(Provisional Translation)

June 30, 2006

Certified Public Accountants and Auditing Oversight Board

Quality Control of Audits of the Four Largest Japanese Audit Firms

Recognizing the recent events involving financial audits and the international trends in supervision and monitoring of audit firms, the Certified Public Accountants and Auditing Oversight Board ("Board") announced in October 2005 that it would urgently inspect the four largest audit firms (referred to in this report as "Big Four firms"), namely KPMG AZSA & Co., Deloitte Touche Tohmatsu, Ernst & Young ShinNihon, and ChuoAoyama Pricewaterhouse Coopers, in order to protect the public interest and investors. After having examined the quality control review report of the Japanese Institute of Certified Public Accountants ("JICPA"), the Board conducted inspections of the Big Four firms.

To the extent examined in the inspections, the Board found that all of the Big Four firms were insufficient in quality control as a firm, specifically in the systematic management of audit engagements that ensures quality control of audits. In particular, deficiencies were identified in the overall management of audit engagements, auditors' independence, acceptance of new clients and client retention, performance of audit works, audit working papers, internal review of audit engagements, supervision of the quality control system, joint audits, systematic audits, etc. Concerning the quality control of individual audit engagements, deficiencies were identified in the compliance with generally accepted audit standards ("GAAS"). It is necessary for the firms to improve the systematic management of audit engagements for the quality control of audits, so that they will be able to consistently maintain the sufficient level of audit quality required by the GAAS, for example, especially for audit engagements involving higher risks.

The Board has notified each Big Four firm of the result of these inspections and has pointed out the deficiencies that require improvements in the quality control of audits and the management of audit works. Furthermore, the Board, in order to secure the public confidence in financial audits and the transparency of the securities market, has summarized the results of the inspections of the Big Four firms and decided to make them public.

It should be noted that the purpose of the above inspections is not to make a general assessment of these audit firms, nor of the individual audit engagements that were inspected, but rather essentially to review the quality control of audits and identify deficiencies to be improved. The issues identified are to the extent examined and observed by the inspectors during the course of these inspections. Therefore, it does not necessarily mean that they are common issues occurring in all of the audit engagements of each audit firm. The Board believes that, by overcoming these deficiencies, including potential ones, the quality of audits will be improved.

It is important to note that just because deficiencies were identified in the systematic management of the quality control of audit engagements which require improvements, this does not immediately indicate that the audit opinions expressed by each firm were not appropriate. The Board believes that the Big Four firms are working to improve their quality control and that the quality of many of individual audit engagements is secured.

Besides, the Board has exchanged views with the relevant agencies of foreign countries in bilateral and multilateral settings. Inspection methods of these inspections have taken into account the inspections of foreign countries and an effort has been made to attain similar degrees of coverage and depth in inspections. Many of these inspection results have common contents with those of foreign countries. (The United States, Canada, and the United Kingdom have already conducted inspections of the Big Four firms and have released reports on the results. In each of these countries, each of the Big Four firms has undertaken remedial measures, and their follow-ups are being conducted.)

Based on these inspection results, the Board will implement follow-up inspections from the fiscal year 2006 to review the progress of improvements by the Big Four firms.

1. Inspection by the Board

Pursuant to the Certified Public Accountant Law ("CPA Law") and from the viewpoint of quality control of audits, the Board examines the reports of the JICPA's quality control reviews, and when deemed necessary and appropriate to protect the public interest and investors, conducts inspection of audit firms.

Recognizing the recent events involving financial audits and the international trends in supervision and monitoring of audit firms, the Board announced in October 2005 that it would take measures including urgent inspections of the Big Four firms. After examining the quality control review report of the JICPA, the Board conducted inspections of the Big Four firms.

In these inspections, inspectors of the Board secretariat ("staff'') visited each firm and inspected accounting records and other materials related to selected audit engagements, from the viewpoint of quality control of audits, that is to say, quality control as an audit firm and quality control at the level of individual audit engagements, as well as from the viewpoint of compliance with the CPA Law, the Securities and Exchange Law, and the GAAS, (which directly affects the quality of audits). In terms of quality control as an audit firm, the staff examined related documents, and interviewed the audit firm's chairman, who is the head of the firm, and other partners. Regarding quality control of individual audit engagements, the staff examined documents related to the audit engagements selected by the Board as well as those selected by the JICPA for their review, and interviewed engagement partners in charge.

2. Outline of the Big Four firms

The Big Four firms, namely KPMG AZSA & Co., Deloitte Touche Tohmatsu, Ernst & Young ShinNihon, and ChuoAoyama Pricewaterhouse Coopers, each has approximately 200 to 300 representative partners, 200 non-representative partners, 1,500 certified public accountants including these partners, and 700 to 900 junior accountants. Including other employees, each firm has a total of approximately 3,000 staff members. The percentage of representative partners and other partners to the total of certified public accountants and junior accountants belonging to a firm is about 20%. Each firm has about 30 local offices other than the head office and approximately 10 to 20 affiliated companies. Each of the Big Four firms, in reaching its present size, has undergone a number of mergers. Each is affiliated with one of the international Big Four firms - KPMG, DTT, E&Y, and PwC.

The number of audit clients of each audit firm is 3,500 to 4,700 companies, of which approximately 2,000 companies were audited pursuant to the Securities and Exchange Law and the Law for Special Exceptions to the Commercial Code. Coverage by the Big Four firms of these 2,000 companies is approximately 80%. The average operating revenue of the Big Four firms amounts to approximately 50 billion yen.

3. Management of Audit Engagements in General

Each of the Big Four firms has a chairman or a CEO, and has set up decision-making bodies such as assembly of partners and board of directors and established internal regulations for performing audit engagements. In terms of quality control of audits, each firm has made efforts to ensure quality control and improve the quality of audits by establishing an operations management division, and by using audit manuals based on those developed by their foreign affiliates. Local offices are controlled through meetings of office directors, etc. Some of the firms have adopted an independent operations system or an independent accounting system for local offices. Each audit engagement is conducted by an audit team led by an engagement partner who is appointed by the audit firm and is responsible for the audit engagement concerned. The chairman, CEO, or other officers in charge of management of the audit firm are not directly involved in individual audit works.

In terms of systematic management of the quality control of audits, deficiencies were identified at each of the Big Four firms. Although a few firms had received administrative actions in the past, remedial measures taken thereafter had been deemed insufficient at the time inspections commenced. One of the firms that reviewed previous incidents, however, had not taken sufficient measures to improve the quality of audits. Regarding compliance with laws etc., deficiencies were identified at each of the firms in its recognition of the necessity and scope of compliance, and measures taken to improve its system. As for management of local offices, each firm had deficiencies, for example, leaving the management to the local offices' discretion.

4. Professional Ethics and Independence

In order to secure professional ethics and independence of auditors, each firm has established its own standards based on the foreign affiliate's manuals which are stricter than what is required by law. Furthermore, for compliance with such standards, various procedures have been established in each firm such as, yearly simultaneous inspections across the board, and pre-approval procedures for stock holdings of audited companies, and loans from audited companies.

Regarding the simultaneous provision of non-audit services, each firm established and implemented pre-approval procedures regarding contracts for non-audit services, pursuant to the enforcement of the Amended CPA Law, which prohibits such provisions, or even before the enforcement.

However, cases were found where procedures for independence confirmation had been omitted, or pre-approval procedures were implemented retrospectively. The implementation of these procedures was deemed insufficient in each of the firms.

5. Training (Including Human Resource Management)

Each firm provides its partners and staff with a number of training programs for professional knowledge. Furthermore, pursuant to the CPA Law, certified public accountants are required to participate in training programs by the JICPA. Each firm has a system to review the participation in these programs.

However, at each of the firms, deficiencies were identified in the review of CPAs' training, partly because some certified public accountants personally lacked recognition of the importance of training, and partly because the review by each audit firm was not sufficient due to the recognition that fulfilling the required training programs by the JICPA was basically a personal matter. At more than one firm, cases were found where a partner had not acquired the minimum credits required by law.

As to sanctions against partners and employees by the audit firms, more than one firm were observed in which improvements in related bylaws were not sufficient, and sanctions in accordance with their bylaws were not rendered, therefore, deficiencies were identified in this area.

6. Acceptance and Retention of Clients

Regarding acceptance of new clients or retention of clients, each firm, pursuant to Legal Commission Research Report No.3 of the JICPA, documents the agreed upon provisions regarding audit engagements in a written contract, evaluates the audit risk of the respective contracts, and in accordance with the audit risks, establishes and implements pre-approval procedures.

However, at each of the firms, deficiencies were identified in risk evaluation and procedures. Cases were found where audit teams began audit works without obtaining pre-approval or before contracts were entered into. At each of the firms, the staff found many cases where there were deficiencies in the entry of agreed upon provisions etc. into the audit contract.

7. Performance of Audit Engagements

Each firm performs its audit engagement in a systematic manner in accordance with audit manuals and by an audit team consisting of an engagement partner, managers or accountants, and other assistants. Furthermore, for large companies, multiple engagement partner systems (in which two or more partners are assigned as engagement partners) are adopted, and for statutory audits, designated partner systems are adopted.

(Audit Plans)

At one of the firms, the staff found some cases where its approval process of audit plans was not sufficient. Also, at more than one firm, deficiencies were identified in applying materiality thresholds. At each of the audit firms, the staff found several cases where risk approaches were insufficient.

(Substantive Test)

Concerning confirmations, the staff found many cases where confirmations of balance were not sufficiently implemented, the results of confirmations of balance were not sufficiently followed-up, or alternative procedures were not sufficiently taken.

Concerning other substantive testing procedures, cases were identified at each firm where sufficient and appropriate audit evidences were not obtained because audit procedures were not sufficient.

At more than one firm, examination of the scope of consolidation was deemed insufficient.

(Accounting Estimates, etc.)

Concerning financial statements as a whole, audit teams evaluate the reasonableness of accounting estimates made by managements of audit clients. They also evaluate the degree of inherent risks and control risks related to accounting estimates. They collect audit evidence to verify that significant accounting estimates to be reflected in the financial statements are made in a comprehensive and reasonable manner.

However, at more than one firm, deficiencies were identified in the evaluation of inventories, securities, investments in and loans to affiliates, credited loans, or the estimation of allowances for uncollectible debts, or the accounting estimation of deferred income tax assets and liabilities, and furthermore, in the audit procedures related to examination of real estate securitization.

(Other Procedures)

At more than one firm, the staff found cases where the discussions between the audit team and the client management, etc. were deemed insufficient. Also at more than one firm, the staff found insufficient audit procedures performed on the going concern assumption and subsequent events.

One of the firms had not taken appropriate procedures related to attorney confirmation letters to comprehend litigation that would have a material effect on financial statements.

With regard to the use of audit results of other auditors, cases were found at each firm where confirmation letters on independence of other auditors were not obtained in utilizing the audit results of those of foreign consolidated subsidiaries. At more than one firm, cases were found where required documents were not obtained, such as responses to auditing instructions.

At one of the firms, cases were found where procedures to detect frauds and errors were not sufficiently implemented.

(Procedures for expressing Audit Opinions)
At more than one firm, procedures performed by audit teams in advance of expressing audit opinions were deemed insufficient in preparing summary lists of detected items, obtaining letters of representation, or preparing audit reports.

8. Audit Working Papers (Audit Documentation)

Audit working papers are prescribed by the cabinet office orders and the GAAS. Also, Auditing Standards Board Report No. 16 of the JICPA stipulates that audit working papers are to be prepared as materials to prove that audit work was performed in accordance with the GAAS and that the auditor’s opinion was prepared with sufficient and appropriate audit evidence, while meeting the requirements of completeness, orderliness, clarity, accuracy, and economy. Each firm has established internal rules for audit working papers by way of audit manuals and prepares and preserves them in accordance with cabinet office orders, and the GAAS, etc .

At each of the firms, although audit teams asserted that audit procedures had been sufficiently implemented, there were many cases where after-the-fact examinations were difficult because documentation of audit works was insufficient. At each of the firms, there were many cases where the review of audit working papers was insufficient. Furthermore, at each of the firms, the preservation of audit working papers or preservation system was deemed insufficient as observed in many cases at its local offices where document management in this regard was insufficient.

9. Reviews of Audit Work

Concerning internal reviews of audit plans and auditor’s opinions, each firm has established a layered structure system where the review task is first assigned to a representative partner or other partner who has not been assigned to the audit team under review, and subsequently or as necessary, forwarded to an upper-level reviewing group comprised of two or more members. The reviewers receive explanations from the engagement partner, etc. based on documents prepared by the audit team and review both the audit plan and the auditor’s opinion. The upper-level reviewing group, based upon the results of the review performed by the first reviewer, receives explanations from the engagement partner, etc., and again reviews the audit results by group deliberation.

At each of the firms, since some reviews were limited to checking only routine matters without further depth, or were focused only on matters indicated by the audit team or the first reviewer, cases were found where reviews were not sufficiently performed from a perspective of outsiders of the audit team, or as the higher level reviewing group. This led the Board to conclude that the review systems were deemed insufficient or partly insufficient for the audit firms in identifying problems of individual audit engagements, and in confirming whether judgments made or measures taken for such identified problems were appropriate.

10. Monitoring of the Quality Control System

Each firm has established a system to inspect and monitor its quality control system and inspects the quality control by each division and local offices, and engagement partners. At each firm, cases were found where the implementation of this system was deemed insufficient.

11. Joint Audits

Each firm performs joint audits. Besides joint audits with small audit firms, the Big Four firms sometimes conduct joint audits among themselves. Each firm formulates policies and procedures with regard to joint audits in its audit manuals, pursuant to Auditing Standards Board Report No. 12 of the JICPA, and based upon these, conducts joints audits.

At each of the firms, especially where joint audits were implemented by the Big Four firms, cases were found where an audit team did not have sufficient communication with the other audit team because the firms had not clearly agreed upon the concrete policies and procedures for the joint audit, or, once particular roles had been assigned to the other party, the audit team left them entirely up to the other audit team in charge.

12. Systemic Audits

Audit firms are established for performing systemic audits as a firm. In cooperation with overseas affiliates, each firm carries out systemic audits based upon audit manuals, etc. and manages audit work to fulfill such a purpose.

At each of the firms, many cases were found where examination of audit working papers by supervisors or audit assistants with supervising functions in audit teams was insufficient. It was identified that sufficient instruction was not provided inside the audit teams and that systemic audits were deemed insufficient at the team level.

Furthermore, each firm's review system of audit plans and audit opinions prepared by audit teams was found to be insufficient or partly insufficient. The system needs to identify problems arising from individual audit engagements and confirm whether judgments made or procedures taken regarding such problems were appropriate, as an audit firm. Management of local offices by the firms was found insufficient or partly insufficient. This led the Board to conclude that each of the firms did not sufficiently conduct audits as a firm.

13. Others

Regarding time and human resources for audits, there were firms where the staff of the board was informed by their audit teams that the time and human resources actually allocated to audits were insufficient as compared to what was considered necessary.

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Following the result of the inspections above, pursuant to Article 41.2 of the CPA Law, the Board made a recommendation to the Commissioner of the Financial Services Agency that instructions for improving operation under the provision of Article 34.21.1 of the said Law be issued to the Big Four firms.