Case Report from Audit Firm Inspection Results

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Certified Public Accountants and Auditing Oversight Board

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Expectations for Audit Firms

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. From the perspective of promoting voluntary efforts by audit firms to maintain and improve their audit quality, the CPAAOB has been issuing, since February 2008, the "Case Report from Audit Firm Inspection Results" (in Japanese), a compilation of examples of deficiencies identified through the most recent inspections.

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 causes 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 often be 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, partners 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 Engagement Performance" section in the "Individual Audit 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 many 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 other areas, not just an insufficiency in the knowledge, experience, competence and capabilities of the engagement team.

Lastly, as described in Quality Control System "9. Cooperation with Those Charged with Governance," the CPAAOB's inspection results show that, in many cases, there is not sufficient cooperation between those charged with governance of the entities and the auditors. Those charged with governance and auditors are expected to cooperate to ensure and improve audit quality through enhanced and strengthened cooperation. In particular, those charged with governance of the entities should promote cooperation with auditors, for example, by actively asking them about the QC status and review, the CPAAOB's inspections results, etc., making full use of this Case Report.

Important Points for Users of this Case Report

In the 2014 Case Report, the organization of the previous report is maintained, with the contents divided into two parts: “Quality Control System” and “Individual Audit Engagements,” as outlined below (Note):

► In the Quality Control System section, 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 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 "2. Professional Ethics and Independence" through "8. Joint Audit" describes direct causes of deficiencies and their analysis. On the other hand, in "1. Management Systems," the root causes of deficiencies found in the quality control systems of audit firms (including those related to individual audit engagements) are analyzed and described based on those direct causes analyzed in 2. to 8.

► The "Individual Audit Engagements" part of this Report is organized 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 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," "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.

In order to improve the quality control systems of audit firms and deficiencies in their individual audit engagements, CPAAOB recognizes that it is necessary to take essential actions to deal with the root causes of the deficiencies. From this viewpoint, we allocated more space in this Case Report for 2014 to describe the analysis of the causes.

(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 "Standard to Address Risks of Fraud in an Audit".

I. 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 sufficient and appropriate 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.

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 reveals any deficiency in the quality control system of an audit firm, the CPAAOB not only examines the direct causes of the deficiency but places emphasis on the finding of root causes (such as problems in the CEO or other top management's approach for management or quality control).

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 level 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.

Some small and medium-sized audit firms also worked to maintain and improve their quality control system, for example, by appointing a full-time PICOQC dedicated to QC practices.

(Outline of identified deficiencies)

As shown in the Case Example section below, some audit firms (mainly small and medium-sized) did not work to maintain and improve their quality control systems adequately. In some audit firms, the CEO, the PICOQC, or other responsible person did not fully fulfill their QC duties.

Some audit firms have not sufficiently improved deficiencies identified in the QC review; others have deficiencies in performing audit engagements repeatedly. In addition, there were some cases where audit teams did not respond to the audit risk appropriately with professional skepticism.

(Analysis of causes of deficiencies)

Root causes of the identified deficiencies can be categorized into the following types:

(1) Management system, management policy or business model of the audit firm;

(2) QC efforts by the CEO and other managers; and

(3) Partners' awareness of their duties; checks and balance among partners.

(1) Management system, management policy or business model of the audit firm

- The CEO placed more emphasis on business expansion than audit quality control. For example, the partners' performance and compensation were evaluated and determined based on their commercial results, but excellence of audit quality and compliance with professional ethics were not taken into consideration. Accordingly, the entire staff of the audit firm did not emphasize quality control.
- The audit firm failed to maintain consistent operation throughout the office. For example, the P&L status was controlled or salaries of partners were determined individually by each regional office. Or, the corporate head office was not involved in or did not supervise the operations of regional offices.
- Partners and other accountants employed by an audit firm were allowed to engage in their own private practice, besides their duties in the audit firm. Many of them spent more time on their private practice than on their duties for the audit firm. Governance by the CEO over these partners and accountants was not effective enough.

(2) QC efforts by the CEO and other managers

- The CEO and PICOQC did not understand the quality control system level required by the practical audit guidelines or other similar documents. Therefore, they mistakenly believed that the efforts made by the audit firm for improving the quality control system were sufficient.
- Despite the repeated finding of deficiencies in CPAAOB's inspections and QC reviews, the CEO and other managers did not recognize that the audit firm had serious deficiencies in its quality control system.
- The CEO and other managers recognized that the awareness of audit quality improvement varied among partners and audit quality varied among engagement teams, and that there were gaps between the audit quality levels of individual engagements. Despite this, the CEO and other managers did not take necessary measures to maintain and improve the audit quality of all engagements to a given level or higher.
- The CEO and other managers recognized that the audit firm did not have a sufficient number of experienced certified accountants who could take charge of audit engagements. Despite this, the CEO and other managers had not fully considered taking the action necessary to secure a sufficient number of audit practitioners having adequate audit capabilities and competence.
- The CEO and other partners participating in the management of the audit firm did not take the quality of their audits seriously. Accordingly, they did not plan or take measures to promptly improve the quality of all their audit engagements to a given level or higher.

(3) Partners' awareness of their duties; check and balance among partners

- In some auditing firms, there were more certified accountants with limited experience than experienced certified accountants. In such a situation, individual partners totally relied upon the CEO or the PICOQC for quality control for 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.
- Partners did not recognize that they must critically monitor and inspect the quality of audit engagements which other partners were in charge of.
- Understanding of the necessity and significance of organizational auditing was not shared among partners because no discussions had been conducted about it.

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 the above section 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 under which quality is essential in performing each engagement.

Case 1: Establishment of quality control system

Matters to be resolved by the partners meeting, such as the acceptance and continuance of audit engagements, were implemented without discussion or approval of the partners meeting. A system in which each partner monitors and examines other partners' performance, to ensure, collectively as an organization, the appropriate performance of audit engagements, had not been established.

Although many deficiencies were pointed out in the QC review regarding the performance of individual audit engagements, no action was taken in a concrete manner to understand and examine the implementation status of improvement measures. This indicates the audit firm as a whole had not established a system to maintain and improve audit quality.

(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 undertaken audit engagements of listed companies as an engagement partner or equivalent position prior to assuming the CEO position of 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 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 identified in the CPAAOB's inspection

The audit firm had been repeatedly warned in the previous inspections by the CPAAOB and the JICPA that it had deficiencies in individual engagements. Despite this, the CEO did not understand that the audit firm had serious problems in its quality control system and did not take action or fulfill his duties as CEO. Specifically, the CEO just followed the formality of giving directions to the PICOQC and audit practitioners to take action against the deficiencies. Planning and implementation of specific actions were left to the PICOQC and audit practitioners. As a result, effective improvement measures were not taken.

When managing the audit firm, the CEO made light of quality control. Because this CEO's mindset permeated the whole firm, other managing partners and partners did not think that they had responsibility for audit quality, and thus failed to perform their duties as partners of the audit firm.

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

Case 4: The CEO's response to deficiencies pointed out in the QC review

The CEO did not take serious action to enhance the partners' awareness, capabilities and competence to control audit quality and perform audit engagements.

The PICOQC did not fully confirm whether or not the quality control system was effective. Accordingly, he or she did not plan or take appropriate action for audit quality improvement.

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

Case 5: Partners' awareness of their duties; check and balance among partners

The CEO of an audit firm did not understand to what extent the firm was required to develop its quality control system. The CEO placed emphasis only on the engagement quality control review, made light of other QC activities and left all QC responsibilities to the PICOQC.

The PICOQC neither understood his/her duties nor the quality control level currently required for the audit firm.

Moreover, partners other than the CEO and the PICOQC did not pay attention to the quality control issues within the audit firm. They did not think that they needed to participate in QC activities. Consequently, there was no mutual check and balance among the partners.

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

Case 6: Responsibility for quality control in regional offices

The regional offices is independent from the principal office in terms of finance and personnel matters of the office as well as decisions making on their own on many matters other than those requiring Partners Meeting approval.

Therefore, the principal office did not sufficiently recognize the QC status of the regional office, and did not give adequate directions to the regional office. The audit firm failed to integrate its operation and thereby to improve the quality of audit engagements.

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

(2) Initiatives to Improve Performance

<u>Points of focus</u> 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 audit engagements, and inspects, for each item, each engagement to see how each item of the improvement of deficiencies previously identified in each individual audit engagement is progressing. 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)

There were cases where the deficiencies identified in the QC review were sufficiently and appropriately addressed. For example, some audit firms achieved improvement by establishing specific improvement measures, under the leadership of the PICOQC, based on the improvement plan submitted to the JICPA and taking carefully into account the actual operational conditions of the firm and individual engagements and the characteristics of their entities. The status of such improvement measures was promptly examined by the engagement partners and the EQC reviewers or the like in charge of individual engagements.

(Outline of identified deficiencies)

As shown in the Case Example section below, in some firms, 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)

Causes of the identified deficiencies:

- The PICOQC or the like considered that the deficiencies identified in the QC review came from the individual audit engagements reviewed and the circumstances specific to the audit team. Thus, he or she did not investigate the root causes of those deficiencies.
- The PICOQC or the like used a checklist which included the deficiencies pointed out in the QC review and corresponding improvement measures to be taken, but the verifying was perfunctory. Engagement partners and EQC reviewers did not examine the improvement of their own audit engagements based on a correct understanding of the deficiencies.

Expected response

Audit firms must recognize that deficiencies identified in the CPAAOB's inspection or the QC review are not just problems related to specific engagements. When planning and implementing improvement measures, audit firms must fully examine, based upon reasons why the identified deficiencies were inappropriate, whether any other item not only in the specific engagements in which they were found but in other engagements needs to be improved. They should also thoroughly check whether the planned improvement measures have been properly implemented, and thus improve the performance of all audit engagements they undertake. For example, to improve a deficiency found 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 of specific policies and procedures for improvement

The audit firm developed a checklist for improving deficiencies found in the QC review. But the checklist only listed the deficiencies. It did not include implications of the deficiencies. There were also problems with the users (audit practitioners) of the checklist. Audit practitioners who utilized the checklist only carried out superficial verification. For example, a checklist listed a deficiency of "failure to verify real estate sale/purchase transaction against external evidence." A user of the checklist placed a check mark in the "Not Applicable" box just because the entities he was in charge of had no real estate sale/purchase transactions. They conducted verification without understanding of implication of the deficiencies.

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

Case 2: 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 ensured 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, we observed, often in small or medium-sized audit firms, deficiencies concerning the establishment, communication, or application of internal rules.

(Analysis of causes of deficiencies)

One of the reasons causing this type of deficiency is that 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 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

The PICOQC of the audit firm thought that it would be sufficient for each engagement team to refer to the "Guideline for Auditing of Financial Statements Based on the New Drafting Plan" (issued by the JICPA) as needed. Accordingly, the internal rules related to auditing had not been revised to reflect the guidelines stipulated in the "Materiality in Planning and Performing an Audit" (Auditing Standards Committee Statements 320) and the "Group Audits" (Auditing Standards Committee Statements 600).

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

Case 2: Establishment of internal rules

The PICOQC of the audit firm did not verify the consistency of the partners meeting rules, etc., as established or revised, with the articles of incorporation of the firm. Therefore, inconsistencies were found between the internal rules and the articles of incorporation; for example, the articles of incorporation stated that the appointment of engagement partners and compensation of partners “shall be determined by unanimous approval of the partners,” while the partners meeting rules, etc. stated that they “shall be determined by a majority of the votes of the partners present at a partners meeting where a majority of all the partners are present.”

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

Case 3: Establishment of internal rules

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 4: 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 5: 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 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’ 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 CPAAOB, therefore, inspects the status of compliance with applicable laws, regulations, and professional standards, and the status of the establishment and implementation of the management systems to ensure such compliance.

Outline of inspection results

(Observed effective efforts)

The Act on Prevention of Transfer of Criminal Proceeds requires audit firms to verify customer identification data for certain transactions. In accordance with this requirement, some audit firms (regardless of their size) have established internal rules relating to this requirement and checked that they were not involved in transactions subject to this requirement.

(Outline of identified deficiencies)

As shown in the Case Example section below, some audit firms, mainly small and medium-sized, had compliance-related deficiencies, including breach of the non-compete obligation by partners, misstatements in their business reports, 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 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

Audit firms should establish appropriate management systems for 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: Matters stated in business report

Without a centralized system in place for gathering and managing information to be stated in business reports, the CEO of the audit firm, who is in charge of business report preparation, prepared reports, and nobody else other than the CEO verified the accuracy of the reports. This resulted in some errors in the description of "status of partners, employees, etc.," "status of cyclical inspection of audit engagements." etc. of the submitted business report.

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

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. Therefore, audit firms are required to establish and operate information security systems that fully and appropriately meet the sensitive needs of the IT environment, etc.

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

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

Outline of inspection results

(Observed effective efforts)

Some effective efforts observed in our inspections were:

- ・ Prohibiting, as a general rule, the carrying of computers 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 computers 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, including computers, used for their audit engagements.
- ・ Verifying periodically the storage conditions of written materials before they were compiled into audit documents to prevent a leakage of confidential information from unattended written or printed documents.

(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. Others did not distribute copies of their internal information security rules to audit practitioners.

(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.

Expected response

Audit firms should fully understand the damage and other adverse effects that may occur in the event of an information leakage, 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 an information leakage were established.
- Stored data were not classified according to their crisis level; no backup or encrypted data were created for stored data; no ID codes or passwords were assigned to audit practitioners to protect critical electronic data from unauthorized access.
- The firm required all members to submit a "security policy compliance report," but some members failed to submit it.

(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

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)

(6) Prevention of Insider Trading

Points of focus

CPAs hold the important social mission of ensuring the reliability of the capital markets, so if one 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 a 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 the preventive measures specified in such rules were never implemented.

(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: Operation of internal anti-insider trading rules

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: Operation of internal anti-insider trading rules

Although the internal rules required the anti-insider trading manager to communicate to firm members promptly in the event of any entity personnel change, the anti-insider trading manager did not make some of the entity 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: Operation of internal anti-insider trading rules

The anti-insider trading manager of the audit firm notified firm members of changes of entities to which the audit firm provided audit services, but not with those of listed companies to which the audit firm provided non-audit services.

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

Case 4: Operation of internal anti-insider trading rules

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 appropriateness of the procedures for confirming the satisfaction of independence requirements 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;
- ► 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 appropriate independence confirmation procedures on all those subject thereto, according to classification of those confirmed;
- ► 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.

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 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 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: Annual independence confirmation

The audit firm did not perform independence confirmation procedures annually. It did not appoint practitioners in charge of independence confirmation. It did not have specific procedures therefor, either.

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

Case 2: Confirmation procedures for accepting new engagements

The audit firm did not have concrete measures in place to confirm independence, such as practitioners in charge of independence confirmation and specific procedures. Before acceptance or renewal of 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: Confirmation procedures for accepting new engagements

The audit firm did not have internal rules in place that required documentation of independence confirmation results for storage. The firm did not keep written results of the confirmation procedures that it claimed its partner who was to serve as an engagement partner had performed before acceptance or renewal of audit engagement.

(Quality Control Standards Committee Statement No. 1, paragraphs 25 and 56)

Case 4: 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:

- In the annual independence confirmation procedures, “checklists for accounting firms in the Ethics Rules section,” and “checklists for audit firm partners in the Laws and Regulations section” were not obtained from the audit firm and the partners;
- Annual independence confirmation procedures were not performed for audit practitioners who were not partners;
- Independence confirmation procedures were not performed for some affiliated entities of the audit firm;
- The PICOQC did not implement the independence confirmation procedures for some newly joined partners at the time of joining or of annual implementation;
- Although the PICOQC claimed that they verbally provided information to part-time audit practitioners about audit engagements performed by the audit firm at the time of conclusion of the employment agreement and that they confirmed independence using an independence checklist, they did not notify the said audit practitioners of the names, etc. of affiliates of the entities;
- As the PICOQC was not aware that the “Independence Checklist for Auditors” (Ethics Committee Statement No. 1) had been recently revised, the old independence checklist was used for the confirmation of independence;
- 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, he or she 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?"

- When the PICOQC examined the independence checklists submitted by partners, he or she failed to see that certain items were not check-marked.

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

Case 5: 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 independence confirmation procedures.

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

Case 6: 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)

3. Acceptance and Continuance of Engagements

(1) Performance of Internal Procedures

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, 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 ("audit risks"), including the integrity of the entity;
- ► Whether the audit firm retains audit practitioners having knowledge, experience, capabilities and competence required to deal with the specified audit risks appropriately; and
- ► Whether the audit firm could comply with requirements related to professional ethics

Regarding the examination of integrity 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.

In consideration of the above, the CPAAOB inspects the status of performance of the internal procedures for acceptance and continuance of audit engagement at each audit firm.

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, a firm used a checklist as stipulated in its internal rules, but the people who performed the check just placed check marks on the list to indicate that they did not find any problems. Thus, they did not perform any detailed risk assessment.

(Analysis of causes of deficiencies)

Causes for the identified deficiencies:

- The engagement partner (prospective) 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 engagement partner (prospective) 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 an engagement proposed by the partner who would take charge of the engagement, 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. Such re-examination should include, for example, checking whether or not the procedures for risk assessment have become a mere formality.

In addition, the Fraud Risk Response Standard states that:

"... in their policies and procedures for determination of acceptance and continuance of audit engagement, audit firms should include assessing all risks, including fraud risks, associated with acceptance and continuance of audit engagements, and have an appropriate department or person other than the engagement team verify the adequacy of such assessment depending on the degree of risk when accepting and continuing an audit engagement. "

Accordingly, each audit firm should strengthen its risk assessment procedures for the acceptance and continuance of audit engagements, including central control of fraud risk information, in light of the cases described below.

Case 1: Discussion in the Partners meeting

The engagement partner (prospective) considered that, regarding the acceptance and continuance of audit engagements, decisions could be made only through consulting the CEO or the PICOQC on an as-needed basis. As a result, the acceptance and continuance of audit engagements, which were matters to be resolved by a Partners meeting under the internal rules, were performed without holding a Partners meeting.

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

Case 2: Discussion in the Partners meeting

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 engagement partner (prospective), 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)

Case 3: Implementation of risk assessment procedures

A new engagement was proposed for auditing a listed company. The engagement partner (prospective) received a report from the predecessor auditor stating that the mid-year audit had revealed deficiencies in the internal control of said listed company. The engagement partner (prospective) checked the reliability of the internal control of the prospective client by using a "checklist for proposal of a new audit engagement." But the engagement partner failed to assess what engagement risks such internal control information obtained from the predecessor auditor implied.

(Quality Control Standards Committee Statement No. 1, paragraph 25; Auditing Standards Committee Statement No. 220, paragraph 11)

Case 4: Implementation of risk assessment procedures

The information obtained during the preliminary audit and inquires of the predecessor auditor indicated that the actual business performance of the entity had been far below the earnings outlook stated in their business plan, or that problems might exist in the management's attitude regarding application of accounting standards and the control environment.

When accepting the audit engagement with the entity, however, the engagement 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. 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 25; Auditing Standards Committee Statement No. 900, paragraphs 9 and 12)

Case 5: Implementation of risk assessment procedures

The engagement partner (prospective) received a report from the predecessor auditor about this engagement. With regard to whether there is any question regarding integrity of the top management, the report stated that "the top management of the entity was reluctant to report impairment losses because it insisted on reporting of profit at 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) did not assess these problems reported by the predecessor auditor as questioning the integrity of the top management. He or she 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 25; Auditing Standards Committee Statement No. 900, paragraph 12)

Case 6: Availability of human resources

When the audit firm discussed whether to accept or renew the audit engagement for financial institutions, the audit firm knew of the firm-wide lack of knowledge and experience necessary to perform sufficiently and appropriately audit procedures specific to financial institutes. However, the audit firm accepted or renewed such an audit engagement without taking sufficient and appropriate action to supplement this lack.

(Quality Control Standards Committee Statement No. 1, paragraph 25; Auditing Standards Committee Statement No. 220, paragraphs 11 and 23)

(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 auditor and the successor auditor are therefore required to ensure that the following points addressed:

- ► The predecessor auditor must carry 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 performs the audit engagement.

  The predecessor auditor must respond to inquiries made by the successor auditor, honestly with correct information. Especially in the case where the predecessor auditor is aware of information or circumstances concerning significant fraud in the financial statements that affected or could affect the auditor's opinion, the predecessor auditor must provide such information to the successor auditor;
- ► The successor auditor must communicate with the predecessor auditor regarding the handover of the audit engagement, by making inquiries, reviewing audit documentation, and other means; and the results must be properly documented.

In addition, the successor auditor must, in order to make a proper judgment as to whether the audit engagement should be accepted, inquire of the predecessor auditor about at least the following matters:

- ・ Whether there is any concern about the integrity of the management;
- ・ The predecessor auditor's opinion regarding the reason for change of the auditor;
- ・ Whether there were major differences of opinion between the predecessor auditor and the client, regarding accounting methods, presentation, and audit procedures;
- ・ Whether there were any cases of fraud by the management or significant fraud by any employee, or any signs of such fraud;
- ・ Whether there were any significant unlawful acts or acts suspected to be unlawful;
- ・ Whether there were any significant contingent liabilities or events that could possibly become significant contingent liabilities;
- ・ Whether there were any significant deficiencies regarding the internal control of financial reporting;
- ・ Whether there were any events or circumstances that would pose significant uncertainty regarding the going concern assumption;
- ・ In the event of an auditor change in the middle of the fiscal year, whether there were any uncorrected misstatements that had already been identified;
- ・ Whether there were any misstatements identified and eventually corrected in the course of past audits.

In consideration of the above, the CPAAOB inspects the status of the handover of audit duties in each audit firm.

Outline of inspection results

(Observed effective efforts)

Some effective efforts observed in our inspections were as follows.

A company changed audit firms during the fiscal year. The predecessor auditor passed on to the 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 another audit firm, before it accepted an audit engagement with a listed company, the engagement partner (prospective) contacted the predecessor auditor. The partner made inquiries of the predecessor and collected information about this prospective entity, and documented the collected information. The quality control department of the firm checked this document to confirm that the takeover of the entity from the predecessor auditor was properly completed. Moreover, in the same audit firm, when any of its entities that were a listed company terminated the audit engagement with the firm, the engagement partner for that entity followed the procedure to hand over the entity to a successor auditor and documented this handover process in the same manner used for taking over an engagement from another firm. The quality control department of the firm checked this document to confirm that the handover of the entity to the successor auditor was properly completed.

(Outline of identified deficiencies)

As shown in the Case Example section 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 adequate and timely internal procedures.

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 engagements

In addition, the Fraud Risk Response Standard requires that proper handover procedures be performed appropriately between the predecessor auditor and the successor auditor of an entity so as to share sufficient and accurate information concerning the risks of auditing the entity, stating that:

"The audit firm shall establish policies and procedures for the handover of an entity to the successor auditor requiring the firm to communicate significant matters arising from the audit, including how it addressed the risks of fraud, to the successor auditor and to accept the request from the successor auditor to review the relevant working papers. "

"The audit firm shall establish policies and procedures for the handover of an entity from the predecessor auditor requiring the firm to make inquiries of the predecessor auditor as to the reason for the change of auditor as well as significant matters arising from the audit, including how the risks of fraud were addressed. "

"The audit firm shall establish policies and procedures for the handover of an entity between the predecessor and the successor auditors requiring the engagement team to report the results of the handover communications to the appropriate department or person outside the engagement team. "

In addition, the Fraud Risk Response Standard also requires sufficient and accurate communication of audit risk information in the case of replacement of an engagement team within the audit firm, stating that:

"The audit firm shall have in place policies and procedures for quality control in performing audit engagements that require the audit firm to ensure that important audit matters, including the status of fraud risk responses, are appropriately communicated in the case of replacement of all the audit practitioners in charge of auditing the same entity. "

Case 1: 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 had started auditing the financial statements for the current year but had not yet submitted an auditor's report, and one that had completed the auditing and submitted an auditor's report for the previous year. When considering whether to accept the proposed engagement, the partner who would take charge of that engagement made inquiries only of the former predecessor but not the latter predecessor.

(Auditing Standards Committee Statement No. 900, paragraphs 8 and 9; and No. 230, paragraph 7)

Case 2: Inquiries to the predecessor auditor

In an audit firm, a new audit engagement with a fund entity was proposed. The engagement partner (prospective) did not make inquiries of the predecessor auditor of this entity. The engagement partner (prospective) 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 a fund entity for which the firm had performed audits for some time, and because the predecessor auditor did not notify the firm of any significant information when making inquiries previously.

(Auditing Standards Committee Statement No. 900, paragraphs 8 and 9; and No. 230, paragraph 7)

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 participants;
- ► Whether the audit firm provides education/training programs designed to maintain and improve the audit competence and capabilities of participants; this may include, for example, accurately identifying areas where audit practitioners tend to have less understanding and providing training focusing on these areas.

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 including group discussions on the depth of required audit procedures and factors inhibiting adequate audit procedures, etc.
- ・ 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. Audit practitioners identified audit risks from the sample financial statements, created an audit plan and presented the results of their study to experienced partners.
- ・ The audit firm provided training programs using this Case Report issued in previous years, and participants in the training program discussed and learned specific audit procedures required under the Auditing Standards Committee Statements and other regulatory documents.
- ・ In order to provide on-the-job training, on an appropriate scale, to audit practitioners with limited experience, the audit firm formed personnel units comprised of members within the specified numbers. A unit leader who took charge of developing and training the members of the unit was appointed to each unit.

(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. In particular, practical training programs were not provided on specific procedures necessary for auditing accounting estimates and group audit, and effective training programs were not provided on audits requiring expertise, such as those of financial institutions or funds.

(Analysis of causes of deficiencies)

Causes of the deficiencies include: the PICOQC or equivalent entirely entrusted the training of audit practitioners, including providing engagement-related knowledge, to the engagement partners, who provided instruction and supervision at the audit site; and a lack of awareness of maintaining and improving 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 found that some audit firms did not successfully put the advice given and awareness enhanced during training programs into practice in audit engagements. This suggests that audit firms face the challenge of how to enhance audit practitioners' professional skepticism and "sensibility" 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. The efforts may include, for example, 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 participants' knowledge, experience and current competence and capabilities.

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 and the scope of their audit engagements. 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: 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 practical training on specific procedures necessary for the auditing 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)

Case 3: Effectiveness of training, etc.

The audit firm explained to audit practitioners specific procedures for the auditing accounting estimates, self-assessment 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 have sufficient training in place based on the review of audit documentation to confirm whether the procedures performed by audit practitioners were sufficient and appropriate or confirm that the procedures performed 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 performance evaluation, compensation, 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 high priority on audit quality in the policies and procedures relating to personnel affairs;
- ► Whether the audit firm has designed 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:

- ・ The audit firm regularly evaluated the quality of audits performed by audit practitioners according to the evaluation items specified by the firm. The results thereof were communicated to audit practitioners.
- ・ 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 results 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 was increased when their audit performance was 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.

(Analysis of causes of deficiencies)

Causes of the deficiencies include: compensation for audit practitioners being determined for a long period of time based on a subjective performance evaluation of them by the CEO or other top management in some audit firms (mainly small and medium-sized). In some other firms, engagement partners were reluctant to assess the quality of audit engagement among them.

Expected response

Audit firms need to establish and implement policies and procedures for personnel evaluation, in order to maintain and enhance 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

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 are no specific policies or procedures established as to how the capability of audit practitioners and quality of audit engagements performed by them should be evaluated and how the results of such evaluation should be reflected in their compensation and promotion.
(Quality Control Standards Committee Statement No. 1, paragraph 28)

Case 2: Evaluation records for audit practitioners

The CEO and other top management of the audit firm believed that they can understand and manage the partners, members and their performance via daily communications with them. Thus, the firm had not stipulated what specific methods and procedures should be used when evaluating the partners and audit practitioners. In addition, the firm said that the performance of audit practitioners had been evaluated, but no records of such evaluation were found in our inspection.
(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, 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, ability to exercise judgment, 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 capacity of the audit firm as a whole to perform audits and other practices;
- The audit firm did not correctly understand the QC competence and capabilities of engagement partners.

Expected response

Audit firms need to assign audit practitioners who have professional knowledge, practical experience, ability to exercise judgment, 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

An engagement partner who lived at a distance from the audit firm and the entity, and mainly performed non-CPA services, was assigned as the engagement partner. The partner performs substantially no audit procedure other than visiting the entity once every quarter and thus did not spend sufficient time on audit engagements.

(Quality Control Standards Committee Statement No. 1, paragraph 29)

Case 2: Composition of engagement team

The engagement team for a listed entity consisted of three persons: the engagement partner and two junior accountants. Moreover, despite lacking sufficient competence/capabilities and experience to perform the audit, the junior accountants were assigned to a task related to significant items. These facts indicated that insufficient time and human resources were allocated given the audit risk involved.

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

Case 3: Assignment of engagement partner

The audit firm did not correctly understand the QC competence and capabilities of individual partners, and did not sufficiently identify audit risks for all entities based on their business environments and other relevant factors. Accordingly, engagement partners and EQC reviewers assigned to some engagements were often inappropriate for the business or audit risk associated with those engagements.

(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 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)

Deficiencies as described below were often observed by the CPAAOB's inspection.

- 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 point estimate and assumptions, relevant audit procedures performed by the engagement team and the basis for the auditor's conclusion.
- Some audit documentation was registered as "completed" despite the fact the significant audit procedures had not been completed.

Many other deficiencies were observed in audit documentation, such as lack of description of audit procedure which firms said they performed, the scope of testing some selected items in a population, audit evidence obtained, and the judgment process and the conclusion.

(Analysis of causes of deficiencies)

Causes for the identified deficiencies:

- The engagement partner or equivalent did not give sufficient instruction and supervision to the members of the engagement team, such as timely and appropriate review of audit documentation prepared by the team.
- Audit practitioners did not fully recognize the importance of audit documentation.
- The engagement team did not fully verify whether audit documentation was prepared regarding significant audit procedures before forming the audit opinion or registering the audit documentation.
- The audit firm identified that audit documentation was not prepared appropriately relating to the significant audit procedures in the cyclical inspections. Despite this, the firm did not correct this deficiency to appropriately perform audit procedures and prepare audit documentation in the

following years.

- Some engagement partners (often small and medium sized firms) did not review audit documentation 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 (often small and medium sized firms) did not provide sufficient direction or supervision to less experienced audit practitioners even though less experienced audit practitioners formed the majority due to frequent turnover of audit practitioners.

Expected response

Audit practitioners shall 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 made to reach those conclusions.

Engagement partners must realize that their review of audit documentation is a good opportunity to educate and train audit practitioners by communicating the level of audit procedures to be performed for each engagement as well as how they are to be described in the 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.

(2) Retention of Engagement Documentation

Points of focus

Audit firms are expected to pay sufficient consideration to the retention of audit documentation prepared by auditors. For this reason, the CPAAOB inspects the status of retention of audit documentation from the following perspectives:

- ► Whether the audit firm ensures the reliability of audit documentation, by tracking 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 that ensure 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 as follows. 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 in charge of quality control promptly verified whether the engagement teams completed preparation of the final audit documentation and whether they were properly registered in the database.

As another example, an 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. Moreover, some firms only monitored in 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 how audit documentation is controlled and retained. 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: Retention of audit documentation

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

- While no material problems had occurred in an audit firm, the PICOQC did not establish specific procedures, the person in charge of implementation, or other related matters regarding the completion of audit files and the retention of audit documentation;
- The audit firm did not keep track of the number of audit files, year prepared, retention period or other relevant matters;
- The audit firm only recorded the names of audit entities, business year, and the number of audit files in the summary, and did not record the serial number placed on each audit file or brief explanations of the contents;
- The audit firm did not conduct periodical physical inspection; instead it only kept audit documentation register. They had too much confidence that the current control method was sufficient because no problems, such as loss of audit documentation, had occurred in the past.
- At the stage of the completion of audit documentation, engagement teams did not fully confirm that they had prepared and retained audit documentation related to audit procedures for significant accounts. Accordingly, audit documents which were still in process were registered in the audit documentation control system.
- The audit firm registered some quarterly review documents in the management ledger after the appropriate deadline although the documents were not completed for filing within the period for final arrangement set forth in the internal rules (within 60 days from the date of review).

(Quality Control Standards Committee Statement No. 1, paragraphs 45 and 46)

6. Engagement Quality Control Review

Points of focus

Auditors, before expressing an opinion, must undertake 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 nature, timing or extent of audit procedures critically and sufficiently based on its unique viewpoint by being fully aware that the EQC reviewer, as a different position that is independent from the engagement team, is expected to play the role of the "last line of defense" in reviewing the appropriateness and sufficiency of the audit procedures.

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 sufficient and appropriate experience and ability to perform the duties is appointed as the EQC reviewer;
- ► Whether the EQC reviewer reviews at an appropriate time for the planning of an audit, significant audit judgments, and expressions of audit opinion;
- ► Regarding significant judgments and audit opinions made by the engagement team, whether the EQC reviewer discusses with the engagement partner, reviews audit documentation, evaluates audit opinions, and reviews the appropriateness of financial statements and the 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 experts and the conclusion reached, and records of significant judgments made by the engagement team in audit documentation;
- ► Whether 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 determined to be inappropriate are reached.

Outline of inspection results

(Observed effective efforts)

Some effective efforts observed in our inspections were that some audit firms had a council consisting of partners other than engagement partners and that 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)

As there are some cases of identified deficiencies including where the EQC reviewer did not fully review the necessity and sufficiency of the audit procedures related to significant matters and its judgment process, audit firms still face the challenge of enhancing and strengthening their EQCR system. In addition, as shown in the Case Example section below, there were cases of identified deficiencies: the EQC reviewer was not appointed in accordance with audit risk; and the effectiveness of review was not ensured because the EQC reviewer did not review from a critical standpoint.

(Analysis of causes of deficiencies)

Causes of the identified deficiencies include:

- ・ Despite high engagement risk, the EQC reviewer was not appointed in accordance with the risk;
- ・ The EQC reviewer had too much faith in the engagement partner, believing that the engagement team had carried out sufficient and appropriate audit procedures;
- ・ As the engagement team did not pass on to the EQC reviewer (including cases entrusted an

external EQC reviewer) 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 subject to EQCR 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, in addition to assessment of significant accounting practices.
- (Especially at small and medium-sized audit firms) partners responsible for QC gave priority to their own audit engagement and did not spend sufficient time on the EQCR because the firms were operated by a small number of partners.
- (Especially at small and medium-sized audit firms) no measures were taken to secure and bring up partners who were qualified to be the EQC reviewers, although there was a shortage of partners with necessary and sufficient knowledge and experience to carry out the review.

Expected response

When reviewing the audit planning, the EQC reviewer needs to review the risk assessment procedure conducted 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 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. 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, in some cases 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.

Meanwhile, audit firms must notice that the Fraud Risk Response Standard requires audit firms to improve and strengthen their EQCR system even for fraud risk response, and the EQC reviewers to perform effective review with due understanding of the magnitude of their own responsibilities, stating that:

"The audit firm should have in place the policies and procedures for EQCR that require the audit firm to review whether, if material misstatements are deemed to be contained due to fraud, the revised audit plan and procedures are adequate, and whether the audit evidence obtained is sufficient and appropriate," and "The audit firm should appoint qualified persons with sufficient and appropriate experience and positions (including a council consisting of eligible persons) to respond to such suspicions. "

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 their eligibility.

(Quality Control Standards Committee Statement No. 1, paragraph 38)

Case 2: Eligibility of the EQC reviewer

Partners who had knowledge and experience in accordance with audit risk were not appointed as the EQC reviewer to review audit engagements with high audit risk. Consequently, the checks-and-balances system of the EQC reviewer against the engagement team did not work

properly.
(Quality Control Standards Committee Statement No. 1, paragraph 38)

Case 3: Securing effective review

With regard to material audit items (evaluation of investments in and loans to affiliated companies, examination of the recoverability of deferred tax assets, and examination of the necessity of recognizing the impairment loss of fixed assets, etc.), the EQC reviewer judged that necessary and sufficient audit procedures had been taken, without undertaking a review critically and deeply from its original standpoint. Consequently, such EQC reviewer overlooked deficiencies arising in the audit procedures related to the above mentioned items.
(Auditing Standards Committee Statement No. 220, paragraph 19 and 20)

Case 4: Securing effective review

The EQC reviewer completed reviewing without undertaking a review in depth from a critical standpoint, believing that he or she was sufficiently able to exchange information on the audit engagement through daily communication with the engagement team. Consequently, such EQC reviewer overlooked deficiencies arising in the audit procedures responsive to significant risks.
(Quality Control Standards Committee Statement No. 1, paragraph 34 to 37)

Case 5: Securing effective review

Regarding significant items pointed out during EQCR by the EQR reviewer, the EQC reviewer only heard explanations of additional audit procedures carried out by the engagement team the other day and final audit judgments, and did not inspect the appropriateness and sufficiency of the relevant procedures carried out by the engagement team by examining the audit documentation.
(Quality Control Standards Committee Statement No. 1, paragraph 41 and 42)

Case 6: 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 contents of the audit procedures that they carried out for the items deemed to entail high audit risk. In addition, the engagement partner merely verbally provided the external EQC reviewers with a brief summary from the improvement recommendations and deficiencies identified in the QC review, but did not issue a written document containing the said improvement advice, 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 perform inspections 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 sufficient and 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 sufficient and 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 the 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 effective inspections, for example, by making inquiries with the engagement team and reviewing audit documentation and other documents instead of 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 recognized during the CPAAOB's inspection and the QC review;
- ► Whether the audit firm evaluates the impact of deficiencies identified as a result of inspections and ensures that the relevant engagement partner takes appropriate improvement measures.

Outline of inspection results

(Observed effective efforts)

Effective efforts observed in our inspections were: some audit firms tried to improve the quality of individual audit engagements by not only reviewing the appropriateness of risk assessment and sufficiency of audit procedures related to 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 reviewing 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.

(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;
- ・ Cyclical inspection practitioners did not realize the importance of cyclical inspections, lacked awareness in assessing the sufficiency and appropriateness of the audit procedures from an

objective standpoint, and did not perform critical inspections;

- (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 heavy workload;
- Audit firms only instructed third-party CPAs, to whom cyclical inspection was entrusted, to perform formal inspection according to the checklist.

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 audit engagements and identify inspection items by taking into account the economic environment, the business condition of the entity, and results of the latest 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.

Meanwhile, the Fraud Risk Response Standard requires audit firms to improve and strengthen cyclical inspections even from the standpoint of responding to fraud risk, stating that:

"The audit firm shall ascertain whether the following matters have been conducted in conformity with the quality control policies and procedures of the audit firm, by performing cyclical inspections as to how the risks of fraud have been addressed:

- Acceptance and continuance of audit engagements
- Education and training concerning fraud
- Audit performance (including supervision and review, dealing with information provided from inside and outside the audit firm, inquiries of technical opinions, EQCR, and handover between the predecessor and the successor engagement partners when there has been a change of engagement partner within the audit firm)
- Handover between the predecessor and the successor auditors"

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)

Case 2: Effectiveness of ongoing monitoring

The PICOQC at the audit firm got involved in many audit engagements as an engagement partner and did not spend sufficient time on inspecting the establishment of quality control system. Consequently, the firm did not review inspection items in the "inspection checklist" used for cyclical inspections upon change of accounting standards.

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

Case 3: Selection of targets for cyclical inspection

Although many deficiencies were pointed out regarding audits of financial institutions carried out by regional offices of an audit firm, no consideration was given to such problems when

selecting individual audit engagements as targets for cyclical inspections.
(Quality Control Standards Committee Statement No. 1, paragraph 47)

Case 4: Selection of targets for cyclical inspection

Although the internal rules required an audit engagement for each engagement partner to be selected as a target for cyclical inspection once every three years, some engagement partners had not been inspected in the three-year cycle.
(Quality Control Standards Committee Statement No. 1, paragraph 47)

Case 5: 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.

Therefore, 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 fixed 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 missed in the audit procedures of a joint audit performed by their partner firm.

(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 firms without sufficiently examining the appropriateness, etc., of the audit procedures performed by the partners.

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 joint auditor obtained copies of the audit documentation related to specific audit procedures performed by their joint audit partners, such as auditing accounting estimates and substantive procedures. However, because of poor inspection of the audit documentation concerned, the joint auditor overlooked deficiencies in the audit procedures performed by the joint audit partners.

(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, inspection of the details of notices about the relevant QC review given to those charged with governance by audit firms that received the QC review revealed that 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 QC review did not contain limitations but delivered improvement recommendations.

In addition, there were still some audit firms that did not give any notice, saying "the QC review only indicated minor deficiencies and it was deemed unnecessary to report to the statutory auditors," or "notification has not been specifically requested by the statutory auditors."

(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."

Meanwhile, the Fraud Risk Response Standard also state that:

" ...the auditor must ensure appropriate cooperation with those charged with governance at each stage of the audit, through consultation or otherwise, depending on details and degree of fraud risk. "

Furthermore, audit firms are thus required to strengthen cooperation between accounting auditors and those charged with governance from the standpoint of audit quality improvement, and not merely from the standpoint of fraud risk response. Accounting auditors and those charged with governance should also actively promote cooperation 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.

Meanwhile, the CPAAOB requests audit firms that were inspected by the CPAAOB to disclose to its clients the fact that it was inspected by the CPAAOB, whether or not the relevant entity was selected as a target for the inspection, whether or not there were deficiencies related to the relevant entity, the details of deficiencies related to the relevant entity, and assessment of the overall quality control, after sending the notice of inspection results to the firm (Note 1, 2 and 3). In principle, any disclosure of the CPAAOB's inspection results to a third party shall be subject to prior consent from the CPAAOB. However, it should be kept in mind that the above mentioned items can be disclosed without prior consent given the importance of cooperation between accounting auditors and those charged with governance.

(Note 1) Regarding "assessment of the overall quality control," the audit firm should disclose the inspection results after adjusting to reflect the establishment of quality control conducted at the audit firm instead of disclosing the relevant part of the notice of inspection results as it is.

(Note 2) In principle, no disclosure, including the fact that the audit firm is being inspected by the CPAAOB, is permitted during the inspection.

(Note 3) Disclosure should be made, preferably, in writing to clearly transmit information without causing any inconsistency in recognition to arise between both parties.

(2) Response to the Discovery of Fraud/Non-Compliance

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's inspects the status of how the audit firm responded to a discovery of fraud or non-compliance.

Outline of inspection results

(Observed effective efforts)

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

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.

II. Individual Audit Engagements

Audit Engagement Performance

Summary

The examples of identified deficiencies in individual audit engagements identified during the CPAAOB's inspections broadly cover audit planning through to the formulating the reports.

This section, "II. Individual Audit 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: auditing accounting estimates; audits of financial institutions, an industry on which emphasis is placed as audit engagement by industry; fraud in financial statement audits on which future development is the focus of attention; and audits of internal control over financial reporting, to 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 "I. 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 examples of the identified deficiencies in the preparation of appropriate audit documentation should be judged that the required audit procedures have not been carried out in most cases, instead of regarding as a mere documentation problem.

Analysis of causes of deficiencies

Immediate causes of the identified deficiencies contain in "II. Individual Audit 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 review because he or she did not appropriately understand the purpose of the accounting standards and the audit standards and lacked experience of 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 professional skeptic attitude to critical 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 insufficiently reviewed significant audit matters and the process of formulating of report from an objective and a 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 action to improve the quality of audit engagements because they considered deficiencies identified in the CPAAOB's inspection and the QC review as minor problems related to relevant individual audit engagements, not as problems affecting the whole firm.

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 any of 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 the formulating of reports.

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

In addition, if deficiencies are identified by the CPAAOB's inspection, the QC review, or cyclical inspection, they should be assessed and reviewed not only by the engagement team in charge, 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 a template 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 transactions that are outside the normal course of business 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 develop audit procedures 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 associated internal control regarding significant risks;
- ► Whether the engagement team intends not only to discover material misstatements individually but to develop procedures address audit risks considering 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 any 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 examples where the engagement team merely completed templates, such as the risk evaluation table, 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; and where the engagement team followed the responses to audit risks in the previous fiscal year, without properly reflecting identified risks in the audit plan.

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 at the audit firm that did not have a person with sufficient knowledge of IT participate in the engagement team, though the engagement team needed to understand the IT use status at the entity in identifying and assessing the risk of material misstatement.

Expected response

Audit practitioners should note that they must perform substantial risk identification and assessment referring to this Case Report and the Audit Proposals issued by the JICPA without placing too much

reliance on audit experience. In addition, when developing the responses to audit risk, they should carefully examine whether the procedures respond 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 implementation.
For more information on fraud response required in this process, see “6. The Auditor’s Responsibilities Relating to Fraud in Financial statement audits.”

(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 the nature, timing and extent of direction and supervision of the engagement team members and 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 application of 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 substantive analytic procedures and nature and extent of tests of details.
(Auditing Standards Committee Statement No. 300, paragraph 8)

Points to Note:
In designing and performing responses to audit risk, the engagement team shall carefully consider the timing and extent of audit procedures responsive to the assessed risks of material misstatement. Besides the nature of the procedures, the team shall consider whether the audit procedures respond to the assessed risks of material misstatement and whether sufficient appropriate audit evidence be obtained.

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 change designing and performing substantive procedures for each material class of transactions, account balance, although there were changes in the business environment and 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, as a result of changes in business activities due to the reorganization of the entities, or overdue accounts receivable and slow-moving and

obsolete inventories occurred, the engagement team needs to modify the audit risk assessment. Although the engagement team recognized these changes, the engagement team did not consider the necessity of revising the audit plans.

(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

- ► As the engagement team collectively assessed risks 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 25)

- ► The entity operated several businesses. Under such circumstances, the engagement team collectively identified risks of material misstatement related to revenue at the assertion level. The team did not identify risks of material misstatement at the assertion level considering differences in the revenue recognition policies, the revenue transactions, and the relevant internal control.
  (Auditing Standards Committee Statement No. 315, paragraph 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. The engagement team should note that they need to identify and assess the risks of material misstatement, by the class 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.

Case 2: Identifying and assessing risk of material misstatement

- ► The entity examined the recoverability of shares in subsidiaries and affiliates whose liabilities exceed assets based on the business plan assuming sales growth, but the relevant business plan involved uncertainties over a wide range. Impairment of the shares in subsidiaries and affiliates would have a significant impact on the entity's financial statements.
  However, the engagement team did not assess whether the risk of material misstatement due to valuation of the shares of subsidiaries and affiliates identified are a significant risk.
  (Auditing Standards Committee Statement No. 315, paragraphs 26 and 27)

- ► 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 are 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

planning of risk assessment and its response procedures under the audit plan. Specifically, for example, the engagement team only recognized fraud 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 would turn out to be 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 transactions that are outside the normal course of business 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 gross profit 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 appears to be substantially different from the anticipated income 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 it needs to carefully examine 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 change the determination of materiality from the previous year, 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

- ► Although account balances exceeded the performance materiality, the engagement team did not examine rational reasons not to identify the risk of material misstatement at the assertion level as a significant account.
  (Auditing Standards Committee Statement No. 330, paragraph 17)

- ► Although the engagement team recognized that inventories stored at external warehouses were significant in the entity's financial statements, they did not examine whether they should perform substantive procedures, such as a physical inventory observation and

external confirmation.
(Auditing Standards Committee Statement No. 330, paragraph 18; No. 501, paragraph 7)

Points to Note
The engagement team shall design and perform substantive procedures for each material class of transactions, account balance, and disclosure, 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 developed an audit plan relying on the internal control for revenue transactions, in which they identified significant risks.
However, the engagement team cannot rely on the internal control at the issuing auditor's report under the Companies Act, because it evaluated the operating effectiveness of the relevant internal controls after the date. But it designed the test of details as if they could rely on the internal control.　Consequently, it resulted in an insufficient number of samples for the test of details.
(Auditing Standards Committee Statement No. 330, paragraph 20)

Points to Note:
In addition to the identified deficiencies mentioned above, examples of responses to the assessed risks of material misstatement due to fraud, such as accounting estimates and revenue recognition, are described in "3. Auditing Accounting Estimates" and "6. Fraud in Auditing Financial Statements." Please refer to them, accordingly.

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

► In examining segment information, since the engagement team had not developed an audit plan, the engagement team only agreed the report of segment information with the consolidated balance sheet and income statements. The engagement team did not examine any procedures to verify the accuracy of segment results or elimination of intersegment transactions/balances.
(Auditing Standards Committee Statement No. 330, paragraph 19; No. 501, paragraph 12)

► In examining the consolidated cash flow statements, since the engagement team had not developed an audit plan, the engagement team only performed analytical procedures of 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

Although the entity posted the amortization of goodwill in the statements of income, the engagement team overlooked that the entity did not disclose information on the amount of amortized goodwill and the unamortized goodwill balance by reportable segment.
(Auditing Standards Committee Statement No. 330, paragraph 23)

Points to Note
There were some cases where the engagement teams overlooked misstatements in disclosure, since they had not included the examination of disclosures in their audit plans, though they examined specific accounting treatment when the entities performed reorganization or adopted new accounting policies. The

engagement teams should note that they need to include the examination of disclosures when developing or revising their audit plans.

(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 or 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 engagement team used a type 2 report as audit evidence that controls at the service organization are designed and operating effectively. However, the engagement team had not developed procedures to confirm whether changes were made to those internal controls outside the period covered by the type 2 report.

(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 obtain an understanding of the services provided by a service organization and its internal control in the entity's operations. Meanwhile, when obtaining an understanding of entity's internal control, the engagement team shall evaluate the design and implementation of relevant controls at the entity that relate to the services provided by the services organization. Note that these are required to be performed not only in financial statement audits but also audits of internal control over financial reporting.

(6) Evaluation of misstatements identified as the audit progresses

Case 1: Examination of identified misstatements as the audit progresses

- ► The engagement team did not consider whether the nature of identified misstatements and the circumstances of their occurrence indicate that other misstatements may exist.
  (Auditing Standards Committee Statement No. 450, paragraph 5)

- ► The engagement team did not consider whether the number of samples considering the sampling risk and the 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 financial statements and account balances as a whole, although they identified many uncorrected misstatements.

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

(7) Identifying and assessing the risks of material misstatement about the information system and procedures of the auditor's response to assessed risks

Case 1: General understanding of IT use

The engagement team did not plan any audit procedures to obtain general information on IT,

such as an overview of the IT infrastructure and the number of cases processed by IT, regarding the use of IT by the entity at the initial audit engagement.
(IT Committee Practical Guidelines No. 6, paragraph 4)

Points to Note:
The purpose of obtaining a general understanding of IT use is the same for the initial year audit and the ongoing audit.
However, unlike the ongoing audit, the engagement team does not necessarily have enough information on the entity in the initial audit engagement when developing the audit plan. Therefore, the engagement team should note that it needs to pay careful attention, when taking over from the predecessor auditor or on other occasions, to the control environment related to IT use, such as deficiencies of internal control related to IT in past years and the management's understanding and recognition of IT, and try to understand them at an early phase of the audit.

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

The engagement team planned to use the lists of overdue accounts receivable and slow-moving and obsolete inventories generated an information system in performing substantive procedures about overdue accounts receivable and slow-moving and obsolete inventories, 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 it needs 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 and 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 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 examine 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 it did not assess the nature and relevance of data to be used for estimation purposes.
- ► Even though the assessed risk of material misstatement was high, the engagement team performed the tests of details using only the entity's internal vouchers and other less reliable audit evidence without assessing the quality of the obtained audit evidence.
- ► In sampling in the audit procedures to respond to the assessed risk, the engagement team did not extract 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 assess 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 "6. The Auditor's Responsibilities Relating to Fraud in Financial Statement Audits.

Expected response

The engagement team needs to assess appropriately whether it has 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 reliable and adequate.

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 instructions 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 refer to the cases observed in the inspection; however, it needs to design appropriate audit procedures in each audit engagement from the variety of audit procedures available to apply.

(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 audit procedures beyond inquiry because the team did not detect any problems in the entity's inventory valuation based only on the entity's reply asserting that there were no slow-moving and obsolete inventory.
(Auditing Standards Committee Statement No. 330, paragraph 25; and No. 500, paragraph 5)

► The engagement team designed audit procedures to respond to the assessed risk in combination with substantive analytical procedures and tests of details to verify sales amounts.
However, the engagement team did not sufficiently perform substantive analytical procedures. In the tests of details, the team did not examine individual transactions because there were no transactions in excess of the threshold amount set by the team although the accounts as a whole exceeded the performance materiality. Under these circumstances, the engagement team did not evaluate the sufficiency of audit evidence obtained through audit procedures to respond to the assessed risk.
(Auditing Standards Committee Statement No. 330, paragraph 25; and No. 500, paragraph 5)

Points to Note:
Generally, mere inquiry 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 to address audit risks to corroborate the evidence obtained through inquiry. That applies not only to procedures for significant risks but also to audit procedures to respond to the assessed risk.
Auditors design audit procedures to respond to the assessed risk in substantive analytical procedures, tests of details, or a combination of both, depending on the conditions, but not all audit procedures to respond to the 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, but did not obtain quantitatively or qualitatively 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, as a result of the analytical procedures and tests of details performed, the engagement team did not examine the necessity of fraud risk assessment or additional audit procedures even though inconsistencies and irregularities arose between financial data.

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

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

- ► The engagement team did not obtain relevant audit evidence to ensure cut-off of sales—such as vouchers containing the product delivery dates.
(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 balance external confirmation as an audit procedure responsive to the risk. Through the confirmation, the team recognized the significant discrepancy from the customer response.
However, the engagement team verified the subsequent cash receipt of only part of the receivable as a procedure to attest 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 only examined the entity's internal vouchers, such as billings, execution instructions, etc., not external vouchers such as customers' acceptance certificates and delivery receipts, in order to ensure the existence and cut-off of sales. However, the team did not assess the relevance and reliability of audit evidence in the course of planning and execution of audit procedures.
(Auditing Standards Committee Statement No. 330, paragraph 25; and No. 500, paragraph 6)

- ► The engagement team compared net sales values and book values of inventories held more than 3 months since the last purchase date for inventory valuation.
However, the team did not obtain relevant audit evidence since the samples team examined mostly consisted of inventories held less than 3 months since the last purchase date.
(Auditing Standards Committee Statement No. 330, paragraph 25; and No. 500, paragraph 9)

Points to Note:
Like the examples of identified deficiencies mentioned above, the engagement team did not obtain audit evidence relevant to the audit purpose; or just routinely verified books against vouchers overlooking inconsistencies in information contained in the evidence.
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 the reliability and relevance of audit evidence in the planning and the execution of audit procedures.
When tests of internal control were used as substantive tests (dual-purpose tests), the engagement team did not consider the procedures' relevance to assertion and effectiveness as substantive procedures. For example, the team just extracted samples from shipment vouchers, not from sales transactions in the books, and simply verified the manager's seal on vouchers routinely without confirming whether the transactions were recorded in the books, even though the team performed the audit procedures as substantive tests for

sales generated. When planning and performing tests of internal control and substantive tests, the team needs to evaluate whether planned procedures are relevant to audit purposes.

Case 3: Work of management's experts

The engagement team used a share valuation report prepared by the entity's external expert as audit evidence for the valuation of shares that the entity acquired, but did not evaluate the competence, capabilities or objectivity of the expert.

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

Points to Note:

When using the work of the management's experts (including pension actuary, attorney, real estate appraiser), 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 4: Accuracy and completeness of materials prepared by the entity

The engagement team only verified the mathematical accuracy of calculations of the slow-moving and obsolete inventory list prepared by the entity. The team did not examine the accuracy and completeness, or quantity and price of listed inventories.

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

Points to Note:

There were still cases where the engagement team utilized as audit evidence documents prepared by the entity without verifying the accuracy and completeness of the information therein. When using information obtained from entities as audit evidence—not limited to that generated from information systems—the engagement team needs to sufficiently examine the reliability of such information.

(2) External confirmation

Case 1: Reliability of reply to confirmation request

In balance confirmation of accounts receivable, the engagement team only received replies via fax and did not collect the originals. In addition, the team did not examine the reliability of the responses, affixed only with an unofficial seal of the person in charge of confirmation, by inquiry of the counterparty.

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

Points to Note:

In external confirmation, the engagement team needs to review not only the reliability of replies but also the completeness of the population in selecting counterparties. The team also needs to examine the relevance between financial statements and audit evidence by verifying the accuracy of the values on the confirmation letters against those on the sub-ledger.

Case 2: Alternative audit procedures

► In confirming outstanding receivables and payables, the engagement team did not perform alternative procedures even though 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 treated replies

with a blank in the amounts as replies without exception. The team did not perform necessary procedures including requesting additional confirmation letters and alternative procedures.
(Auditing Standards Committee Statement No. 505, paragraph 11)

► The engagement team identified the existence of the accounts receivable as a significant risk, but did not perform sufficient alternative procedures for counterparties with no confirmation replies. The team only agreed to identify the portion of transactions subject to confirmation against the relevant invoices.
(Auditing Standards Committee Statement No. 505, paragraph 11)

Points to Note:
External confirmation generally provides relevant and reliable evidence. Therefore, if the counterparty does not reply to confirmation, the engagement team needs to perform alternative audit procedures. At the same time, the team should carefully assess whether it has obtained relevant audit evidence at the same level as confirmation replies.

Case 3: Exception in relation to confirmation

► The engagement team did not obtain adequate audit evidence 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 exceptions with internal vouchers including sales slips, without examining the adequacy of the nature of replies with external vouchers.
(Auditing Standards Committee Statement No. 505, paragraph 13)

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

Points to Note:
The engagement team should investigate the differences between the confirmed and stated amounts and obtain audit evidence such as specific vouchers for the cause of the recognized material exception.
If the engagement team identifies as a misstatement in relation to confirmation as a result of cause analysis, the team also needs to evaluate the effectiveness of internal control and the impact of the misstatement on the financial statements.

Case 4: Timing of substantive procedures (procedures for remaining period)

The engagement team performed balance confirmation procedures before the date of financial statements, but did not perform substantive procedures for the remaining period to the date of financial statements.
(Auditing Standards Committee Statement No. 330, paragraph 21)

(3) Analytical procedures

Case 1: Requirements for substantive analytical procedures

- ► The engagement team designed substantive analytical procedures as substantive procedures for detailed accounts of more than performance materiality for 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 analyzing the difference between the recorded depreciation expense ratios and those of the auditor's expectation.
  (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 procedures, including verification of budget development process, for examining the accuracy and reliability of the budget when the team used the budget prepared by the entity for sales and gross profits as expectation.
  (Auditing Standards Committee Statement No. 520, paragraph 4)

- ► In performing substantive analytical procedures for annual sales, the engagement team used the modified business budget, second half year budget with first half year actual result, as expectation. However, the engagement team did not assess the appropriateness of the expectation to identify a misstatement that, individually or when aggregated with other misstatements, may cause the financial statements to be materially misstated.
  (Auditing Standards Committee Statement No. 520, paragraph 4)

- ► The engagement team determined a threshold percentage as the amount of any difference of

recorded amounts from expected values that is acceptable without further investigation when performing substantive analytical procedures for sales and cost of sales. However, the team did not determine an appropriate threshold to identify a misstatement that, individually or when aggregated with other misstatements, may cause the financial statements to be materially misstated, since regardless of the significance in the amount of difference of the recorded amount from the expectation, no further investigation was performed below the threshold percentage.
(Auditing Standards Committee Statement No. 520, paragraph 4)

Points to Note:
In some cases, substantive analytical procedures did not meet individual requirements stipulated in the audit standards. For example, the engagement team used the actual previous period data as expectation 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, individually or when aggregated with other misstatements, may cause the financial statements to be materially misstated.

Case 3: Investigation of results of substantive analytical procedures

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 cause 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)

Points to Note:
In analytical procedures in the final stage of the audit, the engagement team performed annual comparisons of financial statements routinely without considering the purposes of the audit procedures. The team overlooked inconsistencies between financial statement amounts or between financial statement amounts and information obtained from other audit procedures. In the analytical procedures that assist when forming an overall conclusion, the engagement team needs to analyze and evaluate whether the financial statements are consistent with the auditor’s understanding of the entity.

(4) Audit sampling

Case 1: Planning of audit sampling

- ► In sampling in the audit procedures to respond to the assessed risk, the engagement team decided the number of sampling items with 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)

Points to Note:
In planning audit sampling, the engagement team needs to consider purposes of the audit procedures and the most suitable combination of audit procedures to archive those purposes, in consideration of the characteristics of the population from which test target items are to be extracted. 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 quantitatively significant items and obtaining information including the nature of transactions. Therefore, the engagement team needs to decide an effective method to achieve the purpose of the audit procedure by combining testing specific items and audit sampling.
The engagement team also needs to pay attention to the completeness of the population in audit sampling.

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 remaining portion.
(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 remaining portion because it is impossible to project certain characteristics for the entire population from the results of audit procedures through testing specific item.
If the engagement team detects any misstatement through testing sampling items, 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 majority 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 majority shareholder group.
  (Auditing Standards Committee Statement No. 550, paragraph 10)

- ► Although the subsidiary's main customers are related parties such as fellow subsidiaries, the

engagement team did not comprehensively examine its related party transactions.
(Auditing Standards Committee Statement No. 550, paragraphs 10 and 24)

► The entity collected questionnaires from all its directors on the date of the financial statements regarding related party transactions.
However, the engagement team did not perform audit procedures to ensure the completeness of related party transactions, as the questionnaires only asked for descriptions of transactions of in excess of a certain amount.
(Auditing Standards Committee Statement No. 550, paragraphs 10 and 14)

Points to Note:
Related party transactions are often carried out in the normal transaction process, but also tend to carry higher risks than non-related third party transactions, with fraud more likely to be committed. Therefore, the engagement team needs to pay attention to, as a precondition for performing audit procedures, comprehensively understanding the entity's related parties and its relationships with them, and carefully evaluating the reasonableness of business in recognized transactions.
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 whether 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."

Case 2: Communication with those charged with governance

The engagement team recognized significant changes in the related parties (main stockholders) during the year but did not communicate with those charged with governance regarding material matters in relation to the related parties.
(Auditing Standards Committee Statement No. 550, paragraph 26)

(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, 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.

Case 2: Additional audit procedures when events or conditions are identified

- ► The entity identified the events that might cast significant doubt on the going concern assumption, as it posted significant operating losses and negative operating cash flows due to deterioration in earnings during the year, rapidly becoming cash-strapped. On the other hand, the entity judged that there was no material uncertainty about the entity's ability to continue as a going concern because the entity obtained a letter of intent of financial support from the major shareholders and might allocate new shares to third parties.
  However, the engagement team did not evaluate the feasibility of the financial support from the major shareholders to the entity. The team also did not examine the entity's entire financial plan including sources of finance, financing estimates and feasibility. Specifically, the team did not examine the feasibility of future capital increase although the entity had not executed the recently scheduled allocation of new shares to third parties.
  In respect of refinancing of loans that have fallen due, the engagement team did not obtain appropriate audit evidence that can confirm the intent of the counterparties to the contracts.
  (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 date of the financial statements 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 financial planning, also see "Case 5: Evaluation of reasonableness of business plan" of "(1) Matters common to auditing of 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 for events occurring between the date of the financial statements and the date of the auditor's report, including at least:
(1) Understanding the procedures performed by the management;
(2) Inquiry of the management;
(3) Reviewing the minutes of board of directors meetings;
(4) Reviewing 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, paragraphs 4)

► The engagement team sent to an attorney a letter of confirmation containing a list of litigation, but the team failed to describe the assessment of the results of the litigation and the management's estimate of financial impact, including relevant expenses, in the letter. Consequently, the team did not obtain any opinion from the attorney regarding such assessment or impact.
(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 the litigation or claim arose and how long it continued, the status of the litigation or claim and the degree of likelihood of losses arising therefrom; and an estimate of expected losses.

Case 3: Consolidated financial statements

► In examining the adequacy of 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 adequacy of 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 the 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)

► The engagement team did not examine the profits and losses of affiliated companies' subsidiaries, although it was necessary to include them, if important, in earnings of affiliated companies.
(Auditing Standards Committee Statement No. 500, paragraph 5; Auditing System

Committee Statement No. 9, paragraph 3)

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 gross profits in the case of complicated intragroup transactions. The engagement team needs to appropriately understand the business group, including that an assessment of capital structure, substantial control, and 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 assumptions used by management in accounting estimation;
- ► Whether, in case the engagement team identifies significant risks in accounting estimates, the engagement team performs deeper audit procedures to assess estimation uncertainty and examines the adequacy of the accounting treatment;
- ► 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.

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:

- ► In auditing accounting estimates including 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 failed to assess the critical standpoint by obtaining specific audit evidence and only performed inquiries of management.
- ► The engagement team did not sufficiently inspect the reasonableness of the management's assumptions in the accounting estimates.
- ► The engagement team did not estimate company category in examining the recoverability of deferred tax assets based on the Auditing 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, " "Test of data on which the accounting estimate is based, " "Review of prior period accounting estimates, " "Evaluation of reasonableness of business plan, " "Evaluation of reasonableness of other estimates, " and "Timeliness of accounting treatment. " In addition, matters to keep in mind in relation to audit procedures specific to accounts are described per account heading in from " (2) Evaluation investments in affiliated companies’ " to " (7) Recoverability of deferred tax assets."

Expected response

Accounting estimates are accompanied by uncertainty. The risks of material misstatement vary depending on the degree of uncertainty. Thus, auditors should examine the elements affecting the 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

- ► The entity recognized impairment for the entire value of the goodwill related to its subsidiary's business due to a significant deterioration of the business environment, while judging no indications of impairment of long-lived assets related to the subsidiary business. The engagement team did not consider the reasonableness of the management judgment.
(Auditing Standards Committee Statement No. 540, paragraph 12)

- ► The entity, which had credits to advances and accounts due to the same customer, recognized allowance for doubtful accounts for half the amounts of the both advance and accounts due as it lost contact with the customer.
However, the engagement team made inconsistent judgments for the advances and accounts due. The team proposed the necessity of additional allowance for the advances, resulting in an uncorrected misstatement. On the other hand, the team agreed with the management's judgment that no additional allowance is needed for the accounts due.
(Auditing Standards Committee Statement No. 540, paragraph 12)

Points to Note:
Other than the examples of identified deficiencies mentioned above, there were inconsistent judgments between accounts. For example, although the entity recognized impairment loss on its subsidiary’s shares, the equivalent goodwill posted 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 entity calculated the allowance for sales returns by multiplying the accounts receivable balance by the rates of sales returns and of profit, without considering the potential effect of sales returns from the inventories at customers, in circumstances where significant sales returns occurred every year for old products following the release of new products.
However, the engagement team did not review the adequacy of the calculation method for the allowance and the sufficiency of the allowance.
(Auditing Standards Committee Statement No. 540, paragraphs 7 and 12)

- ► The engagement team did not examine the adequacy of the entity's calculation method for allowance; the entity calculated the allowance for sales returns based on past overall rates of sales returns and of profit for all the products in aggregate even though the rates of sales returns and of profit vary by each product.
(Auditing Standards Committee Statement No. 540, paragraphs 7 and 12)

- ► The engagement team did not examine the reasonableness of the fact that the entity did not accrue any allowance for product warrantee even though it provided long-term product warrantee. Specifically, the team did not examine the past experience for warrantee for damaged products and any relevant warrantee 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.

Case 3: Test of data on which the accounting estimate is based

- ► In examining the appropriateness of basic data used by the entity to project retirement benefit obligation, the engagement team only inquired of the entity's staff in charge, without examining the adequacy of the entity's projected retirement rate or the projected payment election rate on lump sum payment.
(Auditing Standards Committee Statement No. 540, paragraphs 7 and 12)

- ► The engagement team examined documents prepared by the entity in audit procedures to identify indications of impairment in long-lived assets, but did not verify the accuracy and completeness of operating profits of each store and the adequacy of allocation of corporate expenses described in the documents.
(Auditing Standards Committee Statement No. 500, paragraph 8; and No. 540, paragraph 7)

Points to Note:
The engagement team needs to review the reasonableness of the management's accounting estimate by examining the accuracy, completeness and relevance of basic data, as well as the reliability of the information that the management utilized for its assumptions.

Case 4: Review of prior period accounting estimates

- ► In examining impairment of long-lived assets, the engagement team did not evaluate the degree of reliability of the entity's estimation process or degree of uncertainty even though there was a significant deviation between the entity's business plan and actual results for the previous year.
(Auditing Standards Committee Statement No. 540, paragraph 8)

- ► For auditing allowance for customer loyalty program, the engagement team did not analyze the results against the estimates of the previous years to evaluate the degree of uncertainty of the management's estimate.
(Auditing Standards Committee Statement No. 540, paragraph 8)

Points to Note:
In some cases, the engagement team only ascertains the reason for deviation between the estimate for the previous period and the actual results in reviewing the entity's business plan, but it does not apply the obtained understanding in evaluating the management's estimate in the current period. The team needs to note that reviewing the accounting estimates for the previous period is to identify a possible management bias and to evaluate the degree of the uncertainty of estimates.

Case 5: Evaluation of reasonableness of business plan

- ► In examining the recoverability of investment in the affiliated company with significantly deteriorating financial conditions, the engagement team inquired of and obtained a reply from the entity as to the reasons for the significant increase in projected sales and profits in the business plan compared to past actual results.
However, the team did not examine the reply with specific supporting evidence.
(Auditing Standards Committee Statement No. 540, paragraph 12)

- ► The entity identified indications that long-lived assets might be impaired with the

considerably deteriorating business environment in its core business, but judged it unnecessary to recognize impairment.
However, the engagement team did not sufficiently examine the reasonableness and feasibility of the medium-term business plan which was utilized for the undiscounted future cash flows.
(Auditing Standards Committee Statement No. 540, paragraph 12)

► In examining the recoverability of deferred tax assets, the engagement team judged regarding the reasonableness of the business plan which was a base of the future taxable income projection that it was highly probable for the entity to perform better than the current year due to introducing new products, expanding overseas sales and reducing distribution costs although its performance deteriorated significantly.
However, the engagement team did not examine the reasonableness of the business plan with numerical figures and other specific supporting evidence.
(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.

Case 6: Evaluation of reasonableness of other estimates

The engagement team did not examine the reasonableness of the management's point estimate by verifying the accuracy of the total man-hours estimate in the budget or the subsequent occurrence of additional costs as tests of details about the revenue recognition under the percentage of completion method.
(Auditing Standards Committee Statement No. 540, paragraph 12)

Case 7: Timeliness of accounting treatment

► In the previous year, the engagement team judged it unnecessary to recognize impairment on the entity's subsidiary’s shares whose carrying value exceeded its net asset value by 50%, without performing audit procedures except inquiry. The entity asserted that the subsidiary

would achieve the profit plan with new product sales and other measures, leading to recovery of the net asset value of the shares to the acquisition costs. In the current year, however, the entity recognized impairment loss impaired to the salvage value on the shares because net asset of the subsidiary's shares further deteriorated with a slump in new product sales.
However, the engagement team did not assess whether the prior year estimate in the subsidiary shares was a misstatement.
(Auditing Standards Committee Statement No. 540, paragraphs 11 and 17)

► The entity had accrued allowance for inventory valuation by systematically reducing cost based on passage of time from the acquisition but in the current year it changed the policy for valuation of inventories as net sale values often exceeded corresponding cost. Consequently it reversed the allowance recognized in the previous years and increased acquisition costs in the current year.
However, the engagement team neither examined the entity's accounting with the specific audit evidence nor whether it was prior year misstatement.
(Auditing Standards Committee Statement No. 540, paragraphs 11 and 17)

Points to Note:
In some cases, the engagement team did not sufficiently examine the assessment of credits, inventories, investments in affiliates, long-lived assets, goodwill, or deferred tax assets despite the radically deteriorated business environment and financial performance of the entity. This led to the recognition of valuation losses in the subsequent year. The engagement team needs to carefully examine appropriateness of the timing of accounting including changes in accounting policies and changes in accounting estimates.

(2) Evaluation investments in affiliated companies
Case 1: Valuation of subsidiaries' shares under particular circumstances
Although the subsidiary’s shares declined more than 70% in the net assets compared to the book value, the entity judged it unnecessary to recognize the impairment because the subsidiary was established only three years ago and its business was growing. The subsidiary had continued in deficit since its inception, and its actual business performance had not met its original business plan.
However, the engagement team did not examine the reasonableness of the entity's judgment.
(Auditing Standards Committee Statement No. 540, paragraph 12)

Points to Note:
Without any reasonable counter evidence, it is necessary to recognize impairment losses if shares decrease in net asset value by more than around 50% compared to the acquisition cost. The same applies to the valuation of shares of affiliated companies even just after their establishment or merger. Careful evaluations should be made, including examination of the estrangement between the original business plan and the actual results.

Case 2:Review of net assets
Although the subsidiary’s shares declined more than 50% in terms of 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:
In one case of valuation of a subsidiary’s shares, the engagement team considered but did not sufficiently examine the excess earning power at the time of acquisition of the shares. If the originally expected excess earning power decreases after acquisition of shares, the value of shares may significantly decrease. In this case, it is necessary to recognize 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

► An entity's subsidiary changed its valuation method for slow-moving and obsolete inventories in the current year. However, the engagement team did not specifically examine the reasonableness of the change based on the business operations, sales results of the prior years, or its internal and external business environments.
(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 low-volume, high- variety products.
(Auditing Standards Committee Statement No. 540, paragraph 7)

Points to Note:
Other than the examples of identified deficiencies mentioned above, the engagement team did not examine whether the inventories were valuated appropriately considering that the entity held a certain quantity of repair parts for the long term.
The engagement team needs to review the reasonableness of the method of the management's estimate

with an appropriate understanding of the current economic environment of the entity, because the original assumptions for the entity's method of inventory valuation may deviate as the changes in the environment.

Case 2: Review of recognition and measurement review

- ► The engagement team did not evaluate the reasonableness of the entity's not deducting the estimated amounts of sales and other cost from net sale values in the examination of inventories valuation.
(Auditing Standards Committee Statement No. 540, paragraphs 11 and 12)

- ► The engagement team did not verify the completeness of the data of actual loss on product past disposal that the entity used for calculation of valuation loss on inventories. The team did not examine the adequacy of the recognized amount of the valuation loss either.
(Auditing Standards Committee Statement No. 540, paragraphs 11 and 12)

(5) Impairment of long-lived assets
Case 1: Review of cash generating units

The entity's cash generation unit was each operating division. The engagement team did not examine the appropriateness of the entity's grouping policy although the entity managed operating profits and investment decisions by each store.
(Auditing Standards Committee Statement No. 540, paragraph 11)

Points to Note:
Cash generating units should, in 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 adequacy of the policy to cash generating units, where 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 indications of impairment of long-lived assets, the engagement team did not examine, based on reasonable counterevidence, the entity's assertion that the operating loss of some stores for two consecutive years did not indicate impairment as the stores were expected not to report operating loss in the subsequent year.
(Auditing Standards Committee Statement No. 540, paragraph 12)

Points to Note:
Other than the examples of identified deficiencies mentioned above, the engagement team did not regard the entity's temporary fractional income in a period as an indication of impairment despite experiencing loss continuing from past years, 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. The engagement team should carefully examine indications of impairment.

Case 3: Review of idle assets

The entity judged 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 but accepted the entity's judgment without obtaining sufficient audit evidence about 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:
In 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 of or 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 and other aspects of how long the asset has been idle. The engagement team, for example, should examine even soon after the asset becomes idle whether the period is deemed necessary to define the future use of the asset.

Case 4: Review of residual value

The entity recognized impairment losses on some stores because no future cash flows were expected from them. At the same time, the entity judged it possible to utilize the furniture and fixtures installed in the stores for use in other stores and evaluated the furniture and fixtures as their residual values.

However, the engagement team did not examine the possibility of the furniture and fixtures to be used in other stores and the entity's past results of reutilization of furniture and fixtures.

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

Points to Note:
The engagement team needs to carefully examine the feasibility, including reasonableness, of the entity's conversion plans even though assets for which impairment loss is not recognized with a conversion plan were functionally available.

(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 assets acquired and the liabilities assumed plus 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 the amortization period up to 20 years.
(Auditing Standards Committee Statement No. 540, paragraphs 11, 12 and 17)

► The engagement team did not examine indications of goodwill impairment and the period for which goodwill would continue to be effective, although the acquired company experienced worse performance than originally planned and resignation of most of its executives who were taking the lead in the business of the company.
(Auditing Standards Committee Statement No. 540, paragraphs 11 and 17)

Points to Note:
The engagement team needs to sufficiently examine indications of impairment even in the year the goodwill first arises, if significant. This is why indications of impairment could exist even in the 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).
The engagement team also needs to note that the impairment of goodwill in the consolidated financial statements affects the valuation of subsidiary shares in the individual financial statements.

(7) Recoverability of deferred tax assets
Case 1: Review of company classification

► The entity classified itself as "company class 3" as specified in the Auditing 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 fell 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 carried forward arose in the current and previous years, although the entity had significant tax losses carryforward 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 the Auditing Committee Statement No. 66, the following cases were often 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 No. 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 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 5: 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 specified in the 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 it too early to reverse the allowance and the timing of the reversal to be 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 from 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)

4. Using the Work of Others

Point of focus

(1) Group audit

Recently fraud cases in foreign subsidiaries have been reported. The CPAAOB inspects 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 an area other 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 verify 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.

Expected response

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 auditor needs to develop an appropriate audit plan and perform audit procedures, and evaluate whether sufficient appropriate audit evidence has been obtained to gain a basis for an opinion regarding group financial statements.

In addition, the auditor should take sole responsibility for the audit opinion that it expresses, even if it uses experts in making use of the work of others. Therefore, before 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 audit evidence conforming to the audit purpose.

(1) Group audit

Case 1: Significant components

► The group engagement team examined the impact of the revenue of subsidiary components on consolidated financial statements in determining the scope of use of audit results of the component auditors. However, the group engagement team did not determine the scope by considering the components' benchmarks other than revenue.
(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 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:
In determining significant components, it is necessary to consider the materiality in group financial statements not only quantitatively but also qualitatively.

Case 2: Materiality

► The group engagement team revised both materiality for the financial statements as a whole and performance materiality. However, the team did not notify the significant component auditors of the revised materiality.
(Auditing Standards Committee Statement No. 600, paragraph 39)

► The group engagement team set the materiality level for significant components the same as that for the group financial statement audit purpose, not lower.
(Auditing Standards Committee Statement No. 600, paragraph 20)

► The entity announced during the fiscal year the revised consolidated sales projection mainly due to the deteriorating performance of the existing business and an increase through acquisitions in the number of consolidated subsidiaries. Reflecting the announcement, the group engagement team changed the index used for calculating materiality for the financial statements as a whole applied to the group financial statements from the consolidated sales for the previous year to the revised consolidated sales projection, resulting in increased materiality for the financial statements as a whole.

Although the group engagement team recognized the deteriorating performance of the existing business of the entity group, the team allocated across the board the revised materiality to significant components operating the existing business, without considering the factors for change in the sales projection. As a result, the materiality applied to the existing business components increased, but the team did not examine the adequacy of the materiality.

(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 due to organizational restructuring, in particular, 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: Response to Assessed Risks

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, the group engagement team did not examine whether the matters identified by the component auditors as significant risks should be identified as significant risks of the group financial statements.

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

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, the group engagement team obtained the audit plan and other information from component auditors late. 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 note to sufficiently communicate with component auditors on significant risks of the subsidiary group to examine the necessary to reflect such risks in risk assessment of the group financial statements.

Furthermore, the group engagement team should also assess the necessity to perform additional audit procedures if the group engagement team has encountered the events that were not identified when developing the audit plan regarding subsidiaries or other insignificant components.

Case 4: Consolidation process (uniform accounting policies)

As for foreign subsidiaries regarding which the group engagement team did not use audit results from the component auditors, the group engagement team did not verify whether significant differences existed between the local accounting standards at the subsidiaries and International Financial Reporting Standards.

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

Case 5: 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 6: Sufficiency and appropriateness of audit evidence obtained

- ► The group engagement team was not able to obtain audit results from the component auditors by the date of the auditor's report. Therefore, the group engagement team performed alternative procedures.
  However, as the alternative procedures, the group engagement team only compared the component's financial figures with those of the prior period, without obtaining sufficient appropriate audit evidence as the group auditor.
  (Auditing Standards Committee Statement No. 600, paragraphs 42 and 43)

- ► Although the group engagement team received information from the component auditors regarding uncorrected misstatements, it did not evaluate the quantitative and qualitative impact caused by the uncorrected misstatements and whether the uncorrected misstatements resulted from fraud or its possibility of fraud.
  The group engagement team did not evaluate the impact caused by the uncorrected misstatements on audit concerning internal control over financial reporting either.
  (Auditing Standards Committee Statement No. 600, paragraph 44; and No. 450, paragraph 10)

- ► The group engagement team did not evaluate the details of audit procedures planned or performed by the component auditors for significant risks of the group financial statements.
  In addition, the group engagement team did not examine whether the audit procedures performed by component auditors were sufficient and appropriate to provide a basis to express opinions on the group financial statements.
  (Auditing Standards Committee Statement No. 600, paragraphs 30, 41 and 43)

- ► The group engagement team did not evaluate the details of audit procedures planned or performed by component auditors regarding significant risks of the group financial statements, although the auditors of significant component subsidiaries had identified accounts with estimates as significant risks.
  (Auditing Standards Committee Statement No. 600, paragraphs 41 and 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 performed by the component auditors, and whether sufficient appropriate audit evidence has been obtained to reach a rational

conclusion that will provide a basis to express opinions.
Even if component auditors are network firms, the group engagement team also needs to evaluate the audit evidence obtained alike.

(2) Making use of experts

Case: 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 to evaluate.

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)

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 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 to address 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 firms had their QC and financial institution auditing departments lead the work with local offices to maintain and improve the quality of auditing financial institutions nationwide. Small and medium-sized audit firms also worked to maintain and improve the quality of audit engagement of financial institutions, including expert training.

However, some audit firms did not plan or perform audit procedures adapted to the significant risks of material misstatement of the financial institution, as shown below. 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. Other audit firms did not provide a clear basis for audit judgment because their audit documentation did not contain sufficient or appropriate descriptions concerning the audit evidence they obtained on material matters.

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 based on an understanding of the environment surrounding finance administration such as revision of the financial inspection manual and the characteristics 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 needs 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 including verification of self-assessment, 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 identified self-assessment of loans (valuation of loan-loss provisions) as a significant risk.

However, the engagement team only inspected the data and inquired about an audit procedure for the risk, without performing sufficient substantive procedures.

(Auditing Standards Committee Statement No. 330, paragraph 20; Special Committee for Bank Auditing Statement No. 4 V and [Reference Appendix] thereto)

Points to Note:

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

The following are 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 sufficiently document the debtor categorization process or conclusion of the debtor categorization process in the audit documentation, and did not retain in the audit documentation but discarded materials including management improvement plans that support determining the adequacy of debtor categorization.

(2) Write offs/ Loan Loss provisions

Case 1: Accuracy of actual rate of irrevocable loans

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

(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

The engagement team did not consider obtaining from the financial institution the back test results of actuals vs forecasts prepared in previous years, for loan-loss provisions.

In addition, the engagement team did not examine whether the estimated amount of uncollectible receivables subsequently occurring as of 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 examine the financial institution's review process for collateral evaluation. In the substantive procedures, the engagement team did not verify the collateral coverage, valuation method or 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 carryforward had been generated by one-time significant debtor bankruptcies.

However, the engagement team did not examine whether the cause of the tax loss had an 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 taxable loan-loss provisions and securities impairment losses in large amounts through write offs because of their industry characteristics. Therefore, there may deductible temporary differences at year end far larger than past ordinary profit levels. Significant losses carryforward 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 provision," the engagement team should carefully determine extraordinary events such as business restructuring or legal amendment as reasons for the occurrence of the significant losses carryforward.
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 a 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)

- ► In assessing the operating effectiveness of IT general controls, the engagement team determined the operating conditions as effective only by inquiry and inspection, without performing appropriate audit procedures including reperformance.
  (Auditing Standards Committee Statement No. 330, paragraph 9)

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.
The engagement team also needs to obtain sufficient appropriate audit evidence for validating the operation conditions of the IT general controls in auditing financial institutions with high IT use, because IT general controls are designed to support effective operation of IT application controls by ensuring the continuous and appropriate operation of information 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 or 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

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 result 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 amount was below the performance materiality.
(Auditing Standards Committee Statement No. 330, paragraph 17)

Points to Note:
The auditor needs to plan and implement substantive procedures for quantitatively material classes of transactions, account balances and disclosure, regardless of the significance of assessed risk of material misstatement. Unlike general companies, financial institutions, in particular, normally have a larger scale of total assets than pretax profit level because of their industry characteristics, therefore using balance sheet items as the materiality calculation index. It is necessary therefore to note to non-sampling risks when using the monetary sampling method to profit and loss account items.

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

The engagement team did not examine the adequacy of the cut-off of the policy reserve calculation file. The team only extracted transactions (including posted insurance revenues and provisions for outstanding claims) before and after the creation date of the file, without sufficiently verifying whether the said transactions properly reflected the file. The team did not perform a cut-off test to verify, in particular, whether new contracts established and insurance claim contracts realized during the entity's settlement catch-up period had been properly accounted according to the appropriate settlement catch-up standards.
The engagement team also did not sufficiently verify whether data that were not included in the policy reserve calculation file during the settlement catch-up period were corrected during closing adjustment classification.
(The Industry Audit Committee Report No. 3, paragraph 2, Appendix 1 and Appendix 2)

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 valuated 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 whether a misstatement, if identified, is indicative of fraud; and evaluates the implications of the misstatement in relation to other aspects of the audit, particularly the reliability of management representations, recognizing that an instance of fraud is unlikely to be an isolated occurrence in the audit plan;
- ► 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 fraud in which the management is involved are 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 failed to identity indications of fraud that could have been identified from an objective and critical standpoint in actual fraud cases.

Expected response

Conventionally, auditors have been expected to preserve professional skepticism. In view of the Fraud Risk Response Standard being applied to the audit of the fiscal year ended in March 2014, auditors should maintain and exercise professional skepticism, always paying attention to fraud risks regardless of the experience of audits in the past.

To appropriately identify risks of material misstatement due to fraud, auditors should understand fraud which has been made public, and general and industry-specific business practices, and should assess the likelihood of fraud using such business practices. The engagement team should discuss them and reflect them in the audit plan and planned procedures.

They should recognize and assess how internal control reduces fraud risks, and should perform appropriate audit procedures to respond to risks of management override.

Furthermore, they should be always conscious of the likelihood of material misstatement due to fraud, paying attention to the business reasonableness of transactions in the entity.

In addition, auditors should obtain audit evidence that is more relevant or reliable or in greater quantity, for the assertion related to the identified risk of fraud than that for other assertions in which no risk of fraud is identified. They should also perform additional audit procedures if sufficient appropriate audit evidence has not been obtained. If auditors identify any circumstances indicating possibility of material misstatements due to fraud in the course of audit procedures, in particular, they should inquire and ask for explanations 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 carefully evaluate whether the misstatements indicate fraud more than other aspects.

(1) Risk assessment procedures

Case 1: Assessment of fraud risk factors, and identification and assessment of material misstatement risks

- ► The representative director who is the main stockholder of the entity guarantees of loan obligations of the entity. A change in the financial condition of the entity has a significant impact on the representative director. Therefore the entity in general is highly susceptible to management fraud.
  However, the engagement team did not evaluate risks of misstatement of financial statements due to management fraud as fraud risks.
  (Auditing Standards Committee Statement No. 240, paragraph 23)

- ► The engagement team understands that the entity operated IT-related business is generally considered as high-risk, that there were cases of fraud and business trouble 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:
It is necessary to maintain and exercise professional skepticism in identifying fraud risk factors, including incentives or pressure to commit fraud, or events or situations which create opportunities to do so; as well as in assessing the risks of material misstatement.

Case 2: Discussion within the engagement team

The engagement team asserts that they discussed about risks of material misstatements due to fraud in the team meeting. However, the engagement team did not pursue substantial discussions regarding possible material misstatements due to fraud.
(Auditing Standards Committee Statement No. 240, paragraph 14)

Case 3: Inquiries with the management

The engagement team had discussions 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, or 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, or 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 indication of improper timing of revenue recognition. 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 such as 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 inquires 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. Although the primary responsibility to prevent fraud lies with the management, considering the situation where many fraud cases at entities have been reported recently, the engagement team needs to perform audit engagements with a sufficient understanding of auditors' responsibilities and with professional skepticism.

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) Response to assessed risk of material misstatement due to fraud

Case: Business rationality of significant transactions

► 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 financial statement captions.

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

► Although there were conditions of risks of related party transactions or unusual sales returns in the business environment of the entity, the engagement team did not assess the business rationality or potential risks of such transactions.

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

► The entity transferred the subsidiary stocks and loans receivable of its wholly-owned insolvent subsidiary in book value from itself to another wholly-owned subsidiary in the group.

The significant unrecognized losses in the entity's individual financial statements were transferred to its subsidiary with the transaction, but the engagement team did not evaluate the business rationality of the transaction or whether the transaction indicated fraudulent financial reporting.

In addition, the engagement team did not assess the reasonableness of the transaction including the price of transfer within the consolidated group, and the appropriateness in the entity's

individual financial statements.
(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 loan to the company and its representative.
  In relation to these unusual transactions 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 or 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 or the necessity of a re-assessment of risks related to revenue recognition.
  (Auditing Standards Committee Statement No. 240, paragraph 31)

- ► The engagement team recognized through analytical procedures with annual comparisons that an insignificant affiliated company initiated lending material loans in reference to its business volume. However, the engagement team did not assess the necessity of performing additional audit procedures including examining the borrowers and the purposes of loan.
  (Auditing Standards Committee Statement No. 240, paragraph 22)

Points to Note:
The engagement team should evaluate whether the business reasonableness of unusual significant transactions indicates the likelihood that they have been carried out to conduct fraudulent financial reporting or to conceal misappropriation of assets.
The engagement team should also assess with exercising professional skepticism whether to perform additional audit procedures on unusual transactions identified not only during audit planning but also in the course of audit.

(3) Auditors' procedures in response to fraud risk
Case: Audit procedures to respond to management override

- ► The engagement team obtained the year end adjusting entries as part of the procedures to respond to risks related to management override and reviewed whether unusual transactions existed. However, the engagement team did not define the term "unusual."
  In addition, the engagement team did not consider the necessity to inspect the journal entries and the adjusting entries through the year.
  (Auditing Standards Committee Statement No. 240, paragraph 31)

- ► The engagement team recognized that the entity had unusual significant 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 the account with the unusual transactions.
  (Auditing Standards Committee Statement No. 240, paragraph 31)

Points to Note:
Other than the example mentioned above, there were many cases where doubt arose over exercise of

professional skepticism. The engagement team only performed journal entry testing routinely without fully taking the fraud risks into consideration.

Although the primary responsibility to prevent fraud lies with the management, considering the situation where many fraud cases at entities have been reported recently, it is necessary to perform audit engagements with a sufficient understanding of auditors' responsibilities and with professional skepticism throughout the entire audit process.

(4) Evaluation of audit evidence

Case 1: Consideration of risk assessment if the auditors identify indication of material misstatement due to fraud

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 over 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 sources outside. Therefore the team did not sufficiently assess the reasonableness of the transaction, and as a result, missed that it was a misstatement.

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

Case 2: Evaluation of identified misstatement

The engagement team detected during branch visit audit a misstatement in posted sales and requested the entity to revise it. However, the team did not assess whether the misstatement fell under an indication of fraud, such as by reviewing similar transactions at other branches. In addition, the team did not perform additional audit procedures including examination of quantitative impact on the whole entity and deficiencies in internal control, and as a result, overlooked misstatements in other branches.

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

Points to Note:

Like 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, to assess the possibility of the identified misstatement occurring in the entity as a whole, and 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, as clarified in the Fraud Risk Response Standard, plan audit procedures and revise the audit plan directly to respond to the situation of possible fraud, and perform the audit procedures in accordance with the revised audit plan.

(5) Revenue recognition

Case 1: Audit procedures in response to risk identification

► 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 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 obtained the sales contracts as a substantive procedure. However, the team did not consider the collateral conditions to the contracts, and overlooked that the sales were inappropriately recorded the amount before discounts.
(Auditing Standards Committee Statement No. 240, paragraph 22)

► The engagement team inspected construction contract sales with construction completion reports and receipt documents. However, the team did not assess the reasonableness of the transactions although there were many cases of receipt of payment before rendering of service.
(Auditing Standards Committee Statement No. 240, paragraph 22)

► The engagement team examined the entity's revenue recognition without sufficiently examining the collateral conditions to 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 realized the exception 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 lease agreement with end users pertaining to the transactions would start more than a year after receiving product inspection by 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)

► Regarding the transaction consisting of product sales and incidental work, the entity posted sales from the product selling portion of the transaction because part of the incidental work was unfinished although the entity had yet to invoice the customer for product sales.
However, the engagement team did not examine the appropriateness of posting the sales of the transactions for the current period.
(Auditing Standards Committee Statement No. 240, paragraph 22)

Points to Note:
Like the examples of identified deficiencies mentioned above,

・ There were deficiencies in procedures for risk assessment and procedures to respond to the assessed risk in relation to revenue recognition. In one case, the engagement team did not sufficiently perform risk assessment on revenue recognition with an understanding of the entity’s business and its business environment including its type of business and the characteristics of its sales transactions. The team therefore did not plan appropriate audit procedures.
・ In another case, the engagement team identified risks of material misstatement due to fraud in revenue recognition but did not specifically identify kinds of risk existed in each assertion. The team therefore did not plan appropriate audit procedures.

For revenue recognition, the Auditing Standards Committee Statement No. 240, paragraph 25 stipulates "When identifying and assessing the risks of material misstatement due to fraud, the auditor shall, based on a presumption that there are risks of fraud in revenue recognition, evaluate which types of revenue, revenue transactions or assertions give rise to such risks." Particular attention should be paid in auditing to revenue recognition.

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

Case 2: Irregularities in audit evidence

- ► The engagement team obtained the contract document to verify the existence of accounts receivable. Although the service hours under the contract for one-month rendering of service significantly exceeded the service availability hours for one month, the team did not evaluate the reasonableness of the contract period, overlooking that the contract document was counterfeit and that fictitious sales were posted.
(Auditing Standards Committee Statement No. 240, paragraphs 11 and 12)

- ► The engagement team ascertained that the entity as a whole saw its profitability worsening due to greatly increased additional costs without sales. However, the engagement team did not analyze the factors behind the increased additional costs, overlooking the inappropriate accelerated revenue recognition in the preceding fiscal year.
(Auditing Standards Committee Statement No. 240, paragraph 33)

Points to Note:
Like the examples of identified deficiencies mentioned above, the engagement team only routinely verified books against vouchers overlooking agreement details inconsistent with the realities. The team needs to consider inconsistencies in the audit evidence obtained and the business reasonableness of the transactions.

(6) Related parties
Case 1: Rationality of related party transactions

- ► The entity bought products of subsidiary A through subsidiary B and its affiliated company C. The products under this transaction were delivered to the entity a considerable period of time after departure from subsidiary A. However, this arrangement was suspected as the entity's possible intention to conceal slow moving and obsolete inventory with no actual movement of the products.
Although the engagement team recognized other complicated transactions related parties' transactions which indicate potential indicate fraud risk, the team did not evaluate the reasonableness of related party transactions.
(Auditing Standards Committee Statement No. 240, paragraph 22; and No. 550, paragraphs 17 to 19)

- ► Related party transactions including those with a relatively high rate of return occurred within the entity. However, the engagement did not evaluate the adequacy of the entity's accounting treatment, and did not evaluate whether the transactions were reasonable in terms of business and whether the transactions suggests that they may have been entered into to engage in fraudulent financial reporting.
(Auditing Standards Committee Statement No. 240, paragraph 22; and No. 550, paragraphs 17 to 19)

- ► Regarding the transactions with the main customer, a major stockholder of the entity's parent company and identified as a related party, the engagement team did not perform sufficient risk assessment. In addition, the engagement team neither developed an audit plan for related party transactions nor examined the reasonableness of the transaction price.
(Auditing Standards Committee Statement No. 240, paragraph 22; and No. 550, paragraphs 17 to 19)

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.
The engagement team needs to pay attention to the following indications that significant transactions falling outside the entity's ordinal transaction process or deemed unusual may have been carried out to conduct fraudulent financial reporting or to conceal misappropriation of assets:

- 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 economic 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.

Case 2: Evaluation evidence obtained in related party transactions

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)

Points to Note:
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. In addition, the team needs not only to confirm evidence supporting individual transactions, but also to perform sufficient appropriate audit procedures, including comprehensively evaluating all the transactions considering their execution periods and conditions to evaluate the reasonableness of the transactions.

7. Audit of Internal Control over Financial Reporting

Point of focus

Auditors should express audit opinions based on evidence obtained by auditors, whether the internal control report prepared by the management reports the assessment of internal control 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 with consideration given to 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 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 it to the management, so as to correct and to examine timely 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 the course of 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 evidence 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 audit.
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 or 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 material accounts

The entity, an IT service provider, selected three accounts indicated in the standard (sales, accounts receivable, inventories) as important accounts for the entity’s operational objective. However, the engagement team did not take it into consideration that other accounts closely related to the operational objective, such as software, personnel costs or so on, had more significant than the three accounts above. The team did not carefully examine the adequacy of the entity's scope of assessment.
(Auditing and Assurance Practice Committee Statement No. 82, paragraphs 98 and 100)

Points to Note:
"Important accounts for operational objective (3 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 of 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 a business processes, related to the accounts with the 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 have discussions again with the management to evaluate the reasonableness of the scope of assessment.
If the engagement team considers that the business processes selected by the management for assessment are not appropriate, the engagement team needs to request the management to take additional actions including reconsidering the business processes to be assessed.
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

- ► The engagement team selected samples mainly during the first half-year, not throughout the year, when performing tests of internal control over business processes.
(Auditing Standards Committee Statement No. 530, paragraph 7; Auditing and Assurance Practice Committee Statement No. 82, paragraph 153)

- ► The engagement team selected only the samples used by the management for assessment in the tests of controls over subsidiaries, which were newly selected as significant business locations/units. The team did not sufficiently evaluate the reasonableness of the selection method of the samples by the management.
(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)

Case 2: Roll-forward procedures

The engagement team considered that they performed the procedure to assess the operating effectiveness of business processes and IT general control processes during the year. However, the team only performed the inquiry as to whether internal control effectiveness continued to the date of the fiscal year end, without examining relevant documents and observation.
(Auditing and Assurance Practice Committee Statement No. 82, paragraphs 131 and 160)

Case 3: 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 sign 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 did not examine adequacy of the scope for assessment and the appropriateness of assessment procedures performed by the entity, in evaluating internal and IT general controls over business processes relevant to the significant risk.
(Auditing Standards Committee Statement No. 330, paragraphs 7 and 14; Auditing and Assurance Practice Committee Statement No. 82, paragraph 97 and 183)

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 has 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, into the documentation.
The engagement team also needs to pay attention to changes in the entity's business activities and profit structure, without being bound by audit experience, in examining the scope of internal control evaluation.

Case 4: Timing of assessment procedures

The engagement team developed an audit plan which relied on the entity’s IT application controls in the initial audit engagement.
However, the engagement team did not timely perform risk assessment or procedures to respond to the assessed risk. The team did not perform the evaluation of the entity’s IT general controls until the date of the auditor’s report for the Companies Act.
(Auditing Standards Committee Statement No. 300, paragraphs 8, No. 330, paragraphs 7 and 8; Auditing and Assurance Practice Committee Statement No. 82, paragraphs 117, 118 and 185)

Points to Note:
The evaluation of the operation effectiveness of IT application controls requires the evaluation of associated IT general controls. When relying on the entity’s IT control, it is necessary to evaluate the effectiveness of IT general controls as well as the review of the evaluation of operating effectiveness of IT application controls before performing 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, even though it was not same as the materiality in the consolidated financial statements.
(Auditing and Assurance Practice Committee Statement No. 82, paragraph 188)

Case 2: Determination of material weakness

► In the evaluation of the significance of internal control deficiencies, the engagement team determined that the misstatement identified in the audit of financial statements was caused by deficiencies in internal control. The engagement team also acknowledged that the deficiencies were not corrected by the year-end.

However, the engagement team did not assess whether such internal control deficiencies are material weakness; failed to consider qualitative materiality, compensating control, accounts affected by the internal control deficiencies, the potential quantitative impact and likelihood occurrence of the deficiencies.
(Auditing and Assurance Practice Committee Statement No. 82, paragraphs 42 and 190-211)

- ► The engagement team did not assess whether the misstatements, detected during the financial statement audit, are deficiencies in the internal control audit.
(Auditing and Assurance Practice Committee Statement No. 82, paragraphs 190 to 211)

Case 3: Assessment of deficiencies in design or operating effectiveness of internal control

- ► The engagement team identified the possibility of the deficiency in the credit control of new business as a sub-process of the sales process when the auditor detected the write-off of receivables in the last month of the fiscal year. The entity determined that the process should be included in the assessment scope of internal control, and, as a result of the assessment, recognized it as a deficiency and corrected it until the year end.
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 that the deficiencies could cause material misstatements in financial reporting.
(Auditing and Assurance Practice Committee Statement No. 82, paragraph 185)

(4) Use of Management Assessment

Case: Extent of using the work of internal auditors

The engagement team utilized the results performed by the entity's internal auditors to assess the operating effectiveness of internal control over business processes. However, the team did not sufficiently conduct evaluation with audit evidence for objectivity and competency of the internal audit and quality of the internal audit result.
(Auditing and Assurance Practice Committee Statement No. 82, paragraphs 230 and 237; Auditing Standards Committee Statement No. 610, paragraphs 7 to 11)

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