Case Report：Deficiencies in Audit Quality Control

July 2011

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 viewpoint of enhancing the quality of audit in Japan and securing public interests.

In the course of those inspections, the CPAAOB identified various deficiencies in audit firms concerning their audit engagement performance as well as their quality control system, in the areas of, for instance, (i) leadership responsibilities for quality control, (ii) independence, (iii) audit files, (iv) engagement quality control review and (v) monitoring of quality control systems. To make those deficiencies publicly available, the CPAAOB has been issuing, since 2008, a Japanese version of the "Case Report: Deficiencies in Audit Quality Control" every year.

For this English version of "Case Report: Deficiencies in Audit Quality Control," we chose from the cases mentioned in our latest (2011) Japanese version those deficiencies, which are, in our analysis, assumed to be not peculiar to Japanese firms but to have some relevancy to foreign audit firms. In Part I of this English version, we introduce the deficiency cases concerning the firms' quality control system, and, in Part II, the deficiency cases concerning audit engagement performance.

We believe this English version of the report is beneficial for foreign audit firms, especially those having filed the notification required under the Certified Public Accountants Act of Japan with the Financial Services Agency, in making their continuous efforts to enhance the audit quality.

Chairperson of the CPAAOB
Yoshimasa Tomosugi

Part I Quality Control System

Management of Quality Control System

1. The CEO and the partner in charge of quality control did not issue instructions to maintain the appropriateness of the quality control system of the firm. They did not consider, from the viewpoint of reasonably securing the audit quality, how to allocate audit staff to each engagement and thus sufficient personnel was not allocated to each engagement. In addition, they assumed almost none of their obligations to issue necessary instructions concerning quality control or to supervise audit staff's performance, which were imposed under the relevant audit standards. Neither engagement quality control review nor ongoing evaluation of the quality control system was performed in an effective manner.

2. The main office of the firm did not properly monitor whether or not the local offices appropriately assumed the firm's internal procedures concerning the acceptance and continuance of audit engagements. The main office did not request the local offices to report the results of the ongoing evaluation of the quality control system conducted by them either.

Leadership Responsibilities for Quality Control

3. The CEO of the firm did not provide the partner in charge of quality control with specific instruction as to how the quality control system of the firm should be established and managed. In addition, the CEO did not appropriately supervise how the partner in charge of quality control assumed his responsibilities.

4. The operational responsibilities for the firm's system of quality control were assumed solely by the partner in charge of quality control and the firm did not allocate sufficient personnel to fulfill those responsibilities. The board of partners, which had the ultimate responsibility for the firm's system of quality control, did not appropriately supervise how the partner in charge of quality control assumed his/her responsibilities.

5. The firm did not clearly define the scope of responsibility to be assumed by each of the board of partners, the CEO, and the partner in charge of quality

control, in connection with the firm’s quality control system. None of them performed proper oversight over the system. Those deficiencies led to defects in certain areas, such as the development of the firm’s compliance system, information security, monitoring system, the establishment and notification of internal rules, and the retention of audit files.

Establishment of Internal Policies and Procedures

6. The internal rules of the firm did not reflect the recent amendments of related laws and regulations.

7. The most recent audit manual of the firm did not provide for the procedures dealing with the new accounting standard for measurement of inventories, which had to be implemented in relation to the fiscal years beginning on or after April 1, 2008.

8. The firm failed to distribute the firm’s audit manual to some of the audit staff. In addition, the firm did not recognize such failure until revealed in the course of the on-site inspection.

9. The internal rules of the firm provided that, when a new employee joined the firm or when the firm’s policies and procedures concerning its quality control system were amended, the partner in charge of quality control should explain those policies and procedures to the audit staff; however, the partner did not explain those policies and procedures to them in a timely manner.

Compliance with Professional Standards

10. A firm auditing the consolidated financial statements of a company concurrently provided the company with the service of “compiling the company’s financial statements,” by way of calculating the figures to be shown in the consolidated financial statements on the basis of the documents submitted from the company and providing those figures to it.

11. The CEO of the firm did not recognize that the consulting company, which was under the CEO’s control through his ownership of the company’s shares, fell into the category of the firm’s “affiliated entity.” Therefore the CEO did not notice that the fact that the firm audited a company and the affiliated company

concurrently performed compiling of the financial statements of the same violated the regulations restricting concurrent provision of audit and non-audit services.

12. The firm had no procedures to confirm whether or not the service provided by the firm violated the regulations restricting concurrent provision of the audit service and the non-audit service to a single client. Rather, the firm completely relied on each partner's judgment as to whether the service provided by him/her violated the above regulations.

Information Security

13. The firm failed to establish policies and procedures regarding information security.

14. As for the PCs rented by the firm to its audit staff, the firm did not establish policies and procedures concerning the password for them nor monitor whether or not the staff properly set up and amend the password in a timely manner. In addition, the firm failed to establish policies and procedures for the security of data saved on each PC and did not monitor whether or not the staff properly saved the data in a secured manner.

15. In relation to the PCs owned by the temporarily-employed staff and used by them for the firm's engagements, the firm did not implement appropriate measures for security password management or anti-virus protection.

Quality Control Review by the Japanese Institute of Certified Public Accountants (JICPA)

16. 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 plan for implementing the remedial action or appropriately communicate the identified deficiencies to its staff.

17. The firm did not develop a detailed remedial action plan with regard to

deficiencies identified in the course of JICPA's quality control review. The firm did not implement appropriate measures to confirm whether or not the remedy was appropriately in progress.

18. The firm did not substantially analyze the root causes of the deficiencies identified in the course of JICPA's quality control review and thus failed to develop remedial actions reflecting the root causes.

Independence

19. In confirming the independence of the partners and staff, the firm did not confirm their independence in relation to subsidiaries and other affiliated entities of the audited companies.

20. The firm failed to confirm the independence of audit assistants, who engaged in the input of the audited company's financial figures in the audit files.

21. 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.

22. The engagement partner failed to confirm, with respect to each member of the engagement team, whether or not any event that might create threats to their independence had occurred after the annual confirmation of their independence.

23. 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 thus failed to confirm his/her independence in relation to the engagement.

24. In confirming the independence of audit staff in relation to a new engagement by email, the firm mentioned only the name of the prospective client and failed to mention the names of those affiliated with the prospective client.

Human Resources

25. The firm failed to establish policies regarding how the quality of engagement performed by partners and staff was taken into consideration in their evaluation

as well as the determination of their remuneration and promotion.

26. The firm’s evaluation of the partners and staff was not performed in accordance with the firm’s internal rules.

Acceptance and Continuance of Audit Engagements

27. The firm provided audit services to certain companies and schools without performing risk assessments, obtaining internal resolutions required under the firm’s rules or executing written agreements.

28. While the firm identified certain problems in the course of considering whether to continue an existing engagement and finally decided to continue the engagement irrespective of existence of the problems, it failed to document how the problems were resolved.

29. Under the firm’s rules, when accepting a new client, a partner was required to submit to the board of partners a report describing the outline of business and the 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

30. Although it was apparent from the audit files that the audit team had not appropriately conducted some of the necessary audit procedures, the reviewer issued no instructions to the team after the review of the files.

31. No descriptions were made in the audit files as to who conducted the relevant audit procedures or when and by whom the audit files were reviewed.

32. In relation to the retention of audit files, the following deficiencies were found:
    a) The firm had no detailed procedures for completing the assembly of final engagement files or keeping safe custody of the files;
    b) The firm failed to record the numbers, retention periods and other type of information relating to the retained files;

c) The firm failed to record in the register some of the files retained by it; and
d) The firm did not keep record of the disposal of files.

33. In relation to the custody of audit files, the following deficiencies were found:
a) During the on-site audit period, the audit team kept audit files in the lockers in the audited company without holding their keys under the team's control;
b) Audit files were retained by its partner in the cabinets at his/her office for personal business; and
c) The audit files were retained in unlocked cabinets.

Engagement Quality Control Review (EQCR)

34. A person involved in an audit engagement as an assistant subsequently acted as an engagement quality control reviewer of the same.

35. 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 without having a discussion among the committee members.

36. The firm had no policies or procedures for the review of an audit plan.

37. The firm did not review the audit plan regarding the client's financial statements or its internal control, either.

38. The audit plan and the audit report were reviewed on the same occasion.

39. The firm's internal rules required an audit team to have an EQCR partner review any matter related to the change of audit principle or going concern; however, a team issued an audit report, although the reviewer was yet to review the description relating to a change of software sales recognition or going-concern conditions.

40. The engagement partner issued the audit report before the EQCR partner's review was completed.

41. The firm did not record in an appropriate manner that the review procedure had

been completed before the audit report was issued.

42. An engagement quality control reviewer failed to fill in the section titled “Results of Review” in the EQCR document.

43. The drafts of a financial statement and an audit report, which the EQCR partner claimed to have reviewed, were appropriately saved in the EQCR files and thus were unidentifiable.

44. The engagement partner issued the audit report before the matters indicated by the EQCR partner were completely resolved.

Ongoing Evaluation of Quality Control System

45. In relation to the ongoing evaluation of the quality control system, the firm did not establish specific procedures, document the results of the evaluation, or report to the CEO (or equivalent) the deficiencies identified as a result of the evaluation.

46. The firm did not perform ongoing evaluation of the process and decisions made in connection with the continuance of audit engagements.

Periodic Inspection of Completed Audit Engagements

47. With respect to periodic inspection of completed audit engagements, the firm did not specifically determine the timing of inspection, the inspection cycle or any other specific procedures.

48. The firm failed to communicate to the relevant engagement partner and the CEO deficiencies identified as a result of the periodic inspection.

49. In the course of periodic inspection, the person in charge only confirmed what procedures the audit team had conducted on a verbal basis and did not review any relevant audit files.

50. In relation to the deficiencies identified as a result of the periodic inspection, the firm did not assess the effects of those deficiencies or consider what remedial actions should be taken in relation to the relevant engagement or

individual.

Joint Audit

51. While the auditor claimed that he confirmed the quality control system of the joint auditor was managed in a manner sufficient to secure the quality of the joint audit, the auditor failed to document the above conclusion and the process for reaching it.

Part II Audit Engagement Performance

Audit Planning

1. The audit team calculated the audit materiality amount only based on their experience as auditors and did not consider materiality in terms of accounts or transactions.

2. The audit team changed the audit materiality but did not consider the necessity of change to an audit plan including the extent of procedures subject to audit sampling.

3. 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.

4. 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.

5. The audit team did not perform any procedures to assess the IT general control of the significant subsidiary.

6. Although the audit team could not use the results of their previous 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 accounts balances were appropriately carried forward to the beginning balances either.

7. While the audit team recognized the deficiencies related to the control of privileged ID for the client's accounting system, they failed to perform audit procedures corresponding to the deficiency.

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; it did not perform other procedures in addition to observation and review of related documentation.

9. In relation to the client's general control over the IT-based information system, the audit team failed to consider the accuracy of their calculation results made by the material spread sheet and user-developed program related to financial reporting. While they noted there was no design of control, they failed to perform alternative procedures for that.

10 . In relation to the valuation of delinquent accounts receivable and inventories, the audit team insisted that they considered the accuracy and completeness of the information generated from the Client's IT system, but they failed to document the consideration process and conclusion in their working papers.

Audit Procedures regarding Control Risk of Subcontracted Services

11. The audit client subcontracts the computation-related procedures of its payroll process to a third party contractor. However, the audit team failed to consider the effect of its internal controls on the client's financial statements.

12. The audit team used the outside contractor's auditor's report in order to ascertain the contractor's design and the effectiveness of its internal control. However, the audit team failed to check whether there had been any changes to its internal control from the audit report date to the audit client financial year end.

13. The audit client outsources maintenance services of their IT system. However, the audit team did not obtain a copy of service contract or a detailed arrangement letter. The team failed to ascertain the effectiveness of the internal control of this outsourced service, too.

Fraud-related Procedures

14. The audit team did not perform the audit procedures to identify and understand the significant misstatement risk due to fraud, such as inquiring with the client management and statutory auditors regarding their understanding about those risks and their identification of actual fraud.

15. While the auditor’s manual indicates a rebuttable assumption that there is a fraud risk with revenue recognition it also describes instances where the auditor need not identify fraud risk with the revenue recognition. For that reason the audit team failed to document their decision that they did not identify fraud risk with the client’s revenue recognition and rationale behind it in their audit working papers.

16. In relation to the audit procedures corresponding to the risk of management override, the audit team failed to check the completeness of journal-entry data which had been booked on the general ledger.

Risk-related Audit Procedures

17. As procedures for assessing the effectiveness of daily and multiple controls relating to the revenue and the purchase processes, the audit team selected all sample items from transactions in the 4th quarter. Thus they failed to obtain audit evidence in order to assess the effectiveness of daily and multiple controls throughout the year.

Audit for Estimates

18. In relation to inventory valuation procedures, the audit team tested the data that the audit client prepared for the items whose net realizable value are 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.

19. In relation to audit procedures for retirement benefit allowance, which the audit client calculated by 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.

20. In relation to the long-term rate of return of pension assets, the client has not changed it since its adoption of a new accounting standard in terms of pension accounting. In these circumstances the audit team failed to consider the rationale of unchanged rate of return by checking the effect of actual returns for

prior years to corresponding incomes, for example.

21. Although the leased assets balance exceeded the audit materiality, the team failed to consider the necessity of leased assets' impairment.

22. 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 the client should recognize impairment loss or not on a consolidated group basis.

23. In relation to the audit of consolidated subsidiaries' accounts receivable with significant balance, the audit team failed to check whether there is any doubtful accounts or ascertain the appropriateness of reserve for doubtful receivables.

Consideration for Derecognition of Financial Asset

24. In relation to the transaction where the audit client transferred its accounts receivable to a third party, the audit team did not obtain the copy of the transfer agreement and failed to consider whether the transaction met the criteria for derecognition of a financial asset. Although the audit team did not have legal expertise, the team failed to obtain an opinion letter from an eligible legal specialist.

Revenue Recognition

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

Confirmation Procedures

26. The audit team noted that there are problems with the collection of accounts receivable confirmations. For example, a large number of confirmations are 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. Irrespective of the above recognition, the audit team used the month-end date 3 months before the year-end as the confirmation balance.

27. The audit team circulated the confirmation of accounts receivable balance as of January 31, 2009 for most of the customers but as of January 20, 2009, for a part of the customers considering their monthly cut off date. However, in relation to the roll-forward procedures, they only checked the period from February 1, 2009, to March 31, 2009 (year end) but not for the period between January 21, 2009, and January 31, 2009.

28. In relation to the confirmation of completed constructions receivable, the audit team let the audit client deliver them and failed to control the processes for sending and receiving confirmations. The team did not consider the reliability of customer responses, either.

29. In relation to confirmation procedures, although the audit team received certain responses with no specific amounts filled in the form, they did not recirculate the confirmations in question or perform any alternative procedures, either.

Substantive Analytical Procedures

30. In relation to the substantive analytical procedures, the audit team failed to either 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.

Substantive Procedures

31. While the audit client sold its material subsidiary company's shares at a price significantly higher than its net asset value, the audit team did not perform any procedures to check the appropriateness of the selling price or the recognized gain from the sale.

32. In relation to real estate properties with significant balance held as inventory by the client, the audit team failed to ascertain their existence and right of use by conducting substantive procedures, such as physical inspections and the review

of the certified copy of register.

Audit of Consolidated Financial Statements

33. 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 but failed to document the changes to the audit plan in their working papers.

Related Party Transactions

34. In relation to the audit procedures of related party transactions, the audit team failed to perform the following procedures:
   a) Review of the investigation forms which the audit client requested and obtained from directors and their close family members regarding transactions between them;
   b) Inquiry with the CEOs on the alliance and joint venture relationships with other entities; and
   c) Review of the register of shareholders to identify key shareholders.

35. The team did not consider the client's internal control in terms of approval or records of the related party transactions, either.

Communication with Audit Committee

36. Although the audit team insisted that they communicated with the audit committee about the matters which the team noted as important from the perspective of the audit committee's performing its duties, the team failed to document such communication in the audit working papers.

Subsequent Events

37. 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

38. 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.

Management Representation

39. The audit team only obtained a pdf copy file of the management representation letter from the audit client, not the original, when they submitted the auditor's report to the client.

Other Auditors' Work

40. In relation to the audits of overseas' subsidiaries, the audit team relied on other auditors' work. However, the team failed to ascertain whether or not the other auditors performed their audits in accordance with auditing standards that are virtually the same as the standards applied in Japan. They did not figure out the audit materiality amounts, either.

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

Use of Specialists

42. 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.

43. The audit team obtained and checked the opinion letter issued by an independent real estate valuation specialist whom the client used for its properties held as inventory. The team used the letter as audit evidence but failed to consider the capacity and the objectivity of the specialist.

Final Analysis

44. The audit team did not perform a final analysis of the financial statements as a whole at the last stage of their audit.

Assessment of Client Control over Litigation Risks

45. In relation to the client's control over litigation risks, 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

46. The audit team concluded that there is 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 was prepared by the director in charge of accounting and was not duly approved by a party with proper authority, such as the board of directors.