Case Report from Audit Firm Inspection Results

July 2013

Certified Public Accountants and Auditing Oversight Board

Table of Contents

Introduction

Since its establishment in April 2004, the Certified Public Accountants and Auditing Oversight Board (CPAAOB) has been performing inspections of Japanese audit firms from the viewpoint of enhancing 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 2012 Case Report contained the revisions made from the perspective of promoting voluntary efforts to maintain and improve audit quality, presenting the standards expected by the CPAAOB, and providing reference information to directors and statutory auditors of listed entities, etc. and to market players, including public investors, etc. In the 2013 Case Report, the organization of the previous report is maintained with the content divided into two parts: "Quality Control System" and "Individual Audit Engagements," as outlined below (Note 1):

► 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/or examples that are considered useful in addressing identified deficiencies and improving quality control), expected response by audit firms, etc.

► The Individual Audit Engagements section is organized according to the system of the Auditing Standards Committee Statements. This part contains separate items that introduce the areas where many deficiencies were identified: auditing accounting estimates; audits concerning internal control over financial reporting; audits of financial institutions, an industry with specific accounting requirements; fraud in financial statements, to which future responses will attract attention; and audits concerning internal control over financial reporting, to which standards apply that are different from those concerning audits of financial statements. Each item describes the "Points of focus" in the inspection, etc., along with examples of identified deficiencies, and points to note in performing audit procedures are appended.

The CPAAOB expects each audit firm to check its own QC system with reference to the deficiencies, and causes thereof, 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 fundamental cause(s) thereof. Although QC system deficiencies are primarily the responsibility of the chief executive officer (CEO), the person in charge of quality control (PICOQC), etc. of the audit firm, and their fundamental and essential causes can be often found in the organizational culture of the audit firm, including its operational policy and operational control system. The establishment of a QC system should not be only the individual responsibility of the CEO, PICOQC, etc., but rather an operational task to be performed by the entire staff with management responsibilities within the audit firm. Keeping this in mind, staff should identify operational factors that may lead to deficiencies in the QC system, and then work together in an organized manner to improve such factors (Note 2).

In addition, 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 always sufficient cooperation between those charged with governance of the entity and the auditors. The importance of cooperation between those charged with governance and the auditors is emphasized also in the recently revised Auditing Standards and the newly established Fraud Risk Response Standards in Auditing. 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.

Note 1: In introducing the examples of identified deficiencies, as much background information behind such identified deficiencies and their causes as possible has been provided. In addition, regarding the matters specific to individual audit firms, etc., expressions are partially modified.

The old standards, etc., which were effective and applied at the time when the inspections were performed, have been, as a general rule, replaced with practical audit guidelines, etc. based on the new drafting plan, when they are quoted. In cases where there are multiple applicable provisions in the standards, etc., which serve as a basis for deficiency identification, only the principal provisions are quoted.

Note 2: Examples of identified deficiencies in the quality control reviews performed by the Japanese Institute of Certified Public Accountants (JICPA) are introduced in the section "Outline of Recommendation Reports Issued, etc." in the Annual Report of the Quality Control Committee; please refer to those examples along with this Case Report.

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 "CPE" stands for Continuing Professional Education.
- 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 Standards” refers to audit standards responding to fraud risks.

I. Quality Control System

1. Management Systems

(1) Quality Control (QC) Systems

Points of focus

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

- ► Whether the audit firm has a QC system in place for its audit practitioners to perform audit engagements in compliance with the professional standards and to issue appropriate auditor's reports;
- ► Whether the audit firm has appropriate policies and procedures in place to promote an internal culture recognizing that quality is essential in performing engagements, or effectively applies such established policies and procedures;
- ► Whether the CEO or equivalent fulfills their duties as the person ultimately responsible for the QC system of their audit firm, for example, through involvement in the establishment of the firm's QC system, and through keeping track of implementation of QC-related work by the PICOQC or equivalent to give directions as needed;
- ► Whether the audit firm appoints a person with sufficient and appropriate experience and ability to take charge of QC;
- ► Whether the appointed PICOQC fulfills their duties as the person responsible for involvement in the establishment of QC 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.

Outline of inspection results

Large audit firms had their QC department lead the work to maintain and improve their internal QC. Some small and medium-sized audit firms also actively worked to maintain and improve their QC system, for example, by appointing a full-time PICOQC dedicated to QC practices. Of these audit firms, however, some showed insufficiencies in improving the deficiencies identified in the QC review; others were continuously inadequate in performing audit engagements. In addition, there were some cases where it is hard to say that audit engagements were performed to appropriately address audit risks based upon occupational professional skepticism.

Moreover, as shown in the Case Example section below, some audit firms did not take sufficient measures to establish QC systems, and other firms saw the CEO, the PICOQC, or other responsible persons not fully perform the duties related to QC. Behind these are the following organizational causes found in such firms, which suggest that the firms need to carry out organizational and other radical measures to maintain and improve their QC systems.

- While the partners made individual efforts to perform audit engagements of which they were in charge, the audit firm did not work to ensure integrated organizational operation.
- The partners performed double duties for the audit firm to which they belonged, and their own office, but did not spend sufficient time carrying out their duties for their audit firm.
- The CEO, PICOQC, etc. were not fully aware that the QC system should be maintained to reasonably ensure audit quality.
- The CEO, PICOQC, etc., lacked knowledge and experience of audit firm operations.
- Despite the poor recognition of to what specific level to develop the QC system, the CEO assessed the QC system of their audit firm as having no special problems and that it maintained a certain level.
- The PICOQC did not take the time necessary to carry out QC-related work.

Expected response

Audit firms need to examine the status of establishment and operation of QC 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. Audit firms also need to ensure firm-wide QC performance and promote an internal culture recognizing that quality is essential in performing each engagement, for example, by not only improving deficiencies detected as a result of the inspection but also investigating their fundamental causes to implement organizational and other radical improvements.

Case 1: Establishment of QC systems

Matters to be resolved by the Board of Partners, such as the acceptance and continuance of audit engagements, were implemented without discussion or the approval of the Board of Partners. 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.

Furthermore, the CEO, with the ultimate responsibility for the QC system, merely entrusted the partner in charge of QC with the QC-related duties, and did not properly understand the status of QC at the audit firm or secure the necessary personnel, etc. required to perform QC-related duties.

In addition, the PICOQC did not understand the contents of their duties that should be performed in a concrete manner or spend sufficient time on the QC-related duties. (Fiscal 2011 Inspection)

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

Case 2: Establishment of QC systems

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 as an engagement partner with a listed company or in an equivalent position prior to performing the role as an engagement partner in the firm.

In addition, the CEO, who also held the post of PICOQC, did not properly establish a QC 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. (Fiscal 2012 Inspection)

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

Case 3: Operation of QC systems

The CEO believed that there was no material problem in the QC system of the audit firm. The firm did not sufficiently evaluate whether the QC department was effectively functioning for firm-wide integral quality control improvement.

In addition, the CEO gave directions about the establishment of QC only to certain members of the QC department. Other partners did not spend sufficient time on QC-related work because of a lack of understanding concerning the need to improve QC firm-wide in an integrated manner. (Fiscal 2012 Inspection)

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

Case 4: QC-related responsibilities of CEO

The CEO did not fulfill his/her duties as the person ultimately responsible for the QC system. The CEO only kept track of the operational status of the original QC system as established; and did not take necessary measures to improve the QC system as appropriate for the operations of the audit firm. (Fiscal 2012 Inspection)

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

Case 5: QC-related responsibilities of CEO, etc.

Where the PICOQC could not spend sufficient time on the establishment of the QC system, and did not properly divide the QC-related work into two parts: work to be done itself, and work to be done by other partners. Regarding the work to be done by other partners, clear instructions were not provided before the work, and no examination was performed after the work.

In addition, the CEO did not clearly define the authority given to the PICOQC, did not understand the actual condition of work performed by the PICOQC, and did not provide specific instructions to

ensure the appropriate establishment of QC systems. (Fiscal 2011 Inspection)
(Quality Control Standards Committee Statement No. 1, paragraphs 15–18)

Case 6: QC-related responsibilities of CEO, etc.

The PICOQC did not spend the necessary time on revising relevant internal rules and implementing other QC-related practices. They were also unaware that the operational status of the QC system should be monitored on a daily basis.

Therefore, the PICOQC did not fulfill the duties of the position. They did not revise the internal rules to timely reflect revisions of applicable laws, ordinances, or standards. Before commissioning a new engagement, they did not always confirm the conformity of the engagement with the internal rules and the contents of the deficiency improvement plan submitted to the CPAAOB.

In addition, the CEO did not fulfill their duties as the person ultimately responsible for the QC system of their audit firm. The CEO did not take specific measures for early completion of revisions of the internal rules despite being aware of delays in revising the rules. (Fiscal 2012 Inspection)
(Quality Control Standards Committee Statement No. 1, paragraphs 15–18)

Case 7: Establishment of QC systems of local firms

The audit firm had principal and local offices that independently performed profit administration and personnel management, and which made decisions on their own on many matters other than those requiring General Meeting approval. Therefore, the principal office did not sufficiently recognize the QC status of the local office, and did not give adequate directions to the local office. The audit firm failed to operate the offices as a whole in an integrated manner and thereby improve the quality of audit engagements. (Fiscal 2012 Inspection)
(Quality Control Standards Committee Statement No. 1, paragraphs 15–18)

(2) Initiatives to Improve Performance

Points of focus

The CPAAOB performs inspections based on QC review reports. In particular, the CPAAOB inspects the improvement status of deficiencies identified in the QC review. As a general rule, it selects multiple individual audit engagements, and inspects, for each item, the improvement status of deficiencies identified in each individual audit engagement. In the case where the improvement is deemed insufficient, the CPAAOB seeks to identify the operational and structural issues that might be the cause of such insufficiency.

Outline of inspection results

There were useful cases where most of the deficiencies identified in the QC review were sufficiently and appropriately addressed. Examples of such improvement include the results of initiatives in which the audit firms established specific improvement measures, under the leadership of the PICOQC, based on the improvement plan submitted to the JICPA. They also include cases resulting from the fact that the status of such improvement measures was promptly examined by the engagement partner and the QC review partner, etc. of the corresponding individual engagement.

On the other hand, as shown in the Case Example section below, there were many audit firms where 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. The causes included: the engagement partners recognized that the deficiencies identified in the QC review came from the individual audit practices reviewed and the circumstances specific to the audit team who performed the audit engagements; and the engagement partners did not sufficiently examine the improvement status of their own audit engagements based on the purpose of the identifications of deficiencies in the QC review.

Expected response

Audit firms need to improve the overall performance of audit engagements, from the perspective of whether improvements have been made regarding the deficiencies identified in the QC review, with a full understanding of the indications made therein; and particularly of whether the improvement is merely superficial; for example, the improvement measures are undertaken only for the individual audit engagements related to the identified deficiencies.

Case 1: Establishment of specific policies and procedures for improvement, etc.

The CEO and the PICOQC had not established specific policies and procedures for the implementation of the improvement plan to address the deficiencies identified in the JICPA QC review, and did not evaluate the implementation status of improvement measures. (Fiscal 2010 Inspection)

Case 2: Review of improvement status (involvement of CEO)

Although many deficiencies were pointed out in previous QC reviews, and action under Article 131 of the JICPA Rules (Note), etc. was ordered, the CEO left the engagement partner to implement improvement measures, and did not review the status of such improvement. In addition, the engagement partner had not taken the necessary improvement measures. (Fiscal 2011 Inspection)

Note: An action that is ordered to urge the improvement, etc. of the condition of audit QC, when substantial concerns are raised concerning the condition of an audit firm's audit QC during the QC review.

Case 3: Initiatives for improvement

Partners, including the CEO and the PICOQC, believed that the deficiencies identified in the QC review were caused by something unique to the reviewed audit engagement; as a result, they did not examine the root cause of the identified deficiencies. This indicated that the audit firm did not undertake sufficient initiatives to improve their overall audit engagements and did not take action to understand and examine the implementation status of corrective actions in a concrete manner. (Fiscal 2011 Inspection)

Case 4: Verification of improvement status

The audit firm said that they developed an improvement checklist to examine the implementation status of measures to improve deficiencies identified in the QC review, and had the chief 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 chief examiners.

When the chief manager of each engagement team checked the implementation status of improvement measures, however, they ticked the “Improved” columns of the improvement checklist without checking 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 rechecked each checklist only by confirming whether there were no items with “Unimproved” ticked by the chief examiner in the course of checking. (Fiscal 2012 Inspection)

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

<u>Points of focus</u>

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

- ► Whether the audit firm documents policies and procedures for the establishment of a QC system as internal rules to reasonably ensure audit quality, or whether the audit firm works to ensure the adequacy of the internal rules, for example, by sufficiently confirming consistency between the rules during development or revision, and revising the internal rules as appropriate for the revision of the practice guidelines;
- ► Whether the PICOQC or equivalent distributes 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, etc. appropriately monitor the status of compliance.

<u>Outline of inspection results</u>

Examples of actions at audit firms considered useful include: audit firms established internal rules based on the template of the Audit Quality Control Regulations published by the JICPA, with revisions added according to the actual situation; and 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.

On the other hand, as shown in the Case Example section below, there were examples of identified deficiencies concerning the establishment, communication, or application of internal rules. The causes included: audit firms adopted as their internal rules the Audit Quality Control Regulations on an as-they-are basis, without making revisions according to their actual situation; or where the partners operating the audit firm did not refer to its internal rules, as needed, in the performance of operations.

<u>Expected response</u>

Audit firms need to perform sufficient examinations and reviews as to whether engagements are performed in accordance with the internal rules, and to establish a management system concerning the appropriate establishment, dissemination, and implementation of internal rules, for example, by establishing a workflow in accordance with the actual condition of the individual firm.

Case 1: Implementation of internal rules (operation of Board of Partners, etc.)

The CEO, etc., in managing operations, did not sufficiently consult the internal rules, such as the Articles of Incorporation, the rules for QC of audit, etc., and did not review, as necessary, the internal rules to reflect the actual status of 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 Board of Partners under the internal rules, were performed without referring such matters to the Board of Partners.

In addition, although the Articles of Incorporation prescribe that an engagement partner shall be appointed by the unanimous agreement of all partners, engagement partners were assigned for the audit engagement of some listed entities without obtaining the agreement of a partner who was absent from the Board of Partners' meeting, and engagement partners were assigned for the audit engagement of unlisted entities without the unanimous agreement of all partners. (Fiscal 2011 Inspection)

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

Case 2: Establishment of internal rules

The PICOQC checked and examined the necessity of the revision of the internal rules, but did not spend the necessary time on completing such work. Part of the audit manual remained as not responding to the latest version of Auditing Standards Committee Statements, as time was not allocated to complete the said work. (Fiscal 2012 Inspection)

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

Case 3: Establishment of internal rules (review when laws and regulations, etc. are revised)

The PICOQC, etc. were not aware of the revisions made to laws, regulations, and professional standards; as a result, certain cabinet office ordinances, which had already been repealed, were quoted in the internal rules. (Fiscal 2011 Inspection)

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

Case 4: Establishment of internal rules (review when JICPA Rules are revised)

Although, under the JICPA Rules, the number of required units of Continuing Professional Education (CPE) that each audit practitioners should undertake during one business year was changed to two units in professional ethics, and six units in audit QC, the PICOQC, etc. had not made amendments to the internal rules accordingly. (Fiscal 2011 Inspection)

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

Case 5: Dissemination of internal rules

The PICOQC thought it sufficient to give a summary of the internal rules orally to part-time audit practitioners and did not distribute the internal rules regarding the QC system—including the Audit Quality Control Regulations—to part-time audit practitioners at all. (Fiscal 2012 Inspection)

(Quality Control Standards Committee Statement No. 1, paragraph 16)

Case 6: Inconsistencies between internal rules

The PICOQC did not verify the consistency of the partners' association rules, etc., as established or revised, with the certificate of incorporation. Therefore inconsistencies were found between the internal rules; for example, the certificate 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' association rules, etc. stated that they "shall be determined by a majority of the votes of the partners present at a partners' association meeting where a majority of all the partners are present." (Fiscal 2010 Inspection)

(Quality Control Standards Committee Statement No. 1, paragraph 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

As shown in the Case Example section below, audit firms had deficiencies identified relating to the provision of services not stated in the Articles of Incorporation, non-compete obligation by partners, matters stated in the business report, notification of any changes to the Articles of Incorporation, etc. The causes included: the PICOQC or equivalent did not appointed 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 need to 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: Provision of services not stated in the Articles of Incorporation

Although the Articles of Incorporation state that the audit firm performs only audit services, it also provided non-audit services. (Fiscal 2010 Inspection)
(Article 34-5 of the Act)

Case 2: Non-compete obligation by partners

The audit firm did not ascertain that certain partners, as individuals, accepted non-audit service engagements included in the scope of business of the audit firm, without obtaining approval from all other partners. (Fiscal 2012 Inspection)
(Article 34-14, paragraph 2 of the Act)

Case 3: Matters stated in business reports

Without a centralized system in place for gathering and managing information to be stated in business reports, the CEO, who is in charge of business report preparation, wrote reports, and nobody else other than the said CEO verified the accuracy of the reports. This resulted in errors in the description of “status of partners, employees, etc.,” “status of cyclical inspection of audit engagements,” etc. of the submitted business report. (Fiscal 2011 Inspection)
(Article 34-16 paragraph 2 of the Act)

Case 4: Notification of changes to the 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. (Fiscal 2011 Inspection)

(Article 34-10 paragraph 2 of the Act)

(5) Information Security

Points of focus

CPAs are in a position where they may often be exposed to the confidential information of entities, etc. in the course of performing their duties.

CPAs, in the course of their duties, carry around personal computers and exchange business information with entity contacts, etc. via e-mail on a daily basis (refer to the "Guidelines for Information Security in the Services of Certified Public Accountants" (IT Committee Statement No. 4)). In such circumstances, audit firms are required to establish and maintain 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 an information security system, 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 risk;

► Whether an information security manager ensures compliance of internal information security rules, for example, by monitoring at any time whether audit practitioners (including part-time staff) and other personnel observe the internal rules.

Outline of inspection results

Examples of actions at audit firms considered useful to reduce information leak risks include cases of:

- Prohibiting, as a general rule, carrying a PC on which data obtained from entities, etc. is stored;
- 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 the information devices, such as PCs, used for their audit engagements.

On the other hand, as shown in the Case Example section below, there were examples of identified deficiencies: some audit firms did not distribute their internal information security rules to audit practitioners, and other audit firms did not carry out any measures to prevent information leakage as specified in their internal information security rules. The causes included: the information security manager, etc. established internal information security rules only as a formality, leaving application of the rules to audit practitioners (including part-time staff) using PCs, etc.; and they 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 need to fully understand the damage, etc. that may occur in the event of information leakage, and establish information security systems in accordance with how information devices are used at each audit firm.

Case 1: Distribution of internal rules on information security, etc.

The PICOQC believed it sufficient to give a summary of the internal information security rules orally to part-time audit practitioners and did not distribute 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. (Fiscal 2012 Inspection)

(Article 27 of the Act; IT Committee Statement No. 4, IV2 and 5)

Case 2: Monitoring, etc. of information security operations systems

Although the internal rules concerning information security specify the implementation of periodic training, and the monitoring of the condition of password setting and management, as well as the operation of information security systems, the PICOQC, etc. did not perform the specified monitoring for some business use PCs, including the checking of whether the passwords are changed periodically, and whether the antivirus program is updated.

In addition, some audit practitioners did not set a password for their business use PCs. (Fiscal 2011 Inspection)

(Article 27 of the Act; IT Committee Statement No. 4, IV5 and V3)

Case 3: Monitoring of the condition of electronic data storing, etc.

The PICOQC, etc. did not monitor, as required by the internal information security rules, the condition of electronic data storing, etc. for PCs provided for use by full-time personnel, etc., or for PCs personally owned by part-time personnel and used for audit engagements of the audit firm. (Fiscal 2010 Inspection)

(Article 27 of the Act; IT Committee Statement No. 4, IV5)

(6) Prevention of Insider Trading

<u>Points of focus</u>

If a CPA, who holds the important social mission of ensuring the reliability of the capital market, partakes in insider trading using the insider information of an enterprise acquired in the course of business, this may seriously damage trust in the CPA audit. In addition, not only will the CPA involved in insider trading be held liable, but also such involvement can seriously damage trust in the audit firm to which the CPA belongs. Each audit firm is therefore required to constantly take effective measures to prevent any of its members from participating in insider trading.

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

- ► Whether the audit firm has internal rules in place that provide for effective procedures to prevent any of their members from participating in insider trading, and makes them known to their members;
- ► Whether the audit firm appropriately takes 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.

<u>Outline of inspection results</u>

We confirmed that most audit firms had established and implemented rules for preventing insider trading that contain provisions relating to, for example, the prohibition of trading of specified securities issued by the entities to which services are provided (those provided with audit certification or non-audit certification service by the audit firms), ensuring a thorough notification of entities to which services are provided, and collecting written pledges, by using, as a base, such materials as the "Rules for Preventing Insider Trading" template provided at the JICPA's training program. Examples of actions at audit firms considered useful include cases of:

- Periodically collecting from members records of transactions relating to specified securities, etc. to check the conditions concerning the holding and transactions of specified securities, etc.; and
- Undertaking measures, including imposing a certain level of restrictions on the trading of specified securities other than those issued by the entities to which services are provided.

On the other hand, as shown in the Case Example section below, there were examples of identified deficiencies, where only internal rules were prepared by using the template "Rules for Preventing Insider Trading" as a guide, and the preventive measures specified in such rules were never implemented. The causes included: the anti-insider trading manager or equivalent did not comprehensively understand the anti-insider trading measures to be performed under the internal rules; and they did not carry out anti-insider trading measures specified in the internal rules in a timely manner, questioning their effectiveness or placing too much reliance on members of their audit firms to be compliant with relevant rules.

Expected response

Audit firms have to carefully study the “Q&A Concerning Insider Trading” issued by JICPA (September 2, 2008), etc., 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: A notification of entities to which services are provided, etc.

It is specified in the rules for preventing insider trading that a list of entities to which services are provided shall be distributed to members in order to provide a warning about insider trading, and that members shall submit written pledges to the effect that they will not carry 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. (Fiscal 2010 Inspection)

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

Case 2: Communication of client information (timely communication)

Although the internal rules require the anti-insider prevention manager to communicate with audit practitioners and other personnel promptly in the event of any client personnel change, the anti-insider trading manager did not make some of the client personnel changes known to members promptly after the changes. (Fiscal 2012 Inspection)

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

Case 3: Communication of client information (comprehensiveness of client information)

The anti-insider trading manager notified firm members of changes of clients to which the audit firm provided audit services, but not with those of listed companies to which the audit firm provided non-audit services. (Fiscal 2012 Inspection)

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

Case 4: Operation of anti-insider trading system

The anti-insider trading manager obtained from firm members written promises “not to sell, buy, or otherwise trade specified securities of the audit firm’s clients for their own interest,” but did not notice that some members did not include in their written promises their responses to matters that should be pledged. (Fiscal 2012 Inspection)

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

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 interest, 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 mainly from the following perspectives:

- ► Whether the audit firm obtains, at least once each year, confirmation letters concerning compliance with policies and procedures for the maintenance of independence from all firm members 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 engagement, 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

As shown in the Case Example section below, there were examples of identified deficiencies, such as not implementing the independence confirmation procedures specified in the internal rules or otherwise. The causes included: the PICOQC, etc. did not establish specific procedures (including but not limited to how to gather the latest information on consolidated subsidiaries, etc. of the entity) and period of independence confirmation, and did not appoint practitioners in charge thereof.

Expected response

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

Case 1: Procedures for annual independence confirmation

The audit firm did not perform independence confirmation procedures. It did not appoint practitioners in charge of independence confirmation, and did not have specific procedures therefor. (Fiscal 2012 Inspection)

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

Case 2: Confirmation procedures in concluding new engagements

The audit firm did not have concrete measures in place to confirm independence, including practitioners and 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. (Fiscal 2012 Inspection)

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

Case 3: Confirmation procedures in concluding 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. (Fiscal 2012 Inspection)

(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;
- The annual independence confirmation procedures were not performed for those audit practitioners who are not partners;
- The 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 independent checklists with “NO” already checked in advance for all items.

(Fiscal 2011 Inspection)

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

Case 5: 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. (Fiscal 2011 Inspection)

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

Case 6: Independence confirmation procedures until the date of auditor’s report

The 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). (Fiscal 2012 Inspection)

(Auditing Standards Committee Statement No. 220, paragraph 10)

3. Acceptance and Continuance of Engagements

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, such as expressing the auditor's opinion. 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 commissioned or renewed audit engagements taking into consideration the risk assessment and the information regarding entities involved, etc., obtained in the course of judgment on the commission or renewal.

Outline of inspection results

The acceptance and continuance of audit engagements should be a central issue in the audit firm's managerial judgment; however, in reality, as shown in the Case Example section below, deficiencies were identified, including those where internal procedures relating to the acceptance and continuance of audit engagements were not executed, where proper risk assessment was not performed, and where records of materials handed over were not properly kept. The causes included: engagement partners, etc. prioritized undertaking early audit procedures rather than performing careful risk assessment procedures or timely and appropriately taking over from the predecessor auditors and internal procedures; and they did not appropriately identify or assess audit commission risks based on facts found through preliminary audit or otherwise because of a lack of experience as an engagement partner.

Expected response

In consideration of the importance of the policies and procedures relating to the acceptance and continuance of audit engagements, audit firms need to re-examine the status of establishment and implementation of such policies and procedures from the perspective of whether the procedures for risk assessment, etc. are functioning appropriately.

In addition, the newly established Fraud Risk Response Standards require audit firms to consider fraud risks in the acceptance and renewal of audit engagement. Each audit firm should strengthen their risk assessment procedures for the acceptance and renewal of audit engagement in light of the cases described below.

(1) Execution of Internal Procedures, etc.

Points of focus

In accepting or continuing audit engagements, audit firms are required to meet all of the following conditions:

- ► That the audit firm is competent and has the necessary capabilities, including time and human resources, to perform the audit services;
- ► That the audit firm is capable of complying with the relevant ethical requirements;
- ► That the audit firm examines the integrity of the entity involved and does not identify any matter that could have a significant negative effect on the acceptance and continuance of engagements.

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 renewal of audit engagement at each audit firm.

Outline of inspection results

As shown in the Case Example section below, there were examples of identified deficiencies in the internal procedures relating to the acceptance and continuance of audit engagements and in risk assessment procedures. There were also deficiencies identified, such as a case where, at the time of continuing audit engagement, in-depth risk assessment was not performed; instead, only check marks indicating “no problems noted” were placed in the check boxes of the checklist that is specified in the internal procedures.

Expected response

Audit firms need to re-examine whether the policies and procedures relating to the acceptance and continuance of audit engagements have been properly established and implemented.

In addition, the newly established Fraud Risk Response Standards state that “in their policies and procedures for determination of acceptance and renewal of audit engagement, audit firms should include assessing all risks, including fraud risks, associated with acceptance and renewal 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 renewing an audit engagement.”

Each audit firm should strengthen its risk assessment procedures, etc. in light of the cases described below.

Case 1: Implementation of internal procedures

The engagement partner (prospective) considered that, regarding the acceptance and continuance of audit engagements, decisions could be made only through consultation with the CEO or the PICOQC on an as-needed basis; as a result, the acceptance and continuance of audit engagements, which was a matter to be resolved by the Board of Partners under the internal rules were performed without holding Board of Partners' meetings. (Fiscal 2011 Inspection)

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

Case 2: Implementation of risk assessment procedures

When accepting or continuing audit engagements, risk assessments based on the "Checklist when accepting an audit engagement" or "Checklist when continuing an audit engagement" were not performed. (Fiscal 2010 Inspection)

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

Case 3: Implementation of risk assessment procedures (integrity of the entities involved)

The engagement team recognized information through inquiry with the predecessor auditor, etc. that indicated that the entities' actual business performance was far below the earnings outlook in their business plan, or which suggested that problems might exist in the management's attitude over the interpretation of accounting standards or the control environment. When accepting audit engagements with these entities, however, the engagement team mentioned only as a formality in the checklist that there were no problems noted, but did not identify matters recognized through the inquiry, etc. as engagement acceptance risks. In addition, the team did not sufficiently examine concrete measures to reduce the risks expected in the event of acceptance of the audit engagement. (Fiscal 2012 Inspection)

(Quality Control Standards Committee Statement No. 1, paragraphs 25; Auditing Standards Committee Statement No. 900, paragraphs 9 and 12)

Case 4: Implementation of risk assessment procedures (human resources)

When the audit firm discussed whether to accept or renew the audit engagements for financial institutions, the audit firm knew 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 and renewed such an audit engagement without taking sufficient and appropriate action to supplement this lack. (Fiscal 2012 Inspection)

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

Case 5: Documentation of risk assessment results

The engagement partner (prospective) considered that it was not necessary to document the assessment results, etc. in the cases of those entities other than listed entities and SPCs, as the audit

risks involved in such cases were minimal. As a result, the assessment results, etc. of matters that would significantly affect the judgment on the acceptance and continuance of engagements were not recorded. (Fiscal 2011 Inspection)
(Auditing Standards Committee Statement No. 220, paragraphs 11 and 23)

Case 6: Documentation of consideration process of identified problems (assessment of insolvency assessment)

The engagement partner, who was aware of the fact that the entity (listed entity) had become insolvent as of the end of the fiscal year and that its shares were designated as shares subject to a grace period leading to insolvency, did not record the process of consideration of this matter in the "Checklist when continuing an audit engagement." (Fiscal 2011 Inspection)
(Quality Control Standards Committee Statement No. 1, paragraphs 26; Auditing Standards Committee Statement No. 220, paragraphs 11 and 23)

Case 7: Documentation of consideration process of identified problems (assessment of going concern assumption)

The engagement partner, who was aware that there were events or circumstances that posed a significant uncertainty regarding the going concern assumption, including the fact that the entity reported operating losses and net losses in consecutive years, did not record the process of consideration of these matters when the audit engagement was continued. (Fiscal 2011 Inspection)
(Quality Control Standards Committee Statement No. 1, paragraphs 26; 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 successor auditor are therefore required to ensure the following are 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; when asked by the successor auditor, the predecessor auditor must provide information with integrity and in a clear manner. 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 the following matters, at least:
  - Whether there is any concern about the integrity of the management;
  - The predecessor auditor's opinion regarding the change of auditor;
  - Whether there are major differences of opinions regarding the accounting, presentation, and audit procedures;
  - Whether there has been any fraud by management or significant fraud by any employee, or any signs of such fraud;
  - Whether there are any significant unlawful acts or acts suspected to be unlawful;
  - Whether there are any significant contingent liabilities or events that could possibly become significant contingent liabilities;
  - Whether there are any significant deficiencies regarding the internal control of financial reporting;
  - Whether there are any events or circumstances that would pose significant uncertainty regarding the going concern assumption;
  - In the event of a change during the fiscal year, whether there are any uncorrected misstatements that have been already 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

Examples of actions at audit firms considered useful include, in the case of changes during the fiscal year, there were cases where the predecessor auditor passed on to the successor auditor detailed information regarding the condition of the entity obtained in the course of audits, including the provision of an explanation about the content of notifications, etc. issued to the entity pursuant to Article 193-3 of the FIEA.

On the other hand, as shown in the Case Example section below, there were examples of identified deficiencies, such as the case where inquiries to and responses from the predecessor auditor were not documented, and a case where there was concern about the scope and accuracy of the information provided to the successor auditor.

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 manner. 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.

The newly established Fraud Risk Response Standards require predecessor and successor auditors to appropriately perform handover procedures so as to ensure sufficient and clear communications about information concerning audit risks in the entity with each other, stating that:

"The audit firm should communicate to the successor audit firm important audit matters, including the status of fraud risk responses, and make relevant documentation available upon request to the successor audit firm for inspection";

"The audit firm should have in place policies and procedures for handover from the predecessor audit firm that require the audit firm to inquire with the predecessor audit firm about the reasons for replacement and important audit matters, including the status of fraud risk response";

"The audit firm should have in place the policies and procedures for handover between audit firms that require the audit firm to report the status of handover by the engagement team to appropriate departments or persons out of the engagement team."

In addition, note that the Fraud Risk Response Standards also require sufficient and clear communication of audit risk information in the case of replacement of an engagement team within the audit firm, stating that:

"The audit firm should have in place the 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

When the (successor) engagement partner was about to conclude an audit engagement that required interim replacement of auditors, there were predecessor auditors who had started auditing but had yet to submit an auditor's report of financial statements for the current year, and predecessor auditors who submitted an auditor's report of financial statements for the previous year. Before conclusion of the audit engagement, however, the engagement partner inquired only with the former predecessor but not the latter predecessor. (Fiscal 2012 Inspection)

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

Case 2: Documentation of content of inquiries, etc. to the predecessor auditor

Under the internal rules, it was required: (i) to comply with the Auditing Standards Committee Statement No. 33 (before amendment), paragraph 13; and (ii) for the PICOQC to confirm whether the communication was performed in compliance with the policies and procedures specified by the audit firm; however, there were audit engagements in which the documentation of inquiries to and responses from the predecessor auditor were not properly performed. (Fiscal 2010 Inspection)

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

Case 3: Documentation of procedures to assess the reasonableness of the evaluation of the beginning of the year balance, etc.

The engagement team claimed that they inquired of the predecessor auditor whether there were significant unrealized losses, in order to assess the reasonableness of the evaluation of the beginning of the year balance for the accounts associated with accounting estimates; however, the procedures performed and the results thereof were not documented in the audit documentation.

Moreover, in some cases, regarding the accounts associated with accounting estimates and liability items, which were significant in monetary terms, the substantiality, etc. of the beginning of the year balance was not verified; instead, they were only checked against the trial balance, etc. (Fiscal 2011 Inspection)

(Auditing Standards Committee Statement No. 510, paragraph 5; 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 emphasizes that it is important for audit practitioners to receive continuous training, and to maintain and develop the audit practitioner's necessary competence and capabilities by providing necessary training opportunities;
- ► Whether the audit firm properly manages and supervises the status of participation in the CPE program and the units earned by the audit practitioners.

Outline of inspection results

Examples of actions at audit firms considered useful include provision of different training programs to audit practitioners according to their years of experience, and improvement of training programs by adopting workshop-style training with discussion sessions between audit practitioners, in addition to lecture-style programs.

On the other hand, as shown in the Case Examples below, inappropriateness of education/training systems and a lack of appropriate management of completion of the CPE programs were identified as deficiencies. The causes included the PICOQC or equivalent entirely entrusted the audit practitioners' acquisition of audit engagement-related knowledge to the engagement partner instructing and supervising them 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 audit firms, regardless of size, did not successfully put the advice and awareness given in training programs into practice in audit engagements, which 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 need to maintain and develop the audit practitioner's necessary competence and capabilities by providing audit practitioners with appropriate training opportunities, and by properly managing and supervising the status of participation in the CPE program.

Case 1: Development of education and training systems

The audit firm did not have in place an education/training system developed with due consideration of the audit experience of audit practitioners and the scope of ongoing 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. (Fiscal 2012 Inspection)

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

Case 2: Management of participation status in the CPE program

As a result of the audit firm not properly confirming the status of participation in the CPE program and units earned, there was a case where audit practitioners had not earned the necessary units for the compulsory training subjects. (Fiscal 2010 Inspection)

(Article 116 of the JICPA Rules; Article 6 of the Rules for Continuing Professional Education)

(2) Evaluation, Compensation, and Promotion

Points of focus

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

- ► Whether the audit firm reflects the attitude of placing a high priority on audit quality in the policies and procedures relating to personnel affairs;
- ► Whether the audit firm has the policies and procedures in place for evaluation, whether compensation, and promotion are implemented in such a way that efforts and performance to maintain and enhance capabilities and to comply with professional ethics by audit practitioners are fairly evaluated, and whether such efforts and performance are appropriately rewarded.

Outline of inspection results

Examples of actions at audit firms considered useful include evaluation procedures in which the quality of audit performed by audit practitioners are regularly evaluated according to the evaluation items specified by the audit firm, and the results thereof are communicated to audit practitioners.

On the other hand, as shown in the Case Example section below, there were examples of identified deficiencies, including a case where specific policies, etc. were not established as to how the quality of audit engagements performed should be reflected in the performance evaluation of audit practitioners. The causes included many engagement partners being reluctant to assess the quality of audit engagements among themselves.

Expected response

Audit firms need to establish and implement the policies and procedures to evaluate the personnel's efforts and performance to maintain and enhance professional capabilities and the status of compliance with professional ethics, taking into consideration the size and personnel structure of each audit firm, etc.

Case: 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. (Fiscal 2011 Inspection)
(Quality Control Standards Committee Statement No. 1, paragraph 28)

(3) Assignments

Points of focus

Audit firms must establish policies and procedures for the assignment of audit practitioners, and must assign those who are independent and have the ability and experience as auditing audit practitioners (including engagement partners) to properly perform audits in accordance with the business of the entities, etc. and who can spend sufficient time on audit engagements. In addition, in assigning audit practitioners, the engagement partner must confirm that the audit practitioners are independent and have the necessary ability and experience to perform audit engagements, and that they can spend sufficient time on audit engagements.

In consideration of the above, in the inspections, the CPAAOB reviews the appropriateness, etc. of the assignment of audit practitioners from the following perspectives:

- ► Whether the audit firm, regarding the assignment of engagement audit practitioners, specifies policies and procedures to ensure the assignment of audit practitioners who have the required competence and capabilities;
- ► Whether, when assigning audit practitioners, sufficient examinations are made for each audit practitioner regarding the time that can be spent on audit engagements, understanding of professional standards, practical experience, ability to exercise judgment, etc.

Outline of inspection results

As shown in the Case Example section below, there were examples of identified deficiencies, including a case where audit practitioners, etc. were not properly assigned. The causes included where an audit firm gave priority to acquisition of new audit orders to accept commission for a new audit engagement, without due consideration to the audit practitioners' competency and experience, and work performance of the entire audit firm in the case of the new commission of the audit engagement.

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 said partner performs substantially no audit procedure other than visiting the entity once every quarter and thus did not spend sufficient time on audit engagements. (Fiscal 2011 Inspection)

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

Case 2: Assignment of engagement team

The engagement team for a listed entity consisted, in reality, of three persons: the engagement partner and two junior accountants. Moreover, despite lacking sufficient capabilities and experience to perform the audit, the junior accountants were assigned to a task related to significant items. These facts indicated that sufficient time and human resources were not allocated given the audit risk involved. (Fiscal 2011 Inspection)

(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 audit standards, etc. Thus, the audit documentation serves as evidence to directly and specifically show the content of the audit procedures performed by the engagement team. On the other hand, especially in the cases of audit procedures for making an important judgment, if the content of procedures, etc. is not recorded in the audit documentation, evidence other than the audit documentation (for example, oral explanations, etc. by the engagement team who, according to their words 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 documentation is prepared in such a way that an experienced auditor, who has not been involved in that audit, can understand the status of compliance with audit procedures, timing and scope of implementation of audit procedures, the conclusions reached, etc.;
- ► Whether more experienced members of the audit team appropriately inspect the audit documentation prepared by less experienced members;
- ► Whether the engagement partner confirms that sufficient appropriate audit evidence has been obtained to support the conclusions reached and auditor's opinion through the review of audit documentation and discussions with the engagement team.

Outline of inspection results

As described in II. Individual Audit Engagements, one of the main causes of deficiency in individual audit engagements is lack of instruction and supervision by the engagement partner or equivalent over the members of the engagement team for timely and appropriate inspection of audit documentation, etc. In connection with this, examples of identified deficiencies found in preparation of audit documentation include failure to include audit procedures carried out, the scope of testing some selected items in a population, audit evidence obtained, the judgment process and/or the conclusion.

Furthermore, as shown in the Case Example section below, other examples of identified deficiencies include failure to document the reason for an audit procedure omission, partly because of lack of recognition of the importance of audit documentation described in the Points of focus section.

Expected response

Audit practitioners need to ensure that more experienced members of the engagement team properly review the audit documentation, and provide instruction and supervision, etc. to less experienced members; and to record necessary and sufficient information regarding the performed audit procedures.

Case 1: Statement of reasons for omitting audit procedures, etc.

Regarding the audit procedures listed in the statement of auditing procedures, the engagement team neglected to perform a part of the procedures; however, neither the reason for neglecting such audit procedures nor a statement to the effect that the engagement partner approved of the neglecting of such procedures was documented. (Fiscal 2011 Inspection)
(Auditing Standards Committee Statement No. 230, paragraph 7)

Case 2: Statement of cross-referencing working papers, etc.

The relationship between accounts in the financial statements and the audit documentation in which the contents of discussion on each account is stated was not made clear by including the reference working paper numbers, etc. As a result, the corresponding relationship between the amounts of subject-to-audit accounts and the amounts of accounts in the audit documentation, which contain audit evidence, was unclear. (Fiscal 2011 Inspection)
(Auditing Standards Committee Statement No. 230, paragraph 7)

(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 has the policies and procedures properly in place for audit documentation to ensure that their 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

The results of inspections concerning the status of retention of audit documentation at each audit firm revealed that, as shown in the Case Example section below, there were deficiencies concerning the retention of audit documentation. The causes included: each audit practitioner had a lack of awareness that audit documentation plays an important role, such as in performing QC operations at the audit firm and in explanations outside the firm; and the engagement partner or equivalent did not pay due attention to securing the confidentiality, safe custody and integrity of audit documentation.

Expected response

Audit firms need to re-examine the status of management and retention of audit documentation and to implement full-scale measures to prevent any loss of audit evidence, leakage of confidential information, etc. resulting from the loss, etc. of audit documentation.

Case 1: Retention of audit documentation

The following deficiencies were identified concerning retention of audit documentation:
(Quality Control Standards Committee Statement No. 1, paragraph 45)

- ► The audit firm did not have in place specific provisions for the implementation procedures, the person in charge of implementation, and other matters regarding the completion of audit files and the retention of audit documentation (Fiscal 2011 Inspection);
- ► The audit firm did not keep track of the number of audit files, year prepared, retention period, etc. (Fiscal 2011 Inspection);
- ► The audit firm only recorded the names of entities, business year, and the number of audit files in the summary, and did not record the serial numbers placed on each audit file or brief explanations of the content (Fiscal 2009 Inspection);
- ► The audit firm did not recognize the numbers, preparation years, retention periods or other information of files of audit documentation retained in its local offices and the private offices of the partners. (Fiscal 2010 Inspection);
- ► The audit firm registered some quarterly review documents in the management ledger after the appropriate deadline therefor although the documents were completed for filling within the period for final arrangement set forth in the internal rules (within 60 days from the date of review).(Fiscal 2012 Inspection)

Case 2: Integrity of information

The engagement team did not sufficiently inspect audit information for integrity during the final arrangement of audit files. As a result, audit documentation and audit evidence, which should constitute part of the audit file, were individually stored only as electronic files in the server, but their hardcopies were not compiled into the paper audit file. (Fiscal 2011 Inspection)
(Quality Control Standards Committee Statement No. 1, paragraph 45)

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. In addition, audit firms are expected to establish policies and procedures setting out the nature, timing and extent of the EQCR, and to require, in the said policies and procedures, that the engagement report not be dated until the completion of the EQCR.

In consideration of the above, the CPAAOB inspects the appropriateness of review performed by the persons in charge of EQCR from the following perspectives:

- ► Whether the EQC reviewer reviews at an appropriate time for the planning 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, reviews the appropriateness of financial statements and proposed report, etc.;
- ► Whether the EQC reviewer examines the appropriateness of the evaluation of the engagement team members' independence, the necessity of seeking expert opinions and the conclusion reached, and records of significant judgments in audit documentation;
- ► Whether the facts 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 the significant audit judgments and conclusions reached are determined to be inappropriate.

Outline of inspection results

Regardless of the size, audit firms faced the challenge of enhancing and strengthening their review system. This is represented by a failure to perform some audit engagements, including where the EQC reviewer did not fully review some audit procedures for significant audit determination. In addition, as shown in the Case Example section below, there were many examples of identified deficiencies: the review process was not appropriately documented; and deficiencies in the audit procedures were overlooked during the review.

The causes of these identified deficiencies included:

- ・ The EQC reviewer had too much faith in the engagement partners to review critically, believing that the engagement team was supposed to have carried out sufficient and appropriate audit procedures;
- ・ The EQC reviewer gave priority to performing their own audit duties and did not spend sufficient time on EQCR;
- ・ The EQC reviewer did not possess the knowledge and experience necessary to perform review

work;

- 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.

Expected response

Audit firms need to re-examine whether the review system is fully functioning as originally intended (in other words, functions to confirm, from an independent standpoint from the engagement team, that the audit opinion is appropriate and is in accordance with generally accepted auditing standards).

In particular, the newly established Fraud Risk Response Standards require audit firms to improve and strengthen their review system even for fraud risk response, and EQC reviewers to perform effective review with due understanding of the magnitude of their own duties, 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”;

“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.”

As for the audit firm, improvement of preparation and effectiveness of the EQCR is demanded also from the standpoint known as the fraud risk response, and it is demanded that an effective EQCR be carried out with the engagement quality control reviewer recognizing the importance of their duties.

Case 1: Documentation of audit plan review

The EQC reviewer did not document the details of the plan review that they said they had carried out. (Fiscal 2012 Inspection)

(Quality Control Standards Committee Statement No. 1, paragraph 41; Auditing Standards Committee Statement No. 220, paragraph 20)

Case 2: Effectiveness of audit planning review

Effective reviews of planning an audit were not performed, including a case where risks of material misstatement and responses to address such risks were not discussed. (Fiscal 2011 Inspection)

(Auditing Standards Committee Statement No. 220, paragraph 19)

Case 3: Timing of audit planning review

Reviews of planning financial statement and internal control audits were performed concurrently with the review of forming the auditor’s opinion under the Companies Act. (Fiscal 2010 Inspection)

(Quality Control Standards Committee Statement No. 1, paragraph 35)

Case 4: Examination and evaluation of audit procedures (going concern assumption)

In the reviews of planning an audit and forming the auditor's opinions, the EQC reviewer performed reviews only on matters related to the going-concern assumption, and did not examine other risks that required special consideration. As a result, many deficiencies were not identified in the audit procedures performed by the engagement team.

Moreover, regarding the examination of the going-concern assumption, although the engagement team failed to document the process of examination, etc. of the business plan submitted by the entity, the QC reviewer overlooked this deficiency. (Fiscal 2011 Inspection)

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

Case 5: Examination and evaluation of audit procedures (accounting estimates)

The EQC reviewer overlooked deficiencies arising in the audit procedures for items such as accounting estimates. The reviewer did not confirm the procedures performed by the engagement team by inspecting the audit documentation or in other specific ways for important points in question, including the valuation of subsidiary shares regarding which real value had decreased remarkably and the accounting of the loan loss reserve for loans receivable. (Fiscal 2012 Inspection)

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

Case 6: Examination and evaluation of audit procedures (revision of materiality level)

Although the figures of financial statements, which served as a basis of calculation of materiality, changed significantly, the engagement team did not consider the necessity of revising the materiality in forming the auditor's opinion. The EQC reviewer overlooked the above-mentioned deficiency. (Fiscal 2011 Inspection)

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

Case 7: Examination and evaluation of audit procedures (materiality level)

The EQC reviewer overlooked improper descriptions—including no entry of materiality for the financial statements as a whole—in the review documentation submitted by the engagement team. (Fiscal 2012 Inspection)

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

Case 8: Examination and evaluation of audit procedures (summary of exceptions)

The QC reviewer overlooked the fact that the engagement team failed to assemble the exceptions, which should be summarized as uncorrected misstatements. (Fiscal 2011 Inspection)

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

Case 9: Examination and evaluation of audit procedures (internal control audit)

Regarding the internal control audit, the engagement team did not sufficiently record the audit procedures relating to the understanding of the flow of transactions and understanding of the accounting process, management's judgment on the appropriateness of identified control, or the need for and extent of the use of work of internal auditors in the audit documentation. However, the QC reviewer did not verify the sufficiency of the above audit procedures, and as a result, overlooked the said deficiency. (Fiscal 2011 Inspection)

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

Case 10: Targets for review

The EQC reviewer completed the EQCR by reviewing documentation submitted by the engagement team even though no drafted financial statements, drafted detailed statements, drafted auditor's report or other materials were attached to the documentation. (Fiscal 2012 Inspection)

(Quality Control Standards Committee Statement No. 1, paragraph 36)

Case 11: Documentation of review

Under the internal rules the EQC reviewer is required to document the contents of EQCR procedures performed and the results thereof. However, the EQC reviewer documented only the contents of the procedures performed for year-end EQCR for listed companies, but not the contents of the procedures performed for review of other audit procedures. (Fiscal 2012 Inspection)

(Quality Control Standards Committee Statement No. 1, paragraph 41; Auditing Standards Committee Statement No. 220, paragraph 20)

Case 12: Management of auditor's report issuance

The PICOQC, etc. considered that they could recognize the progress of all audit engagements, as there are only a few audit engagements. Because of this, a system had not been established to confirm the completion of review at the time of auditor's report issuance. (Fiscal 2011 Inspection)

(Quality Control Standards Committee Statement No. 1, paragraph 35)

Case 13: 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 high in audit risk. In addition, the engagement partner merely verbally provided external EQC reviewers with a brief summary from the CPAAC of 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 reviewers did not identify or point out material deficiencies in the audit engagements. (Fiscal 2012 Inspection)
(Quality Control Standards Committee Statement No. 1, paragraph 34)

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

Points of focus

The monitoring of the QC system plays an important role in the maintenance and improvement of audit quality as a process to voluntarily identify and understand problems relating to the QC system and to address such problems. For this reason, audit firms are expected to perform ongoing monitoring of the QC system to ensure the sufficient and appropriate establishment and implementation of policies and procedures relating to the QC system; 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, mainly from the following perspectives:

- ► Whether the audit firm assigns as the person responsible for the monitoring of the QC system a person with sufficient and appropriate experience for the role, and vests the assigned person with sufficient and appropriate authority;
- ► 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 impact 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;
- ► Whether the audit firm evaluates the impact of deficiencies identified as a result of inspections and ensures that the relevant engagement partner, etc. takes appropriate improvement measures.

Outline of inspection results

Examples of actions at audit firms considered useful include: the partner not in charge, as well as the PICOQC, objectively examined the appropriateness, etc. of QC-related work, thereby discovering deficiencies in the work and taking improvement measures voluntarily to ensure that ongoing inspection functions effectively. The causes included:

- ・ The PICOQC did not understand ongoing inspection as measures for continuously checking and evaluating the appropriateness of QC maintenance and the effectiveness of QC operations;
- ・ Qualified persons with knowledge and experience necessary to inspect audit risks were not appointed as cyclical inspection practitioners;
- ・ Cyclical inspection practitioners lacked awareness in critically assessing the sufficiency and appropriateness of the audit procedures from an objective standpoint;

- Cyclical inspection practitioners did not recognize the importance of cyclical inspections or spend sufficient time inspecting.

In addition, regardless of the size, audit firms did not undertake cyclical inspections with sufficient depth. Therefore, they performed audit engagements with cyclical inspections not delivering their inherent functionality, such as overlooking deficiencies in audit procedures during inspection.

Expected response

Audit firms need to establish and maintain a system in which the primary function of monitoring the QC system (i.e., voluntarily identifying, understanding, and correcting problems) can be fully exercised.

The newly established Fraud Risk Response Standards require audit firms to improve and strengthen cyclical inspections even for fraud risk response, stating that:

"The audit firm should confirm through cyclical inspections regarding fraud risk response that the following items are performed under its QC policies and procedures:

- Acceptance and renewal of audit engagements;
- Education and training concerning fraud;
- Audit performance (including instruction and review, handling of information from inside and outside the audit firm, inquiries of technical opinions, EQCR, handover between persons in charge of audit practice);
- Handovers between audit firms."

Case 1: Objectivity of the person in charge of performing ongoing inspections

The PICOQC, who was virtually the only person to perform the QC related duties and concurrently served as the person in charge of performing ongoing inspections, was not qualified as a person to objectively identify deficiencies and matters that must be corrected in QC-related operations. As a result, multiple deficiencies in the QC system were overlooked. (Fiscal 2011 Inspection)

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

Case 2: Effectiveness of ongoing inspection

The PICOQC only operated an annual ongoing inspection by using the checklist 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 QC system, including independence checks. (Fiscal 2012 Inspection)

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

Case 3: Effectiveness of ongoing inspections

The PICOQC believed it sufficient as an ongoing inspection to check the operational status of the QC system annually before reporting to the Board of Partners. They showed a lack of awareness of checking it on a daily basis. When commissioning a new audit engagement, therefore, they did not confirm whether the commission procedures were compliant with the internal rules. (Fiscal 2012 Inspection)

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

Case 4: Depth of cyclical inspection (cyclical inspection by external CPA)

The engagement partner appointed an external CPA without sufficient auditing experience as the practitioner in charge of cyclical inspection, and did not give the 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 not substantial deficiencies. (Fiscal 2012 Inspection)

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

Case 5: Selection of targets for cyclical inspection

Although the internal rules require an audit engagement for an engagement partner to be selected once every three years, some engagement partners have not been inspected in the three-year cycle. (Fiscal 2012 Inspection)

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

Case 6: Response to deficiencies identified in cyclical inspection

Although deficiencies regarding the planning of an audit based on a risk approach, etc. were identified during the cyclical inspection, the content of such deficiencies was not communicated to engagement partners, etc. (Fiscal 2010 Inspection)

(Quality Control Standards Committee Statement No. 1, paragraph 49)

Case 7: Checklists for cyclical inspections

The checklist used for cyclical inspections did not contain items related to the new accounting standards and audit guidelines, including the accounting standards for asset retirement obligations. (Fiscal 2011 Inspection)

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

8. Joint Audit

<u>Points of focus</u>

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 QC system of the joint auditor is one that can reasonably ensure audit quality.

<u>Outline of inspection results</u>

The results of inspections of the status of implementation and management of joint audits at each audit firm revealed that there were examples of identified deficiencies, including those in the audit procedures that their joint audit partners firm missed. The causes included the audit firms' over-dependency on the conclusions provided by their joint audit partners without sufficiently examining the appropriateness, etc. of the audit procedures performed by the partners.

<u>Expected response</u>

Audit firms need to secure the quality of joint audits, for example, by reviewing the other audit firm's QC system.

Case 1: Review of joint auditor's QC system

Although the firm claimed that a confirmation procedure was conducted to confirm that the joint auditor's QC system was one that could reasonably secure the quality of joint audits, the content and conclusions of such confirmation were not recorded in the audit documentation. (Fiscal 2009 Inspection)

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

Case 2: Performance of joint audit engagement

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. (Fiscal 2012 Inspection)

(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 during inspection of audit firms.

Outline of inspection results

Some audit firms claimed regarding cooperation with those charged with governance that “they notified those charged with governance of the entity of the QC review results and the current status of their QC system.”

However, a detailed inspection of the reports made by such audit firms revealed that many audit firms only gave notice of nominal matters—including that no material deficiencies were identified in the QC review—but few audit firms detailed the practical points of identified deficiencies in the QC review. Also, most audit firms provided verbal explanations, not written ones. In addition, some audit firms 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.”

In this way, many audit firms inspected failed to exchange information and opinions with auditing officers (Note).

Note: The CPAAOB collected reports from the audit firms not subject to the inspection so as to confirm the status of their QC 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 the 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 finance reporting cases. The recently revised 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. The newly established Fraud Risk Response Standards also state that “the auditor must ensure cooperation with those charged with governance at each stage of the audit, through consultations or otherwise, depending on the details and degree of fraud risk.”

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 QC review and the CPAAOB’s inspections. It is important to work toward securing and enhancing audit quality, and in turn improve and strengthen the corporate governance of the entity.

(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 actions (see Article 193-3, FIEA). By giving such notice appropriately, the auditor is expected to conduct the audit based on its stronger position in relation to the entity.

In light of the important role played by such notice for ensuring the appropriateness of financial statements, the CPAAOB inspects the status of how the audit firm responded to a discovery of fraud or non-compliance.

Outline of inspection results

In addition to cases published upon timely market disclosure, the CPAAOB noted the cases where the audit firm notified the entity under Article 193-3 of FIEA of a matter deemed to affect the appropriateness of financial statements, and the notification lead to the entity’s implementation of corrective measures, including correction of its quarterly report and improvements to internal controls.

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 corrections, 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 audit completion. This section, "II. Individual Audit Engagements," is organized according to the Auditing Standards Committee Statements based on the clarified ISAs. This part contains separate items that introduce the areas where many deficiencies were identified: auditing accounting estimates; audits of financial institutions, an industry with specific accounting requirements; fraud in financial statements audits to which future response will attract attention; and audits concerning internal control over financial reporting, which is a type of audit for which the standards differ from those applied to audits of financial statements. 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.

Other than the examples of identified deficiencies described in this part, 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 prepare audit documentation so that experienced auditors can understand it even if they did not participate in the engagement in question. 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 identified deficiencies in documentation include not only omissions but also deficiencies identified from the standpoint of whether the required audit procedures have been carried out.

Causes of Deficiencies

The main causes of deficiencies in individual audit engagement found in the CPAAOB's inspections are as follows:

- ► The audit practitioner does not undertake a substantial review because of a lack of expertise (standards, industry types, etc.) and experience. The practitioner only prepares audit documentation as a formality based on the templates provided by the audit firm or JICPA.
- ► The audit practitioner has a lack of due professional care and professional skepticism. They identify audit risks in traditional and conventional ways of thinking without being able to precisely recognize environmental changes surrounding the entity, resulting in insufficient or inappropriate further audit procedures.
- ► The engagement team do not perform audit engagements, including timely and appropriate review of audit documentation, appropriately because there is a lack of direction and supervision by the engagement partner or equivalent over the members of the engagement team during the audit engagement.

- ► The EQC reviewer insufficiently reviews the process of forming the audit opinions as a third party outside the engagement team.

Expected response

All audit practitioners should renew their awareness of being responsible as an auditor for all audit engagements 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 have responsibility for supervising engagement team members, considering their competency and experience in performing audit engagements sufficiently and appropriately.

Furthermore, the EQC reviewer should check that audit engagements have been carried out sufficiently and appropriately without issues occurring in the process of forming audit opinions.

In addition, if deficiencies are identified by CPAAOB's inspections, QC reviews, and internal inspection, they should be assessed and reviewed not only by the engagement team in charge thereof, but also by other engagement teams within the audit firm. In particular, engagement partners, who are responsible for the management of the firm, 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

<u>Points of focus</u>

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

- ► Whether the engagement team perform substantial risk assessments, and not merely by the audit practitioner completing a form provided by the audit firm or the JICPA in developing an audit plan;
- ► Whether the engagement team sufficiently understand the realities of the entity to appropriately recognize potential risks, and then plan and implement further audit procedures adapted to such risks;
- ► Whether the engagement team plan appropriate further audit procedures for significant risks upon understanding associated internal control;
- ► Whether the engagement team not intend only to discover material misstatements individually but develop further audit procedures considering that the aggregate of individually immaterial misstatements may cause the financial statements to be materially misstated.

<u>Expected response</u>

In performing risk assessment and responding to assessed risks, audit practitioners need to renew their recognition of the importance that the auditor performs, through understanding the entity and its operating environment, procedures to identify and assess the risk of material misstatement, and responds to such risks, as well as describing the results of such procedures in the audit documentation.

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

(1) Audit planning

Case 1: Assessment of risks of material misstatement and planning of further audit procedures

The engagement team identified significant account balances in developing an audit plan based on the risk approach, but did not plan procedures for identification and assessment of risks of material misstatement, and for further audit procedures based on them. (Fiscal 2011 Inspection)

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

Case 2: Direction and supervision of engagement team members

The engagement partner did not participate in developing an audit plan for on-site visits to foreign subsidiaries. In addition, the engagement partner did not direct the members of the engagement team for on-site visits to foreign subsidiaries by passing on the inherent risks identified by the engagement

team of the parent company. (Fiscal 2010 Inspection)
(Auditing Standards Committee Statement No. 300, paragraph 10)

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

Case 1: Identification and assessment of risks of material misstatement

The engagement team recognized matters suggestive of risks of material misstatement, including inconsistencies in opinions pertaining to accounting treatment between the entity and the predecessor auditor, through handover from the predecessor auditor and preliminary audit before acceptance of the audit engagement. However, the engagement team did not plan appropriate further audit procedures. (Fiscal 2012 Inspection)
(Auditing Standards Committee Statement No. 315, paragraph 4; and No. 330, paragraphs 4 and 5)

Case 2: Analytical procedures performed as risk assessment procedures

The engagement team only commented in the audit documentation that analytical procedures of comparison with the previous year performed before planning found no change in the number of abnormal items and fraud cases. However, the engagement team did not recognize the reason therefor appropriately, and did not review transactions occurring after the period subject to the comparison; nor assess problems or high-risk items or areas in other events. (Fiscal 2011 Inspection)
(Auditing Standards Committee Statement No. 315, paragraph 5)

Points to Note:

Analytical procedures in the audit planning stage should be carried out through assessment of risks of material misstatement so as to provide the basis for planning and implementing further audit procedures. Therefore, in implementing the said procedures, it is necessary to use analytical procedures to identify the situations the entity faced, or unusual or unexpected relations that the auditor may not recognize.

Case 3: Internal control over significant risks

During audit planning, the engagement team recognized the possible overstatement of sales as a significant risk because the entity made adjustments after the date of the financial statements in the past due to a large amount of sales returns.

However, the engagement team did not fully understand internal control including the associated control activities for the process pertaining to sales returns. (Fiscal 2011 Inspection)
(Auditing Standards Committee Statement No. 315, paragraph 28)

(3) Materiality in planning and performing an audit

Case 1: Performance materiality

As the audit firm did not clarify how to handle the materiality for the financial statements as a whole in determining the type, timing, and scope of further audit procedures, the engagement team did not define the performance materiality, and did not perform substantive procedures for sales and cost of sales using an amount lower than the materiality. (Fiscal 2012 Inspection)

(Auditing Standards Committee Statement No. 320, paragraphs 9 and 10)

Case 2: Revision as the audit progresses

The engagement team used the amount of total assets in the consolidated financial statements of the previous period as the appropriate index for determining the materiality at a time of the audit planning. During the current financial year, the amount of total assets significantly decreased through the sale of a subsidiary and associated business divestiture, and this led to a significant difference from the benchmark. Although the engagement team recognized this deviation, the engagement team did not revise its materiality. (Fiscal 2011 Inspection)

(Auditing Standards Committee Statement No. 320, paragraph 11; and No. 450, paragraph 9)

(4) Auditor's procedure to respond to assessed risks

Case 1: Auditor's procedure to respond to risks of material misstatement

The engagement team did not review the inventory observation plan of the entity before physical inventories observation. In selecting the location subject to the observation, the engagement team did not take into consideration the importance of types and amounts of inventories. (Fiscal 2010 Inspection)

(Auditing Standards Committee Statement No. 501, paragraph 3)

Case 2: Substantive procedure related to financial reporting process

► The engagement team only obtained calculation data of the consolidation journal entries from the entity, such as elimination of investment against capital, debts against credits, offsetting of transactions, unrealized gain and losses in the consolidated financial statements. The engagement team did not verify the accuracy and completeness of the information described in the data. (Fiscal 2011 Inspection)

(Auditing Standards Committee Statement No. 330, paragraph 19; and No. 500, paragraph 8)

► Considering that the consolidated cash flow statements were generated by the consolidated accounting system, the engagement team merely confirmed that the amounts were identical in the consolidated cash flow worksheet output by the consolidated accounting system and consolidated cash flow statements, but did not verify conformity with other financial statements

or the adequacy of journal entries pertaining to the preparation of consolidation cash flow statements. (Fiscal 2011 Inspection)
(Auditing Standards Committee Statement No. 330, paragraph 19)

Case 3: Substantive procedure to respond to significant risk

- ► The entity reported sales on a shipment basis as a general rule, but for certain transactions, reported sales without shipment upon receipt of documentation only containing request of ownership transfer from its customer.
  Under these circumstances, although reporting sales without shipment were deemed a higher audit risk than shipment-based reporting, the engagement team did not examine whether such transactions met the sales reporting requirements, considering the economic rationality of the transactions, risk of product, and relationship of burden of storage charge. (Fiscal 2012 Inspection)
  (Auditing Standards Committee Statement No. 330, paragraphs 20 and 25)

- ► The engagement team obtained sales data before and after the date of the financial statements, and planned detailed analysis and cut-off testing, as audit procedures addressing the cut-off of sales that the team recognized as a significant risk.
  However, the engagement team did not perform substantive procedures addressing significant risks, such as voucher verification based on sampling before and after the date of the financial statements. (Fiscal 2011 Inspection)
  (Auditing Standards Committee Statement No. 330, paragraphs 20 and 25)

- ► The entity reported a large amount of negative goodwill following the purchase of a company at a value far less than its net assets, and then received a large dividend from the said acquired company.
  Although the engagement team recognized the acquisition mentioned above as an unusual material transaction under these circumstances, the engagement team examined the rationality of the acquisition cost without due consideration to the assumption as the prerequisite for corporate valuation. (Fiscal 2012 Inspection)
  (Auditing Standards Committee Statement No. 330, paragraphs 20 and 25)

Points to Note:
The auditor’s risk assessment should be based on judgment. As all risks of material misstatement may be identified, it is necessary to plan and implement substantive procedures for material classes of transactions, account balances and disclosure, regardless of the degree of assessed risk of material misstatement.

Case 4: Adequacy of presentation and disclosure

- ► Although environmental measures reserves were included in the financial statements, the engagement team overlooked the fact that the said reserves were not contained in the schedule of reserves attached to the annual securities report. (Fiscal 2011 Inspection)
(Auditing Standards Committee Statement No. 330, paragraph 23)

- ► The engagement team overlooked the fact that notes on exemption from the equity method for non-consolidated subsidiaries exempted therefrom were not contained in the "Matters on Application of the Equity Method" of the "Significant Accounting Policies of the Consolidated Financial Statements" of the annual securities report. (Fiscal 2011 Inspection)
(Auditing Standards Committee Statement No. 330, paragraph 23)

- ► The engagement team overlooked the fact that the difference in valuation of investment securities for which the entity determined not to report deferred tax assets because of a lack of scheduling, was not included in the total amount as deferred tax assets and valuation allowance in the note to the income taxes of the annual securities report. (Fiscal 2011 Inspection)
(Accounting Systems Committee Statement No. 10, paragraph 31; Auditing Standards Committee Statement No. 330, paragraph 23)

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

Case 1: Understanding of services and internal control by the service organization

The entity contracted out services of payroll operation, including salary calculation, etc., within the payroll processes. However, the engagement team did not review, during audit planning, the design and application to operations of internal control of the service organization. (Fiscal 2010 Inspection)
(Auditing Standards Committee Statement No. 402, paragraphs 8 and 9)

Case 2: Audit evidence of operating effectiveness of internal control by the service organization

The engagement team used the report prepared by the service organization's auditor to check the design and operation of internal control of the service organization. However, the engagement team did not confirm whether changes were made to internal control for the period from the cut off date of the report to the financial year end of the entity. (Fiscal 2010 Inspection)
(Auditing Standards Committee Statement No. 402, paragraph 16)

Points to Note:

If the entity contracts out part of its work, the auditor must understand the services provided by the service organization and its internal control. To understand the internal control, the auditor should assess the design and application to operations of internal control of the service organization for the contracted services provided by the service organization, including the internal control of the service organization. Note that these are required to be performed not only in financial statement audits but also audits of internal control over financial reporting.

(6) Evaluation of misstatement identified during the audit

Case: Accumulation and evaluation of identified misstatement

The engagement team identified audit differences that exceeded the materiality but did not examine the impact of the audit differences on the financial statements audit or the audit of internal control over financial reporting. (Fiscal 2011 Inspection)
(Auditing Standards Committee Statement No. 450, paragraph 10)

(7) Identifying and assessing 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 merely described in the current audit plan what they had ascertained during the previous period as a brief summary of the IT infrastructure and composition of the application system, as a general understanding of the IT system. The engagement team did not check whether any changes were made to the information system. (Fiscal 2011 Inspection)
(IT Committee Practical Guidelines No. 6, paragraph 4)

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

- ► The engagement team used data output from an information system in carrying out the audit procedures about the valuation of overdue accounts receivable and slow-moving and obsolete inventories, but did not examine the accuracy and completeness of the said information. (Fiscal 2011 Inspection)
  (Auditing Standards Committee Statement No. 500, paragraph 8; IT Committee Practical Guidelines No. 6, paragraph 41; IT Committee Practical Guidelines No. 42, question 17)

- ► The engagement team used information generated by the lease management system when reviewing the explanatory notes of operating leasing transactions. However, the engagement team did not verify the accuracy and completeness of the said information. (Fiscal 2012 Inspection)
  (Auditing Standards Committee Statement No. 500, paragraph 8; IT Committee Practical Guidelines No. 6, paragraph 41; IT Committee Practical Guidelines No. 42, question 17)

2. Audit Evidence

<u>Points of focus</u>

Auditors should assess information obtained as audit evidence considering its relevance and reliability. The CPAAOB's inspections focused on whether the engagement team obtain sufficient appropriate audit evidence to be able to draw reasonable conclusions on which to base the auditor's opinion, from the following perspectives:

- ► Whether the engagement team pay attention only to the quantitative sufficiency of audit evidence extracted by sampling, and obtain appropriate audit evidence relevant to the assessed risks of material misstatement at the assertion level;
- ► Whether the engagement team assess if the information prepared by the entity and information prepared by the management's experts are sufficiently reliable.

<u>Expected response</u>

In audit sampling, auditors should draw the number of samples relevant to an allowable sampling risk, and in analytical procedures, should estimate with sufficient accuracy to identify misstatements. In addition, auditors should critically assess the relevance for purpose and reliability of the audit evidence obtained. As for significant risk, auditors need to carefully assess in particular whether the audit evidence obtained conforms to the assertions and are more relevant and reliable.

(1) Audit evidence

Case 1: Information for use as audit evidence

- ► The engagement team used information prepared by the entity made in audit procedures for identifying indications of impairment in long-lived assets, but did not verify the accuracy and completeness of the amount of operating profits or cash flow for the past three years by real estate described in the information. (Fiscal 2012 Inspection)
  (Auditing Standards Committee Statement No. 500, paragraph 8)

- ► The entity had many consolidated subsidiaries at the year end. The number of these subsidiaries changed during the year, and they were located in various geographical areas. Under these circumstances, the engagement team did not verify the accuracy or completeness of the information prepared by the entity. (Fiscal 2011 Inspection)
  (Auditing Standards Committee Statement No. 500, paragraph 8)

- ► The engagement team used information prepared by the entity to examine the necessity for impairment of shares in its subsidiaries and affiliates. However the engagement team overlooked the

fact that some affiliates were not included in the information, because the team did not verify the completeness of the information in the information. (Fiscal 2012 Inspection)
(Auditing Standards Committee Statement No. 500, paragraph 8)

Points to Note:
Other than the above cases, the CPAAOB's inspections identified many cases where the audit firm used information obtained from the entity without confirming the accuracy and completeness thereof. When using information obtained from entities as audit evidence—not limited to that generated from information systems—auditors should sufficiently examine the reliability of such information.

Case 2: Sufficient appropriate audit evidence

► The entity included a subsidiary's flood damage as casualty losses in its consolidated financial statements. However, the engagement team did not obtain sufficient audit evidence supporting the casualty losses. (Fiscal 2012 Inspection)
(Auditing Standards Committee Statement No. 500, paragraph 5)

► The entity classified the bonds, such as 20-year national bonds, as an investment held to maturity; however, the engagement team did not review whether the entity had the ability to own the said bonds until their maturity. (Fiscal 2010 Inspection)
(Auditing Standards Committee Statement No. 500, paragraph 5)

► The entity classified bonds conditioned with repayment prices subject to change for specific events as bonds held to maturity. Under these circumstances, the engagement team reviewed relevant internal requests for approval and product brochures prepared by the bond issuers. However, the engagement team did not determine in detail the factors that might affect the repayment prices of the bonds, and did not sufficiently examine the appropriateness of their securities classification. (Fiscal 2012 Inspection)
(Auditing Standards Committee Statement No. 500, paragraph 5)

► The engagement team did not verify whether interest rate swap agreements and foreign currency exchange contracts to which hedge accounting was applied met the hedge requirements set forth in the Accounting Standards for Financial Instruments. In addition, the engagement team did not examine whether outstanding foreign currency exchange contracts not marked to market remained within the scope of hedged anticipated transactions. (Fiscal 2011 Inspection)
(Auditing Standards Committee Statement No. 500, paragraph 5)

► The engagement team merely asked the management whether advance paid accounts at the year end were related to assets reported from the past year end and recoverable. The engagement team did not

carry out audit procedures to support the reasonableness of the management's response. (Fiscal 2012 Inspection)
(Auditing Standards Committee Statement No. 500, paragraph 5)

Case 3: Use of works of management's experts

► The engagement team used the corporate value assessment document prepared by the management's experts as audit evidence. However, the engagement team did not assess the professional competence of the experts or the objectivity of their service, etc. (Fiscal 2012 Inspection)
(Auditing Standards Committee Statement No. 500, paragraph 7)

► The engagement team obtained the real estate appraisal report which the real estate appraiser provided the entity and used this as audit evidence. However, the engagement team did not assess the professional competence of the appraiser or the objectivity of their service, etc. (Fiscal 2011 Inspection)
(Auditing Standards Committee Statement No. 500, paragraph 7)

► The engagement team obtained the actuarial report from an external pension actuary and used this as audit evidence. However, the engagement did not assess the professional competence of the pension actuary or the objectivity of their service, etc. (Fiscal 2011 Inspection)
(Auditing Standards Committee Statement No. 500, paragraph 7)

Points to Note:
In auditing accounting estimates, auditors may use the work of management's experts (pension actuary, attorney, real estate appraiser, etc.) who have professional expertise and skills, etc. for any matter that may seriously affect financial statements. The CPAAOB's inspections identified several examples of deficiencies when auditors used the work of the management's experts; that is, auditors used such work without performing the necessary audit procedures.

Case 4: Assessment of adequacy of work of management experts (inspection of basic data)

The engagement team did not verify the accuracy or completeness of the basic data that the entity submitted to an external pension actuary. (Fiscal 2011 Inspection)
(Auditing Standards Committee Statement No. 500, paragraph 7; and No. 540, paragraphs 11 and 12)

(2) Audit evidence of specific items

Case 1: Inventories

After conducting test counts of inventories, the engagement team did not check the test count quantities representing the largest location of the outstanding inventories against the corresponding

data in the inventory record. In addition, the engagement team did not check the quantities in the reply to the confirmation letter obtained from the warehouse of inventories, against the corresponding data in the inventory record. (Fiscal 2010 Inspection)
(Auditing Standards Committee Statement No. 501, paragraphs 3 and 7)

Case 2: Segment information

Although the operating profits in the "Others" category exceeded 60% of the total operating profits in the segment information disclosure, the engagement team did not examine whether it was appropriate that the entity did not disclose the operating segment in the "Others" category as the reportable segment. (Fiscal 2011 Inspection)
(Auditing Standards Committee Statement No. 501, paragraph 12)

(3) External confirmation

Case 1: Alternative audit procedures

► The engagement team confirmed the bank balances of foreign consolidated subsidiaries with the overseas financial institutions at the year end. Although some of the confirmation letters were not obtained, the engagement team did not carry out alternative audit procedures. (Fiscal 2011 Inspection)
(Auditing Standards Committee Statement No. 505, paragraph 11)

► The engagement team performed alternative audit procedures for non-replied confirmations, collating them with the corresponding copies of billings, which are internal information of the entity. However, the engagement team did not examine whether it was appropriate to use the copies of billings for collation as audit evidence for the existence of the accounts receivable. (Fiscal 2012 Inspection)
(Auditing Standards Committee Statement No. 505, paragraph 11)

Case 2: Reliability of reply to confirmation request

In confirming outstanding accounts and notes receivable, the engagement team only received faxed replies to some of the confirmation letters but did not request that originals be sent. In addition, the engagement team did not examine the reliability of the replies, affixed only with an off-the-shelf seal of the person in charge of confirmation, by making inquiries with the counterpart. (Fiscal 2012 Inspection)
(Auditing Standards Committee Statement No. 505, paragraph 9)

Case 3: Exception in relation to confirmation

► The engagement team only obtained variance analysis results prepared by the entity for analysis of exceptions in relation to confirmation of receivables and payables. The engagement team did not

examine the rationality of the variance analysis results. (Fiscal 2011 Inspection)
(Auditing Standards Committee Statement No. 505, paragraph 13)

► Although there were significant variances between the bank balance of the entity's record and the amount detailed in the bank confirmation letter, the engagement team did not analyze the cause of the variances. (Fiscal 2011 Inspection)
(Auditing Standards Committee Statement No. 505, paragraph 13)

Case 4: Exception in relation to confirmation (projecting misstatements)

Although, in confirming outstanding receivables and payables selected by sampling, some exceptions in relation to confirmation exceeded the posting threshold of misstatements, the engagement team regarded the exceptions as immaterial and did not investigate the details or causes of the exceptions. The engagement team did not assess the impact on the purpose of audit procedures or other audit areas. In addition, the engagement team did not project misstatements identified in the confirmation procedures to the population. (Fiscal 2011 Inspection)
(Auditing Standards Committee Statement No. 505, paragraph 13; and No. 530, paragraphs 11 and 13)

Case 5: Timing of substantive procedures (procedures for remaining period)

Though the engagement team performed balance confirmation procedures of accounts payable at an interim period, they did not perform substantive procedures for the remaining period from the interim date to the period end. (Fiscal 2011 Inspection)
(Auditing Standards Committee Statement No. 330, paragraph 21)

(4) Analytical procedures

Case 1: Substantive analytical procedures (appropriateness of procedures)

Substantive analytical procedures for sales, etc. should be carried out to develop an expectation of recorded amounts, compare between the expectation and amounts recorded in the financial statements, and to investigate material variance. However, the engagement team only compared financial figures with those for the previous period. (Fiscal 2012 Inspection)
(Auditing Standards Committee Statement No. 520, paragraph 4)

Points to Note:

Substantive analytical procedures should be carried out to obtain audit evidence conforming to specific assertion for accounts and transactions. Therefore, the following procedures are required: (1) development of expectation and evaluation of its precision; (2) determination of an acceptable amount of differences; (3) calculation of differences in amount or rate between expectations and recorded amounts; and (4) investigation and assessment of material differences of more than the acceptable amount (inquiries to the management and to obtain appropriate audit evidence against them, and other audit procedures).

Case 2: Substantive analytical procedures (evaluation of the precision of expectations)

The engagement team said that it carried out substantive analytical procedures for sales and cost of sales only through year-to-year comparisons and monthly tracking comparisons. However, the engagement team did not develop the expectation of the recorded amounts with sufficient precision to identify a misstatement. (Fiscal 2012 Inspection)

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

Case 3: Substantive analytical procedures (acceptable level of differences)

The engagement team did not determine the amount of any differences of recorded amounts from expected values that is acceptable without further investigation in substantive analytical procedures for sales, etc. (Fiscal 2012 Inspection)

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

Case 4: Investigation of results of analytical procedures

Although there were deviations between the theoretical interest rates computed by the engagement team and the actual interest rate, the engagement team did not investigate deviations in analytical procedures for interest expenses for short-term debts. (Fiscal 2011 Inspection)

(Auditing Standards Committee Statement No. 520, paragraph 6)

Case 5: Analytical procedures that assist when forming an overall conclusion

The engagement team only calculated differences between the previous and current closing balances items as analytical procedures near the end of the audit. The engagement team did not perform the analytical procedures as to whether the financial statements are consistent the auditor's understanding of the entity. (Fiscal 2011 Inspection)

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

(5) Related parties

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

► The engagement team did not obtain a list of the names of all known related parties from the entity or verify the completeness of related party information. (Fiscal 2012 Inspection)
(Auditing Standards Committee Statement No. 550, paragraph 12)

► In the context of the frequent replacement of related parties, including main stockholders or officers, the engagement team did not verify the completeness of the transactions with related parties or

receive replies to questionnaire asking whether the directors had transactions with the entity. (Fiscal 2011 Inspection)
(Auditing Standards Committee Statement No. 550, paragraph 12)

- ► The engagement team did not verify the internal controls of the entity for approval or records of related party transactions, including identification of approval procedures and transactions concerning related party transactions. (Fiscal 2011 Inspection)
(Auditing Standards Committee Statement No. 550, paragraph 13)

Case 2: Identified related parties

- ► The engagement team obtained information and basic data pertaining to related party transactions from the entity in reviewing related party transactions. However, the engagement team did not carry out procedures for verifying the completeness of the information on related party transactions provided by the entity (including assessment of the procedures carried out by the entity to identify related party transactions). (Fiscal 2012 Inspection)
(Auditing Standards Committee Statement No. 550, paragraph 12)

- ► The engagement team examined the completeness of related parties based on a questionnaire that the entity obtained from directors, etc. However, under the circumstances where the entity did not obtain questionnaire forms from some directors, the engagement team only received an explanation from the entity, etc. that there was no change to the responses in previous questionnaires. The team did not confirm the status of close family members, for example, by obtaining questionnaires from them. (Fiscal 2012 Inspection)
(Auditing Standards Committee Statement No. 550, paragraph 12)

Case 3: Maintaining alertness for related party information when reviewing records or documents

The engagement team overlooked the fact that transaction confirmation letters obtained from related parties did not contain information on transactions subject to examination and did not request an additional confirmation letters. In addition, the team did not perform procedures to examine the adequacy of the condition for transactions with related parties. (Fiscal 2012 Inspection)
(Auditing Standards Committee Statement No. 550, paragraphs 14 and 15)

Points to Note:
Related-party transactions often become the extensive and complicated relations between related parties. In some cases, transactions may not be conducted as arm's length transactions. Related party transactions may therefore pose a higher risk of misstatement in financial statements than transactions with third parties. Furthermore, the entity and related parties may easily commit fraud through related parties by conspiracy or otherwise.

In performing risk assessment procedures and further audit procedures pertaining to related party transactions, keep these points in mind. It is important to obtain sufficient appropriate audit evidence.

(6) Subsequent events

Case: Events occurring between the date of the financial statements and the date of the auditor's report

► The engagement team did not examine the design or operating effectiveness of the 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. (Fiscal 2012 Inspection)
(Auditing Standards Committee Statement No. 560, paragraph 6)

► The engagement team said it had reviewed the minutes of the Board of Directors meetings held after the balance sheet date during audit procedures for subsequent events. However, the engagement team did not record in the audit documentation the results of the review of the minutes of some Board of Directors meetings held after the balance sheet date. (Fiscal 2012 Inspection)
(Auditing Standards Committee Statement No. 560, paragraph 6)

(7) Going concerns

Case: Additional audit procedures when an event or situation is identified

► The entity said that events or conditions that may cast significant doubt on the entity's ability to continue as a going concern existed because it reported a large decrease in sales and significant losses for the current period. As measures to resolve or improve such events or conditions, the entity reconsidered its sales mix, reduced its costs, and improved its financial strength. However, even though these improvement measures were taken, there remained material uncertainty about the entity's ability to continue as a going concern. The entity therefore provided a special note of "Matters for the going concern assumption" in the annual securities report.
Under these circumstances, the engagement team did not examine the following points for going concern assumption:

• Review of the measures developed by the management
The engagement team said that it recognized significant doubt about the going concern assumption as a significant risk, and as audit procedures therefor, would obtain the projections, cash flow forecast, and their preconditions from the entity in order to examine the feasibility of the measures. However, the engagement team did not examine the significant assumption of the basis for projected financial information, and the reliability of the projections through a comparison of the projected financial information and actual results.

• Discussion with the management

The engagement team said that it discussed with the management about the going concern assumption at the audit planning and during the year end audit. However, the minutes of discussions for both days only contain deliberations about the general conditions of business—they do not refer to the discussions with the management on the going concern assumption.

• Examination of subsequent events

The Board of Directors resolved a downward revision of the business plan at the meeting held after the auditor's report date issued based on the Companies Act. As a result, a large deviation arose between the business plan and the budget obtained in performing audit procedures about the going concern assumption. However, the engagement team did not recognize such revision until the audit opinion was issued based on the Financial Instruments and Exchange Law; therefore, it did not examine the impact on the financial statements caused by the revision.

(Fiscal 2011 Inspection)

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

► The engagement team reviewed the business plan developed by the management as a measure to resolve or improve events or conditions that may cast significant doubt on the entity's ability to continue as a going concern, and determined that the entity's business plan was reasonable.

However, the engagement team did not examine the reason for or rationality of the change in the time of receipt of part of the income projected in the business plan from September, as set forth in the agreement, to December, in the business plan.

In addition, the engagement team only commented in the audit document that there were "orders and references received" though the sales estimates became many times higher than the actual performance compared with the previous year. The engagement team did not check them with supporting materials and did not sufficiently examine the reasonableness of the business plan. (Fiscal 2012 Inspection)

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

Points to Note:

The management's assessment of the entity's ability to continue as a going concern involves making judgment, at a particular point in time, about inherently uncertain future outcomes of events or conditions. When examining the management's assessment, the engagement team should not only obtain assessment results but also sufficiently and critically examine the audit evidence obtained.

(8) Assessment of the risk management system for litigation and claims

Case: Auditors' assessment of risk management system for litigation and claims

The engagement team did not recognize the management system for litigation and claims designed

and implemented by the entity, and did not examine the adequacy of the management's decisions and assessments on risks of litigation and claims. (Fiscal 2012 Inspection)
(Auditing and Assurance Practice Committee Statement No. 73, paragraphs 4(3) and (4))

(9) Scope of consolidation

Case:

► Although one affiliate consisted of a high percentage of the consolidated net profit and retained earnings, the entity determined not to apply the equity method to the affiliate because the high percentage consisted of temporary events and less qualitative effects on the financial statements. However, the engagement team did not sufficiently examine the reasonableness of the decision.
In addition, when examining the scope of equity method to the affiliate, the engagement team obtained a summary of evaluation of impact of the affiliate to the consolidated net profit and retained earnings. However, the engagement team did not recalculate the summary and did not confirm the consistency between the figures used by the entity and the business plan. (Fiscal 2012 Inspection)
(Auditing Standards Committee Statement No. 500, paragraph 8)

► When considering the scope of a consolidation, the engagement team decided that the company in which directors of the entity hold all voting rights did not fall under the category of subsidiary based upon their understanding of its transactions and association of responsibility for business through inquiring with the directors. When this decision was made, however, the engagement team did not obtain information on the composition of the directors of the company, existence of agreements on the decision of business policy, the status of financing, or whether the entity controlled the board of directors of the company. (Fiscal 2012 Inspection)
(Auditing and Assurance Practice Committee Research Report No. 52, paragraph 8; Accounting Standards Board of Japan (ASBJ) Statement No. 22, paragraph 7; ASBJ Guidance No. 22, paragraph 9)

3. Auditing Accounting Estimates

<u>Points of focus</u>

The Auditing Standards Committee Statement No. 540 "Auditing accounting estimates" has been applied as practical business guidelines for accounting estimates and associated disclosures to audit or interim audit for accounting periods starting on April 1, 2012. Based on the application of the practical business guidelines, the CPAAOB conducts inspections from the following perspectives:

- ► Whether the engagement team appropriately assess/identify risks of material misstatement in the accounting estimates, and develop/implement appropriate further procedures to address such risks;
- ► Whether, in case the engagement team identify significant risks on accounting estimates, the engagement team carry out additional substantive procedures;
- ► Whether the engagement team, in accounting estimates, identify any indications of possible bias by management judgment, and develop/implement further procedures to address such bias.

<u>Expected response</u>

Accounting estimates are accompanied by uncertainty. Risks of material misstatement vary according to the degree of uncertainty. Thus, the elements affecting the uncertainty—including the nature and method of accounting estimates, associated internal control, indications of possible bias by management judgment—should be examined, and risks of material misstatement should be assessed and identified. These procedures are defined as "requirements" in the practical business guidelines. In addition, risks of material misstatement identified should be addressed through the development and implementation of appropriate audit procedures.

(1) Securities

Case 1: Review of business plan (review of the management's assumptions)

- ► In examining impairment in investment security of which net assets significantly decreased, the entity considered the net assets of the investee as recoverable to its acquisition costs and unnecessary to write it down because sales were anticipated to largely increase in the future according to the business plan. The engagement team agreed with the entity.

  However, the engagement team did not obtain sufficient audit evidence supporting the reasonableness of the anticipated increase in sales in the business plan. (Fiscal 2012 Inspection)

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

- ► The entity reported investment loss reserves concerning its affiliate faced with deterioration of business results, but the engagement team did not obtain sufficient audit evidence that reasonably supported the recoverability of the net assets, such as a review of the concrete business plan. (Fiscal 2012 Inspection)
(Auditing Standards Committee Statement No. 540, paragraphs 11, 12 and 17)

- ► In examining the impairment of investment in an insolvency subsidiary, the entity determined the impairment unnecessary because the subsidiary's net assets would be recoverable to its acquisition cost within four years according to the business plan of the subsidiary prepared by the equity. The engagement team considered the entity's decision is reasonable. According to the business plan, sales were expected to increase drastically by introducing new products into the market in the future, making the subsidiary profitable. However, it is difficult to project sales of the new products from the characteristic of the industry to which the subsidiary belongs, and since its establishment, the subsidiary has been in net deficit and has never achieved the projection in its business plan. Although the subsidiary was in such conditions, the engagement team did not obtain sufficient audit evidence supporting the reasonableness of the business plan. (Fiscal 2011 Inspection)
(Auditing Standards Committee Statement No. 540, paragraphs 11, 12 and 17; Auditing System Committee Statement No. 14, paragraphs 92 and 285)

Case 2: Review of net assets

In examining impairment in investment security, the entity compared the net assets per share calculated on the financial statements obtained from the investee, with the acquisition costs.

However, the engagement team did not examine the adjustments of the net assets such as debtors and net unrealized holding gain on investment securities adding to the assessment of the financial position of the investee. (Fiscal 2012 Inspection)

(Auditing Standards Committee Statement No. 540, paragraphs 11, 12 and 17; Auditing System Committee Statement No. 14, paragraph 285)

(2) Recoverability of deferred tax assets

Case 1: Review of the company classification (review of the management's assumptions)

The entity reported significant tax losses carried forward for the current and the previous years, but reported some ordinary profits over the years excluding losses caused by unusual and special items. The entity therefore determined that it fell under paragraph 5 (1) (ii) of the Audit Committee Statement No. 66.

However, in such conditions, the engagement team did not sufficiently examine the classification, including the reasonableness of excluding unusual and special loss items. (Fiscal 2012 Inspection)

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

Statement No. 66, paragraphs 5(1) and (3))

Case 2: 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 period in which the reversals of the temporary differences are expected to occur and the method of reversals of the temporary differences per security. (Fiscal 2012 Inspection)

(Auditing Standards Committee Statement No. 540, paragraph 12; Audit Committee Statement No. 66, paragraphs 4 and 5(1)(ii))

Case 3: Approval of the Board of Directors (associated internal control)

The engagement team obtained the 5-year business plan from the entity for determining the recoverability of deferred tax assets, but did not verify whether the business plan was approved by the Board of Directors. (Fiscal 2011 Inspection)

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

(3) Impairment of long-lived assets

Case 1: Review of cash generating units

► The entity adopted operating segments in the segment information as a cash generating units when applying impairment of long-lived assets. However, the engagement team did not examine whether the operating segments independently generated cash flow from other groups of assets. (Fiscal 2011 Inspection)
(Auditing Standards Committee Statement No. 540, paragraphs 11, 12 and 17; ASBJ Guidance No. 6, paragraph 7)

► When the entity changed the significant assumption to be the basis of the estimates, such as the cash generating units, the engagement team did not sufficiently examine the reasonableness and timeliness of the change. (Fiscal 2012 Inspection)
(Auditing Standards Committee Statement No. 540, paragraphs 11, 12, 17 and 20)

Case 2: Review of indications of impairment

The engagement team only paid attention to whether the entity had operating deficits for two consecutive years, and did not examine other indicators of impairment (e.g., significant changes in the events or manner in which an asset is used that have an adverse effect on the asset recoverable amount, significant adverse effects in economic circumstances and significant decline in the market value) for other impaired assets. (Fiscal 2012 Inspection)

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

Case 3: Review of idle assets

The entity decided not to recognize impairment losses on the idle assets because reasonable time had not passed since the assets became idle, and the engagement team agreed with the decision.

However, the engagement team did not confirm how long the assets were idle or the completeness of the assets determined by the entity. (Fiscal 2011 Inspection)

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

Case 4: Review of business plan (review of the management's assumptions)

► In examining the impairment of goodwill, the entity decided that there were no indicators of impairment based on the business plan developed in consideration of its high potential growth and future prospects. The engagement team examined the business plan and judged that the plan was reasonable and that revision was unnecessary by confirming the achievement status of the business plan in the past.

However, the engagement team did not examine the feasibility based on market conditions and the status of competition in the preconditions of the plan prepared by the entity. (Fiscal 2011 Inspection)

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

► The entity decided that although the entity's financial results for the current period significantly differed from the plan, the deviation was a temporary event that did not require the revision of the cash flow in the future, and the engagement team agreed with the entity's decision.

However, the engagement team considered the decision valid only through discussions with the management, and did not examine the basis of the plan. (Fiscal 2012 Inspection)

(Auditing Standards Committee Statement No. 540, paragraphs 11, 12, 17 and 20)

Points to Note:

In auditing accounting estimates, there are many cases of examining the reasonableness of the business plan prepared by the management in terms of the impairment of investment securities, deferred tax assets, and long-lived assets. However, the inspection for the current year identified many cases where auditors had not sufficiently and appropriately examined the reasonableness of the management's business plans. Auditors still need to be careful.

Case 5: Approval of the Board of Directors (associated internal control)

In examining indicators of impairment of long-lived assets, the engagement team reviewed the business plan prepared by the entity to examine whether long-lived assets fell under idle assets. However, the engagement team did not confirm the entity's approval procedure for the business plan. (Fiscal 2012 Inspection)

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

(4) Reserve for employees' retirement benefits

Case: Examination of actuarial assumptions

The engagement team did not examine the adequacy of the actuarial assumptions such as expected rate of retirement, salary increase, return on assets, and lump sum payments election. (Fiscal 2011 Inspection)

(Auditing Standards Committee Statement No. 540, paragraphs 11 and 12; Auditing System Committee Statement No. 13, paragraphs 13, 16 and 19)

(5) Warranty reserve for completed construction

Case: Review of accounting estimates of the previous fiscal year

The engagement team identified that the actual amount for warranty expenses of completed constructions for the current year significantly exceeded the warranty reserve for completed constructions. However, the engagement team did not carry out risk assessment procedures, including identifying and understanding the reason for the variance. (Fiscal 2011 Inspection)

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

(6) Asset retirement obligation

Case: Review of the management's assumptions

The entity did not account for an asset retirement obligation because it is difficult to reasonably estimate the timing of closing the stores due to the unclear leasing period of the stores and does not have a plan to close the stores. Although the engagement team recognized that the entity continuously closed its stores, and planned to relocate stores for the next period in its business plan, the engagement team agreed with the entity's claim without examining or paying particular attention to the reasonableness of the entity's claim. (Fiscal 2012 Inspection)

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

(7) Intangible assets

Case: Review of the management's assumptions

The entity determined the amortization period of goodwill on the basis of investment value. However, the engagement team did not verify the reasonableness of the basis. In addition, the engagement team did not examine the adequacy of the amortization period of goodwill newly reported on the basis, considering the development period of excess earning power based on the business plan. (Fiscal 2011

Inspection)

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

(8) Inventories

Case 1: Review of business plans (review of the management's assumptions)

The entity assessed real estate under suspension of development based on net realizable value assuming that development of the real estate would be resumed for sale.

However, the engagement team did not examine the adequacy of the entity's assumptions on the basis of its business plan and the progress. (Fiscal 2012 Inspection)

(Auditing Standards Committee Statement No. 540, paragraphs 11, 12, and 17; Auditing and Assurance Practice Committee Statement No. 69, paragraphs 2(3) and 4(2))

Case 2: Recognition and measurement

The entity, a real estate operator, treated amounts assessed by the income approach as net realizable value of real estate for rent.

However, the engagement team overlooked the fact that the entity evaluated by the income approach without deducting the expense portion from the yearly rent. (Fiscal 2012 Inspection)

(Auditing Standards Committee Statement No. 540, paragraphs 11, 16, and 17; Auditing and Assurance Practice Committee Statement No. 69, paragraphs 2(3) and 4(2))

(9) Reserve for sales return

Case: Risk assessment procedures

Although a considerable number of sales returns in relation to defective products occurred in the new business of the entity, the engagement team did not examine whether the reserves for sales return are accounted for. (Fiscal 2012 Inspection)

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

4. Using the Work of Others

Points of focus

The Auditing Standards Statement No. 600 “Group audit” has been applied to audits for the business year starting April 1, 2012, or later. The group engagement team is required to participate in risk assessment procedures and further audit procedures by component auditors concerning component’s financial information of components, such as subsidiaries. Recently, cases of accounting fraud in foreign subsidiaries have been reported. The CPAAOB inspects firms from the following perspectives:

- ► Whether the group engagement team identify significant components based on the nature and status of each component, as well as quantitative indexes, such as sales, and drew up an audit plan with sufficient knowledge of the professional competence of the component auditors;
- ► Whether the group engagement team give directions clarifying appropriate component materiality and significant risk to assess the scope of work of component auditors, and holds timely discussions with component auditors in the process of audit;
- ► Whether, in response to reports from component auditors, the group engagement team perform, or direct component auditors to perform additional audit procedures as necessary, and assess the impact given by uncorrected misstatements reported by component auditors on the group financial statements, including qualitative impact in terms of internal control and fraud.

In addition, auditor’s experts may be included as using the work of others. The CPAAOB inspects whether auditors appropriately evaluated the appropriateness of expert services for the purpose of auditing financial statements.

Expected response

The group audit requires that the group engagement team sufficiently communicate with component auditors about the scope and timing of work, as well as findings, concerning component financial information; and obtains 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. As there is an increasing number of matters to be considered during group audit procedures under these circumstances, it is necessary to draw up appropriate audit plans in response to such matters.

In addition, auditors should take sole responsibility for the audit opinions that they express, even if they use auditor’s experts in using the work of others. Therefore, before using auditor’s experts, auditors should determine the necessity of use, assess the qualifications, competency and objectives of the experts, and evaluate the appropriateness of auditor’s experts for audit purposes.

(1) Group audit

Case 1: Significant components

The group engagement team examined the impact given by the sales 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 impact given by the components' benchmarks other than sales on consolidated financial statements. (Fiscal 2012 Inspection)

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

Case 2: Understanding component auditors

The group engagement team requested the component auditors to audit foreign consolidated subsidiaries, but did not obtain an understanding of the independence or professional competence of the component auditors. (Fiscal 2010 Inspection)

(Auditing Standards Committee Statement No. 600, paragraph 18)

Case 3: Materiality

In auditing consolidated foreign subsidiaries, the group engagement team believed that the component auditors carried out the audit with lower component materiality than the group materiality. Therefore, the group engagement team did not provide the component auditors with the component materiality or the threshold above which misstatements cannot be regarded as clearly trivial for the group financial statements. (Fiscal 2011 Inspection)

(Auditing Standards Committee Statement No. 600, paragraphs 20 and 39)

Case 4: Component materiality

The group engagement team did not provide the component auditors with the component materiality for auditing the component financial information but provided materiality for the group financial statements. (Fiscal 2012 Inspection)

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

Case 5: Consolidation process (unification of accounting policies)

As for foreign subsidiaries that did not use audit results from the component auditors, the group engagement team did not confirm whether significant differences between the local accounting standards at the subsidiaries and the International Financial Reporting Standards. (Fiscal 2012 Inspection)

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

Case 6: Subsequent events

The group engagement team requested the component auditors to submit a confirmation of subsequent events so as to confirm whether significant subsequent events had occurred in the foreign subsidiary. However, the group engagement team did not obtain a confirmation of subsequent events from the component auditors before the date of the auditor's report based on the Companies Act due to a lack of communication with the component auditors. (Fiscal 2012 Inspection)

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

Case 7: Communication with component auditors and assessment of adequacy of their work

► The group engagement team received information from the component auditors in auditing the foreign subsidiary to the effect that the subsidiary had employees' retirement benefit obligations unknown to the entity and that the subsidiary provided guarantees to unconsolidated subsidiaries. However, the group engagement team did not perform additional audit procedures for the reported information. (Fiscal 2011 Inspection)

(Auditing Standards Committee Statement No. 600, paragraphs 41 and 42)

► The group engagement team was informed by the component auditors of uncorrected misstatements in excess of the posting threshold. However, the group engagement team did not examine whether it was necessary to perform additional audit procedures, such as questioning the component auditors about details of the uncorrected misstatements and whether the uncorrected misstatements should be described in the written representation, because the uncorrected misstatements were less than the materiality in the forming of audit opinions. (Fiscal 2012 Inspection)

(Auditing Standards Committee Statement No. 600, paragraphs 41 and 42)

► The group engagement team was not able to obtain audit results from the component auditors before completion of the audit. Therefore, the group engagement team performed alternative procedures.

However, as the alternative procedures, the group engagement team only compared component's financial figures with those of the prior period, and did not obtain sufficient appropriate audit evidence as the group auditor. (Fiscal 2012 Inspection)

(Auditing Standards Committee Statement No. 600, paragraphs 42 and 43)

Case 8: Sufficiency and appropriate audit evidence

The group engagement team received information from the component auditors of uncorrected misstatements. However, the group engagement team did not examine the following procedures about the uncorrected misstatements:

- Quantitative and qualitative impacts on the entire financial statements associated with individual items, subtotals, or totals in the financial statements;
- Whether the uncorrected misstatements were, or may have been, caused by fraud;

- Impact given by the uncorrected misstatements on audit of internal control over financial reporting.

(Fiscal 2011 Inspection)

(Auditing Standards Committee Statement No. 600, paragraph 44; and No. 450, paragraph 10)

(2) Using the work of an auditor's expert

Case: Agreement with the auditor's experts

Based on the information generated by the entity's information system, the engagement team performed the substantive analytical procedures for cost of sales and audit procedures for recognition of indication of impairment of long-lived assets.

However, the engagement team did not clearly agree with IT experts on the scope of verification of the accuracy of such information, and did not verify the accuracy or completeness of information pertaining to the cost of sales and selling and administrative expenses of the operational division. (Fiscal 2012 Inspection)

(Auditing Standards Committee Statement No. 620, paragraphs 10 and 11)

5. Auditing Financial Institutions

Points of focus

Since fiscal year 2011, the JICPA QC review has covered the services of a credit association of a certain scale or over. In fiscal year 2012, the CPAAOB accordingly decided to expand its scope of inspection to audit firms commissioned to audit such financial institutions.

Conventionally, the audit engagements of banks and other financial institutions have been subject to CPAAOB's inspections. Since examples of identified deficiencies in such audit engagements have accumulated, we have decided to compile and introduce case examples of audits of financial institutions.

The auditing of financial institutions requires different viewpoints from 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 the audits of financial institutions predominantly from the following perspectives:

- ► Whether the engagement team perform appropriate procedures on the basis of risks specific to financial institutions before acceptance and continuance of audit engagements. (For case examples, see Case 5 of "3. Acceptance and continuance of engagements" of "I. Quality Control System.");
- ► Whether sufficient and appropriate manpower with knowledge and experience specific to auditing financial institutions is allocated;
- ► Whether the engagement team perform risk assessment procedures after fully recognizing the audit risks of auditing financial institutions, and develop appropriate further audit procedures;
- ► Whether, under the audit plan, the engagement team obtain sufficient appropriate audit evidence on accounting estimates, including, in particular, self-assessment, allowance for doubtful accounts and deferred tax assets, and prepare sufficient and appropriate audit documentation.

Expected response

Examples of the actions at audit firms considered useful include: some audit firms give directions based on the actualities of debtors in the self-assessment through active communication with the management of auditing financial institutions. On the other hand, as shown below, there are examples where audit firms seemed not to obtain sufficient appropriate audit evidence, and where the audit evidence obtained is insufficiently or inappropriately described in the audit documentation.

In consideration of the above, audit practitioners in charge of auditing financial institutions should perform in depth audit procedures and sufficiently and appropriately document them.

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

(1) Self-assessment of assets

Case 1: Review of self-assessment standards (preparation of the debtor's adjusted position and assessment of debt repayment capability)

The engagement team knew that auditing financial institutions had in place obscure rules for preparing the debtor's adjusted position of debtor and obscure criteria for debt repayment capability. However, the engagement team was not involved as an auditor of the financial institutions in developing methods and criteria for preparing debtor's adjusted position and determining debt repayment capability.

Under these conditions, the engagement partner recognized it as a significant risk that "loans were likely to become uncollectible with the debtor's performance worsening," and directed audit assistants to verify the debtor's adjusted position and debt repayment capability. However the engagement partner did not develop concrete inspection procedures to identify any matters. (Fiscal 2012 Inspection)

(Auditing Standards Committee Statement No. 540, paragraph 12; Special Committee for Bank Auditing Statement No. 4 IV 1(2))

Case 2: Adequacy of debtor categories

(Debt repayment capability)

- ► The engagement team did not verify the consistency between the debt repayment capability and categories of debtors whose years of repayment of interest-bearing debts divided by earnings before depreciation were longer than stated in their business categories. (Fiscal 2012 Inspection)

  (Auditing Standards Committee Statement No. 540, paragraph 12; Special Committee for Bank Auditing Statement No. 4 V [Reference Appendix])

- ► The engagement team did not inspect equipment-dependent debtors and did not pay attention to the deviation between remaining equipment's useful life and years of debt repayment.

  In addition, the engagement team did not specifically verify the rationality/feasibility of their business improvement plans. (Fiscal 2011 Inspection)

  (Auditing Standards Committee Statement No. 540, paragraph 12; Special Committee for Bank Auditing Statement No. 4 IV 1 and 2 (note 5)-(note 7))

- ► The engagement team did not sufficiently verify the rationality that when assessing the ability of a debtor to repay its liabilities, the auditing financial institutions underestimated profit-repayable debts by including investments and loans unrelated to the debtor's main business line in its normal working capital, and deducting them from interest-bearing debts. (Fiscal 2010 Inspection)

  (Auditing Standards Committee Statement No. 540, paragraph 12; Special Committee for Bank Auditing Statement No. 4 V [Reference Appendix])

(Terms and conditions of loans)

The financial entity classified as sound debtors to whom unusual lending terms applied, providing as operating capital loans and discounts substantially exceeding the required working capital based on the most recent closing accounts level. However, the engagement team did not sufficiently verify the adequacy of the said debtor classification. (Fiscal 2012 Inspection)

(Auditing Standards Committee Statement No. 540, paragraph 12; Special Committee for Bank Auditing Statement No. 4 V [Reference Appendix])

(Follow-up after provisional base data)

The engagement team was unable to find in the financial institutions' Board of Directors minutes a statement that the credit status of debtors to the financial institutions had significantly changed through the entity extending substantially more credit than its conventional outstanding credit from the end of December—the date designated by the financial institutions as a provisional base date for self-assessment—to the end of March of the following year. However, the engagement team did not revise the debtor category on the basis of the said situation. (Fiscal 2010 Inspection)

(Auditing Standards Committee Statement No. 540, paragraph 12; Special Committee for Bank Auditing Statement No. 4 IV 1(2))

(Debtor's adjusted position)

► The engagement team did not inspect the appraised value on the debtor's adjusted position of real estate owned by debtors who held idle real estate for disposal and/or substantial assets in excess of their business scale. (Fiscal 2012 Inspection)

(Auditing Standards Committee Statement No. 540, paragraph 12; Special Committee for Bank Auditing Statement No. 4 V [Reference Appendix])

► The engagement team did not examine whether debtors reporting substantial inventories had unrecognized losses.

In addition, the engagement team did not review the real proprietary capital reflecting unrealized real estate profits and losses of debtors planning real asset disposal to reduce liabilities. Nor did they inspect the breakdown and amounts of assets of virtually insolvent debtors' representatives contained in the real assets. (Fiscal 2012 Inspection)

(Auditing Standards Committee Statement No. 540, paragraph 12; Special Committee for Bank Auditing Statement No. 4 [Reference Appendix])

(Business improvement plans)

► In the inspection of debtors needing other monitoring likely to require improved management, the engagement team did not sufficiently inspect all debtors with operating and ordinary profits lower than estimated since the period soon after development of their business improvement plan, by

verifying the factors making their profits lower than estimated and the likelihood of their business improvement. The engagement team did not examine the status of repayment performance by debtors needing close monitoring according to their business improvement plan. (Fiscal 2012 Inspection)
(Auditing Standards Committee Statement No. 540, paragraph 12; Special Committee for Bank Auditing Statement No. 4 V [Reference Appendix])

► The engagement team did not examine the status of repayment by large-lot debtors with whom caution should be exercised, according to the management improvement plan. (Fiscal 2012 Inspection)
(Auditing Standards Committee Statement No. 540, paragraph 12; Special Committee for Bank Auditing Statement No. 4 [Reference Appendix])

(Ability for guaranty of credit guaranty company)

When the engagement team examined the financial institution's determination of the ability for guaranty of credit guaranty company, the engagement team did not verify the adequacy of the financial institution's determination by comparing the reserve for loss on guarantees reported by the financial guarantors and their latest performance of loan repayment or collection of subrogated rights of indemnity. (Fiscal 2010 Inspection)
(Auditing Standards Committee Statement No. 540, paragraph 12)

(Audit documentation)

The engagement team only included in the audit documentation inquiries made to the financial institution as to its view on the adequacy of the debtor category. The engagement team did not detail in the documentation the financial institution's determination on important matters, such as the appraisal processes for debtors' adjusted net assets and debt repayment period, and the possibility of improvement of debtors with worsening debtors' adjusted net assets. (Fiscal 2012 Inspection)
(Auditing Standards Committee Statement No. 230, paragraph 7)

Case 3: Adequacy of classified amount

► The financial institution assessed rental office buildings and other profitable properties as mortgage collateral by land value and replacement cost without using the capitalization method. Disposable estimates were calculated without considering security deposits and other financial burdens so that actual disposed amounts of mortgage collateral might be different from the disposable estimates.
Under these circumstances, the engagement team did not verify the consistency between the collateral value and disposable estimates calculated by the financial institution and the actual disposed amounts, for example, by grouping profitable properties as collateral disposed of by the financial institution in the past to compare their disposable estimates with the actual disposed amounts. (Fiscal 2012 Inspection)

(Auditing Standards Committee Statement No. 540, paragraph 12; Special Committee for Bank Auditing Statement No. 4 V [Reference Appendix])

► The engagement team identified that the amount of collateralized properties auctioned was only around 40% of the estimated disposable amount. However, the engagement team did not examine whether it needed to review the calculation methods for collateral valuation and disposable amount estimation. (Fiscal 2012 Inspection)
(Auditing Standards Committee Statement No. 540, paragraph 12; Special Committee for Bank Auditing Statement No. 4 [Reference Appendix])

► The engagement team did not inspect materials concerning collateral when examining internal assessment results for loans to borrowers at risk of failure or worse. The engagement team did not examine whether the respective amount of class III and IV loans to borrowers at risk of failure or worse were calculated with appropriate amounts of loans expected to be collectible by collateral. (Fiscal 2010 Inspection)
(Auditing Standards Committee Statement No. 540, paragraph 12; Special Committee for Bank Auditing Statement No. 4 VI (3)-(5))

(2) Write offs/reserves

Case 1: Sufficiency of loan loss reserves

The engagement team did not obtain from the financial institution back-test results for loan loss reserves, and did not examine the reasons behind the past years when lost funds exceeded loan loss reserves at the previous year end. (Fiscal 2012 Inspection)
(Auditing Standards Committee Statement No. 540, paragraph 8)

Case 2: Actual rate of irrevocable loans

► Although the actual rate of irrevocable loans of debtors classified as “on caution” exceeded that of debtors classified as “substandard”, the financial entity adopted, without correcting or otherwise adjusting, the respective calculated actual rates as the reserves rates for debtors needing other and special monitoring.
Under these circumstances, the engagement team did not examine whether the prerequisites used to determine reserve rates for grouping debtors for calculation of actual rates of irrevocable loans were balanced with the credit risks of debtors needing monitoring. (Fiscal 2012 Inspection)
(Auditing Standards Committee Statement No. 540, paragraph 12; Special Committee for Bank Auditing Statement No. 4 VI (note 3))

► The engagement team did not obtain materials supporting the amounts of credits and lost funds at the beginning of year that were used to calculate actual rates of irrevocable loans, and did not verify the accuracy or completeness of the total amount of the lost funds collected. (Fiscal 2012 Inspection)
(Auditing Standards Committee Statement No. 540, paragraph 12; Special Committee for Bank Auditing Statement No. 4 VI (note 4))

(3) Recoverability of deferred tax assets

Case 1: Review of company classification (review of the management's assumptions)

The financial institution regarded its tax losses carried forward as having been generated by special factors including big debtor bankruptcies, classifying itself as the "company class 4 proviso" specified in Audit Committee Statement No. 66 "Audit Handling on Determination of Recoverability of Deferred Tax Assets." However, the engagement team did not examine the non-ordinary nature of the background factors behind major debtor bankruptcies, etc. (Fiscal 2011 Inspection)
(Auditing Standards Committee Statement No. 540, paragraphs 11 and 12; Audit Committee Statement No. 66, paragraphs 5(1) and (3))

Case 2: Review of business plans (review of the management's assumptions)

While its outstanding balance of loans decreased in the past, the financial institution assumed in estimating taxable incomes for future years that credit costs would continue at a certain amount with an increase in the outstanding balance of loans. However, the engagement team does not examine concrete grounds for such an estimate. (Fiscal 2011 Inspection)
(Auditing Standards Committee Statement No. 540, paragraphs 11 and 12; Audit Committee Statement No. 66, paragraphs 5(1) and (3))

Case 3: Review of scheduling (review of the management's assumptions)

The financial institution prepared a schedule for subtracting temporary differences in individual loan loss provisions to be recognized as tax losses in the three years from the next period. The engagement team did not verify the reasonableness of this scheduling, for example, by comparing the prior year scheduling for tax-deduction for loan loss provisions with the actual amount. (Fiscal 2012 Inspection)
(Auditing Standards Committee Statement No. 540, paragraphs 8 and 12; Audit Committee Statement No. 66, paragraph 4)

(4) Substantive procedure

Case: Test of detail

The engagement team carried out the tests of details during the year and confirmations with the date of the financial statements as the reference date, as a substantive procedure for loans, customers'

liabilities for acceptances and guarantees, and credit balances. However, the engagement team did not verify the sufficiency of the number of tests of details, and did not perform the roll-forward procedure for the results of the tests of details performed during the year. (Fiscal 2012 Inspection)
(Auditing Standards Committee Statement No. 330, paragraph 21; and No. 500, paragraph 9)

(5) Others

Case: Confirmation of accuracy and completeness of information generated by an information system

The engagement team used the annual average balance generated by the information system of the financial institution in the analytical procedures for lending interest rates. However, the engagement team did not verify the accuracy or completeness of the annual average balance. (Fiscal 2011 Inspection)
(Auditing Standards Committee Statement No. 500, paragraph 8)

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

Points of focus

Auditors should appropriately respond to fraud risks that may affect the material misstatement of financial statements. Considering this, the CPAAOB inspects the response to the auditor's responsibilities relating to fraud in financial statements audit from the following perspectives:

- ► Whether the engagement team assesse fraud risk factors appropriately;
- ► Whether the engagement team develop audit plans in consideration of fraud risk factors;
- ► Whether the engagement team develop audit procedures to respond to assessed fraud risks.

Expected response

Auditors should maintain professional skepticism during audits to identify and assess fraud risks. In addition, they should recognize and assess how fraud risks are reduced by internal control, and should perform appropriate audit procedures to cope with risks of management override.

(1) Understanding of fraud cases in the enterprise and the industry to which it belongs

Case: Assessment of fraud risk factors

In examining fraud in the audit planning stage, the engagement team identified transactions similar to those that had been deemed to be issues in the past. However, the engagement team did not consider whether the transactions concerned indications of the existence of fraud risk factors. (Fiscal 2011 Inspection)

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

(2) Inquiries related to fraud risk

Case 1: Inquiries with the management

► The engagement team said that it asked the management to identify risks of material misstatement by fraud. However, the engagement team did not include answers to fraud-related questions in the audit documentation, and did not recognize the management's assessment of risks of material misstatement by fraud or a series of management processes implemented by the management for fraud risk identification and response. (Fiscal 2011 Inspection)

(Auditing Standards Committee Statement No. 240, paragraphs 16 and 43)

► The engagement team said that it asked the management about fraud but did not keep records of the inquiries because there were no particular points to be noted. In addition, the engagement team could not explain the discussions with management about fraud, which indicates that the engagement team

may not have performed appropriate audit procedures against fraud. (Fiscal 2012 Inspection)
(Auditing Standards Committee Statement No. 240, paragraphs 16 and 43)

Case 2: Communication with those charged with governance

The engagement team said that it discussed with the management in the audit planning stage, and it understood the entity and its operating environment, including internal control, in assessing risks of material misstatement.

However, during the discussions with management, the engagement team asked only whether fraud or non-compliance cases had occurred in the past. The engagement team did not recognize how those charged with governance monitored the series of management processes implemented by the management for fraud risk identification and response, and the internal control structure implemented by the management to mitigate fraud risks. (Fiscal 2012 Inspection)
(Auditing Standards Committee Statement No. 240, paragraph 19)

(3) Development of audit plans in consideration of fraud risk factors

Case 1: Business rationality of material transactions

► The entity started new business in the current period. The entity's counterparts for new business totally differed from its traditional ones and the entity recorded sales based on exchanges of orders and invoices without involving product delivery.
Under these circumstances, the engagement team did not review the new business in order to fully understand the new business and its operating environment, and did not assess the risk of material misstatements regarding the new business at the level of financial statement captions. (Fiscal 2012 Inspection)
(Auditing Standards Committee Statement No. 240, paragraph 31)

► Although there were conditions of risks of related party transactions or unusual sales returns in the environmental business of the entity, the engagement team did not assess the reasonableness or potential risks of such transactions in themselves. (Fiscal 2012 Inspection)
(Auditing Standards Committee Statement No. 240, paragraph 31)

Case 2: Identifying and assessing the risks of material misstatement

The entity operates a restaurant business, and most sales are settled in cash. The entity checks its cash against the sales record on a daily basis and, after such check, cash is transferred to and managed by an external security company.

Based on these facts, the engagement team considered it unnecessary to identify the risks of material misstatements (significant risk) due to fraud in revenue recognition. However, the engagement team failed to identify possible fraud that could arise in the entity's sales transactions, and did not perform procedures to assess such risks. (Fiscal 2011 Inspection)

(Auditing Standards Committee Statement No. 240, paragraphs 25 and 26)

(4) Discussion/information sharing within the engagement team

Case: Discussion within the engagement team

The engagement team said that they discussed whether material misstatements could be made by fraud in the financial statements within the engagement team member.

However, the engagement team did not pursue substantial discussions regarding possible material misstatements due to fraud. (Fiscal 2012 Inspection)

(Auditing Standards Committee Statement No. 240, paragraph 14)

(5) Auditors' procedures response to fraud risk

Case: Audit procedures' response to risks related to management override of controls

► In the audit procedures' responses to risks related to management override of controls, the engagement team performed scanning over the adjusting journal entries, but did not examine the procedures of appropriateness of journal entries recorded in the general ledger. In addition, the engagement team did not examine whether there was a possibility that the management is biased toward making material misstatements due to fraud concerning accounting estimates. (Fiscal 2011 Inspection)

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

► The engagement team obtained the adjusting entries for the general ledger as part of the procedures to respond to risks of management override and reviewed whether unusual transactions existed. However, the engagement team did not define what unusual transactions actually meant and did not review the necessity to verify the adequacy of the journals and adjusting entries through out the period. (Fiscal 2012 Inspection)

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

► In a situation where the entity had unusual transactions, the engagement team made only sales, cost of sales, and selling and administrative expenses subject to the journal entries test. But, from the test, the engagement team excluded the account balances that included the unusual transactions. (Fiscal 2012 Inspection)

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

(6) Significant risks

Case: Revenue recognition

The engagement team did not identify revenue recognition as a fraud risk and significant risk without rational reasons, and did not perform audit procedures to response to such risks. (Fiscal 2011 Inspection)

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

Points to Note:

In addition to the above-mentioned cases, there were many cases identified in the CPAAOB's inspections where there were concerns about maintaining professional skepticism as described below:

- Fraud-related inquiries with management and discussions among the engagement team members were only carried out as a matter of formality, and such discussions were not deemed to be substantial;
- In the audit procedures response to risks related to management override of controls, journal entry testing was performed only as a matter of formality without fully taking the fraud risk into consideration.

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

7. Audits of Internal Control over Financial Reporting

Points of focus

The CPAAOB inspects the management's assessment of internal control from the perspectives of whether auditors perform sufficient and appropriate reviews and whether the required procedures are performed relating to the use of the work of internal auditors.

Expected response

The engagement team needs to re-confirm the scope and depth, etc. of required audit procedures, and to ensure the performance of sufficient and appropriate audit procedures with their documentation.

(1) Evaluation of Significance of Deficiencies

Case 1: Determination of materiality

The guideline for determining the materiality of internal control deficiencies should be the same as that for determining materiality in a financial statement audit, because it eventually affects the reliability of the financial statements. However, the engagement team failed to verify the reasonableness of the materiality in the audit of internal control over financial reporting, despite it's differing from that in the audit of consolidated financial statements. (Fiscal 2011 Inspection)

(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, although the entity considered that the misstatement identified in the audit of financial statements was caused by deficiencies in internal control, the entity determined that it had no significant impact on the financial reporting, as its quantitative materiality was low.

However, the engagement team did not examine whether the significance of such internal control deficiencies constitutes a material weakness by taking into consideration the qualitative materiality, compensating control, potential quantitative impact of deficiencies and likelihood of an actual impact, and other factors. (Fiscal 2011 Inspection)

(Auditing and Assurance Practice Committee Statement No. 82, paragraphs 42 and 190-211)

Case 3: Assessment of internal control for business processes

The engagement team did not review whether the entity operated internal control over the long-lived asset impairment process—part of its financial reporting process—as designed. (Fiscal 2012 Inspection)

(Auditing and Assurance Practice Committee Statement No. 82, paragraphs 144, 149 and 186)

Case 4: Assessment of deficiencies in internal control

► The entity had bad debt receivables in the last month the financial year from new sales transactions commenced in the current year. The entity determined that the business process for such sales transactions should be included in the assessment scope of internal control, and recognized it as a deficiency over the credit control of new business. The entity developed a business process for credit control as a measure to correct this deficiency, and according to its assessment, the deficiency has improved.

Under these circumstances, the engagement team determined that the deficiency had been improved as of the year end, deeming it unnecessary to contain corrective measures performed after the year end in the internal control report. The engagement team, however, did not obtain audit evidence of the design, implementation or maintenance of corrective measures at the year end. (Fiscal 2012 Inspection)

(Auditing and Assurance Practice Committee Statement No. 82, paragraph 216)

► The engagement team did not obtain the final results of the management's assessment of deficiencies in internal control. (Fiscal 2011 Inspection)

(Auditing and Assurance Practice Committee Statement No. 82, paragraph 216)

(2) Evaluation of the Scope of Assessment of Internal control

Case 1: Selection of significant business locations/units

The entity engaged in business entailing audit risks of which sales went below less than one-third of its total sales. Because of this, the entity excluded the business processes from the scope of audit of internal control.

Under these circumstances, the engagement team identified transactions from that business as a significant risk but did not sufficiently or carefully examine whether the entity had excluded the business process from the scope without considering the qualitative effect on financial reporting. (Fiscal 2012 Inspection)

(Auditing and Assurance Practice Committee Statement No. 82, paragraph 67)

Case 2: Criteria selecting business locations/units

The entity used sales before elimination of inter-company transactions as criteria for selecting significant business locations or units, since it is difficult to accurately determine the sales after elimination of inter-company transactions for each component. However, the engagement team did not examine whether such criteria are appropriate.

In addition, when the sales before elimination of inter-company transactions is used as criteria for selecting significant locations or business units, it is possible that the business locations or units with more inter-company sales would be ranked higher. However, the engagement team did not examine

whether all significant business locations or units that should be selected were actually selected. (Fiscal 2011 Inspection)
(Auditing and Assurance Practice Committee Statement No. 82, paragraph 91)

(3) Evaluation of Assessment of Internal control

Case 1: Evaluation of assessment of company-level internal control

In the evaluation of assessment of the status of establishment and implementation of company-level internal controls, the engagement team failed to examine whether the assessment items adopted by the management were appropriate in light of the conditions of the entity, by referring to the assessment items shown in Exhibit 1 of the "Practice Standards for Management Assessment and Audit concerning Internal Control over Financial Reporting." (Fiscal 2011 Inspection)
(Auditing and Assurance Practice Committee Statement No. 82, paragraph 124)

Case 2: Evaluation of Assessment of Internal control

In the assessment of company-level internal controls and period-end financial reporting processes of consolidated subsidiaries, the engagement team said that they obtained the results of assessment performed by consolidated subsidiaries and examined their appropriateness. However, they did not record performed procedures or conclusions in the audit documentation. (Fiscal 2011 Inspection)
(Auditing and Assurance Practice Committee Statement No. 82, paragraphs 125, 130, and 251; Auditing Standards Committee Statement No. 230, paragraph 8)

Case 3: Sampling

In implementing procedures for the assessment of internal control operations, the engagement team failed to record, in audit documentation, the population, scope and period of sampling, sampling method, etc., which they specified. (Fiscal 2011 Inspection)
(Auditing and Assurance Practice Committee Statement No. 82, paragraphs 251; Auditing Standards Committee Statement No. 230, paragraph 8)

Case 4: Roll-forward procedures

► The engagement team said that they assessed the operating effectiveness of the revenue process during the year. However, they did not perform the procedure to check that internal control effectively continued in line with the date of the financial statements. (Fiscal 2011 Inspection)
(Auditing and Assurance Practice Committee Statement No. 82, paragraphs 131 and 160)

► The engagement team only inquired of internal auditors on the details of unchanged controls in the roll forward procedures of the establishment status of entity level control, IT general control, and business processes. However, the engagement team did not ask questions in combination with

document review and observation. (Fiscal 2011 Inspection)
(Auditing and Assurance Practice Committee Statement No. 82, paragraphs 131 and 160)

Case 5: Procedures for assessed scope

► In reviewing the internal control assessment performed from a company-wide standpoint as part of the entity level control and financial reporting process, the engagement team only reviewed the assessment of the entity, not that of some of its consolidated subsidiaries, because they were under the same control environment. However, the team did not examine the adequacy of such review. (Fiscal 2011 Inspection)
(Auditing and Assurance Practice Committee Statement No. 82, paragraph 124)

► The entity included its business processes for sales transactions starting from the current period in the assessment scope of internal control, but the engagement team did not assess the design, implementation or maintenance of internal control for the processes. (Fiscal 2012 Inspection)
(Auditing and Assurance Practice Committee Statement No. 82, paragraph 144)

(4) Use of Management Assessment

Case 1: Using the work of internal auditors

In the procedures for evaluating business process operations in the audit of internal control, the engagement team fully utilized the work results of internal auditors, instead of performing sampling themselves. However, the engagement team did not verify the objectivity or capabilities of the internal auditors, etc., or the extent of use of internal auditors. (Fiscal 2011 Inspection)
(Auditing and Assurance Practice Committee Statement No. 82, paragraphs 228 to 243)

Case 2: Extent of using the work of internal auditors

The engagement team used the results of the work done by internal auditors but did not sufficiently review whether the internal auditors had objectivity and competency in assessment or whether the work of internal auditors was of high enough quality to be used as audit evidence. (Fiscal 2012 Inspection)
(Auditing and Assurance Practice Committee Statement No. 82, paragraphs 237 and 238)

Certified Public Accountants and Auditing Oversight Board

http://www.fsa.go.jp/cpaaob/index.html