of discussion points to advance understanding of the group audit and implementation of the necessary responses. More specifically, the group engagement team can make it clear what should be done in the group audit by being presented available materials that describe in detail issues pertaining to group audits – tasks to be performed throughout the year, how to prepare audit documentation, methods for communicating with component auditors, etc. – and the responses thereto.
- A dedicated section was established within the audit business department to support and oversee engagement teams that conducted group audits on a global basis. Specifically, the dedicated section gathered information through questionnaire surveys of the engagement teams and interviews with the group engagement team with a significant component in emerging countries.
- The PICOQC emphasized through training that it was necessary to consider not only quantitative materiality based on monetary criteria but also qualitative materiality, such as the existence of significant risk, when identifying significant components, in view of cases where an issue occurred in a component other than a significant component, resulting in restatement of the group financial statements.
- The audit business department prepared, in cooperation with the advisory department, a checklist that summarized the key points in controlling foreign group companies. The group engagement team uses this checklist to improve its understanding of the financial reporting processes and risk management process for new foreign subsidiaries.

Expected response

Group engagement team is required to evaluate the work of the component auditors it uses, always bearing in mind that the responsibility for issuing appropriate auditor's reports lies with the group engagement team.

Group audit requires the group engagement team to sufficiently communicate with the component auditors about the nature, timing and extent of audit procedures, as well as findings concerning the audit procedures performed for component financial information, and to obtain sufficient appropriate audit evidence about component financial information and consolidation processes so as to express opinion about whether the group financial statements have been prepared in accordance with the applicable financial reporting framework. Therefore, the group engagement team needs to develop an appropriate audit plan, perform audit procedures, and evaluate whether sufficient appropriate audit evidence has been obtained to gain a basis for forming an opinion on group financial statements.

In particular, when there are significant foreign components, the group engagement team is required to ascertain the circumstances of such significant foreign components, communicate sufficiently with component auditors, and then appropriately identify the existing risks.

To properly conduct group audits, auditors are required to possess knowledge and experience required for ordinary audits as well as incidental capabilities suited to the circumstances, such as language skills and knowledge of accounting systems in specific countries.

To achieve the above, audit firms should carefully assign engagement partners and other professionals to ensure and improve the quality of group audit.
In the case where the foreign component auditors are arranged in a complex structure, especially when involving an foreign component auditor outside the group auditor's network, audit firms should develop frameworks to provide instructions and support in relation to the group engagement team's instructions to and supervision of the foreign component auditors, evaluation of reports prepared by the foreign component auditors, and understanding of the audited company's management control over new affiliate companies added through acquisition, etc.
Although the concept of" "significant components" will be abolished in the revised Auditing Standards Statement No. 600, when determining significant components based on the current Auditing Standards Statement No. 600, it is necessary to appropriately determine not only sales but also assets, liabilities, cash flows, profits, etc. in the group financial statements as financial indicators to be used in determining individual financial significance, depending on the nature and circumstances of the group. It is also necessary to determine the significant components based on the specific nature and circumstances of components, such as take into account the qualitative significance such as the possibility of existing significant risks pertaining to the group financial statements, in addition to individual financial significance.

Case 1: Understanding the Component Auditor

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

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

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

《Points to Note》

The group engagement team should keep in mind that, when instructing a component auditor to perform audit work related to the component's financial information, it should understand if there are any issues pertaining to the component auditor's independence, whether the component auditor has the appropriate competence and capabilities as a professional expert, and whether it can involve itself in the work of the component auditor. In addition, when instructing a foreign component auditor to audit component financial information prepared in accordance with Japanese GAAP, it is necessary to consider whether the

component auditor has sufficient knowledge to perform the audit.

Case 2: Materiality

The group engagement team uniformly applied the upper limit given in the audit manual in determining the component materiality, and decided that the component materiality for all components were to be slightly below the materiality for the audit of group financial statements as a whole.

However, although employee fraud had been identified in the previous fiscal year at Subsidiary A, a significant component of the audited company, the group engagement team **did not consider whether it was necessary to set a different materiality depending on the circumstances of each component, including the fraud identified**.

(Auditing Standards Statement No. 600, paragraph 20) [Mid-tier, and small and medium-sized audit firms]

《Points to Note》

To reduce the possibility that the total uncorrected and undiscovered misstatements in the group financial statements exceed group materiality to a minimum acceptable level, component materiality shall be set lower than the group materiality. The group engagement team needs to sufficiently understand the business of the audited company's group and its business environment in deciding component materiality. If any changes occur in the business environment, the team needs to appropriately take into account its effects and consider the adequacy of component materiality to perform appropriate audit procedures to address audit risks for each component. In addition to the above case, there were cases in which the group engagement team did not evaluate the appropriateness of the performance materiality, as exemplified by a failure to request component auditors to report on the performance materiality that they had determined.

Case 3: Determining audit procedures to be performed for the financial information of components

NEW

① In preparing the consolidated financial statements, the audited company used the financial statements of Company A, an overseas subsidiary, based on its provisional closing of accounts as of the consolidated closing date (March 31), because the end of the fiscal year of Company A was December 31.

The group engagement team assessed Company A as a significant component with individual financial significance and identified the risks of material misstatement at the assertion level relating to significant account balances.

The group engagement team sent audit instructions to the component auditor of Company A and requested the auditor to audit the financial information for the period ended December 31based on component materiality. In light of the response to the audit instructions from the component auditor, the group engagement team also instructed the component auditor to perform the following additional procedures for the period from January 1 to March 31:

- Detailed test of sales
- Cutoff test of sales
- Inspection of journal entry for cancellation of sales such as returns subsequent to the year-end date (March 31)
- Confirmation of accounts receivable balance (record date: the end of March)
- Valuation of aged accounts receivable
- Valuation of inventories
- Journal entry test
- Investigation of subsequent events

The group engagement team instructed the component auditor of Company A to perform substantive procedures for the risks of material misstatement at the assertion level relating to certain significant accounts above and obtain the results, **however, the group engagement team did not instruct the component auditor to perform substantive procedures for the period from January 1 to March 31** for the risks of material misstatement at the assertion level relating to cash deposits, property, plant and equipment, short-term loans payable, cost of sales, selling, general and administrative expenses, deferred income taxes and other items that were identified as significant account balances by the engagement team.

(Auditing Standards Statement No. 300, paragraphs 21; No. 600, paragraphs 23 and 25) [Mid-tier, and small and medium-sized audit firms]

②The group engagement team determined materiality for the entire group financial statements based on the pre-tax net profits in the business plan, which were also used as the basis of the financial indicator to designate a significant component with individual financial significance. The group engagement team did not identify Company A, a component of the audited company's group, as a significant component that was financially significant to the audited company's group because Company A's pre-tax net profits for the current period accounted for less than a certain percentage of its group net profits. On the other hand, the group engagement team identified a fraud risk of overstatement of accounts related to the fraud in response to the detection of fraud at Company A during the fiscal year, designated Company A as a significant component that may include significant risks in the group financial statement, and performed substantive procedures. However, despite the fact that Company A's "revenue," "cost of sales," and "bonds and loans payable" represented a relatively high proportion of each account in the group financial statements, the group engagement team did not perform substantive procedures for these accounts in Company A other than the procedures to respond to such fraud risk above, and **did not obtain sufficient appropriate audit evidence to provide the basis for expressing an opinion on the group financial statements**.

(Auditing Standards Statement No. 600, Paragraphs 11 and 17). [Mid-tier, and small and medium-sized audit firms]

《Points to Note》

The group engagement team needs to pay attention to whether the work planned by the group engagement team as procedures to be performed for each significant component and non-significant component has been completely communicated to the component auditors, or whether the work to be performed has been appropriately planned and performed by the component auditors.

Case 4: Involvement in audit procedures undertaken by component auditors

FREQUENT

①With regard to a foreign subsidiary that was a significant component of the audited company's group, the group engagement team identified a risk of "understatement of working budget" used for the estimate calculation of the percentage-of-completion method of accounting as a significant risk related to group financial statements.

However, the group engagement team **did not discuss with the component auditor the significant risk of "understatement of working budget" used for the estimate calculation of the percentage-of-completion method of accounting**.

(Auditing Standards Statement No. 600, paragraphs 29) [Mid-tier, and small and medium-sized audit firms]

FREQUENT

②Through discussions with the auditors of significant components of the audited company's group, the group engagement team confirmed that the component auditors had identified the risk of management override and fraud risks in revenue recognition.

However, the group engagement team did not perform the following procedures, even though the team identified these risks as significant risks in the group financial statements.

- **With regard to the fraud risks in revenue recognition, the group engagement team merely gained an understanding of the relevant assertions and was not sufficiently involved in risk assessment by the component auditors; for example, the team did not obtain the details of the risks in the concrete**.
- **With regard to the risk of management override, the group engagement team did not fully evaluate the appropriateness of audit procedures to address the risk; for example, the team did not ascertain the extraction criteria for journal entry testing performed by the component auditors as audit procedures to address the risk**.

(Auditing Standards Statement No. 600, paragraph 29 and 30) [Large-sized audit firms]

《Points to Note》

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

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

Case 5: Consolidation process

①With regard to components' financial information included in the consolidation reporting package prepared by significant components of the audited company's group, the group engagement team take an approach of relying on the results of audits performed by component auditors for the examination of specific account balances concerning significant risks related to the group financial statements, while examining other financial information on its own.

However, with regard to the following financial information which was quantitatively material and for which the group engagement team had decided to examine on its own, **it merely ensured the absence of unusual changes through trend analysis and other means**, and failed to perform substantive procedures.

- The period-end balance of inventory purchased by the components from the consolidated group companies, which form the basis of journal entries concerning the elimination of unrealized profits/losses on inventory.
- The detailed data on changes in the balances of the components' tangible fixed assets, which form the basis of "expenditure due to the purchase of tangible fixed assets" subject to disclosure in the consolidated cash flow statement.

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

②The audited company adjusted the financial statements of a consolidated subsidiary due to material discrepancies in accounting records relating to inter-company transactions between the group companies resulting from the difference between the closing date for the consolidated subsidiary and the consolidated closing date.

Amid this situation, the group engagement team understood that the audited company had adjusted the financial statements using the same debit and credit accounts as those used in the previous year. Although the group engagement team identified the risk of material misstatement in the adjustments and recognized that the adjusted amount represented a significant increase from the previous fiscal year, it **did not sufficiently examine the basis of the reason for the adjustments and the adjusted amount**.

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

③When a consolidated subsidiary, Company A conducted a public offering of shares at the time of listing, Company A received capital injection from the non-controlling shareholders of Company A. As a result, the audited company's equity ratio in Company A decreased. The audited company accounted for the decrease in the equity ratio as an increase in non-controlling interests for the entire amount of capital injection in the consolidated financial statements.

However, the group engagement team overlooked the erroneous accounting treatment made by the audited company for a decrease in the parent company's interest due to the capital injection at market value by the consolidated subsidiary, and **did not appropriately verify the accounting treatment made by the audited company**.

(Auditing Standards Statement No. 600, paragraph 32 and 33) [Mid-tier, and small and medium-sized audit firms]

《Points to Note》

There were cases in which: when examining consolidated journal entries, the group engagement team merely made comparisons with the previous period's balances and observed documents prepared by the audited company, and did not perform substantive procedures; or, due to a lack of a sufficient understanding of the audited company and its business environment at the group level to provide the basis for risk assessment of group financial statements, the group engagement team did not examine whether unrealized profits were completely eliminated even though complex inter-company transactions had occurred.

There were also cases in which the group engagement team did not examine whether component financial information reported by component auditors was reflected in the group financial statements, and cases in which the group engagement team did not consider the necessity of adjusting the accounting treatment to be based on the same accounting standards as the group financial statements when an overseas component prepared its financial statements based on local accounting standards.

The group engagement team shall understand the group, its components and their environment, as well as the consolidation process, including group-wide controls. The group engagement team shall plan and implement the nature, timing and extent of audit procedures to address the risks of material misstatement in the group financial statements arising from the consolidation process, and shall evaluate the appropriateness and completeness of adjustments and reclassifications for consolidation.

Case 6: Subsequent events

The group engagement team instructed the auditors of multiple foreign components of the audited company group to report on subsequent events and seek their responses.

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

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

《**Points to Note**》

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

Case 7: Communication with component auditors

FREQUENT

①The group engagement team sent audit instructions concerning the financial information of a significant component of the audited company's group to the auditor of the component and received a response from the auditor, but did not sufficiently communicate with the auditor on the following points:

・The audit engagement team did not communicate with the auditor regarding the threshold for accumulating identified misstatements, below which was clearly trivial in respect of the group financial statements.

・Although the group engagement team **had identified significant risks in the group financial statements of the components** (fraud risks related to revenue recognition and risk of management override), the group engagement team did not communicate with the auditors these risks.

・The group engagement team **did not comprehensively communicate the list of related parties with the auditors**, as the team informed them of the audited company's subsidiaries and affiliates as related parties, but did not inform of its major shareholders and executives as related parties.

・The group engagement team did not instruct the auditors to report any indications of management bias at the components material weaknesses in internal controls over financial reporting identified in the components, and any other significant matters that the auditors had reported or planned to report to those charged with governance of the components.

(Auditing Standards Statement No. 600, paragraph 39 and 40) [Mid-tier, and small and medium-sized audit firms]

NEW

②The group engagement team received a report from the component auditor of Company A, a consolidated subsidiary of the audited company and a significant component, that the team had identified a misstatement relating to an overstatement of sales due to the recognition of revenue at a point of time that should have been recognized over a certain period of time under the new contractual arrangements (hereinafter referred to as the "Misstatement"). The group engagement team carried out additional procedures to ascertain details of the Misstatement and to determine the amount of the Misstatement, including communicating with the component auditor and inspecting related audit documentation. The group engagement team also concluded that the Misstatement was a simple error and did not pose an audit issue after the audited company corrected the Misstatement in its consolidated financial statements. The engagement team did not receive any reports report from the component auditor on whether or not the Misstatement was an indication of fraud or an internal control deficiency.

However, the group engagement team did not instruct the component auditor to report on the examination of **whether or not the Misstatement was an internal control deficiency of the audited company group or an assessment of whether or not the Misstatement was an indication of fraud**, and did not sufficiently communicate with the component auditor.

(Auditing Standards Statement No. 240, paragraph 34; No. 265, paragraph 6; No. 600, paragraph 40 and 41)[Mid-tier, and small and medium-sized audit firms]

《Points to Note》

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

However, as shown above, there were cases in which the group engagement team did not appropriately communicate with component auditors such risks. There were also cases in which: the team did not communicate with the component auditors component materiality; or, even though component auditors reported significant risks to the group engagement team, the team did not sufficiently examine those risks constituted significant risks in respect of the group financial statements; or the timing of obtaining information, including audit plans, from component auditors was too late; or the group engagement team did not present an exhaustive list of related parties that included executives. Group engagement teams need to engage in effective two-way communication with component auditors.

Case 8: Sufficiency and appropriateness of audit evidence obtained

NEW

①The group engagement team instructed the auditor of Company A, which the group engagement team deemed to be a significant component of the audited company's group, to perform an audit of the financial information of Company A. The group engagement team received a report from the auditor of this component concerning an uncorrected misstatement in the financial statements of Company A, which exceeded the amount deemed to be clearly trivial in respect of the group financial statements.

However, the group engagement team **did not assess the impact of this uncorrected misstatement reported by the auditor of this component on the audit opinion on the consolidated financial statements**.

(Auditing Standards Statement No. 450, paragraph 4; No. 600, paragraphs 30 and 44) [Mid-tier, and small and medium-sized audit firms]

NEW

FREQUENT

②The group engagement team designated Company A, a consolidated subsidiary of the audited company, as a significant component of the audited company's group, and sent audit instructions concerning Company A's financial information to the component auditor. As a result of performing balance confirmation procedures for related parties, the group engagement team received a report from the component auditor stating that (a) responses to some balance confirmations had not been received, and (b) investigations into some confirmation differences had not been completed.

However, the group engagement team **did not hold discussions with the component auditor regarding the results of performing balance confirmation procedures in (a) and (b) above**. The group engagement team also did not consider whether alternative audit procedures should be performed for the related parties for which balance confirmation had not been answered, and did not consider whether additional procedures should be performed for the related parties for which investigations into confirmation differences had not been completed to determine whether the differences indicated misstatements.

(Auditing Standards Statement No. 505, paragraph 11 and 13; No. 600, paragraph 41 and 42) [Mid-tier, and small and medium-sized audit firms]

③The group engagement team instructed the auditor of a significant component of the audited company's group to perform an audit and used the results of the audit.

However, despite receiving a report from the auditor of the component that internal control deficiencies had been identified as a result of the assessment of the audit for internal control over financial reporting, the group engagement team did not assess these deficiencies and did not consider the necessity of additional procedures.

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

④Regarding the financial information for two significant components, the group engagement team sought a quality review for the purpose of expressing an opinion regarding the audited company's group financial statements before completing its review of audit working paper relating to the accounts with risks of material misstatement, including significant risks in respect of the group financial statements. Thus, the group engagement team did not obtain sufficient appropriate audit evidence **<u>before expressing an audit opinion on the audited company's group financial statements.</u>**

(Auditing Standards Statement No. 600, paragraph 43) [Mid-tier, and small and medium-sized audit firms]

《Points to Note》

Group engagement teams should evaluate whether audit procedures performed on the consolidation

process and on component financial information by the group engagement team and component auditors provide sufficient appropriate audit evidence to form a basis for expressing an opinion on the group financial statements.

However, as in the above examples of deficiencies, there were cases in which the group engagement team did not receive reports on the results of audit procedures from the component auditors in a timely manner, cases in which the group engagement team only obtained information on the results of audit procedures from the component auditor and did not evaluate the sufficiency and appropriateness of audit evidence obtained for significant risks, and cases in which the group engagement team did not evaluate component misstatements that were uncorrected and in an amount exceeding the amount deemed to be cleary trivial in respect of group financial statements or internal control deficiencies. Notably, even if a component auditor is in the same network as the group engagement team, the group engagement team still needs to evaluate the reports received from the component auditor.

Column

Auditing Standards Statement 600 (Special Considerations – Audits of Group Financial Statements)

As at January 12, 2023, an amendment of the Auditing Standards Statement 600 was released and renamed from "Group Audit" to "Special Considerations – Audits of Group Financial Statements."

The outline of the amendment is as follows:

Effective Date

From an audit of financial statements for the fiscal years starting on or after April 1, 2024 and an interim audit of financial statements for the interim accounting period starting on or after April 1, 2024 (for audit firms other than large-scale audit firms under the Certified Public Accountants Act, from an audit of financial statements for the fiscal years starting on or after July 1, 2024 and an interim audit of financial statements for the interim accounting period starting on or after July 1, 2024 by special exception)

Major amended points

・ The name changed from "group audit" to "special considerations –audits of group financial statements"

- Clarified that all other Auditing Standards Statements need to be applied as a matter of course to group audits, in particular by referring to or expanding on Auditing Standards Statements 220, 230, 300, 315 and 330, and emphasized that Auditing Standards Statement 600 provides practical guidance on matters to be considered in group audits; and

・ Discontinuation of the concept of significant components;

- Greater emphasis on group auditors' identification and assessment of the risks of material misstatement in the group financial statements, and determination of auditor’s responses to the assessed risks of material misstatement in the group financial statements, and more flexibility in component determination (refer to [Figure 8]);

・ Materiality

- "Component materiality" was changed to "Component performance materiality" as an appropriate threshold for designing and performing audit procedures for component financial information.

・ Materialization of the definition of "group financial statements"

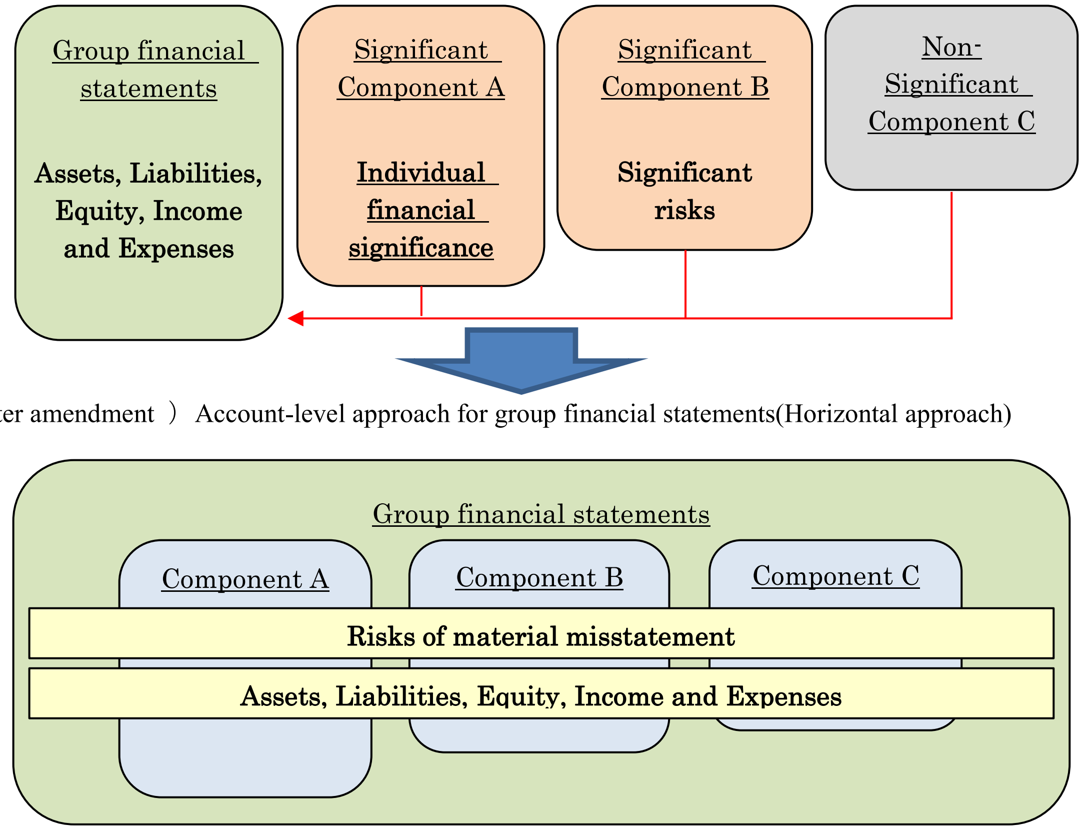
- Even in the case of stand-alone audits, if there are branches, departments, shared service centers, etc., they may be subject to group audits.

・ Define the scope of work in the component;

- Provisions of (I) "design and implementation of responses to the assessed risks of material misstatement for overall component financial information", (ii) "design and implementation of responses to the assessed risks of material misstatements for one or more classes of transactions, account balances and disclosures", and (iii) "implementation of specific responses to the assessed risks of material misstatements";

[Figure 8] Changes in approaches to group audits

(Before amendment) Approach by component (Vertical approach)



(Materials) Prepared by the CPAAOB based on materials published by the JICPA

6. Using the work of Auditor’s expert

Points of focus

The auditor may make use of expert to obtain sufficient appropriate audit evidence if the auditor needs expertise in areas other than accounting or auditing. The CPAAOB inspects whether the engagement team evaluate if the auditor’s expert has the necessary competence, capabilities and objectivity for the purposes of the audit of financial statements, and whether the auditor evaluates the appropriateness of the expert’s work.

Outline of inspection results

The CPAAOB noted cases that the engagement team did not determine whether to use the work of the auditor’s expert even when specialized knowledge was required, and that the engagement team did not sufficiently evaluate the appropriateness of expert’s work, due to the engagement team relied excessively on the results of expert’s work.

The CPAAOB also noted cases that the engagement team did not have sufficient communication with the auditor’s expert about the scope to be used and purpose of the work, and that the engagement team did not sufficiently evaluate the appropriateness of the expert’s work.

Expected response

Engagement team should always keep in mind that the engagement team is solely responsible for the audit opinion expressed in the audit of financial statements, and that the use of an expert’s work does not relieve its responsibility. Therefore the engagement team should evaluate appropriateness of the auditor’s expert’s work.

When using expert’s work, the engagement team should determine whether to use, evaluate the competency, capabilities and objectivity of the auditor’s expert, and evaluate the appropriateness of the expert’s work for the audit purpose. Also, the engagement team should sufficiently consult with the expert about the purpose and scope of the work to be used, without relying everything on the expert, in order to obtain sufficient appropriate audit evidence conforming to the audit purpose.

Case 1: Determining the need for auditor's expert

NEW

The audited company recorded impairment losses on the fixed assets of Factory A and Overseas Subsidiary B (hereinafter referred to as the "Fixed Assets") based on the net selling value obtained from real estate appraisers who are external experts (hereinafter referred to as the "Appraisers").

The engagement team identified significant risk on impairment of the Fixed Assets and determined it is as Key Audit Matter (KAM). According to such judgment, the engagement team evaluated the competence, capabilities and objectivity of the Appraisers, and also examined the appraisal value by them.

However, the engagement team **did not determine whether to use an auditor’s expert**, despite

the fact that the valuation of the fixed assets for the impairment of test needs an expert's knowledge about real estate appraisal.
(Auditing Standards Statement No. 620, paragraphs 6) [Mid-tier, and small and medium-sized audit firms]

Case 2: Competence, capabilities and objectivity of auditor's expert

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

Case 3: Agreement with auditor's experts

With regard to a part of real estate inventories for sale that had been valued by the audited company based on real estate appraisal, the engagement team requested an internal expert of the audit firm for a review of the real-estate appraisal report.
However, the engagement team **did not give appropriate instructions** to the internal expert by clarifying the specific tasks requested, including the nature, scope and objectives, and thus the engagement team and the internal expert were **not in an agreement with each other regarding their roles and responsibilities**.
(Auditing Standards Statements No. 620, paragraph 10) [Large-sized audit firms]

《Points to Note》

When using the work of an auditor's expert in areas of expertise other than accounting and auditing, engagement team should not leave matters entirely to the expert but should discuss with the expert to determine the scope of work for which their services are used, evaluate their competence, capabilities and objectivity and evaluate whether their work is appropriate in light of auditing purposes.
In addition to the above cases, the CPAAOB also noted cases in which, although the evaluation method adopted by the auditor's expert was different from the one designated by the engagement team, the team did not examine the appropriateness of the work done by the expert.
It should be noted that, for requirements when the engagement teams undertake consultation on matters that involve difficulties in accounting or auditing judgments, refer to paragraph 35 of "Quality Control in Audit Engagements" in Auditing Standards Statement No. 220 (revised in June 2023). For points to note in the case where audit evidence is based on the work of experts used by the audited company's management, refer to the section "3. Audit Evidence".

7. Audit of Internal Control over Financial Reporting

Points of focus

The CPAAOB performs inspections of audit of internal control over financial reporting from the following perspectives:

- Whether the engagement team develops an audit plan in consideration of materiality, with an understanding—based on the audited company's business environment and business characteristics—of the design and operating effectiveness of internal control and evaluation thereof by the management;
- Whether the engagement team evaluates the reasonableness of the method used by the management to determine the scope of evaluation of internal controls and the basis for the determination.
  In particular, in cases where the management has prepared an internal control report that excludes the scope of matters for which evaluation procedures could not be performed, whether the engagement team examines the reasonableness of the reason why the management has excluded such scope, and the impact of such exclusion on the financial statement audit;
- Whether the engagement team appropriately evaluate the deficiencies identified by the management; especially in evaluating the degree of control deficiencies, does the engagement team examine the potential impact of the deficiencies and the possibility of the occurrence of a material misstatement by taking into consideration the quantitative and qualitative effect on the overall internal controls over financial reporting of the audited company;
- Whether, in the course of an audit of internal control over financial reporting, the engagement team reports the deficiencies detected by the engagement team to the appropriate person in a timely manner and examines the possibility of the deficiencies being significant deficiencies to be disclosed;
- Whether, if the engagement team has discovered a material weakness, the team reports this to the management and requests the management to remediate it, and examines progress made in remediating the deficiencies in a timely manner; and
- Whether the engagement team evaluates the impact of the misstatements identified during the course of the audit of financial statements on the audit of internal control over financial reporting.

Outline of inspection results

The CPAAOB noted some cases, the engagement team, without enough professional skepticism, relied on the results of the audited companies' internal control assessment, without evaluating the adequacy of the scope of evaluation of internal control, the internal auditors' capability and objectivity, the appropriateness of samples, and the method for evaluation on internal control and so on.

Furthermore, there were cases in which responses in internal control audits remained perfunctory, despite changes in the environment at audited companies, such as changes in significant business locations due to corporate acquisitions and the commencement of new business. The CPAAOB also noted cases in which the engagement team did not determine whether to expand the scope of work performed by the auditor itself despite the fact that the process involved significant risks when using the work of internal auditors, etc. The CPAAOB also noted cases in which the engagement team did not determine whether a deficiency identified in the course of the financial statement audit was a significant deficiency that should be disclosed. The CPAAOB also noted cases in which the engagement team did not obtain audit evidence that specifically indicated the status of improvement of the deficiencies.

Expected response

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

To that end, in consideration of materiality, auditors should adequately understand management's design and operating effectiveness of internal controls as well as assessment results and should carry out financial statement audit and internal control audit in an integrated manner from the perspective of effective and efficient audits.

Meanwhile, the purpose of the internal control reporting system under the Financial Instruments and Exchange Act is to ensure disclosure reliability through managements' internal control report prepared based on their evaluation of the internal controls over financial reporting and the audit on the internal control report. Therefore, an auditor should provide insights into design of internal controls based on the audited company's background, including its size and business structure to the audited company.

To meet the expectations mentioned above, an auditor need to examine the scope, timing and appropriateness of audit procedures to evaluate the adequacy of the scope of internal control evaluation, the approach of internal control evaluation, and the evaluation of the significance of internal control deficiencies. An auditor should not perform procedures uniformly and routinely without sufficient consideration.

In particular, an auditor should carefully evaluate whether sufficient appropriate audit evidence has been obtained for high-risk areas, such as processes newly included in the scope of assessment and processes related to significant risks.

(1) Evaluation of the Scope of Evaluation of Internal Control

Case 1: Selection of significant accounts of significant relevance to business objectives

The audited company (a labor-intensive consulting firm) considered sales, accounts receivable, and inventories as significant accounts for the audited company's business objectives and included them in the scope of evaluation of internal control.

However, the engagement team **did not evaluate whether payroll, which was larger in amount than inventories according to the characteristics of the audited company's business, should be included in the scope of evaluation of internal control**.

(Auditing Standards for Internal Controls over Financial Reporting Statement No. 1, paragraphs 98 and 100) [Mid-tier, and small and medium-sized audit firms]

《**Points to Note**》

"Significant accounts for business objective (three accounts: sales, accounts receivable and inventories)" are just examples, described in the Practice Standards for Management Assessment and Audit concerning Internal Control over Financial Reporting. It is necessary to note that the engagement team should appropriately select significant accounts in consideration of the audited company's type of industry, business environment and business characteristics. In particular, when changes occur to the audited company's business activities or profit structure, it is necessary to carefully determine the selection of important accounts.

In addition to the above example case, net sales are often used as an indicator for selecting significant business locations or units. However, it must be noted that using a different or additional indicator may be more appropriate depending on the environment or nature of the business of the audited company.

Case 2: Identifying significant business processes

NEW
FREQUENT

① The audited company included inventories in the scope of internal control evaluation because they are accounts significantly involved with business purposes of a consolidated subsidiary that is a significant business location.

However, the engagement team **did not examine the reasonableness of the fact that the audited company excluded the processes related to inventories from the scope of internal control evaluation, except for the process of physical inventory count**.

(Auditing Standards for Internal Controls over Financial Reporting Statement No. 1, paragraph 97 and 101) [Large-sized audit firms]

NEW
FREQUENT

② Although the engagement team identified significant risks in the revenue recognition of a consolidated subsidiary of the audited company, the engagement team **did not examine reasonableness of the fact that the audited company did not to include the sales process in the evaluation of internal controls**.

(Auditing Standards for Internal Controls over Financial Reporting Statement No. 1, paragraph 112) [Large-sized audit firms]

③ The audited company used an ERP system composed of sales management, procurement and inventory management, production management, project management, financial accounting, management accounting, and personnel management modules.

Amid this situation, the engagement team evaluated the design of IT general controls relating to the system, but did not evaluate the operating effectiveness of IT general controls relating to it.

Moreover, in evaluating internal control over business processes, the team evaluated only the operating effectiveness of manual internal controls and did not evaluate the operating effectiveness of IT application controls.

However, although the system was a key system widely related to internal control over business processes and financial reporting, the engagement team **did not evaluate the appropriateness of not testing the operating effectiveness of IT general controls and its IT application controls of the ERP system**.

(Auditing Standards Statement No. 315(Before amendment in June 2021), paragraphs 17 and 20; Auditing Standards for Internal Controls over Financial Reporting Statement No. 1, paragraph 144) [Mid-tier, and small and medium-sized audit firms]

《Points to Note》

It is considered that business processes relating to accounts with significant risks should normally be included in management's evaluation of internal controls.

If such business processes are not included in the scope of management's evaluation of internal controls, the engagement team should discuss with the management about the management's method for determining the scope of assessment and the basis for the determination, and carefully examine whether there are reasonable grounds for not including them in the scope of assessment.

In addition, if there is a business process that is included in business processes significantly related to the business objectives of a significant business location, but is excluded from the assessment by the management because it is not related to a significant business or operation and has an insignificant impact on financial reporting, the engagement team should carefully examine the reason for not including it in the assessment.

Furthermore, when evaluating the design of internal controls, the engagement team needs to pay attention to whether or not there are any omissions in the IT application controls that should be subject to evaluation, in order to prevent the IT application controls from not being identified as internal controls.

(2) Method of Evaluation of Internal Control

Case 1: Sampling

NEW

①In the procedures for evaluating the operating effectiveness of internal controls related to the audited company's journal entry process, the engagement team did not include journal entries related to sales in the population, and did not set an appropriate population for the purpose of audit procedures. (Auditing Standards Statement No. 530, paragraph 5) [Mid-tier, and small and medium-sized audit firms]

NEW

②With regard to internal controls over the operation of checking whether products were appropriately transferred to product installers in the audited company's sales process, when performing an audit procedures for operating effectiveness of internal control, the engagement team determined the number of samples to be four in consideration of the frequency and risks of internal controls.

As a sample, the engagement team selected four randomly selected months, however, for two of the four selected months, there was no product transfer and the internal controls were not performed. As a result, the engagement team performed tests of the operating effectiveness of the internal controls for two samples selected from the remaining two months.

However, the engagement team did not sufficiently examine the appropriateness of the final sample size (two samples) in the procedures for evaluating the operation of internal controls over the audited company's sales process.

(Auditing Standards Statement No. 530, paragraph 6) [Mid-tier, and small and medium-sized audit firms]

《Points to Note》

When designing audit sampling, it should be noted that consideration must be given to the objectives of the audit and the characteristics of the population from which the sample is to be taken, and that a sufficient sample size must be determined to limit sampling risk to a minimum acceptable level.

When conducting sampling for the procedures for evaluating the operating effectiveness of internal controls, it is necessary to fully understand the purpose of Auditing Standards Report 530 ("Audit Sampling"), and to set an appropriate population and select an appropriate sample.

Case 2: Evaluation of design and operating effectiveness of internal controls

①The engagement team identified fraud risks of manipulating cut-off of revenue recognition in respect of sales relating to the condominium management business of the audited company's consolidated subsidiary.

However, although the engagement team performed procedures to evaluate the operating effectiveness of internal controls in respect of business processes relating to sales associated with the condominium management business by vouching with the table of approval stamps for selected samples, the team **did not appropriately evaluate the operating effectiveness of internal controls, as the table of approval stamps did not contain any date information and the engagement team only vouched the amounts, without examining the appropriateness of the timing of revenue recognition**.

(Auditing Standards Statement No. 330, paragraphs 7, 9 and A22) [Mid-tier, and small and medium-sized audit firms]

NEW

②In performing procedures for evaluating the design of internal controls for the audited company's sales and cost accounting processes, the engagement team **<u>only confirmed changes in key control points, except for the key control points for sales recording, from the previous fiscal year and did not perform procedures for evaluating the design of controls the current period.</u>**
(Auditing Standards Statement No. 315(Before amendment in June 2021), paragraphs 12) [Mid-tier, and small and medium-sized audit firms]

NEW

③With regard to procedures for evaluating the operating effectiveness of internal controls over the audited company's sales processes, the engagement team **<u>only performed procedures for evaluating IT application controls with regard to internal controls over order approval by the sales division manager, which was a key point in controls. The engagement team did not perform procedures for evaluating the operating effectiveness of internal controls over manual application processes</u>**.
(Auditing Standards Statement No. 330, paragraphs 7) [Mid-tier, and small and medium-sized audit firms]

《Points to Note》

When evaluating the design and operating effectiveness of internal controls, the engagement team should pay attention to evaluating internal controls that appropriately respond to the identified risks of material misstatement. In addition, when evaluating internal controls for IT, the engagement team should pay attention to designing and implementing appropriate responses to IT-related risks by also referring to Auditing Standards Statement 315 Practical Guidance No. 1.

When evaluating internal controls, the engagement team should also pay attention to changes in the business activities and profit structure of the audited company, without being caught up in past audit experience.

In addition, the closing and financial reporting processes are business processes that are extremely important in terms of the reliability of financial reporting, and there are many internal controls that have a wide range of impact compared to other business processes related to daily transactions. Therefore, the engagement team should note that the engagement team must perform audit procedures with due care when examining the design and operating effectiveness of internal controls.

In addition, the assessment of information processing controls where manual work and IT work together requires a holistic understanding and assessment of both.

In addition to the above examples of deficiencies, the CPAAOB noted cases in which internal control operation evaluation procedures were performed only on the basis of whether approval stamps were affixed, cases in which IT general controls (program changes, responses to system failures, access controls, etc.) were insufficiently evaluated, cases in which the necessity of including automated information processing controls in the scope of internal control audit was not considered, and cases in which, when a system change was made, only the information processing controls of the old system were evaluated and the information

processing controls of the new system were not evaluated.

Case 3: Timing of evaluation procedures

①The engagement team did not obtain sufficient and appropriate audit evidence to express an audit opinion regarding the audit based on the Companies Act, as **the engagement team performed audit procedures regarding the audited company's IT application controls** relating to individually evaluated financial closing and reporting processes such as various allowances, taxes and tax effects, and business processes such as automatic journal entries **after the date of the auditor's report under the Companies Act, but before the date of the auditor's report under the Financial Instruments and Exchange Act.**

(Auditing Standards Statement No. 330, paragraph25) [Mid-tier, and small and medium-sized audit firms]

②The engagement team inspected management evaluation result verified based on the samples selected from the transactions in the first quarter, and made inquiries and observed relevant documents as of the interim date. In addition, the engagement team obtained the documents from the audited company confirming whether or not any material changes to internal controls were made, subsequently after the year-end closing date. As the result of the audit procedures above, the engagement team determined that the design and operating effectiveness of process-level controls as effective.

However, the engagement team **did not determine what additional procedures to perform in order to evaluate whether the evaluation results of internal controls as of the interim date, that was verified based on the samples selected from the transactions in the first quarter, remained effective as of the year-end closing date**.

(Auditing Standards Statement No. 330, paragraph 11; Auditing Standards for Internal Controls over Financial Reporting Statement No. 1, paragraph 160) [Mid-tier, and small and medium-sized audit firms]

《Points to Note》

With respect to the evaluation of process-level controls of which the engagement team rely on the operating effectiveness in the audit of financial statements, it is necessary to complete procedures for evaluating the operating effectiveness and roll-forward procedures by the date of the Companies Act audit report.

For the determinants of obtaining additional audit evidence in performing roll-forward procedures, please refer to Auditing Standards Statement 330, Paragraph A32.

Furthermore, if the engagement team plans to rely on related internal controls when determining the type, timing and scope of substantive procedures for the financial statement audit, it is recommended that the engagement team complete an audit procedures on an operating effectiveness of process-level controls

before performing significant substantive procedures.

This also applies to the evaluation of the effectiveness of information processing controls, including IT, and general controls over IT that supports the information processing controls.

(3) Assessment of Deficiencies

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

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

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

(Auditing Standards Statement No. 315(Before amendment in June 2021), paragraph 30; IT Committee Practical Guideline No. 6(Abolished in October 2022), paragraph 53) [Mid-tier, and small and medium-sized audit firms]

Case 2: Evaluation of internal controls relevant to misstatements

NEW

FREQUENT

The engagement team identified an uncorrected misstatement in the audited company's consolidated financial statements.

The engagement team also examined whether the misstatement indicated deficiencies in internal controls, and as a result, identified deficiencies in internal controls in the audited company group.

However, the engagement team did not ascertain the specific details of the aforementioned internal control deficiencies, and did not examine the likelihood of occurrence of misstatements and the extent of potential impact on financial reporting as a whole due to the deficiencies. The engagement team also did not examine whether these deficiencies, singly or in combination, constituted significant deficiencies to be disclosed by the audited company.

(Auditing Standards Statement No. 265, paragraph 6 and 7; Auditing Standards for Internal Controls over Financial Reporting Statement No. 1, paragraphs 187) [Mid-tier, and small and medium-sized audit firms]

《Points to Note》

Deficiencies in an internal control can be classified into deficiencies in design and deficiencies in operating effectiveness. Deficiencies in design include the absence of internal control and failure of the existing internal control to fulfill the objectives of the internal control, while deficiencies in operating effectiveness consist of failure to perform the internal control as designed, the existence of many errors in performing internal control and a poor understanding of the nature and objectives of the internal control by the person who performs the internal control.

When finding a deficiency in internal control, the engagement team is required to: confirm which classification it falls under; take into account its quantitative and qualitative materiality and existence of compensating controls; calculate the potential quantitative impact of the deficiency discovered; and examine which accounts will be affected by such deficiency and to what extent, and the likelihood of occurrence of material misstatement. The engagement team needs to pay attention to the fact that it is required to carefully judge if the deficiency discovered falls under significant deficiencies to be disclosed.
It should also be noted that if the misstatement identified by the auditor resulted from a failure of the internal control to function, it may indicate the possibility of other misstatements.

(4) Use of the work of internal auditors

Case: Extent of using the work of internal auditors

NEW FREQUENT

①The engagement team identified the risk of inappropriate revenue recognition by the audited company as a significant risk.
In addition, the engagement team used the work results of the audited company's internal auditors in performing audit procedures for operating effectiveness of internal controls on the sales process. However, although the engagement team **identified a significant risk with the revenue related to the sales process, the engagement team used the work results of the internal auditor to the same extent as if the significant risk had not been identified, and did not sufficiently determine whether to expand the scope of work to be performed by the auditor itself**.
(Auditing Standards Statement No. 610, paragraphs 14) [Large-sized audit firms]

NEW FREQUENT

②The engagement team re-performed part of the sample testing by the internal auditor of the audited company, and tested additional samples selected by the engagement team for operating effectiveness of internal control.
However, the engagement team **did not confirm the completeness of the population subject to the sample testing** performed by the internal auditor for evaluating operating effectiveness of internal controls.
(Auditing Standards Statement No.530, paragraph 7, No. 610, paragraph 13 and 19) [Mid-tier, and small and medium-sized audit firms]

《Points to Note》

From the viewpoint of conducting effective and efficient audits, there are many cases of using the work of internal auditors. However, it should be noted that the auditor is solely responsible to express audit opinion, and the auditor's responsibility cannot be reduced even if the engagement team use the work of internal auditors.
Where the work of internal auditors is used, the auditors must perform audit procedures to assess the objectivity and competence of the internal auditors and to assess the appropriateness of the work used.

In addition, auditors should keep in mind that if the risks of material misstatement, such as significant risks, are high, the scope of use of the work of internal auditors should be reduced compared to otherwise.

(5) Review of internal control report

Case: Review of internal control report

NEW

The engagement team **did not sufficiently examine the appropriateness of the fact that the audited company had identified four accounts, "sales," "accounts receivable," "inventories," and "sales promotion expenses," as "accounts significantly related to the company's business objectives," but only three accounts, "sales," "accounts receivable," and "inventories," were included in the internal control report**.

(Auditing Standards for Internal Controls over Financial Reporting Statement No. 1, paragraphs 257)

[Large-sized audit firms]

《Points to Note》

The engagement team needs to read through the internal control report prepared by the audited company, and examine whether there are any material misstatements (including omissions) with respect to the scope of internal control assessment, assessment procedures, assessment results, and supplementary notes.

Column

Revision of Auditing Standards for Internal Controls over Financial Reporting Statement No. 1 "Audit of Internal Controls over Financial Reporting"

Application period

This shall be applied from the internal control audit for the fiscal year starting from April 1, 2024.

Main points to be noted in connection with the revision

・Fraud risk considerations

➢ Fraud risks need to be considered in "risk assessment and response", which is a basic element of internal controls.

In evaluating company-wide internal controls, the auditor shall pay attention to whether fraud risks and risks of management ignoring or overriding internal controls are appropriately considered, and whether risks are reassessed in response to changes in risks and responses to risks are reviewed in a timely manner.

It is necessary to pay attention to these risks in business processes as well as in the closing and financial reporting processes.

・Determination of the scope of evaluation

➢ When selecting business locations and business processes to be evaluated, make a judgment according to the environment in which each company is located and the characteristics of its business, instead of making a mechanical judgment using the listed selection criteria. In addition, it is necessary to consider whether or not it is necessary to include specific business locations and business processes that have been outside the scope of evaluation for a long period of time in the scope of evaluation.

・Impact of the results of the financial statement audit on the internal control audit

➢ If a deficiency in internal controls is identified during the course of the financial statement audit outside the scope of the management's assessment of internal controls, the impact of the deficiency on the scope and assessment of the internal controls should be fully considered.

・Clear indication of matters that should be included in the internal control report

➢ The following shall be included in the scope of evaluation of internal controls in the internal control report:

(1) Indicators used in the selection of significant business locations and their percentage

(2) Accounts that are materially relevant to the business objectives of the company selected in identifying the business processes to be evaluated

(3) Business locations and business processes that were individually added to the scope of evaluation

8. Key Audit Matters (KAM)

Points of focus

The CPAAOB inspects audit procedures concerning Key Audit Matters ("KAM") from the following perspectives:

- Whether the engagement team determines matters that it judges to be particularly important, as a professional expert, as KAM through an appropriate process that includes communication with company auditors, etc.
- Whether the engagement team appropriately describes the content of KAM and the reason for determining KAM in the audit report.
- Whether the engagement team appropriately performed the audit procedures described as audit responses in KAM in the audit report.

Outline of inspection results

The CPAAOB noted cases where the reference to the notes in the financial statements included in KAM in the audit report was inaccurate, and some of the audit responses included in KAM were not performed.

(Observed effective efforts)

The following examples can be cited as effective efforts to improve the appropriateness of the content of KAM.

- A dedicated team for KAM was established within the quality control department to provide overall support to engagement teams, including preparation of working paper templates, development and dissemination of example entries and manuals, and implementation of training related to KAM.
- Quality control system for KAM was developed, such as implementing requirement to have KAM draft reviewed by reviewers other than the EQC reviewer and individual reviews by the EQC reviewer.
- Requiring the consultation and senior review on important issues.

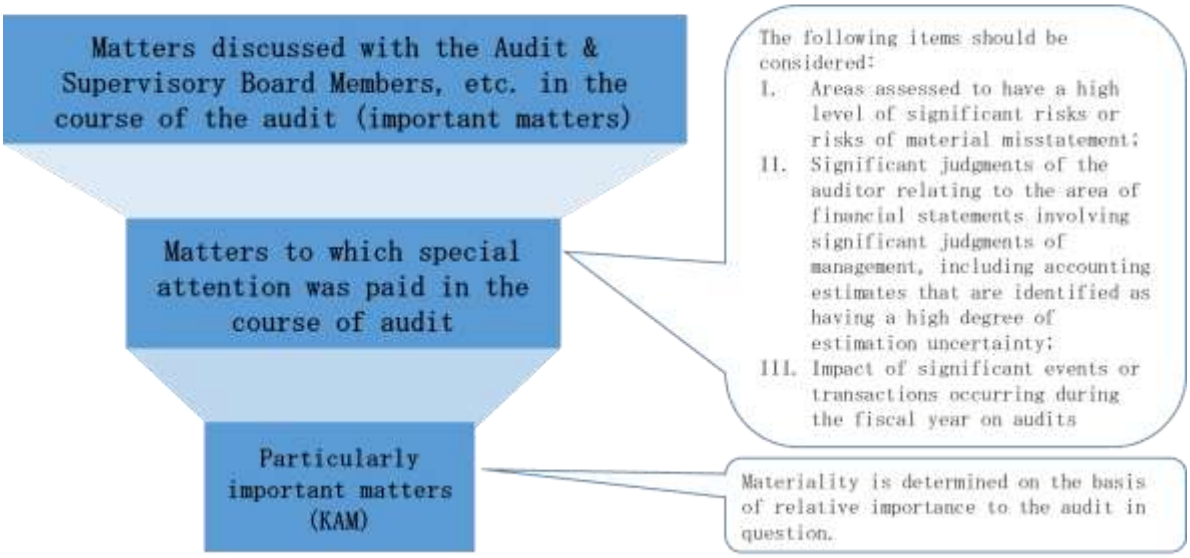
Expected response

The purpose of KAM is to enhance the informational value of audit reports by enhancing transparency regarding audits performed. KAM can also enhance audit transparency by providing users of financial statements with additional information that may help them understand matters that the engagement team, as a professional, determine to be particularly important. Therefore, auditors are required to take appropriate actions based on a full understanding of the purpose of KAM so that they do not turn KAM into a boilerplate or a mere facade. Please refer to [Figure 9] for the process of determining KAM.

For the appropriate description of KAM, please also refer to Auditing Standards Statement 700 Practical Guidance No. 1 "Q & A on Audit Reports (Practical Guidance)" published by the JICPA. When determining KAM, the engagement team is required to have active communication with the management and company auditors of the audited company. It is also necessary to note that the "Description of and Reason for

Determination of KAM" included in the audit report should be directly linked to the audited company's specific circumstances by identifying the scope and amount of the KAM. In addition, the "Audit Response" included in the audit report should be as specific as possible about procedures or audit approaches that conform to the factors listed in the reason for determining KAM.

[Figure 9] Reference image: KAM Determination Process



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

Case 1: Description of the KAM and the reason for deciding on it

In considering the KAM for the audit of the consolidated financial statements, the engagement team determined that the recoverability of deferred tax assets recorded in the company's non-consolidated financial statements is to be as KAM.

However, in the auditor's report on the consolidated financial statements submitted to the audited company, the engagement team specified the amount of deferred tax assets given in the consolidated financial statements after referring to the note in the consolidated financial statements regarding deferred taxes accounting, but without disclosing the scope of deferred tax assets covered by the KAM, thereby resulting in a description which implies that the KAM would cover the examination of the recoverability of entire deferred tax assets recorded in the consolidated financial statement. Thus, the engagement team **did not sufficiently consider the appropriateness of the description of KAM and the reason for deciding on it for the consolidated financial statements**.

(Auditing Standards Statement No. 701, paragraphs 12 and A47) [Mid-tier, and small and medium-sized audit firms]

Case 2: Descriptions relating to audit responses

NEW

FREQUENT

The engagement team stated in the audit report on the audited company's consolidated financial statements that the engagement team determined valuation of goodwill as KAM and performed audit procedures as audit responses, such as comparing past business plans with subsequent results, inspecting materials on recent sales results from major customers, and inspecting materials on expected orders and project wins.

However, the engagement team **did not actually perform the above procedures as an audit response relating to KAM, but stated in its audit report that it did**.

(Auditing Standards Statement No. 701, paragraphs 12 and A46) [Mid-tier, and small and medium-sized audit firms]

《Points to Note》

The CPAAOB noted many cases where procedures that were described as having been performed as an audit response were not actually performed. The engagement team should sufficiently confirm the accuracy of KAM, because the KAM is the information how the engagement team respond to matters that the auditor determined to be particularly important in the audit of financial statements for the current fiscal year, from among matters that the engagement team paid particular attention and discussed with company auditors, etc. during the audit process, and because users of financial statements pay close attention to the KAM.