

Case Report : Deficiencies in Audit Quality Control  
(English version)

July 2010

Certified Public Accountants and Auditing Oversight Board

## **Introduction**

Since its establishment in April 2004, the Certified Public Accountants and Auditing Oversight Board (“CPAAOB”) has been conducting inspections of Japanese audit firms from the view point of enhancing the audit quality in Japan and securing the public interests.

In the course of those inspections, the CPAAOB has identified various deficiencies in audit firms concerning their audit engagement performance as well as their quality control system, especially in the areas of (i) responsibility of quality control, (ii) ethical requirements and independence, (iii) audit files, (iv) engagement quality control review and (v) monitoring the firm’s quality control system. To make those deficiencies public, the CPAAOB issued, in Japanese, the first edition of the “Case Report: Deficiencies in Audit Quality Control” in February 2008, its second edition in June 2009, and its third edition in June 2010.

In this English version of “Case Report: Deficiencies in Audit Quality Control”, we selected out of those mentioned in our third edition of the report in Japanese the deficiencies, which, in our analysis, are not peculiar to Japanese audit firms but might also be found in foreign audit firms. In Part I of this English version, we introduce the deficiencies concerning the firms’ quality control system, and, in Part II, the deficiencies concerning audit engagement performance.

The CPAAOB trusts that this English version of the report is useful for foreign audit firms, especially those having provided to the Financial Services Agency the notification required the Certified Public Accountants Act of Japan, in making their continuous efforts to enhance the audit quality.

Chairperson of the CPAAOB  
Yoshimasa Tomosugi

## **Part I Quality Control System**

### **Responsibility for Quality Control**

1. In relation to the firm's quality control system, the firm did not clearly define the responsibility to be assumed by each member of the Board of Partners, the CEO and the partner in charge of quality control, and neither of them performed proper oversight over the system. Consequently certain deficiencies were caused in relation to the development of the firm's compliance system, information control system, monitoring system, the establishment and notification of internal rules and the retention of audit files.
2. The CEO of the firm did not give the partner in charge of quality control specific instruction as to how the quality control system should be established and managed. The CEO did not appropriately supervise how the partner assumed his responsibilities as the one in charge of the quality control system, either.
3. Only the representative partner of the firm took charge of the administrative matters of the firm, such as the establishment and abolition of internal rules, the arrangement of partners' meetings, the preparation of the minutes for the meetings, while the other partners shared no responsibilities for those matters. Some of the internal rules and manuals did not appropriately reflect the latest business operations of the firm or the recent amendments to the audit standards.

### **Compliance with regulations and rules**

4. The internal rules of the firm provided that, when a new employee joined the firm or the firm's policies and procedures concerning its quality control system were amended, the partner in charge of the firm's quality control had to explain those policies and procedures to the audit staff; however, the partner did not make timely explanation of those policies and procedures.
5. The internal rules of the firm did not reflect the recent amendment to or abolishment of relevant laws and regulations.
6. The most recent audit manual of the firm did not provide for the procedures concerning audit of internal control over financial reporting, which had to be

conducted in relation to the fiscal years beginning on or after April 1, 2008.

7. A firm auditing the consolidated financial statement of a company concurrently provided the company with the service of “compiling the company’s financial statements,” by receiving the financial documents from the company and calculating and providing to it the figures to be shown in the consolidated financial statements.
8. The CEO of the firm did not recognize that the consulting company, the shares of which were mostly owned by the CEO, was deemed to be the firm’s affiliated entity. Due to this lack of recognition, the CEO did not notice that the firm’s audit of a company and the affiliated company’s concurrent performance of compiling the financial statements of the same company violated the rule regarding restriction on concurrent provision of audit and non-audit services.
9. The firm had no procedures to confirm whether or not the service provided by the firm violated the regulation prohibiting certain concurrent provision to a single client of the assurance service and the non-assurance service. Rather, the firm completely relied on each partner’s judgment as to whether the service provided by him/her violated the above regulation.

#### **Policy for Information Security**

10. The firm rented the PCs to its audit staff without taking appropriate security measures.
11. The firm did not monitor the data saved on each of the PCs rented to its audit staff.
12. In relation to the audit services, the firm did not establish an information security policy nor develop the system of information security control.

#### **Quality Control Review by Japanese Institute of Certified Public Accountants**

13. The firm did not adequately communicate to its audit staff the deficiencies identified in the inspection process conducted by the Japanese Institute of Certified Public Accountants (“JICPA”) nor the remedial actions which had to

be taken in relation to those deficiencies.

14. The firm confirmed in writing that it would perform sufficient and appropriate measures to remedy deficiencies identified in the course of JICPA's quality control review, such as communicating the identified deficiencies to the audit staff, strengthening monitoring over the quality control system and so on; however, the firm did not develop a detailed action plan for implementing the above measures or appropriately communicate those deficiencies to its staff.

### **Ethical Requirements and Independence**

15. In the course of annual confirmation of independence, the partner in charge of the confirmation process failed to collect sufficient information necessary to appropriately conduct the process.
16. In confirming the independence of new employees, the firm did not confirm their independence over the subsidiaries, etc. of the audited companies.
17. The firm failed to confirm the independence of audit assistants, who engaged in the input of the audited company's financial figures for use in the audit files.
18. In changing the assignment of a temporarily-employed audit staff, the firm did not confirm his/her independence in relation to the company newly assigned to him/her.
19. The firm did not establish the procedures for confirming the independence of a person who joined the audit team subsequent to its initial formation, and failed to confirm his/her independence over the engagement.
20. In confirming the independence of audit staff over a new engagement by email, the firm mentioned only the name of the prospective client but failed to mention the names of those affiliated with the prospective client.

### **Human Resources**

21. In selecting the engagement partner for a new engagement, the firm did not pay sufficient consideration to the characteristics of the business conducted by the prospective client or to the competence and experience of the partner.

## **Acceptance and Continuance of Client Relationships and Specific Engagements**

22. The firm did not establish policies and procedures for acceptance and continuance of a new engagement or document the results of risk assessment conducted in the course of its acceptance or continuance.
23. The firm provided audit services to certain companies and schools without executing engagement agreements, performing risk assessments or obtaining internal resolutions required under the firm's rules.
24. Under the firm's rules a partner was required, when accepting a new client, to submit to the board of partners a report describing the outline of business and financial status of the new client and thereafter obtain the board's approval. However, some of the engagement agreements were executed without obtaining the board's approval. In some cases completed versions of the reports were not submitted to the board in the process of obtaining the board's approval.

## **Audit Files**

25. A reviewer of the firm failed to give instructions to the audit team when it was apparent from the audit files that some of the necessary procedures had not been appropriately conducted by the team.
26. Some of the audit files had no description as to who conducted the relevant audit procedures or when and by whom the audit files were reviewed.
27. A senior member of the audit team, who was in charge of the review of the audit files, failed to point out the deficiencies of the audit procedures apparent from the audit files.
28. During an on-site audit period, an audit team continued to keep the audit files in the lockers of the audited company without taking hold of their keys.
29. Some of the audit files of the firm were stored by its representative partner in the cabinets at the office used for his personal practice.

## **Engagement Quality Control Review**

30. A person involved in an audit engagement as an assistant subsequently acted as an engagement quality control reviewer of the same.
31. The internal rules of the firm provided that an engagement quality control review had to be conducted by the firm's review committee. However, for each engagement the review was conducted substantially by a single member and only its chief commissioner reviewed the results of the member's review; other members did not take part in the review process at all.
32. The firm had no policies or procedures for the review of an audit plan or the one materially changed after its establishment.
33. The firm reviewed neither the audit plan of the client's financial statements nor the audit plan of the client's internal control.
34. The firm's internal rules required an audit team to have an engagement quality control reviewer review any matter related to the change of audit principle or going concern; however, a team issued an audit report, when the reviewer was yet to review the description relating to a change of software sales recognition or going concern conditions.
35. An engagement partner issued an audit report without having the engagement quality control reviewer review the same in a situation where, as the partner claimed, there was little time left before the deadline of the report and the partner was unable to contact the reviewer.
36. The firm did not keep the documents evidencing that the review procedure had been completed before issuance of an audit report.
37. An engagement quality control reviewer failed to fill in the section titled "Results of Review" in the review records.
38. The drafts of a financial statement and an audit report that the engagement quality control reviewer claimed to have reviewed were not appropriately saved and thus were unidentifiable.

## **Monitoring the Firm's Quality Control System**

39. In the firm's monitoring process it was discovered that some confirmations had not been timely collected from the audit staff; however, the monitoring partner only orally urged the relevant parties to collect those confirmations without taking any other follow-up procedures.
40. While the partner in charge of the firm's quality control claimed to have appropriately conducted ongoing monitoring procedures, no documents were kept in this relation and certain deficiencies were indentified in relation to monitoring the collection status of written confirmations.
41. In the process of monitoring the firm's audit process, the firm did not review whether or not the audit was conducted in accordance with the relevant audit standards and accounting standards. The firm did not review whether or not appropriate actions were taken in relation to remedy the deficiencies identified in the course of JICPA's review, either.
42. In the course of monitoring the firm's audit practice, the person in charge only orally confirmed what procedures the audit team had conducted without reviewing any relevant audit files.

## **Part II Audit Engagement Performance**

### **Audit Planning**

1. The firm had a policy requiring that when the audit team determined the audit materiality regarding the financial statement level they should consider how effective the internal control of the audited company was. Although it was an initial audit engagement, the team did not assess the effectiveness of the company's internal control at the audit planning stage until March 2009, even though the company's fiscal year end was March 31, 2009. Without performing any procedures the team assumed that the internal controls of the company were effective.
2. The audit team assessed audit materiality based on the prior year's financial figures of the audit client. Although there was a significant change with regard to current financial figures from last year, the audit team failed to consider the necessity of reassessing the audit materiality.
3. The audit team changed the audit materiality but did not consider the necessity of an audit plan including the extent of procedures subject to audit sampling.
4. Audit procedures related to understanding the audit client's internal control were limited to inquiries with client management and statutory auditors and the audit team did not perform procedures, such as observation, or review covering the assessment of internal control design.
5. Risks identified in the audit working paper for understanding the entity and its environment were not listed in the working paper which should summarize significant fraud risks. However, the latter working paper included certain risks which were not identified in the former working paper. The documentations of these key working papers were inconsistent, which showed that the audit team failed to document the process of identifying significant fraud risks sufficiently.
6. The audit team failed to identify significant fraud risks at the entity level, significant fraud risks at the financial statement level and risks that require special audit consideration. From this perspective the team failed to plan the audit procedures corresponding to those risks.

7. Although the audit team could not use the results of their assessment of internal control designs, they did not consider the effect of the new accounting system that the client had implemented at the beginning of its financial year. They did not ascertain whether the account balances were appropriately carried forward to the beginning balances, either.
8. In relation to an assessment of the client's IT general control, the audit team concluded that there was no change and that the control level was good as a result of only inquiry procedures by relying upon the prior year's control assessment; they did not perform other procedures in addition to observation and review of related documentation
9. The audit client outsources maintenance services of their IT system. However, the audit team did not obtain a copy of the service contract or a detailed arrangement letter. The team also failed to ascertain the effectiveness of the internal control of this outsourced service.
10. In relation to the sales process IT system of the initial audit client, although the audit team recognized that, rather than a simple package system, it was a third-party-developed sophisticated system which supported electrical trade and enabled the customers to place purchase orders and to make payments on the client web site, they assessed that the client's IT utilization was limited, and failed to perform procedures for understanding and assessing the IT-related internal control of that process.
11. In relation to the valuation of delinquent accounts receivable and inventories, although the audit team insisted that they considered the accuracy and completeness of the information generated from the client's IT system, they failed to document the consideration process and conclusion in their working papers.
12. The audit team had an audit planning meeting of the initial audit client. However, the only participants were the engagement manager, senior accountants and staff accountants; the engagement partner did not attend the meeting, stating that the engagement manager and he had enough communication when they had meetings with the client. There was no documentation of his instructions to the audit team in their audit working papers.

13. The audit team did not perform the audit procedures to identify and understand the significant risk of misstatements due to fraud, failing to inquire of the client management and statutory auditors regarding their understanding about those risks and their identification of actual fraud.

#### **Risk-related Audit Procedures**

14. As procedures for assessing the control effectiveness of daily and multiple controls relating to the purchase process, the audit team selected all sample items from transactions in December 2008 as they thought it preferable since they selected December 2008 and January 2009 for samples when they performed other related monthly control assessment procedures. In order to assess the effectiveness of daily and multiple controls, samples should be selected throughout the year, but they were not. Thus the audit team failed to obtain audit evidence.

#### **Estimates**

15. In relation to inventory valuation procedures, the audit team tested the data that the audit client prepared for the items whose net realizable value was lower than their book value and ascertained whether those valuation losses were appropriately booked or not. They failed to check the completeness of the data or to perform a further substantive test on a sample basis.
16. In relation to audit procedures for retirement benefit allowance, which the audit client calculated using package software, the audit team failed to perform those procedures to ascertain the reliability of the software and perform a substantive test such as vouching or calculation verification on a sample basis in order to check the accuracy of the year-end allowance balance.
17. Although the leased assets balance exceeded the audit materiality, the team failed to consider the necessity of leased assets' impairment.
18. In relation to the grouping of assets so as to recognize the impairment loss of the client's fixed assets, the audit team obtained the client-prepared materials but failed to ascertain the appropriateness of them. The team did not consider whether or not the client should recognize impairment loss on a consolidated

group basis.

### **Physical Inventory Taking**

19. In relation to the audit of a client in the real estate development business, the audit team agreed with the client decision not to conduct physical counts or inspect their inventory properties and properties in the construction stage even though the team had not conducted a test of related internal control to ascertain effectiveness. The team failed to document that they did not attend physical inventory taking and the reasons therefore in their audit working papers.

### **Revenue Recognition**

20. The audit client engaged in subleasing of the real estate properties as its main business. The audit team performed only a vouching procedure for the revenue of the client and they did not perform further substantive procedures such as inspection of leased properties or analytical procedures to ascertain the relevance between the revenue and the cost because the team did not assume fraud risk based on the client's revenue recognition.

### **Confirmation Procedures**

21. In relation to confirmations not received until the audit reporting date, the audit team failed to perform alternative procedures for confirmations and provided no reasons therefore.
22. The audit team noted that there were problems with the collection of accounts receivable confirmations. For example a large number of confirmations were not received from customers in accordance with set conditions. The team also recognized that there was a case of fraud caused by one of the client's employees two months before the year-end. The audit team used the month-end date 3 months before the year-end as the confirmation balance date but they failed to document the rationale of setting the confirmation balance date before the year-end, including the status of the client internal controls responding to related audit risks and the relationship with roll-forward procedures.
23. After the audit team conducted confirmation procedures by setting a confirmation date before the year-end, they recognized an occurrence of

employee fraud. Although they considered the effect of this fraud on internal control audit, the necessity of amending the financial statements, including the adding of notes related to subsequent events, they failed to consider the necessity of re-performing confirmation procedures at the year-end.

24. In relation to the confirmation procedures for the client's accounts receivable as of February 28, 2009, the audit team selected the samples but they did not send the confirmation to over 10% of the selected customers as they were explained by the client that it would impair its business relationship with those customers. The audit team failed to document the reason why they did not send the confirmation to certain customers and failed to document their assessment of whether the limit of their audit procedures indicated occurrence of fraud.

### **Substantive Analytical Procedures**

25. In relation to the significant financial statement items, the audit team performed substantive audit analysis as only substantive procedures. But they failed to develop an expectation at a sufficient level of precision or consider the amount of difference from an expectation that can be accepted without further investigation.

### **Group Audit**

26. Although the audit team planned to visit certain subsidiaries, review their financial statements and perform confirmation procedures, they did not prepare relevant audit programs. They actually did not perform the planned confirmation procedures and failed to document the changes to the audit plan in their working papers.

### **Related Party Transactions**

27. In relation to audit procedures of related party transactions, the audit team used the firm-prepared checklist and considered the information related to related party transactions. However, there were only check marks on the list and no detailed documentation was made in the working papers about audit procedures regarding such matters as the scope of the party, whether there were transactions or not, and the significance and appropriateness of those transactions, if any. The team did not consider the internal controls on the client's approval or record

the related party transactions, either.

### **Subsequent Events**

28. The audit team planned to rely on other auditors' work for certain subsidiaries. However they collected the reports in respect of subsequent events from other auditors after the audit report date without performing any alternative procedures before that date.

### **Financial Statement Disclosures**

29. In relation to notes to the financial statements in respect of leases, investment securities, retirement benefits and deferred taxes, the audit team only compared the figures in the notes to the summary sheets prepared by the client and failed to verify the appropriateness of the client-prepared sheet.

### **Other Auditors' Work**

30. The audit team relied on other auditors' work for overseas subsidiaries; they only checked the material impairment loss recognized in their financial statements and failed to consider the necessity of additional procedures, including the request of details supporting documents from or inquiries with the auditors.

### **Use of Specialists**

31. In relation to the calculation of allowances for retirement benefits, the audit team utilized the actuary reports issued by the trust bank which the client outsourced. However, the team failed to consider its competency as an actuary specialist.
32. The audit team obtained and checked the opinion letter issued by an independent real estate valuation specialist whom the client used for its idle land. The team used the letter as audit evidence and explained that they considered the objectivity of the specialist but failed to document the procedures and conclusion.

### **Final Analysis**

33. The audit team did not perform a final analysis of the financial statements as a whole at the last stage of their audit. Thus they failed to obtain an overall understanding of the financial statements taken as a whole.

### **Assessment of Client Control over Litigation Risks**

34. Although there were situations where the audit client made an apology advertisement in a newspaper, disclosed significant claims as subsequent events, and had other claims, the audit team failed to ascertain whether the client had an adequate department and whether there was a sufficient process to manage risks related to litigations and claims.

### **Going Concern**

35. In fiscal 2009, the audit team concluded that there was no significant uncertainty related to the client's going concern assumption as a result of their analytical procedures of the management-prepared business plan. However, the plan had been prepared by the director in charge of accounting and had not been duly approved by a party with proper authority, such as the board of directors.

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