

(Provisional Translation)

November 8, 2006  
Certified Public Accountants and Auditing Oversight Board

## **Regarding Quality Control of Audits by Small Scale Audit Firms (summary)**

Pursuant to its basic examination and relevant policies, the Certified Public Accountants and Audit Oversight Board (“the Board”) examined quality control reviews of business year 2004 and 2005 by the Japanese Institute of Certified Public Accountants (“the JICPA”) and inspected audit firms. It has recently issued an interim report titled “Regarding Quality Control of Audits by Small Scale Audit Firms.” This report is based upon accumulated cases concerning reviews, examinations and inspections of small scale audit firms.

In this report, cases where improvement advice by the JICPA was given in its quality control reviews, cases where problems were identified by the Board in its examination and inspection, and problems which were categorized under main items regarding performance of audit engagements, were summarized. Finally, generalization of problems and regulatory issues identified through examination and inspection were summarized.

The Board’s examination and inspection principally points out problems and issues in the quality control of audits that need improvement. It is necessary to give due consideration to the fact that problems identified in this report are recognized in the quality control review by the JICPA and in the examination and inspection by the Board. These identifications do not mean that audit opinions expressed in individual audit reports of each audit firm are improper, and that issues not raised here are not to be construed to mean that they are all proper.

### **1. The structure of this report**

This report is structured with the following contents.

- (1) Summary of small scale audit firms
- (2) Problems with quality control of audits at small scale audit firms
  - Audit procedures
  - Examinations for expressing audit opinions
  - Client acceptance and retention
  - Rotation of the partner in charge of audits
  - Joint audits
- (3) Illustrative cases
- (4) Generalization of problems of small scale audit firms
- (5) Regulatory issues regarding small scale audit firms and recommendations

### **2. Summary of small scale audit firms**

In this report, “small scale audit firms” mean small scale audit corporations and individual certified public accountants (individual firms). Small scale audit firms are those in Japan other

than the big 4 audit firms (corporations) and the medium sized audit firms (the top 20 firms (They are all corporations) in size after the big 4 audit firms).

The small scale audit firms that are taken up in this report consist of small scale audit corporations (88) and individual firms (128) which total 216 firms that were subject to quality control reviews in business year (July to June) 2004 and 2005.

### **3. Problems and issues with quality control of audits**

This report takes up cases and problems with regard to performance of individual audit engagements by small scale audit firms. The main contents are as follows:

(1) Audit procedures

Cases and problems regarding each of the following categories are mentioned: “improvements in audit manuals,” “planning of audit plans based on a risk approach,” “recording of audit documents,” “confirmation,” and “accounting provisions.” For example, regarding “planning of audit plans based on a risk approach,” problems were observed at most of the small scale audit firms. Furthermore, in a wide range of categories, there were problems in documentation.

(2) Reviews and examinations for expressing audit opinions

Cases and problems regarding improvements and applications of the reviews and examination structure are mentioned. Problems were observed in 60% of the small scale audit firms.

(3) Client acceptance and retention

Cases and problems regarding risk evaluation at the time of renewing audit contracts are mentioned. Problems were observed in 30% of the small scale audit firms.

(4) Rotation of the partner in charge of audits

Cases and problems regarding improvements in the rotation system of the partner in charge of audits are mentioned. Problems were observed in most of the individual firms and 40% of the small scale corporations.

(5) Joint audits

Cases and problems regarding the performance of joint audits (such as allocation of audit work, etc.) are mentioned. Cases where division of audit work based upon joint audit agreements was not made are observed.

### **4. Illustrative cases**

In regard to individual audit engagements implemented by individual firms, widely observed problems and issues on audit procedures are raised.

### **5. Generalization of problems**

Problems thought to be peculiar to small scale audit firms are broken down into the following three categories and summarized: “the structure for conducting audits of large scale companies, etc.,” “understanding of importance of quality control of audits,” and “problems of audited companies.”

Regarding small scale audit firms, conditions making it difficult to have a structured audit system for large scale companies etc. were observed, as well as problems in the delay for improving audit systems. Problems in understanding of importance of quality control of audits were also observed.

## **6. Regulatory issues and recommendations**

With regard to securing appropriate audit work at individual firms, the following regulatory issues are summarized.

- In contrast with audit corporations, “necessary instructions” where their management of audit work needs to be improved, and disciplinary measures merely where the management of audit work is severely inappropriate cannot be taken against certified public accountants. A recommendation would be to introduce measures such as “necessary instructions” and disciplinary measures which can be taken where necessary.
- Furthermore, although it is possible to give admonitory warnings to and suspend services of certified public accountants who certify financial statements having significant misrepresentations due to negligence, as not having such. A recommendation would be to add an option such as cancelation of registration just like in the case of intentional certification such falsified financial statements.