

Case Report from Audit Firm Inspection Results

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Certified Public Accountants and Auditing Oversight Board

[**Table of Contents**]

Introduction	1
Expectations for Audit Firms	2
To Directors, Those Charged with Governance, Investors and Other Stakeholders	3
Important Points for Users of this Case Report	4
I. Root Cause Analysis	9
II. Quality Control System	17
1. Management Systems.....	17
2. Professional Ethics and Independence.....	27
3. Acceptance and Continuance of Engagements.....	30
4. Employment, Education and Training, Evaluation and Assignment.....	35
5. Audit Documentation.....	40
6. Engagement Quality Control Review.....	44
7. Monitoring the Firm’s Quality Control Policies and Procedures.....	47
8. Joint Audit.....	50
9. Cooperation with Those Charged with Governance.....	51

III. Individual Audit Engagements	55
Audit Engagement Performance.....	55
1. Risk Assessment and Response to Assessed Risks.....	58
2. Audit Evidence.....	70
3. Auditing Accounting Estimates.....	87
4. Using the Work of Others.....	102
5. Auditing Financial Institutions.....	109
6. The Auditor's Responsibilities Relating to Fraud in Financial Statement Audits.....	117
7. Audit of Internal Control over Financial Reporting.....	129

Introduction

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

The CPAAOB's inspections have identified various deficiencies in audit firms concerning matters pertaining to audit quality control, such as management systems of audits, professional ethics and independence, acceptance and continuance of engagements, performance of audit engagements, audit documentation, engagement quality control reviews, and 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 (including privately-operated accounting firms) to maintain and improve their audit quality, by providing specific examples of major deficiencies identified in the CPAAOB's inspection and by presenting the audit quality level expected by the CPAAOB. In addition, this Report also serves as a reference material to be provided to directors/those charged with governances of listed companies and other companies subject to audit by independent auditors, general investors and other market stakeholders.

Expectations for Audit Firms

In this case report, the CPAAOB presents cases that would be useful as a reference for audit firms when they take actions to improve their quality control systems.

The CPAAOB expects each audit firm to check its own quality control system, including individual engagements, with reference to the deficiencies and their causes described in this Case Report. If any deficiency is discovered in the system, the audit firm should not only remedy the deficiency itself but also investigate and improve the root cause(s) thereof.

Although quality control system deficiencies, including deficiencies in individual engagements, are primarily the responsibility of the chief executive officer (CEO), the person in charge of quality control (PICOQC) or an individual having a similar function, their root causes can be often found in the business management system, management policy or business model of the audit firm. The establishment of a quality control system should not be only the individual responsibility of the CEO, PICOQC, or other individual, but rather a corporate responsibility to be fulfilled by the entire management staff of an audit firm. Keeping this in mind, staff 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 the "Quality Control" part and the "Audit Engagement Performance" section in the "Individual Engagements" part 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 and/or other areas, not just insufficiency in the knowledge, experience, competence and capabilities of the engagement team.

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

Regarding the relationship between directors/those charged with governance of a business entity and an independent auditor, the revised Companies Act enforced in May 2015 stipulates that those charged with governance of a business entity have the authority to decide on the contents of a proposal to appoint or dismiss an independent auditor. Moreover, the Corporate Governance Code adopted in June 2015 requires, from the perspective of investor protection and securing the reliability of the capital market, that those charged with governance in a business entity establish policies for the 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 business entities have been highlighted recently. As efforts to improve/enhance the financial statements audit by independent auditors become more important, directors and those charged with governance in business entities are expected to take appropriate actions to ensure that fair accounting audits are conducted by such independent auditors.

Accordingly, recognizing the importance of communication between those charged with governance and independent auditors, the CPAAOB clarified in the Basic Guidelines for Inspection by Certified Public Accountants and the Auditing Oversight Board (published in April 2015) that the results of the CPAAOB's inspection may be disclosed to those charged with governance in a business entity that receives an audit by an inspected independent auditor.

The CPAAOB expects that directors and those charged with governance in business entities, investors and other stakeholders should actively use this Case Report as a reference material when communicating with independent auditors. Especially, those charged with governance in business entities should actively utilize this Case Report. They are expected to improve and strengthen cooperation with independent auditors by actively asking 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, and should make appropriate assessment of independent auditors and take sufficient time for auditing to ensure that appropriate accounting audits are conducted by such independent auditors.

This Case Report compiles deficiencies identified in the CPAAOB's inspection from the perspective of "promoting voluntary efforts by audit firms to maintain and improve their audit quality" and "providing a reference material to directors/those charged with governance in listed companies in business entities subject to audit by independent auditors, general investors and other stakeholders in the market." We believe that this Report can be referred to by those charged with governance in business entities and other stakeholders in the market when they conduct examination to understand the performance of independent auditors.

Important Points for Users of this Case Report

The new topic "Root Cause Analysis" is included

In the Case Report for 2015, the new topic "Root Cause Analysis" is included in addition to the existing "Quality Control System" and "Individual Engagements" topics, as outlined below (Note):

- ▶ "Root Cause Analysis" describes the importance of examining the root causes of deficiencies. Root causes found in past CPAAOB inspections are classified based on their patterns, together with descriptions of actual cases to help understanding of the root causes.

- ▶ In the Quality Control System section, following the format of the previous year's report, examples of identified deficiencies are introduced in detail for each quality control item, with descriptions of "Points of focus" in the inspection, an outline of inspection results (outline of examples, the causes of occurrence thereof, and/or examples that are considered useful in addressing identified deficiencies and improving quality control), expected response by audit firms, etc. The "Analysis of causes of deficiencies" topic in "1. Management Systems" through "8. Joint Auditing" describes direct causes of deficiencies and their analysis.

- ▶ The "Individual Engagements" part of this Report is organized, following the format of the previous year's report, according to the structure of the Auditing Standards Committee Statements. Separate sections are used to describe deficiencies found in the following areas:
 - audit of accounting estimates: an area where many deficiencies were identified;
 - audit of financial institutions: an industry for which special attention is necessary;
 - fraud in audit of financial statements: future development is the focus of attention; and
 - audit of internal control over financial reporting: different audit standards are applied from those for financial statements.

Each section describes the "Points of focus" in the inspection, "Outline of inspection results," and "Expected response," followed by examples of identified deficiencies, and "Points to Note" to remember when performing audit procedures to improve common identified deficiencies are appended.

(Note) In introducing the examples of identified deficiencies, background information behind such deficiencies and their causes is provided to the extent possible. In addition, regarding matters unique to individual audit firms, expressions are partially modified. In cases where more than one provision in a standard, law or regulation is applicable when identifying a deficiency, the principal provision is quoted.

(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 corporation or a sole practitioner.
- The term the "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 the 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 Causes Analysis

Root Causes Analysis

(Necessity of Cause Analysis)

As a result of the CPAAOB's inspection, 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 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.

For example, in the auditing accounting estimate of impairment for the shares of subsidiaries and associates, deficiency in terms of not examining the reasonableness of a business plan was observed in some auditing firms. As improvement measures for this deficiency, many such auditing firms revised their checklists by adding a check item of "review the reasonableness of the business plan for impairment loss in shares of subsidiaries and associates" and established a rule that the engagement team should examine that the business plan had been reviewed.

However, despite the possibility that a business plan may also have to be examined in the auditing of other accounting estimates, the checklist revised by these auditing firms limited the range of the checking to examination of the business plan in relation to impairment of the shares of subsidiaries and associates. Consequently, after the implementation of improvement measures (check list), similar deficiencies were still found in some auditing firms in the auditing of other accounting estimates, such as no examination of the reasonableness of the business plan for impairment of long-lived asset value which is required as a basis for estimating the undiscounted cash flow. As in this example, because the improvement measures were not fundamental, they did not result in improvement of the quality control of the overall audit operations of the firms.

Therefore, to implement effective improvement measures for a deficiency, each audit firm must analyze and identify the cause of the deficiency and develop improvement measures considering the identified cause. This will not only eliminate the deficiency in question but also result in the elimination of other deficiencies arising from the same cause.

(Direct Causes)

Before analyzing the root cause of a deficiency, an audit firm must analyze the direct cause that caused the deficiency. In the deficiency example described above, the problem was that the reasonableness of the management's assumptions used for the accounting estimate was not examined in the audit. The following may be the direct causes of this deficiency:

- The audit practitioners did not verify the assertion of the business entity for which the firm

performing the 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) by any other process than asking questions to the entity, and thus did not use professional skepticism and did not have a sufficiently critical attitude.

- The engagement partner did not provide sufficient direction and supervision to the members of the engagement team, including timely and appropriate review of the audit documentation.
- The EQC reviewer did not sufficiently examine the significant judgments and opinions given by the auditors from an objective and critical standpoint as a third party outside the engagement team.
- The audit firm did not assign appropriate audit practitioners (including engagement partners) and/or EQC reviewers considering the audit risks associated with those engagements.
- The audit firm did not verify whether the implemented improvement measures effectively worked.

(Root Causes)

In addition to the analysis of the direct cause of a deficiency, the audit firm must identify the root cause that brought about the direct cause and develop improvement measures based on the analysis of the root cause.

A deficiency detected in an inspection may be only a part of a greater deficiency. It is likely that the auditing firm has other undiscovered deficiencies arising from the same root cause. Moreover, there may be a root cause that would offset the effect of the improvement measures implemented to eliminate the direct cause of the deficiency. Improvement measures developed only to eliminate the direct cause, without considering the root cause of the deficiency, would not be effective or sufficient for improving the quality control system of the entire firm, and would not lead to fundamental improvement; thus the quality of the audit by the audit firm would not be improved.

Root causes of deficiencies identified in past CPAAOB's inspections can be categorized into the following main types:

- (1) The management system, management policy (including policies related to assessment and compensation and other incentives) or business model of the audit firm;
- (2) Quality control efforts by the CEO and other partners; and
- (3) Partners' awareness of the duties; mutual checks and balances between partners

Other root causes identified are the business condition of the audit firm, the composition of the staff members' job classes, and the workplace climate of the firm related to quality control.

Analysis of these root causes is essential for fundamental improvement of deficiencies found in an accounting firm. In the International Forum of Independent Audit Regulators (IFIAR), the

importance of analysis of root causes of deficiencies by audit firms and audit regulators was pointed out.

Audit firms should recognize that it is important to identify the root causes of deficiencies in order to improve the quality control system of their organization. If a deficiency is found as a result of a QC review, cyclical inspection or other occasion, investigation should be conducted to identify its root cause, and substantive measures to eliminate the root cause should be implemented, in addition to measures to improve the deficiency itself.

(1) Cases of deficiency in the management system, management policy (including policies related to assessment and compensation and other incentives) or business model of the audit firm

- ▶ The partners' performance and compensation were evaluated and determined based on their commercial results, but the excellence of the audit quality and compliance with professional ethics were not taken into consideration. Accordingly, the entire staff of the audit firm placed more emphasis on expansion of the business than on audit quality control.
- ▶ Each partner operates independently as if had its own private practice, since the compensation of the partner was determined based on the result of his/her engagement team. Each engagement team handled quality control problems and implemented improvement measures and solutions only within the team, and there was an atmosphere wherein partners in an engagement team could not interfere with other engagement teams.
- ▶ 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 members 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.
- ▶ Partners thought that they could earn stable audit income as long as they kept good relationships with the entities who received their audits. They put emphasis on keeping their relationships with their entities, with little focus on the fundamental purpose of the audit, i.e., protecting the interests of investors and creditors.

(2) Cases of deficiency in quality control efforts by the CEO and other managers

- ▶ The CEO and the person in charge of quality control (hereinafter “PICOQC”) of an audit

firm had not had experience in managing an audit firm or as an engagement partner of audit engagements for listed companies before joining the firm. Under these circumstances, they were not very eager to acquire the necessary knowledge, and thus had a poor understanding of the quality level required for audits.

- ▶ The CEO and the PICOQC did not understand the quality control system level required under the audit standards. Therefore, they mistakenly assumed that the efforts made by the audit firm for improving the quality control system were sufficient.
- ▶ The CEO and other partners participating in the management of the audit firm did not take seriously the quality of their audits. Accordingly, they did not plan or take measures to promptly improve the quality of all their audit engagements to a given level or higher.
- ▶ Despite his final responsibility for the quality control system, the CEO had not established a system intended to improve the audit quality of the entire firm and implement audits in an organized manner. The PICOQC did not realize the importance of the quality control system, despite the assigned role to establish and operate a quality control system.
- ▶ The CEO and other management recognized that the audit firm did not have a sufficient number of experienced certified public accountants who could take charge of audit engagements. Despite this, they had not fully considered taking the action necessary to secure a sufficient number of audit practitioners having adequate audit capabilities and competence.
- ▶ The CEO had been engaged in the auditing of the entity for many years since he operated his own private auditing office. After he transferred the entity to the auditing firm when he assumed the position of CEO in the firm, he himself conducted the risk assessment of the entity. Under these circumstances, the CEO was overconfident that he understood the audit risks related to the entity.

(3) Cases of deficiencies related to partners' awareness of duties; mutual checks and balances between partners

- ▶ In some auditing firms, there were more certified public accountants with limited experience than experienced certified public accountants. In such situation, individual partners tended to think that the CEO or the PICOQC was solely responsible for the quality control of the entire firm. Individual partners did not realize that they had their own responsibilities and roles in

maintaining and improving the quality of all audits performed by the audit firm.

- ▶ Because the private auditing office of the CEO had been incorporated into the current auditing firm and the CEO had played a central role in the acceptance of major engagements, other partners felt that the firm was still a private business of the CEO, and thus relied on the CEO for most of the management of the firm.

- ▶ Partners did not recognize that they had to critically monitor and inspect the quality of audit engagements that other partners were in charge of from an equal standpoint.

- ▶ An audit firm has a Partners Meeting, which is an organ assigned the final responsibility for the quality control system. Each partner should have awareness and a sense of responsibility, as a member of this Meeting, for establishing and operating the quality control system. In fact, partners, including the CEO, did not recognize their responsibility regarding the operation of the firm. The Partners Meeting did not function effectively.

II. Quality Control System

1. Management Systems

(1) Quality Control Systems

Points of focus

The CPAAOB inspects audit firms for audit management system problems, particularly the status of establishment of a quality control system as one of the most important inspection items from the following perspectives:

- ▶ Whether the CEO, the PICOQC or other person with similar function in an audit firm has established and operates an effective quality control system with proper understanding of the audit practice required of audit firms; whether such quality control system is appropriate to the size and characteristics of the firm;
- ▶ Whether the CEO or other top management has established a management policy that places emphasis on the audit quality and manages the firm based on that policy; whether the top management confirms the effectiveness of the quality control system by implementing monitoring as needed and by checks and balance among partners;
- ▶ Whether the CEO or equivalent fulfills their duties as the person ultimately responsible for the quality control system of their audit firm, for example, through involvement in the establishment of the firm's quality control system, and through keeping track of implementation of QC-related work by the PICOQC or equivalent to give directions as needed;
- ▶ Whether the PICOQC was appointed from among persons with necessary QC experience, capability and competence; Whether the appointed PICOQC fulfills their duties as the person responsible for involvement in the establishment of quality control system of their audit firm, for example, by precisely evaluating the status of the establishment of the system and, if identifying any deficiency therein, developing and undertaking timely measures to improve it.
- ▶ Whether the CEO or equivalent has established an organizational structure in which the audit firm voluntarily takes action to discover deficiencies, identifies their root causes, and takes fundamental improvement measures.

As described in the "Root Cause Analysis" section, in an audit firm where deficiencies in the quality control system are found, the CPAAOB believes that finding the root causes of such deficiencies is essential to effectively improving their quality control system. Accordingly, when CPAAOB's inspection revealed any deficiency in the quality control system of an audit firm, the CPAAOB not only examined the direct causes of the deficiency but placed emphasis on the finding of root causes.

Outline of inspection results

(Observed effective efforts)

Large audit firms had their QC department lead the work to maintain and improve their internal quality control system. Specifically, we found the following cases, among others:

- A QC leader is appointed from among partners in each department and each office of the audit firm, in order to ensure consistent quality control across the entire organization. The QC leaders perform QC-related duties within their units and maintain close coordination with the QC department.
- When an audit engagement is accepted or continued, the risks involved in the audit of the entity are identified. Based on the extent of the identified risks, an engagement partner and an engagement quality control reviewer ("EQC reviewer") are appointed. In addition, the quality control department provides monitoring and consultation during the fiscal year of the entity.
- To improve the quality of audits of financial institutions performed by regional offices, in principle, a partner from the financial institution audit department of the head office is appointed as the engagement partner for such audits.

(Outline of identified deficiencies)

As shown in the case example section below, in some audit firms (mainly small and medium-sized), the responsibilities for conducting QC-related operations were too concentrated in the CEO. In other

audit firms, they adopted the template of the Audit Quality Control Regulations established by the JICPA without customizing it to their actual operations, the improvement measures were not fundamental, and efforts to establish and operate the quality control system were insufficient. In other firms, the CEO, the PICOQC or equivalent did not fully fulfill his/her QC duties, including confirmation of whether or not their QC systems worked effectively.

(Analysis of causes of deficiencies)

These deficiencies might have been caused mainly by poor governance in the audit firm, including the lack of the CEO's leadership, the CEO's or PICOQC's lack of experience, the CEO's neglect of quality control, or a lack of sense of crisis.

Expected response

Audit firms need to re-examine the effectiveness of quality control system components (education and training, assessment and appointment of audit practitioners; and instruction, supervision and review, engagement quality control review, and cyclical inspection of audit engagements by engagement partners), taking into consideration the following cases, and their backgrounds and causes.

In particular, audit firms must not only improve deficiencies of their quality control systems found by their re-examination but also investigate root causes of the deficiencies, by referring to "I. Root Cause Analysis" of this Report describing the types of root causes. Audit firms thus need to ensure consistent firm-wide QC performance and promote an internal culture where quality is essential in performing each engagement.

Case 1: Concentration of quality control duties in the CEO

All members of an audit firm were allowed to engage in their own private practice, besides their duties in the audit firm. Because virtually no members other than the CEO were involved in the quality control operation, and the CEO could not govern the firm effectively, the CEO did not assign the quality control duties to other partners. Because the CEO had to perform multiple duties, including the engagement partner role, the duties of a PICOQC, as well as ongoing inspection, the CEO could not take sufficient time for management of the quality control system that he had to perform as a PICOQC. Thus, the CEO could not perform thorough verification of each quality control operation.

(Quality Control Standards Committee Statement No. 1, paragraphs 15-18)

Case 2: The CEO's understanding of expected QC level

The CEO had a poor understanding of the deficiencies indicated in previous QC reviews and, therefore, could not properly develop and implement the necessary measures to correct such deficiencies because he had not had experience in managing an audit firm or in audit engagements of listed companies as an engagement partner or equivalent position prior to joining the firm.

In addition, the CEO, who also held the post of PICOQC, did not properly establish a quality control system because of a lack of understanding as to what extent the audit firm was required to develop such a system. The CEO put internal rules in place only as a formality, merely adopting the template of the Audit Quality Control Regulations established by the JICPA, without customizing it to their actual operation, and did not carry out effective ongoing and cyclical inspections.

(Quality Control Standards Committee Statement No. 1, paragraphs 15-18)

Case 3: The CEO's response to deficiencies pointed out in the QC review and the CPAAOB's inspection

The CEO simply followed the formality of giving directions to the PICOQC and audit practitioners to take action against the deficiencies identified in the QC review or the CPAAOB's inspection. The CEO did not seriously investigate the root cause of the deficiencies and did not take serious action to enhance the partners' awareness, capabilities and competence to control audit quality and perform audit engagements, either.

Moreover, because the CEO's negative attitude toward quality control permeated across the firm, the PICOQC did not recognize his responsibility for quality control and did not fully verify the effectiveness of the quality control system of the firm.

(Quality Control Standards Committee Statement No. 1, paragraphs 15–18)

Case 4: Establishment of a system for improving the audit quality

The PICOQC and other partners in charge of quality control did not fully recognize how the audit environment had changed, and did not understand the required quality control. In particular, the PICOQC had not established a system to detect QC-related deficiencies within the firm, analyze the root cause of the detected deficiencies, and take improvement measures.

(Quality Control Standards Committee Statement No. 1, paragraphs 15–18)

Case 5: Establishment of a system for cross-sectional control of QC-related operations

The CEO assumed without doubt that the partners had the required level of abilities related to audit quality control and sufficient awareness of quality control. Thus the CEO was not very concerned about the status of the firm's audit quality.

Accordingly, in this audit firm, the responsibility for establishing and operating a system to control a QC-related operation, such as engagement quality control review, acceptance and continuance of audit engagements, and education and training, was solely left to a representative partner who was assigned to that operation. The firm did not have a supervisor who comprehensively monitored the quality of the audit of the entire organization. The firm had not established systems to assess the performance of its quality control-related operations or to develop and implement cross-sectional measures necessary for maintaining and improving the level of the audit quality across the organization.

(Quality Control Standards Committee Statement No. 1, paragraphs 15–18)

(2) Initiatives to Improve Performance

Points of focus

The CPAAOB performs inspections based on QC review reports. In particular, the CPAAOB inspects the improvement of deficiencies identified in the previous CPAAOB's inspection or QC review. As a general rule, it selects multiple Individual Engagements, and inspects, for each item, each engagement to see how each item of the improvement 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.

Outline of inspection results

(Observed effective efforts)

For an engagement in which a deficiency was detected in the CPAAOB inspection, the quality control department of an audit firm required the engagement team to submit the audit documentation for that engagement after implementing improvement measures to confirm the status of the improvement. The results of the improvement measures were reported to the CEO, as needed. In addition, the engagement quality control reviewer reviewed other engagements to check whether similar deficiencies had not occurred in other engagements.

(Outline of identified deficiencies)

As shown in the case example section below, in some small and medium-sized audit firms, initiatives to improve the deficiencies identified in the QC review were not sufficiently undertaken and insufficient or no improvement measures had been made regarding multiple identified deficiencies.

(Analysis of causes of deficiencies)

Possible causes of the identified deficiencies:

The PICOQC did not identify the root cause of the deficiency, considering the reason why it was pointed out in the QC review. The audit firm lacked the attitude to achieve the improvement of the entire audit operations.

Expected response

The audit firm must fully examine to what range and extent a deficiency should be improved, considering the reason why it was identified as a problem in the QC review or the CPAAOB's inspection. Based on the results of that examination, the firm must develop and implement appropriate improvement measures for the identified deficiency. The firm must check whether the improvement measures developed based on the examination have been properly implemented. This should include examination of other audit engagements to check whether they had situations similar to the identified deficiency, considering the reason the deficiency was identified as a problem in the inspection. Thus, the firm must take measures to improve all audit engagements undertaken by the firm. For example, to improve a deficiency detected in the procedure of auditing accounting estimates, an audit firm should examine all the engagements it undertakes to identify all areas in which such a deficiency may occur and should verify each of these areas in detail to confirm whether sufficient appropriate audit procedures have been followed.

Case 1: Establishment and implementation of specific policies and procedures for improvement

The PICOQC of an audit firm developed a checklist for improving deficiencies found in the QC review. But the checklist only listed the deficiencies. It did not include explanations as to why the identified deficiencies were problems. It did not include specific improvement procedures to be followed, either. Accordingly, the firm did not develop or implement appropriate improvement measures that would fully cover the range and extent of improvements required.

There were also problems with the users (audit practitioners) of the checklist. For identified deficiencies, they 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 perform review accounting estimates for management biases and evaluate whether the circumstances producing the bias or significant transactions which are outside the normal course of business for the entity suggested that they may have been entered into to engage in fraudulent financial reporting.

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

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 15–16)

Case 3: Verification of improvement

The audit firm developed an improvement checklist to examine the implementation of measures to improve deficiencies identified in the QC review, and had the manager of each engagement team use the checklist to check the improvement status of each deficiency before expressing audit opinions. The firm also said that they had the engagement partners and EQC reviewers re-check the results of self-checking by the managers.

When the manager of each engagement team verified the implementation status of improvement measures, however, he or she ticked the "Improved" columns of the improvement checklist without verifying in detail the sufficiency or other aspects of the audit procedure carried out in light of the specific improvement measures described in the improvement plan.

In addition, both the engagement partners and the EQC reviewers rechecked each checklist only by confirming whether there were no items with “Unimproved” ticked by the manager in the course of checking.

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

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

Points of focus

The CPAAOB inspects audit firms for the status of establishment, communication, and application 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;
- ▶ Whether the PICOQC or equivalent distributes copies of the internal rules to audit practitioners (including part-time staff) and other personnel, 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

(Observed effective efforts)

There were audit firms ensuring that operations were performed under their internal rules by appointing an appropriate number of practitioners and developing a detailed workflow for each QC-related task.

(Outline of identified deficiencies)

As shown in the case example section below, some firms (often small or medium-sized audit firms) did not establish internal regulations related to independence and non-audit services. Some firms did not communicate internal rules to part-time audit practitioners. Some other firms did not follow internal regulations related to the Partners’ Meeting.

(Analysis of causes of deficiencies)

Some of the reasons for these types of deficiencies were that the members of the audit firms did not understand the laws and standards underlying the internal rules, and that the audit firms adopted the template of the Audit Quality Control Regulations as their internal rules without customizing 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 must perform sufficient examination and review as to whether their engagements are performed in accordance with the internal rules. They also need to establish a management system concerning the appropriate establishment, communication, 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 did not correctly understand the Guideline for Independence established by the JICPA. As a result, the Regulations for Audit Quality Control (internal rules of the firm) stipulate that even if compensation received from a single client accounted for 15% of the firm's total revenues for two consecutive years, and it turns to less than 15% in the third year, the firm could avoid the application of the Safe Guard. This rule did not correctly reflect the

Guideline for Independence.
(Quality Control Standards Committee Statement No. 1, paragraphs 15–16)

- ▶ The PICOQC in an audit firm only stipulated 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 15–16)

Case 2: Establishment of internal rules regarding non-audit services

The audit firm decided to commence the provision of non-audit services, and revised its articles of incorporation accordingly. However, the audit firm has not established internal rules that set forth procedures to accept new non-audit engagements or to approve competing transactions.
(Quality Control Standards Committee Statement No. 1, paragraphs 15–16)

Case 3: Dissemination of internal rules

The PICOQC of the audit firm considered it sufficient to provide a summary of the internal rules orally to part-time audit practitioners and did not distribute copies of the internal rules regarding the quality control system—including the Audit Quality Control Regulations—to part-time audit practitioners at all.
(Quality Control Standards Committee Statement No. 1, paragraphs 15–16)

Case 4: Implementation of internal rules

In managing operations, the CEO or other top management of the audit firm did not sufficiently consult the internal rules, such as the Articles of Incorporation and the internal rules regarding the QC system and did not revise, as necessary, the internal rules to reflect the actual operations. This resulted in a situation where the acceptance and continuance of audit engagements, and the evaluation and determination of compensation for audit practitioners, which are matters to be resolved by the Partners Meeting under the internal rules, were performed without referring such matters to the Partners Meeting.

In addition, although the firm's Articles of Incorporation prescribe that an engagement partner shall be appointed by the unanimous consent of all partners, engagement partners were assigned for the audit engagements of some listed entities without obtaining the consent of a partner who was absent from the Partners Meeting, and engagement partners were assigned for the audit engagements of unlisted entities without the unanimous consent of all partners.
(Quality Control Standards Committee Statement No. 1, paragraphs 15–16)

(4) 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 CPAAQB, 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

(Outline of identified deficiencies)

As shown in the case example section below, some audit firms, mainly small and medium-sized, had deficiencies related to legal compliance, including lack of internal rules regarding the non-competing obligation by partners, lack of partners' qualifications required for operational control, and failure to submit a report of changes to their Articles of Incorporation.

(Analysis of causes of deficiencies)

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 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 15–16)

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

An audit firm did not satisfy the requirement that the majority of partners have been engaged in audit engagements 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 such partners who had less than three years audit experiences into the number of those with at least three years experiences 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: Notification of changes to Articles of Incorporation

The audit firm merely entrusted the CEO with the duties of submitting various notifications, etc. and did not take any measures to manage and verify the submission status of legally required notifications. This resulted in a failure to submit a notification of changes to the Articles of Incorporation by the submission due date.

(Quality Control Standards Committee Statement No. 1, paragraphs 15–16, Article 34-10 paragraph 2 of the Act)

(5) 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 stored 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 of 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
(Observed effective efforts)

Some effective efforts observed in our inspections were:

- Prohibiting, as a general rule, carrying PCs on which data obtained from entities, etc. is stored, outside the office, including on visits to the entities. In the same firm, audit practitioners constantly checked their PCs to confirm what confidential data were stored, and under what conditions.
- Preparing a self-check list for information security in accordance with the IT Committee Statement No. 4, and requiring full-time and part-time audit practitioners to go through the checklist for information devices, such as PCs, used for their audit engagements.
- Verifying periodically the storage conditions of written materials before they were compiled into audit documents to prevent leakage of confidential information from unattended written or printed documents.
- Establishing regulations for information security control or similar regulations in which the required security levels are specified for various types of information, such as information about audit clients and other entities with which the firm has transactions, and information on the business, personnel, manuals and other affairs of the firm; establishing rules to manage these data, and a code of conduct to be observed by members of the firm to manage the security of information.

(Outline of identified deficiencies)

As shown in the case example section below, some audit firms (many of them were small or medium-sized) did not appropriately carry out any measures to prevent information leakage as specified in their internal information security rules. Or, some did not distribute copies of their internal information security rules to part-time audit practitioners. Some firms did not establish internal rules to properly control the use of Internet server services for the firm's operation.

(Analysis of causes of deficiencies)

Causes of the identified deficiencies:

- The information security manager or equivalent established internal information security rules only as a formality, leaving 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

Audit firms should fully understand the serious, adverse effects that information leakage would impose on the operation of the firm, and establish 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 nor encrypted data were

created for stored data; no ID codes and 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 15–16; Article 27 of the Act; IT Committee Statement No. 4, IV 2 and 5)

Case 2: Communication of internal information security rules to part-time audit practitioners

The PICOQC of the audit firm believed it sufficient to give a summary of the internal information security rules orally to part-time audit practitioners, and did not distribute copies of the internal rules to part-time audit practitioners who were engaged in audit engagements using their own PCs. In addition, the PICOQC did not confirm the status of customer data storage and encryption software installation on such PCs.

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

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 users 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)

(6) 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, this may seriously damage trust in the CPA audit.

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 measures, including confirmation of specified securities transactions by its members.

Outline of inspection results

(Outline of identified deficiencies)

As shown in the case example section below, we observed cases, often in small or medium-sized audit firms, where internal rules were prepared by using the template “Rules for Preventing Insider Trading” as a guide, but such rules were not followed.

(Analysis of causes of deficiencies)

Causes of the 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 have to carefully study “Q&A Concerning Insider Trading” issued by JICPA (September 2, 2008) and other relevant documents, re-examine the conditions of establishment, dissemination, and implementation of the rules for preventing insider trading, and consider whether the strengthening of systems to prevent insider trading is required.

Case 1: Submission of written pledges regarding anti-insider trading

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 not carrying out any transactions for themselves to buy/sell specified securities issued by the entities to which services are provided; however, the anti-insider trading manager did not prepare a list of entities to which services are provided, and did not request part-time audit practitioners to submit written pledges.

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

Case 2: Notification of personnel changes in clients

Although the internal rules required the anti-insider trading manager to communicate to firm members promptly in the event of any personnel change in clients (including clients to which non-audit certification services are provided), the anti-insider trading manager did not make some of the client personnel changes known to firm members promptly after the changes.

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

Case 3: Confirmation of the written pledge regarding anti-insider trading

The anti-insider trading manager of the audit firm obtained from firm members written promises “not to sell, buy, or otherwise trade specified securities of the audit firm's entities for their own interest.” but did not notice that some members did not include their written promises in their responses to matters that should be pledged.

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

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, confirmation letters 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 or renewal 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 restriction, and restriction 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

(Observed effective efforts)

In 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 inhabiting factor to a tolerable level.

For example, when an audit firm selected a CPA from another independent audit firm for (1) the engagement quality control reviewer before issuing auditor's report or (2) the cyclical inspector after issuing auditor's report, it carefully considered his or her audit experience, capability 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.

(Outline of identified deficiencies)

As shown in the case example section below, some audit firms (many of them are small and medium-sized) had deficiencies, such as not properly implementing the independence confirmation procedures specified in the internal rules or otherwise.

(Analysis of causes of deficiencies)

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 practitioners in charge thereof.

Expected response

Audit firms need to establish a system to implement comprehensive procedures for confirming their independence in a timely and sufficient manner in order to ensure the reliability of audits.

Case 1: Independence confirmation procedures for audit practitioners

On the part of the PICOQC, etc., due to the insufficient consideration of the scope of targets and method of investigation regarding the maintenance of independence, the following deficiencies were identified concerning the independence confirmation procedures:

- Annual independence confirmation procedures were not performed for audit practitioners who were not partners, and the independence confirmation procedures were not performed for some newly joined partners at the time of joining and the annual confirmation time; Independence confirmation procedures were not performed for some affiliated entities of the audit firm;
- In the independence confirmation procedures for partners, the PICOQC distributed independence checklists with “NO” already checked in advance for all items. Thus no actual procedures were performed.
- 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 audit firm did not appoint a person in charge of independence confirmation or establish specific procedures to confirm independence. Before acceptance or renewal of an audit engagement, the firm did not perform the independence confirmation procedures set forth in its internal rules for the part-time audit practitioners who were to engage in the audit engagements concerned.

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

Case 3: Independence confirmation until the date of auditor's report

An audit firm did not have a mechanism in place where the engagement partner or equivalent could confirm whether any problems had not arisen over the maintenance of independence of audit practitioners from the start of implementation of annual independence confirmation procedures to the date of the auditor's report. The firm did not confirm that no problems had arisen over the maintenance of independence of audit practitioners from the start of annual independence confirmation to the date of the auditor's report (approx. one year).

(Quality Control Standards Committee Statement No. 1, paragraph 20; Auditing Standards Committee Statement No. 220, paragraph 10)

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 Safe Guard, 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 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 verified 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 of Audit Engagement

Points of focus

In order to reasonably ensure audit quality, in principle, audit firms need to carefully assess 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 a wrong 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 required 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 matters that could have a serious effect when performing the audit engagement ("engagement acceptance risks"), including the integrity of the top management of the entity;
- ▶ Whether the audit firm retains audit practitioners having knowledge, experience, capabilities and competence required to deal with the specified engagement acceptance risks appropriately; and
- ▶ Whether the audit firm could comply with requirements 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 situations 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 evaluation be reviewed by an appropriate department or person outside the engagement team.

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

(Observed effective efforts)

Some effective efforts observed in our inspections were:

- In accepting audit engagements, the audit firm assessed the risks involved in such engagement, based on the criteria designated in its internal rules (criteria based on the business type of the entity). Audit engagements were then classified into multiple risk categories. According to this classification, the availability of a competent engagement partner and an EQC reviewer for the engagement was checked before deciding on accepting the engagement.
- When the same audit engagement was continued, the above-mentioned risk classification assigned to the engagement at the time of its initial acceptance was reviewed based on information obtained during its audit.

(Outline of identified deficiencies)

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 observed in some audit firms (many of them are small or medium-sized firms) in internal procedures

relating to the acceptance and continuance of audit engagements. For example, information on an entity obtained by a 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 any detailed risk assessment.

(Analysis of causes of deficiencies)

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 and 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

- ▶ The acceptance and continuance of audit engagements, which were matters to be resolved by the Partners' Meeting under the internal rules, were decided without holding a Partners' Meeting.
(Quality Control Standards Committee Statement No. 1, paragraph 25)
- ▶ The partner who would take charge of the engagement sent e-mails to all the other partners to obtain their approvals for the proposed engagement. However, details of the discussions made until these approvals were obtained, including questions posed by other partners, were not shared between all the partners.
(Quality Control Standards Committee Statement No. 1, paragraph 25)
- ▶ When the partner of an audit firm proposed the acceptance of an engagement, 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 board members information necessary and sufficient for making the right decision.
(Quality Control Standards Committee Statement No. 1, paragraph 25)
- ▶ The Partner's Meeting gave an approval for the conclusion of an engagement contract before obtaining responses from the predecessor auditor to their questions.
(Auditing Standards Committee Statement No. 220, paragraph 11; and No. 900, paragraph 9)

- ▶ The application for approval submitted by the partner who would take over the engagement from the predecessor auditor did not comprehensively describe inquiries and responses made between that successor auditor and the predecessor auditor. Despite this situation, the approver for the acceptance of engagements did not obtain the minutes or similar document recording such inquiries and responses.
(Quality Control Standards Committee Statement No. 1, paragraphs 25 and 26)

Case 2: Implementation of risk assessment procedures

- ▶ The information obtained during the preliminary audit and inquiries to the predecessor auditor indicated that problems might exist in the prospective audit client, including the management's attitude regarding the interpretation of accounting standards and the control environment. When accepting the audit engagement with the entity, however, the audit team mentioned only as a formality in the checklist that there were no problems noted, and did not identify the engagement acceptance risks found through these inquiries, considering the risk of fraud. In addition, the team did not sufficiently examine concrete measures to reduce the risks expected in the event of acceptance of the audit engagement.
(Quality Control Standards Committee Statement No. 1, paragraph 26)
- ▶ The engagement partner who would take over an engagement from the predecessor auditor received a report from the predecessor auditor. This report indicated that "the top management of the entity was reluctant to record impairment losses because it strongly insisted on reporting profit on the bottom line" and that "a loan provided to a director in the past was not approved by the Board of Directors in a timely manner." Nevertheless, this engagement partner (prospective successor) did not assess these problems reported by the predecessor auditor to check the "integrity of the top management," 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)

Case 3: Availability of human resources

When the audit firm discussed whether to accept or continue an audit engagement for an entity, the audit firm knew the firm-wide lack of knowledge and experience necessary to perform audit procedures sufficiently and appropriately according to the audit risk specific to that entity. However, the audit firm accepted or renewed such an audit engagement without taking sufficient and appropriate action to supplement this deficiency.
(Quality Control Standards Committee Statement No. 1, paragraph 25; Auditing Standards Committee Statement No. 220, paragraph 11)

(2) Communications between Predecessor and Successor Auditors

Points of focus

In cases where auditors change, the information collected and obtained by the predecessor auditor in the course of performing audit engagement 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 necessary information 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 carries out communications in a timely and adequate manner in order to provide the 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 conduct 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 hand-over of the engagement;
- ▶ Whether the audit firm confirms that the hand-over is properly conducted, by having the audit team report the status of the communication to an appropriate department or a person who does not belong to the audit team.

Outline of inspection results

(Observed effective efforts)

Some effective efforts observed in our inspections were:

- A company changed audit firms during the fiscal year. The predecessor auditor passed on to the prospective successor auditor detailed information regarding the condition of this entity obtained in the course of its audit. This information included explanations about the content of notifications and other documents issued by the predecessor to the entity pursuant to Article 193-3 of the Financial Instruments and Exchange Act ("FIEA").
- In some audit firms, the quality control department checked whether the hand-over of an engagement from the predecessor to the successor auditor was properly conducted before accepting or terminating an audit engagement with a listed company or equivalent, by examining whether the engagement partner or equivalent had checked the document that recorded the results of inquiries made by the successor to the predecessor auditor and the status of the hand-over.

(Outline of identified deficiencies)

As shown in the case examples below, deficiencies were observed in some audit firms (many of them were small or medium-sized firms) regarding communication with the predecessor auditor, including failure to make appropriate inquiries.

(Analysis of causes of deficiencies)

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 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 predecessor 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 fully and clearly be communicated from the predecessor audit team to the successor audit team.

Case : Inquiries, etc. to the predecessor auditor

- ▶ A company terminated the contract with its auditor before its current fiscal year was closed. An

audit engagement with this company was proposed to another audit firm. This prospective client had more than one predecessor auditor: one that is still auditing the current year financial statements, and one that had completed the audit for the previous year. When considering whether to accept the proposed engagement, the prospective engagement partner made inquiries only of the former predecessor but not the latter predecessor.

(Auditing Standards Committee Statement No. 900, paragraphs 8 and 9)

- ▶ 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 executive officers and the predecessor auditor of the fund entity were the same as those of the other fund entity for which the firm had conducted audits for some periods, and because no significant information was notified from the predecessor auditor to the firm at the time of first acceptance of the engagement for the other fund entity for which the firm had continued audits for some periods.

(Auditing Standards Committee Statement No. 900, paragraphs 8 and 9)

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 directions and supervisions to audit practitioners so that they can fully utilize and exercise the knowledge and awareness acquired in the training in the audit field work.

Outline of inspection results

(Observed effective efforts)

Some effective efforts observed in our inspections were:

- The audit firm customized education/training programs to audit practitioners based on years of experience, etc. The firm also strove to improve the contents of the training, for example, providing not only classroom lectures but also training that included group discussions, such as the depth of required audit procedures and factors inhibiting adequate audit procedures.
- The audit firm provided case study training to audit practitioners with limited experience. Sample financial statements were used as education materials of the case study. These audit practitioners identified audit risks from the sample financial statements, created an audit plan and presented the results of their study to experienced partners.
- An audit firm provided training programs for part-time audit practitioners so that they could acquire knowledge of the same level as the full-time audit practitioners.

(Outline of identified deficiencies)

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 because they did not use specific case examples to explain the specific steps and the extent of procedures necessary for the audit, including the development of an audit plan based on a risk-based approach, the audit of accounting estimates, and group audit.

(Analysis of causes of deficiencies)

Causes of the deficiencies include: the PICOQC or equivalent entirely entrusted training of audit practitioners, including providing engagement-related knowledge, to the engagement partner(s) who provided direction and supervision in the field work. However, the engagement partner or equivalent did not give sufficient direction and supervision to the members of the engagement team, including timely and appropriate review of audit documentation prepared by the team. Not a few 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 kept an appropriate level of knowledge, etc. of audit engagements.

In addition, it was noted that, in some audit firms, the advice given and awareness enhanced during training programs were not successfully put into practice in audit field work. This suggests that audit firms face the challenge of how to enhance audit practitioners' professional skepticism and "sensitivity" regarding audit risks through training, etc.

Expected response

Audit firms must provide effective education and training in order to maintain and improve the

competence and capabilities of their audit practitioners including part-time audit practitioners, so that the advice and awareness obtained during training programs can be put into practice in audit field work. The efforts may include accurately understanding in which areas the audit practitioners do not have sufficient knowledge, and developing education/training programs based on this understanding and also fully taking into account the knowledge, experience and current competence and capabilities of the individual audit practitioners.

Case 1: Development of education/training systems

The audit firm did not have in place an education/training system developed with due consideration of experience of audit practitioners, the scope of their audit engagements, newly adopted audit standards and other factors. In addition, the audit firm did not make every effort to equally maintain and improve the quality of audits by its engagement teams. The audit firm did not, for example, take specific measures to share within the firm audit issues and audit techniques identified by each engagement team.

(Quality Control Standards Committee Statement No. 1, paragraph 28)

Case 2: Education and training of part-time members

Some audit firms did not provide part-time audit staffs assigned to major audit engagements with the training, including outside seminars, necessary to perform their duties, or take other measures to improve their performance levels.

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

Case 3: Effectiveness of training

- ▶ The audit firm had actively hired persons who recently passed the CPA certification examination. As a result, the firm had many less-experienced accountants. Nevertheless, the firm did not provide to these audit practitioners in-depth practical training on specific procedures 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. The firm did not provide training on audits that require special knowledge, such as the auditing of financial institutions, either.
(Quality Control Standards Committee Statement No. 1, paragraph 28)

- ▶ The audit firm explained to audit practitioners specific procedures for the audit of accounting estimates, self-assessment on loan losses and other audit practices, through training and other occasions. However, the specific procedures to be performed were not instructed clearly to audit practitioners. Moreover, the firm did not give sufficient directions and supervisions based on the review of audit documentation to confirm whether the procedures performed by audit practitioners were sufficient and appropriate or were properly recorded.
(Quality Control Standards Committee Statement No. 1, paragraph 28)

(2) Evaluation, Compensation, and Promotion

Points of focus

Audit firms are expected to design appropriate policies and procedures for compensation, performance evaluation, and promotion of personnel to ensure that a corporate culture is cultivated 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 a 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.

Outline of inspection results

(Observed effective efforts)

Some effective efforts observed in our inspections were:

- An audit firm established an assessment system that placed emphasis on whether individual members were able to demonstrate their abilities in the field work, rather than their abilities themselves.
- EQC reviewers evaluated performance of engagement partners in listed companies' audits. This included evaluation of "understanding of the entity," "knowledge of accounting," "audit competence and capabilities" and "partners' commitment in the engagement." Based on the result of this performance evaluation, the audit firm appointed engagement partners and provided education and training individually to partners with low evaluation.
- The firm linked partners' compensation with the quality level of their audit performance. Thus, the internal rules of the audit firm stipulated that the compensation for partners should be reduced if the quality of their audit performance was found to be extremely poor in the QC review or cyclical inspection, and compensation was reduced if the audit quality of a partner was determined to be poor by these reviews, while compensation of partners were increased when their audit performance were determined to be excellent as a result of inspection, etc. by external parties.

(Outline of identified deficiencies)

As shown in the case example section below, deficiencies were found in some audit firms (many of them were small and medium-sized firms) regarding the performance evaluation of audit practitioners, including a case where specific policies, etc. were not established as to how the quality of audit performance should be evaluated and how the evaluation results should be reflected in compensation or promotion.

(Analysis of causes of deficiencies)

Causes of the deficiencies include: compensation for audit practitioners being determined for a long period of time based on the subjective performance evaluation of them by the CEO or other top management in some audit firms (mainly small and medium-sized). In some audit firms, an evaluator of partners thought that there was no significant difference in the quality of the audit performance between the partners.

Expected response

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 1: Policies and procedures for evaluating audit practitioners

Some audit firms did not establish policies and procedures for the performance evaluation of audit practitioners and did not conduct performance evaluation of audit practitioners based on the quality of their audit performance.

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

Case 2: Policies and procedures to reflect the performance evaluation of audit practitioners in compensation and promotion

The audit firm had internal rules in place specifying that the evaluation of audit practitioners shall be performed by paying attention to the audit quality and the status of compliance with professional ethics. However, the compensation for each audit practitioner was determined in a situation where there were no specific policies or procedures established as to how the evaluation of the capability of audit practitioners should be reflected in their compensation and promotion.

(Quality Control Standards Committee Statement No. 1, paragraph 28)

(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 of professional standards, practical experience, and abilities, etc.

Outline of inspection results

(Observed effective efforts)

Some effective efforts observed in our inspections were: department and regional office managers of an audit firm appointed engagement partners based on the results of engagement team assessment performed by the EQC reviewer and the results of cyclical inspection provided by the quality control department.

(Outline of identified deficiencies)

As shown in the case example section below, deficiencies were observed in personnel assignment, including a case where an engagement partner was not properly assigned or an engagement team did not have appropriate members.

(Analysis of causes of deficiencies)

Causes for the identified deficiencies:

- 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;
- It became the firm's normal practice that an engagement partner assigned specific members as assistants to his/her audit team or that a person promoted from an assistant to a partner while engaging in the same audit team was appointed as its engagement partner without sufficient discussion.
- 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 professional knowledge, practical experience, and abilities, etc. required in accordance with the size and business of entities, and to establish a system for properly carrying out engagements to ensure the engagement team can spend sufficient time on audit engagements, for example, by monitoring the work load.

Case 1: Assignment of engagement partner

The audit firm did not correctly understand the QC competence and capabilities of the engagement partners and how much time they could spend on audit engagements. The audit firm did not sufficiently identify the audit risks for all entities based on their business environments and other relevant factors. Accordingly, in some audit engagements, engagement partners and/or EQC reviewers were not assigned based on their abilities or the time they could spend on the engagements.

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

Case 2: Composition of engagement team

- ▶ The engagement team members for a listed entity substantially consisted of three persons: the engagement partner and two junior accountants. Moreover, despite lacking sufficient competence/capabilities and experience to perform the audit procedures, the junior accountants were assigned to a task related to significant subject items. These facts indicated that sufficient time and human resources were not allocated given the audit risk involved.

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

- ▶ Engagement partners in effect personally employed and appointed audit staffs for their teams. Moreover, partners who had been promoted from audit staffs remained as engagement partners with the same engagement team. Thus, this audit firm did not check whether the persons appointed by engagement partners had the same competence and abilities necessary to conduct an audit perform audit engagements in accordance with the professional standards and applicable laws and regulations as their engagement team members.

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

(Outline of identified deficiencies)

In the CPAAOB's inspection, deficiency in terms of lack of appropriate audit procedures was found in many audit firms. Although accounting estimates made by the entity had conditions that might imply the risk of material misstatement, the audit documentation did not include the management assertions, e.g. management's estimates and assumptions, relevant audit procedures performed by the engagement team and the basis for the auditor's conclusion. Under such circumstances, these audit firms often did not conduct a complete review of audit documentation from the viewpoint of whether sufficient and appropriate audit evidence had been obtained for important matters.

(Analysis of causes of deficiencies)

Causes for the identified deficiencies:

- Audit practitioners did not fully recognize the importance of audit documentation.
- Engagement team did not fully verify whether audit documentation was prepared regarding to significant audit procedures before forming the audit opinion or assembling the final audit file.
- Some engagement partners did not review audit documentation nor provide sufficient attention because they placed too much confidence on sharing awareness of the entity issues and audit procedures to be performed among their engagement team.
- Some engagement partners did not provide sufficient direction and supervision to less experienced audit practitioners despite less experienced audit practitioners were in the majority due to frequent turnover of audit practitioners.

Expected response

Some firms did not prepare audit documentation so that the audit procedures taken for individual engagements could be grasped clearly. There were also many cases where the processes to reach an important conclusion were not recorded in 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, 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 and professional judgments leading to those conclusions.
- Audit practitioners must check the audit documentation as to whether the audit procedures performed are consistent with the purpose of the examination. The process of this checking and the results must be clearly indicated in the audit documentation.

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 each engagement 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 following deficiencies were observed concerning the preparation of audit documentation:

- The audit 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. Therefore, it could not be known what audit procedures were taken.
- The engagement team only added comments to the documents prepared by the entity. Audit procedures appropriate to the audit purpose were not taken.
- There were contradictions or inconsistencies in the examinations recorded in audit documents prepared by an engagement team.

(Quality Control Standards Committee Statement No. 1, paragraph 45; Auditing Standards Committee Statement No. 220, paragraph 16, Statement No 230, paragraphs 7, 8 and 10)

Case 2: Review of audit documentation

Engagement partners assumed that sufficient time was taken for implementing audit procedures and that audit staffs performed appropriate audit procedures. Therefore, the engagement partners did not conduct sufficient review of audit documentation, such as reviewing whether the procedures responsive to assessed risks related to important matters determined at the audit planning stage were appropriate, whether appropriate substantive procedures were performed corresponding to the risks, or, in particular, whether sufficient and appropriate audit evidence was obtained for accounting estimates.

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

(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;
- ▶ Whether the audit firm has the policies and procedures properly in place for audit documentation to ensure the 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

(Observed effective efforts)

Some effective efforts observed in our inspections were: the person in charge of quality control appointed at each regional office of an audit firm reminded engagement partners of the due dates for registration of the audit documentation for individual engagements twice a month. After such due dates passed, the person in charge of quality control promptly verified whether the engagement teams completed assembly of the final audit documentation and whether they were properly registered in the database.

As another example, the audit firm took measures to assign electromagnetic recording tags to audit files to protect and ensure the confidentiality, management, retention and retrievability of audit documentation.

(Outline of identified deficiencies)

As shown in the case example section below, deficiencies were observed in audit documentation, mainly in small and medium-sized audit firms. Some 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. Moreover, some firms only checked the audit documentation register and they did not perform physical inspection.

(Analysis of causes of deficiencies)

Causes for the identified deficiencies:

- The PICOQC did not take proper measures to ensure retention of audit documentation, including procedures to confirm their actual control and retention status. The PICOQC just assumed that they had no deficiencies.
- Audit practitioners did not fully realize that audit documentation plays an important role, such as in performing quality control operations at the audit firm and in explanations outside the firm.

Expected response

The PICOQC in each audit firm needs to re-examine the condition of the final assembly of the audit file and the control and retention of the audit documentation. Audit firms must complete the final assembly of the audit file after the date of the auditor's report and by the proper due date. When controlling and retaining audit documentation, audit firms must 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 1: Final assembly of the audit file

The following deficiencies were identified concerning final assembly of audit files:

- The PICOQC did not establish specific procedures, the person in charge of implementation, and other related matters regarding the final assembly of audit files;
- The audit firm only provided an instruction that an engagement team shall record the names of audited entities, business year, and the number of audit files in the control register. The audit firm did not provide an instruction that an engagement team shall record the serial number of each audit file or brief explanations of the contents;
- At the stage of the final assembly, engagement teams did not fully confirm that they had

prepared and retained audit documentation related to audit procedures for significant or material account items. Accordingly, audit documents which were still in process were registered in the audit documentation control system.

(Quality Control Standards Committee Statement No. 1, paragraph 44)

Case 2: Retention of audit documentation

The following deficiencies were observed concerning the retention of audit documentation:

- The audit firm did not keep track of the number of audit files, the year prepared, the retention period, and other relevant matters;
 - The audit firm registered some quarterly review documents in the management ledger after the appropriate deadline although the assembly was completed before the deadline set forth in the internal rules (within 60 days from the date of review).
 - There was no control over the taking out of audit documentation outside the office. Periodical physical checking was not performed for several fiscal years' audit files stored in the document storage room within the audit firm before they were transferred to the storage house of the external warehouse operator or the storage room on the basement floor.
 - The audit firm did not conduct periodical physical inspection; instead it only kept an audit documentation register. It had too much confidence that the current control method was sufficient because no problems, such as the loss of audit documentation, had occurred in the past.
- (Quality Control Standards Committee Statement No. 1, paragraphs 45 and 46)

Case 3: Final assembly of audit files related to initial public offering of stocks

- ▶ An entity made an initial public offering of its stocks. The audit firm conducted audits of the financial sections on both "financial report for a new-listing application" and "securities registration statement" for the same year. In the audit engagement for this entity, the PICOQC instructed the audit team to perform the final assembly of the audit files related to the audit of such "financial report for a new-listing application" on the same day as the due date for the final assembly of the audit files related to the audit of the "securities registration statement." Because the date of the auditor's report for the "securities registration statement" was later than the date of the auditor's report for the "financial report for a new-listing application," the audit team did not perform the final assembly of the audit files for the "financial report for a new-listing application" for a long time.

(Quality Control Standards Committee Statement No. 1, paragraphs 44, 45 and 46; Auditing Standards Committee Statement No. 230, paragraph 13)

- ▶ For the audit files related to the initial public offering of stocks of an entity, the PICOQC of an audit firm could not specify the date of the auditor's report in advance for the "securities registration statement." Because the engagement team did not obtain information related to the date of the auditor's report, the measures established by the audit firm to prevent delay in the audit process did not effectively work. Accordingly, the final assembly of audit files related to several audit engagements of the "securities registration statement" was not completed by the due date in some audit engagements.

(Quality Control Standards Committee Statement No. 1, paragraphs 44, 45 and 46; Auditing Standards Committee Statement No. 230, paragraph 13)

6. Engagement Quality Control Review

Points of focus

Auditors, before expressing an opinion, must undergo an Engagement Quality Control Review (“EQCR”) concerning the expression of opinion in order to confirm that their opinions are appropriate and in accordance with generally accepted auditing standards.

The EQC reviewer is required to review the appropriateness and sufficiency of audit procedures performed by the engagement team critically and sufficiently by being fully aware that the EQC reviewer, from a standpoint independent from the engagement team, is expected to play the role of the “last line of defense” in reviewing them.

In consideration of the above, the CPAAOB inspects the appropriateness of review performed by the EQC reviewer from the following perspectives:

- ▶ Whether a person with 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 proposed audit report, etc.
- ▶ Whether the EQC reviewer examines the appropriateness of the evaluation of the engagement team members’ independence, the necessity of consultation with expert 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.
- ▶ Whether the following matters are properly documented, the procedures required in the review policy of the audit firm are performed, the review is completed before the date of the auditor’s report, and no significant audit judgments and conclusions reached that are determined to be inappropriate.

Outline of inspection results

(Observed effective efforts)

Some effective efforts observed in our inspections were: some audit firms had a council consisting of partners other than engagement partners and the EQC reviewers review significant audit matters and items with high audit risk through consultation in addition to ordinary review by the EQC reviewers.

(Outline of identified deficiencies)

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 related to significant matters and its judgment process, from a critical viewpoint; the EQC reviewer could not discover or prevent deficiencies in the important audit procedures in individual engagements. Audit firms still face the challenge of enhancing and strengthening their EQCR system. There also were cases of deficiencies where an EQC reviewer having abilities corresponding to the audit risk was not appointed.

(Analysis of causes of deficiencies)

Causes of the identified deficiencies include:

- An EQC reviewer having sufficient knowledge and experience corresponding to the audit risk was not appointed;
- 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 firm did not take actions to recruit or develop a person qualified as an EQC reviewer;
- 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 realize that the important judgments made by the engagement team and the sufficiency and appropriateness of their audit procedures should have been assessed from an objective viewpoint;

- 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 cases entrusted 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.
- The engagement team did not understand the necessity to be objectively assessed by the EQC reviewer regarding the sufficiency and appropriateness of audit procedures performed by audit practitioners.

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 and critical standpoints, by taking into account not only business activities and changes of business performance of the entity, but also 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 in depth from a critical standpoint 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 played a role as the 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 in depth. 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 the EQC reviewers, since some audit firms did not take any measures to improve the capability of EQC reviewers other than training and did not inspect the eligibility of them.
(Quality Control Standards Committee Statement No. 1, paragraph 38)
- ▶ The audit firm did not appoint partners who had knowledge and experience in accordance with audit risk as the EQC reviewer to review audit engagements with high audit risk. Consequently, the monitoring of the EQC reviewer over the engagement team did not work properly.
(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 other EQC reviewers, that EQC reviewer could not take sufficient time for 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 perform critical and in-depth reviews of important audit-related judgments made by engagement teams based on audit documentation, by confirming whether the engagement teams' explanations about important audit areas, such as risks requiring special consideration, and audit procedures for important accounting estimates, were supported by sufficient and appropriate audit evidence.
(Auditing Standards Committee Statement No. 220, paragraph 19 and 20)

- ▶ The EQC reviewer assumed, from the daily communications with engagement teams, that the audit procedures performed by the teams were sufficient and appropriate. Thus, the EQC reviewer only received explanations from engagement teams and confirmed their conclusions by checking the audit documentation, but did not review to confirm whether the audit procedures taken by the engagement teams were based on sufficient and appropriate audit evidence. (Auditing Standards Committee Statement No. 220, paragraphs 19 and 20)

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

For important problems found by the EQC reviewer in the review, the EQC reviewer only received explanations from the engagement team about additional procedures and the final audit-related 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 and 42)

Case 4: Entrusted review

The engagement partner verbally explained the process and conclusion of audit judgments that they themselves considered important to the external CPAs who were contracted to perform EQCR (external EQC reviewers). However, the engagement partner did not explain the details of the audit procedures that they carried out for the items deemed high in audit risk. In addition, the engagement partner merely verbally provided the external EQC reviewers with a brief summary of improvement recommendations and deficiencies identified in the QC review, but did not provide to each EQC reviewer a written document containing the improvement recommendations, etc.

Therefore, the external EQC reviewers undertook their work without sufficiently examining the appropriateness of audit procedures based on the audit documentation. As they also did not review the audit engagements based on the improvement recommendations, etc., the external reviewers did not identify or point out material deficiencies in the audit engagements. (Quality Control Standards Committee Statement No. 1, paragraph 34)

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

Points of focus

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

In consideration of the above, the CPAAOB inspects whether ongoing inspections are effectively functioning from the following perspectives:

- ▶ 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 with the engagement team 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

(Observed effective efforts)

Effective efforts observed in our inspections were: some audit firms tried to improve the quality of individual engagements by not only reviewing the appropriateness of risk assessment and sufficiency and adequacy of audit procedures related to important audit-related issues in audit engagements deemed to contain high audit risk during a period, but also encouraging the engagement team to appropriately respond to deficiencies in the audit procedures discovered during the inspection by the date of the auditor's report.

(Outline of identified deficiencies)

As shown in the case example section below, there are cases where practitioners responsible for ongoing monitoring and cyclical inspection (including external practitioners) failed to perform effective monitoring and inspection or cases where the audit firm did not take appropriate improvement measures for deficiencies found in the inspection.

(Analysis of causes of deficiencies)

Causes of the identified deficiencies include the following problems:

- Qualified persons with knowledge and experience appropriate for audit risks and other characteristics of audit engagements to inspect were not appointed as cyclical inspection practitioners;
- The PICOQC entrusted cyclic inspections to a third-party certified public accountant but only instructed the CPA to perform inspection by using a checklist as a formality.

- The PICOQC did not give appropriate instructions to the person in charge of cyclic inspections and the engagement team regarding improvement measures.
- The person in charge of cyclical inspection did not realize that cyclical inspections were necessary to assess the sufficiency and appropriateness of the audit procedures from a critical standpoint;
- (Especially at small and medium-sized audit firms) cyclical inspection practitioners did not recognize the importance of cyclical inspections or spend sufficient time inspecting due to the burden of a heavy workload;

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's inspection and the QC review; and they also need to have eligible cyclical inspection practitioners perform in-depth inspections in addition to formal inspections conducted according to the checklist designated by each firm 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 designated by internal rules as a formality and within an extremely short period of time. The PICOQC did not perform specific inspections, such as confirming internal rules and documents pertaining to QC-related work. Therefore, deficiencies were overlooked in the system of QC. For example, the completeness of targets for independence checks was not secured at some audit firms. Other firms didn't ensure that procedures relating to accepting new audit engagements were compliant with the internal rules and regulations.
(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 members 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: Selection of targets for cyclical inspection

The internal rules of an audit firm stipulate that target engagements to be inspected should be selected so that the audit engagements performed by each engagement partner are inspected once every three years. However, there were some partners of which any engagements had not been inspected for more than three years.
(Quality Control Standards Committee Statement No. 1, paragraph 47)

Case 3: Effectiveness of cyclic 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 inspection. 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 in-depth inspections of whether the audit plan had been developed based on a risk-based approach. He did not perform in-depth inspection of the

audit of accounting estimates, either. As a result, the person in charge of cyclic inspection failed to find deficiencies discovered in the QC review. Thus, the firm could not find and 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 QC department did not follow up on the improvement status of the engagement team.

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

- ▶ The engagement team performed additional audit procedures as corrective measures against the deficiency found in the cyclic inspection. The QC department did not sufficiently inspect the audit documentation to confirm 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)

Case 4: Eligibility of the external CPA who performs cyclic inspections for the audit firm

An audit firm entrusted cyclic inspections to an external CPA. The firm did not completely check the eligibility of the external CPA. For example, the firm selected an external CPA who had never been engaged in the audit engagement of listed companies in the capacity of an engagement partner or equivalent, or who had not been engaged in audit engagements in the last two years or so.

(Quality Control Standards Committee Statement No. 1, paragraph 47)

Case 5: Effectiveness of cyclical inspection by external CPA

The audit firm appointed an external CPA with limited auditing experience as the entrusted practitioner in charge of cyclical inspection, and did not give a specific explanation about the audit procedures performed for the items deemed to be of high audit risk to the said practitioner. In addition, the said practitioner performed cyclical inspection only as a formality according to the checklist. Moreover, the practitioner did not inspect the audit documentation or perform other specific procedures.

As a result, in the course of cyclical inspection, the practitioner indicated only formal deficiencies—for example, omissions of the date of audit procedure performed—in the audit documentation, but did not indicate essential deficiencies such as those related to the engagement team's insufficient procedures regarding judgment on the necessity of recognizing the impairment loss of long-lived assets.

(Quality Control Standards Committee Statement No. 1, paragraph 47)

8. Joint Audit

Points of focus

In the case of joint audits with other audit firms, audit firms are also required to reasonably ensure audit quality.

For this reason, the CPAAOB inspects cases of joint audit from the perspective of whether the audit firms confirm that the quality control systems of the joint auditors can reasonably ensure audit quality.

Outline of inspection results

(Outline of identified deficiencies)

As shown in the case example section below, there were deficiencies including those in the audit procedures missed by the partner firm in a joint audit.

(Analysis of causes of deficiencies)

Causes of the identified deficiencies include the audit firms' over-dependency on the conclusions provided by their joint audit partner firm without sufficiently examining the appropriateness, etc., of the audit procedures performed by the joint audit partner firm.

Expected response

Audit firms need to secure the quality of joint audits, for example, by reviewing the other partner audit firms' quality control systems.

Case: Review of procedures performed by other joint audit partners

As part of mutual inspection prescribed in the joint audit agreement, the auditor obtained copies of the audit documentation related to specific audit procedures performed by the other joint audit partner firm, such as an audit of accounting estimates and substantive procedures. However, because of poor review of the related audit documentation, the auditor overlooked deficiencies in the audit procedures performed by the other joint audit partner(s).

(Quality Control Standards Committee Statement No. 1, paragraph 61)

9. 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 timely sharing information identified during audits, 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 inspection of the explanations about the QC review on the audit firms, which the audit firms reported to those charged with governance, there were many cases where audit firms only gave a conclusion verbally instead of in writing, saying "no material deficiencies were identified in the QC review," because the overall QC review conclusion was satisfactory with improvement recommendations.

Some audit firms notified to the entity the fact that QC review was held but did not notify the review results because the person 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 the 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 that "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 and implementation of the audit plan, 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's inspection and the QC review. It is important to work toward securing and enhancing audit quality, and in turn improve and strengthen the corporate governance of the entity.

It should be noted that the Audit 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 results of the QC review or the CPAAOB's 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's 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 Fraud/Illegal Act Discovered

Points of focus

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). By giving such notice appropriately, the auditor is expected to conduct the audit based on its stronger position in relation to the entity.

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 fraud or illegal act discovered.

Outline of inspection results

(Observed effective efforts)

Some effective efforts observed in our inspections were: when regulations regarding responses to facts discovered 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 to those charged with governance of the entity in case of discovery of facts such as 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 discovering any deficiency during audit that may affect the appropriateness of financial statements, audit firms should respond to such deficiency by requiring correction, including reviewing whether to give notice under Article 193-3 of FIEA.

III. Individual Engagements

Audit Engagement Performance

Summary

The examples of identified deficiencies in Individual Engagements identified during the CPAAQB's inspections broadly cover audit planning through to formulating of the reports.

This section, "III. Individual Engagements," explains those deficiencies with a composition similar to the Auditing Standards Committee Statements. This part also contains separate items that introduce the areas where many deficiencies were identified: audits of accounting estimates; audits of financial institutions, on which emphasis is placed as audit engagement by industry; fraud in financial statement audits for which more cautious responses are needed in accordance with the Fraud Risk Response Standard; and audits of internal control over financial reporting, in which different audit standards are applied from those applied for audits of financial statements.

In addition, 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 for future engagements.

Meanwhile, there were still many examples of identified deficiencies where the results of audit procedures performed and audit evidence obtained were not contained in the audit documentation. As described in "5. Audit Documentation" of "II. Quality Control System," it is necessary to describe the audit procedures performed, the results of audit procedures performed, audit evidence obtained, the conclusions of the audit practitioner, and the reasons for the professional judgment made to reach the conclusions in the audit documentation. If the audit documentation contains no descriptions of the audit work performed by auditors and the conclusions therefrom, the work and conclusions cannot be well supported merely by verbal explanation. It is of particular note that in most of the examples of deficiencies in the preparation of appropriate audit documentation, it was regarded that the required audit procedures had not been carried out, rather than a case of failure to create the necessary documents.

Analysis of causes of deficiencies

Immediate causes of the identified deficiencies contained in "III. Individual Engagements" are classified broadly into the following two groups: (i) Problems with the audit practitioner and (ii) Problems related to the operation of the audit firm.

(i) Problems with the audit practitioner

- ▶ The audit practitioner assessed risk by sticking to past audit experience without precisely recognizing the change of business environment of the entity, resulting in insufficient risk assessment, overlooking indicators of the risks of material misstatement and fraud, and insufficient or inappropriate procedures to address those risks.
- ▶ The audit practitioner did not undertake a substantial examination because he or she did not

appropriately understand the purpose of the accounting standards and the audit standards nor had enough experience in audit engagements. The practitioner only prepared audit documentation as a formality using the templates provided by the audit firm or the JICPA.

- ▶ In auditing accounting estimates, the audit practitioner did not demonstrate the attitude of professional skepticism that is critical to assessment. Even though there were uncertainties in the estimates, the practitioner only verified the entity's assertion by inquiry instead of using other procedures, such as examining specific evidence.
- ▶ The engagement team did not perform audit engagements appropriately because there was a lack of direction and supervision by the engagement partner or equivalent over the members of the engagement team, including timely and appropriate review of audit documentation.
- ▶ The EQC reviewer did not fully review the important audit-related judgments and auditors' opinions from an objective and critical standpoint as a third party outside the engagement team.

(ii) Problems related to the operation of the audit firm

- ▶ The audit firm did not appoint the audit practitioners (including the engagement partner) and the EQC reviewer appropriate to the audit risk of the entity.
- ▶ The audit firm was not able to recognize whether appropriate audit procedures were performed on significant audit matters because cyclical inspections to review the quality of audit engagements were performed as a formality and lacked effectiveness.
- ▶ The audit firm did not take any firmwide action to improve the quality of audit engagements because it considered deficiencies identified in the CPAAOB's inspection and the QC review as minor problems only applicable to the specific engagements with findings.

Expected response

Audit practitioners should renew the awareness of their social responsibility as an auditor and develop their expertise and accumulate knowledge that can be obtained through practical experience, etc., as professional experts because their basic attitude as an auditor will be questioned in the event that deficiencies arise from the causes mentioned above.

The engagement partners should confirm that they are responsible for supervising engagement team members, considering their competency and experience in performing audit engagements sufficiently and appropriately, and should proactively engage in every phase from audit planning through forming of opinions.

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

In addition, if deficiencies are identified by the CPAAOB's inspection, the QC review, and cyclical inspection, they should be assessed and reviewed not only by the engagement team receiving the

findings, but also by other engagement teams within the audit firm which should assess and review such identified deficiencies just as though they had occurred in their own audit engagements.

1. Risk Assessment and Response to Assessed Risks

Points of focus

Risk assessment and response to assessed risks are particularly important procedures in audit engagements. The CPAAOB performs inspections from the following perspectives:

- ▶ Whether the engagement team performs appropriate assessment of the risks of material misstatement at the financial statements as a whole and at the assertion level when it develops an audit plan, considering the business environment, the structure of corporate governance, and business risks of the entity, instead of merely completing templates provided by the audit firm or the JICPA;
- ▶ Whether the engagement team takes into account, when it identifies significant risks, not only fraud in revenue recognition but, for example, significant irregular transactions for the entity and matters dependent on significant judgments including accounting estimates;
- ▶ Whether the engagement team sufficiently understands the substance of the entity and the transactions including business rationale, appropriately evaluates potential risks, and develops audit procedures that respond to such risks;
- ▶ Whether the engagement team determines the nature, timing, and extent of procedures taking into account the risks of material misstatement temporarily assessed when developing a detailed audit plan related to substantive procedures; and in particular, whether the engagement team considers the performance materiality instead of the materiality for the financial statements as a whole when determining the extent of procedures;
- ▶ Whether the engagement team understands relevant internal control regarding significant risks;
- ▶ Whether the engagement team develops audit procedures not only to discover material misstatements individually but to develop procedures considering audit risks that the aggregate of individually immaterial misstatements may cause the financial statements to be materially misstated.
- ▶ Whether the engagement team develops an audit plan suited to the IT use status considering the influence of the IT used by the entity on the audit.

Outline of inspection results

There were many examples where the engagement team did not develop substantive procedures addressing risks in assessing risks and responding to assessed risks; and where substantive procedures at the end of the fiscal year were not sufficient and appropriate because the engagement team did not revise an audit plan in a timely manner when, for example, the business environment of the entity changed. In particular, there were several cases where the engagement team merely completed templates, such as the “audit tool” and the “documentation sample forms” provided by the audit firm or the JICPA, and did not yet perform appropriate risk assessment taking into account changes in the

business results of the entity and business activities, such as reorganization. There were also cases where the procedures actually taken in response to assessed risks differed from the audit plan developed by using audit tools; the engagement team merely followed the procedures in response to assessed risks in the previous fiscal year, without properly reflecting identified risks in the audit plan. These deficiencies were caused because the audit firm did not fully understand the entity and its business environment, or because the firm assumed that it fully understood the entity and its business environment from the past and continuing involvement in audit engagements for the entity, and thus underestimated the new risks generated from the change in the business environment.

In addition, there were still 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, though the engagement team needed to understand the use of IT at the entity in identifying and assessing the risk of material misstatement.

Expected response

Audit practitioners should note that they must pay due attention and exercise professional skepticism, when identifying and assessing audit risks, referring to this Case Report and the Audit Proposals issued by the JICPA without placing too much reliance on the past audit experience. In addition, when developing the responses to audit risk, they should carefully examine whether the procedures in response to 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 procedure.

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

(1) Audit planning

Case 1: Involvement of key engagement team members

The engagement partner was not involved in developing an audit plan. Specifically, for example, the partner did not discuss the possibility of material misstatement in the group financial statements with the key engagement team members.

(Auditing Standards Committee Statement No. 300, paragraph 4)

《Points to Note》

The engagement partner and other key members of the engagement team shall plan direction and supervision of the engagement team members and the nature, timing and extent of the review of their work. In addition, the engagement partner and other key engagement team members shall discuss the susceptibility of the entity’s financial statements to material misstatement, and the applicable financial

reporting framework to the entity's facts and circumstances. Meanwhile, this discussion shall place particular emphasis on how and where the entity's financial statements may be susceptible to material misstatement due to fraud, including how fraud might occur.

Case 2: Detailed audit planning

The engagement team did not appropriately design audit procedures to respond to the assessed risks of material misstatement at the assertion level, because the engagement team did not clarify the nature and extent of substantive analytic procedures and tests of details.

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

《Points to Note》

There were cases where the firm simply followed the audit procedures used in past years as a formality and did not develop an adequate audit plan which specified the types of audit procedures and other details that should be taken by individual 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 types 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.

Case 3: 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 in the previous fiscal year.

However, the engagement team did not revise the audit plan, 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 despite the changes in business activities due to the reorganization of the entity, or the delinquency of significant accounts receivable and slow-moving and obsolete inventories, the engagement team did not consider the necessity of updating and changing the audit risk assessment and making other updates in the audit plans. If an engagement team recognizes any 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.

Case 4: Additional considerations in the initial audit

When conducting an audit in the first year of engagement with an entity, the engagement team did not reflect in the audit plan information obtained from the predecessor auditor or audit risks identified through the acceptance procedures within the firm.

(Auditing Standards Committee Statement No. 300, paragraph 12; and No. 315, paragraphs 6 and 8)

《Points to Note》

In the first year of an audit engagement, engagement teams should make sure that the audit plan for the first year properly reflects the audit risks identified in the process of accepting the new engagement, including major problems identified through communication from the predecessor auditors or discussions with the management of the entity to be audited.

(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 entity operated several businesses. Under such circumstances, the engagement team collectively identified single risk of material misstatement related to revenue at the assertion level. The team did not identify risks of material misstatement of each business at the assertion level considering differences in the revenue recognition policies, the revenue transactions, and the relevant internal control of individual businesses.

(Auditing Standards Committee Statement No. 315, paragraphs 10 and 25)

- ▶ As the engagement team collectively assessed single risk regarding selling, general and administrative expenses instead of assessing by the class of transactions when it developed the audit plan, they did not design audit procedures for these individual accounts, although there were accounts with material account balances and ones with deemed higher audit risk, such as rebates and sales promotion expenses.

(Auditing Standards Committee Statement No. 315, paragraph 10 and 25)

《Points to Note》

As shown in the above example of identified deficiencies, 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 control when identifying and assessing those risks. There were also cases where the audit firm understood the individual businesses of each reporting unit of the entity, including its subsidiaries, but did not understand these businesses and their commercial distribution at the group level. The engagement team should note that they need to identify and assess the risks of material misstatement, by the classes of transactions for example,

based on information obtained through an understanding of the entity and its environment including internal control, since the type of effective audit evidence differs, even in the same account, according to the type of transaction.

In another case, the audit firm did not sufficiently examine the adequacy of the revenue recognition basis of the entity, based on the states of the entity's transactions. When understanding an entity and its business, the audit firm should note that it must understand the basis of revenue recognition and other accounting policies of the entity, and must assess each year whether those accounting policies are still appropriate for the current business condition of the entity.

Case 2: Identifying and assessing risk of material misstatement

- ▶ When assessing the risks of material misstatement, the engagement team did not undertake assertion-level assessment procedures on the existence or the cut-off for each account.

(Auditing Standards Committee Statement No. 315, paragraph 24)

- ▶ The audited entity had some conditions that might imply fraud risks or the risk of devaluation of assets due to operating losses for consecutive years. Nevertheless, the engagement team did not perform necessary assessment corresponding to the conditions of the entity, regarding the determination not to recognize the evaluation of assets and other accounting estimates made by the entity as a significant risk.

(Auditing Standards Committee Statement No. 315, paragraphs 26 and 27; and No. 540, paragraph 10)

- ▶ Although the engagement team recognized there were unusual transactions with related parties around the end of the fiscal year, they did not consider whether the risk of material misstatement due to the related party transactions identified were a significant risk.

(Auditing Standards Committee Statement No. 315, paragraphs 26 and 27)

《Points to Note》

There were several audit engagements in which many deficiencies were pointed out regarding substantive procedures. The reasons include: the engagement team failed to perform sufficient and appropriate risk assessment in audit planning and procedures responsive to the audit plan. Specifically, for example, the engagement team only recognized fraud risk in revenue recognition as significant risk, and although they identified uncertainty in accounting estimates and significant transactions that were out of the normal course of business, they did not carefully consider whether these events should be determined as significant risks. The engagement team should note that they need to identify and assess the risks of material misstatement through an understanding of the entity and its environment, fully considering significant irregular 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 accounting estimates and related party transactions as significant risks at the assertion level, they did not obtain an understanding of the entity's internal controls, including control activities, relevant to these risks.

(Auditing Standards Committee Statement No. 315, paragraph 28)

(3) Materiality when planning and executing the audit

Case 1: Materiality when planning the audit

Although there were no significant changes in the business circumstances of the entity in the current year, the engagement team changed benchmarks for calculating the materiality as a whole from net income before taxes to net sales. Consequently, the materiality calculated for the current year largely increased from the previous year.

However, the engagement team did not sufficiently consider the rationale for changing benchmarks for calculating the materiality in the current year and appropriateness of the level of materiality.

(Auditing Standards Committee Statement No. 320, paragraph 9)

Case 2: Revision as the audit progresses

Although the actual ordinary income turned to be substantially different from the anticipated one that was used initially to determine materiality for the financial statements as a whole, the engagement team did not examine the necessity of revising the materiality.

(Auditing Standards Committee Statement No. 320, paragraph 11)

《Points to Note》

The engagement team should note that they need to carefully examine the needs for financial information including matters to which users of the entity's financial statements pay attention, the business environment of the entity, and the relative stability of the benchmark when they choose benchmarks used for determining materiality and the percentage applied to individual benchmarks, because the engagement team's determination of materiality was a matter of professional judgment.

(4) The auditor's responses to assessed risks

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

- ▶ When determining the types of procedures responsive to assessed risks related to net sales, and the timing and scope of the procedures, the engagement team had a policy of performing double-purpose tests that would satisfy both the purposes of the test of controls and the substantive procedures. However, the audit plan was not developed enough to obtain sufficient and appropriate audit evidence for substantive procedures.

(Auditing Standards Committee Statement No. 330, paragraph 6)

- ▶ When designing audit procedures responsive to assessed risk for important accounts related to purchasing expenses, such as shipping costs and storage costs, and selling and general administrative expenses, the engagement team developed an audit plan to perform the tests of controls and to rely on those operating effectiveness. However, only the payment process was assessed, and the process for recognizing expenses was not included in the tests of controls. (Auditing Standards Committee Statement No. 330, paragraph 6)

- ▶ The engagement team did not plan substantive procedures for quantitatively material accounts. (Auditing Standards Committee Statement No. 330, paragraph 17)

《Points to Note》

When designing audit procedures responsive to assessed risk, auditing firms should develop an audit plan that ensures obtainment of sufficient audit evidence corresponding to the material misstatement risks at the assessed assertion level, considering the types of related transactions, the characteristics of the account balances, and the relevant controls.

The engagement team should also note that it must design and perform substantive procedures for each material class of 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 internal control, including management override.

Case 2: Substantive procedures responsive to significant risks

- ▶ The engagement team identified overstatement of net sales as a significant risk, and associated it with cut-off, accrual and accuracy as relevant assertions.
 However, the engagement team only designed an audit plan to check the balance of the accounts receivable as of the closing day of the fiscal year and to perform a cut-off test on transactions before and after the closing day of the fiscal year. The team did not design substantive procedures for the occurrence and accuracy of sales transactions throughout the year corresponding to the sales overstatement risk. (Auditing Standards Committee Statement No. 330, paragraph 20)

- ▶ The engagement team identified a fraud risk in the construction revenue of a branch office of an entity which was not included in the scope of the entity's internal audit. The team also identified a significant risk with respect to the assertions of occurrence and cut-off.
 However, the team did not perform tests of details for a completed construction project in which construction revenues significantly exceeding the budget of the branch office. (Auditing Standards Committee Statement No. 330, paragraphs 17 and 20)

《Points to Note》

If the engagement team assesses that a risk of material misstatement is high, including significant risk, it should increase the volume of the evidence and obtain more relevant and reliable evidence for more persuasive audit evidence.

In addition to the identified deficiencies mentioned above, examples of substantive procedures responsive to assessed risks of material misstatement due to fraud, such as accounting estimates and revenue recognition, are described in “3. Auditing Accounting Estimates” and “6. The Auditor's Responsibilities Relating to Fraud in Financial Statement Audit.” Please refer to them accordingly.

Case 3: Substantive procedures related to the financial statement closing process

- ▶ Since the engagement team had not developed a detailed audit plan for examining segment information, the engagement team only verified the amounts in the underlying data provided by the entity against the consolidated balance sheet and income statements. The engagement team did not perform any procedures to verify the accuracy of each segment's result and elimination of intersegment transactions / balances.

(Auditing Standards Committee Statement No. 330, paragraph 19; No. 501, paragraph 12)

- ▶ Since the engagement team had not developed a detailed audit plan for examining the consolidated cash flow statements, the engagement team only performed analytical procedures by comparison with the previous year. The engagement team did not examine consistency with other financial statements or the adequacy of consolidated cash flow journal entries.

(Auditing Standards Committee Statement No. 330, paragraph 19)

Case 4: Adequacy of presentation and disclosure

- ▶ The engagement team overlooked the fact that the entity did not disclose in its annual securities report the exercise of stock acquisition rights by major shareholders of the entity as transactions with related parties.

(Auditing Standards Committee Statement No. 330, paragraph 23)

- ▶ In an entity audited by the firm, renovation costs recurrently accrued in connection with its sales activities because of the characteristics of its business. Despite this, the engagement team for the entity did not examine the adequacy of the presentation of the renovation costs (the entity recorded the renovation costs of sales offices as extraordinary losses).

(Auditing Standards Committee Statement No. 330, paragraph 23)

- ▶ The engagement team did not examine the underlying materials for notes to financial statements.

(Auditing Standards Committee Statement No. 330, paragraph 23)

《Points to Note》

Other than above, there were cases where the engagement team did not examine the adequacy of the segment classification, or where the engagement team overlooked an error in the presentation on a cash flow statement. Many deficiencies were found in the presentation and disclosure. Engagement teams should design and perform audit procedures to examine whether the overall presentation of financial statements, including related disclosures, comply with the applicable financial reporting framework.

(5) 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

Although the engagement team recognized that the entity used an external operator's (service organization) system as the main system to process key operations including recording sales, the engagement team did not develop procedures to understand the services provided by the external operator and its internal control.

(Auditing Standards Committee Statement No. 402, paragraphs 8 and 9)

Case 2: Audit evidence regarding the internal control operation of the service organization

The entity audited by the audit firm uses a network developed by a service organization as an IT system for its important business processes. The entity had obtained the auditor's report on a description of the service organization's system and the suitability of the design and 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 evaluate the design and implementation 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 audits of internal control over financial reporting.

Since the cloud migration of systems has been progressing recently, audit firms must often judge which of the client 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 client. 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.

(6) Evaluation of misstatements identified as the audit progresses

Case 1: Examination of identified misstatements as the audit progresses

- ▶ In the examination of variances identified in the external confirmation procedures for the accounts receivable, the engagement team detected an error in the entity's process. However, the team did not perform analysis of the cause of the error.

In response to the detection of that error, the engagement team did not consider whether the risk assessment of net sales and the accounts receivable or the substantive procedures originally planned for the remaining period should be changed. The 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)

- ▶ The engagement team did not consider whether the number of samples reflecting the sampling risk and other audit procedures need to be revised, although the aggregate of misstatements during the audit approaches materiality.

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

Case 2: Evaluating the effect of uncorrected misstatements

- ▶ The engagement team did not evaluate the effect of the uncorrected misstatements on the account balances and financial statements as a whole, although they identified many uncorrected misstatements.

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

- ▶ The entity corrected immaterial past-year misstatements in the current year's financial statements. However, the engagement team did not evaluate whether restatements of the prior years' financial statements were necessary, by accumulating not only the corrected prior years' misstatements but also other past uncorrected misstatements. Additionally, the team did not evaluate the impact that the correction of these prior years' misstatements made on the current year's financial statements, either.

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

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

Case 1: Development of an audit plan for the use of IT systems

- ▶ The engagement team did not examine the appropriateness of deductions of internal profit because they were calculated by the IT system. However, the team had not examined the operating effectiveness of the IT system for five years.

(IT Committee Practical Guidelines No. 6, paragraph 6)

- ▶ The overseas subsidiary of an entity is a significant component having independent financial significance. Despite this, the engagement team did not take actions to understand the general structure of the subsidiary's IT systems, such as the IT infrastructure and the network structure.

(IT Committee Practical Guidelines No. 6, paragraphs 4 and 8)

《Points to Note》

Business enterprises use information systems for their business operations. By understanding the status, characteristics and operation of information systems of the entity, the engagement team can properly identify and assess 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 because the entity used IT systems 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 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 account closing process, are reflected in or associated with the IT systems.

Case 2: Evaluation of the accuracy and completeness of information generated by the information system

In performing substantive procedures about overdue accounts receivable and slow-moving and obsolete inventories, the engagement team planned to use the lists containing such overdue information generated by an information system, but had not developed a detailed audit plan to verify the accuracy and completeness of these lists.

(Auditing Standards Committee Statement No. 500, paragraph 8; IT Committee Practical Guidelines No. 6, paragraph 41)

《Points to Note》

When using various lists generated by the entity's information system for the test of controls or substantive procedures, the engagement team shall evaluate 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 a considerable time to complete the audit. Therefore, the engagement team should note that they need to develop an audit plan for the above procedures at an early phase.

2. Audit Evidence

Point 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; not only focuses on the quantitative sufficiency of audit evidence;
- ▶ Whether the engagement team performs in-depth further audit procedures to reduce audit risk to an acceptably low level for significant risk;
- ▶ Whether the engagement team performs appropriate audit procedures in individual situations as tests of controls and substantive procedures;
- ▶ Whether the engagement team assesses if 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 obtaining sufficient audit evidence.
- ▶ 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 data to be used for developing expectations of recorded amounts, etc.
- ▶ Even though the assessed risk of material misstatement was high, the engagement team performed the tests of details only by obtaining the entity's internal vouchers and other less reliable audit evidence without assessing the quality of the obtained audit evidence.
- ▶ During sampling among 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 the 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 Audit.

Expected response

The engagement team needs to assess appropriately whether they have obtained enough audit evidence relevant to the purposes of audit procedures to respond to identified risks. Particularly, the team should assess whether the audit evidence obtained for significant risk is sufficiently relevant and reliable.

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. In many other cases, the engagement team appropriately performed risk assessment and design 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 risk assessment and audit procedures to be performed. The team should also comprehensively evaluate the sufficiency and appropriateness of audit evidence obtained through the audit procedures.

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 inventory valuation as a significant risk but performed no other audit procedures, simply relying on the entity’s affirmative reply to the engagement team’s inquiry on the sales potential of loss-making products and products with no past record of sales. Despite implying possible deterioration in the entity’s earnings capability, the engagement team concluded that there were no concerns over the entity's inventory valuation. (Auditing Standards Committee Statement No. 330, paragraph 25; and No. 500, paragraph 5)

- ▶ The engagement team designed audit procedures responsive to the assessed risk in combination with substantive analytical procedures and tests of details to examine the occurrence of sales.

However, the engagement team simply conducted a trend analysis of quarterly sales without setting the acceptable level of difference between expectation 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 for a full accounting period. The engagement team only checked the occurrence of sales 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)

- ▶ The engagement team did not examine the reasonableness of the method adopted by the entity for accounting cost variances and allocating indirect manufacturing costs for individual cost accounting.

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

«Points to Note»

Generally, inquiry alone neither proves that there is no material misstatement at the assertion level, nor means that sufficient audit evidence has been obtained; however, the engagement team completed audit procedures only by inquiry in many cases. The engagement team needs to perform procedures responsive to audit 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 to be obtained because the adequacy of evidence depends on the significance of assessed risk.

In one case, the engagement team performed multiple audit procedures, yet did not quantitatively or qualitatively obtain sufficient evidence in any procedure. As a result, the team did not obtain sufficient audit evidence to reduce audit risk as a whole to a low level.

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

The engagement team should not perform planned audit procedures routinely, but comprehensively evaluate events identified during the audit and the sufficiency and appropriateness of audit evidence obtained through multiple audit procedures.

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

- ▶ In an audit procedure to verify the occurrence of sales, the engagement team only matched the credit amount of accounts receivable and the payment records against accounts receivable for the fiscal year covered by the audit, and did not obtain relevant audit evidence.

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

- ▶ The engagement team identified the cut-off of sales as a significant risk, and performed external confirmation of accounts receivable as an audit procedure responsive to the risk. Through the confirmation, the team recognized a significant discrepancy from the customer response.
However, the engagement team verified subsequent cash receipt of only part of the receivable as a procedure to determine that the discrepancy was not a misstatement. The team did not perform audit procedures relevant to the assertion of the cut-off of sales, including agreeing shipment vouchers against acceptance certificates.
(Auditing Standards Committee Statement No. 330, paragraph 25; and No. 500, paragraph 6)

- ▶ The engagement team developed a plan to compare net realizable values and book values of inventories held for more than three months since the last purchase date for inventory valuation.
However, the team did not obtain relevant audit evidence since the samples the team examined mostly consisted of inventories held for less than three months since the last purchase date.
(Auditing Standards Committee Statement No. 330, paragraph 25; and No. 500, paragraph 9)

- ▶ In verifying the entity's occurrence of sales, the engagement team planned to implement sampling for the purpose of both tests of controls and substantive procedures.
However, the engagement team did not acquire audit evidence from substantive procedures, such as agreeing acceptance letters issued by customers of the audited entity with the transactions recorded in the sales summary. Instead, the team performed testing only by confirming that the sales summaries were sealed by relevant staff members.
Further, the engagement team did not evaluate whether the number of samples was adequate as audit evidence for tests of controls and substantive procedures.
(Auditing Standards Committee Statement No. 330, paragraph 25; and No. 500, paragraphs 5–6)

«Points to Note»

Like the examples of identified deficiencies mentioned above, the engagement team did not obtain audit evidence relevant to the audit purpose. In many other cases, the engagement team did not obtain appropriate audit evidence relevant to the assessed risks. 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 reliability and relevance of audit evidence in the planning and the execution of audit procedures.

When tests of controls were used as substantive tests (dual-purpose tests), the engagement team did not consider whether to satisfy the purpose of substantive procedures. When planning and performing

tests of controls and substantive procedures, the team should be aware of the necessity of evaluating whether tests are planned and performed considering the relevant audit purposes.

Case 3: Consistency between financial statements and audit evidence

- ▶ In external confirmation procedures of receivables and payables, the engagement team did not examine the consistency between financial statements and audit evidence, by, for example, checking the completeness of the population from which samples were extracted and verifying 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 which was used to select samples of 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

- ▶ The engagement team used an actuarial valuation report and a real estate appraisal report prepared by the entity's external expert as audit evidence for the valuation of the entity's retirement benefit obligations and rental properties, etc., but did not evaluate the competence, capabilities and objectivity of the expert.

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

- ▶ The audited entity utilizes an appraisal report prepared by a real estate appraiser to estimate the value of long-held real estate assets for sale.

However, the engagement team did not examine the real estate appraiser's objectivity, given the fact that most of his or her services are ordered by the entity.

Additionally, the entity had a development plan that had not been executed for more than five years nor was expected to progress further. The real estate appraiser included certain development plans in his or her assumptions for appraising the real estate assets above, but the engagement team did not verify the appropriateness of works of the management's experts.

(Auditing Standards Committee Statement No. 500, paragraph 7; Auditing and Assurance Practice Committee Statement No. 69, paragraph 2 (4), 4, and 5(1))

«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 materials 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 information contained in the list.

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

«Points to Note»

There were a number of cases, which 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)

Although the confirmation procedure and onsite inspection of inventory were performed at interim dates prior to the balance-sheet date, the engagement team did not perform substantive procedures including substantive analytical procedures, or tests of details regarding the overall population for the remaining period from the cut-off date to the balance-sheet date.

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

«Points to Note»

It should be kept in mind that when performing substantive procedures as of a cut-off date set before the balance-sheet date, additional audit procedures are required to cover the remaining period for extending the audit conclusions from the interim date to the balance-sheet date.

(2) External confirmation

Case 1: Reliability of responses to confirmation request

- ▶ In the confirmation procedure of the accounts receivable, the engagement team, despite the suspicious situation where a respondent of the confirmation request was different from the expected one, did not verify the reliability of the response by making inquiries to the respondent.

(Auditing Standards Committee Statement No. 505, paragraph 9)

- ▶ Although the engagement team received a reply to the confirmation letter from a party

different from the intended addressee, it did not perform an audit procedure to confirm the adequacy of the source of information and the reliability of the given response.

(Auditing Standards Committee Statement No. 505, paragraph 9)

«Points to Note»

External confirmation procedure generally provides strong audit evidence to auditors. Depending on the situation in which the information is obtained, such as responses via facsimile or email or responses by a person different from the auditor’s initial expectation, it is necessary to perform an audit procedure to confirm the reliability of the response and mitigate risks of falsification and fraud.

Case 2: Alternative audit procedures

- ▶ In confirming outstanding receivables and payables, the engagement team did not perform alternative procedures although some confirmation letters came back with “addresses unknown.”

(Auditing Standards Committee Statement No. 505, paragraph 11)

- ▶ In confirming outstanding receivables and payables, the engagement team received a reply from the addressee, giving neither a response agreeing or disagreeing with the amount that the team requested for confirmation, nor an answer of the addressee’s outstanding account balance. However, the team did not treat this as exception, and failed to perform necessary audit procedures including requesting additional confirmation letters and alternative procedures.

(Auditing Standards Committee Statement No. 505, paragraph 11)

- ▶ The engagement team identified the existence of accounts receivable as a significant risk. However, for counterparties that did not provide a reply, the team only agreed the amount with invoices issued by the entity, and did not perform alternative procedures to obtain more persuasive audit evidence such as checking against acceptance letters or other external evidences.

(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 are adequate and appropriate in view of the risks of material misstatement.

Case 3: Exception in relation to confirmation

- ▶ While there were exceptions beyond materiality in the accounts receivable confirmation procedure, the engagement team did not investigate those exceptions.
(Auditing Standards Committee Statement No. 505, paragraph 13)

- ▶ The engagement team did not obtain adequate audit evidence in order to determine whether the exceptions noted in the confirmation replies were a result of misstatements.
(Auditing Standards Committee Statement No. 505, paragraph 13)

- ▶ In confirmation of accounts receivables, the engagement team recognized exceptions due to timing differences of recognition of the transactions because the entity's counterparties had not completed receiving inspection. However, based on the assessment that the entity's internal control worked effectively, the team only agreed the differences with internal vouchers including sales slips, without examining the validity of replies with external vouchers.
(Auditing Standards Committee Statement No. 505, paragraph 13)

- ▶ As a result of investigating the cause of differences in relation to confirmation procedures, the engagement team identified a misstatement resulting from unrecognized returns and liabilities. However, the team did not evaluate the effectiveness of internal control, fraud risks and the impact thereof on the financial statements.
(Auditing Standards Committee Statement No. 505, paragraph 15)

«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 vouchers for the recognized material cause of the differences.

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: Requirements for substantive analytical procedures

- ▶ The engagement team selected substantive analytical procedures as substantive procedures for detailed accounts more than performance materiality of sales, cost of sales, and selling, general and administrative expenses. However, the team only ascertained reasons for change in items of accounts mainly through annual fluctuation and monthly fluctuation analyses, which did not meet requirement of substantive procedures. Consequently the team did not

perform substantive procedures.

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

- ▶ The engagement team selected substantive analytical procedures as substantive procedures for depreciation expenses. However, the team only performed annual comparison of depreciation expense ratios, which did not meet the requirements for substantive analytical procedures. The team did not perform substantive procedures, such as developing the auditor's expectation of depreciation expense or ratios.

(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 or the like 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 recorded amounts or ratios is developed, taking account of source, comparability, and nature and relevance of information available, and controls over preparation**
- (2) Develop the expectation of recorded 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 recorded amounts from expectation that is acceptable without further investigation**

Case 2: Identified deficiencies in substantive analytical procedures

- ▶ In performing substantive analytical procedures for sales, the engagement team did not perform audit procedures, including verification of budget development process, for examining the accuracy and reliability of the budget prepared by the entity when the team developed an expectation of sales and gross profits using those budgets.

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

- ▶ The engagement team planned to perform substantive analytical procedures for procedure responsive to assessed risk in relation to occurrence of sales.

However, while the engagement team used the financial forecast released by the entity as the auditor's expectation, the team did not examine whether the financial forecast was sufficiently precise to identify potential material misstatements individually or aggregated.

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

- ▶ In performing substantive analytical procedures for sales and cost of sales, thereby setting up a threshold to determine a difference of recorded amounts from the expected values that is acceptable without further investigation, if the percentage of difference is below threshold, the engagement team usually omitted further investigation. Therefore, the engagement team did not use the absolute amount of difference, regardless of the significance of the amount of difference.

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

«Points to Note»

In some cases, substantive analytical procedures met requirements stipulated in the audit standards on surface, but examinations as to the reliability of data and the accuracy of the expected value, which were necessary to reduce the audit risk at a minimum acceptable level, were not performed. For example, the engagement team used the actual previous period results and financial forecast as expectations without rational reasons 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 3: Investigation of results of substantive analytical procedures

- ▶ In substantive analytical procedures in relation to cost of sales, the engagement team, despite the difference between expected values and recorded values in excess of materiality, did not perform further investigation.

(Auditing Standards Committee Statement No. 520, paragraphs 4 and 6)

- ▶ The engagement team utilized the previous period unit prices when developing expectation in substantive analytical procedures for sales.

However, when analyzing difference between the expectation and recorded amount, the team only ascertained the facts of unit price change by inquiry and did not perform additional procedures including unit price variability analysis and analysis unit fragmentation to examine the reasonableness of the nature of variance.

(Auditing Standards Committee Statement No. 520, paragraphs 4 and 6)

«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 analyze quantitative differences 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.

Case 4: Analytical procedures that assist when forming an overall conclusion

In the final stage of the audit, the engagement team did not perform analytical procedures that assist when forming an overall conclusion as to whether the financial statements are consistent with the auditor's understanding of the entity.

(Auditing Standards Committee Statement No. 520, paragraph 5)

(4) Audit sampling

Case 1: Planning of audit sampling

▶ When designing an audit sampling responsive to the assessed risk, the engagement team determined a sample size with their professional judgment based on past audit experience. However, the team did not consider performance materiality and failed to reach reasonable grounds to reduce sampling risk to an acceptably low level.

(Auditing Standards Committee Statement No. 530, paragraphs 5 and 6)

▶ The engagement team selected samples only among transactions that occurred in a certain period of time or at one branch as the procedures responsive to the assessed risk. However, the team did not consider whether the selection range of the samples was sufficient to reach a conclusion for the entire population.

(Auditing Standards Committee Statement No. 530, paragraph 7)

▶ In substantive procedures for receivables and payables, the engagement team performed tests of details by selecting specific items from the population. As a result, the remainder of the population after excluding the portion covered by the tests of details exceeded the performance materiality. However, the engagement team did not consider the necessity of audit evidence for the remainder of the population.

(Auditing Standards Committee Statement No. 500, paragraph 9)

«Points to Note»

When designing audit sampling, the engagement team needs to consider purposes of the audit procedures 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 in consideration of

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 unlike audit sampling, this approach does not provide audit evidence regarding the remainder of the population.

Case 2: Projecting misstatements

The engagement team performed confirmation procedures through testing specific items for the accounts receivable at the year end and noted the differences in the confirmation replies. However, the team only extrapolated misstatements in the whole accounts receivable from the detected difference rate against the balance subject to the confirmation without performing appropriate audit procedures for the remainder of the population.

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

«Points to Note»

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

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

(5) Related parties

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

- ▶ Although the major shareholder group might exercise significant influence on the entity, the engagement team did not perform audit procedures to comprehensively understand the related parties, including gaining an overall view of the major shareholder group and checking the existence of any company and its subsidiary holding more than half of the voting rights on their account of the major shareholder.

(Auditing Standards Committee Statement No. 550, paragraphs 10 and 14)

- ▶ While recognizing ongoing transactions between the entity and the management or their close family members, the engagement team only verified whether the members of the management and their close family members owned the majority of shares of any company. It did not obtain enough information to identify risks of material misstatement such as by making inquiries to the management to confirm the existence of the entity's transactions with such companies or the management.

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

- ▶ The entity collected questionnaires from all its directors as of the balance-sheet date regarding related party transactions.

However, the engagement team did not examine the completeness of related party transactions, as the questionnaires only asked for descriptions of transactions more than a certain amount.
(Auditing Standards Committee Statement No. 550, paragraphs 10 and 14)

«Points to Note»

If the management has implemented the internal control for identifying related party transactions and approving material transactions, the engagement team also needs to understand the internal control and perform other appropriate risk assessment procedures as deemed appropriate.

Other than the examples of identified deficiencies mentioned above, the entity did not appropriately disclose the terms and the conditions of related party transactions in case that the entity provided non-interest bearing loans and guarantee without charging fee. Or the engagement team did not sufficiently examine the terms and conditions of transactions which were disclosed as arms' 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 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 Audit."

Case2: Identification and evaluation of risks of material misstatement associated with transactions with related parties

The engagement team recognized the substantial amount of property trading within the entity group, but did not consider whether such group transactions should have been recognized as a significant risk.

(Auditing Standards Committee Statement No. 550, paragraph 17)

«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 non-related third party transactions, with fraud more likely to be committed. Therefore, as a precondition for performing 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 recognized transactions. The team should keep in mind that material transactions with related parties outside the entity's normal course of business transactions should be treated as a significant risk.

(6) Going concern

Case 1: Identification of any events or circumstances that may cast significant doubt on the entity's

ability to continue as a going concern

The entity claimed that neither events nor conditions occurred that might cast significant doubt on the going concern assumption, despite severe business conditions resulting in continuing operating losses and negative operating cash flows and difficulties in financing as evidenced by multiple financial institutions' rejection of the entity's request for loans, because these losses had arisen from reconstructing business operations.

However, the engagement team did not examine the reasonableness of the entity's claim.
(Auditing Standards Committee Statement No. 570, paragraphs 9 and 11)

《Points to Note》

Material events or conditions that may damage the continuity of business activities rarely occur suddenly.

Since the seeds of such events or conditions are likely to appear in advance in business activities, the engagement team should carefully ascertain any events or circumstances 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 so serious that they are not subject to additional disclosure in the section “Notes Related to Going Concern Assumptions.” However, there were cases where engagement teams did not recognize the requirement. When there are events or conditions that might cast significant doubt on the going concern assumption of the entity, the engagement team should be aware of 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 events or conditions are identified

- ▶ The entity posted ordinary losses and net losses for five consecutive years. The engagement team acknowledged the situation above as an event or condition that may cast doubt on the going concern assumption, and considered it a significant risk whether to disclose it in the note regarding the going concern assumption.

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

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

- ▶ The entity was facing conditions that might cast significant doubt on the going concern assumption, making it difficult to gain new funding. So the parent and subsidiary companies financed each other and the consolidated subsidiary guaranteed obligations for loans payable of an affiliated company accounted for by equity-method.

However, the engagement team only examined the entity's cash flow for one year after the balance-sheet date on an individual basis, not a consolidated basis.

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

«Points to Note»

In one case, the engagement team did not specifically examine the feasibility of financing in the entity's financing plan. 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 comprehensively evaluate the entity's financial position based on specific audit evidence and the effectiveness and feasibility of the measures taken by the 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 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 engagement team did not examine the design or operating effectiveness of internal control for subsequent events, or the procedures and the evaluation of the results performed by the management in audit procedures to identify significant subsequent events completely.

(Auditing Standards Committee Statement No. 560, paragraph 6)

«Points to Note»

In many cases, the engagement team performed audit procedures related to subsequent events only with inquiries of management. The engagement team needs 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) Inquiry of the management;**
- (3) Reviewing the minutes of board of directors meetings;**
- (4) Reviewing the latest subsequent monthly financial statements, if available.**

Case 2: Risks of litigation

- ▶ The engagement team recognized that several lawsuits had been filed against the entity for the financial instruments sold by the entity, but did not examine the risk management system for litigation and claims designed and implemented by the entity.

(Auditing and Assurance Practice Committee Statement No. 73, paragraph 4)

- ▶ The engagement team did not examine the potential loss that might be incurred by the entity, despite the entity's general counsel's reply to 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."

(Auditing and Assurance Practice Committee Statement No. 73, paragraph 3)

- ▶ In sending to an attorney a letter of confirmation, the engagement team only filled in the names of lawsuits, etc. to be confirmed, and requested an attorney to fill other columns in the reply, such as his/her views.

However, the team only obtained the attorney's reply as to whether the named lawsuits actually existed, and failed to obtain information necessary to determine whether the litigation risk, etc., was appropriately reflected in the entity's financial statements, such as the attorney's assessment regarding the outcome of ongoing lawsuits.

(Auditing Standards Committee Statement No. 501, paragraph 9)

«Points to Note»

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

Case 3: Consolidated financial statements

- ▶ In examining the scope of consolidation when a company is 40% owned by the entity and 30% owned by its officers, the engagement team did not examine whether the officers fell under "close persons," those expected to exercise their voting rights in the same manner as the intent of the entity.

(Auditing Standards Committee Statement No. 315, paragraph 10; and No. 600, paragraph 16)

- ▶ In examining the scope of consolidation, the engagement team did not examine the reasonableness of the assertion by the entity that its subsidiaries were excluded from its consolidation because they recognized net losses as only temporary, despite significant impact on the current consolidated net income.

(Auditing Standards Committee Statement No. 500, paragraph 5; Auditing and Assurance

Practice Committee Statement No. 52, paragraph 4)

- ▶ In the past years, the entity traded properties with consolidated companies, and eliminated losses generated out of these transactions in the process of preparing consolidated financial statements.

However, the engagement team did not examine the entity's accounting of unrealized losses based on an accounting standard 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 adequately understand the entity and its business environment as a premise for risk assessment of consolidated financial statements. The team did not examine the completeness of elimination of unrealized profits in the case of complicated intragroup transactions. The engagement team needs to appropriately understand the business group, including an assessment of capital structure, and substantial control or influence is necessary in auditing consolidated financial statements.

For information on typical cases related to consolidated financial statements, also see "(1) Group audit" of "4. Using the Work of Others."

3. Auditing Accounting Estimates

Point 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 the management's assumptions in accounting estimates;
- ▶ Whether the engagement team, in auditing accounting estimates, 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 audit procedures for responding to the significant risk, to assess the estimation uncertainty and to examine the adequacy of the accounting estimates.

Outline of inspection results

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

- ▶ The engagement team did not sufficiently review the reasonableness of the management's assumptions in the accounting estimates.
- ▶ In auditing accounting estimates about investment in affiliated companies, recoverability of deferred tax assets and impairment of long-lived assets, although the engagement team assessed reasonableness of the business plan prepared by management, the team only performed inquiries of management and failed to assess critical standpoint by obtaining enough audit evidence.
- ▶ The engagement team did not evaluate company category with the recoverability of deferred tax assets based on the Audit Committee Statement No. 66.

The following provide typical cases regarding "(1) Matters common to auditing of accounting estimates" which are classified into "Reasonableness of management's assumptions," "Review of the method for accounting estimation," "Review of prior period accounting estimates," and "Evaluation of reasonableness of business plan." In addition, matters to keep in mind in relation to audit procedures specific to accounts are described from "(2) Evaluation investments in affiliated companies" to "(9) Asset retirement obligations."

Expected response

The risks of material misstatement depend on the degree of 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 inspect the reasonableness of the management's point estimates from a critical standpoint as professionals.

(1) Matters common to auditing accounting estimates

Case 1: Reasonableness of management's assumptions

- ▶ When considering the impairment of long-lived assets, the entity designated each shop as a cash generating unit, the lowest level of unit that generates cash flows that is independent of the cash flows from the other shops or any other groups of assets. The entity had adopted a management policy that if any shops were operated for less than two years from the date of foundation or completion of refurbishment, they are not subject to any impairment losses except in the case of the termination of the shops.

However, the engagement team did not examine whether the management policy was reasonable and in light of accounting standards in relation to the impairment of long-lived assets.

(Auditing Standards Committee Statement No. 540, paragraphs 11 and 20)

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

In this case, the engagement team did not verify the reasonableness of the management's assumptions, which were inconsistent.

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

《Points to Note》

Other than the examples of identified deficiencies mentioned above, there were cases where the management's assumptions were inconsistent between accounts. For example, although the entity recognized 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 evaluate whether the events it ascertained were accounted for consistently.

Case 2: Review of the method for accounting estimation

- ▶ The engagement team did not perform procedures on the management's methods and data used for accounting estimates to understand the relevant internal controls.

(Auditing Standards Committee Statement No. 540, paragraph 7)

- ▶ The entity had normally calculated the allowance for sales returns on a tax law basis, which was applied for the current year.

However, the engagement team did not review the appropriateness of the amount of allowance for the current year, the appropriateness of using the tax law-based calculation method, the current year's rate of sales returns and the gross margins of the entity's wholesale business.

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

- ▶ The engagement team did not examine the management's method that allowed the entity not to accrue any allowance for product warranty even though it provided long-term product warranty. Specifically, the team did not examine the past turn-over of warranty for damaged products and any relevant warranty arrangements with suppliers.

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

«Points to Note»

The engagement team needs to review the method of the management's accounting estimates by evaluating whether the management's method for measurement is appropriate for the particular 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 basic data used for accounting estimates, and whether the accounting estimates are calculated appropriately with the basic data and the management's assumptions**
- **Examination as to source of information, relevance, and reliability of external data or information (including information from external experts used by the management)**
- **Examination as to the consistency of information for accounting estimates and the recalculation thereof**
- **Examination of the applicable financial reporting frameworks**

Case 3: Review of prior period accounting estimates

- ▶ The engagement team did not assess the management's bias. For example, the engagement team did not examine the appropriateness of the past year's accounting estimates such as loss provisions and impairment losses.

(Auditing Standards Committee Statement No. 240, paragraph 31; and No. 540, paragraph 8)

- ▶ In examining impairment of long-lived assets, the engagement team did not evaluate the reliability of the entity's estimation process for the current year and uncertainty although there was a significant deviation between the entity's business plan formulated in the previous year

and the actual results.

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

- ▶ In auditing allowance for doubtful accounts, the engagement team did not conduct a historical analysis of the outcome of accounting estimates to assess the uncertainty of the management's estimate.

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

- ▶ The engagement team did not perform a retrospective analysis as to whether the current year's significant impairment loss on tangible assets held by the entity should have been recognized in the previous year.

(Auditing Standards Committee Statement No. 540, paragraphs 11 and 17)

«Points to Note»

In some cases, the engagement team only ascertained the reason for deviation between the values estimated in the previous period and the outcome in the current period in reviewing the entity's business plan, and did not apply the obtained understanding in evaluating the management's estimate for the current period. The team needs to note that reviewing the accounting estimates for the previous period requires identifying possible management bias and evaluating the degree of the uncertainty of estimates.

It should be noted that the existence of a gap between the outcome of accounting estimate(s) and the recognized value in the previous year's financial statements does not necessarily indicate misstatements in the previous year's financial statements. However, it is possible to make a reasonable basis that the entity could estimate fairly close to the actual value, if the management had used certain information available at the time of the estimates, as well as information reasonably expected to be obtained or considered at the time of preparing and releasing the financial statements. In such a case, the auditor should be aware of the need to consider the possibility of misstatements in the previous year's financial statements that could be indicated by the difference between the outcome and estimation.

Case 4: Evaluation of reasonableness of business plan

- ▶ The entity did not recognize impairment loss on securities issued by an affiliate company whose net asset value had declined substantially against the acquisition cost because of the management's assumption about the recovery of the net asset to level with the acquisition cost through profit generation expected for the following two years based on the affiliate company's business plan.

However, the engagement team did not examine the reasonableness of the management's assumption despite a huge gap between the affiliate's performance in the past years and the

business plan.

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

- ▶ In a review of impairment of a factory which had indication of possible impairment, the engagement team did not examine the reasonableness of the factory's future plan, which was utilized for the undiscounted future cash flows prepared by the entity.

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

- ▶ The engagement team did not review the entity's capability to achieve the business plan in a critical manner or objectively based on supporting documents obtained externally, although the engagement team considered it to be highly unlikely that the entity could utilize its tax loss carried forward within the reasonable period.

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

《Points to Note》

In examining accounting estimates including valuation of investments in 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 the management.

If any significant risk arises in accounting estimates, the engagement team needs to evaluate the following:

- (1) How the management considered alternative assumptions or outcomes and why they rejected them, or how the management otherwise addressed estimation uncertainty in making the accounting estimates;**
- (2) Whether the significant assumptions used by the management are reasonable;**
- (3) Where relevant to the reasonableness of the significant assumptions used by the management or the appropriate application of the applicable financial reporting framework, the management's intent to carry out specific courses of action and its ability to do so.**

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

The engagement team should also set the auditor's allowable range as needed to evaluate the reasonableness of the accounting estimates if the engagement team judges that the management did not appropriately deal with the impact of uncertainty of accounting estimates that may pose significant risk.

(2) Evaluation of investments in 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 for no impairment on the share, despite the fact that the entity assumed that the value of the share would recover to about 50% of the book value in about five years based on the subsidiary's business plan.

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

- ▶ Although the subsidiary's shares declined substantially in the net asset value per share compared to the book value, the entity recognized the shares at acquisition cost in its individual financial statements without evaluation based on the judgment that the subsidiary reported stable profits every year and its excess earning power at the time of acquisition of the shares still remained.

However, the engagement team did not sufficiently examine whether the excess earning power anticipated at the time of acquisition had significantly decreased.

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

《Points to Note》

When the net asset value of shares of an entity's affiliate company, whose market value is extremely difficult to estimate, declines by more than approximately 50% of the acquisition cost, the entity is required to consider it a substantial decline in net asset value and recognize an appropriate amount of impairment losses on such shares. This consideration needs to apply to 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.

Additionally, for the valuation of affiliate companies' shares purchased with the premium based on the issuer's excess earning power, the engagement team, in many cases, reviews for possible reduction of the net asset value of such shares by excluding the effect of the excess earning power. In such cases, the engagement team should be aware that it could be necessary to examine thoroughly whether the excess earning power expected at the acquisition has declined after the acquisition, and in case of a decline, the engagement team should consider recognizing impairment losses even if the subsidiary is not in insolvency.

(3) Valuation of receivables

Case: Review of recognition and measurement

The entity has posted allowance for doubtful accounts for 50% of the delinquent receivables from a sales agency, of which corresponding revenues were recorded in the prior year, because it

did not have information of financial conditions of the agency.

However, the engagement team had not sufficiently examined the adequacy of the allowance for doubtful accounts, although the agency was actually under bankruptcy reorganization. The entity had not obtained such information because it already terminated the business relationship with the sales agency.

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

«Points to Note»

It is necessary to examine the adequacy of receivables categorization as well as the completeness of receivables in recognition and measurement of valuation of receivables.

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

(4) Inventory valuation

Case 1: Method of inventory valuation

- ▶ The engagement team did not examine the reasonableness of the management's method for inventory valuation in light of accounting standards when the entity's inventory valuation policy excluded some part of the inventories from the scope of inventory valuation without rational reason.

(Auditing Standards Committee Statement No. 540, paragraph 7)

- ▶ The engagement team did not evaluate, in accordance with the accounting standards, the reasonableness of the entity's method of inventory valuation by which the entity judged the deterioration of profitability of entire inventories in aggregate for wide-variety, low-volume products.

(Auditing Standards Committee Statement No. 540, paragraph 7)

«Points to Note»

Other than the examples of identified deficiencies mentioned above, there were some cases where the engagement team did not examine the management's method for inventory valuation that did not reflect the characteristics and conditions of the entity's inventories, such as slow-moving and obsolete.

When the entity revises the method for inventory valuation due to the difference between the assumptions and the actual status of the inventories, the engagement team should be aware that it is necessary to review the new method's conformity to accounting standards, as well as the timeliness of

the revision.

Case 2: Review of recognition and measurement review

- ▶ The engagement team did not evaluate the management's method for inventories valuation that estimated the inventory's value without deducting the estimated amounts of sales and other cost from net sale values.

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

- ▶ The engagement team completed its review of an entity's inventory valuation only by verifying the information used to calculate inventory valuation losses recognized by the entity, without reviewing from the aspect of completeness, for example, by investigating whether there were other inventories required for valuation losses.

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

«Points to Note»

There were some cases where the engagement team did not entirely examine the completeness of the entity's scope of inventories when reviewing for possible reductions in book value.

Inventories held by the entity included items with special characteristics, such as with highly variable value such as real estate assets for sale and development projects in progress, those whose objective value is difficult to obtain and so on. The engagement teams should keep in mind that inventories with special characteristics should not be excluded from the review for possible valuation loss due to the deterioration of 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, the engagement team did not examine the reasonableness of the assumption that it had only one cash generating unit for impairment.

(Auditing Standards Committee Statement No. 540, paragraph 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 almost independent of those of other assets or cash generating units. Therefore, the engagement team should examine the appropriateness of the policy of 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 the 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 perform verification taking into consideration the deterioration of the business environment such as a sudden decline in sales orders received just before the end of the financial year.

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

- ▶ The entity determined that there were no indications of impairment on idle long-lived assets because they were likely to be utilized for other locations or purposes in the future. However, the engagement team did not examine indications of impairment of long-lived assets and accepted the entity's judgment without obtaining sufficient audit evidence regarding the feasibility of future usage including past records of reuse of idle assets.

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

«Points to Note»

Other than the examples of identified deficiencies mentioned above, there are cases where the engagement team did not identify an indication of impairment because of the entity's temporary fractional income in a period despite experiencing past years of continuing loss, based on a literal interpretation of the phrase "continuing" in the accounting standards. In another case, the engagement team did not analyze the cause of the entity's deteriorating performance, as the entity asserted that the deterioration was extraordinary and temporary. Therefore, the engagement team should carefully examine indications of impairment.

Further, as a principle, if an asset or a cash generating unit becomes idle, it indicates significant declines in the recoverable amount of the asset or the cash generating unit due to a significant change in the scope or manner in which assets or cash generating units are used. In the review of indications of idle assets, therefore, the engagement team needs to carefully examine the reasonableness by aspects such as how long the asset has been idle. The engagement team should consider whether the duration of asset being idle is deemed necessary to determine the future alternative use of the asset.

Case 3: Review of recognition and measurement of impairment

- ▶ The engagement team did not examine the reasonableness of the remaining economic life of major assets used by the entity to calculate future cash flows.

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

- ▶ In reviewing the entity's estimates for future cash flow, the engagement team could not

detect the fact that the entity did not exclude indirect expenditure such as corporate expenses.
(Auditing Standards Committee Statement No. 540, paragraph 12)

- ▶ Despite the entity's conclusion that it would be difficult to achieve the revenue budgeted for the following year to be used as the basis for estimating future cash flows, the engagement team did not examine the reasonableness of the entity's decision not to recognize impairment losses.

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

«Points to Note»

The entity must largely rely on cash flow estimates to recognize impairment losses and in measuring such losses. Therefore, the engagement team should keep in mind the necessity of verifying the management's assertion regarding impairment losses by carefully examining the elements used to estimate future cash flows, including the remaining economic life, the utility value of assets, and the business plan that is the basis of cash flow estimates, and the feasibility of such plan. Additionally, when the entity adopted net sale value as the asset's recoverable value, the engagement team should carefully examine it.

(6) Valuation of goodwill

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

The entity acquired all the shares of a company in cash to make it a consolidated subsidiary. The entity recognized as goodwill the entire difference between the net of assets acquired and liabilities assumed and the acquisition costs as of the date of business combination.

However, the engagement team did not examine the reason for the goodwill arising.

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

«Points to Note»

When recognizing goodwill in business combination, major points are the adequacy of allocation to goodwill and other accounts, and the amortization period of goodwill. The engagement team needs to carefully examine the reason for goodwill arising, including comprehensively ascertaining identifiable assets and liabilities, and appropriately allocating acquisition costs to them. In the case of negative goodwill in particular, the engagement team needs to analyze the factors for the goodwill arising and carefully examine the adequacy of allocation to the other identifiable assets and liabilities, keeping in mind that negative goodwill is treated as profits for when it incurs.

Case 2: Amortization period of goodwill and indications of goodwill impairment

- ▶ As a result of acquisition of a company whose liabilities far exceeded its assets, the entity recognized most of the acquisition costs of the equity as goodwill in its consolidated financial

statements.

However, the engagement team did not examine indications of impairment of the goodwill in the fiscal year which the entity acquired, while recognizing that a significant amount of the acquisition cost was allocated to goodwill.

(Auditing Standards Committee Statement No. 540, paragraphs 11, 12, 17; Accounting Standards for Business Combination, paragraph 109)

- ▶ The engagement team did not specifically examine the reasonableness of the entity's decision of making the amortization period 20 years.

(Auditing Standards Committee Statement No. 540, paragraphs 11, 12 and 17)

- ▶ The engagement team did not adequately examine whether the entity should have recorded the goodwill impairment, by, for example, verifying potential deterioration in excess earning power associated with the goodwill for the consolidated subsidiary while recognizing that the entity's consolidated subsidiary, for which significant goodwill was recorded, had been posting losses every year after becoming the entity's consolidated subsidiary.

(Auditing Standards Committee Statement No. 540, paragraphs 11, 12 and 17)

«Points to Note»

The engagement team needs to sufficiently examine whether there is any indication of impairment even in the year the goodwill first arises, if significant. This is why indications of impairment could exist even in the first year of business combination if the amount of allocation to goodwill and the other intangible assets are relatively significant (Accounting Standards for Business Combination, paragraph 109).

Additionally, for amortization period of goodwill, the acquirer must determine a reasonable period based on future effect of goodwill for each business combination 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.

(7) Recoverability of deferred tax assets

Case 1: Review of company classification

- ▶ The entity classified itself as "company class 3" as specified in the Audit Committee Statement No. 66 on the basis of the latest taxable income before deducting tax losses carryforward, although the entity had a significant amount of tax losses carryforward at the date of the financial statements. However, the engagement team did not examine whether the entity's tax losses carryforward did not fall under significant tax losses carryforward as specified as "company class 4."

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

- ▶ The entity classified itself under the “company class 4 proviso” specified in Audit Committee Statement No. 66 because taxable income before deducting tax losses carryforward arose in the current and previous years, although the entity had significant tax losses carried forward at the end of the year.

However, the engagement team did not sufficiently 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 and whether, without the losses, the entity made a taxable income in every fiscal year.

(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 company classification specified in Audit Committee Statement No. 66, the following cases were identified. The engagement team needs to carefully examine company classification in accordance with the relevant accounting standards.

- **The engagement team did not classify the entity with a significant amount of tax losses carryforward as "company class 4" without sufficient examination that the amount had no materiality.**
- **The engagement team classified the entity under the “company class 4 proviso” because significant tax losses carryforward arose from a special cause, but did not sufficiently examine the extraordinariness of this cause of occurrence.**

Case 2: Estimation of taxable income

- ▶ The engagement team did not examine the reasonableness of the estimated future taxable income. For example, the team did not conduct comparative analysis between the estimated and the outcome of the taxable income in the past years.

(Auditing Standards Committee Statement No. 540, paragraphs 8, 11 and 12)

- ▶ The engagement team obtained the 5-year business plan from the entity for estimating taxable incomes for future fiscal years, but did not verify whether the business plan had been approved by the board of directors.

(Auditing Standards Committee Statement No. 540, paragraphs 11, 12 and 17; Audit Committee Statement No. 66, paragraph 5 (3))

- ▶ The engagement team only compared the estimated future taxable income with the past

ordinary profit without examining the origin of taxable income. Therefore, the engagement team did not consider the effects of a significant amount of exclusion from dividend from subsidiaries, overlooking the substantial deviation of the estimated future taxable income from the past ordinary profit.

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

《Points to Note》

In a review of the recoverability of deferred tax assets, the engagement team often examines the reasonableness and other aspects of the business plan prepared by the management for estimation of taxable income. In this connection, see the above-mentioned points to keep in mind in "Case 4: Evaluation of reasonableness of business plan" of the above-mentioned "(1) Matters common to auditing accounting estimates."

If the entity posts deferred tax assets because of the sufficiency of taxable income based on its profitability, the business plan, a factor for taxable income, should in principle be approved by the board of directors. So the engagement team needs to perform audit procedures to secure the feasibility of taxable income, including verifying the reasonableness of adjustments from profits in the business plan to taxable income.

Case 3: Review of scheduling

- ▶ For examining the scheduling of temporary differences pertaining to investment security valuation losses, the engagement team did not obtain audit evidence in relation to the specific period in which the reversals of the temporary differences are expected to occur, although the entity fell under company class 3 as specified in Audit Committee Statement No. 66.

(Auditing Standards Committee Statement No. 540, paragraph 12; Audit Committee Statement No. 66, paragraphs 4 and 5)

- ▶ The entity posted a substantial amount of allowance for doubtful accounts for receivables from a subsidiary that had liabilities largely exceeding assets in the past fiscal year. While the subsidiary's performance was getting better, the engagement team considered reversal of the allowance as premature and timing for the reversal was unclear. However, the team did not sufficiently examine the reasonableness of recognition of deferred tax assets for the full amount of allowance for doubtful accounts.

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

《Points to Note》

In many cases, the engagement team did not appropriately and 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 temporary differences in the future related to affiliated companies in particular, because complicated conditions such as organizational restructuring may often be involved.

Case 4: Recoverability of deferred tax assets under consolidated tax payment system

If the amount of deferred tax assets under the consolidated tax payment system is less than the combined amount of deferred tax assets posted by entities in their individual financial statements, the entity needs to deduct deferred tax assets to the estimated recoverable amount on the basis of the consolidated tax payment system. However, the engagement team did not examine the estimated recoverable amount of deferred tax assets under the consolidated tax payment system.

(Auditing Standards Committee Statement No. 540, paragraphs 11, 12, and 17; Temporary Handling of Deferred Tax Accounting under Consolidated Tax Payment System (Part 2) Q4)

(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.

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

«Points to Note»

When estimating retirement benefit obligations, actuarial assumptions could influence the results greatly. As such, the engagement team should be aware of the importance of examining the appropriateness of the assumptions made by the entity.

(9) Asset retirement obligations

Case 1: Completeness of accounting process

The engagement team did not fully understand long-lived assets that were 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. 315, paragraph 10; and No. 540, paragraph 11)

Case 2: Appropriateness when reasonable estimates cannot be obtained

The engagement team did not assess the entity's claim not to accrue asset retirement

obligations on an existing operation base because the entity could not reasonably estimate the timing of closure, despite experiences in closing similar operation bases in the past.

(Auditing Standards Committee Statement No. 315, paragraph 10; and No. 540, paragraph 11)

«Points to Note»

Even though the amount of asset retirement obligations cannot be fixed due to the lack of clarity in timing and method, asset retirement obligations should be recognized if information to reasonably estimate the timing and probability regarding the fulfillment of asset retirement obligations are available. As such, the engagement team should keep in mind that it should examine the reasonableness of management assertion 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. Using the Work of Others

Point of focus

(1) Group audit

Recently fraud cases in foreign subsidiaries have been reported. The CPAAOB inspects the engagement from the following perspectives:

- ▶ Whether the group engagement team appropriately identifies significant risks and risks of material misstatement, and develops audit procedures relevant to the risks in the group financial statements;
- ▶ Whether the group engagement team identifies significant components based on the nature and status of each component, not only quantitative indexes, such as revenue;
- ▶ Whether the group engagement team develops an audit plan with sufficient knowledge of the professional competence of the component auditors;
- ▶ Whether the group engagement team sufficiently communicates with component auditors, and evaluates the sufficiency and appropriateness of audit procedures performed by component auditors for the identified risks;
- ▶ Whether, in response to reports from component auditors, the group engagement team performs, or directs component auditors to perform, additional audit procedures as necessary, and assesses the impact of uncorrected misstatements reported by component auditors on the group financial statements, including qualitative impact in terms of internal control and fraud.

(2) Making use of experts

The auditor may make use of experts to obtain sufficient appropriate audit evidence if the auditor needs expertise in other areas than accounting or auditing. The CPAAOB inspects whether the auditor evaluates the appropriateness of the experts' work, by evaluating whether the experts have the necessary qualifications, competency and objectivity for the purposes of auditing financial statements, and whether their conclusions are reasonable and consistent with other audit evidence.

Outline of inspection results

In identifying significant components, in one case, the group engagement team did not perform sufficient risk assessment without considering 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.

In addition, the auditor 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 situations where outside parties were involved, such as in component auditors or experts, there were many cases where the engagement team excessively relied on the work of others and did not adequately evaluate 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 for the audit opinions of the whole financial statements is on the group auditors.

Group audit requires the group engagement team to sufficiently communicate with 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, in all material respects, the group financial statements have been prepared according to the applicable financial reporting framework. Therefore, the group auditor 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.

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' works for audit purposes. In using the experts' work, the auditor 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.

(1) Group audit

Case 1: Significant components

- ▶ When determining significant components, although the entity was a manufacturing company, the group engagement team selected revenues excluding inter-company transactions as a financial benchmark to determine the significant components, and thus did not designate manufacturing subsidiaries that owned significant fixed assets, etc., as significant components, as the group engagement team did not examine whether it was necessary to use benchmarks other than revenues in light of businesses operated by the entity's group companies and the group structure.

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

- ▶ Although the impact of the equity in earnings of affiliated companies on financial statements is material, the group engagement team did not examine whether affiliated companies should be significant components, taking their quantitative and qualitative impacts into consideration.

(Auditing Standards Committee Statement No. 600, paragraphs 8 and 17)

- ▶ In identifying significant components, the group engagement team ascertained that the subsidiary had inventory balance in excess of materiality for the financial statements as a whole, that the inventory turnover was long and that the subsidiary had a past record of slow-moving and obsolete inventories due to a sales slump. However, the team did not perform risk assessment including these impacts.

(Auditing Standards Committee Statement No. 600, paragraphs 8 and 17)

«Points to Note»

The engagement team should determine significant components considering the subject corporate group's characteristics and circumstances and the individual financial materiality, as well as the qualitative materiality, such as potential significant risks in group financial statements.

Case 2: Materiality

The group engagement team set the same, not lower, materiality level for significant components when conducting the group financial statement audit.

(Auditing Standards Committee Statement No. 600, paragraph 20)

«Points to Note»

To reduce the possibility of the total of uncorrected and undiscovered misstatements in group financial statements exceeding group materiality to a level as low as acceptable, 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

- ▶ The group engagement team did not conduct audit procedures based on the materiality of the components without conducting 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》

It is necessary to consider if both significant components and other components have been planned appropriately.

Case 4: Involvement in tasks undertaken by component auditors

- ▶ The group engagement team did not discuss with its component auditors the likelihood of material misstatements due to fraud or error in the component financial information in order to identify significant risks of the group financial statements. Therefore, component auditors identified significant risks in relation to account items associated with accounting estimates, but the group engagement team did not examine whether such risks should be identified as significant risks of the group financial statements.

(Auditing Standards Committee Statement No. 600, paragraph 29)

- ▶ The engagement team did not assess the adequacy of procedures by the component auditors to cope with significant risks in group financial statements.

(Auditing Standards Committee Statement No. 600, paragraph 30)

《Points to Note》

The group engagement team shall be involved in the component auditor's risk assessment to identify significant risks of the group financial statements.

However, in one case, a significant component auditor identified significant risks and reported them to the group engagement team, but the team did not sufficiently evaluate the risks. In another case, it was late when the group engagement team obtained the audit plan and other information from component auditors. The group engagement team needs to communicate timely and sufficiently with component auditors to identify significant risks of the group financial statements and to assess the reported risks.

If the entity group has performed a so-called "sub-consolidation"—the parent company utilizes the consolidated financial statements prepared by its subsidiaries—in preparing consolidated financial statements, the group engagement team needs to sufficiently communicate with component auditors on significant risks of the subsidiary group to examine the necessity of reflecting such risks in risk assessment of the group financial statements.

Furthermore, the group engagement team should also assess the necessity of identifying items as significant components and performing additional audit procedures if the group engagement team encounters the events that were not identified when developing the audit plan regarding subsidiaries or other insignificant components.

Case 5: Consolidation process (uniform accounting policies)

The entity prepared its consolidated financial statements without adjusting to Japan GAAP for

its overseas components' financial information prepared under the local GAAPs. However, the group engagement team did not adequately consider adjusting the GAAP differences.

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

Case 6: Subsequent events

The group engagement team requested the component auditors to submit a confirmation of subsequent events so as to confirm whether significant subsequent events had occurred in the foreign subsidiaries. However, the group engagement team did not obtain a confirmation of subsequent events from the component auditors by the date of the auditor's report based on the Companies Act.

(Auditing Standards Committee Statement No. 600, paragraphs 37 and 38)

Case 7: Communication with component auditors

- ▶ The group engagement team did not communicate to the component auditors regarding the significant risks in relation to group financial statements that would impact the tasks performed by the component auditors.

(Auditing Standards Committee Statement No. 600, paragraph 39)

- ▶ The group engagement team revised downward the materiality and performance materiality, but did not inform the revised levels to the auditors of significant components.

(Auditing Standards Committee Statement No. 600, paragraph 39)

Case 8: Sufficiency and appropriateness of audit evidence obtained

- ▶ The group engagement team did not obtain information regarding specific procedures performed by component auditors and their outcomes to evaluate whether the component auditors had obtained sufficient and appropriate audit evidence when the group auditor instructed auditors of significant components to perform journal entry tests because the engagement team identified the management override risk as a significant risk.

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

«Points to Note»

Like the examples of identified deficiencies mentioned above, the group engagement team simply obtained information of the results of the audit procedures performed from the component auditors without evaluating the sufficiency and appropriateness of the audit procedures performed for significant risks. The group engagement team needs to evaluate the sufficiency and appropriateness of audit procedures responsive to significant risks of the group financial statements planned by the component auditors.

Even if component auditors are network firms, the group engagement team also needs to evaluate

the audit evidence obtained alike.

Case 9: Communication with those charged with group governance

- ▶ The group engagement team did not communicate with the board of auditors of the entity regarding the overview of the group auditor's involvement in tasks performed by component auditors, and quality issues and concerns over the performance of component auditors identified through the evaluation of tasks completed by the component auditors.
(Audit Standards Committee Statement No. 600, paragraph 48)

(2) Making use of experts

Case 1: Agreement with experts

- ▶ The engagement team asked IT experts to evaluate the IT general controls but did not consult the scope of IT systems which the entity's financial reporting relied on and the methodology used in the evaluation.

In addition, the engagement team only obtained the conclusion of the evaluation results provided by the IT experts without performing any audit procedures to understand the entity's response to risks attributable to IT.

(Auditing Standards Committee Statement No. 315, paragraphs 19, 20 and 31, and No. 620, paragraphs 7 and 10; IT Committee Practical Guidelines No. 6, paragraph 46)

- ▶ 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 requested the other expert to assess the valuation reports but the engagement team did not examine whether the materials provided by the entity were adequate to perform the assessment properly.

In addition, the engagement team did not give appropriate instructions to the expert without clarifying the tasks requested to the expert, 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 Statement No. 620, paragraph 10)

Case 2: Evaluation of adequacy of work 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 them.

However, the engagement team did not examine the adequacy of the expert's work even though the expert conducted the assessment assuming that the assessment had been requested in relation to the impairment as a long-lived asset, not as a real estate inventory for sale.

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

《Points to Note》

Before using experts' work, the engagement team needs 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.

5. Auditing Financial Institutions

Point of focus

The auditing of financial institutions requires different viewpoints than the auditing of general companies, including an understanding of financial administration, and a deep awareness of the environment surrounding the auditing of financial institutions.

The CPAAOB inspects audit firms regarding auditing of financial institutions from the following perspectives:

- ▶ Whether the engagement team performs appropriate evaluation on the basis of risks specific to financial institutions before acceptance and continuance of audit engagements;
- ▶ Whether appropriate manpower with knowledge and experience specific to auditing financial institutions is allocated;
- ▶ Whether the engagement team sufficiently understands the realities of the financial institution to appropriately recognize the potential risks of material misstatement, and then plan and implement further audit procedures address to such risks;
- ▶ Whether the engagement team actively uses IT experts to plan and perform procedures for understanding IT-related internal controls as financial institutions generally have a highly IT-based internal control system in place;
- ▶ Whether the engagement team assesses if the information prepared by the financial institution and the information prepared by the management's experts is sufficiently reliable;
- ▶ Whether the engagement team sufficiently understands the purpose of the Industry Committee Practical Guidelines No. 46 and ensures coordination with financial inspections.

Outline of inspection results

Large audit corporations had their QC and financial institution auditing departments lead the work with local offices to maintain and improve the quality in auditing of financial institutions nationwide.

However, as shown below, there were cases where audit procedures adapted to the significant risks of material misstatement of the financial institution were not planned and performed. For example, in substantive procedures for posting of bad debts written off/loan-loss provisions, some audit firms did not sufficiently and appropriately perform audit procedures including critical verification of the debtor categorization of financial institutions.

Expected response

In performing risk assessment and responding to assessed risks, engagement teams in charge of financial institutions need to, in consideration of the above, renew their recognition of the importance that the auditor performs, through understanding the financial institution's business environment, procedures to identify and assess the risk of material misstatement, and responds to such risks, as well as describing such procedures in the audit documentation. For example, monetary unit sampling and

testing specific items considering the environment surrounding finance administration such as revision of the financial inspection manual and the audit risk arising from the characteristics, etc., of borrowers of the financial institutions may be combined for use in selecting individual debtors subject to the auditor's procedures (including verification of self-assessment) relevant to the risks of material misstatement identified regarding posted written-off bad debts/loan-loss provisions.

The engagement partner and experienced members of the financial institution's engagement team need to appropriately instruct and supervise through timely inspection of audit documentation so that audit assistants can accurately understand the specifics of significant audit procedures in a financial institution audit and the depth of procedures to be performed.

For more information on auditing accounting estimates see "3. Auditing Accounting Estimates."

(1) Self-assessment of loans

Case: Adequacy of debtor categories

- ▶ The engagement team did not examine the reasonableness of the financial institution's designation of debtors to debtor categories based on their characteristics as below;
 - a) The engagement team did not verify the reasonableness and feasibility of the plan for debtors recognized as "requires caution" based on their "reasonable and feasible plan."
 - b) The engagement team failed to verify the financial condition of debtors (including the recognition of unrealized loss/gain).
 - c) The engagement team did not verify the appropriateness of the group assessment, the financial condition and so on, etc., of the debtor group as a whole, or in the case where a financial institution conducted self-assessment of a debtor group as a whole.
(Auditing Standards Committee Statement No. 540, paragraph 14)

- ▶ The engagement team performed substantive procedures to examine the financial institution's self-assessment of loans, which was conducted with a tentative cut-off date of December 31, 2013, but failed to perform substantive procedures for the remaining period up to the date of the financial statements.
(Auditing Standards Committee Statement No. 330, paragraph 21)

《Points to Note》

Audits of deposit-taking financial institutions (DTIs) often identify the valuation of loans as a significant risk, with audit plans depending on internal control. In addition to substantive procedures, it is necessary to perform the test of controls. The test of control for posted loan-loss provisions may be effective with a combination of record/document inspection and reperformance. Reperformance procedures of self-assessment to be performed with sampling of debtors can serve as the tests of controls and of details, but it is necessary to sufficiently note that even though identical materials are

used, different procedures are to be applied due to the difference in the purposes of the tests.

The following are the examples of identified deficiencies regarding substantive procedures deemed necessary when inspecting debtor categories. The engagement team needs to perform critical verification of claims of financial institutions.

- The engagement team did not confirm the latest profit situation of debtors by inspecting the latest trial balances of debtors.
- The engagement team did not substantially examine the debtor's financial positions calculated by the financial institutions.
- The engagement team did not verify the basic interest rate on the date of the financial statements.
- The engagement team did not verify the reasonableness of the change of debtor categories (including verification of reasonableness of the management improvement plan).
- The engagement team did not verify the accuracy of normal operating capital and cash flow used for calculation of the debt repayment term.
- The engagement team did not perform a procedure to confirm the debtor credit status from the provisional base date to the base date.
- The engagement team did not confirm the lending terms (including modification of conditions).
- The engagement team did not verify the adequacy of the assignment of a debtor category to a debtor group and the debtor group's overall financial condition, etc.

(2) Write offs/ Loan Loss provisions

Case 1: Accuracy of actual rate of irrevocable loans

In examining the actual loan loss ratio, the engagement team did not examine the accuracy and completeness of the amounts of credits and lost funds at the beginning of year for the calculation period set by the financial institution.

(Auditing Standards Committee Statement No. 540, paragraph 12; Special Committee for Bank Auditing Statement No. 4 IV (5))

Case 2: Confirmation of accuracy and completeness of information generated by the information system

The engagement team did not examine the accuracy and completeness of system-generated forms, including the Document for Calculation of the Actual Loan Loss Ratio, prepared by the financial institution for use in examining the actual loan loss ratio.

(Auditing Standards Committee Statement No. 500, paragraph 8; Special Committee for Bank Auditing Statement No. 4 IV (5))

Case 3: Sufficiency of loan loss provisions

For loan-loss provisions the engagement team did not consider obtaining from the financial

institution the back test results of actuals vs. forecasts prepared in previous years.

In addition, the engagement team did not examine whether the estimated amount of uncollectible loans subsequently occurred to the date of the auditor's report was within the scope of future estimates assumed in the posted loan-loss provisions.

(Auditing Standards Committee Statement No. 540, paragraphs 8 and 12; Special Committee for Bank Auditing Statement No. 4 II 2)

«Points to Note»

It is necessary to note that the procedure to inspect the sufficiency of loan-loss provisions should be performed based on the material debtor credit status from the date of the auditor's report to the date of the financial statements.

Case 4: Evaluation of collateral

The engagement team identified the evaluation of loans as a significant risk but did not understand the internal controls associated with the financial institution's review process for collateral evaluation. In the substantive procedures, the engagement team did not verify the collateral coverage, valuation method and valuation period, and failed to examine the adequacy of the collateral value estimates.

(Auditing Standards Committee Statement No. 330, paragraphs 14 and 20, and No. 540, paragraph 14; Special Committee for Bank Auditing Statement No. 4 IV and V, and Reference Appendix thereto)

«Points to Note»

Other than the examples of identified deficiencies mentioned above, the engagement team did not inspect the assessment rate of collateral for collateral disposal value estimation by comparing relevant sales records. The engagement team should carefully inspect collateral valuation and the guarantor company's guaranty ability, which may have significant effects on the financial institution's loan-loss provisions.

(3) Recoverability of deferred tax assets

Case 1: Review of company classification

The financial institution classified itself as “company class 4 proviso” specified in Audit Committee Statement No. 66 because its tax losses carried forward had been generated by one time significant debtor bankruptcies.

However, the engagement team did not examine whether the cause of the tax loss was extraordinary nature.

(Auditing Standards Committee Statement No. 540, paragraphs 11, 12 and 17; Audit Committee Statement No. 66, paragraph 5 (1) and (3))

«Points to Note»

Compared with general companies, DTIs often post deductible temporary differences arising from loan-loss provisions and securities impairment losses in large amounts because of their industry characteristics. Therefore, there may exist deductible temporary differences at year end far larger than past ordinary profit levels. Significant losses carried forward may also exist at year end or occur during the subsequent year by tax deduction of large amounts of loan-loss provisions. In judging whether such financial institutions should be classified under “company class 4 proviso” the engagement team should carefully determine extraordinary events such as business restructuring or legal amendment as reasons for the occurrence of the significant losses carried forward.

As a DTI's ordinary profits include loan-loss reserve reversal and other nonrecurring profits, loan-loss provisions, and loans and investments write-off and other nonrecurring costs, the engagement team may use core operating profits, DTI-specific indexes for core business performance, as well as ordinary profits for judging the company class. In judging the stability of past ordinary profits, the engagement team should sufficiently understand average deposits, loans and securities balances and yield tendency as well.

Case 2: Review of business plan

While its outstanding balance of loans decreased in the past, the financial institution assumed in estimating taxable income for future years that the credit costs would continue at a certain amount with an increase in the outstanding balance of loans. However, the engagement team did not examine concrete grounds for such a business plan.

(Auditing Standards Committee Statement No. 540, paragraphs 11, 12 and 17; Audit Committee Statement No. 66, paragraph 5 (1) and (3))

«Points to Note»

Audits of financial institutions often identify the recoverability of deferred tax assets as a significant risk. It is necessary to note that combination of non-inquiry procedures should be performed to judge the reasonableness of estimating taxable income for future years.

Case 3: Review of scheduling

The financial institution prepared a schedule for tax-deduction for loan loss provisions with a constant fixed amount in five years from the next period.

However, the engagement team did not verify the reasonableness of this schedule, for example, by comparing the prior year schedule for tax-deduction for loan loss provisions with the actual amount.

(Auditing Standards Committee Statement No. 540, paragraphs 8 and 12; Audit Committee Statement No. 66, paragraph 4)

«Points to Note»

Inconsistencies may arise in tax deduction schedules in bad loan write-off policy and tax effect accounting as the schedules often fall under the charge of different departments within the DTI. Therefore, the engagement team needs to pay due attention to the consistency between both schedules in verifying scheduling.

As for tax deduction scheduling in tax effect accounting, the engagement team should confirm that the tax deduction schedule has been approved by the board of directors, to eliminate arbitrariness from scheduling verification.

(4) Audit planning

Case 1: General understanding of IT use

- ▶ The engagement team did not have a general understanding of IT use when making the audit plan. The team did not ascertain which IT systems were subject to assessment of the risks of material misstatement.

(Auditing Standards Committee Statement No. 330, paragraph 9; Audit Committee Statement No. 6, paragraph 4)

- ▶ The engagement team did not have a precise understanding of whether data were generated manually or generated through IT systems linked to a contract master system, the types of applications used for data generation if IT systems were used, and the timing at which such data were reflected in the contract master system and the accounting system in assessing the data generation in relation to the normal course of business operations such as receipts of insurance premiums and insurance payouts.

(Auditing Standards Committee Statement No. 315, paragraphs 17 and 28; and IT Committee Practical Guidelines No. 6, paragraphs 22, 24 and 25)

«Points to Note»

Financial institutions belong to an industry with high IT use. Therefore, the engagement team needs to have a general understanding of the IT used for risk assessment. It is necessary to note that the general understanding of IT use should cover not only the entity's own systems, but also systems jointly operated by multiple financial institutions and external operators' systems.

Case 2: Materiality in audit planning

The engagement team changed the benchmarks for materiality from pretax profits to net assets in the previous year, and changed in the current year the rate by which the benchmark is to be multiplied. As a result, the materiality has considerably increased over three years. Although the scale of the entity's operations has not changed, the engagement team did not examine the reasonableness of changing the bases of the materiality calculation and the adequacy of the

amount of materiality.

(Auditing Standards Committee Statement No. 320, paragraph 9)

《Points to Note》

Unlike general companies, financial institutions often have a larger scale of total assets than pretax profit level and large changes in their business performance tend to be ascertained in a low interest rate environment because of their industry characteristics. When the materiality calculation index and index multiplier are changed, therefore, the engagement team should carefully examine as professionals the appropriateness and timeliness of the change and record the process in audit documentation.

(5) Substantive procedure and other issues

Case 1: Investigation of results of substantive analytical procedures

In performing substantive analytical procedures for securities interest and dividends, the engagement team did not sufficiently analyze differences between the expectation and the actual more than performance materiality from the viewpoint of changes in both investment yield and average securities balances.

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

Case 2: Procedure to respond to risks of material misstatement

Although each of the accounts identified as risks of material misstatement exceeded the performance materiality, the engagement team did not perform any substantive procedure because each individual transaction amounts was below the performance materiality.

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

Case 3: Verification of the cut-off of policy reserve calculation file

The engagement team did not verify the appropriateness of the cut-off regarding the policy reserve calculation file without confirming whether transactions executed during the current period were reflected accurately in the policy reserve calculation file when the entity calculates the policy reserve as of the date of the financial statements using the policy reserve calculation file.

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

Case 4: Examination of purpose of sales of policy-reserve-matching bonds

In the audit of insurance companies since the majority of their liabilities are made up by policy reserves not marked to market because of their financial characteristics, bonds meeting certain requirements should be categorized as policy-reserve-matching bonds. If the policy-reserve-matching bonds are valued and accounted for using the depreciation method,

the bonds may be treated as adequate in auditing. The accounting of the policy-reserve-matching bonds at time of sale varies depending on whether the sales transaction is aimed at adjusting the target duration.

Under these circumstances, the engagement team only obtained a reply from the entity stating that all the sale transactions of the policy-reserve-matching bonds during the current consolidated fiscal year were aimed at adjusting the target duration, without sufficiently examining the purposes of the policy-reserve-matching bond sales by inspecting the written approvals for asset management.

(The Industry Audit Committee Report No. 21, paragraph 6)

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

Point of focus

Auditors should appropriately respond 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 one or more fraud risk factors are present and considers them in identifying fraud risks in the financial statements and financial statement items in the audit plan;
- ▶ Whether the engagement team evaluates if a misstatement, in the case that one is identified, is indicative of a fraud; recognizes that an instance of fraud is unlikely to be an isolated occurrence when judging such misstatement to be indicative of a 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 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.
- ▶ Whether the engagement team appropriately ensures coordination with those charged with governance who audit the execution of duties by directors, if material misstatements due to fraud or the fraud which the management is involved is discovered.

Outline of inspection results

We have observed cases such as: the engagement team did not consider 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; the engagement team, in some cases, overlooked indications of fraud that could have been identified from an objective and critical standpoint.

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 it is expected that they should maintain professional skepticism in all processes of auditing and exercise it when examining risks of material misstatement due to fraud.

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

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 there is a possibility that material misstatement due to fraud could occur, and draw up general responses to risks of material misstatement due to fraud at the entire financial statement level and at the assertion level. In doing so, auditors should recognize and assess how internal control reduces fraud risks, and pay sufficient attention to the background in which risks of material misstatement due to fraud have been recognized, such as the management's bias, the business rationality of the transactions, and fraud risks in revenue recognition in addition to factors for fraud risk.

In implementing procedures to cope with 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. At the same time, in the process of auditing, auditors should also perform additional audit procedures if sufficient appropriate audit evidence has not been obtained.

In addition, if auditors identify any indicating of material misstatements due to fraud in the course of audit, they should make inquire and ask for explanation from 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 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 did not take this into account when evaluating fraud risks although the engagement team recognizes that round-tripping transactions have occurred in an industry to which the entity belongs.

(Auditing Standards Committee Statement No. 240, paragraph 15, F15-2)

- ▶ The engagement team understands that the entity operated IT-related business is generally considered as high audit risks, that there were frauds and business troubles in the past, that

the significant related party exists, and that the entity was underperforming. However, the engagement team did not take these facts into consideration in assessing fraud risk.

(Auditing Standards Committee Statement No. 240, paragraph 23)

«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 fraud cases in the past. 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 frauds, 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 financial statements, including the possibility of frauds 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, paragraph 14; No. 315, paragraph 9; and No. 550, paragraphs 11 and 16)

Case 3: Inquiries to the management

The engagement team discussed with the management, but did not obtain the management's assessment of the likelihood of material misstatement due to fraud, specific fraud risks identified by the management, and the management's view of account balances, transactions or disclosures in which fraud risks may exist.

(Auditing Standards Committee Statement No. 240, paragraph 16)

Case 4: Communication with those charged with governance

The engagement team did not recognize how those charged with governance monitored the series of management processes implemented by the management to identify and respond to fraud risks, and the internal control structure implemented by the management to mitigate fraud risks.

(Auditing Standards Committee Statement No. 240, paragraph 19)

Case 5: Communication with management and those charged with governance

The engagement team recognized during branch audit an indicative of revenue recognition improper timing. After reporting to those charged with governance, the engagement team

received their opinion that the audited branch might be intentionally recognizing revenue too early. However, the engagement team did not reflect the opinion in risk assessment and did not perform additional audit procedures including assessment of the quantitative impact on the whole entity and deficiencies in internal control.

(Auditing Standards Committee Statement No. 240, paragraphs 22, 39 and 40)

«Points to Note»

Other than the examples of deficiencies mentioned above, the engagement team only carried out fraud-related inquiries to the management or discussions within the team routinely. The team often did not hold substantial discussions including examination of possible risks in relation to the entity in reference to published fraud cases. When an engagement team identifies fraud or obtains information about indication of fraud, the team needs to timely report to the management at the appropriate level who are responsible to prevent fraud to inform the matter 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 the revenue recognition, the engagement team did not examine rational reasons for not identifying the risks of material misstatement due to fraud regarding the revenue recognition.

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

- ▶ The engagement team only identified the specific assertion (cut-off) related to revenue recognition as a risk of material misstatement due to fraud, but did not consider whether to identify other assertions related to revenue recognition than cut-off as a risk of material misstatement due to fraud.

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

- ▶ The entity started new business in the current period. The entity's counterparts for new business totally differed from its usual ones and the entity recorded sales based on an exchange of documents of sales orders and invoices without involving product delivery.

In understanding of the entity and its environment, the engagement team did not address the new business. The team also did not assess the risk of material misstatements regarding the new business at the level of assertions.

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

Case 2: Risks related to management override

Although the engagement team needed to identify risks related to management override as significant risks in all enterprises, it did not identify them as significant risks.

(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, revenue 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

- ▶ In inspecting the appropriateness of journal entries recorded in the general ledger, the engagement team conducted journal entries tests on some journal entries, such as closing adjustment entries, but did not perform reasonable examination of the appropriateness of the test scope of journal entries.

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

- ▶ The engagement team recognized that the entity had significant unusual transactions. However, the engagement team made only sales, cost of sales, and selling, general and administrative expenses subject to the journal entries test, and excluded accounts with the unusual transactions.

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

- ▶ The engagement team assessed that the entity, as a listed company, had fraud factors such as pressure from third parties. However, the engagement team did not conduct journal entry tests by taking into consideration fraud factors. For examples, the team did not examine the necessity of inspecting journal entries throughout the year, and did not examine the standards for extracting unusual 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

- ▶ At the time of the year-end closing, the entity reclassified most of its outsourcing expenses paid during the period to an unrelated third party that operated only entrusted businesses as loans to the unrelated 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)

- ▶ The entity posted unusual sales from providing first ever services to unrelated third parties, and soon after the period end, provided significant loans to the company and its representative. In relation to these unusual transactions that occurred around the period end, the engagement team did not assess the appropriateness of the revenue recognition based on the relationship between the company and the entity group and the business reasonableness of the transactions as a whole.

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

- ▶ The engagement team recognized that some of the sales posted in the year end were cancelled from the book in the following month, and that the sales returns were abnormally high in the last month of the fiscal year. With doubt arising over the adequacy of the posted sales, however, the engagement team did not assess the reasonableness of the revenue recognition and the necessity of a re-assessment of risks related to revenue recognition.

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

«Points to Note»

Indications that show significant transactions falling outside the entity's ordinary transaction process or deemed unusual may have been carried out to conduct fraudulent financial reporting or to conceal misappropriation of assets are as follows:

- **The form of such transactions appears complex (e.g., transactions involves 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 economics 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 transaction 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 questions to 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 forged accounting treatments by carrying out complicated transactions with several business partners. Therefore, in examining the business rationality of significant transactions, it is important that the engagement team 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

- ▶ **The engagement team identified fraud risks in transactions related to sales and needed to implement procedures to obtain sufficiently reliable and adequate audit evidence. However, the engagement team examined only internal vouchers, such as shipment instructions and invoices, and did not verify more reliable external vouchers such as acceptance certificates for the audit procedures on revenue recognition.**
(Auditing Standards Committee Statement No. 240, paragraph 29; and No. 500, paragraph 5 and 6)
- ▶ **The engagement team planned their audit procedures only by substantive procedures to respond to the identified fraud risk of round-tripping transactions. However, the team did not sufficiently perform substantive procedures relevant to the fraud risk; they did not evaluate the business reasonableness of transactions pertaining to the commercial distribution.**
(Auditing Standards Committee Statement No. 240, paragraph 29)
- ▶ **The engagement team did not use end users' receipts as evidences for verifying the sales**

through sales agents; the engagement team only conducted validation tests using receipts issued by sales agents to suppliers and did not implement audit procedures to confirm shipments to end users.

(Auditing Standards Committee Statement No. 240, paragraph 29)

- ▶ The engagement team examined the entity's revenue recognition without sufficiently examining the collateral conditions of the contracts, including reservation of ownership. The team 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 account receivables from sales transactions to a leasing company; the engagement team received a reply from the leasing company stating 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.

However, the engagement team did not examine the generation and cut-off of sales from the transactions, including the reasonableness of transactions and contract conditions pertaining to them.

(Auditing Standards Committee Statement No. 240, paragraph 22)

- ▶ The engagement team obtained the contract document to verify the existence of accounts receivable. Although the amount of service rendered under the contract significantly exceeded the service availability provided by the entity, the team did not evaluate the reasonableness of the contract details, overlooking the fact that the contract document was counterfeit and that fictitious sales were posted.

(Auditing Standards Committee Statement No. 240, paragraphs 11 and 12)

«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 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, the 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

- ▶ Although the engagement team recognized there were complicated transactions among the entity's group including related parties, and also several transactions between the group companies that indicated potential fraud risks, the team did not evaluate the reasonableness of the transactions with the related parties.

(Auditing Standards Committee Statement No. 240, paragraph 22; No. 550, paragraphs 17 to 19)

- ▶ In examining transactions with related parties, the engagement team did not examine whether or not loans from related parties under unfavorable conditions to the entity fell under the scope of the entity's ordinary transaction process.

(Auditing Standards Committee Statement No. 240, paragraph 22; No. 550, paragraph 17)

- ▶ The entity made a significant borrowing from a company whose representative director was the main shareholder of the entity. Although the engagement team recognized the loans as significant transactions falling outside the entity's ordinary transaction process, the team did not evaluate the reasonableness of the transactions.

(Auditing Standards Committee Statement No. 240, paragraph 22; No. 550, paragraph 17)

- ▶ The entity posted a significant amount of sales to an affiliated company, a special purpose company, near the end of period.

However, the engagement team did not evaluate the terms and conditions of the transaction, including the reasonableness of the transaction price. In addition, the team only verified the delivery confirmation note issued by the affiliated company. The team neither obtained nor verified necessary and sufficient audit evidence about the transactions with the affiliated company, including documents issued by a third party, such as documents indicating the fact of shipment issued by a carrier. Nor did the team evaluate the competence of the evidence obtained.

(Auditing Standards Committee Statement No. 240, paragraph 22; and No. 550, paragraphs 19,

22 and 23)

- ▶ In examining a loan that may be lent to a related party, the engagement team confirmed to the original borrower and assessed the assets pledged as collateral. However, the team did not carry out audit procedures, such as full understanding of the flow of capital and the reasonableness of loan transactions 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, paragraph F11- 2 and 31; and No. 550, paragraph 22)
- ▶ The entity posted a significant gain on sales of investment securities to its related party near the end of the period. However, since the related party faced cash flow problems, the entity set the deadline for payment of proceeds at a far later date. Under such a situation, the engagement team did not examine whether the transaction with the related party had business rationality. (Auditing Standards Committee Statement No. 240, paragraph 31)

《Points to Note》

Discussions within the engagement team required in the Auditing Standards Committee Statement No. 550, paragraph 11, "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 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 characteristic 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.

Furthermore, there are some cases where, in conducting fraudulent accounting treatment, the entity forged accounting treatments by carrying out complicated transactions with several related parties. Therefore, as responses to fraud risk in transactions with related parties, it is important that the engagement team 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 5: Other

- ▶ Although there were financial covenants that prohibited the posting of ordinary loss on a consolidated basis, the entity booked all expenses including general and administrative expenses for a subsidiary, which it resolved to liquidate in a prior period and planned to sell in

the current period, as extraordinary loss, and posted ordinary income on a consolidated basis.

However, the engagement team did not examine the appropriateness of treating the expenses as extraordinary, despite the fact that the entity neither sold the subsidiary by the end of period nor fixed the selling plan in the next period.

(Auditing Standards Committee Statement No. 240, paragraph 22; and No. 500, paragraph 5)

《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 financial records and vouchers, the bases for financial statements**
- **Misstatement and intentional exclusion of transactions, accountable events, or material information on financial statements**
- **Intentional inappropriate adoption of accounting standards regarding amounts, classification, indication, or disclosure**

(4) Evaluation of audit evidence

Case 1: 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 deficiencies in internal control, and as a result, overlooked misstatements at other branches.

(Auditing Standards Committee Statement No. 240, paragraph 34)

Case 2: Examination of identified misstatement

The engagement team identified an event posing suspicion of acceleration of sales, and sought an explanation from the entity.

Although the engagement team recognized that there was doubt concerning the reasonableness of the entity's explanation, the team judged only based on the explanation that the transaction did not contain unreasonable factors, without verifying additional audit evidence from outside sources. Therefore the team did not sufficiently assess the reasonableness of the transaction, and as a result, missed the fact that it was a misstatement.

(Auditing Standards Committee Statement No. 240, paragraph 32-2)

《Points to Note》

As in the examples of identified deficiencies mentioned above, there were deficiencies in

procedures for fraud-related risks, including failures to sufficiently assess whether the misstatement identified during the audit fell under an indication of a fraud, failures to assess the possibility of the identified misstatement occurring in the entity as a whole, and failures to consider risk assessment if an indication of material misstatement due to fraud was identified.

If the engagement team identifies suspicion of a material misstatement due to fraud, the team needs to revise its risk assessment and responses to audit risks it has planned, 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 evidences regarding the suspicion.

7. Audit of Internal Control over Financial Reporting

Point of focus

Auditors should express audit opinions based on evidence obtained by auditors, such as whether the internal control report assessed by the management was prepared appropriately 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 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 reasonableness and the way the management decides the scope of assessment; and particularly in the case that the management excludes some part of the transaction cycles to 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, particularly in evaluating the significant deficiencies in internal control;
- ▶ Whether the engagement team examines the quantitative and qualitative effect on the overall internal control of the entity and the possibility of material misstatements;
- ▶ Whether, in the course of an internal control audit, the engagement team timely reports to the appropriate person about the deficiencies detected by the auditors and examines possibilities of the deficiencies to be the material weakness;
- ▶ Whether, if there could be some material weakness, the engagement team reports them to the management, so as to correct and to timely examine the progress to correct the deficiencies, 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 for assessment and the adequacy of samples, assessment scheme and so on. In the event of the 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 the material weakness. The engagement team did not

obtain enough audit evidences to evaluate the correction for the deficiencies.

Expected response

The internal control reporting system of the FIEA is organized by the management to assess its internal control over financial reporting, thereby to ensure disclosure reliability. Auditors should lead the entity to design efficient internal control based on the entity's background, including scale and business structure. Auditors should also sufficiently understand the design, the operation, and the assessment methodologies of the internal control so as to integrate internal control audit and financial statement audit considering audit materiality for effective and efficient audits.

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 significance of internal control deficiencies. They should not perform procedures uniformly and routinely without enough examination. Sufficient and appropriate audit procedures should be performed particularly on the entity's business locations/units deemed to have relatively high risks, like the processes newly added to be assessed.

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

Case 1: Selection of significant business locations/units

To select significant business locations/units, the engagement team included the main business in the scope of assessment only based on the scale of sales. The team did not consider qualitative aspects and the importance of other business units which earn profits and cover the loss of the main business unit.

(Standards for Management Assessment and Audit Concerning Internal Control Over Financial Reporting III3 (2); Practice Standards for Management Assessment and Audit Concerning Internal Control Over Financial Reporting II2 (2) / III3 (2); Auditing and Assurance Practice Committee Statement No. 82, paragraph 79)

《Points to Note》

Revenue is often selected as an index to select significant business locations/units. It is necessary to note that it might be appropriate to use different or additional indexes depending on the entity's business environment and characteristics.

Case 2: 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 higher amount than inventories, 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.

Case 3: Selection of material business processes

The engagement team did not examine the reasonableness of the scope exclusion of business processes related to the accounts with significant risks from the management's internal control assessment of the business processes.

(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 discuss again with the management to evaluate 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.

If some processes included in significant business locations/units are excluded from assessment because of their limited relevance to material businesses or operations, the engagement team should carefully evaluate the reason for exclusion from assessment, etc.

(2) Evaluation of Assessment of Internal Control

Case 1: Sampling

- ▶ In assessing the operation of internal control, the engagement team used samples the entity had assessed, but did not examine the completeness of the entire population of samples subject to assessment.

(Auditing Standards Committee Statement No. 500, paragraph 8; No. 530, paragraph 5)

- ▶ In assessing the operation of internal control, the engagement team used the procedures the

entity had performed, but did not examine the appropriateness of the selection method of the samples the entity had assessed.

(Auditing Standards Committee Statement No. 500, paragraph 9; Auditing and Assurance Practice Committee Statement No. 82, paragraph 153)

- ▶ In the previous year, the entity's internal controls had material weakness on the financial reporting process, the company-level controls of significant component subsidiaries, and some business processes (marketing/purchase/inventory management). The engagement team recognized the deficiencies mentioned above and could expect the deviations in internal control during the audit planning phase for the current year.

However, the team did not perform additional audit procedures, including increasing the number of samples for the tests of controls.

(Auditing Standards Committee Statement No. 530, paragraph 6; Auditing and Assurance Practice Committee Statement No. 82, paragraphs 57 and 137)

- ▶ The engagement team conducted sampling tests for the procedures to assess the internal control regarding sales processes. However, the team did not examine whether the number of samples extracted was sufficient to reduce the sampling risk to an acceptably low level. For example, the team did not decide the number of samples by taking into account the frequency of control activities and the number of control activities at each point.

(Auditing Standards Committee Statement No. 530, paragraph 5)

Case 2: Assessment of design and operating effectiveness of internal control

- ▶ In assessing the operating effectiveness of the revenue process, the entity identified and assessed its control for review of individual contracts and signed on the approval column of the monthly sales summary sheet by supervisors.

However, the engagement team only verified the signatures affixed to the approval column routinely in reviewing the entity's assessment, without obtaining sufficient audit evidence showing whether internal controls were operated appropriately.

(Auditing and Assurance Practice Committee Statement No. 82, paragraphs 149 to 151)

- ▶ The engagement team asserted that it assessed the operation of internal control regarding revenue recognition. However, it only verified the amounts on the sales statements against those on the external vouchers, and did not perform the procedures for assessing the operation of internal control regarding revenue recognition.

(Auditing and Assurance Practice Committee Statement No. 82, paragraphs 149 to 151)

《Points to Note》

In some internal control evaluation procedures, the engagement team described only the results of control activities in the audit documentation, like whether a signature had been affixed to a document. With sufficient understanding of the Auditing Standards Committee Statement No. 230 ("Audit Documentation"), the team needs to take into consideration the 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 experiences in the past year.

Furthermore, in implementing a detailed test and procedures for assessing the operation for the same transaction as dual-purpose tests, the engagement team needs to pay attention to whether it can take procedures that are suited to the purposes of the both tests, 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 identified 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 and 6; 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, and No. 330, paragraphs 5 and 6; 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: Determination of materiality

As the guideline for determining the materiality of internal control deficiencies, the materiality should be the same as the materiality for financial statement audit because it could eventually affect the reliability of the financial statements. However, the engagement team did not examine the reasonableness of materiality in the audit of internal control over financial reporting, despite the fact that it was not same as the materiality in the consolidated financial statements.

(Auditing and Assurance Practice Committee Statement No. 82, paragraph 188)

Case 2: 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)

- ▶ The engagement team judged that the deficiencies in IT general control, identified by the entity's internal auditor, were not deficiencies of internal control over financial reporting. However, the team did not assess the possibility whether the deficiencies could cause the material misstatements on the financial reporting.

(Auditing and Assurance Practice Committee Statement No. 82, paragraph 185)

Case 3: Determination of material weakness

- ▶ In assessing deficiencies in the internal control that had not been corrected by the end of period, the engagement team did not examine if said deficiencies fell below the level of material weakness after taking into account qualitative materiality, compensating control, accounts affected by the internal control deficiencies, the potential quantitative impact, and the likelihood of occurrence of deficiencies.

(Auditing and Assurance Practice Committee Statement No. 82, paragraphs 42 and 190 to 211)

- ▶ The engagement team did not examine if the misstatements that were found during the auditing of financial statements were deficiencies in the internal control audit that affected financial reporting.

(Auditing and Assurance Practice Committee Statement No. 82, paragraphs 190 to 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 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 of performing the internal control as designed, many errors in performing internal control, and poor understanding on the nature and objectives of the internal control by the person who performs the internal control.

When finding a deficiency in internal control, the auditor 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 below the level of material weakness.

(4) Use of Management Assessment

Case: Extent of using the work of internal auditors

- ▶ The engagement team failed to notice that the team could not use management's assessment because the person who assessed the internal control in the entity performed controls subject to assessment in some cases, undermining the objectivity of such assessment.

(Auditing Standards Committee Statement No.610, paragraphs 8 and 10; and Auditing and Assurance Practice Committee Statement No. 82, paragraph 238)

- ▶ In assessing the operating effectiveness of internal control over business processes, the engagement team planned to carry out an assessment using its own samples selected by the team in addition to re-performance of samples tested by management.

However, the team only verified the approval seal of the person in charge through reviews and did not re-perform the assessment performed by the management. Furthermore, the engagement team did not select and test its own samples other than the assessment performed by the management.

(Auditing Standards Committee Statement No. 610, paragraphs 8 and 10; and Auditing and Assurance Practice Committee Statement No. 82, paragraph 238)

«Points to Note»

The auditors used the works 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 the quality of assessment by the internal auditors is high enough to be used as audit evidence.

In this case, the auditor should keep in mind that it is necessary to examine the degree of risk corresponding to internal control that the auditor plans to use, 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 works performed by the internal auditors.



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