Case Report from Audit Firm Inspection Results

July 2016

Certified Public Accountants and Auditing Oversight Board

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Introduction

Since its establishment in April 2004, the Certified Public Accountants and Auditing Oversight Board (CPAAOB) has been conducting inspections of Japanese audit firms from the viewpoint of securing the public interest and protecting investors with the aim of maintaining and improving the quality of auditing in Japan.

The CPAAOB's inspections have identified various deficiencies in audit firms concerning matters pertaining to audit quality control, such as management systems of audit engagements, professional ethics and independence, acceptance and continuance of engagements, performance of audit engagements, audit documentation, engagement quality control reviews, and the monitoring of quality control systems. Since February 2008, the CPAAOB has been issuing the "Case Report from Audit Firm Inspection Results," a compilation of examples of deficiencies identified in the inspections.

The purpose of this Case Report is to promote voluntary efforts by audit firms to maintain and improve their audit quality, by providing specific examples of major deficiencies identified in the CPAAOB's inspections and by presenting the audit-quality level expected by the CPAAOB. In addition, this Report also serves as reference material to be provided to the directors/those charged with governances of listed companies and other companies subject to audit by independent auditors, investors and other market stakeholders.

This year's edition has been revised to enhance the convenience of users along with reflecting the comments given in the questionnaire survey on last year's edition and it classifies the cases into those of large audit firms and those of other audit firms based on the nature of the cases in "I. Root Cause Analysis" and "II. Quality Control System."

Please submit any comments or requests regarding this year's edition to the dedicated e-mail address below.

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Responses Expected of Audit Firms

The reliability of audits has once again been called into question following recent cases of accounting fraud. Given these circumstances, it is necessary for each audit firm to verify its audit engagements and quality control system with reference to the deficiencies and their causes described in this Case Report. If deficiencies are identified in the quality control system, the audit firm should not only remedy the deficiencies but also analyze the root causes and improve them.

The chief executive officer (CEO) of an audit firm, such as the chief director, and the person in charge of quality control (PICOQC) are required to fully analyze the root causes of the deficiencies that occurred, develop and execute appropriate improvement measures, and ensure the penetration of the measures across the firm. Furthermore, the design and operation of a quality control system should not only be the individual responsibility of the CEO or PICOQC, but rather a corporate responsibility to be fulfilled by all the partners of an audit firm. Keeping this in mind, each partner of an audit firm should identify root causes and fundamental factors that may lead to deficiencies in the quality control system, and then work together in an organized manner to improve such causes.

As described in the "Audit Documentation" section in "Quality Control" and the "Audit Engagement Performance" section in "Individual Engagements" of this Report, if any audit document has not been prepared properly for an important audit matter, this is not simply a deficiency of documentation, but in most cases, it implies that the necessary audit procedures have not been followed. Moreover, the lack of a proper audit document usually implies that the entire audit firm also has deficiencies in engagement quality control review, cyclical inspection, education, training (review of audit assistants in particular) and/or other areas, not just insufficiency in the knowledge, experience, competence and capabilities of the engagement team.

The CPAAOB's inspections have detected the following characteristics of issues depending on the size of the audit firm.

Large audit firms have a large organization and more than one department, as well as offices in remote locations. However, issues such as the lack of frequent communication among divisions and between the head office and regional offices, failure to ensure the penetration of the firm's measures across all divisions, and failure of establishment of an effective system to monitor the entire organization have been pointed out.

Large audit firms in particular should not only comply with audit standards in their quality control systems and individual audit engagements but also make improvements toward higher quality.

Many second-tier audit firms have expanded their operations through a merger or obtaining new audit engagements from entities for which an audit firm performs an audit (hereinafter a business entity for which an audit firm performs or has performed an audit shall be referred to simply as an "entity" throughout this Report). It is identified that management at these firms is not sufficiently integrated as the result of the merger and that quality control system functions do not match the expanded size of the firms.

With regard to small and medium-sized audit firms, many CEOs and PICOQCs do not understand the importance of quality controls. Each partner of a firm relies on the CEO for the management of the firm and fails to make proactive efforts. In addition, they lack the resources to design quality control systems.

Each audit firm shall appropriately cope with issues identified in consideration of the fact that the issues differ depending on the size of the firm, and respond appropriately according to its situation.

To Directors, Those Charged with Governance, Investors and Other Stakeholders

Regarding the relationship between the directors/those charged with the governance of a business entity and an independent auditor, although the revised Companies Act enforced in May 2015 and related regulations such as the Corporate Governance Code adopted in June 2015 were developed, incidents of large-scale accounting fraud by large listed companies occurred, which led to administrative sanctions against large audit firms.

Under such circumstances, from the perspective of investor protection and securing the reliability of the capital market, those charged with governance in a business entity are required to establish policies for the appropriate selection of independent auditor candidates and evaluation of independent auditors and give adequate time to ensure high quality audits. The responsibilities of directors and those charged with governance of entities have been further highlighted. As efforts to improve/enhance audits by independent auditors become more important, directors and those charged with governance in business entities are further expected to take appropriate actions to ensure that proper audits are performed by such independent auditors.

In particular, those charged with governance in business entities should actively utilize this Case Report. They are expected to improve and strengthen cooperation with independent auditors through inquiries with independent auditors about their QC status and the results of the Japanese Institute of Certified Public Accountants' (JICPA) QC review and the CPAAOB's inspection. In addition, they are expected to make appropriate assessment of independent auditors and allow sufficient time for auditing to ensure that appropriate audits are performed by such independent auditors.

This Case Report compiles deficiencies identified in the CPAAOB's inspections, which include recent accounting fraud cases, from the perspective of promoting voluntary efforts by audit firms to maintain and improve their audit quality. In addition, this Report is issued to provide directors and others charged with governance in listed companies, investors and other stakeholders in the market with reference materials, subject to audits by independent auditors. We believe that stakeholders in the market can refer to this Report when they understand the performance of independent auditors. Please also refer to the "General Aspects of Audit Firms (Monitoring Report in Fiscal 2016)," which has been compiled to provide information on the situation of audit firms in the most easily comprehensible manner possible not only to accounting experts but also to the general public.

The "Examples of Questions by Those Charged with Governance to Accounting Auditors" are not included in this year's Case Report. However, those charged with governance in business entities are expected to take appropriate actions in light of the "Operational Guideline for Company Auditors Concerning the Assessment and Election Standard Formulation of Accounting Auditors," which was published by the Japan Audit & Supervisory Board Members Association in November 2015, as it includes detailed examples of questions directed at independent auditors by those charged with governance.

Important Points for Users of this Case Report

1. Regarding Cases Included in the Report

(1) Although this Case Report is a compilation of relatively new cases of deficiencies that were identified in the inspections, that does not mean that the CPAAOB puts less importance on cases that were not included in the Case Report.

(2) The cases included in the Report may have had facts omitted or changed to the extent that does not affect the purport of the case.

(3) The number of cases included in the Report does not reflect the number of deficiencies identified in inspections of large audit firms and other audit firms (second-tier audit firms and small and medium-sized audit firms [hereinafter, "small and medium-sized audit firms"])[1], or the number of deficiencies identified in inspections by inspection item.

(4) Deficiencies that were not included in the Case Report may include matters that should be noted by the audit firms and engagement teams, or may be included in the points to note of relevant items of audit procedures that are desired as improvements of the deficiencies.

(5) In cases where more than one provision in a standard, law or regulation is applicable when identifying a deficiency, the principal provision is quoted.

2. Main Changes in the 2016 Edition

(1) Because audit firms' management and operation, particularly quality control systems, vary depending on the size of the firms, cases of inspection results tend to be categorized by the size of the firms. Therefore, cases are separately described at large audit firms and small and medium-sized audit firms in "I. Root Cause Analysis" and "II. Quality Control System."

(2) "I. Root Cause Analysis" distinguishes cases into large audit firms and small and medium-sized audit firms from this year as mentioned in (1) and describes the importance of the root cause analysis of deficiencies. Root causes identified in CPAAOB inspections are classified, together with descriptions of actual cases to aid the understanding of the root causes.

(3) "II. Quality Control System" distinguishes cases into large audit firms and small and medium-sized audit firms from this year, as mentioned in (1). It also introduces examples of

[1]The CPAAOB classifies audit firms and others as follows, according to their size.

・Large-scale audit firms (Large audit firms)
Audit firms with 1,000 full-time audit practitioners or more, auditing around 100 listed companies or more.

・Audit firms with a size below that of large-scale audit firms (Second-tier audit firms)
Audit firms other than large audit firms that audit a relatively large number of listed companies.

・Small and medium-sized audit firms
Small and medium-sized audit firms (audit firms other than large and second-tier audit firms), joint offices and sole practitioners).

identified deficiencies in detail for each quality control item, with descriptions of “Points of focus” in the inspection, an outline of inspection results, expected response by audit firms, etc.

(4) In “III. Individual Engagements,” background information behind the deficiencies such as the business environment and audit situation of the entity is described to the extent possible so as to facilitate understanding of the importance of deficiencies in audit procedures. The total number of cases included in the Report has decreased, since cases were revised from the perspective of contributing to the improvement of audit quality.

The contents that previously included “Using the Work of Others” are distinguished into “4. Group Audit” and “5. Making Use of Experts.” Under the circumstances in which the series of accounting fraud has occurred, descriptions of related contents are enhanced in “6. The Auditor’s Responsibilities Relating to Fraud in Financial Statement Audits.” The content that was described in “Auditing Financial Institutions,” which constituted a section up to last year’s edition, has been included in each section according to the nature of the deficiencies.

(Definition of terms)

○The term “Act” refers to the Certified Public Accountants Act.

○The term “Ordinance” refers to the Cabinet Office Ordinance for Enforcement of the Certified Public Accountants Act.

○The term “audit firm” refers to an audit firm, joint office or a sole practitioner.

○The term “JICPA” stands for the Japanese Institute of Certified Public Accountants.

○The term “FIEA” stands for Financial Instruments and Exchange Act.

○The term “quality control (QC) review” refers to the quality control review performed by JICPA under Article 122 of the JICPA Rules.

○The term “Fraud Risk Response Standard” refers to the “Standard to Address Risks of Fraud in an Audit.”

I. Root Cause Analysis

(Necessity of Cause Analysis)

As a result of the CPAAOB's inspections, it was noted that if a deficiency was detected in a QC review or cyclical inspection, many audit firms developed and took improvement measures merely as a formality, without fully identifying the cause of the deficiency. Because they did not understand the reason for the deficiency, they often experienced the same or similar deficiencies despite the improvement measures they took, regardless of the size of the firm.

Deficiencies identified in inspections may be only a part of deficiencies, which have not been identified yet. It is likely that the audit firms have other undiscovered deficiencies arising from the same root causes. Moreover, there may be root causes that would invalidate the improvement measures implemented to cope with the direct causes of the deficiencies. Improvement measures developed only to cope with the direct causes, without the root cause analysis, would not be effective or sufficient for improving the quality control system of the entire firms, and would not lead to fundamental improvement; therefore, the quality of the audits by the audit firms would not be improved.

Thus, root cause analysis is essential for fundamental improvement of deficiencies identified in audit firms. The International Forum of Independent Audit Regulators (IFIAR) pointed out the importance of root cause analysis of deficiencies at audit firms and audit regulators.

Therefore, although the CPAAOB had previously pointed out the necessity for audit firms to analyze the cause of deficiencies and develop improvement measures based on the analysis, it has clearly stated the necessity to verify the root causes in the "Audit Firms Monitoring Policy for Fiscal Year 2015 (On-site Monitoring and Inspection)" in order to further promote analysis and development.

Such root causes of deficiencies are not unique to certain audit firms but may exist widely in audit firms, whether or not they have appeared. For example, they include the business condition of the audit firm, the composition of professional staff, and the culture of the firm related to quality control.

Therefore, audit firms shall understand the importance of root cause analysis of deficiencies in order to improve the quality control system of their organization. If deficiencies are identified as the result of a QC review, cyclical inspection or other occasion, investigation should be conducted for its root cause analysis, and substantive measures should be implemented, using the following example cases as reference, instead of perfunctory measures.

As cases of inspection results tend to be categorized by the size and characteristics of audit firms, the root cause analyses are separately described for large audit firms and for small and medium-sized audit firms from this year.

1. Large Audit firms

Although quality control systems are designed at large audit firms, we understand that there are deficiencies in the effectiveness of their operation, since many deficiencies have been continuously identified in individual audit engagements.

Root causes of deficiencies identified in large audit firms in CPAAOB's inspections are categorized as follows:

(1) Lack of understanding of quality control

Since large audit firms have several thousand employees and multiple offices, including those outside major cities, they usually have some divisions, each consisting of several hundred staff and managed by a division manager, and so on.

Under such circumstances, it is necessary for each division to not only design the organization and procedures of a quality control system, but also to instill the improvement measures in the engagement teams under the strong leadership of the management, including the CEO, in order to improve the QC level across the entire organization.

However, there may be issues in leadership, including the management's awareness in quality control, and in initiatives of the divisions.

The following cases have been identified as specific root causes:

- The CEO and PICOQC of an audit firm understood that the engagement partners had the required level of audit quality control capability and sufficient awareness of audit quality, and did not take seriously the quality of the audits conducted by the audit firm.
- There was an atmosphere of overconfidence by the CEO, PICOQC and engagement partners in the quality of audit engagements conducted by partners of the audit firm and members of member firms abroad, as they were strictly managed in accordance with the quality control policy of the network firm to which they belonged.
- There was a lack of atmosphere among the management, including the CEO, to review operations from a broad perspective and to enable engagement teams to voluntarily improve the audit quality engagement teams.
- Divisions, which are responsible for audit quality improvement, had not thoroughly enforced efforts to improve audit quality by engagement teams based on the policy of the management, including the CEO.

(2) Insufficient verification of improvement measures

The CEO and PICOQC shall understand the situation of each division and verify whether quality control measures have been instilled over the entire organization, and lead the results of the verification to further improvement, so that the improvement measures permeate the huge and complex organization. In addition, each division must take the initiative in implementing measures to improve audit quality.

However, there may be the issue of a lack of sufficient verification of whether improvement measures are actually carried out.

The following cases have been identified as specific root causes:

- Although the PICOQC was supposed to verify whether the quality of all audits had been improved with cyclical inspections and interim reviews, he/she had failed to establish a system to carry out effective monitoring (i.e. PICOQC did not take timely actions for audit procedures concerning audit engagements that require immediate improvement, despite combining cyclical inspections and interim reviews).
- Since information on the ability of each partner in quality control had not been sufficiently gathered, such ability had not been sufficiently analyzed, and individual measures such as re-education of partners had not been implemented.
- With regard to the improvement measures for quality control deficiencies, simultaneous reviews are only performed on listed companies.
- Each partner's quality control abilities and awareness for audit quality had still not been grasped sufficiently, nor had the audit risks of entities been understood by the Quality Control Division or each division. Furthermore, since the ability of partners and audit risks had not been thoroughly grasped, engagement teams that can deal with audit risks of entities had not been thoroughly organized, as evidenced by audit engagements where no engagement partners or independent engagement quality control (EQC) reviewers that can deal with risks have been assigned.
- Regarding improvement measures for the deficiencies identified, the CEO and PICOQC only provided instruction to engagement teams as in the past, and did not verify the appropriateness or effectiveness of the improvement measures, as they did not understand the necessity of verification.

2. Small and Medium-sized Audit Firms

Small and medium-sized audit firms vary in size and history, and the level of quality control also differs significantly among firms. However, the size of their organization is relatively small and they typically have difficulty in providing sufficient organized support, such as a quality control system, to engagement teams. The features among small and medium-sized audit firms is that the level of operation and quality control often depends significantly on the competence of individuals that belong to the audit firm, including the CEO, and the relationship between the partners and the firm.

Based on the above background, the root causes of deficiencies identified in CPAAOB's inspections can be categorized as follows:

(1) Management system, management policy (including policies related to evaluation, compensation and other incentives) or business model of audit firms
(2) Quality control efforts by the CEO and PICOQC
(3) Partners' awareness of responsibilities; mutual monitoring between partners

Many second-tier audit firms expand their operations through mergers between audit firms and the undertaking of new audit contracts. Under these circumstances, deficiencies concerning post-merger integration have been identified, such as cases where the quality control system has not been sufficiently designed and operated, despite the expansion of operations, and cases where some of the merged firms have failed to maintain the level of quality control of each audit engagement after the merger, since the purport and requirements of audit standards are not fully understood.

The following cases have been identified as specific root causes:

(1) Management system, management policy (including policies related to evaluation, compensation and other incentives) or business model of audit firms

- Each partner operated at the direction of the individual as if it were a firm under private management, since the compensation of each partner was determined based on the performance of his/her engagement teams. Each engagement team handled quality control issues, implemented improvement measures and the solutions by themselves. There was an atmosphere wherein partners in an engagement team could not interfere with other engagement teams.
- Engagement partners thought that they could earn stable audit income as long as they maintained good relationships with entities. They emphasized maintaining their relationships with the entities,

rather than focusing on the primary purpose of the audit, i.e., protecting the interests of investors and creditors.

- All partners of an audit firm were allowed to engage in their own private practice, besides their duties in the audit firm. Because virtually no partners other than the CEO were involved in the quality control operation, the firm was not able to perform audits in an organized manner. In such conditions, the CEO could not govern the firm effectively.
- With no management philosophy or policy, nor a clear direction of management, the CEO excessively relied on other partners with longer experience as a certified public accountant or longer audit experience than him/her, and considered that the other partners would manage the firm appropriately without him/her exercising leadership. As a result, there was no system to enable partners to monitor each other’s work in managing the firm.
- On the inspection base date, an audit firm neither met the criteria for the statutory requirements of partners involved in the operational control system nor secured enough human resources to perform audits. The system to perform audits in an organized manner did not reflect audit risks.

(2) Quality control efforts by the CEO, PICOQC and engagement partners

- The CEO and engagement partners relied on the assertions of entities based on their audit experience, and were not sensitive to risks of fraud. In particular, certain engagement partners relied on the assertions of a high audit risk entity and did not perform audit procedures with professional skepticism. They also did not understand current accounting and audit standards.
- Partners lacked experience in quality control operations of an audit firm or in forming audit opinions of listed companies prior to the establishment of the firm. They also had insufficient understanding and knowledge of the quality level required under audit standards. In addition, with regard to quality control of the audit firm and audits of listed companies, they lacked an attitude to improve audit quality and professional skills since they assumed that they could fully deal with issues based on their experience.
- The PICOQC was busy dealing with a merger and other matters, and failed to thoroughly enforce the use of audit tools by the engagement teams in light of audit standards. He/she had not taken sufficient actions, such as sufficient verification of improvement, in order to improve the quality of engagement teams that did not meet the quality level required for audits.
- Professionals, including engagement partners, had a poor understanding of the current audit standards because the education and training provided by an audit firm did not address audits of listed companies.
- The CEO has been involved in an audit of an entity for many years in his own private audit office. With regard to new audit engagements, he conducted risk assessment of the entities in the firm. Under these circumstances, the CEO was overconfident that he understood the audit risks related to the entities.

- Since the engagement partner and the audit team had lengthy audit experience and were continuously involved with the entity, the CEO assumed that the engagement team would carry out audit procedures audit risks that the CEO had understood, as long as he conveyed the risks to them.
- With regard to deficiencies identified in the JICPA quality control review, the CEO and PICOQC did not carry out a comprehensive verification of whether issues similar to the deficiencies had occurred in other audit engagements, and only added the deficiencies in their checklist without sufficient cause analysis of the deficiencies.
- As the organization expanded, a structure related to quality control, such as a quality control department, was established. However, the effectiveness of whether the organization worked had not been verified from the perspective of the entire current organization.
- The CEO did not sufficiently verify the effectiveness or actual situation of the current quality control system in the audit firm when considering the expansion of the business, although he understood that there was a discrepancy in the level of audit quality between engagements. Therefore, the CEO did not take specific measures to maintain and enhance the audit quality of all engagements in the audit firm other than to change engagement partners.

(3) Partners' awareness of responsibilities; mutual monitoring between partners

- Under the circumstances surrounding an audit environment, the partners lacked an attitude to maintain and improve the audit quality of the firm, such as proactive actions to revise conventional QC methods and audit procedures, and were reluctant to change themselves under a situation where major audit issues were unlikely to occur.
- Because the current audit firm was incorporated based on the private audit office of the CEO and the CEO led the acceptance of major engagements, other partners considered that the firm was still the private business of the CEO, and thus relied on the CEO for most of the management of the firm.
- As a partners' meeting has ultimate responsibility for the quality control system in an audit firm, each partner should be aware of the responsibility, as a member of this meeting, to design and operate the quality control system of the audit firm. However, partners, including the CEO, were not aware of their responsibility regarding the operation of the firm and the partners' meeting did not function.

II. Quality Control System

Implementation of Quality Control Operation

Outline

The CPAAOB inspects whether measures developed by audit firms to ensure adequate operations and maintenance/enhancement of the QC system are appropriate to the size and characteristics of the firm.

In "II. Quality Control System," examples of deficiencies identified in CPAAOB inspections are introduced according to the provisions of "Quality Control for Audit Firms" (Quality Control Standards Committee Statement No. 1).

Major changes in this Case Report

Since QC systems are developed according to the size and characteristics of the audit firm, responses to requirements for QC systems under the audit standards vary between large audit firms with several thousand members, and small and medium-sized audit firms. Furthermore, many deficiencies identified in the past reflect the size and characteristics of each audit firm, in addition to the background to the deficiency.

Under such circumstances, in light of the fact that the "Improvement of Effectiveness of CPAAOB Inspections: Large Audit Firms" published by the CPAAOB in March 2016 pointed out deficiencies in the effectiveness of the format (organization and procedures) of QC systems, including their operation, at large audit firms, and that last year's questionnaire on the Case Report included a request by users to describe cases based on the size of the audit firm, the Case Report divides "II. Quality Control System" into the "Large Audit Firms" section and the "Small and Medium-sized Audit Firms" section from this year, so that users can use information on QC systems according to the size and characteristics of the audit firm.

Of the information related to deficiencies identified at second-tier audit firms, characteristic contents are included in the "Small and Medium-sized Audit Firms" section.

Analysis of deficiencies that occurred

Regardless of the size of an audit firm, the purpose of establishing a QC system is to reasonably ensure the quality of audit engagements.

However, some audit firms developed a QC system only as a formality. In such cases, the QC system developed by the audit firm often does not work as expected and results in deficiencies, due to causes such as the failure to appropriately operate the system and to organically link the system to the improvement of individual engagements.

At large audit firms, although deficiencies related to the design of a QC system have seldom been identified in recent years, there are still many deficiencies in individual engagements. Therefore, it can be assumed that there are deficiencies in the operation of the QC system. Specifically, many operation-related deficiencies have been identified in areas such as reviews of audit documentation, EQC reviews and cyclical inspections.

Furthermore, deficiencies in individual engagements that were identified in the past by CPAAOB inspections and quality control reviews have not been appropriately improved and have continued to be identified in other individual engagements. From such cases it may be deemed that there are deficiencies in the operation of the QC system.

For example, cases where measures that were developed to improve the deficiencies have not permeated the entire firms, including engagement teams, have resulted in failure to achieve the expected effects and in the identification of the same or similar deficiencies as in the past, the following deficiency has been identified: since communication between the QC department at the headquarters and the individual engagement team was not appropriately carried out and the intent for improving the deficiencies was not shared, the measures for quality improvement was designed as a formality and audit practitioners including engagement partners did not understand the improvement of deficiencies.

At small and medium-sized audit firms, deficiencies continue to be identified in a broad range of areas in terms of both the design and operation of the quality control system. In addition, as at large audit firms, there were cases where deficiencies that had been identified in the past by CPAAOB inspections and quality control reviews were not appropriately improved in individual engagement inspections. Many such cases were deemed attributable to the quality control system. The above resulted from the facts that the CEO and the PICOQC did not understand the purpose of quality control operations, and that the design and quality control system were not conducted or used appropriately. In addition, there were cases where sufficient resources were not applied to the establishment of a quality control system that directly affects the audit quality.

A cause that is unique to second-tier audit firms is the failure of quality control system functions to suit the expansion of the size of the corporation through merger or acceptance of new audit engagements. For example, although persons in charge of each function of the quality control system including EQC reviews and education/training were appointed, they could not identify deficiencies that are inherent in terms of quality control and individual engagement because there was no one to manage the functions and be responsible for the quality of audit.

Expected response

Based on the primary purpose of a quality control system, which is to reasonably ensure the quality of audit engagements, all audit firms are required to establish such a system effectively and efficiently, depending on the size and characteristics of each audit firm, so that the QC system can effectively work in individual engagements. Specifically, the CEO and PICOQC of audit firms should understand the purpose and importance of the quality control system, and take the initiative in ensuring that each professional in a firm understands that the primary purpose of the QC system is to spread measures to improve the quality of audit throughout the entire organization, and monitors its effects at all times.

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

Large Audit Firms

1. Initiatives to Improve Performance

Points of focus

Since large audit firms have established QC systems of a certain level, the CPAAOB inspects, in particular, the improvement of deficiencies identified in the previous CPAAOB inspection or QC review at cyclical inspections. Specifically, in principle, CPAAOB selects multiple individual engagements, and inspects, for each item, each engagement to see the improvement status of deficiencies previously identified in each individual engagement. In the case where the improvement is deemed insufficient, the CPAAOB seeks to identify the operational and structural issues that might be the cause of such insufficiency, and inspects the effectiveness of the improvements carried out by the large audit firm.

Outline of inspection results

At large audit firms, measures for deficiencies identified in CPAAOB inspections and QC reviews are planned under the initiative of the QC department at the headquarters, and engagement teams learn about them through training and notifications. Each engagement team then carries out appropriate response through the revision of audit procedures based on the risks of each entity considering the content of the measures. The improvement of audit quality is thus achieved throughout the corporation.

However, deficiencies that are the same as or similar to those found in the previous CPAAOB inspection or QC review continue to be identified at some large audit firms. As their causes, the CPAAOB has identified deficiencies in various stages of operation of the QC system, such as initiatives to instill improvement measures throughout the entire organization, the understanding by individual engagement teams, or the monitoring of how improvement measures had spread across the entire firm in the process of improving the deficiencies. In particular, there were cases where improvements were not permeated throughout firms whose engagement partners in engagement teams were responsible for many audit engagements and at those whose departments and regional offices had no personnel exchange with other departments, resulting in static human resources.

As causes for the failure to appropriately improve operations in individual engagement teams, many cases resulted from an engagement partner being in a position to lead the engagement team that actually carries out the improvement of audit. Specifically, it was identified that engagement partners rely on other engagement team members' performance of audit procedures in the field of audit for the application of auditing standards and audit of entities for which the engagement partner is responsible. As a result, the engagement partners were not able to lead the engagement team adequately.

Expected response

Large audit firms employ several thousand staff members and have multiple offices, including those outside major cities. Therefore, they usually have more than one department, each consisting of several hundred staff members and managed by a department manager or equivalent. In order to disseminate improvement measures planned by the QC department at the headquarters to the entire organization as a response toward improvement and achieve sufficient effects, the entire firm should respond to any deficiency together with the management of the firm, such as division managers, based on the understanding of all members of the firm involved in quality control, instead of response only by limited divisions, such as the QC division. Thus, the expected effects can be achieved.

The CEO in particular should take the initiative in encouraging all members, especially the engagement partners, who are in a position to lead the engagement teams, to carry out quality control and improve operations, so that the intent of the improvement permeates the entire organization. Thereupon, the PICOQC is required to plan and implement the timely and appropriate measures under the instructions of the CEO, while division managers are not required to only carry out quality control and improve operations but to provide appropriate instructions and urge audit practitioners under their management to make appropriate responses.

Furthermore, the CEO and PICOQC should together with division managers or equivalent, establish an effective system to monitor improvement and take appropriate actions to promptly resolve any issues that were identified in the inspection.

Case 1: Verification of improvement

The PICOQC only recommended the engagement teams to use a checklist that was prepared to improve deficiencies identified in the CPAAOB inspection. He/she did not instruct engagement partners to verify the improvements or instruct EQC reviewers to monitor whether improvements were made, and did not fully verify whether the improvements had spread to audit engagements other than those in which deficiencies were identified.

Furthermore, the engagement partners communicated with the staff of engagement teams as well as relying on the staff, and did not verify through audit documentation whether the deficiencies identified in the CPAAOB inspection were improved.

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

Case 2: Penetration of measures (existence of a unique culture)

Certain departments had little personnel exchange with headquarters and other departments, since members unique to the department had managed the department. This had led to static human resources. Therefore, there was a unique culture in their operations of adopting a management style based on its own policy instead of that of the firm's.

Therefore, the instructions of the headquarters had not fully penetrated the department and, as a result, no improvements were made toward deficiencies identified in CPAAOB inspections and other reviews.

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

《**Points to Note**》

In addition to the above, even though the initiative of improvement was not effective, the QC division did not carry out monitoring or other actions and not verify the improvement status for each engagement team. Then, the CPAAOB inspection was made before appropriate improvement guidance could be provided. This led to the identification of cases of an "unimproved" situation.

It would be effective to use quality control systems such as EQC reviews and cyclical inspections to understand the progress of improvements at audit firms on a timely basis.

2. Operation of the Quality Control System

Points of focus

At large audit firms, although deficiencies related to the design of a QC system have seldom been identified in recent years, there are still deficiencies identified in individual engagements. The CPAAOB believes that, although the format (organization and procedures) of QC systems is developed, there are deficiencies in the effectiveness of QC systems including their operation.

Therefore, the CPAAOB inspections examine the existence of operational deficiencies of the QC system related to individual engagements from the perspective of whether the QC system that the audit firm established has failed to lead to the maintenance and improvement of the quality of the audit that each engagement team implements, resulting in the failure to identify and prevent audit deficiencies.

Outline of inspection results

In terms of the operation of QC systems, the CPAAOB has identified many deficiencies in areas such as reviews of audit documentation, EQC reviews and cyclical inspections. Specifically, there were many cases where the engagement partners or equivalent who review audit documentation, the EQC reviewer and the person in charge of cyclical inspections had not fully understood the changes in the environment surrounding entities, the circumstance of the entities, or the audit procedures performed by the engagement team, and failed to detect the deficiencies that were inherent in individual engagements.

The CPAAOB has pointed out as the causes that, although there were differences in awareness of audit quality and abilities of quality control among partners such as engagement partners and EQC reviewers, the QC department could not fully understand the differences or assign the appropriate engagement partners and EQC reviewers, and, in addition, the engagement teams did not proactively consider how to ensure audit quality as they relied on manuals and the headquarters' instructions.

Expected response

Engagement partners should understand that they are responsible for supervising engagement team members, considering their competency and experience, and leading them to conduct audit engagements sufficiently and appropriately, and should proactively engage in every phase from audit planning through the forming of opinions.

Furthermore, EQC reviewers should confirm that audit engagements have been conducted sufficiently and appropriately by, for example, reviewing audit procedures and audit evidence related to significant matters described in the audit documentation to ascertain that there were no problems in the process of forming opinions.

The CEO and PICOQC should then establish a system where the engagement partners conducting reviews and EQC reviewers can appropriately carry out operations.

Specifically, audit firms should assign appropriate engagement partners and EQC reviewers, considering each partner's awareness of required audit quality, abilities in QC and audit risk based on the entity's corporate environment. In addition, if a deficiency in audit improvement caused by an engagement partner has been detected, for example, the audit firm should re-evaluate the ability in QC of the engagement partner and appropriate allocate resources based on the ability and provide re-training to engagement partners who are responsible for audit engagements.

Large audit firms utilize contents such as electronic audit documentation systems, in which audit procedures are described, and checklists that are used in EQC reviews and cyclical inspections in order to perform audits and related operations effectively and efficiently. In addition, they have established consultation and council systems at the headquarters, where difficult audit issues are discussed and advice or solutions are provided. While such a system is useful in maintaining audit quality at a certain level throughout the audit firm, it might lower the awareness of engagement teams to proactively consider audit quality.

The CEO and engagement teams, including engagement partners, should endeavor to appropriately conduct audit engagements by fully understanding the benefits and limitations of a system such as the above.

Case 1: Securing effective review

The EQC reviewer did not conduct sufficient reviews of audit documentation concerning important audit judgments made by engagement teams and their conclusion, by ascertaining whether the engagement teams' explanations for important audit areas, such as audit procedures for significant risks, were supported by sufficient and appropriate audit evidence.

(Auditing Standards Committee Statement No. 220, paragraphs 19 and 20)

Case 2: Effectiveness of cyclical inspections

The engagement team performed additional audit procedures as corrective measures against the deficiency identified in the cyclic inspection. The QC department did not sufficiently monitor the audit documentation to ascertain whether the judgments made by the engagement team for these additional audit procedures were supported by sufficient and appropriate audit evidence.

(Quality Control Standards Committee Statement No. 1, paragraphs 50 and 51)

《Points to Note》

It should be noted that EQC reviews and cyclical inspections are required to evaluate the content of the engagement teams' explanations objectively based on documents, through examination of audit documentation.

Case 3: Review of audit documentation

Engagement partners or equivalent did not conduct sufficient review or provide direction as they assumed that the audit procedures performed by audit staff were sufficient and appropriate; therefore, they could not detect deficiencies in audit procedures through reviews.

(Quality Control Standards Committee Statement No. 1, paragraphs 31 and 32; Auditing Standards Committee Statement No. 220, paragraphs 15 and 16)

Engagement partners or equivalent could not identify deficiencies in audit procedures since they did not understand the need to ascertain the sufficiency and appropriateness of audit evidence through reviews of audit documentation, as well as the importance of the education of audit staff.

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

《Points to Note》

In a limited time frame, such as year-end audits, it is required to appropriately plan the content, timing and scope of the review of audit documentation in order to conduct appropriate reviews and direct engagement teams through reviews.

Small and Medium-sized Audit Firms

1. Operational Control System

(1) Initiatives to Improve Performance

Points of focus

The CPAAOB performs inspections based on QC review reports, in principle. In particular, the CPAAOB inspects the improvement of deficiencies identified in the previous CPAAOB inspection or QC review. Specifically, as a general rule, CPAAOB selects multiple individual engagements, and inspects, for each item, each engagement to see how the deficiencies previously identified are improved. In the case where the improvement is deemed insufficient, the CPAAOB seeks to identify the operational and structural issues that might be the cause of such insufficiency.

Outline of inspection results

As shown in the case example section below, in some audit firms, initiatives to improve the deficiencies identified in the QC review were not fully implemented, and in more than one deficiency, no improvement measures were made or the improvement was insufficient.

Possible causes of the identified deficiencies include the following.

The PICOQC merely carried out measures as a formality, such as simply disseminating information on the deficiencies through training and only instructing to respond to the items included in the checklist for improvement related to identified deficiencies, without considering why the matter was identified as a deficiency in the QC review. The audit firm lacked the attitude of seeking improvement in all audit engagements, and had not established a system to effectively monitor the improvement of deficiencies.

Furthermore, engagement partners that review the audit documentation, the EQC reviewer and the person in charge of cyclical inspection or the equivalent did not fully understand the purpose of their functions and completed their work by reviewing audit documentation and implementing checklists merely as a formality. They also relied on the engagement practitioners for the development of knowledge required for audit engagement. The audit firm did not proactively seek to maintain and improve the aptitude of audit practitioners or develop their capabilities. All of this led to the inability to detect the same or similar deficiencies that were inherent in individual engagements, and thus to make any improvement.

(Observed effective efforts)

The following responses were made at an audit firm where many deficiencies were identified in the QC review:

- The CEO directly ascertained the improvement of deficiencies in all audit engagements.

- A system that enables to find audit issues early was established, such as the implementation of a preliminary EQR review system.
- The identified deficiencies were understood and the improvement measures were disseminated through discussions in each engagement team.

Expected response

The audit firm must fully understand to what range and nature a deficiency should be improved, considering the reason why it was identified as a problem in the QC review or the CPAAOB inspection. Based on the results of that examination, the firm should develop and implement appropriate improvement measures for the identified deficiency. The firm should not only examine the individual engagement where the deficiency was identified, but also check whether other individual engagements had the same or similar situations as the identified deficiency, and fully examine whether the improvement measures developed have been properly implemented. Thus, the firm must take measures to improve all audit engagements undertaken by the firm.

Case 1: Establishment and implementation of specific procedures for improvement

The PICOQC of an audit firm communicated to each engagement team the recommendations for improvement that were identified for deficiencies in individual engagements. However, while the details of the deficiencies were communicated to the teams, the PICOQC did not provide specific instructions to reflect accounting estimate issues similar to the deficiencies in the audit procedures of each team.

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

In using the checklist to improve deficiencies found in QC reviews, the audit practitioners did not make thorough fact-finding inspections, based on the implications of the deficiencies and the extent of improvement needed. For example, in a case where a deficiency was pointed out to the effect that "the firm did not perform audit procedures responsive to risks related to management override of controls," the audit practitioner of the firm only tested journal entries recorded and placed a check mark in the "Done" box, but did not review accounting estimates for management biases or evaluate whether the circumstances producing the bias or significant transactions which are outside the normal course of business for the entity suggested that it may have been engaged in fraudulent financial reporting.

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

Case 2: Communication of specific policies and procedures for improvement

There were cases where the specific policies and procedures for improvement were not fully communicated within the organization. For example, in the checklist designed for cyclical inspection, the PICOQC included deficiencies identified in the QC review and improvement plans for them. However, the PICOQC did not explain to other members in the firm why the deficiencies happened and the purpose of the improvement plans. For part-time employees, only a postal mail describing the deficiencies was sent.

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

Case 3: Verification of improvement

The CEO disseminated the improvement measures for the deficiencies identified in the QC review and monitored the improvement status through cyclical inspection, but did not verify the improvements for operations that were not subject to cyclical inspection.

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

《Points to Note》

As initiatives to improve services, although the audit firm developed an improvement checklist to examine the implementation of measures to improve deficiencies identified in the QC review, and had each engagement team use the checklist to check the improvement status, the engagement teams did not check in detail the sufficiency or other aspects of the performed audit procedure in light of the specific improvement measures described in the improvement plan of the audit firm. Therefore, there were cases where no improvement was made.

In addition, when using the improvement checklist or equivalent, it should be noted that it is necessary to communicate the specific measures to improve deficiencies to members of the audit firm, and for the PICOQC and engagement partners to inspect the improvement status in light of why the matter was identified as a deficiency as well as the scope of procedures that should be improved.

(2) Establishment, Dissemination, and Implementation of Internal Rules

<u>Points of focus</u>

The CPAAOB inspects audit firms for the status of establishment, dissemination, and implementation of internal rules, from the following perspectives:

- ▸ Whether the audit firm has internal rules in place to reasonably ensure audit quality, which are adequate for the size and operations of the audit firm;
- ▸ Whether the audit firm works to ensure the adequacy of the internal rules, for example, by sufficiently confirming consistency between the rules when establishing or revising them, or by revising the internal rules according to revised practice guidelines as needed;
- ▸ Whether the PICOQC or equivalent distributes copies of the internal rules to audit practitioners (including part-time staff) and other personnel without fail, and, as needed, ensures their familiarization with the rules, for example, by verbally explaining them;
- ▸ Whether the PICOQC or equivalent ensures compliance with the internal rules, for example, by

having audit practitioners or other staff monitor the status of compliance in a timely manner as needed.

Outline of inspection results

In the establishment, dissemination and implementation of internal rules, as shown in the case example section below, some firms did not establish internal rules related to independence and non-audit services. Some firms did not follow internal rules related to contract management.

Some of the reasons for the above types of deficiencies were that the members of the audit firms did not understand the laws and standards that are applied to audit firms, and that the audit firms adopted the template of the "Audit Quality Control Regulations" that are provided by JICPA as their internal rules without customizing them to their actual operation.

Expected response

Audit firms need to reconfirm that their internal rules are in compliance with the applicable laws and standards and are adequate considering the actual operational conditions of the firms. Based on this reconfirmation, they should perform sufficient examination and review as to whether their operations are performed in accordance with the internal rules. They also need to establish an operational control system concerning the appropriate establishment, dissemination, and implementation of internal rules, for example, by establishing a workflow in accordance with the actual conditions of the individual firm.

Case 1: Establishment of internal rules related to independence

The PICOQC of an audit firm stipulated in the firm's internal rules that even if fees received from a single client accounted for 15% of the firm's total revenues for two consecutive years, if it fell to less than 15% in the third year, the firm could avoid the application of the Safeguard. This rule did not correctly reflect the "Guideline for Independence."

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

The PICOQC of an audit firm only stipulated the prohibition of trading of specific securities of clients in the internal rules "Regulations for Preventing Insider Trading," and prohibited the provision of excessive entertainment and gifts to clients in the internal rules "Code of Conduct." The firm did not establish internal rules that comprehensively secured the independence of the firm.

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

Case 2: Implementation of internal rules

Although the CEO and PICOQC stipulated in the "Contract Management Regulations" that the conclusion of a contract shall be notified to all partners and an inquiry of the contract details be requested when entering into a non-audit service contract with a client, neither notification nor inquiry was carried out when the majority of the non-audit service contracts were concluded. (Quality Control Standards Committee Statement No. 1, paragraphs 15 and 16)

《Points to Note》

The number of identified deficiencies in establishing rules, such as the non-existence thereof, has decreased due to the enhancement of templates provided by JICPA or equivalent. However, since the templates were used without being customized to the audit firm's actual operation, and the internal rules did not suit the actual situation of the firm, the rules were not actually followed at some firms.

In addition to cases described here, deficiencies in the operation of the Partners' Meeting.

(3) Compliance with Laws, Regulations, and Professional Standards

Points of focus

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

Outline of inspection results

From the perspective of compliance with laws, regulations and professional standards, some audit firms had deficiencies related to legal compliance, including a lack of internal rules regarding the non-competing obligation by partners, lack of partners' qualifications required for operational control, and a discrepancy between matters described in the articles of incorporation as the purpose of the audit firm and the firm's actual operation. In particular, multiple deficiencies were identified in the satisfaction of partners' qualifications required for operational control.

Causes of the deficiencies include: the PICOQC or equivalent did not fully understand the applicable laws, regulations and professional standards or did not appoint practitioners to take charge of the confirmation of regulatory compliance of each task that requires such confirmation, and did not establish a clear and concrete workflow for confirmation.

Expected response

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

Case 1: Non-compete obligation by partners

The audit firm did not have internal rules that set forth procedures to check that each partner's private practice did not compete with the business of the audit firm and detailed procedures to approve such competing transactions.

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

Case 2:Development of operation control structure at audit firms (Satisfaction of partner requirements)

An audit firm did not satisfy the requirement that the majority of partners have been engaged in audit certification services for three years or more after being registered as certified public accountants. Despite this situation, the CEO did not take necessary improvement measures. Moreover, in the business report, the firm incorrectly included three partners who had less than three years of audit certification experience in the number of those with at least three years of experience after being registered as certified public accountants.

(Certified Public Accountants Act, Article 34-13, paragraph 1, Article 34-16, paragraph 2; Ordinance for Enforcement of the Certified Public Accountants Act, Article 25, Article 38, paragraphs 1 and 2; Quality Control Standards Committee Statement No. 1, paragraph 28)

Case 3: The objective described in the audit firm's articles of incorporation and implemented operations

Although this audit firm limited the firm's objective described in its articles of incorporation to the audit or attestation services for financial documents (operation described in Article 2, paragraph 1 of the Certified Public Accountants Act), it provided the service of preparation of comfort letters, which was the service of compiling financial documents, examining or planning financial matters, or being consulted on financial matters (operation described in Article 2, paragraph 2 of the Certified Public Accountants Act). Thus, the actual scope of operations did not comply with the articles of incorporation.

(Quality Control Standards Committee Statement No. 1, paragraph 31; Article 34-5 of the Act)

《Points to Note》

Other deficiencies have been identified such as the failure to submit a notification of changes to the articles of incorporation by the submission due date.

(4) Information Security

Points of focus

CPAs, in the course of their daily duties, often carry paper documents and personal computers that contain or store confidential information of entities. They also use e-mail to communicate with the contact persons of the entities. Audit firms also store electronic audit documentation and electronic data before compilation in servers installed in and outside their offices. Therefore, audit firms are required to establish and operate information security systems that fully and appropriately meet the sensitive needs of the IT environment, etc.

In consideration of the above, the CPAAOB inspects audit firms for the status of establishment of information security systems, from the following perspectives:

- ▶ Whether the audit firm properly assesses information leakage risks, for example, by analyzing the type of information, etc. held by the audit firms;
- ▶ Whether the audit firm has security policies and other internal information security rules in proper operation in accordance with such risks;
- ▶ Whether an information security manager ensures compliance with internal information security rules, for example, by continually monitoring whether audit practitioners (including part-time staff) and other personnel observe the internal rules.

Outline of inspection results

As shown in the case example section below, some audit firms did not appropriately carry out any measures to prevent information leakage as specified in their internal information security rules, which others did not establish internal rules to properly control the use of Internet server services for the firm's operation.

Causes of the identified deficiencies:

- ・ The information security manager or equivalent established internal information security rules only as a formality, leaving the application of the rules to audit practitioners (including part-time staff) who use computers and other information devices.
- ・ The information security manager or equivalent did not implement any measures to keep track of the operational status of the internal information security rules at their audit firms, placing too much reliance on such audit practitioners being compliant with the internal rules.
- ・ The information security manager or equivalent did not establish internal rules appropriate for the information devices actually used in the firm.

Expected response

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

Case 1: Establishment and operation of internal information security rules

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

- A security policy to prevent information leakage was in place. However, no policy or procedures for action to take in the event of information leakage were established.
- Stored data were not classified according to their crisis level; no backup or encrypted data were created for stored data; no ID codes or passwords were assigned to audit practitioners to protect critical electronic data from unauthorized access.
- The firm required all members to submit a "security policy compliance report," but some members failed to submit this report.

(Quality Control Standards Committee Statement No. 1, paragraphs 15 and 16; Article 27 of the Act; JICPA IT Committee Practical Guideline No. 4, III 1, IV 2, 5 and 10)

Case 2: Operation of internal information security rules for part-time audit practitioners

The PICOQC of the audit firm had stipulated in the "Information Security Regulations" to monitor remaining data related to audit engagements on personal PCs when a part-time audit practitioner used his/her personal PC for audit engagements. However, the PICOQC merely used the "Checklist on Information Security" as a formality and did not actually ascertain whether there was remaining audit engagement data on the PC.

(Quality Control Standards Committee Statement No. 1, paragraphs 15 and 16; Article 27 of the Act; JICPA IT Committee Practical Guideline No. 4, IV 2 and 5, and V 2)

Case 3: Security in using Internet servers for operations

An audit firm uses an Internet server service provided by a leading Internet service provider. The firm has not established internal security rules for the use of an Internet server service for the firm's operations. Because of the lack of such internal rules, when the firm performed regular assessment of the service provider, the firm did not check whether the service provider took measures to prevent unauthorized access, whether the service provider used subcontractors for providing services, or other security-related matters of the service provider.

(JICPA Code of Ethics, Article 6, paragraphs 1 and 3, JICPA IT Committee Practical Guideline, No.4, III 3, IV 2 and 3)

《Points to Note》

It should be noted that, as described in Case 2, when a part-time employee uses his/her personal PC for audit engagements and work as well as a full-time employee, it is necessary to take the same level of security measures for a full-time employee.

(5) Prevention of Insider Trading

Points of focus

If a CPA, who holds the important social mission of ensuring the reliability of the capital markets, partakes in insider trading using the insider information of an enterprise acquired in the course of business, trust in CPA audit may be seriously damaged.

In addition, not only will the CPA involved in insider trading be held liable, but also such involvement can seriously damage trust in the audit firm to which the CPA belongs. Each audit firm is therefore required to constantly take effective measures to prevent any of its members from participating in insider trading.

In consideration of the above, the CPAAOB inspects audit firms regarding the status of establishment and operation of an anti-insider trading system, from the following perspectives:

- ▶ Whether the audit firm has internal rules in place that provide for effective procedures to prevent any of their members from participating in insider trading, and makes these procedures known to their members;
- ▶ Whether the audit firm appropriately takes the anti-insider trading measures set forth in its internal rules, and, whenever necessary, carries out monitoring, including confirmation of specified securities transactions by its members.

Outline of inspection results

As shown in the case example section below, we observed cases where internal rules were prepared by using the template "Rules for Preventing Insider Trading" as a guide, but such rules were not followed.

Causes of identified deficiencies:

- ・ The anti-insider trading manager or equivalent did not comprehensively understand the anti-insider trading measures to be performed under the internal rules;
- ・ The anti-insider trading manager or equivalent did not confirm whether members were actually compliant with the anti-insider trading rules, having too much confidence that members were appropriately observing the relevant rules.

Expected response

Audit firms should understand that negative effects of insider trading on capital markets are generally known and take even more effective measures to prevent such trading.

Specifically, audit firms should take necessary responses such as carefully studying “Q&A Concerning Insider Trading” issued by JICPA (September 2, 2008) and other relevant documents, re-examining the conditions of establishment, dissemination, and implementation of the rules for preventing insider trading, and considering whether the strengthening of systems to prevent insider trading is required.

Case 1: Implementing training to prevent insider trading

The PICOQC and the partner in charge of training of an audit firm only carried out training to prevent insider trading once in the past. Although regulations concerning insider trading were subsequently revised, after which new partners joined or new audit assistants were hired, no training to prevent insider trading nor surveys of the status of training to prevent insider trading were conducted.

(Quality Control Standards Committee Statement No. 1, paragraph 15 and 19; Article 26 of the Act)

Case 2: Submission of written pledges regarding anti-insider trading

The PICOQC requires the submission of a written pledge to comply with the “Rules for Preventing Insider Trading,” which prohibit all members from buying/selling specified securities issued by the entities to which services are provided. However, the written pledge was only required to be submitted at the time of hiring, and no anti-insider trading measures such as monitoring all members for trading of specified securities were carried out subsequently.

(Quality Control Standards Committee Statement No. 1, paragraph 19; Article 26 of the Act)

《Points to Note》

In addition to the above cases, it is specified in the “Rules for Preventing Insider Trading” that a list of entities to which services are provided shall be distributed to members in order to provide a warning about insider trading, and that members shall submit written pledges to not carry out any transactions for themselves to buy/sell specified securities issued by the entities to which services are provided; however, examples of deficiencies were identified in the operation of internal rules for preventing insider trading, such as the anti-insider trading manager not preparing a list of entities to which services are provided.

2. Professional Ethics and Independence

Points of focus

In order for the audits performed by CPAs to be viewed as trustworthy by related parties, it is important that auditors maintain a fair and impartial attitude, not represent any special interests, and make fair judgments on the appropriateness of financial statements. To that end, audit firms are required to establish policies and procedures regarding compliance with professional ethics and independence requirements to objectively show that auditors maintain a fair and impartial attitude. In addition, the engagement partner is required to comply with such policies and procedures and to ensure that their assistants comply with them.

In consideration of the above, the CPAAOB inspects the professional ethics and independence of an audit firm from the following perspectives:

- ▶ Whether the audit firm obtains, at least once a year, a confirmation letter concerning compliance with policies and procedures for the maintenance of independence from all persons required to maintain independence; and whether appropriate verification procedures are used according to the classifications of such applicable persons;
- ▶ Whether the audit firm performs the independence confirmation procedures set forth in its internal rules before acceptance and continuance of audit engagements, and when issuing the auditor's report, appropriately confirms that there was no change in the status of independence;
- ▶ Whether the audit firm carries out independence confirmation procedures after providing those subject thereto with the latest correct information on the subsidiaries, etc. of the entity;
- ▶ Whether the audit firm establishes and communicates policies and specific procedures to ensure the observance of professional ethics, such as no dependence on a single income source, employment restrictions, and restrictions on gift-giving and entertainment, and whether the audit firm instructs the audit practitioners to follow these policies and procedures; and whether the audit practitioners follow the policies and procedures for the observance of professional ethics stipulated in the internal rules of the firm;
- ▶ Whether the audit firm establishes and implements policies and procedures related to engagements associated with long periods of time to ensure compliance with the legal requirement of rotation.

Outline of inspection results

As shown in the case example section below, there were identified deficiencies, such as not properly implementing the independence confirmation procedures specified in their internal rules or otherwise. Causes of the deficiencies include: the PICOQC or the equivalent did not establish specific procedures (including but not limited to how to gather the latest information on consolidated subsidiaries, etc. of the entity) and period of independence confirmation, and did not appoint a practitioner in charge thereof.

(Observed effective efforts)

Some small and medium-sized audit firms where compensation received from a single entity accounted for more than 15% of the firm's total revenues they took some measures to reduce the independence-inhibiting factor to a tolerable level. For example, when an audit firm selected a CPA from another independent audit firm as (1) the engagement quality control reviewer before issuing the auditor's report or (2) the cyclical inspector after issuing the auditor's report, it carefully considered his or her audit experience, capabilities and independence. Moreover, at the time of requesting such an inspection, the audit firm fully explained the following to the CPA: issues the engagement team faced when auditing, significant risks, audit procedures adopted by the team, conclusions reached by the team and other necessary information.

Expected response

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

Case 1: Independence confirmation procedures for audit practitioners

When the PICOQC examined independence checklists submitted by partners, the PICOQC missed the fact that some check boxes had been left blank or missed some responses indicating problems. For example, he or she missed the answer "Yes" to the question "Has any partner (or other member) been involved in the same engagement for a long time other than the partner in charge of such engagement?"

(Quality Control Standards Committee Statement No. 1, paragraphs 20, 21 and 23)

Case 2: Confirmation procedures for accepting new engagements

The policy and procedures for retaining independence that were established by the audit firm required that a written confirmation of the auditor's independence, or equivalent, be obtained from all professionals of the audit firm before the acceptance of an engagement. However, the PICOQC obtained the written confirmations only from the engagement partners and audit assistants who were to engage in the new engagements, and did not obtain them from other partners or professionals.

(Quality Control Standards Committee Statement No. 1, paragraph 23)

Case 3: Simultaneous provision of audit certification and non-audit certification services

When an engagement team provided non-audit services to a listed entity, the PICOQC and engagement partner did not examine whether the services were allowed to be provided simultaneously.

(Article 24-2, Article 34-11-2 of the Act; Article 6 of the Enforcement Regulations of the Act; Guideline for Interpreting the Revised Act concerning Independence No. 4, paragraph 5)

Case 4: Incomplete list of entities

Partly due to the fact that the PICOQC did not take measures to centrally collect the most recent information about entities, etc., and reflect such information in the "List of Entities" distributed at the time of annual independence confirmation, some entities were omitted from the "List of Entities" distributed at the time of the independence confirmation procedures.

(Quality Control Standards Committee Statement No. 1, paragraphs 20, 21 and 23)

Case 5: Calculation of dependence on income from a single entity

The CEO and the PICOQC incorrectly interpreted the provisions in the JICPA Guideline for Independence and other independence-related rules. When calculating the percentage of compensation received from one single entity to judge the necessity of the Safeguard, revenues which should not have been included were included in the total revenues of the firm (denominator), such as the revenues of a real estate lease company at which a partner of the firm served as a representative director and the revenues of a tax accounting firm that were not attributable to a partner who worked concurrently for the tax accounting firm.

(Guideline for Independence, paragraphs 220 and 222, Guideline for Interpreting Professional Ethics Q13)

Case 6: Length of engagement by engagement partners

The PICOQC assigned a back-office employee to prepare the document used for determining the rotation of engagement partners. The PICOQC also assumed that each partner checked the lengths of his/her individual engagements. The PICOQC did not check the accuracy of the document prepared by the back-office employee. As a result, the PICOQC could not detect that the document prepared for engagement rotation contained incorrect lengths of audit engagements of some engagement partners.

(Quality Control Standards Committee Statement No. 1, paragraphs 20 and 24)

3. Acceptance and Continuance of Engagements

(1) Assessment of Risk Associated with Acceptance and Continuance of Engagements

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

In order to reasonably ensure audit quality, in principle, audit firms need to carefully assess the potential risks involved in the acceptance and continuance of engagements (hereinafter "engagement acceptance risks"), by collecting information regarding the integrity, etc. of the entity involved from a wide range of sources, prior to the acceptance or continuance of engagements. If insufficient consideration is given to the process of risk assessment regarding the conditions of entities, or if a judgment as to whether audit engagement should be accepted, etc. is made based on an incorrect understanding of the audit performance system, it might result in a situation where auditors cannot fully execute their responsibilities. It is, therefore, evidently required that careful judgment based on properly collected, sufficient information is carried out in accepting or continuing audit engagements.

In addition, it is necessary to perform newly accepted or continued audit engagements taking into consideration the risk assessment and the information regarding entities involved, etc., obtained in the course of judgment on the acceptance or continuation.

Therefore, before acceptance and continuance of engagements, audit firms must consider the following matters:

- ▶ Whether there are engagement acceptance risks, including questions regarding the integrity of the top management of the entity;
- ▶ Whether the audit firm retains audit practitioners having sufficient knowledge, experience, capabilities and competence required to deal with the specified engagement acceptance risks appropriately; and
- ▶ Whether the audit firm could comply with regulations related to professional ethics

Regarding the examination of integrity of the top management of the entity involved in particular, audit firms are required to obtain the information deemed necessary in light of the situation in accepting engagements, and the case of continuing existing engagements, as well as, in the case of accepting or continuing engagements despite the fact that problems were identified, document how the firm resolved such problems.

The audit firm should establish policies and procedures for the acceptance and continuance of audit engagements, which include the evaluation of risks relating to the acceptance and continuance of the audit engagement considering the risks of fraud. The policies and procedures should also require that the adequacy of the evaluation be reviewed by an appropriate department or person outside the engagement team, according to the degree of risk upon acceptance or continuation of engagements.

In consideration of the above, the CPAAOB inspects how the engagement acceptance risks were assessed in each audit firm. The CPAAOB also inspects whether the identified engagement acceptance risks were properly reflected into the audit planning for individual engagements.

Outline of inspection results

The acceptance and continuance of audit engagements should be an essential issue in an audit firm's managerial judgment. In reality, as shown in the case example section below, deficiencies were identified in internal procedures relating to the acceptance and continuance of audit engagements. For example, information on an entity obtained by the partner who would take charge of the engagement for the entity was not shared with the approvers of the acceptance/continuance of engagements (such as the Partners' Meeting). Thus, they did not perform an appropriate risk assessment.

Causes for the identified deficiencies:

- The prospective engagement partner prioritized quick acceptance and quick commencement of the engagement rather than performing careful risk assessment and taking timely and appropriate actions for any identified problems.
- The prospective engagement partner did not have sufficient experience to make appropriate decisions regarding management fraud, audit of internal control, accounting estimates or other matters. Therefore, the engagement partner failed to properly identify and assess risks related to accepting the engagement based on facts found in a preliminary audit or information provided by the predecessor auditor.
- When discussing a proposed engagement, the partners did not recognize how important it was to assess the risk associated with the proposed engagement based on information gathered by the predecessor auditor, and other partners were reluctant to express critical opinions as to whether or not the engagement should be accepted.

Expected response

Decisions on the acceptance and continuance of audit engagements are essential matters in an audit firm's management. Fully recognizing this, audit firms need to re-examine what policies and procedures for acceptance and continuance of audit engagements are established and how they are operated. Regarding the risk assessment at the time of acceptance or continuance of an engagement, re-examination should be made about the policy and procedures as well as their implementation and operating effectiveness, from the viewpoints such as whether the decision of acceptance was made by identifying engagement acceptance risks based on collected information, and considering measures to manage such risks.

Case 1: Approval in Partners' Meeting

- ▸ Whether an audit engagement could be accepted or not was to be decided at the Partners' Meeting. However, the information materials to be presented to the Partners' Meeting were selected only by the prospective engagement partner at his or her sole discretion. As a result, the acceptance of engagements was decided and approved without communicating to the Partners' Meeting information necessary and sufficient for making the right decision.

(Quality Control Standards Committee Statement No. 1, paragraph 25)

- Approval was given for the conclusion of an audit contract before completing the procedures required by the audit firm, such as obtaining responses from the predecessor auditor to questions.
  (Auditing Standards Committee Statement No. 220, paragraph 11; and No. 900, paragraph 9)

Case 2: Risk assessment procedures when concluding a new audit contract

- The prospective new entity is in a state that may cast significant doubt on the entity's ability to continue as a going concern, such as recording net loss and negative operating cash flows for several years. Nevertheless, the entity did not disclose the footnote information regarding a going concern assumption on the grounds of financial support from its president.
  Under such circumstances, the prospective engagement partner obtained from the predecessor auditor a copy of financial support letter by the president upon the acceptance of the engagement. However, the engagement partner did not fully perform risk assessment procedures, such as verifying the feasibility of the financial support described in the letter by checking the financial status of the president.
  (Quality Control Standards Committee Statement No. 1, paragraphs 25 and 26; Auditing Standards Committee Statement No. 220, paragraph 11)

- The prospective engagement partner obtained information from the predecessor that would raise questions on the integrity of the top management. Nevertheless, this prospective engagement partner did not assess the impact of this information on the prospective engagement, and did not plan specific measures to reduce the risks expected from the acceptance of such an engagement to a tolerable level, either.
  (Quality Control Standards Committee Statement No. 1, paragraph 26; Auditing Standards Committee Statement No. 220, paragraph 11)

《Points to Note》

In addition to the above, in the case of a merger with another audit firm, some audit firms did not fully consider the adequacy of audit procedures performed by the acquirer in the past years including audit procedures for the incurrence of material asset and liability items that the entity recorded, although they understood important matters that should be examined upon acceptance of the audit engagements. It should be noted that appropriate risk assessment procedures are necessary in the audit engagement acceptance procedures upon the merger of audit firms.

Case 3: Risk assessment procedures when continuing an engagement

Although the entity carried out several transactions, which the engagement team should

carefully examine the business rationality of, such as subscription to a third-party allocation of shares by a company that is unrelated to the entity’s business and conducting significant transactions with related parties, the engagement partner did not perform assessment of contract risk in light of these events.
(Quality Control Standards Committee Statement No. 1, paragraphs 25 and 26; Auditing Standards Committee Statement No. 220, paragraph 11)

《Points to Note》

In addition to the above, some firms did not examine the integrity of the top management of entities from the perspective of responses to indications of inappropriate restrictions to the extent of audit and significant internal control deficiencies over financial reporting, although they had identified that information necessary for audits was not provided by the top management and that there were material weaknesses concerning entity-level controls and process-level controls.

Audit firms must pay attention, not only when accepting a new engagement but also when continuing an existing contract, to whether the acceptance of engagements is decided after identifying engagement acceptance risks and considering actions for the risks based on information that was obtained.

Case 4: Availability of human resources

Upon acceptance of a new engagement, the CEO did not consider whether there was a system including sufficient time and human resources, in order to carry out procedures for high risk engagement.
(Quality Control Standards Committee Statement No. 1, paragraphs 25 and 26)

(2) Communications between Predecessor and Successor Auditors

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

In cases where auditors change, the information collected and obtained by the predecessor auditor in the course of performing audit engagements in the past is extremely important. The predecessor audit firm and the prospective successor audit firm should follow appropriate procedures to hand over the engagement from the predecessor auditor to the successor auditor so that the successor auditor can obtain the information necessary to determine whether it can accept the proposed audit engagement and useful information for the performance of the audit.

In consideration of the above, the CPAAOB inspects whether an audit firm uses appropriate procedures for handing over an audit engagement to another audit firm, mainly from the following perspectives:

- ▸ Whether the predecessor auditor communicates in a timely and adequate manner in order to provide the prospective successor auditor with useful information that can be used when the successor auditor makes a judgment as to whether the audit engagement should be accepted and when the successor auditor conducts an audit.

- Whether the predecessor auditor responds honestly and clearly to inquiries made by the successor auditor. Especially in the case where the predecessor auditor is aware of information or circumstances concerning significant material misstatements in the financial statements that affected or could affect the auditor's opinion, whether the predecessor auditor provides such information to the successor auditor;
- Whether the prospective successor auditor makes inquiries required under the audit standards to the predecessor auditor, including the reason for the replacement of the audit firm, and the status of measures against fraud risks, to determine whether or not to accept the engagement;
- Whether the prospective successor auditor and the predecessor auditor respectively create and store detailed records of the processes performed for the handover of the engagement;
- Whether the audit firm confirms that the handover is properly conducted, by having the engagement team report the status of the communication to an appropriate department or a person who does not belong to the engagement team.

Outline of inspection results

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

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

Expected response

The predecessor auditor needs to understand that it is essential to provide information relating to the audit risks of the entity, etc. obtained in the course of performing audit engagements to the successor auditor in a sufficient and accurate matter.

In addition, the successor auditor needs to establish a system in which the information relating to audit risks of the entity, etc. obtained from the predecessor auditor in the process of communications between auditors, etc. is properly documented and fully used in the audit.

Similarly, when an engagement is handed over within the same audit firm, information related to audit risks should be fully and clearly communicated from the predecessor engagement team to the successor engagement team.

Case: Inquiries, etc. to the predecessor auditor

In an audit firm, a new audit engagement with a fund entity was proposed. The prospective engagement partner did not make inquiries of the predecessor auditor of this entity. The

prospective engagement partner assumed that no additional inquiries were necessary because the engagement partners and the predecessor auditor of the fund entity were the same as those of another fund entity that had been handed over in the past, and because the predecessor auditor did not notify the firm of significant information upon the handover of the engagement from the other fund entity in the past.
(Auditing Standards Committee Statement No. 900, paragraphs 8 and 9)

《Points to Note》

In addition to the above, some firms did not carry out examinations in accordance with the engagement rules established by the audit firm before the due date when being handed over audit contracts, due to the significant increase in new engagements following an expansion of operations.

4. Employment, Education and Training, Evaluation and Assignment

(1) Education and Training

Points of focus

Auditors, as professional experts, are expected to always strive to develop their expertise and accumulate knowledge that can be obtained through practical experience, etc. The CPAAOB inspects education and training provided at each audit firm from the following perspectives:

- Whether the audit firm develops and provides education/training programs that fully take into account the knowledge, experience, competence and capabilities of the audit practitioners;
- Whether the audit firm provides education/training programs designed to maintain and improve the audit competence and capabilities of the audit practitioners; this may include, for example, accurately identifying areas where audit practitioners tend to have less understanding and providing training focusing on these areas;
- Whether the engagement partner provides direction and supervision to audit practitioners so that they can fully utilize and exercise the knowledge and awareness acquired in the training in audit field work.

Outline of inspection results

As shown in the case examples below, deficiencies in education and training were observed. Some firms did not establish proper education/training systems. The training programs provided by those firms were not effective in the specific steps of procedures necessary for important audit items, such as the development of an audit plan based on a risk-based approach and the audit of accounting estimates.

Furthermore, some firms failed to provide opportunities for education and training in areas that require special knowledge, such as the auditing of financial institutions.

Causes of the deficiencies include: the PICOQC or equivalent entirely entrusted the training of audit practitioners, including providing engagement-related knowledge, to the engagement partner(s) who provided direction and supervision in the field work. However, sufficient education and training were not carried out, as the engagement partner or equivalent did not give sufficient direction and supervision to audit assistants, such as timely and appropriate review of audit documentation prepared by the engagement team.

Several audit firms thought it was sufficient to rely on the voluntary efforts of part-time audit practitioners to improve their capabilities, and thus lacked awareness of the need to maintain and improve audit quality by ensuring that the audit firm as a whole maintained an appropriate level of knowledge, etc. of audit engagements.

Expected response

Audit firms must maintain and improve the competence and capabilities of their audit practitioners including engagement partners and part-time audit practitioners. The efforts may include accurately understanding in which areas the audit practitioners do not have sufficient knowledge, and developing and implementing education/training programs based on this understanding as well as fully taking into account the knowledge, experience and current competence and capabilities of the individual audit practitioners. It is also important to enhance the effectiveness of education and training through reviews of audit documentation, etc. so that the advice and awareness obtained during training programs can be put into practice in audit field work.

Case 1: Effectiveness of training

- In training, emphasis was placed on explaining the revisions to audit tools and checklists for audit procedures. The audit firm did not provide audit practitioners with training that supported the specific procedures that can be used in actual audit processes, including the development of an audit plan based on a risk-based approach, the audit of accounting estimates, and group audit. (Quality Control Standards Committee Statement No. 1, paragraph 28)

- The PICOQC provided training within the firm once a month mainly for their members. However, the PICOQC did not conduct internal training for special knowledge, such as the auditing of financial institutions or give sufficient instructions to participate in outside training. As a result, an education/training system that would enable auditing for the risks of the entities was not established.
(Quality Control Standards Committee Statement No. 1, paragraph 28)

Case 2: Education and training of part-time members

The audit firm's quality control rules prescribe part-time audit assistants as "professionals" who are required for education and training. However, the PICOQC did not provide part-time audit assistants assigned to major audit engagements with the training, including outside seminars, necessary to perform their duties, or take other measures to educate and train them.
(Quality Control Standards Committee Statement No. 1, paragraph 28)

《Points to Note》

In addition to the above, audit firms did not provide audit practitioners with opportunities to maintain and improve the knowledge, competence/capabilities. They only monitored the achievement status of practitioners' CPE enrollment obligations, and did not develop/provide an education and training system that was sufficiently based on audit experience, the audit engagements, and audit standards that were newly introduced, or equivalent.

In many audit firms, where deficiencies were identified in individual engagements, they resulted from deficiencies in the education/training for audit practitioners. Audit firms are required to maintain and

improve the competence/capabilities of audit practitioners through education and training in order to properly perform audit engagements.

(2) Evaluation, Compensation, and Promotion

<u>Points of focus</u>

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

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

<u>Outline of inspection results</u>

Audit firms did not evaluate audit practitioners or equivalent based on professional competence and capabilities, particularly those of quality control, and compliance with professional ethics.

The above deficiency resulted from evaluation and compensation for audit practitioners being determined based on the subjective evaluation of them by the CEO. In some audit firms, an evaluator of partners assumed that there was no significant difference in the quality of the audit performance between the partners.

<u>Expected response</u>

Audit firms need to establish and implement policies and procedures for personnel evaluation, in order to maintain and enhance their professional competence and capabilities, particularly those of quality control, and compliance with professional ethics of members, taking into consideration the size, personnel structure and other relevant factors of the audit firm.

Case: Policies and procedures for evaluating audit practitioners

Some audit firms did not establish policies and procedures for the evaluation of audit practitioners and did not take into consideration the quality of their audit performance in evaluation.

(Quality Control Standards Committee Statement No. 1, paragraphs 15 and 28)

《**Points to Note**》

In addition to the above cases, although some audit firms had internal rules in place specifying that the evaluation of audit practitioners shall be performed by paying attention to the audit quality, the evaluation of the capability of audit practitioners was not specifically reflected in their compensation and promotion.

(3) Assignment

Points of focus

When assigning audit practitioners (including engagement partners) to audit engagements, audit firms must select persons who have the knowledge, competence/capabilities and experience necessary to properly perform the audits, considering the business and characteristics of the entities, and who can take sufficient time for the assigned engagements.

In consideration of the above, in the inspections, the CPAAOB reviews the assignment of audit practitioners to engagements, including their appropriateness, from the following perspectives:

- ▶ Whether the audit firm has assignment policies and procedures to ensure that audit practitioners, including engagement partners, with the required competence and capabilities are assigned to individual engagements;
- ▶ Whether, when assigning audit practitioners (including engagement partners), sufficient examinations are made for each audit practitioner regarding the time that can be spent on assigned audit engagements, understanding professional standards and laws, practical experience, abilities, etc.

Outline of inspection results

Deficiencies were observed in personnel assignment, including cases where the assignment of an engagement partner and the composition of an engagement team were not appropriately conducted based on audit risks. Causes for the identified deficiencies were as follows:

- ・ The audit firm failed to appropriately conduct risk assessment for entities, or compose an engagement team based on risk assessment;
- ・ The audit firm gave priority to acquiring new audit engagements without due consideration to the audit practitioners' competence/capabilities and experience, or the performance capability of the audit firm as a whole;
- ・ The audit firm did not correctly understand the QC competence of engagement partners and how much time they could spend on audit engagements.

Expected response

Audit firms need to assign audit practitioners who have the professional knowledge, practical experience, and abilities, etc. required in accordance with the size, risk and business of entities, and to establish a system for properly carrying out engagements to ensure that the engagement team can spend sufficient time on audit engagements, for example, by monitoring the work load.

Case 1: Assignment of engagement partner

The CEO assigned a partner, who was busy with his/her own private practice and who could not spend enough time on the audit engagement, as an engagement partner, although he knows the partner's situation.

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

Case 2: Composition of engagement team

- The audit firm did not specifically examine whether engagement partners and audit assistants could spend enough time on the assigned audit engagement through monitoring the persons` involvement in other audit engagements.

  (Quality Control Standards Committee Statement No. 1, paragraph 30)

- Engagement partners, when assigning audit assistants to each engagement team, did not consider whether the persons assigned had sufficient knowledge and experience necessary to perform audit engagements in accordance with the professional standards and applicable laws and regulations.

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

5. Audit Documentation

(1) Preparation and Review of Audit Documentation

Points of focus

Audit documentation provides evidence to show that an auditor has obtained the basis for issuing an auditor's report and that the auditor has conducted the audit in accordance with generally accepted auditing standards. Thus, the audit documentation serves as evidence to directly and specifically demonstrate the audit procedures performed by the engagement team.

On the other hand, especially in the case of audit procedures concerning significant or material matters, if the procedures performed were not recorded in the audit documentation, evidence other than the audit documentation (for example, oral explanations by an engagement team member who performed the procedures) cannot serve as solid and reliable evidence of the work performed by the auditor, or its conclusion. Auditors, as professionals, must pay full attention to this matter.

In consideration of the above, the CPAAOB inspects the status of the preparation and review of audit documentation from the following perspectives:

- ▸ Whether audit practitioners prepare audit documentation in such a way to sufficiently describe the status of compliance with the generally accepted audit standards, the timing and scope of implementation of audit procedures, the grounds for judgments, the conclusions reached, and other information;
- ▸ Whether more experienced members of the audit team appropriately review the audit documentation prepared by less experienced members;
- ▸ Whether the engagement partner reviews the audit documentation and has discussions with the engagement team to confirm that sufficient appropriate audit evidence has been obtained to support the reached conclusions and audit opinion.

Outline of inspection results

Deficiencies in lack of audit documentation, which means that engagement teams did not perform appropriate audit procedures, were identified in many audit firms. In the preparation and review of audit documentation, audit procedures performed by engagement teams and the basis for auditor's conclusion were not documented. Furthermore, as a result of the failure of the engagement partner to review from the perspective of whether the audit procedures performed were appropriately documented, deficiencies in audit documentation were identified.

Causes for the identified deficiencies were as follows:

- ・ The audit practitioner did not fully understand the important role of the audit documentation when performing quality control operations in the audit firm and providing explanation of audits to others.
- ・ Engagement partners did not consider the need to review audit documentation and left the audit

procedures to audit assistants because they misunderstood that there was a shared awareness among the engagement team of the entity issues and audit procedures to be performed, since the partner always accompanied on site audits and understood the situation.

- The engagement partner did not sufficiently understand audit procedures through review of audit documentation and obtained oral explanation or equivalent from the audit assistants

Expected response

Some firms did not prepare audit documentation so that the audit procedures taken for individual engagements could be clearly grasped. There were also many cases where the processes to reach an important conclusion could not be understood from the audit documentation. The firms in which these deficiencies were found should strictly instruct the audit practitioners to follow the following processes:

- All procedures should be recorded clearly in the audit documentation, while confirming their adequacy and completeness;
- Audit practitioners must check that the audit procedures are consistent with the audit plan that was established, and describe the audit procedures performed, the results of the audit procedures and the audit evidence obtained in the audit documentation. In addition, the audit documentation must also include the conclusions reached as well as the professional judgments and the process leading to those conclusions.

Engagement partners must realize that their review of audit documentation is a good opportunity to educate and train audit practitioners by communicating the level of audit procedures to be performed for individual engagements as well as the required level of audit documentation, including the conclusions reached by audit practitioners and the basis for reaching those conclusions. Keeping this in mind, engagement partners must fully verify whether the conclusions reached by the engagement team are supported by the obtained audit evidence.

Case 1: Preparation of audit documentation

The audit documentation only included the information material obtained from the entity and did not include a description of audit procedures performed. The documentation contained conclusions related to the audit procedures but did not contain the purpose of the examination, records of the processes used to reach the conclusions, and what items were examined.

(Auditing Standards Committee Statement No. 230, paragraphs 7 and 8)

Case 2: Review of audit documentation

- Engagement partners did not sufficiently review important matters. Therefore, they could not appropriately grasp whether the procedures responsive to assessed risks related to important matters determined at the audit planning stage were sufficient and appropriate, or whether appropriate substantive procedures were performed for the risks identified.

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

- Engagement partners did not sufficiently supervise or instruct audit assistants through reviews of audit documentation, since they did not have knowledge of the level required under audit standards and enough time for supervision and instruction.
  (Quality Control Standards Committee Statement No. 1, paragraphs 31 and A31; Auditing Standards Committee Statement No. 220, paragraphs 15, F15-2, and 16)

《Points to Note》

Engagement partners should understand that they are required to appropriately assess audit procedures that were performed through review of audit documentation, concerning the relevance of audit procedures performed by audit practitioners, and whether the conclusion that was reached was supported by sufficient and appropriate audit evidence.

(2) Final assembly of audit files and control and retention of audit documentation

Points of focus

After the audit report date, and within the due period, the audit firm should assemble the audit documentation within the audit file, and complete the administrative procedures for the final assembly of the audit file. The audit firm should pay sufficient attention to the final assembly of the audit file and the control and retention of the audit documentation.

In consideration of the above, the CPAAOB inspects audit firms for final assembly of the audit file and control and retention of the audit documentation from the following perspectives:

- Whether the audit firm has established appropriate policies and procedures for the final assembly of the audit file;
- Whether the audit firm completed the final assembly of the audit file by the due date, by appropriately applying the policies and procedures mentioned above;
- Whether the audit firm ensures the traceability of any correction made after the final registration of the audit documentation and the reason and process for the correction, from the perspective of reliability of audit documentation;
- Whether the audit firm has policies and procedures properly in place for audit documentation to ensure that confidentiality, safe custody, integrity, accessibility, and retrievability are properly established and implemented;
- Whether the audit firm secures the confidentiality, safe custody and integrity of audit documentation by appropriately applying the policies and procedures mentioned above.

Outline of inspection results

In the control of audit documentation, audit firms had not established specific procedures for the completion of audit files and the retention of audit documentation. Some firms registered audit documents as the final assembly despite the fact that they had not completed important audit procedures, while some firms did not control audit documentation in a register. Cases of identified deficiencies include the following: lack of awareness in the control of audit documentation, as well as the lack of the audit practitioner's understanding of the importance of audit documentation when carrying out quality control-related operations at the audit firm and when explaining audits to others.

Expected response

Audit firms need to ensure the confidentiality, safe custody, integrity, accessibility, and retrievability of audit documentation.

In order for the above, each audit firm must once again recognize the importance of the control of audit documentation and re-examine the condition of the final assembly of the audit file and the control and retention of the audit documentation, under the initiative of controllers such as the PICOQC. Audit firms must also ensure the completion of the final assembly of the audit file after the audit report date and within the due period, and implement all possible measures to prevent loss of audit evidence, leakage of confidential information, or any other damage, resulting from the loss of or damage to audit documentation.

Case: Final assembly of the audit file

The PICOQC did not monitor if the assembly of the audit documentation for annual audits and quarterly reviews were completed within the due period determined by the audit firm.
(Quality Control Standards Committee Statement No. 1, paragraph 44)

《Points to Note》

In addition to the above cases, audit firms did not establish specific procedures, the person in charge, and other related matters regarding the final assembly of audit files, while other firms only controlled the name of the entity, fiscal year and the total number of audit files, and did not keep track of the content of the audit documentation.

6. Engagement Quality Control Review

Points of focus

In principle, audit firms should establish policies and procedures for reviews in order to objectively evaluate the audit procedures performed, and the significant audit judgments and opinions made by the engagement teams for all audit engagements.

The CPAAOB inspects the appropriateness of review performed by the EQC reviewer from the following perspectives:

- ▶ Whether a person with the necessary experience and ability to perform the duties is appointed as the EQC reviewer;
- ▶ Whether the EQC reviewer reviews at an appropriate time for the planning of an audit, significant audit judgments, and expressions of audit opinion;
- ▶ Regarding significant judgments and audit opinions made by the engagement team, whether the EQC reviewer discusses with the engagement partner, reviews audit documentation, evaluates audit opinions, and reviews the appropriateness of financial statements and the draft of audit report, etc.;
- ▶ Whether the EQC reviewer examines the appropriateness of the evaluation of the engagement team members' independence, the necessity of consultation with experts and the conclusion reached, and whether the important judgments made by the engagement team were supported by sufficient and appropriate audit evidence, by reviewing the audit documentation.

Outline of inspection results

Ineffectiveness of the review process was observed in many cases of deficiencies, for example, the EQC reviewer did not fully review the appropriateness and sufficiency of the audit procedures and its judgment process related to significant matters, from a viewpoint that the EQC reviewer evaluates objectively; the EQC reviewer could not find deficiencies in the important audit procedures in individual engagements. There were also cases of deficiencies in the adequacy of EQC reviewers, where an EQC reviewer with abilities corresponding to the audit risk was not appointed. Furthermore, there were also many cases where deficiencies were identified in the operation of reviews as a result of analyzing the cause of deficiencies of individual engagements.

Causes of the identified deficiencies include:

- ・ The EQC reviewer did not fully understand the audit procedures that are required under current audit standards;
- ・ Due to reasons such as limitations in the personnel composition of the audit firm, an EQC reviewer with sufficient knowledge and experience corresponding to the audit risk as well as having spent enough time on reviews, was not assigned;
- ・ Although the EQC reviewer paid attention to responding to deficiencies identified in the CPAAOB inspections and QC reviews, he/she merely examined the same matters as the

deficiencies and did not review the situation of responses to similar matters.

- Despite the fact that the firm did not have a sufficient number of partners and members having sufficient knowledge and experience to perform the review, the PICOQC did not examine whether persons qualified as an EQC reviewer have been recruited or developed;
- The EQC reviewer assumed, from the daily communications with the engagement team, that the audit procedures performed by the team were sufficient and appropriate. Thus, the EQC reviewer did not examine the important judgments made by the engagement team and the sufficiency and appropriateness of their audit procedures through audit documentation;
- In an audit firm where a small number of partners operate the business, the EQC reviewer did not spend sufficient time for the review because the EQC reviewer had to give priority to the audit engagements he was in charge of;
- As the engagement team did not pass on to the EQC reviewer (including in cases entrusted to an external EQC reviewer), in writing or by any other appropriate means, information regarding the condition of the entity and the description of significant matters, the engagement team and the EQC reviewer did not share the recognition of risk and other audit matters.

Expected response

When reviewing the audit planning, the EQC reviewer needs to review the risk assessment procedure performed by the engagement team and further audit procedures planned by the engagement team from objective standpoints, by taking into account not only the business activities and changes of business performance of the entity, but also the business risk related to the business objectives and strategies of the entity.

In addition, when reviewing the forming of the audit opinion, the EQC reviewer needs to undertake a review through not only discussing significant matters for forming the audit opinion with the engagement partner but also reviewing the audit documentation related to significant judgment to confirm that the conclusions made by the engagement team were supported by sufficient and appropriate audit evidence. Especially at small and medium-sized audit firms, partners who also fulfilled the role of EQC reviewer were usually quite busy because the firms were operated by a small number of partners. Consequently, there were some cases in which those firms found it difficult to undertake reviews appropriately. Therefore, audit firms are required to take action to enhance and strengthen their EQCR system after reaffirming the importance of the EQCR of audit engagements.

Case 1: Eligibility of the EQC reviewer

- ▶ Partners who did not have sufficient reviewing capability were appointed as EQC reviewers, since the CEO and PICOQC did not take any measures to improve the capability of EQC reviewers other than training and did not inspect their eligibility.
  (Quality Control Standards Committee Statement No. 1, paragraph 38)

- The audit firm did not establish a system that ensured effective reviews. For example, since more review duties were assigned to a specific EQC reviewer than to other EQC reviewers, that EQC reviewer could not spend sufficient time on each review and thus did not check the appropriateness of the extent of the audit procedures for significant audit risks.
  (Quality Control Standards Committee Statement No. 1, paragraph 38)

Case 2: Securing effective review

The EQC reviewer did not review the necessary audit documentation and merely discussed the significant audit procedures performed with the engagement team, such as risks requiring special consideration and important accounting estimates, based on the explanatory material for the review, and completed the review without realizing that the engagement team did not perform sufficient audit procedures.

(Auditing Standards Committee Statement No. 220, paragraphs 19 and 20)

Case 3: Follow-up of deficiencies found in the EQC review

With regard to material deficiencies identified in the review, the EQC reviewer only received explanations from the engagement team about additional procedures and the final audit judgments made by the engagement team after the review, but did not verify the appropriateness and sufficiency of such additional procedures by checking the audit documentation. Thus, the audit firm did not perform effective reviews.

(Quality Control Standards Committee Statement No. 1, paragraphs 41, 42, and 43)

《Points to Note》

It must be noted that even when an audit firm entrusted an external CPA to perform EQC reviews, the external CPA is expected to produce the same response as when a person within the audit firm is appointed as the EQC reviewer.

The EQC reviewer must pay attention to the fact that he/she is required to objectively evaluate the contents of the explanations by the engagement team with records and by carrying out examinations through audit documentation.

7. Monitoring the Firm's System of Quality Control Policies and Procedures

Points of focus

The monitoring of the QC system plays an important role in the maintenance and improvement of audit quality as a process to voluntarily identify and understand deficiencies relating to the QC system and to address such deficiencies. For this reason, audit firms are expected to perform ongoing monitoring of the QC system to ensure the appropriate establishment and implementation of policies and procedures relating to the QC system; and to perform cyclical inspections of completed audit engagements in a specified period for each engagement partner.

In consideration of the above, the CPAAOB inspects whether monitoring of the QC system is effectively functioning from the following perspectives, in view of the importance of functions of QC system monitoring:

- Whether the audit firm assigns as the person responsible for the monitoring of the system of QC a person with appropriate experience for the role, and vests the assigned person with sufficient and appropriate authority;
- Whether the audit firm appropriately grasps the status related to the establishment of a quality control system and has an inspection system in place to identify quality control problems closely;
- Whether the audit firm evaluates the impact of deficiencies identified in the process of ongoing inspection, and takes appropriate improvement measures in accordance with the results of such evaluation.

The CPAAOB also inspects the implementation status of cyclical inspections of audit engagements at audit firms from the following perspectives:

- Whether the audit firm ensures that the person in charge of cyclical inspections performed inspections to confirm whether the audit evidence was sufficient and adequate, for example, by making inquiries of the audit practitioner, etc. and reviewing audit documentation, not only by formal inspection using the checklist, etc.;
- Whether the audit firm selects target duties for cyclical inspections by fully taking into account deficiencies in the audit procedures identified during the QC review, the CPAAOB's inspection or other occasions;
- Whether the audit firm evaluates the impact of deficiencies identified as a result of inspections, instructs the relevant engagement partner to take improvement measures, and checks that the measures taken were appropriate.

Outline of inspection results

As shown in the case example section below, there are cases where practitioners responsible for ongoing monitoring and cyclical inspection (including external practitioners) completed their operation only as a formality by using checklists, etc. There are also many QC system operational deficiencies where the audit firm was not able to appropriately identify deficiencies in individual engagements through cyclical inspections. The primary causes of the identified deficiencies include the lack of appropriate understanding of QC system monitoring at the audit firm, as well as the failure to ensure sufficient time and personnel as a result.

Expected response

Audit firms are required to establish and maintain a system in which the primary function of monitoring the system of QC (i.e., voluntarily identifying, understanding, and correcting problems) can be fully exercised. Specifically, audit firms should fully keep in mind that they need to carefully select individual engagements and identify inspection items by taking into account the economic environment, the business condition of the entity, and results of the last CPAAOB inspection and QC review; and they also need to have eligible cyclical inspection practitioners perform inspections in addition to formal inspections conducted according to the checklist and to establish a system to confirm the adequacy of the improvement measures taken for deficiencies found by the inspection.

Case 1: Effectiveness of ongoing inspection

- The PICOQC only operated an annual ongoing inspection by using the checklist indicated as JICPA's template as a formality. The PICOQC did not perform an effective ongoing inspection, such as confirming related internal rules and documents.
  (Quality Control Standards Committee Statement No. 1, paragraph 47)

- The person in charge of ongoing inspections entrusted all inspections to an office staff member and did not give to the office staff members specific instructions about ongoing inspections. The checklist used by the office staff member for ongoing inspections only indicated conclusions. The person in charge of ongoing inspections did not check what procedures were taken by the office staff member for the ongoing inspections. Thus, the firm's ongoing inspections did not work effectively.
  (Quality Control Standards Committee Statement No. 1, paragraph 47)

Case 2: Effectiveness of cyclical inspections

- The PICOQC did not give instructions to the person in charge of cyclic inspections regarding important inspection points and points to remember when performing the cyclic inspections. Thus, the person in charge of cyclic inspections inspected the sufficiency of the audit procedures taken by the engagement teams only by the inspection using a checklist as a formality. The person in charge of cyclic inspections did not perform inspections of whether the audit plan had been developed based on a risk-based approach. He/she did not perform an inspection of the audit of accounting estimates, either. As a result, the person in charge of cyclic inspection failed to find deficiencies identified in the QC review. Thus, the firm could

not find or control significant deficiencies in individual engagements through cyclic inspections.
(Quality Control Standards Committee Statement No. 1, paragraph 47)

- After a cyclic inspection, the engagement team submitted an improvement plan to the QC department. However, the PICOQC did not follow up on the improvement status of the engagement team.
(Quality Control Standards Committee Statement No. 1, paragraphs 50 and 51)

- The person in charge of cyclical inspection was to perform cyclical inspections and ascertain the improvement status of deficiencies identified in the previous QC review. However, he/she did not sufficiently verify the argument by the engagement team as to whether sufficient audit procedures were performed.
(Quality Control Standards Committee Statement No. 1, paragraphs 50 and 51)

《Points to Note》

In addition to the above, there were deficiencies in the selection of inspection, such as the audit engagements of certain engagement partners not being subject to cyclical inspection.

It should be noted that even when an external CPA was appointed as the person in charge of cyclical inspections, the external CPA expected the same response as when a person within the audit firm is appointed as the EQC reviewer.

It should also be noted that it is required in cyclical inspections to objectively evaluate the explanations by the engagement team with records and by carrying out examinations through audit documentation.

Common Matters

Cooperation with Those Charged with Governance

(1) Cooperation between Accounting Auditors and Those Charged with Governance

Points of focus

Accounting auditors and those charged with governance are obligated to ensure the appropriateness of financial statements under the Companies Act and applicable laws. To perform this obligation, it is important that they cooperate by sharing information identified during audits at an appropriate time, as well as by actively exchanging information and opinions, where, for example, those charged with governance should evaluate the status of QC of audits undertaken by accounting auditors.

In consideration of the importance of cooperation between accounting auditors and those charged with governance as mentioned above, the CPAAOB inspects the status of such cooperation.

Outline of inspection results

Awareness of the necessity of cooperation between accounting auditors and those charged with governance has gradually spread among related persons. There were some indications that regular communications between them took place, though the depth of cooperation varied.

However, as a result of the inspection of the explanations about the CPAAOB inspection and QC review on the audit firms, which the audit firms reported to those charged with governance, there were many cases where, although there were many significant deficiencies in the CPAAOB inspection and improvement recommendations by the QC review, audit firms only gave a conclusion verbally instead of in writing, saying “no material deficiencies were identified in the QC review,” because the CPAAOB inspection did not lead to a recommendation for administrative action and the overall QC review conclusion was satisfactory with improvement recommendations (Note).

Some audit firms did not notify the inspection and review results because those charged with governance of the entity did not ask for reporting of the results.

(Note) The CPAAOB collected reports from audit firms not subject to inspection so as to confirm the status of their quality control system. The results of analysis of such reports indicated patterns regarding cooperation between accounting auditors and those charged with governance similar to the results of inspection shown above.

Expected response

The necessity and importance of cooperation between accounting auditors and those charged with governance has been recently emphasized again in response to the occurrence of fraudulent corporate financial reporting cases. The audit standards state, “the auditor must ensure appropriate cooperation, through consultation or otherwise, with those charged with governance at each stage of the audit.”

Audit firms and those charged with governance of the entity should improve the effectiveness of the audit by sharing audit-related information with each other, including development of the audit plan and implementation of audit procedures, the progress of the audit at each stage of forming the auditors' opinions, and the conditions of the entity discovered in the course the audit. They should also actively promote cooperation with each other through exchange of opinions on audit quality issues based on the results of the CPAAOB inspection and the QC review. It is believed that this cooperation will contribute to securing and enhancing audit quality, and in turn improve and strengthen the corporate governance of the entity.

Audit firms must also establish a system to support engagement teams so as to promote appropriate communication between the engagement teams and those charged with governance of the entity.

It should be noted that the Auditing Standards Committee Statement No. 260 "Communication with Those Charged with Governance," revised in May 2015, stipulates that when performing an audit of an entity, the audit firm should keep close communication with those charged with governance in the entity regarding particularly important matters, and specifies matters that should be communicated to those charged with governance, including the content and method of communication to those charged with governance concerning the results of the QC review or the CPAAOB inspection as part of explanations made by the accounting auditor regarding the establishment and operation of a quality control system (Notes 1 and 2).

(Note 1) Disclosure of the results of the CPAAOB inspection to a third party needs the advance approval of the CPAAOB, in principle. However, no advance approval of the CPAAOB is necessary if the disclosure is made to those charged with the governance or equivalent of the entity audited and the disclosed information is "whether or not there were deficiencies in the establishment or operation of the quality control system of the audit firm and the outline of such deficiencies" or "whether or not there were deficiencies related to the engagement for the entity and the outline of such deficiencies."

(Please refer to "III. Handling of Inspection Results" in the "Basic Policy for Inspections Performed by the Certified Public Accountants and Auditing Oversight Board" published by the CPAAOB in April 2015.)

(Note 2) In principle, any disclosure, including whether or not the audit firm received the CPAAOB's inspection, is not permitted during the inspection.

(2) Response to Detection of Fraud/Illegal Act

<u>Points of focus</u>

In the event of discovering any fact that may affect ensuring the appropriateness of financial statements of the entity, the auditor must notify those charged with governance thereof so as to encourage the entity to implement voluntary corrective action (see Article 193-3, FIEA). In light of the important role played by such notice for ensuring the appropriateness of financial statements, the CPAAOB inspects the status of how the audit firm responded to the detection of fraud or an illegal act.

Outline of inspection results

(Observed effective efforts)

Some effective efforts observed in our inspections were: when regulations regarding responses to detected facts such as legal violations were introduced under FIEA, some audit firms ensured all partners understood them by, for example, showing to partners and employees cases of how to notify those charged with the governance of the entity in the case of the detection of facts such as an illegal act.

In addition, there were cases where the audit firm notified the entity under Article 193-3 of FIEA of a matter deemed to affect the appropriateness of its financial statements, and the notification led to the entity's correction of its quarterly report and strengthening of its organizational structure aiming at implementing appropriate disclosure.

Expected response

It should be kept in mind that in the event of identifying any deficiency during audit that may affect the appropriateness of financial statements, audit firms should respond to such deficiency by requiring entities to make corrections, including reviewing whether to give notice under Article 193-3 of FIEA.

Furthermore, it is necessary for audit firms to develop a system to support engagement teams so that the engagement teams' responses to consultation can be carried out appropriately.

III. Individual Engagements

Audit Engagement Performance

Summary

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

This section, "III. Individual Engagements," explains those deficiencies with a composition similar to the Auditing Standards Committee Statements.

However, this part also contains separate items that introduce fraud in financial statement audits, for which cautious responses are required under the Fraud Risk Response Standard and to which attention is paid due to recent accounting fraud scandals. In addition, accounting estimates, in which many deficiencies are continuously identified, are separately introduced.

Furthermore, audits of internal control over financial reporting, in which different audit standards are applied from those applied for audits of financial statements, are introduced in a separate item, including contents of the use of internal audits (Auditing Standards Committee Statement No. 610).

Each item describes the Points of Focus in inspection, etc., along with examples of identified deficiencies, and Points to Note in performing audit procedures are appended for reference.

Analysis of deficiencies

Deficiencies identified in individual engagements result from lack of requirements of audit standards or standards of the Auditing Standards Committee Statement ("requirement(s)").

Causes of the deficiencies include various factors that are remotely due to engagement teams and the environment surrounding entities. However, in recent cases the following three causes were found relatively frequently:

- Insufficient consideration for the relevance and sufficiency of audit procedures
- Lack of an attitude of professional skepticism required of an auditor
- Insufficient knowledge of audit standards and the Auditing Standards Committee Statement

(i) Cases of deficiency due to insufficient consideration for the relevance and sufficiency of audit procedures

(Reference case) Extent of test of details—Case where audit procedures were not clearly positioned

The engagement team identified a significant risk since it considered a risk of material misstatement due to fraud for the recognition of revenues in a significant component. The team developed and performed a test of details of collection of receivables processing as a substantive procedure corresponding to the significant risk.

However, the engagement team did not examine whether sample size was sufficient to address the significant risk, although they recognized that the specified number of samples of the test of details was extremely small. (Auditing Standards Committee Statement No. 240, paragraph 29)

When performing audit procedures, it is required under audit standards to develop and perform procedures to address the identified risks based on risk assessment. The nature, timing and extent of specific procedures considering audit risks are determined based on the professional judgment of the engagement team, in light of the situation of the entity. In particular, it is required that procedures in response to assessed risks at the assertion level are formulated in a detailed audit plan.

However, there are many cases where it is not clear whether the procedures considering audit risks that were planned by the engagement team are appropriate for obtaining sufficient and adequate audit evidence, since the engagement team did not clarify the nature, timing and extent of the specific procedures at the assertion level in the detailed audit plan.

At some audit firms, regardless of size, engagement teams still only consider misstatement risks of each account item and not at the assertion level. Thus, they have not been able to develop appropriate audit plans.

(ii) Cases of deficiency due to the lack of a professional skepticism that an auditor should have

(Reference case) Audit of accounting estimates—Case where the audit firm only understood accounting estimates argued by the entity but did not perform audit procedures that should have been performed in response to the argument.

The entity accounts for deferred tax assets, excluding the future deductible amount that is collected over a period of more than five years based on the assumption that the profit before income taxes' budget for the next fiscal year continues for the next five years.

However, the engagement team did not consider the feasibility of management's assumption that the same amount of profit before income taxes would be generated from the second year until the fifth year, despite comparing the profit plan with the amount in the budget that was submitted to the Board of Directors when considering the collectability of deferred tax assets. (Auditing Standards Committee Statement No. 540, paragraph 12)

In this case, a deficiency in audit procedures was identified since the argument of management, such as the feasibility of the business plan that was used in accounting estimates, was not evaluated objectively and procedures to verify the rationality of the argument were not performed, even though the engagement team understood the management's assumption and the adequacy of accounting, due to a lack of professional skepticism. Similarly, at some audit firms there were cases where audit procedures were deemed insufficient since a material misstatement risk was overlooked due to the lack of professional skepticism.

Apart from the above causes, as a result of the argument of the entity being understood and shared within the engagement team upon auditing accounting estimates, the team considered that the significant matters related to this argument did not need to be verified. Consequently, the background to the entity's assertion that should be documented and the process of the engagement team's understanding of the argument, as well as the process that led to the formation of a reasonable basis of judgement toward the argument concerning the accounting estimate that was identified as a significant audit risk were not documented in working papers at many firms. This fact also requires attention.

(iii) Cases of deficiency due to insufficient knowledge of the requirements

(Reference case) Substantive analytical procedures—Case of failure to respond to requirements

The engagement team mentioned that they performed substantive analytical procedures for account balances over performance materiality including sales, cost of sales, and selling, general and administrative expenses. However, the team did not set the acceptable level of difference between expectation and actual amounts, and thus did not satisfy the requirements of substantive analytical procedures. (Auditing Standards Committee Statement No. 520, paragraph 4)

In the above cases, two of the following three requirements, which are required when adopting substantive analytical procedures, were not met. Therefore, a deficiency of failure to perform substantive procedures was identified.

- Evaluate the reliability of data from which auditors expectation of booked amounts or ratios is developed, considering the source, comparability, nature and relevance of information available and controls over preparation.
- Develop the expectation of booked amounts or ratios and evaluate whether the expectation is sufficiently precise to identify a misstatement that, individually or when aggregated with other misstatements, may cause the financial statements to be materially misstated.
- Determine the acceptable level for differences of booked amounts from expectation without further investigation.

When performing audit procedures, if the engagement team does not fully understand the requirements, and requirements are not satisfied in the audit procedures performed, the purpose of audit cannot be achieved with the performed procedures and it results in a deficiency at audit procedures.

In addition to substantive analytic procedures described as an example, there tend to be many deficiencies due to the non-performance of requirements in areas such as management bias in accounting estimates (Auditing Standards Committee Statement No. 540, paragraph 20), audit procedures for transactions with related parties (Auditing Standards Committee Statement No. 550), audit procedures for preliminary assessment of management’s assumption about the entity’s ability to continue as a going concern (Auditing Standards Committee Statement No. 570, paragraph 9 and others), audit procedures on group audits (Auditing Standards Committee Statement No. 600), Using the work of Internal Auditor’s (Auditing Standards Committee Statement No. 610), and Using the work of an auditor’s expert of experts (Auditing Standards Committee Statement No. 620).

Expected response

Engagement teams are required to exert professional skepticism in all audit aspects, as well as to update and accumulate the required knowledge such as audit standards, in order to maintain the quality of individual audit engagements. Upon this, it is necessary to respond to individual audit engagements from the perspective of whether sufficient audit plans are developed for misstatement risk, and whether the audit procedures planned are performed according to the requirements of standards of audit, such as the Auditing Standards Committee Statement, in order to reasonably reduce audit risk to a low level.

There continue to be many cases where engagement teams argue “deficiency in audit documentation” when identifying deficiencies in individual 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 maintain and enhance the quality of individual engagements through QC systems to prevent the occurrence of deficiencies that were identified in individual engagements.

In order for the penetration and establishment of measures across the entire firm, it may need to establish a system that monitors each engagement team’s understanding of improvement measures, as well as the individual operation status of each engagement team. Use of existing systems, such as cyclical inspections and QC reviews, is also effective, instead of additional new QC systems. Each audit firm is required to endeavor to effectively and efficiently enhance audit quality in a way that suits the nature of each firm.

Regardless of the size of the audit firm, some deficiencies in individual engagements are caused by engagement partners with an insufficient understanding of the concept of risk-based approach. In this case, it is necessary to note that appropriate responses as an audit firm are required, such as re-education of partners and appropriate assignment.

Deficiencies in individual engagements identified by the CPAAOB's inspections are required by the Auditing Standards Committee Statement No. 260, etc. to be explained by engagement teams and audit firms to those in charge of governance of the entity that was subject to the inspection. Therefore, each engagement team must strive to accurately understand the deficiencies so that it can explain the deficiencies that were identified in the inspection to the entity.

Once again, it is necessary for not only the engagement teams of the individual engagements that were subject to inspection but also other engagement teams to refer to the deficiencies identified in the CPAAOB’s inspections, QC reviews, and cyclical inspections within the firm during their own audit engagements and examine/review such deficiencies on a timely manner .

1. 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 entity and its environment, business risks and internal control of the entity, instead of merely completing templates provided by the audit firm or JICPA;
- Whether the engagement team makes appropriate judgment, when it identifies significant risks, in light of matters that are required by the Auditing Standards Committee Statement to be taken into account; and whether the team understands internal control relevant to significant risks;
- Whether the engagement team develops an overall response required by the Auditing Standards Committee Statement in accordance with the assessed risks of material misstatement in the financial statements as a whole, and plans the nature, timing, and extent of procedures in response to the 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;
- 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 entity for the audit.

Outline of inspection results

There were many cases in assessing risks and responding to assessed risks where the engagement team did not appropriately develop and perform procedures responding to assessed risks because the engagement team did not carry out an appropriate assessment of risks.

For example, there were many cases where risk assessment and inappropriate responses to the assessed risks became the cause of deficiency in procedures responsive to risk, such as cases where a deficiency arose in operation assessment procedures and substantive procedures because the engagement team did not develop appropriate procedures responsive to the assessed risks, or a deficiency was caused in the nature, timing and extent of year-end substantive procedures as a result of the failure to appropriately consider revising the audit plan when an uncorrected misstatement was identified or changes occurred in the entity’s business environment.

Moreover, there were still engagement partners and audit assistants who did not fully understand the concept of a risk-based approach. Therefore, 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 JICPA, and did not perform appropriate risk assessment. There were also cases where the nature, timing and extent of the procedures actually taken in response to the assessed risks did not respond to the risks since the engagement team did not examine the adequacy of the procedures in the audit plan developed by using audit tools.

In addition, engagement teams need to understand the use of IT at the entity in identifying and assessing the risk of material misstatement. Upon doing so, there were examples of deficiencies where the engagement team did not reach the general understanding of the IT system necessary to develop an audit plan or the audit firm did not assign a person with sufficient knowledge of IT to the audit engagement.

Expected response

Audit practitioners should note that they must pay due attention and exercise professional skepticism in fully understanding the entity and its environment as well as assessing risk through such understanding, and carefully identify and assess audit risks, referring to this Case Report and the Audit Proposals issued by JICPA. In addition, when developing responses to audit risk, they should carefully consider whether the procedures respond to the assessed risks and whether the procedures enable sufficient and appropriate audit evidence to be obtained, including not only the types of procedure, but also the timing and the extent of the procedures.

For more information on response to fraud required in this process, see “6. The Auditor’s Responsibilities Relating to Fraud in Financial Statement Audits.”

Furthermore, some audit practitioners still do not recognize the importance of audit planning and have no understanding of the theoretical background that the material misstatement risks and the details of the procedures responsive to the assessed risks, i.e., the nature, timing and extent of the procedures, can be connected with audit planning.

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 audit practitioners who have failed to catch up with the current audit standards and responding in terms of the personnel allocation of engagement teams.

(1) Audit planning

Case 1: Detailed audit planning

The engagement team did not establish a detailed audit plan for accounts receivable related to the collectability of credits and allowance for doubtful accounts, although they identified the collectability of credits owned by the entity’s subsidiary as a significant risk.

(Auditing Standards Committee Statement No. 300, paragraph 8)

《Points to Note》

As deficiencies in audit planning, there were cases where the engagement team only followed audit procedures in the past as a formality and did not appropriately develop a detailed audit plan such as the nature of audit procedures that should be performed by engagement team members.

The engagement team shall carefully consider the timing and extent of audit procedures responsive to the assessed risks of material misstatement, as well as the nature of audit procedures, regarding whether the developed audit procedures correspond to the assessed risks and whether sufficient appropriate audit evidence has been obtained from those audit procedures.

Moreover, deficiencies in the participation of audit members were pointed out in the past, such as the failure of discussions between the engagement partner and the key members of the engagement team.

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

In the audit plan developed at the beginning of the fiscal year, the engagement team designed and performed substantive procedures for each material class of transactions, account balance, and disclosure, based on figures from the financial statements for the previous fiscal year.

However, the engagement team did not consider the necessity to revise the audit plan, such as re-assessment of materiality, although there were changes in the business environment and worsening of the business performance of the entity during the fiscal year.
(Auditing Standards Committee Statement No. 300, paragraph 9)

《Points to Note》

In addition to the examples of identified deficiencies mentioned above, there was a case where the engagement team did not consider the necessity of updating and changing the audit risk assessment and making other updates in the audit plans when events not foreseen by the engagement team occurred, such as changes in business activities due to the reorganization of the entity, or the delinquency of significant accounts receivable and slow-moving and obsolete inventories. If an engagement team is aware of information significantly different from the original information used for the development of the original audit plan, the team should consider whether the plan should be updated.

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

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

The engagement team identified that the entity conducted a merchandise sales business in addition to a product sales business as an important profit-making business, and understood that the operation process of each business was different.

Under such circumstances, while the engagement team assessed the existence of a material misstatement risk that should be identified in the product sales business, they did not assess

whether material misstatement risk that should be identified existed in the merchandise sales business.
(Auditing Standards Committee Statement No. 315, paragraph 10)

《Points to Note》

As shown in the above example, there were several cases where the engagement team did not identify and assess the risks of material misstatement by the classes of transactions, although there was a possibility that effective audit procedures and audit evidence that should be obtained would differ due to the difference in the class of transactions within the same account, since the engagement team did not identify misstatement risks by operation process.

There were several cases where the engagement team did not identify and assess the risks of material misstatement at the assertion level considering differences in the class of transactions and relevant internal controls when identifying and assessing those risks. There were also cases where the audit firm understood the individual businesses of significant components, including its subsidiaries, but did not understand these businesses and their transactions at the group level.

Case 2: Identifying and assessing risk of material misstatement

Although the engagement team identified a transaction where listed shares held by the entity and its subsidiary were sold to a large shareholder who was a related party not directly related to the business of the entity's group as an unusual significant transaction with a related party, they did not identify it as a significant risk.
(Auditing Standards Committee Statement No. 550, paragraph 17)

《Points to Note》

In audit engagements in which many deficiencies were identified regarding substantive procedures, the causes include the engagement team's failure to perform sufficient and appropriate risk assessment in audit planning and procedures responsive to the audit plan.

The engagement team should note that it needs to identify and assess the risks of material misstatement through an understanding of the entity and its environment, fully considering unusual significant transactions for the entity and matters dependent on the management's judgments.

Case 3: Understanding of the entity's internal control relevant to significant risks

Although the engagement team identified the generation and cut-off of sales as a significant risk in a subsidiary that was a significant component, they did not perform audit procedures to understand the subsidiary's internal controls relevant to sales.
(Auditing Standards Committee Statement No. 315, paragraph 5)

(3) The auditor's responses to assessed risks

Case 1: Audit procedures responsive to the assessed risks of material misstatements

When implementing procedures responsive to the assessed risks related to sales, the engagement team planned to perform dual-purpose tests where a test of internal controls serves as substantive procedures. However, the engagement team did not develop procedures responsive to assessed risks from the perspective of obtaining sufficient and appropriate audit evidence for substantive procedures.

(Auditing Standards Committee Statement No. 330, paragraph 17)

《Points to Note》

When planning audit procedures responsive to assessed risk, an auditor should develop audit procedures to obtain sufficient audit evidence corresponding to the material misstatement risks at the assessed assertion level, considering the nature of related transactions, the characteristics of the account balances, and the relevant controls.

When planning dual-purpose audit procedures in particular, it must be noted if the procedures are appropriate for both the purposes of procedures to assess internal control effectiveness and substantive procedures.

The engagement team should also note that it must plan and perform substantive procedures for each nature of significant transactions, account balance, and disclosure irrespective of the assessed risks of material misstatement, because the engagement team may not identify all risks of material misstatement, and there are inherent limitations to an audit, including the risk of management override of internal control.

Case 2: Adequacy of presentation and disclosure

- The engagement team overlooked the fact that rental properties held for investment purposes were not classified and presented as investment and other assets. Moreover, the team did not consider the rationality of presenting the entire amount of fixed assets for use not only for sales but also for rent as property, plant and equipment.
  (Auditing Standards Committee Statement No. 330, paragraph 23)

- The engagement team overlooked the fact that the entity did not disclose the exercise of subscription rights to shares by major shareholders of the entity as related party transactions.
  (Auditing Standards Committee Statement No. 330, paragraph 23)

《Points to Note》

Other than the above, there were cases where the engagement team did not examine the adequacy of the presentation of segment classification, which did not follow the management approach, or where the engagement team overlooked an error in the presentation on a cash flow statement. Many deficiencies

were identified in the presentation and disclosure.

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

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

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

The entity used an external warehouse to manage its inventories, including shipment and acceptance as the Service Organization

Under such circumstances, the engagement team did not understand how the entity used the operations of the warehouse, which is the service organization. Moreover, in understanding internal controls relevant to audit, the engagement team did not assess the design of the entity's internal controls relevant to the services provided by the warehouse and the application of the controls to the service.

(Auditing Standards Committee Statement No. 402, paragraphs 9 and 10)

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

The entity uses a network system developed by a service organization as an IT system for its important business operation processes. The entity had obtained the auditor's report on a description of the service organization's system, the suitability of the design of controls, the application of the controls to the service, and the operating effectiveness of controls.

However, the engagement team only reviewed this report obtained by the entity and did not perform assessment of the service, such as assessment of the adequacy of the assessment procedures taken by the auditor of the service organization.

(Auditing Standards Committee Statement No. 402, paragraph 16)

《Points to Note》

If the entity uses the services of one or more service organizations, the engagement team shall understand how the entity uses the services provided by a service organization in the entity's operations. Meanwhile, when understanding the internal control related to auditing, the engagement team shall assess the design and operating effectiveness of relevant controls at the entity that relate to the services provided by the service organization. Note that these are required to be performed not only in financial statement audits but also in audits of internal control over financial reporting.

Since the migration of systems to the cloud has been progressing recently, audit firms must often judge which of the entity and the service organization is responsible for the internal control over the underlying operations for the financial reporting, depending on the contents and the mode of service that the service organization provides for the entity. Audit firms need to fully understand the contents of services

provided by service organizations and their importance, and their impact on the internal control over financial reporting.

(5) Evaluation of misstatements identified during the audit

Case 1: Examination of identified misstatements during the audit

In the examination of variances identified in the external confirmation procedures for the accounts receivable, the engagement team identified an error in the entity's process. However, the team did not consider whether the risk assessment of sales and the accounts receivable or the substantive procedures originally planned for the remaining period should be changed. The engagement team did not examine the impact of the error on the audit of the internal control over financial reporting, either.

(Auditing Standards Committee Statement No. 450, paragraph 5)

Case 2: Evaluating the effect of uncorrected misstatements

The entity corrected immaterial past-year misstatements in the current year's financial statements.

However, the engagement team did not evaluate the impact that the correction of these prior years' misstatements had on the current year's financial statements.

(Auditing Standards Committee Statement No. 450, paragraph 10)

《Points to Note》

Auditors shall judge whether the overall audit strategy or detailed audit plans should be revised when the nature of the identified misstatements and the circumstance that may indicate the possibility of other misstatements, and when there is possibility that the aggregation of other misstatements might become a material misstatement.

Moreover, it is necessary to consider the necessity of the above revision when the total amounts of the misstatements that were aggregated during audit are close to the materiality in the latest audit plan.

Furthermore, auditors shall examine the identified misstatements individually or aggregately and judge whether the uncorrected misstatements are material. In doing so, they shall consider the size and nature of the misstatements against the financial statements as a whole and the related class of transactions, account balance or disclosure, as well as the specific circumstance in which the misstatements occurred. In cases where past-year uncorrected misstatements occurred, auditors must also take into full account their influence on the financial statements as a whole and the related class of transactions, account balance or disclosure.

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

Case: Development of an audit plan for the use of IT systems

The engagement team only inquired if there were significant changes from the previous year in its understanding of the general structure of IT use in mission-critical systems for sales and purchase operations, and did not perform procedures for understanding the stability of information systems, the overview of IT infrastructure and the degree of IT use, etc.

Moreover, the engagement team did not consider whether they should use an IT specialist although there was no one in the team who had sufficient knowledge of IT.

(Auditing Standards Committee Statement No. 315, paragraphs 17 and 20; IT Committee Practical Guidelines No. 6, paragraph 4)

《Points to Note》

Business enterprises use information systems for their business operations. Through understanding the status, characteristics and operation of the information systems of the entity, the engagement team can properly identify and assess the risks of material misstatements resulting from those systems. There were some cases in which the audit firm judged that the potential material misstatement risk was low without understanding the general structure of those IT systems. When developing an audit plan, audit firms should understand the IT-related environment of the entity, and identify IT systems that should be included in the assessment for risks of material misstatement.

Moreover, when understanding the general structure of IT systems of an entity in a group audit, the audit firm should be careful not to omit significant components. The engagement team must develop a proper audit plan by considering how the accounting policies and the control environment of the entity, including the year-end closing process, are reflected in or associated with the IT systems.

Furthermore, when using various lists generated by the entity's information system for the test 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 entity, 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.

2. Audit Evidence

Points of focus

Auditors should assess information obtained as audit evidence considering its relevance and reliability. The CPAAOB inspects whether the engagement team has designed and performed audit procedures to obtain sufficient appropriate audit evidence to draw reasonable conclusions on which to base the auditor's opinion 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 audit procedures 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;
- ▶ Whether the engagement team assesses whether the information prepared by the entity 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 the past year, are also frequent in the current year:

- ・ The audit procedures performed and audit evidence obtained were not relevant to the assessed risks of material misstatement.
- ・ The engagement team identified significant risks but completed audit procedures only by inquiry, without performing any substantive procedures.
- ・ The engagement team identified inconsistencies and irregularities with other audit evidence but did not determine the necessity of additional audit procedures.
- ・ The engagement team only performed annual comparisons and monthly fluctuation analyses. The procedures performed by the engagement team as substantive analytical procedures did not meet the requirements for substantive procedures because they did not assess the nature and relevance of the data to be used for developing expectations of recorded amounts, etc.
- ・ In sampling for the audit procedures in response to the assessed risk, the engagement team did not select samples from the appropriate selection range to reach a conclusion for the entire population.
- ・ When using information prepared by the entity, the engagement team did not evaluate whether the information had sufficient reliability for audit purposes.

For more information on audit procedures to address audit risks for revenue recognition, also see items (2) "Identifying and assessing the risks of material misstatement due to fraud" and (3) "Response to assessed risk of material misstatement due to fraud" in "6. The Auditor's Responsibilities Relating to Fraud in Financial Statement Audits."

Expected response

The engagement team needs to assess appropriately whether they have obtained sufficient audit evidence relevant to the purposes of audit procedures to respond to identified risks. Particularly, for significant risks, the engagement team shall perform substantive procedures individually.

Many examples of identified deficiencies in relation to obtaining sufficient appropriate audit evidence resulted from the engagement team's failure to appropriately perform risk assessment and procedures to address audit risks, and the team's lack of in-depth understanding of the entity's business for the fiscal year subject to audit (See paragraph titled "Expected response," in "1. Risk Assessment and Response to Assessed Risks" in Chapter III).

In many other cases, the engagement team appropriately performed risk assessment and designed audit procedures to respond to the assessed risk but the engagement partners neither gave specific directions nor exercised specific supervision. Audit practitioners therefore performed only conventional audit procedures, leading to a lack of organic coordination between the audit plan and actual audit procedures. Thus, when auditing the entity, the engagement team should, through the audit period, gain a deep understanding of the entity and its business environment and sufficiently discuss the risk assessment and audit procedures to be performed. The engagement team should also comprehensively evaluate the sufficiency and appropriateness of audit evidence obtained through the review of audit documentation.

The engagement team should respond to similar cases in each audit engagement, not adhering to the cases but considering the points of the cases, because audit evidence is obtained in various phases.

(1) Matters common to audit evidence

Case 1: Sufficient appropriate audit evidence (sufficiency of audit evidence)

- The engagement team identified inappropriate inventory valuation as a significant risk but performed no other audit procedures and concluded that there was no concern over the entity's inventory valuation, simply relying on the entity's affirmative reply to the inquiry on the potential of selling loss-making products that were showing deterioration in profitability and products with no record of sales at a price higher than their book value.

  (Auditing Standards Committee Statement No. 330, paragraphs 20 and 25; and No. 500, paragraphs 5 and A2)

- To examine the occurrence of sales, the engagement team designed audit procedures responsive to the assessed risk by combining substantive analytical procedures and tests of details to examine the occurrence of sales.

  However, the engagement team simply conducted a trend analysis on quarterly sales without determining an acceptable level of difference between expected and actual amounts. It is not considered a valid audit approach that meets the requirements for substantive analytical

procedures. Further, in the test of details, the engagement team failed to examine the cut-off of sales through the year. The engagement team only verified revenue recognition around the balance-sheet date, through confirmation procedures for accounts receivable at the balance-sheet date and examinations on the cut-off of sales around the balance-sheet date.
(Auditing Standards Committee Statement No. 330, paragraph 25; and No. 500, paragraph 5)

《Points to Note》

Generally, inquiry alone neither proves that there is no material misstatement at the assertion level, nor means that sufficient audit evidence as to the effectiveness of internal controls has been obtained; however, the engagement team often completed audit procedures by inquiry only. The engagement team needs to perform procedures responsive to assessed risks to corroborate the evidence obtained through inquiry. That applies not only to audit procedures for significant risks but also to audit procedures responsive to assessed risk.

Auditors design substantive analytical procedures, tests of details, or a combination of both as audit procedures responsive to assessed risk, depending on the conditions, but not all audit procedures responsive to assessed risk require strong audit evidence because the adequacy of audit procedures depends on the significance of assessed risk.

In one case, the engagement team performed multiple audit procedures, yet the quantitative or qualitative appropriateness of audit evidence was not verified through the planned audit procedures. As a result, it was considered that the team did not obtain sufficient audit evidence to reduce the overall audit risk to a low level.

In other cases, the engagement team did not obtain appropriate audit evidence to conclude that the entity's important accounting policies were in accordance with a relevant financial reporting framework.

The engagement team should not perform planned audit procedures for formality, but comprehensively assess the events identified during the audit and the sufficiency as well as the appropriateness of audit evidence obtained through multiple audit procedures.

Case 2: Sufficient appropriate audit evidence—appropriateness of audit evidence

- As audit procedures for completeness of accounts payable, the engagement team traced the ending balance of accounts payable to invoices per vender, but only covered accounts with an outstanding balance at the year-end. This did not meet the purpose of audit procedures to verify unrecorded liabilities.
(Auditing Standards Committee Statement No. 330, paragraph 25; and No. 500, paragraphs 5-6)

- In verifying the existence and cut-off of sales, the engagement team planned to perform tests on a sample basis for dual purposes, for tests of internal controls and substantive procedures.

However, the engagement team performed tests only by checking that sales details were sealed by the entity's personnel, and failed to perform audit procedures that were relevant to the assertion of the existence and cut-off of sales in which the team identified the risks of material misstatements, such as tracing acceptance forms issued by customers to transactions recorded in the sales details.

Further, the engagement team did not evaluate whether the number of samples extracted in the tests of internal controls was adequate to maintain the sampling risk at a minimum acceptable level or to estimate the amount of misstatement in substantive procedures.

(Auditing Standards Committee Statement No. 330, paragraph 25; and No. 500, paragraphs 5-6)

《Points to Note》

Other than the cases where the engagement team did not obtain audit evidence relevant to the audit purpose, such as above, there were a number of cases where the engagement team, despite the identified fraud risk, often did not obtain appropriate audit evidence relevant to the assessed risks at the assertion level. For example, the team completed audit procedures only by verifying easily available audit evidence such as the internal vouchers of the entity. The team needs to evaluate the reliability and relevance of audit evidence when planning and executing audit procedures.

When a test of internal controls was also used as a substantive procedure (dual-purpose test), the engagement team did not consider the effectiveness of such test as a substantive procedure. When planning and performing tests of controls and substantive procedures, the engagement team should be aware of the necessity of evaluating whether the tests are planned and performed considering the relevant audit purposes.

Case 3: Consistency between financial statements and audit evidence

In confirming the balance of receivables and payables, the engagement team indicated to the entity a set of criteria for selecting customers to which confirmation letters should be sent, and received from the entity information on the selected customers (names of selected customers and corresponding outstanding balance). In doing so, the engagement team did not examine the consistency between the financial statements and the audit evidence, thereby failing to perform procedures to verify the completeness of the population from which the entity extracted samples and to verify the amounts on confirmation letters against the sub ledgers.

(Auditing Standards Committee Statement No. 500, paragraphs 5-6)

《Points to Note》

As outlined in the case above, the consistency between the financial statements and the audit evidence

should be taken into consideration when performing tests of details, which include the verification of completeness of the population from which samples were selected for external confirmation procedures and the accuracy of the amounts on the confirmation letters against those in the sub-ledgers.

Case 4: Work of management's experts

When verifying the appropriateness of the entity's estimated impairment loss on the assets in the head office, the engagement team used a real estate appraiser's valuation report obtained through the entity's affiliate company.

However, the engagement team failed to verify the real estate appraiser's competence, capabilities and objectivity.

Further, the engagement team did not examine the accuracy of the data used by the real estate appraiser, the reasonableness of the assumptions and the appropriateness of the appraisal approaches.

(Auditing Standards Committee Statement No. 500, paragraph 7)

《Points to Note》

When using the work of the management's experts (including pension actuary, real estate appraiser, etc.), the auditor needs to evaluate the competence, capabilities and objectivity of such experts, and understand the expert's work, paying attention to evaluating the adequacy of the expert's work used as audit evidence in light of related assertions.

Case 5: Accuracy and completeness of information prepared by the entity

- In the verification of overdue receivables, the engagement team used the list of overdue payments prepared by the entity, but did not examine the accuracy and completeness of the basic information contained in the list, including the amount, date, etc. of transactions.
  (Auditing Standards Committee Statement No. 500, paragraph 8)

- In examining the valuation of work-in-progress inventories, the engagement team planned to check for the necessity to write down the work-in-progress inventories, the ending balance of which was in excess of a pre-determined threshold.

  In this regard, the engagement team, using the "work-in-progress inventories control form" prepared by the entity, ascertained that the estimated cost did not exceed the projected sales amount for each work-in-progress inventory. However, the engagement team failed to perform an audit procedure to verify the reliability regarding the following items in the "work-in-progress inventories control form."

  - Sales projected by the entity for transactions of which a sales agreement had yet to be concluded
  - Additional costs included in the estimated total costs of goods sold

(Auditing Standards Committee Statement No. 500, paragraph 8)

《Points to Note》

There were a number of cases that were mainly identified in the audit of accounting estimates, where the engagement team utilized documents prepared by the entity as audit evidence without verifying the accuracy and completeness of the information contained in such documents. When using information obtained from entities as audit evidence, the engagement team should thoroughly examine the reliability of such information. This is not limited to information generated through information systems.

Case 6: Timing of substantive procedures (procedures for remaining period)

The engagement team confirmed the balance of accounts receivable as of the cut-off date, which was set three months before the balance sheet date. Then, as a roll-forward procedure, it selected major customers whose accounts receivable balance had increased or decreased from the cut-off date to the balance-sheet date.

However, the engagement team only ascertained the consistency between answers to inquiries and internal data in relation to the selected customers whose accounts receivable balance increased substantially from the cut-off date to the balance sheet date. The engagement team did not perform additional procedures including detailed tests, such as checks of supporting documents and substantive analytical procedures thereby failing to confirm the appropriateness of the audit evidence obtained through the procedures.
(Auditing Standards Committee Statement No. 330, paragraph 21)

《Points to Note》

It should be kept in mind that in the case where substantive procedures were performed as of a cut-off date set before the balance-sheet date, additional substantive procedures should be performed for the period from a cut-off date to the balance sheet date to reasonably support the use of audit conclusions of the substantive procedures to cover the remaining period.

(2) External Confirmation

Case 1: Reliability of responses to confirmation request

Although the engagement team received a reply to a confirmation letter from a company, which was different from the intended addressee, it did not perform an audit procedure to ascertain the appropriateness of the information source and the reliability of the confirmation obtained.
(Auditing Standards Committee Statement No. 505, paragraph 9)

《Points to Note》

External confirmation procedures generally provide strong audit evidence to auditors. Depending on

the circumstances in which the information is obtained, such as responses via facsimile, email or responses by a person different from the auditor's initial expectation, it is necessary to perform an audit procedure to ascertain the reliability of the responses and mitigate the risks of falsification and fraud.

Case 2: Alternative audit procedures

- In confirming the outstanding balance of receivables and payables, the engagement team received a reply, neither agreeing nor disagreeing with the amount requested for confirmation, nor indicating any specific outstanding balance. However, the engagement team did not treat this as an exception, did not perform any investigation and failed to perform necessary audit procedures including resending the confirmation letter and conducting an alternative procedure.
  (Auditing Standards Committee Statement No. 505, paragraph 11)

- The engagement team performed alternative procedures by tracing confirmation letters for uncollected accounts receivable to internal vouchers such as sales invoices. However, the engagement team did not consider the adequacy of the procedures to obtain sufficient appropriate audit evidence.
  (Auditing Standards Committee Statement No. 505, paragraph 11)

《Points to Note》

External confirmation is an audit procedure that generally provides persuasive evidence. Therefore, 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

- While there were exceptions over materiality in the accounts receivable confirmation procedure and, in the case of misstatements, it was evident that such exceptions would affect the process of forming an audit opinion, the engagement team did not investigate those exceptions.
  (Auditing Standards Committee Statement No. 505, paragraph 13)

- The engagement team examined the exceptions identified in the process of confirming outstanding balances only by inquiry and did not obtain adequate audit evidence to exclude the possibility of a misstatement.
  (Auditing Standards Committee Statement No. 500, paragraphs 5 and A2; and No. 505, paragraph 13)

《Points to Note》

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

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

(3) Analytical procedures

Case 1: Identified deficiencies in substantive analytical procedures

- In performing substantive analytical procedures for sales, the engagement team used publicly available data for the Japanese market, external data prepared for a period other than the period audited, and the entity's budget by business unit as expected values.

  In examining the reliability of the publicly available external data, however, the engagement team, while the entity's sales were substantially from overseas, did not consider the reasonableness of using external data pertaining to the Japanese market. Additionally, when performing substantive analytical procedure for sales of a different business unit of the entity, the engagement team used publicly available external data that deviated by nine months from the period audited, but failed to consider the reasonableness of using such data.

  (Auditing Standards Committee Statement No. 520, paragraph 4)

- In examining sales, the engagement team mentioned that it had completed substantive analytical procedures. However, the engagement team only compared sales for the current year with the previous year's sales and budget. For the identified difference, the engagement team concluded that it did not result from an extraordinary cause only based on inquiry to the entity, instead of considering the appropriateness of using sales for the previous year and budget as expected values. The team failed to determine an amount of difference between the actual and the auditor's expected values that is acceptable without any additional procedures, thus did not meet the requirements for substantive analytical procedures.

  (Auditing Standards Committee Statement No. 520, paragraph 4)

- The engagement team performed substantive analytical procedures using an expected value of costs of goods sold (COGS) of a subsidiary that was a significant component, which was calculated from sales for the current year and gross profit ratio for the previous year.

  However, the engagement team failed to check the accuracy of the expected value given the subsidiary's changing sales mix with an increasing share of OEM products with lower COGS margins as compared to the previous period, which led to substantial fluctuations in

monthly COGS margins.
(Auditing Standards Committee Statement No. 520, paragraph 4)

- In performing substantive analytical procedures for selling, general and administrative expenses, despite the fact that the amount set as an acceptable amount of difference between expected value and actual value was in excess of materiality, the engagement team did not examine the reasonableness of the level of such amount.
(Auditing Standards Committee Statement No. 520, paragraph 4)

《Points to Note》

In many cases, the engagement team selected substantive analytical procedures as substantive procedures, but only performed annual comparisons that did not meet the requirements of substantive analytical procedures.

The engagement team needs to design and perform substantive analytical procedures that meet the following requirements:

(1) Evaluate the reliability of data from which the auditor's expectation of actual amounts or ratios is developed, taking account of the sources, comparability, nature and relevance of information available, and controls over preparation;

(2) Develop an expectation of actual amounts or ratios and evaluate whether the expectation is sufficiently precise to identify a misstatement that, individually or when aggregated with other misstatements, may cause the financial statements to be materially misstated;

(3) Determine the amount of any difference of actual amounts from an expectation that is acceptable without further investigation.

It should be noted that in some cases, substantive analytical procedures met requirements stipulated in the audit standards, but examinations as to the reliability of the data and the accuracy of the expected value, which were necessary to reduce the audit risk to a minimum acceptable level, were not performed. For example, the engagement team used the actual previous period results and financial forecast as expectations without the rational reason when performing such procedures. The engagement team should consider the nature and relevance of information sufficiently, and that any difference of recorded amounts from expectation may turn out to be material misstatement.

Case 2: Investigation of results of substantive analytical procedures

In substantive analytical procedures for current assets identified as significant accounts and substantive procedures as roll-forward procedures, the engagement team identified the difference between the expected value and the actual value as of the balance sheet date exceeding the level set as acceptable, but simply requested an explanation from the entity without obtaining any appropriate audit evidence supporting the entity's response.
(Auditing Standards Committee Statement No. 520, paragraph 6; and No. 330, paragraph 21)

《Points to Note》

In many cases, the engagement team only performed 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 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

Case 1: Planning of audit sampling

- The engagement team performed a cutoff test as part of audit procedures in relation to the raw material purchases identified as significant accounts.

  However, in the process of sampling for the cutoff test, the engagement team did not consider the adequacy of the sample selection of items and sample size in view of reducing the sampling risk to an acceptably low level, and thus failed to evaluate the sufficient audit evidence pertaining to the risks of material misstatement.

  (Auditing Standards Committee Statement No. 500, paragraph 9; and No. 530, paragraphs 6-7)

- The engagement team identified the existence and cut-off of the entity's sales as risks of material misstatement due to fraud, and as a substantive procedure for such risks, performed a test by extracting a specific number of samples from within the last business day of the two selected months of the relevant period as a population.

  However, the team did not examine the adequacy of the sampling selection of the item above, including the relevancy of the random sampling to the purpose of audit, as well as the sufficiency of the sample size. Further, the team did not develop an assurance process regarding the overall population. Thus, the team failed to evaluate the sufficient audit evidence pertaining to the risks of material misstatement due to fraud.

  (Auditing Standards Committee Statement No. 240, paragraph 29; No. 500, paragraph 9; and No. 530, paragraphs 6-7)

- In order to verify the existence of outstanding balances of receivables and payables as of the balance sheet date, the engagement team performed tests of details by testing specific items, confirming the outstanding balance with selected major customers and suppliers.

  However, the engagement team did not consider the appropriateness of not performing substantive procedures for the receivables and payables not covered by the tests of details.

  (Auditing Standards Committee Statement No. 500, paragraphs 9 and A55)

《Points to Note》

When designing audit sampling, the engagement team needs to consider the purposes of audit and the most suitable combination of audit procedures to achieve those purposes, in consideration of the characteristics of the population from which samples are to be selected. Additionally, when performing audit sampling, it is necessary to consider the completeness of the population.

It should be noted that testing specific items from classes of transactions or account balances is an efficient method to obtain audit evidence from the viewpoint of examination considering unusual transactions, high-risk items, and items with significant amounts and obtaining information including the nature of transactions. However, it should be kept in mind that the sampling of specific items does not provide audit evidence for the remaining items.

Apart from the above, in some cases, the engagement team, after extracting specific items, did not consider or perform audit procedures regarding the remaining items.

Case 2: Projecting misstatements

The engagement team performed confirmation procedures by testing specific items for the year-end balance of accounts receivable. However, the engagement team only extrapolated misstatements in the whole accounts receivable by dividing the identified difference for samples by the ratio of the account receivable balance subject to a confirmation letter to the total balance without performing appropriate audit procedures for the remaining items.

(Auditing Standards Committee Statement No. 500, paragraphs 9 and A55; and No. 530, paragraph 13)

《Points to Note》

The engagement team should perform appropriate audit procedures for the remaining items because it is impossible to project certain characteristics for the entire population from the results of testing specific items.

If the engagement team identifies any misstatement through tests of details by audit sampling, it needs to project the amount of misstatement for the entire population.

(5) Related parties

Case 1: Understanding the entity's related party relationships and transactions

While understanding ongoing transactions between the entity and the management or their close family members, the engagement team only examined whether executive officers including the management and their close family members owned a majority of the shares of any companies. The engagement team did not make inquiries to management to ascertain the existence of transactions between the entity and such companies, as well as the entity's executive officers including the entity's management. Thus, the engagement team failed to verify the completeness of the entity's transactions with related parties. Further, the engagement team did not consider whether to recognize the risks of material misstatement in relation to transactions with related parties.

(Auditing Standards Committee Statement No. 550, paragraphs 10 and 15)

《Points to Note》

In addition to the above, there was a case where the engagement team did not examine related parties and transactions with related parties completely. If the management has implemented an internal control for identifying related party transactions and approving significant transactions, the engagement team needs to understand the internal control and perform other appropriate risk assessment procedures as deemed appropriate.

Further, the entity did not appropriately disclose the terms and conditions of related party transactions while the entity provided non-interest bearing loans and guarantee without any charge. In addition, the engagement team did not sufficiently examine the terms and conditions of transactions that were disclosed as arm's length transactions. The engagement team should carefully evaluate whether identified relationships with related parties and related party transactions have been properly accounted for and disclosed in accordance with the applicable financial reporting framework.

For information on cases related to identification and assessment of the risk of material misstatement and audit procedures responsive to the assessed risk regarding related party transactions, including the consideration of fraud risk required in the Auditing Standards Committee Statement No. 240, also see "6. The Auditor's Responsibilities Relating to Fraud in Financial Statement Audits."

Case 2: Identification and assessment of risks of material misstatement associated with transactions with related parties

While recognizing that the entity's sales from subsidiaries are mostly from a specific company that is a related party, the engagement team did not consider whether to recognize this as a risk of material misstatement.

(Auditing Standards Committee Statement No. 240, paragraph 25; and No. 550, paragraph 17-18)

《Points to Note》

Related party transactions are often carried out in the normal transaction process, but also tend to carry higher risks of material misstatement of financial statements than third party transactions, due to fraud conducted by related parties without difficulty. Therefore, as a precondition for audit procedures, the engagement team needs to comprehensively understand the entity's related parties and its relationships with them, and carefully evaluate the business rationale in identified transactions. The team should keep in mind that significant transactions with related parties outside the entity's normal course of business transactions, if any, should be treated as a significant risk.

(6) Going concern

Case 1: Identification of any events or conditions that may cast significant doubt on the entity's ability to continue as a going concern

Despite severe business conditions that resulted in continuing operating losses and negative operating cash flow, and difficulties in financing as evidenced by multiple financial institutions' refusal to provide loans, the entity mentioned that neither an event nor a condition which might cast significant doubt on the going concern assumption had occurred, maintaining that these losses had arisen from restructuring business operations.

However, the engagement team did not examine the reasonableness of the entity's argument.

(Auditing Standards Committee Statement No. 570, paragraphs 9 and 11)

《Points to Note》

Early signs of significant events or conditions that may damage the continuity of business operations are likely to appear in business activities, so the engagement team should carefully ascertain any events or conditions that would cast significant doubt on the going concern assumption.

It should be noted that the "Cabinet Office Ordinance on the Disclosure of Corporate Affairs, etc." stipulated to report the background and progress of the events or conditions that may seriously impact an entity's going concern assumptions in the sections "Business-related Risks, etc." and "Analysis of Financial Conditions, Results of Operations and Status of Cash Flows" of the entity's annual securities reports, even though such events or conditions are not serious enough to be subject to additional disclosure in the section "Notes Related to Going Concern Assumptions." However, there were cases where engagement teams were not aware of this requirement. When there are events or conditions that might cast significant doubt on the going concern assumption of the entity, the engagement team should consider the potential need to revise the evaluation as to the risks of material misstatement and types, timing and scope of procedures responsive to the assessed risk.

Case 2: Additional audit procedures when an event or condition is identified

The entity accounted for operating losses and net losses for several years including the current period. The engagement team understood this as an event or condition that may cast significant doubt on the going concern assumption, and considered it a significant risk to disclose it at the footnote regarding the going concern assumption.

However, in examining the feasibility of the entity's business plan as part of the review of the going concern assumption, the engagement team only made inquiries with persons in charge on the details of the entity's business plans, and did not perform necessary audit procedures to verify the management's argument, including reviews regarding the feasibility of the planned sales or the potential impact of scheduled in-house manufacturing to improve gross margins, etc.

(Auditing Standards Committee Statement No. 570, paragraph 15)

《Points to Note》

In one case, the engagement team did not examine the entity's financing plan specifically for the feasibility of financing. In other cases, the engagement team did not sufficiently examine, on a consolidated basis, factors having a significant impact on the going concern assumption, including subsidiaries' additional financing needs.

The engagement team needs to evaluate the entity's financial position comprehensively based on specific audit evidence and the effectiveness and feasibility of the measures taken by management in relation to the assessment of the entity's ability to continue as a going concern.

For more information on examination of the reasonableness of accounting estimates in relation to the entity's business plan as the prerequisite for the cash management plan, also see "Case 4: Evaluation of reasonableness of business plan" of "(1) Matters common to auditing accounting estimates" of "3. Auditing Accounting Estimates."

(7) Others

Case 1: Subsequent events

The entity executed an agreement to extend the due date of the significant loan that was approximately 20% of the entity'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 entity's financial statements or affect the entity's financial statements in the following year and thereafter.

(Auditing Standards Committee Statement No. 560, paragraph 7)

《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:

(1) Understanding the procedures performed by the management to identify subsequent events;

(2) Inquiries with the management;

(3) Reviewing the minutes of board of directors meetings;

(4) Reviewing the latest subsequent monthly financial statements, if available.

Case 2: Risk of litigation

The engagement team did not examine the potential loss that might be incurred by the entity, despite the entity's lawyer's comments at a confirmation letter about the existence of "matters that may give rise to filing for litigation or claim for compensation, correction, assessment or

imposition, or equivalent matters to the same effects."
(Audit Committee Statement No. 73, paragraph 3)

《Points to Note》

In the case of confirmation with the attorney, the engagement team needs to confirm the facts that caused the litigation or claim, when it arose or how long it continued, its status and the likelihood of losses arising therefrom, and an estimate of expected loss.

Additionally, in the case where the payment of compensation due to litigation, etc. is likely to impact the entity's financial statements materially, the engagement team should examine the appropriateness and effectiveness of the entity's litigation risk management framework.

Case 3: Consolidated financial statements

In the past years, the entity traded properties with inter companies and eliminated losses arisen from these transactions at the consolidation process.

However, the engagement team did not examine the reasonableness of the entity's accounting approach, despite the accounting standard for unrealized losses that prohibited the elimination of the uncollectible portion of the seller's book value.

(Auditing Standards Committee Statement No. 500, paragraph 5; and Corporate Accounting Standard No. 22, paragraph 36)

《Points to Note》

In one case, the engagement team did not sufficiency understand the entity and its business environment as a basis for risk assessment of consolidated financial statements. The engagement team did not examine the completeness of elimination of unrealized gains in the case of complicated inter-company transactions. In auditing consolidated financial statements, the engagement team needs to appropriately understand the corporate group, including the assessment of capital structure, substantial control and influence.

For information on typical cases related to consolidated financial statements, also see "4. Group Audit."

3. Auditing Accounting Estimates

Points of focus

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

- Whether, considering the degree of estimation uncertainty, the engagement team appropriately identifies and assesses the risks of material misstatement in the accounting estimates, and performs appropriate audit procedures to address such risks, particularly considering the reasonableness of management's assumptions;

- Whether the engagement team identifies any indication of possible management bias, considering the risks of material misstatement due to fraud, and performs further audit procedures responsive to the management bias if any;
- Whether, in the case that the engagement team identifies significant risks in accounting estimates, the engagement team performs an evaluation required under Auditing Standards Committee Statement No. 540, paragraph 14 in addition to the planned audit procedures and assesses the appropriateness of disclosure as to the uncertainty associated with the accounting estimates in the financial statements.

Outline of inspection results

In auditing accounting estimates, there were some cases where the engagement team understood management's assumptions and the appropriateness of accounting approaches but due to the lack of professional skepticism, did not objectively evaluate management's arguments regarding the achievability of its business plan that the entity's accounting estimates were based upon, thereby failing to examine the reasonableness of the management's arguments adequately.

Further, required audit procedures were often not performed, due to the lack of understanding of requirements under Auditing Standards Committee Statement No. 540.

Expected response

Accounting estimates are accompanied by uncertainty, and the risks of material misstatement associated with them depend on the degree of the uncertainty. Thus, auditors should examine the estimation uncertainty—including the nature and method of accounting estimates, associated internal control, indications of management bias—and should identify and assess the risks of material misstatement.

Auditors should also perform appropriate audit procedures relevant to the risk of identified and evaluated material misstatements, and verify the reasonableness of the management's estimates from a critical standpoint as professionals.

(1) Matters common to auditing accounting estimates

Case 1: Reasonableness of management's assumptions

- Based on the assumption that net profit before tax budgeted for the next year would continue for a certain assumed period, the entity accounted for deferred tax assets excluding the deductible temporary differences that would be utilized over such assumption.

  However, in examining the recoverability of the deferred tax asset, the engagement team did not consider the achievability of the management's assumption of continuing the same level of net profits for the next year and thereafter.

(Accounting Standards Committee Statement No. 540, paragraph 12)

- At the end of the current year, the entity revaluated the previous year's losses from a voluntary recall of products that were identified as breaching legal and regulatory requirements, based on the ratio of the actual amount of products recalled to the initially estimated amount, and included such amount in the provision for voluntary recall of products.

  The engagement team understood that the amount of products that were recalled had declined, and based on the actual quarterly amount, it was necessary to revise the entity's initial estimate downward. However, the engagement team did not perform a specific review on measures planned by the entity's management to promote the ongoing product recall and achieve the revised estimate and associated effects/costs, thereby failing to verify the reasonableness of the entity's assumptions for loss estimate.

  (Auditing Standards Committee Statement No. 540, paragraphs 12, 14 and 16)

《Points to Note》

In examining accounting estimates, such as valuation of investments and loans for affiliate companies, impairment of fixed assets, and recoverability of deferred tax assets, it is often the case that the reasonableness of the management's assumptions, including the business plan developed by management, are examined.

However, in many cases, the engagement team made qualitative assessment of management's assumptions only by inquiry, failing to verify their consistency, etc. with the assumptions under the past business plan and the general economic environment and examine them adequately and appropriately from a critical perspective as a professional.

Particularly, when a significant risk is identified in accounting estimates, the engagement team must evaluate the following.

(1) The methodology taken by management to consider an alternative assumption/result and their reasons for not using such alternative assumption/result; or the process of examining the uncertainty of estimation in the case that management did not consider an alternative assumption/result;

(2) The reasonableness of management's material assumptions;

(3) Management's intent and capability to abide by their principles, in terms of the reasonableness of the management's material assumptions or the appropriateness of the applied reporting framework.

(Auditing Standards Committee Statement No. 540, paragraph 14)

- The entity used the next year's budget to assess both the recoverability of deferred tax assets and the impairment of long-lived assets. The entity did not account for any deferred tax assets because of the uncertainty of the budget, while they considered it unnecessary to recognize the impairment loss of long-lived assets as the budget was likely to be certain. Therefore, the management's judgment on accounting estimates was inconsistent.

However, in examining accounting estimates, the engagement team did not verify the reasonableness of applying inconsistent assumptions to project business performance for an identical period.

(Auditing Standards Committee Statement No. 500, paragraph 10; and No. 540, paragraphs 12 and 20)

《Points to Note》

Other than the examples above, there were cases where the engagement team did not sufficiently consider the inconsistency in management's assumptions among accounts. For example, although the entity accounted for impairment loss on its subsidiary's shares in individual financial statements, the equivalent goodwill recognized in its consolidated financial statements was not written off. The engagement team should comprehensively evaluate the consistency of events they understood.

Case 2: Review of the method of accounting estimation

The entity had continued to calculate the allowance for sales returns on a tax law basis, which was applied in the current year.

However, the engagement team did not verify the reasonableness of management's accounting policy for the allowance for the current year, including the appropriateness of calculation based on tax law considering the current year's actual sales returns ratio and gross profit ratio of the entity's business.

(Auditing Standards Committee Statement No. 540, paragraphs 7 and 12)

《Points to Note》

The engagement team needs to verify the method of the management's accounting estimates by evaluating whether the management's method for measurement is appropriate under certain circumstances and whether the management's assumptions are reasonable under the applicable accounting standards. Further, when reviewing the management's methods for accounting estimates, the engagement team should consider the following:

- **Examination as to the accuracy, completeness and relevance of the basic data used for accounting estimates, and whether the accounting estimates are made appropriately with the basic data and management's assumptions**
- **Examination as to the source of information, the relevance, and reliability of external data or information (including information from external experts used by management)**
- **Examination as to the consistency of information for accounting estimates and the recalculation thereof**
- **Examination of management's review and approval for accounting estimates**

Case 3: Review of prior period accounting estimates

The entity accounted for deferred tax assets at year-end in the amount not exceeding the projected taxable income for the next year. In examining the recoverability of the deferred tax assets, the engagement team independently estimated the achievable level of taxable income for the next year by multiplying the next year's projected net income before tax by the expected achievement rate determined based on the actual achievement rate for the current year (the ratio of actual amount to the initial projection) and concluded that the amount of deferred tax assets accounted for by the entity was at an appropriate level.

However, the engagement team did not appropriately examine the reasonableness of the entity's calculation of the expected achievement rate for the following year without taking into account that the current year's achievement rate for the net income was substantially lower than the initial projection.

(Auditing Standards Committee Statement No. 540, paragraph 8)

《Points to Note》

In some cases, when reviewing the entity's accounting estimates, the engagement team only ascertained the reason for deviation between the value estimated in the previous period and the outcome in the current period and did not consider the background of the deviation in evaluating the management's estimate for the current period. The team needs to note that reviewing the accounting estimates for the previous period is required in order for identifying possible management bias and evaluating the degree of the uncertainty of estimates.

It should be noted that the existence of a difference between actual amounts and estimated amounts in the previous year's financial statements does not necessarily indicate a misstatement in the previous year's financial statements. However, it is possible to make a reasonable basis that the entity could estimate close to the actual amount, if management used certain information available when estimating, as well as information reasonably expected to be obtained or considered when preparing the financial statements. In such a case, the auditor needs to consider that the difference could increase misstatements in the previous year's financial statements.

Case 4: Evaluation of reasonableness of business plan

The entity did not recognize impairment loss on securities issued by an affiliate company of which the net asset value had declined substantially against the acquisition cost, assuming that the net asset would recover to the level of the acquisition cost with profits over the following two years based on the affiliate company's business plan.

However, the engagement team did not examine the reasonableness of the entity's management's assumptions in the business plan despite a significant difference between the affiliate's actual performance in past years and the business plan.

(Auditing Standards Committee Statement No. 540, paragraph 12)

《Points to Note》

In examining accounting estimates, including the valuation of investments and loans for affiliated companies, impairment of long-lived assets and recoverability of deferred tax assets, the engagement team often evaluates the reasonableness and other aspects of the business plan prepared by management.

However, in many cases, the engagement team evaluated the plan qualitatively only through interviews with management without verification of the details of the business plan with supporting evidence. As such, the engagement team did not sufficiently or appropriately examine the reasonableness of the business plan from a critical standpoint as professionals. The engagement team should carefully consider the business plan by examining the consistency between the plan and the business environment, comparing it with past actual results, and verifying specific measures contained in the plan to increase revenues and reduce costs.

(2) Evaluation of shares of affiliate companies

Case: Examination of net asset value and recoverability

In valuing the shares of a non-performing subsidiary, the engagement team did not examine the reasonableness of the entity's decision not to realize impairment on the shares, despite the fact that the entity assumed that the value of the shares would recover to approximately 50% of the book value in five years based on the subsidiary's business plan.

(Auditing Standards Committee Statement No. 540, paragraph 12)

《Points to Note》

When the net asset value of shares of the entity's affiliate company for which the market value is extremely difficult to estimate declines by more than 50% from the acquisition cost, the entity is required to consider that the net asset value deteriorated substantially and recognize an appropriate amount of impairment loss. This treatment should also apply to the valuation of shares of affiliate companies shortly after establishment or acquisition, and the net asset value of the shares should be carefully considered in analyzing the difference between an affiliate company's performance and its business plan.

(3) Valuation of receivables

Case 1: Review of recognition and measurement

While the entity classified overdue receivables from an overseas sales agency as receivables with default possibility, it did not account for an allowance for doubtful accounts because the receivables would be fully recoverable with collateral assets.

However, the engagement team did not examine the reasonableness of the calculation and recoverability maintained by the entity, such as the condition, disposal value and collateralization by other creditors regarding the assets expected to be seized.

(Auditing Standards Committee Statement No. 540, paragraph 14)

《**Points to Note**》

When recognizing and measuring receivable value, it is necessary to consider the completeness of target receivables, including the appropriateness of receivable classification.

Additionally, if it is difficult to obtain data that helps judge the debtor's ability to pay, there is a simplified method of valuing receivables with default possibility by, for example, provisioning 50% of the balance net of the estimate disposal value of the collateral. As for individually material receivables with default possibility, it is necessary to obtain sufficient data to the extent possible and to sufficiently examine whether the receivables are appropriately estimated at the time of valuation.

Case 2: Self-assessment of loans (appropriateness of borrower category)

- When auditing a tier-2 regional bank, the engagement team did not examine the entity's decision-making as to borrower category as follows:
  - a) While the engagement team considered that the "Reasonable and Highly Achievable Plan" prepared by a debtor was unachievable, the team agreed with the financial institution's decision to classify the debtor as category "requires attention." The engagement team did not perform audit procedures for the inconsistency above.
  - b) While recognizing that a debtor had substantially negative assets with an unrealized loss, the financial institution did not adjust the debtor's financial profile to reflect its actual status (including an adjustment based on the unrealized loss). However, the engagement team understood the unrealized loss but did not examine the appropriateness of the financial institution's decision.
  - c) Despite the fact that a huge loss incurred by Company A was covered by Company B, the audited financial institution did not treat the two companies as a group in its self-assessment process. However, the engagement team did not examine the appropriateness of not treating the two companies as a single group and assign to a single borrower category or review the financial condition of the two companies as a borrower group.

  (Auditing Standards Committee Statement No. 540, paragraph 14)

- The engagement team performed substantive procedures for the self-assessment, as of the tentative cut-off date of December 31, conducted by the financial institution, which is a cooperative financial institution (it is similar to a credit union) but did not perform the roll-forward procedures for the remaining period.

  (Auditing Standards Committee Statement No. 330, paragraph 21)

《**Points to Note**》

In auditing a deposit-taking financial institution, it is often the case that the entity's evaluation of loans is identified as a significant risk, and the audit plan is designed based on the internal controls. In that case,

it is necessary to perform tests on the operating effectiveness of controls, in addition to substantive procedures. Re-performance, in addition to reviewing records and documents, is considered effective in the tests of operating effectiveness of controls regarding the allowance for doubtful accounts. Extracting a borrower as a sample and re-performing self-assessment on it can cover both the tests of operating effectiveness and of details. However, it is important to fully consider that even when using identical information, procedures vary based on the purpose of these tests.

Case 3: Accuracy of loan loss ratio

In the examination of loan loss ratio, the engagement team did not take into account the accuracy or completeness of the beginning loan balance or the amount of loss for a calculation period prepared by the financial institution that is a cooperative financial institution.

(Auditing Standards Committee Statement No. 540, paragraph 12; and the Japanese Institute of Certified Public Accountants' Special Audit Committee for Banks and Other Financial Institutions Report No. 4, section IV, item 5)

《Points to Note》

It is important to perform procedures to verify the sufficiency of allowance for doubtful accounts, considering any material changes in the creditworthiness of borrowers for the period from the balance sheet date to the audit report date.

(4) Inventory valuation

Case: Examination as to the completeness of scope of valuation

The engagement team completed its review of the entity's inventory valuation only by verifying the information used to calculate inventory valuation losses recognized by the entity, and did not trace the book value of inventories to the balance shown in the information used to calculate valuation losses. As such, the engagement team did not verify the completeness, for example, by investigating whether there were other inventories subject to valuation losses.

(Auditing Standards Committee Statement No. 540, paragraph 12)

《Points to Note》

In addition to the examples above, there were some cases where the engagement team did not examine the reasonableness of the entity's methodology for inventory valuation or the appropriateness of its approach for valuation loss calculation.

Also, entities have inventories with special characteristics, such as property for sale and development projects in progress, which are different in value and difficult to calculate an objective value for. It is necessary to keep in mind that these special inventories, in general, should not be excluded from the scope of reduction in book value due to a decline in profitability.

(5) Impairment of long-lived assets

Case 1: Review of cash-generating units

Despite the fact that the entity owned a number of factories operating as separate profit centers, the engagement team did not examine the reasonableness of the entity's assumption to treat them as a single cash-generating unit.

(Auditing Standards Committee Statement No. 540, paragraph 11 and 12)

《Points to Note》

Other than the cases above, there were some cases where the engagement team could not detect the fact that the entity's cash-generation unit did not accurately reflect the actual status and where the engagement team did not consider the appropriateness of the grouping of corporate assets.

Cash-generating units should, as a principle, be based on minimum units 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 entity manages profits and losses in units smaller than the cash-generating units selected by the entity.

Case 2: Review of indications of impairment

- In the review of the indications of impairment of long-lived assets of a subsidiary that had been loss making in past years, the entity determined that there was no indication of impairment based on the fact that the subsidiary generated a small amount of profits in the current year. However, the engagement team did not take into consideration other factors to identify indications of impairment, such as a rapid decline in sales orders received just before the end of the financial year.

  (Auditing Standards Committee Statement No. 540, paragraphs 11 and 12)

- While having accounted for impairment losses on owned idle assets (land/building) in past years, the entity determined that there was no impairment for the current year even though the assets remained idle.

  However, the engagement team did not examine the reasonableness of the entity's action not to consider whether to take impairment loss while recognizing a significant decline in roadside land prices in the area surrounding the idle assets,.

  (Auditing Standards Committee Statement No. 540, paragraphs 11 and 12)

《Points to Note》

Other than the examples above, there was a case where the engagement team agreed to the entity's argument that its deteriorated performance was unusual and temporary, without analysis of the cause. The engagement team should carefully examine indications of impairment.

Further, as a principle, when an asset or a cash-generating unit becomes idle, it means a change that

will reduce the recoverable amount of such asset or cash-generating unit significantly in the scope and method that the asset, etc. is used. Therefore, when examining the indications of impairment of idle assets, the engagement team needs to carefully examine the reasonableness of the amount of time that has passed since the assets became idle. For example, in the case where an asset just fell into the idle state, the engagement team should examine whether the duration can be treated as time necessary to determine the future use of the asset.

Case 3: Review of recognition and measurement of impairment

The engagement team did not examine the reasonableness of the entity's determination of the estimation period to calculate future cash flows without taking into account the remaining economic life of major assets of each asset group such as machinery used for manufacturing. (Auditing Standards Committee Statement No. 540, paragraphs 11 and 12)

《Points to Note》

The entity must largely rely on estimated future cash flows to decide whether to recognize impairment loss and to measure such loss. Therefore, when verifying the management's assertion on the necessity to recognize impairment loss, the engagement team should note that it is necessary to carefully examine components of the estimated future cash flows, including the remaining economic life used to calculate the utility value of assets, and the business plan that is the basis of estimation, and the feasibility of the business plan. Additionally, when the entity adopted net sale value as the asset's recoverable value, the engagement team should carefully examine the basis of calculating the net sale value.

(6) Valuation of goodwill

Case 1: Cause analysis, allocation of goodwill to identifiable assets and amortization period

For an acquisition completed in the current period, the entity 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 entity was appropriate only on the basis that the period did not exceed 20 years. Therefore, the team did not examine the appropriateness of the goodwill amortization period by verification of the period during which the subject goodwill would remain effective and the reasonable period of return on the investment.

In addition, despite an accounting standard stipulating that a relatively large amount out of acquisition costs allocated as goodwill may indicate the possibility of goodwill impairment in the year of acquisition, the engagement team determined that there was no indication of impairment based on the operating profit generated by the acquired subsidiary on an unconsolidated basis without taking into account the goodwill amortization. As such, the engagement team failed to examine whether to take impairment loss in line with the accounting standard.

(Auditing Standards Committee Statement No. 540, paragraphs 11 and 12)

《Points to Note》

Major issues in recognizing goodwill in business combination include the adequacy of allocation to goodwill and other accounts, and the period of goodwill amortization. The engagement team needs to carefully examine the reason for goodwill arising, by comprehensively ascertaining identifiable assets and liabilities and examining the appropriateness of allocation of acquisition costs to them. Particularly, in the case of negative goodwill, the engagement team needs to analyze the factors for the goodwill arising and carefully examine the accounting treatment used by the entity, such as the adequacy of allocation to other identifiable assets and liabilities, keeping in mind that negative goodwill is treated as profit when it occurs.

Additionally, the acquirer must determine 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 use in reference of a reasonable payback period. With this understanding, the engagement team should be aware that it is necessary to verify the adequacy of the amortization period applied by the entity.

Case 2: Indications of goodwill impairment

The engagement team identified substantial changes in the business environment surrounding the entity's consolidated subsidiary for which goodwill was recorded, such as the resignation of the owner of the subsidiary as president at the acquisition and substantial underachievement of the subsidiary's earnings against business plan at acquisition. However, the engagement team did not adequately examine whether these circumstances should have been treated as indications of impairment.

(Auditing Standards Committee Statement No. 540, paragraphs 12 and 17)

《Points to Note》

As noted in Case 1 above, when the amount of allocation to goodwill and other intangible assets is relatively large, it may be considered as an indication of impairment even in the first year of business combination. As such, the engagement team needs to adequately examine whether there is any indication even in the first year of goodwill recognition, if the amount is considerably large.

(7) Recoverability of deferred tax assets

Case 1: Review of company classification

The entity classified itself as a "company class 4 proviso" as specified in Audit Committee Statement No. 66 based on its taxable income before tax losses carryforward in the current and previous years, although the entity had significant tax losses carried forward at the end of the current year.

However, the engagement team did not adequately examine the cause of the tax losses carryforward, and the reasonableness of this classification, including whether the losses occurred due to an extraordinary, special cause.

(Auditing Standards Committee Statement No. 540, paragraphs 11, 12 and 17; Audit Committee Statement No. 66, paragraph 5 (1))

《Points to Note》

In relation to the company classification specified in the Audit Committee Statement No. 66 "Audit Treatment of Judgments with Regard to Recoverability of Deferred Tax Assets," the engagement team needs to remain conservative and carefully check the company classification in light of relevant accounting standards.

It is noted that going forward, the engagement team should take account of related accounting standards, including guidance documents "Implementation Guidance on Recoverability of Deferred Tax Assets (Corporate Accounting Standards Implementation Guidance No. 26)" published in December 2015 and "Implementation Guidance on Tax Rates Used in Applying Tax Effect Accounting (Corporate Accounting Standards Implementation Guidance No. 27)" in March 2016.

Case 2: Estimation of taxable income

The entity accounted for deferred tax assets in the amount not exceeding the projected taxable income for the following year. In this regard, the engagement team's audit procedures were insufficient as follows.

a) The entity had a large amount of deductible temporary difference for the current year, thus the engagement team recognized the possibility of a substantial reduction in taxable income for the following year depending on a schedule prepared by the entity. However, the engagement team did not verify the schedule.

b) The engagement team failed to identify that the entity did not take into account the maximum amount of loss carryforward permitted to be included when calculating deferred tax assets by multiplying the estimated taxable income for the following year with the effective statutory tax rate.

(Auditing Standards Committee Statement No. 540, paragraphs 8, 10, and 14; and Audit Committee Statement No. 66, paragraph 5(1))

《Points to Note》

In reviewing the recoverability of deferred tax assets, the engagement team often examines the reasonableness and other aspects of the business plan prepared by the entity's management for estimation of taxable income. In this regard, see the points to keep in mind provided in "Case 1: Reasonableness of management's assumptions" in "(1) Matters common to auditing accounting estimates."

If the entity posts deferred tax assets based on the sufficiency of taxable income backed by its earnings

capability, the business plan, a basis for taxable income, should in principle be approved by the board of directors. Further, in the case of material adjustments between the business plan and taxable income, the engagement team needs to perform audit procedures to secure the feasibility of taxable income, including verification of the reasonableness of adjustments from profits in the business plan to taxable income.

Case 3: Review of scheduling

For the valuation loss on shares of a subsidiary recorded in the past, the entity estimated the timing of the reversal of the temporary difference, and concluded that the deferred tax asset associated with the valuation loss was recoverable.

However, the engagement team, in considering the recoverability of deferred tax assets, only ascertained the management's intention to sell the shares through discussions and a management representation letter, failing to examine the feasibility of the intended sale based on the fact that the entity had not executed sales for a long time.

(Auditing Standards Committee Statement No. 540, paragraph 14)

《Points to Note》

In many cases, the engagement team did not appropriately or sufficiently examine the feasibility of the schedule for tax deduction of temporary difference in the future. For example, there is inconsistency between the assumption for valuation of securities and allowance for doubtful accounts and the planned period for tax deduction of relevant temporary differences in the future. The engagement team needs to exercise due care when examining the reasonableness of the schedule for tax deduction of deductible temporary differences arising from the valuation of investments in affiliated companies in particular, because complicated conditions such as organizational restructuring may often be involved.

(8) Retirement benefit obligations

Case: Reasonableness of actuarial assumptions

The engagement team did not examine the reasonableness of actuarial assumptions for the calculation of retirement benefit obligations, such as the retirement rate and the rate of compensation increase.

(Corporate Accounting Standard Implementation Guidance No. 25, paragraph 32; and Auditing Standards Committee Statement No. 500, paragraph 7 and No. 540, paragraph 12)

《Points to Note》

When estimating retirement benefit obligations, actuarial assumptions could influence the results greatly. Other than the examples above, there were some cases where the engagement team failed to examine the reasonableness of actuarial assumptions, such as a revised discount rate. The engagement team should be aware of the importance of examining the appropriateness of the actuarial assumptions made by the entity.

(9) Asset retirement obligations

Case 1: Completeness of accounting process

The engagement team did not examine the reasonableness of the entity not conducting a complete analysis of long-lived assets subject to recognition as retirement obligations, whether the lease agreements require the site to be restored to its original condition, and whether the laws and regulations require long-lived assets to be retired.

(Auditing Standards Committee Statement No. 540, paragraphs 11 and 12)

Case 2: Appropriateness when reasonable estimates cannot be obtained

The engagement team did not assess the reasonableness of the entity (retailer)'s assertion that the entity decided not to accrue asset retirement obligations on an existing operation base because the entity could not reasonably estimate the timing of closure despite its experience of closing similar operation bases in the past.

(Auditing Standards Committee Statement No. 540, paragraphs 11 and 12)

《Points to Note》

Even though the amount of asset retirement obligations cannot be fixed due to the lack of clarity in timing and methods, asset retirement obligations should be recognized if information is available to reasonably estimate the timing and probability regarding the fulfillment of asset retirement obligations. As such, the engagement team should keep in mind that it should examine the reasonableness of the management's assertions including the possibility of obtaining information useful to estimate asset retirement obligations when the entity asserts that asset retirement obligations cannot be reasonably estimated.

4. Group Audit

Points of focus

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

- Whether the group engagement team appropriately assesses risks associated with the group financial statements and develops basic audit strategy and a detailed audit plan;
- Whether the group engagement team identifies significant components appropriately, including consideration of components with significant risks related to the group financial statements based on the nature and status of each component;
- Whether the group engagement team appropriately understands the component auditors, gets involved in their procedures, and evaluates the appropriateness of such procedures performed;
- Whether the group engagement team appropriately communicates with the component auditors in situations that may influence the work of the component auditors during group audit, such as when a fraudulent material misstatement in relation to the group financial statements is identified;
- Whether the group engagement team evaluates the component auditors' reports, requests additional audit procedures if necessary, or performs the audit procedures, thereby obtaining sufficient appropriate audit evidence; and whether the engagement team, in response to the component auditors' reporting of an uncorrected misstatement, appropriately assesses the impact of such misstatement over the group financial statements.

Outline of inspection results

In identifying significant components in group audits, in one case, the group engagement team did not perform sufficient risk assessment by considering the qualitative aspect. In another case, the group engagement team did not sufficiently communicate with component auditors, or review the sufficiency of identification of significant risks related to group financial statements and audit procedures relevant to such risks.

Expected response

In situations where outside parties were involved, such as group audit, there were many cases where the engagement team excessively relied on the work of others without adequately evaluating it. When auditing the entity's financial statements and group financial statements, the auditor should evaluate the work of others, always keeping in mind that the ultimate responsibility to issue an appropriate audit report is on the group auditors that issue opinions of all the financial statements.

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

Particularly, when a significant component exists in overseas countries, the group engagement team is required to grasp the status of material overseas entities, and identify attributable risks.

It is also noted that the group engagement team, in addition to the knowledge and experience required for general audit practice, is required to be equipped with additional capability to cope with any situations and perform appropriate audit procedures, such as language skills to instruct the component auditors in overseas countries and knowledge of the accounting of specific countries.

To achieve the above, audit firms should carefully assign engagement partners and other professionals to maintain and improve the quality of group audit. Additionally, in the case where the overseas component auditors are arranged in a multi-layered and complex structure, especially when involving an overseas 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 overseas component auditors, evaluation of reports prepared by the overseas component auditors, and understanding of the entity's management control over new affiliate companies added through acquisition, etc.

Case 1: Significant components

- Given that the entity's main business is manufacturing, the group engagement team identified the entity's valuation of fixed assets as a significant risk in the group financial statements.

  However, in determining a significant component, the group engagement team only selected the revenue eliminated with inter-company transactions as a financial benchmark, and did not consider components potentially containing the above significant risks at the group financial statements.

  (Auditing Standards Committee Statement No. 600, paragraph 8)

- The group engagement team did not assess the material risk of misstatements in the group financial statements by taking into account the qualitative materiality of fixed assets owned by an overseas manufacturing subsidiary and sales transactions by a sales subsidiary.

  (Auditing Standards Committee Statement No. 600, paragraph 17)

《Points to Note》

When determining significant components, the engagement team should consider the audited corporate group's characteristics and circumstances including qualitative materiality such as potential significant

risks in the group financial statements, on top of the financial materiality of individual units.

Case 2: Materiality

The group engagement team set the materiality for significant components at the same level as, not lower than, the materiality for the group financial statements.
(Auditing Standards Committee Statement No. 600, paragraph 20)

《Points to Note》

To reduce the possibility that the total uncorrected and undiscovered misstatements in the group financial statements exceed group materiality to a minimum acceptable level, component materiality shall be set lower than group materiality. The group engagement team needs to sufficiently understand the entity group and its business environment in deciding component materiality. If any change occurs in the business environment, the team needs to appropriately consider its effects and examine the adequacy of component materiality to perform appropriate audit procedures to address audit risks for each component.

Case 3: Deciding audit tasks regarding the financial information of components

- Regarding the financial information of components of individual financial significance to the group, the group engagement team failed to perform audit procedures based on the materiality of individual components. For example, the group engagement team did not perform substantive procedures on major accounts such as revenues,
(Auditing Standards Committee Statement No. 600, paragraph 25)

- The group engagement team did not conduct analytical procedures on non-significant components.
(Auditing Standard Committee Statement No. 600, paragraph 27)

《Points to Note》

The group engagement team should consider whether audit tasks have been planned for both significant components and other components appropriately.

Case 4: Involvement in tasks undertaken by component auditors

The group engagement team did not assess the appropriateness of procedures performed by the component auditors for the significant risk of revenue recognition in the group financial statements.
(Auditing Standards Committee Statement No. 600, paragraph 30)

《Points to Note》

The group engagement team shall be involved in the risk assessment performed by the component auditors and identify significant risks in the group financial statements.

However, in one case, a significant component auditor identified significant risks and reported to the group engagement team, but the group engagement team did not sufficiently evaluate the risks. In another case, the group engagement team obtained the audit plan and other information from component auditors later than it should have received them. The group engagement team needs to sufficiently communicate with the component auditors at opportune times, identify significant risks of the group financial statements, and assess the reported risks.

Case 5: Consolidation process (uniform accounting policies)

The entity prepared its consolidated financial statements without adjusting the financial information of overseas components under local accounting standards to Japanese GAAP.

However, the group engagement team did not adequately check whether there was any account requiring adjustments due to differences in accounting standards.

(Auditing Standards Committee Statement No. 600, paragraph 34)

Case 6: Communication with component auditors

The group engagement team had identified a significant risk in the group financial statements in relation to revenue recognition, but did not communicate it to the relevant overseas component auditor.

(Auditing Standards Committee Statement No. 600, paragraphs 23 and 39)

Case 7: Sufficiency and appropriateness of audit evidence obtained

The group auditor identified the management override risk as a significant risk, and instructed the auditor of the relevant significant component to perform journal entry tests.

However, the group engagement team did not evaluate as to whether the component auditor had obtained sufficient and appropriate audit evidence.

(Auditing Standards Committee Statement No. 600, paragraph 43)

《Points to Note》

As pointed out in the examples above, there were a number of cases where the group engagement team simply obtained information from the component auditors on the results of their audit procedures and did not evaluate regarding the sufficiency and appropriateness of audit procedures performed for significant risks. It should be noted that, to respond significant risks of the group financial statements, the group engagement team needs to evaluate the sufficiency and appropriateness of audit procedures planned by the component auditors through appropriate communication.

Of note, even if the component auditors are network firms, the group engagement team also needs to

evaluate the obtained audit evidence.

5. Making Use of Experts

Points of focus

The auditor may make use of experts to obtain sufficient appropriate audit evidence if the auditor needs expertise in areas other than accounting or auditing. The CPAAOB inspects whether the experts used by the engagement team are equipped with the necessary qualifications, competency and objectivity in light of the purposes of auditing financial statements and whether the auditor evaluates the appropriateness of the experts' work.

Outline of inspection results

There was a case where the engagement team did not sufficiently communicate with the experts on the scope and purpose of work to be used, or did not sufficiently assess the appropriateness of the work of experts used by the auditor.

Expected response

In using the work of others, there were many cases where the engagement team excessively relied on the work of others and did not adequately evaluate it. When auditing financial statements, the engagement team is required to evaluate the work of others, always keeping in mind that the ultimate responsibility for the audit opinions of the whole financial statements is on the group auditors.

When using expert services, the auditor should determine the necessity of use, assess the qualifications, competency and objectivity of the experts, and evaluate the appropriateness of the experts' work for audit purposes. In using the experts' work, the engagement team needs to sufficiently consult with the experts on the purpose and scope of work to be used, without leaving everything to the experts, in order to obtain sufficient audit evidence conforming to the audit purpose.

Case 1: Agreement with experts

In the valuation of real estate assets for sale that had been held for a long time as of the date of the financial statements, the entity utilized valuation reports issued by a real estate appraiser.

In connection to this, the engagement team did not give appropriate instructions to the selected expert by clarifying the specific tasks requested, including the details, scope and purposes, and thus the engagement team and the expert were not in agreement with each other regarding their roles and responsibilities.

(Auditing Standards Committee Statements No. 620, paragraph 10)

Case 2: Evaluation of adequacy of experts used by the auditor

The engagement team identified the valuation of real estate inventory for sale as a fraud risk, and requested an expert to perform assessment of it.

However, the engagement team did not examine the adequacy of the expert’s work even though the expert did not use the methodology specified by the engagement team.

(Auditing Standards Committee Statement No. 620, paragraphs 11 and 12)

《Points to Note》

Before using experts’ work, the engagement team needs to avoid relying entirely on their work, and to determine the scope of work to be used through consultation with the experts, assess their qualification, competency and objectivity, and evaluate the appropriateness of the experts’ work for audit purposes.

For points to note in the case where audit evidence is based on the work of experts used by the entity’s management, refer to the section “2. Audit Evidence.”

6. The Auditor's Responsibilities Relating to Fraud in Financial Statement Audits

Points of focus

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

- ▸ Whether the engagement team evaluates whether the information obtained indicates that one or more fraud risk factors are present and considers them in identifying fraud risks in the financial statements, financial statement items, and at the assertion level upon developing the audit plan;
- ▸ Whether the engagement team evaluates if a misstatement, in the case that one is identified, is indicative of fraud; recognizes that an instance of fraud is unlikely to be an isolated occurrence when judging such misstatement to be indicative of fraud; and pays attention to the relationship between the fraud and other aspects of the audit, particularly the reliability of statements by the management, and formulates its audit plan after evaluating the implications of such misstatement;
- ▸ Whether the engagement team performs audit procedures that serve a purpose and obtains relevant and reliable audit evidence to respond to assessed fraud risks;
- ▸ Whether the engagement team ensures coordination with those charged with governance at each stage of the audit; and appropriately ensures coordination with those charged with governance who audit the execution of duties by directors, if material misstatements due to fraud or fraud in which the management is involved is discovered.

Outline of inspection results

There were cases of material deficiencies in audit procedures related to fraud in the audit of financial statements such as: the engagement team overlooked indications of frauds although the risk of material misstatement due to fraud could be identified in the planning and performing stages of audit; and the engagement team did not make appropriate actions.

We have also observed cases such as: the engagement team did not consider the risks of material misstatements due to fraud except in revenue recognition; although the team identified risks of material misstatement due to fraud in revenue recognition, the engagement team did not sufficiently perform audit procedures to respond to the assessed risks; the engagement team performed only perfunctory procedures for risks related to management override; the engagement team did not carefully assess fraud risks therein although the team identified related party transactions and unusual transactions. .

Expected response

Conventionally, auditors have been expected 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 that they are expected to maintain professional skepticism in all processes of auditing and exercise it when examining the risks of material misstatement due to fraud.

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

Therefore, when planning, in order to examine if there are factors for fraud risk, auditors are required to understand major fraud cases published as well as general and industry specific business practices that might be used for fraud, obtain information through interviews with managers and other employees, and carefully examine whether such information indicates the existence of factors for fraud risk, through discussions within the engagement team.

Furthermore, auditors should consider identified factors for fraud risk and identify and evaluate risks of material misstatement at two levels: the level of financial statements as a whole, and the assertion level.

In responding to risks of material misstatement due to fraud that they evaluated, auditors should always keep in mind that there is a possibility that material misstatement due to fraud could occur, and draw up general responses to the risks of material misstatement due to fraud at level of the entire financial statement and at the assertion level. In doing so, auditors should recognize and assess how internal control reduces fraud risks.

In implementing procedures to cope with the risks of material misstatement due to fraud, auditors should keep in mind that they are required to obtain audit evidence, which is more relevant or reliable, or greater in quantity, for assertions related to the identified risk of fraud than for other assertions for which no risk of fraud is identified.

In addition, if auditors identify any indication of material misstatements due to fraud in the course of audit, they should make inquiries and ask for explanation from the management at an appropriate level to determine whether there is suspicion of a material misstatement due to fraud, and should perform additional audit procedures. If any misstatements are identified, they need to evaluate more cautiously than in other situations whether the misstatements indicate fraud.

Meanwhile, among procedures to cope with risks related to management override, regarding content concerning the management's bias in accounting estimates, please refer to "3. Auditing Accounting Estimates (1) Matters common to auditing accounting estimates."

(1) Discussions by the engagement team, risk assessment procedures, and related activities

Case 1: Understanding of fraud cases in an entity and the industry to which such entity belongs

The engagement team identified that a different form of transactions such as purchases and consignment existed in the entity's sales transactions, as well as business practices such as sales based on change of title of inventory.

However, the engagement team did not assess fraud risk factors based on this understanding of such business activities of the entity and industry practices.

(Auditing Standards Committee Statement No. 240, paragraphs 11 and 25)

《Points to Note》

The engagement team needs to sufficiently perform risk assessment with an understanding of the entity's form of transactions, industry practices, and previous fraud cases. The team then needs to develop an appropriate audit plan relevant to the identified risks related to the assertions, so as to perform sufficient and appropriate audit procedures to respond to such risks.

In addition, it is necessary to maintain and exercise professional skepticism in identifying fraud risk factors, including incentives or pressure to commit fraud, or events or situations which create opportunities to do so; as well as in assessing the risks of material misstatement.

Case 2: Discussion within the engagement team

The engagement team did not discuss where risks of material misstatement by type of fraud existed on the financial statements, including the possibility of fraud that may occur in a relationship with a related party or in a transaction with a related party, and also did not share such information within the team.

(Auditing Standards Committee Statement No. 240, paragraphs 14, F15-2)

《Points to Note》

Other than the examples of deficiencies mentioned above, the engagement team only carried out discussions within the team routinely. The team often did not hold substantial discussions including the examination of possible risks in relation to the entity in reference to published fraud cases. There were also some cases where the engagement team only directed fraud-related inquiries to the management or communicated with the management and those charged with governance routinely, and the information obtained was not reflected in the risk assessment.

When an engagement team identifies fraud or obtains information indicating fraud, the team needs to swiftly report to the management at the appropriate level who are responsible to prevent and discover fraud to inform them of matters related to their responsibility. The engagement team also needs to report to those charged with governance. If the management is suspected to be involved in fraud or possible fraud, the engagement team needs to report to those charged with governance and discuss with them the nature, timing and extent of audit procedures necessary to complete the audit, as well as to request the management to take appropriate actions such as remedial actions on the issues.

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

Case 1: Identifying and assessing fraud risks in revenue recognition

Although it was presumed that there were fraud risks regarding revenue recognition, the engagement team did not examine the rationality of not identifying the risks of material misstatement due to fraud regarding revenue recognition.

(Auditing Standards Committee Statement No. 240, paragraph 25)

Case 2: Risks related to management override

Although the engagement team did not identify risks related to management override as significant risks, it did not examine the reason for not identifying them.

(Auditing Standards Committee Statement No. 240, paragraph 30)

《Points to Note》

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.

The engagement team shall keep in mind that it needs to identify and assess the risks of material misstatement due to fraud at two levels—at the level of the financial statements as a whole and at the assertion level—after sufficiently examining risks related to management override according to information and judgment the team has obtained.

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

Case 1: Journal entries test

- Following a rise in product unit costs due to the revision of standard cost, the entity deducted the cost variances from the cost of sales and recorded the cost variances as inventory with the closing journal entries.

  The engagement team deemed the revision of standard cost reasonable due to the business environment and understood that it was approved under the appropriate process of the entity.

  Under such circumstances, the engagement team mentioned that they extracted and examined the above entry in the journal entries test performed as an audit procedure for the risk of management override.

  However, although the engagement team understood that the revision of standard cost was implemented in an unusual way, such as not being implemented by product item and carried out at the year end, they only traced the above entry amount with the calculation documents obtained from the entity and did not examine whether the allocation of cost variances following the revision of standard cost was appropriately carried out.

  (Auditing Standards Committee Statement No. 240, paragraph 31)

- In verifying the appropriateness of journal entries recorded in the general ledger, the engagement team performed journal entries tests on certain journal entries, such as closing journal entries, but did not verify the completeness of the test scope of journal entries.

  (Auditing Standards Committee Statement No. 240, paragraph 31)

《Points to Note》

Other than the example mentioned above, there were many cases where suspicion arose over the

exercise of professional skepticism. The engagement team only performed journal entry testing routinely without fully taking fraud risks into consideration with respect to procedures to respond to audit risks related to management override.

The engagement team shall keep in mind that it needs to formulate and implement effective audit procedures in response to the degree of said risks after understanding that management is in a position to falsify accounting records and prepare fraudulent financial statements by overriding effectively operated internal control.

Case 2: Business rationality of significant transactions

The entity transferred outsourcing costs to a third party, which were recorded as expenses during an interim period, to loan to the third party at year end because it was subsequently determined that the costs would be borne by the third party. However, although the engagement team identified the transactions as unusual transactions, the engagement team did not examine whether or not such transactions had business rationality.

(Auditing Standards Committee Statement No. 240, paragraph 31)

《Points to Note》

Significant transactions falling outside the entity's ordinary transaction process or which can be deemed unusual may have been carried out to conduct fraudulent financial reporting or to conceal misappropriation of assets, indications include the following:

- **The form of such transactions appears complex (e.g., transactions involve multiple entities within a consolidated group or multiple unrelated third parties);**
- **The management has not discussed the nature of and accounting for such transactions with those charged with governance of the entity, and there is inadequate documentation;**
- **The management places more emphasis on the need for a particular accounting treatment than on the underlying economic rationale of the transactions;**
- **Transactions that involve non-consolidated related parties, including special-purpose entities, have not been properly reviewed or approved by those charged with governance of the entity;**
- **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 entity under audit.**

If the engagement team identifies any of the above mentioned indications in the course of the audit, 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 suspicions of material misstatement due to fraud.

Furthermore, there are some cases where, in conducting fraudulent accounting treatment, the entity obscured accounting treatments by carrying out complicated transactions with several business partners.

Therefore, in examining the business rationality of significant transactions, it is important for the engagement team to not only examine individual transactions but also assess and examine the entire picture of a series of related transactions by paying attention to the timing and conditions of such transactions.

Case 3: Response to fraud risks in revenue recognition

- With regard to revenue recognition, the engagement team identified the accuracy of sales based on the percentage-of-completion method, which calculates the progress of construction work using a predetermined overall cost to measure revenue, as a fraud risk. However, regarding a transaction where gross profit significantly decreased since the entity increased the predetermined overall cost, the engagement team only traced the revised predetermined overall cost against the predetermined overall cost stated in the internal documents of the entity and made inquiries with the person in charge, and did not perform detailed tests in response to fraud risk for multiple cases of sales based on the percentage-of-completion method. The engagement team did not perform procedures for management bias such as retrospective tests of the revision to the predetermined overall cost in a timely manner or of the reasonableness of the assumptions of the estimate, although there are multiple cases where the estimate calculated by the entity in past years differed from the actual results or the revised estimates.
(Auditing Standards Committee Statement No. 240, paragraphs 29 and 31; No. 330, paragraph 20; No. 540, paragraphs 8, 14, and 20)

- The engagement team identified a very strong incentive at the entity to expand its revenue and profits since the company was in the rapid growth stage. Under these circumstances, the team identified a fraud risk where sales transactions with unclear underlying economic rationale might occur. The team also identified more than one unusual sales transaction in the entity's rapid increased sales.
However, the engagement team did not examine the appropriateness of the selling price of raw material reselling transactions of the above sales transactions, as well as the reasonableness of recording bill and hold sales. In addition, the team did not examine the reasonableness of changes in collection terms regarding sale transactions of merchandise. Moreover, they did not assess whether the above transactions implied a possibility that they were carried out for fraudulent financial reporting purposes.
(Auditing Standards Committee Statement No. 240, paragraphs 29, 31 and 34; No. 330, paragraph 20)

- Bill and hold sales, which were prohibited by the entity's internal rules, were identified at the entity through direct whistleblowing to the engagement team. The entity argued that the sales in question were realized by the year-end since the merchandise subject to the sales was already shipped by the year-end.

Against this argument, the engagement team conducted a short notice inspection of the storage site on the day following the year-end, in order to examine the entity's argument that the deposited inventory was shipped by year-end, and confirmed that the inventory was removed and no physical items remained.

However, the engagement team did not perform for fraud risks that were necessary for this matter, such as tests based on evidence including shipment slips, if the merchandise was delivered to the customer, and ascertaining whether similar sales existed, since they determined that their procedures above were sufficient as tests of the fact of shipment.

(Auditing Standards Committee Statement No. 240, paragraph F35-2)

- In the examination of the entity's revenue recognition, the engagement team only obtained contracts with collateral conditions, such as sales contracts with reservation of ownership, and did not examine how these collateral conditions might affect the entity's revenue recognition.

  (Auditing Standards Committee Statement No. 240, paragraph 22)

- The engagement team identified exceptions in relation to confirmation in accounts receivable from sales transactions to a leasing company; the engagement team received a reply from the leasing company stating that the cause of the exception was that the lease agreements with the end users pertaining to the transactions would start more than a year after receiving product inspection from the leasing company, and that no liability will be recorded until the start date of the lease agreement.

  However, the engagement team did not examine the generation and cut-off of sales from the transactions, including the reasonableness of the transactions and the contract conditions pertaining to them.

  (Auditing Standards Committee Statement No. 240, paragraph 22)

《Points to Note》

As with the examples of identified deficiencies mentioned above, there were deficiencies in procedures for risk assessment and procedures for responding to the assessed risk in relation to revenue recognition.

- **In one case, the engagement team did not sufficiently perform risk assessment on revenue recognition with an understanding of the entity's business and its business environment, including its type of business and the characteristics of its sales transactions. The team therefore did not plan appropriate audit procedures.**
- **In another case, the engagement team identified risks of material misstatement due to fraud in revenue recognition but did not specifically identify the kinds of risk that existed in each assertion. The team, therefore, did not plan appropriate audit procedures.**

In addition, there were cases where the engagement team only routinely verified books against

vouchers overlooking an abnormal profit ratio and agreement details inconsistent with the realities.

For revenue recognition, Auditing Standards Committee Statement No. 240, paragraph 25 stipulates "When identifying and assessing 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." Particular attention should be paid in implementing responses to audit risks.

Case 4: Response to fraud risks in transactions with related parties

In examining a loan that may be relent to a related party, the engagement team directly confirmed with the original borrower and assessed the assets pledged by the borrower as collateral.

However, the team did not carry out audit procedures, such as obtaining a full understanding of the flow of capital and the reasonableness of the loan transaction with an eye to possible fraud, by taking into account the fact that the objective of the original loan was unclear.

(Auditing Standards Committee Statement No. 240, paragraphs F11- 2 and 31; and No. 550, paragraph 22)

《Points to Note》

According to Auditing Standards Committee Statement No. 550, paragraph 11, discussions within the engagement team "shall include specific consideration of the susceptibility of the financial statements to material misstatement due to fraud or error that could result from the entity's related party relationships and transactions." In auditing related party transactions, the engagement team needs to consider the risks of material misstatement due to fraud.

In entrepreneurial companies in particular, owner-managers are often so strongly influential that internal control may not function over related party transactions. Understanding these characteristics of companies, the engagement team needs to obtain sufficient appropriate audit evidence in performing risk assessment procedures and procedures to address those risks in connection with related party transactions.

Case 5: Responses to situations that imply material misstatement due to fraud

After a customer filed for bankruptcy, the entity amended its past financial statements because transactions with the customer from past years were fraudulent transactions with no transaction reality. It was also described in the third-party committee report on this fraud that the entity had been aware that the customer substantially had negative assets at the beginning of transactions.

However, the engagement team did not examine the existence of suspicion of material misstatement due to fraud, although the fact that the entity did not provide the engagement team with the information was an example of a situation that implied material misstatement due to fraud.

(Auditing Standards Committee Statement No. 240, paragraphs F11-2, 23, and 34)

《Points to Note》

Attention should be paid to the fact that fraudulent financial reporting is made in the following ways:

- **Falsification, forgery, and alteration of accounting records and vouchers, the bases for financial statements**
- **Misstatement and intentional exclusion of transactions, events, or material information on financial statements**
- **Intentional inappropriate adoption of accounting standards regarding amounts, classification, or disclosure**

In addition, if it is identified that management misstated or concealed material information on accounting to the engagement team, the team must carefully consider the possibility of fraudulent financial reporting.

(4) Evaluation of audit evidence

Case: Evaluation of identified misstatement during the audit

During a branch audit the engagement team detected a misstatement in posted sales, and requested that the entity revise it. However, the team did not assess whether the misstatement fell under an indication of fraud, including by reviewing similar transactions at other branches. In addition, the team did not perform additional audit procedures including examination of the quantitative impact on the whole entity and control deficiencies, and as a result, overlooked misstatements at other branches.

(Auditing Standards Committee Statement No. 240, paragraph 34)

《Points to Note》

As in the examples of identified deficiencies mentioned above, there were deficiencies in procedures for fraud-related risks, including failure to sufficiently assess whether the misstatement identified during the audit fell under an indication of fraud, failure to assess the possibility of the identified misstatement occurring in the entity as a whole, and failure to reconsider risk assessment if an indication of material misstatement due to fraud was identified.

If the engagement team identifies the suspicion of a material misstatement due to fraud, the team needs to revise its planned risk assessment and responses to audit risks, and implement audit procedures that directly respond to the situation of possible fraud, including sufficient examination of the suspicion of material misstatement due to fraud, in order to obtain sufficient and appropriate audit evidence regarding the suspicion.

7. Audit of Internal Control over Financial Reporting

Points of focus

Auditors should express audit opinions based on evidence obtained by themselves as auditors, such as whether the internal control report assessed by the management was prepared to appropriately present the results of the assessment of internal control effectiveness in accordance with generally accepted internal control assessment standards.

Under these circumstances, the CPAAOB inspects audit firms regarding auditing internal control from the following perspectives:

- Whether the engagement team develops an audit plan in consideration of audit materiality, with an understanding—based on the entity's business environment and business characteristics—of the design and operation of internal control and assessment thereof by the management;
- Whether the engagement team evaluates the way the management decides the scope of assessment as well as its reasonableness; and particularly in the case that the management prepares an internal control report that excluded some part of the transaction cycles that could not be assessed, the engagement team should examine the reasonableness of the management's exclusion of the scope and the effects of the exclusion on the financial statement audit;
- Whether the engagement team appropriately assesses the deficiencies identified by the management; especially in evaluating the degree of control deficiencies, does the team examine the potential impact of the deficiencies and the possibility of the occurrence of a material misstatement by taking into consideration the quantitative and qualitative effect on the overall internal control of the entity;
- Whether, in the course of an internal control audit, the engagement team reports the deficiencies detected by the auditors to the appropriate person at an opportune time and examines the possibility of the deficiencies being a material weakness;
- Whether, if there could be some material weakness, the engagement team reports such possibility to the management, so as to correct and to examine progress made in correcting the deficiencies at an opportune time, while examining the quantitative and qualitative effect on the overall internal control of the entity and the possibility of material misstatements;
- Whether the engagement team examines the potential impact on the financial reporting by the misstatements found during the course of the financial statement audit.

Outline of inspection results

In some cases, the engagement team, without enough professional skepticism, relied on the results of the entities' internal control assessment, without evaluating the adequacy of the scope of internal control assessment, the internal auditors' ability and independence, the adequacy of samples, assessment scheme and so on.

In the event of significant changes of business locations/units because of acquisition, commencement of new business or other changes of the business environment of the entity, the engagement team only applied routine procedures. The engagement team did not examine whether the deficiencies detected by auditors could be a material weakness. The engagement team did not obtain enough audit evidence to evaluate the correction for the deficiencies.

Expected response

Auditors should sufficiently understand the design, the operation, and the assessment methodologies of the internal control so as to integrate internal control auditing and financial statement auditing considering audit materiality for effective and efficient audits.

Meanwhile, the purpose of the internal control reporting system under the FIEA is to ensure disclosure reliability through managements' assessment of their internal controls over financial reporting and by audits of their assessment. Therefore, auditors should lead the entity to design efficient internal controls based on the entity's background, including its size and business structure.

To meet the expectations mentioned above, auditors need to examine the scope, timing and appropriateness of audit procedures to evaluate the adequacy of the scope of internal control assessment, the methodologies of internal control assessment, and the assessment of the significance of internal control deficiencies. They should not perform procedures uniformly and routinely without sufficient examination.

Appropriate assessment should be performed concerning whether sufficient and appropriate audit procedures were performed particularly on the entity's business locations/units deemed to have relatively high risks, such as processes newly added to be assessed.

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

Case 1: Selection of significant accounts

The entity considered that sales, accounts receivable, and inventories—significant accounts for the entity's operational objective—should be included in the scope of internal control assessment.

However, the engagement team did not assess whether personnel expenses, which was a higher amount than inventories due to the nature of the entity's business, should be included in the scope of internal control assessment.

(Auditing and Assurance Practice Committee Statement No. 82, paragraphs 98 and 100)

《Points to Note》

"Important accounts for operational objective (three accounts: sales, accounts receivable and inventories)" are just examples, described in the Practice Standards for Management Assessment and Audit concerning Internal Control over Financial Reporting. It is necessary to note that important accounts should be appropriately selected in consideration of the entity's type of industry, business

environment and business characteristics. In the event of changes in the entity's business activities and profit structure, in particular, important accounts need to be carefully selected.

In addition to the above example case, net sales are often used as an indicator for selecting significant business locations/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 entity.

Case 2: Selection of material business processes

The engagement team did not examine whether the management's exclusion of items such as the assessment of inventories from the scope of internal control audit was reasonable, although the engagement team identified it as a significant risk.
(Auditing and Assurance Practice Committee Statement No. 82, paragraph 112)

《Points to Note》

Business processes, related to the accounts with significant risks, should be usually selected for internal control assessment by the management because of their characteristics. If such business processes are not selected, the engagement team should note that they are requested to discuss again with the management regarding the management's method of deciding the scope of assessment as well as the basis of the decision, and carefully evaluate the reasonableness of the scope of assessment.

If the engagement team considers that the business processes selected by the management for assessment are not appropriate, the engagement team needs to request the management to take additional actions, including reconsidering the business processes to be assessed, in accordance with the degree of impact on financial reporting.

If some processes included in significant business locations/units are excluded from assessment because of their limited relevance to material businesses or operations and small impact on financial reporting, the engagement team should carefully evaluate the reason for their exclusion from assessment, etc.

(2) Evaluation of Assessment of Internal Control

Case 1: Sampling

- In assessing the operation of internal controls over revenue recognition, the engagement team used samples the entity had assessed, but did not examine the completeness of the entire population of samples subject to assessment, although the samples are concentrated in certain branches.
(Auditing Standards Committee Statement No. 500, paragraph 8; No. 530, paragraph 5; Auditing and Assurance Practice Committee Statement No. 82, paragraph 153)

- In assessing the operation of internal controls over revenue recognition, the engagement team used the procedures the entity had performed, but did not examine the appropriateness of the selection method and sample size the entity had extracted.

(Auditing Standards Committee Statement No. 500, paragraph 9; Auditing and Assurance Practice Committee Statement No. 82, paragraph 153)

- The engagement team tested the operating effectiveness of internal controls for sales processes on a sample basis.

  However, the engagement team selected the samples from certain sites that the team visited, whereas the team should have determined the sampling population to provide all transactions with the opportunity of extraction.

  (Auditing Standards Committee Statement No. 530, paragraph 7)

Case 2: Assessment of design and operating effectiveness of internal control

In assessing the operating effectiveness of the financial reporting process, the engagement team performed procedures including review of trails of management assessment. However, of the contents described in the trail, they overlooked deficiencies that could become material weakness.

(Auditing and Assurance Practice Committee Statement No. 82, paragraph 167)

《Points to Note》

Other than the example mentioned above, in some internal control evaluation procedures, the engagement team described only the results of control activities in the audit documentation, such as whether a signature had been affixed to a document. With a sufficient understanding of Auditing Standards Committee Statement No. 230 ("Audit Documentation"), the team needs to take into consideration significant matters identified and professional judgments arising in the course of the procedures, as well as the results of the procedures, for the documentation. Meanwhile, in examining the scope of internal control assessment, the engagement team also needs to pay attention to changes in the entity's business activities and earnings structure, regardless of audit experience in the past year.

Furthermore, in implementing a detailed test and procedures for assessing the operation for the same transaction as a dual-purpose test, the engagement team needs to pay attention to whether it can take procedures that are suited to both purposes of the test, especially whether audit evidence obtained is appropriate for the assertion of account and internal control to be assessed.

Case 3: Timing of assessment procedures

- In developing its plan for responding to financial statements audit risk, the engagement team planned to rely on the related effective internal controls. However, the team did not complete its evaluation on the design and operating effectiveness of IT general controls and operation-processing controls by the date of the auditor's report for the Companies Act.

  (Auditing Standards Committee Statement No. 300, paragraph 8, No. 330, paragraphs 5, 6, and 10; Auditing and Assurance Practice Committee Statement No. 82, paragraph 27)

- In performing responses to audit risk related to sales, the engagement team relied on the related effective internal control, but the team did not complete roll-forward procedures regarding operation-processing controls by the date of the auditor's report for the Companies Act.

  (Auditing Standards Committee Statement No. 300, paragraph 8, No. 330, paragraphs 5, 6, and 10; Auditing and Assurance Practice Committee Statement No. 82, paragraph 27)

《Points to Note》

If the engagement team plans to rely on related effective internal controls in deciding the nature, timing and extent of substantive procedures in the audit of financial statements, it needs to assess the effectiveness of the company-level controls and IT general controls that support the operation-processing controls as well as the subject operation-processing controls before performing significant substantive procedures.

(3) Evaluation of Deficiencies

Case 1: Assessment of deficiencies in design or operating effectiveness of internal control

The entity said it corrected deficiencies in the operational process pointed out by the engagement team by the end of the period.

However, the engagement team did not obtain adequate audit evidence to prove that the internal control deficiencies were corrected at the end of the year.

(Auditing and Assurance Practice Committee Statement No. 82, paragraph 216)

Case 2: Determination of material weakness

- Although the engagement team identified control deficiencies in the inventory process and the financial reporting process, they did not examine whether or not deficiencies fell below the level of material weakness.

  (Practice Standards for Management Assessment and Audit Concerning Internal Control Over Financial Reporting III. 4 (2) (iv))

- Regarding the results of internal control assessment by management, the engagement team obtained a list of matters to be remedied that was prepared by management, and understood that management assessed that there was no material weakness although there were deficiencies as of the year-end.

  However, the engagement team did not examine the appropriateness of the results of assessment by the management concerning such control deficiencies.

  (Auditing and Assurance Practice Committee Statement No. 82, paragraphs 210 and 211)

《Points to Note》

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

When finding a deficiency in internal control, the engagement team is required to: confirm which classification it falls under; take into account its quantitative and qualitative materiality and compensating control; calculate the potential quantitative impact of the deficiency discovered; and examine which accounts will be affected by such deficiency and to what extent, and the possibility of material misstatement. The team needs to pay attention to the fact that it is required to carefully judge if the deficiency found falls under material weakness.

(4) Use of Management Assessment

Case: Extent of using the work of internal auditors

The engagement team adopted an approach that relied on internal controls for significant risks identified in revenue recognition, and used the results of internal control assessment conducted by internal auditors of the entity in its assessment of control effectiveness.

However, they did not examine the appropriateness of the assessment method, including the sufficiency of sample size examined by internal auditors.

(Auditing Standards Committee Statement No. 610, paragraph 9)

《Points to Note》

The engagement team used the work performed by the entity's internal auditors in many cases to perform effective and efficient audits. However, on such occasions, it is necessary to examine if the objectivity and capability of the internal auditors are secured and if the quality of assessment by the internal auditors is high enough to be used as audit evidence.

In this case, the engagement team should keep in mind that it is necessary to examine the degree of risk corresponding to the internal control where the engagement team plans to use the work performed by the entity's internal auditors, the nature and materiality of the internal control, the operations of internal control, the degree of judgment necessary for assessing operations, and the quality of the work performed by the internal auditors.

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