Provisional Translation

Case Report from Audit Firm Inspection Results

（Program Year 2023）

July 2023

Certified Public Accountants and Auditing Oversight Board

Introduction

Since its inception in April 2004, the Certified Public Accountants and Auditing Oversight Board (CPAAOB) has been conducting inspections of Japanese audit firms from the viewpoint of securing the public interest and protecting investors with the aim of ensuring and improving audit quality in Japan.
The CPAAOB compiled examples of deficiencies identified in its inspections as the “List of Examples of Issues on Audit Quality Control Identified through Inspections” in February 2008 (renamed the “Case Report from Audit Firm Inspection Results” in 2012 (Case Report)), and has since issued revised editions every year.

The purpose of this Case Report is to promote voluntary efforts by audit firms to ensure and improve their audit quality, by providing specific examples of major deficiencies identified in the CPAAOB's inspections as well as observed effective efforts and by presenting the audit quality level expected by the CPAAOB. In addition, this Case Report also serves as reference material to be provided to the directors/ company auditors etc. of listed companies and other companies subject to audit by accounting auditors, investors and other market participants.

This Case Report has been updated to add the latest cases of inspections and redesigned to make the background to audit deficiencies identifies via inspections as understandable as possible, following previous years’ editions in terms of its basic structure.

We plan to present the details of the Case Report and organize dialogue with relevant organizations, such as briefings at regional chapters of the Japanese Institute of Certified Public Accountants (JICPA) and lectures at the Japan Audit & Supervisory Board Members Association and other.

In addition, we have published information about the inspection system and the situation at audit firms in the form of the “2023 Monitoring Report”. Please also refer to this report.

In order to further ensure the reliability of audits, audit firms should review individual audit engagements and quality control systems in reference to examples of deficiencies and causes of the deficiencies described in this Case Report. In particular, small and medium-sized audit firms should make effective use of the Case Report in training programs, for example, in order to voluntarily improve audit quality.

Please submit any comments or requests regarding this Case Report to the dedicated e-mail address below.
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Important Points for Users of this Case Report

1. Regarding Cases Included in the Case Report

(1) Although this Case Report is a compilation of relatively new cases of deficiencies that were identified in the inspections, it does not mean that the CPAAOB puts less importance on cases that were not included in the Case Report.

(2) The CPAAOB inspections classify audit deficiencies as either significant deficiencies or deficiencies, but this Case Report will draw no distinction between the two, listing those deficiencies that comport to the purposes of this Case Report.

(3) The cases included in the Case Report may have had facts omitted or changed to the extent that does not affect the purport of the case.

(4) The number of cases pointed out on the following pages reflects neither the proportion of the number of deficiencies by the size of audit firms, nor the ratio of the number of deficiencies by the inspection items.

(5) Deficiencies that were not included in the Case Report may be included in matters that should have been noted by audit firms and engagement teams, or may be included in the points to be expected in terms of appropriate audit procedures.

(6) In cases where there are multiple criteria for identifying the deficiencies, the principal provision is quoted.

(7) New example cases and observed effective efforts adopted in the 2022 edition of the Case Report are preceded by the mark. NEW

(8) Cases that have been pointed out continuously from previous years or cases that have been pointed out frequently are marked with a frequent occurrence mark at the beginning of the sentence.

FREQUENT

2. Main Characteristics of the 2023 Edition

(1) In "I. Operations Management System (Root Cause Analysis)," the numbers of examples of root cause analysis conducted by the CPAAOB and examples of root causes have been increased in light of the importance of such analysis.

(2) "II. Quality Control Environment" provides more examples of problems with the quality control environment relating to the establishment and implementation of internal rules, compliance with laws, regulations, and professional standards, and EQCR of audit engagements. It also provides more examples of effective efforts that contribute to improvements, particularly at small and medium-sized audit firms.

In addition, in order to enable audit firms to more effectively consider strengthening the quality control environment with the aim of improving audit quality, the "Implementation of Quality Control Activities" section provides a list of rules that serve as the basis for numerous deficiencies and points to keep in mind.

(3) In "III. Individual Audit Engagements," in light of the fact that the occurrence of accounting fraud issues at listed companies and overseas group companies continues to attract attention, we have enhanced descriptions of examples of deficiencies and points to keep in mind in sections such as "1. Fraud in Financial Statement Audits," "4. Audit of Accounting Estimates," and "5. Group Audit." In particular, we have enhanced examples of initiatives at small and medium-sized audit firms that can be evaluated as contributing to improvement.

(4) In "II. Quality Control Environment" and "III. Individual Audit Engagements," figures are provided to assist understanding of the content of "Required Actions" and "Points to Note."

(5) Key points in the case studies are shown in bold and underlined.

(Definitions of terms)

The definition of terms in this Case Report is as follows:

Act	Certified Public Accountants Act
Audit firm	An audit firm, a partnership, and an individual firm
Large-sized audit firm	An Audit firm that has more than approximately 100 domestic listed audited companies and whose full-time staff performing actual audit duties total at least 1,000. In this case report, they specifically refer to KPMG Azsa LLC, Deloitte Touche Tohmatsu LLC, Ernst & Young ShinNihon LLC, and PricewaterhouseCoopers Aarata LLC.
Mid-tier audit firm	An audit firm whose business scale is second only to large-sized audit firms. In this Case Report, this refers to five audit firms: Gyosei & Co., BDO Sanyu & Co., Grant Thornton Taiyo LLC, Crowe Toyo & Co., and PricewaterhouseCoopers Kyoto.
Small and medium-sized audit firm	An Audit firm other than large-sized and Mid-tier audit firms
CPAAOB	Certified Public Accountants and Auditing Oversight Board
JICPA	Japanese Institute of Certified Public Accountants
Quality control (QC) review	Quality control review performed by the JICPA under Article 46-9-2 of the Certified Public Accountants Act and Article 77 of the JICPA Rules
Audit team	Persons engaged in the provision of audit services, and comprises (an) engagement partner(s) and assistants to the engagement partner(s)
Engagement partner	The person responsible for conducting audits, who is a CPA with responsibility for the audit services and their provision as well as the audit report issued
Assistants to engagement partner	Members of an audit team other than the engagement partner

(List of Standards, etc. for Published Cases)

Audit standards, practical guidelines, etc. related to the cases presented in this Case Report are as follows: The auditing standards and practical guidelines described below were effective as of the end of June 2023. In addition, the provisions prior to the 2022 revision are cited in Quality Control Standards Statements No. 1, and the provisions prior to the 2021 revision are cited in Auditing Standards Statements No. 315 and Auditing Standards Report No. 540.

Quality Control Standards Statement No. 1 "Quality Control at Audit Firms"
Quality Control Standards Statement No. 1 Practical Guidelines No. 1 "Guidelines for Information Security in Certified Public Accountant Services"
Auditing Standards Statement 220 (Quality Control in Audit Engagements)
Auditing Standards Statement 230 (Audit Documentation)
Auditing Standards Statement 240 "Fraud in the Audit of Financial Statements"
Auditing Standards Statement 260 Communication with Audit & Supervisory Board Members
Auditing Standards Statement 265 (Communication on Deficiencies in Internal Controls)
Auditing Standards Statement 300 (Audit Plan)
Auditing Standards Statement 315 (Identification and Assessment of the Risks of Material Misstatement)
Auditing Standards Statement 320 (Materiality in the Planning and Conduct of Audits)
Auditing Standards Statement 330 ("Auditors' Procedures for Addressing Assessed Risks")
Auditing Standards Statement 402 ("Audit Considerations for Outsourcing Companies")
Auditing Standards Statement No. 450 "Evaluation of Misstatements Identified during the Audit Process"
Auditing Standards Statement 500 (Audit Evidence)
Auditing Standards Statement 501 (Audit Evidence for Specific Items)
Auditing Standards Statement 505 "Confirmation"
Auditing Standards Statement No. 520 (Analytical Procedures)
Auditing Standards Statement 530 ("Audit Sampling")
Auditing Standards Statement 540 (Auditing of Accounting Estimates)
Auditing Standards Statement 550 "Related Parties"
Auditing Standards Statement No. 560 "Subsequent events"
Auditing Standards Statement 570 ("Going Concern")
Auditing Standards Statement 600 (Group Audit)
Auditing Standards Statement 610 (Use of the Work of Internal Auditors)
Auditing Standards Statement 620 (Use of the Work of Experts)
Auditing Standards Statement 701 (Reporting of Significant Audit Considerations in Audit Reports of Independent Auditors)
Auditing Standards Statement 900 (Changes in Auditors)
Auditing Standards for Internal Controls over Financial Reporting Statement No. 1 (Audit of Internal Control over Financial Reporting)

[Contents]

Responses Expected of Audit Firms

1. Ensuring the Reliability of Audits

In recent years, the powers of Audit and Supervisory Board Members, Audit and Supervisory Boards, Audit Committee Members, and Audit Committees (hereinafter referred to as "company auditors, etc.") have been strengthened, corporate governance codes are introduced, and these developments have helped enhance corporate governance environments. However, incidents of fraud continue to occur both in Japan and overseas and a number of listed companies have announced inappropriate accounting practices and other misconduct through the timely disclosure procedure.

Under these circumstances, efforts have been continuously made to improve the quality of audits and ensure their reliability. For example, audit standards concerning "Key Audit Considerations (KAM)" and "Other Content" in audit reports have been revised, the Quality Control Standards on Audits have been revised to introduce a quality control system based on a risk-based approach, and ethical rules have been revised to strengthen independence concerning remuneration, etc. In the audit of listed companies, mid-tier audit firms and small and medium-sized audit firms are continuing to replace large-sized audit firms. Mid-tier audit firms and small and medium-sized audit firms are playing a greater role as auditors of listed companies, and are urgently required to improve audit quality. It is therefore necessary for each audit firm to continue to verify its individual audit engagements and quality control systems with reference to the deficiencies and their causes described in this Case Report.

In doing so, audit firms should be mindful of striving in practice to ensure and improve the quality of their audits, considering not only whether individual audit engagements and quality control system formally comply with audit standards but also whether they are applying appropriate professional skepticism to identify fraudulent accounting and whether they are focusing at all times on audited companies' business risks to assess and address risk of material misstatement.

If deficiencies are identified in individual audit engagements or quality control systems, the audit firm should not only remedy the deficiencies but also analyze the root causes before making improvements.

This Case Report also includes examples of "observed effective efforts" by audit firms that might serve as guides for improvement, and we ask that you find these informative.

2. Organized Responses

The chief executive officer (CEO) of an audit firm, such as the chief director, and the person in charge of quality control (PICOQC) are required to exercise leadership in the design and operation of a system of quality control. However, the improvement of the quality control systems should not only be an issue for the CEO and PICOQC, but rather a firm responsibility to be fulfilled voluntarily by the partners and employees of an audit firm. It is important, through such organized improvements, to foster a climate that emphasizes audit quality.

With regard to the organizational operation of audit firms, in light of the "Principles for the Organizational Operation of Audit Firms" (Audit Firm Governance Code) (formulated in March 2017), large-sized audit firms and others are working to further establish and strengthen governance environments to ensure and improve audit quality. Amid this situation, the Audit Firm Governance Code was revised in March 2023 to require effective disciplines suited to the size and characteristics of audit firms. The CPAAOB will continue to verify whether the governance environments established and strengthened by each audit firm are effective.

3. Accurately Discerning Deficiencies and Analyzing Causes

One prerequisite for appropriately analyzing root causes is accurately identifying back ground of deficiencies and precisely discerning their essential causes. If these essential causes cannot be precisely discerned, then the root causes cannot be suitably analyzed and the measures responding to root cause will also be unsuitable. For example, we should bear in mind that when appropriate audit work papers on significant matters during the audit has not been prepared, the issue in the vast majority of cases is not simply a lack of documentation but a failure to perform the audit procedures to obtain sufficient and appropriate audit evidence. If the prepared audit documentation does not satisfy the requirements stipulated in Auditing Standards Statement No. 230, paragraph 7, it is necessary to carefully discern whether this is due to the necessary audit procedures not having been implemented without playing it down as simply an issue of documentation. If the necessary audit procedures have not been carried out, the reasons for this must be further analyzed and efforts must be made to improve. To ensure that necessary audit procedures are implemented, the skills of the engagement team must be enhanced through classroom education/training and superiors need to commit to providing guidance on a day-to-day basis to the members of engagement team through supervising the audit practices, reviewing audit work papers, performing engagement quality reviews and conducting periodic inspection, etc.

4. Responding to Issues According to Firm Size

There is wide variation in the sizes of audit firms, with some having just a few personnel while others have headcounts that run into the thousands. There are also differences in operations management system. Because of these factors, it is important to continuously check whether the quality control system established by the audit firm is appropriate in view of the size of the firm and the operations management system.
The following characteristics have been identified as issues relating to the size of the audit firm, so each audit firm should refer to them and take appropriate action based on their size.

[Large-sized audit firms]
We can see that large-sized audit firms are working in an organized manner on improvements for ensuring higher quality, such as rebuilding their governance environments through, for example, the utilization of knowledge of outside third parties, strengthening of collaboration between different levels within the firm

(management, quality control division, audit divisions, engagement teams), and appropriate human resource development and personnel management and evaluation.
On the other hand, at large-sized audit firms, since their organizations are extremely large, issues such as lack of frequent communication among different levels and divisions and between the head office and regional offices and difficulty in ensuring the penetration of the firms' measures across all divisions and offices have still been pointed out. As a means of addressing this, a trend that has been seen recently is to shift the maintenance and improvement of quality control from quality control division to audit divisions, which are closer to the audit frontline. While such initiatives are likely to be effective to some extent, attention needs to be given to ensuring that the quality control division accurately and continuously understands the characteristics of the audit engagements handled by each audit division so as to ensure the effectiveness of the measures carried out by audit divisions.

[Mid-tier audit firms]

Mid-tier audit firms have been improving their organizational structures for ensuring systematic actions with regard to quality system, but their headquarter organizations are still weaker than large-sized audit firms. In addition, the quality control system of some firms is inadequate as a result of limited manpower assigned to quality control and also insufficient awareness of CEOs and PICOQCs concerning quality control. Another issue is that at firms expanding their operations, the competency and capability are not enough to serve new audit contracts in a timely manner. In addition, business administration at each firm is characterized by the reliance on a large number of part-time professional staff and audit support staff for audit engagements and by quality control issues at certain district offices.
Moreover, while Mid-tier audit firms are required to improve their ability to perform audits for large-sized listed companies, they have problems in that they have yet to sufficiently develop a system for securing human resources and offering organizational support to engagement team or a system for international services, such as for effectively utilizing their overseas business alliance.

[Small and medium-sized audit firms]

As a result of lack of awareness of the importance of quality control among the CEOs and PICOQCs, small and medium-sized audit firms fail to proactively address matters of quality control. In addition, they lack the resources for developing quality control systems. Because of these, while they are addressing deficiencies identified in external inspections in their efforts for improving audit quality, this remedial action is often superficial, being based on treating the symptoms rather than tackling the root causes. Some audit firms are also not making an effort on a day-to-day basis to improve audit quality and only followed the previous audit procedures on the grounds that no major issue had occurred in the past.
Some small and medium-sized audit firms prioritize expanding their operations and have concluded new contracts in the belief that risks of new audit contracts (hereinafter, "contract risks," including risks for renewing contracts) had been appropriately assessed even though due consideration had not been given to fraud risks of listed companies with high audit risk. As a result, instances of inadequate and inappropriate

risk assessment procedure and further audit procedures in audit services are found.

To Directors, Company Auditors etc., Investors and Other Stakeholders

The relationship between directors/company auditors of audited companies and accounting auditors has strengthened streamlined through the recent revision of the Companies Act and related regulations such as the Corporate Governance Code. Meanwhile, incidents such as fraudulent accounting by listed companies and overseas group companies continue to be seen.

Management is responsible for preparation of financial statements and the design and operation of internal controls. Furthermore, from the perspective of investor protection and securing reliability of the capital market, directors and company auditors are strongly expected to appropriately evaluate and select accounting auditors, who provide assurance as to fairness of financial statements, as well as to fulfill their responsibilities in order to ensure proper audits, such as by allowing adequate auditing time to ensure high quality audits and by fully collaborating with the accounting auditors.
It is also important for market participants, including shareholders of audited companies, that the directors and company auditors of audited companies appropriately evaluate and select accounting auditors, and that the companies' financial information is properly disclosed on a continuous basis by securing proper auditing.

In particular, effective from the fiscal year ended March 31, 2021, "key audit matters" (hereinafter referred to as "KAM") are required to disclose in order to improve transparency of audits conducted by accounting auditors and increase information value of audit reports. More effective audits are expected to further enhance collaboration and communication between accounting auditors and company auditors, etc. as well as discussions with management, leading to more effective audits. In addition, the Audit Firm Governance Code, which was revised in March 2023, stipulates that audited companies, shareholders, and other capital market participants are expected to actively exchange views with accounting auditors on measures to improve the quality of accounting audits, and utilize the useful information obtained from such exchanges to improve organizational management.

In view of such matters, this Case Report describes examples of deficiencies identified in the CPAAOB's inspections, which include the most recent cases of accounting fraud and matters pertaining to collaboration between accounting auditors and company auditors, etc., in the most easily comprehensible manner from the perspective of providing directors and company auditors, etc., of listed and other companies as well as investors with reference information on audits. This Case Report also describes observed effective cases of improvement efforts by audit firms. We thus hope that this Case Report would be helpful as a reference for the appropriate evaluation of accounting auditors.

I. Operations Management System
(Root Cause Analysis)

1. Operations Management System and Root Cause Analysis

(1) Necessity of Root Cause Analysis

With regard to audit firms that the CPAAOB conducted inspections of, it has been recognized that when a deficiency was detected in a review conducted by the JICPA in accordance with Article 46-9-2 of the Certified Public Accountants Act (below, "the Act") and Article 77 of the JICPA Rules (below, "QC review") or periodic inspection, not a few audit firms only took superficial improvement measures, without fully identifying the causes.

Deficiencies identified in inspections are detected within the scope of investigations. It is likely that the audit firms have other undetected deficiencies arising from the same root causes. Moreover, even if the measures are implemented only to address the superficial causes of the deficiencies, they may be effective temporarily, and similar deficiencies may occur again. Therefore, improvement measures developed only to cope with the superficial causes, without any root cause analysis, would not be effective or sufficient for improving the quality control system of the entire firms, and would not lead to fundamental improvement; therefore, the quality of the audits by the audit firms would not be improved.
On the contrary, taking symptom-treating perfunctory measures such as simply adding checklist items in response to individual deficiencies, for example, would lead to an increase in unnecessary and ineffective workload for professional staff to respond to the checklist and often prevent them from implementing an effective and efficient audit engagements.
Thus, audit firms shall understand importance of root cause analysis of deficiencies in order to substantively improve quality control.

In recent years, with regard to deficiencies relating to individual audit engagements identified through external inspections, etc. and periodic inspections, large-sized audit firms not only specify the factors of deficiencies in audit procedures and audit evidence make them well known, but also incorporate action to analyze their root causes into their quality control system.
For example, the quality control department etc. acts voluntarily to conduct interviews with and questionnaire surveys of the audit team in which deficiencies were identified in order to find out the details of the essential causes of the deficiencies, after which the department analyzes whether these direct causes were the result of the firm's operations management system or quality control system, and then reflects its findings in the improvements to be made.

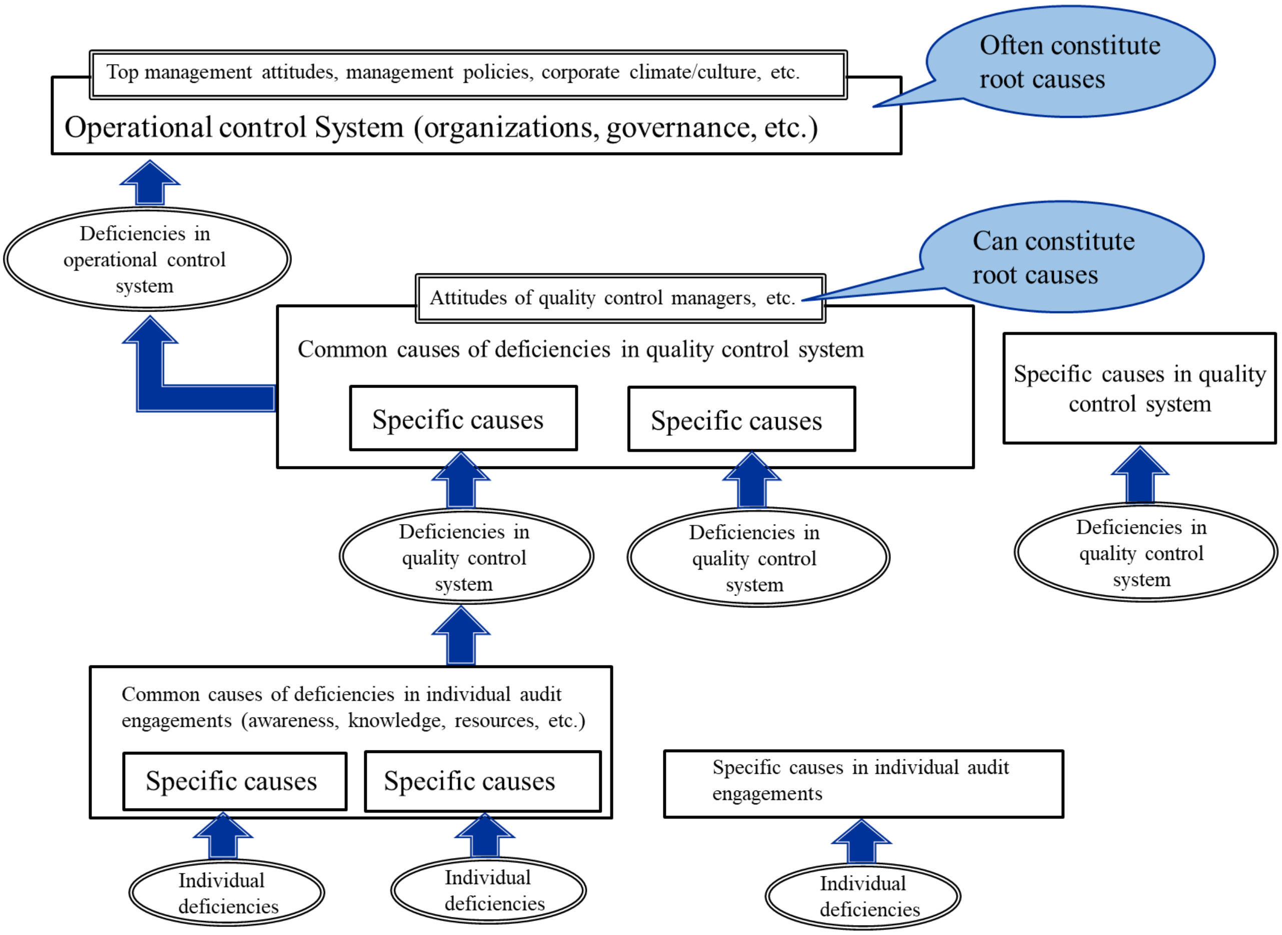
(2) Root Cause Analysis

When conducting root cause analysis, it is first and foremost important to accurately identify the essential causes of deficiencies. Rather than ascribing the direct causes merely to the knowledge, attitudes, or experiences of individual personnel involved, it is essential to identify the direct causes after sufficiently understanding engagement team's circumstances and the business conditions of audited companies, among other factors, and conduct a further analysis to explore the root causes in light of the identified causes.

Direct causes include "specific causes," which are identified with regard to individual deficiencies, and "common causes," which are common to multiple deficiencies. Further examining the underlying causes of common causes often helps to identify the root causes.

In the past inspections, the root causes were frequently related to the operations management system as manifested in the attitudes and policies of top management, the governance environment and the organizational climate. Accordingly, attention must be paid to the effectiveness of the operations management system. At times, the attitude of PICOQC or some other aspect of the quality control system constitutes the root causes (see [Figure 1]).

[Figure 1]Reference image: Identify deficiencies and root causes



The following are examples of root cause analysis in which the CPAAOB analyzed the direct causes of deficiencies, investigated the root causes and discovered the root causes within the operations management and quality control systems.

[Large-sized audit firms]

[Case 1]

At the audit firm, multiple deficiencies, including significant ones, were identified with regard to some individual audit engagements subject to inspection.

The causes of these deficiencies included the fact that in an audit area etc. in which the engagement partner deemed the risk to be relatively low, based on their understanding of the business environment and past audit experience, the engagement partner was not aware of the need to carry out an in-depth audit response in accordance with the assessed risks. The causes also included the fact that assistants to engagement partner lacked commitment to critically considering the explanation provided by the audited company and to in-depth consideration of fraud risks.

In light of this situation, further investigations into the root cause determined that the root cause lay in the fact that the audit firm had not adequately ensured penetration of efforts to appropriately implement audit consideration and responses in areas other than those thought to have particularly high risk of material misstatement.

[Case 2]

NEW

At the audit firm, multiple deficiencies, including significant ones, were identified with regard to some individual audit engagements subject to inspection.

The direct causes of these deficiencies were as follows: engagement partners and assistants to engagement partners did not sufficiently critically review management's assertions concerning the timeliness of accounting treatment for accounting estimates; and engagement partners and assistants to engagement partners did not sufficiently recognize the need to examine whether audit procedures suited to the level of risk were being performed in areas where the risk of material misstatement was deemed to be relatively low. Furthermore, there were common causes for deficiencies in the quality control environment: the Quality Control Headquarters, which led audit quality improvement measures, did not clearly indicate the scope and level of procedures to be performed to the quality control partners of each audit division, who were responsible for implementing remedial measures, when providing systematic support to engagement teams facing risks, and the Quality Control Headquarters did not sufficiently confirm whether improvement effects were being achieved on the audit frontline.

Further considerations into the root cause discovered that the root cause lay in the quality control environment. Specifically, **the management executives did not sufficiently recognize the need to confirm whether the QC Headquarters and the firm implementing the remedial measures were cooperating closely to ensure that the measures were being implemented in line with their original intent and purpose and that remediations were being made on the audit frontline**.

[Case 3]

At the audit firm, multiple deficiencies, including significant ones, were identified with regard to individual audit engagements subject to inspection.

The direct causes of those deficiencies included the assumption among engagement partners and their assistants that it was sufficient to examine material audit matters, such as accounting estimates, based only on the understanding of nature of audited companies' business and past business performance trends and that it was not necessary to examine quantitative supporting data. There were also common causes related to the deficiencies in the quality control system at individual divisions and departments of the headquarters involved in quality control, including: a lack of efforts to ensure that the level of audit procedures required by the current audit standards are penetrated throughout the firm; and a lack of efforts to encourage engagement partners to be proactively involved in the audit engagements that they are in charge of.

Further analysis of the root causes ascribed the above deficiencies to the quality control system. For example, the audit firm assumed that appropriately identifying material risks faced by audited companies and repeatedly communicating the importance of conducting risk-focused audits to engagement teams would be sufficient to improve audit quality. As a result, adequate verification was not conducted as to the extent to which quality control measures had taken hold and how effective they were.

[Mid-tier audit firms]

[Case 1]

At the audit firm, multiple deficiencies, including significant ones, were identified with regard to some individual audit engagements subject to inspection.

The causes of those deficiencies included a lack of awareness of following the previous year in the audit and a lack of professional skepticism in terms of willingness to critically assess relevant assertions. There was a common cause of the deficiencies in the quality control system, which was a lack of awareness on the part of the PICOQC that the inadequate staffing and level of involvement of the quality control division meant it could not identify and remediate deficiencies.

In light of this situation, further investigations into the root cause determined that it lay in the operations management system. More specifically, with operations expanding, the chief executive officer (CEO) was unaware that the headquarter organization was unable to consider the adequacy of personnel allocation and lacked awareness of the need to personally verify the adequacy and effectiveness of the quality control system. For example, the CEO thought that the enhancement of the headquarter organization's functions and improvement of the quality control system would be carried out appropriately if left up to the people in charge at headquarters.

Another root cause, also lying in the operations management system, was determined to be the failure of the CEO and the people in charge at headquarters to develop an adequate environment for verifying the status of efforts to ensure quality control measures take hold in audit fieldwork and their effectiveness, even though engagement partners lacked sufficient awareness of their own responsibility for the audit engagement and its performance and the skill level of audit teams as a whole had not been raised to an adequate degree.

[Case 2]

Multiple significant deficiencies with some individual audit engagements subject to inspections were identified at an audit firm. These concerned, for example, substantive procedures for revenue and procedures for responding to fraud risk. Many of these deficiencies were identified frequently at a specific regional office.

The common cause for these deficiencies in individual audit engagements turned out to be that the engagement partners had not effectively reviewed audit work papers, instead followed same audit procedures from the past years because no major issues had arisen in audit engagements theretofore.

The common cause for these deficiencies in individual audit engagements lay in the quality control system in that the CEO had believed having a mechanism in place to convey decisions made by the head office to regional offices was in and of itself sufficient and he had no intent of revising the practice of regional offices administering these decisions independently, and in that the CEO and the PICOQC followed past practices because no major issues had arisen theretofore in key matters noted with regard to business administration and quality control at the audit firm by outside organizations.

Further investigations into the root cause determined that it lay in the operations management system. More specifically, the audit firm had undergone repeated mergers but the headquarters organization remained fragile and the regional offices established by separate entities were permitted to run their businesses in their own ways, with hardly any exchanges of personnel taking place.

[Case 3]

At the audit firm, multiple deficiencies were identified with regard to all individual audit engagements subject to inspection. Many significant deficiencies, including significant ones, were identified in individual audit engagements at particular regional offices.

Those deficiencies in the individual audit engagements had common causes, including a lack of understanding among engagement partners and their assistants of the level of audit procedures required by the current audit standards, including lack of professional skepticism with regard to response to fraud risks and accounting estimates; and lack of awareness of the need to review risk assessment and risk-related audit procedures every fiscal year due to the assumption that merely following the audit procedures performed in the previous fiscal year would be sufficient. The deficiencies in the individual audit engagements at particular regional offices also had a common cause, which was lack of awareness among some engagement partners of the need to give instructions to and supervise engagement teams and of the need to conduct in-depth review due to the assumption that audit procedures were being properly performed by other engagement partners concurrently serving as the chief auditors.

The common causes of those deficiencies in the individual audit engagements are ascribable to the quality control system. For example, the PICOQC lacked awareness of the need to emphasize the need for cooperation between the quality control and audit divisions under the belief that the audit division should play the leading role in ensuring that improvement measures take hold in audit fieldwork. The common cause of the deficiencies in the individual audit engagements at particular regional offices are also ascribable to the quality control system. Specifically, there was lack of awareness on the part of the manager in charge of the audit division about the need for support from the audit division due to the assumption that engagement teams could be appropriately organized if engagement partners were appropriately assigned.

Further analysis of the root causes ascribed the above deficiencies to the operations management system. For example, in some cases, the CEO, when planning and implementing measures to improve audit quality, refrained from exercising strong leadership and placed emphasis on the independence of the quality control and audit divisions. As a result, there was lack of awareness of the need to quickly make improvements. Furthermore, the executive management team also respected the independence of the quality control and audit divisions and lacked awareness about the need for strong cooperation between those two divisions. In other examples, although the executive management team was aware of audit quality issued at some regional offices, it assumed that the regional offices would be able to make improvements on their own. As a result, there was lack of awareness of the need to actively support the regional offices.

[Small and medium-sized audit firms]

[Case 1]

NEW

Deficiencies were identified in the quality control environment at this audit firm, and numerous significant deficiencies were also identified in individual audit engagements subject to inspection.

The common causes of the deficiencies in individual audit engagements included: engagement partners and assistants to engagement partners did not sufficiently understand the level of procedures required under current audit standards, such as assessment and response to fraud risks and audit of accounting estimates; engagement partners did not perform in-depth reviews of audit documentation because they had too much trust in assistants to engagement partners and therefore believed that they were performing their duties appropriately; and the common causes of the deficiencies in the quality control environment were as follows: the CEO and the PICOQC did not perform a root cause analysis of deficiencies identified in quality control reviews and daily monitoring activities (including periodic inspections) in order to prevent similar deficiencies from occurring; they lacked awareness of the need to implement remedial measures; and they did not recognize that assistants to engagement partners lacked understanding of the level of procedures required under current audit standards.

Further consideration into the root cause discovered that the root cause lay in the operations management environment. Specifically, **the CEO and the PICOQC did not recognize the need to maintain and improve audit quality because they assumed that there were no audit quality issues based on the fact that no major deficiencies had been identified in past quality control reviews. They also did not demonstrate leadership in improving audit quality because they assumed that merely establishing a quality control environment as a formality would lead to improvements in audit quality**.

[Case 2]

Deficiencies were identified in the quality control system at this audit firm, and numerous significant deficiencies were also discovered with individual audit engagements.

The deficiencies in the individual audit engagements were due to a common cause of the engagement teams not sufficiently understanding the levels required by auditing standards pertaining to fraud risks and group audits. The common cause of the deficiencies in individual audit engagements lay in the quality control system in that the PICOQC did not sufficiently understand the level of quality control system demanded by the quality control standards and thus was not aware of the need to establish and administer a suitable quality control system, while the CEO believed that that the audit procedures to be implemented would be of a sufficient level if audit documentation systems, templates, etc., were suitably established and that issues could be addressed to a certain degree using quality control methods similar to those employed before the merger even though the office had expanded in scale because of the merger.

Further analysis of the root causes discovered that they lay in the operations management system. Specifically, they found that the CEO had not sufficiently understood the appropriate levels demanded of operations management and quality control systems in keeping with the office's expanded post-merger scale and that he lacked awareness of the need to rapidly institute organizational improvements in the operations management and quality control systems.

[Case 3]

Although the audit firm is small, its audit division has comprised two departments since its foundation, with audit engagements and financial and personnel affairs of each department independently managed. This has resulted in the development of an organizational culture that gives precedence to the independence of each department. Furthermore, only engagement partners work on a full-time basis, while all staff are certified public accountants and substantially all work part-time.

Under these circumstances, at the audit firm, multiple deficiencies, including significant ones, were identified with regard to the quality control system. In addition, many deficiencies, including significant ones, were identified with regard to individual audit engagements subject to inspection. The deficiencies in the individual audit engagements had common causes, including: a lack of understanding among engagement partners and staff of the level of audits required by the audit standards; a lack of professional skepticism, such as willingness to critically assess relevant assertions; lack of sense of belonging to the firm and of awareness of the need to maintain and improve the quality level of audits among part-time staff. The common causes of the deficiencies in the individual audit engagements are ascribable to the quality control system. For example, the CEO and the PICOQC did not sufficiently understand the depth and methods of analysis of causes necessary for preventing deficiencies similar to the ones detected in the QC review, etc. and placed too much trust in engagement partners and staff had sufficient capabilities given their extensive practical experiences.

Further analysis of root causes ascribed the above deficiencies to the operations management system. For example, the CEO and the PICOQC were not aware of a lack of understanding among all audit team members, including themselves, of the purposes of the current audit standards and of the levels of quality control and audit procedures required by the standards. In other example cases, the CEO and PICOQC assumed that there was no issue with the current organizational structure that had been maintained since the firm's foundation, since no serious deficiencies had been detected in past QC reviews, etc. As a result, they were not aware of the need to achieve integrated operations management, including integrating the two departments, or the need to develop an organized audit operational system, including employing more full-time staff.

As mentioned above, many of the root causes of deficiencies are ascribable to the operations management and quality control systems, and it is important to improve those environments in order to fundamentally remediate deficiencies.

Audit firms, large-sized ones in particular, are currently making efforts to establish and strengthen organizational operations in accordance with the Audit Firm Governance Code. They should give due consideration to the effectiveness of those efforts so that the efforts can contribute to ensuring and improving audit quality.

(3) Specific Examples of Root Causes

The following are specific examples of root causes identified in inspections, including those mentioned in 1. (2) Root Cause Analysis.

To remediate deficiencies, it will be necessary for audit firms to tackle fundamental issues that affect the firm as a whole, such as issues relating to its operations management system and to ensure and improve audit quality with reference to these examples.

[Large-sized audit firms]

While large-sized audit firms have established quality control system, there are issues with the effectiveness of their operation.

Since large-sized audit firms have several thousands of employees, they usually have multiple audit divisions, consisting of several hundreds of staff managed by a division manager, etc., and multiple offices, including some regional offices.

Under such circumstances, in order to improve the quality control level across the entire organization, it is necessary not only for firms to design the organization and procedures of a quality control system, but also for the management, including the CEO, to demonstrate strong leadership, and for each division to instill the improvement measures into the engagement teams. At large-sized audit firms, however, deficiencies such as lack of leadership, including with respect to the management's awareness of quality control, and issues with initiatives by divisions etc.

In recent years, large-sized audit firms, in a bid to address these deficiencies, have, under the leadership of the management, been taking steps to improve audit quality, with the measures being implemented by PICOQCs, quality control departments, etc. Furthermore, to ensure that these quality improvement initiatives are implemented on a sustained basis, they tend to be shifting responsibility for quality control from head-office quality control departments to divisions etc., which are closer to the audit frontline. As a result, divisions etc. are playing a greater role in voluntarily improving audit quality and penetrating a quality-oriented mindset among engagement team members.

However, as the management and the quality control departments, etc. give precedence to the independence of each business division with regard to efforts to improve audit quality, they are leaving those efforts entirely in the hands of individual business divisions or neglecting to ensure sufficient communication with the divisions. As a result, issues occurred, including an insufficient understanding of the actual situation of each business division and an inadequate verification as to whether improvement measures are being appropriately implemented. Therefore, the management and quality control departments etc. need to appropriately identify the efforts being made in each business division and sufficiently examine the extent to which improvement measures have taken hold and how effective they are.

The following are specific examples of root causes of deficiencies at large-sized audit firms identified so far through the CPAAOB’s inspections:

- The executive management team thought that the engagement partners would appropriately fulfill their own roles if the executive management team conveyed to the engagement partners the importance of being proactively involved in the audit engagements that they are in charge of and adjusted the operational workload of engagement partners. In addition, the executive management team thought thorough adherence to in-depth audit consideration and responses in particularly important areas would mean that audit teams would also respond appropriately in accordance with the degree of risk in other areas. Accordingly, the executive management team was unable to adequately confirm that measures to increase the sufficient and appropriate involvement of engagement partners in audit engagement that they are in charge of and improve audit quality among audit teams had taken hold. (With regard to root cause analysis regarding this example, also refer to [Large-sized audit firms] [Case 1] on p. 9)

NEW

- **The management executives were not sufficiently aware of the need to check whether the Quality Control Headquarters, which was leading the remedial measures based on the results of the root cause analysis on the deficiencies identified in the previous CPAAOB inspection, and the partners in charge of quality control at the Audit Division were closely cooperating with each other in order to ensure that the remedial measures were implemented in line with their original intent and purpose and that the remediation made at the audit site were effective**. As a result, the partners in charge of quality control at the Quality Control Headquarters and the partners in charge of quality control at the Audit Division were not sufficiently cooperating with each other, so the penetration and effectiveness of the quality control remedial measures could not be sufficiently verified.– (With regard to root cause analysis regarding this example, also refer to [Large-sized audit firms] [Case 2] on p. 10).
- The management executives believed that, by repeatedly communicating the importance of appropriately identifying material risks at audited companies and conducting risk-focused audits through messaging and training, the engagement team would appropriately understand the level of audit procedures required under the current audit standards and respond to them. Moreover, it assumed that communicating to engagement partners the importance of proactive involvement in the audit engagements that they are in charge of would induce them to appropriately perform their role. As a result, adequate verification was not conducted as to the extent to which quality control measures had taken hold and how effective they were. (With regard to root cause analysis regarding this example, also refer to [Large-sized audit firms] [Case 3] on p. 10).

NEW

- The management executives and the Quality Control Headquarters **believed that, if measures and monitoring were implemented to conduct specific and in-depth examinations of fraud techniques, etc. at each stage of sales transactions, measures to improve audit quality, including responses to fraud risk relating to revenue recognition, would permeate the audit frontline, and audit quality above a certain level would be secured for all engagement teams.** Therefore, they could not sufficiently verify the penetration and effectiveness of quality control measures.

NEW

- The management executives and the Quality Control Headquarters **believed that all engagement partners and assistants to engagement partners had a full understanding of the significance and importance of the CPA registration system, and that they appropriately confirmed and aggregated CPA qualifications and the number of CPAs and engagement hours for each qualification when listing CPA qualifications and the number of CPAs and engagement hours for each qualification in materials submitted outside the firm**.

[Mid-tier audit firms]

Mid-tier audit firms are proceeding with the development of the quality control system. However, generally speaking, the headquarters functions have not been sufficiently strengthened. Furthermore, top managements' awareness about quality control has not kept up with the pace of the firms' expanded operations. In addition, some firms are heavily dependent on part-time staff in the performance of audit engagements, while others are facing audit quality issues at particular regional offices. On the other hand, founding history, operations management systems and size of operations are different firm by firm, so the root causes of issues differ from firm to firm.
As a result, each firm needs to analyze root causes and accelerate effective improvements in considerations with trends of its own operations, their operations management system, and so on.

The following are specific examples of root causes of deficiencies at Mid-tier audit firms identified so far through the CPAAOB's inspections:

- With operations expanding, the CEO was unaware that the headquarter organization was unable to consider the adequacy of personnel allocation and lacked awareness of the need to verify the adequacy and effectiveness of the quality control system. For example, the CEO thought that the enhancement of the headquarter organization's functions and improvement of the quality control system would be carried out appropriately if left up to the right people in charge at headquarters. Moreover, the CEO and the people in charge at headquarters failed to develop an adequate system for verifying the status of efforts to ensure quality control measures take hold in audit fieldwork and their effectiveness, even though engagement partners lacked sufficient awareness of their own responsibility for carrying out operations and the skill level of audit teams as a whole had not been raised to an adequate degree. (With regard to root cause analysis regarding this example, also refer to [Mid-tier audit firms] [Case 1] on p. 11)
- Operations are performed independently at each regional office. Specifically, matters such as the organization of engagement teams, the determination of partners' compensation, periodic inspections, and engagement quality control reviews are determined and implemented under an independent operations management system at each regional office. Furthermore, exchange of partners and staff among different regional offices has been hardly made. Given this situation, the CEO recognizes the need for integrated business administration within the firm, and is taking steps to achieve this, such as strengthening headquarters functions. However, because the role of headquarters is not clearly prescribed in organizational rules etc., and there are no full-timers assigned to headquarters, the functions of headquarters has not been effective, so the steps being taken are inadequate to ensure integrated business administration. (With regard to root cause analysis regarding this example, also refer to [Mid-tier audit firms] [Case 2] on p.11)

- The CEO placed emphasis on the need to foster personnel responsible for maintaining and improving audit quality when planning and implementing measures to improve audit quality. Moreover, since becoming the representative of the audit firm, the CEO had refrained from exercising overly strong leadership and placed emphasis on the independence of activities of the quality control and audit divisions. As a result, there was a lack of awareness of the need to accelerate the improvements of quality management system.

  The executive management team assumed that cooperation between the quality control division and audit divisions would be ensured by sorting out and sharing issues through discussions at executive management meetings. Thus, the executive management and respected the independence of each division, in order to take steps to improve audit quality. As a result, there was lack of awareness of the need for strong cooperation between these two divisions. Furthermore, although the executive management team was aware of audit quality issues at some particular regional offices, it assumed that the regional offices would be able to make improvements on their own. As a result, there was a lack of awareness of the need to actively support regional offices, for example by allocating the human resources necessary for making improvements. (With regard to root cause analysis regarding this example, also refer to [Mid-tier audit firms] [Case 3] on p.12)

NEW
- The members of the Management Committee were convinced that the human and time resource issues had been resolved through such measures as changing the allocation of audit engagements to personnel, introducing monitoring of the percentage of engagement partners involved, and increasing the number of assistants to engagement partners. As a result, the PICOQC and the head of the audit business unit **did not recognize the need to verify the sufficiency of human and time resources for each audit engagement based on an accurate understanding of the situation on the audit frontline**.

NEW
- The members of the Management Committee and the PICOQC were not aware that the attitude of carefully examining whether or not there were fraud risks to be identified when performing individual audit engagements, the attitude of critically examining material assumptions, etc. adopted by management, and the attitude of the EQC reviewer and the monitoring partner, etc. to objectively evaluate the views of the engagement team had not improved since the previous CPAAOB inspection. **They were convinced that implementation of remedial measures in response to the results of the previous CPAAOB inspection would improve and enhance quality control at the firm as a whole, and lacked awareness of the need to understand and verify their effectiveness in detail**.

[Small and medium-sized audit firms]

Small and medium-sized audit firms come in various sizes and have different founding history, and levels of establishment and implementation of quality control system also differ from firm to firm. However, their organizations are relatively small, and they all face the difficulty of providing audit teams with organizational support in areas such as quality control. A key characteristic of the firm, therefore, is that business administration and quality control levels, in many cases, are highly dependent on the abilities of personnel that belong to the audit firm, including the CEOs, and the relationship between the personnel and the firm.

Because of this, low awareness of and involvement in quality control by the CEOs often affect the culture of quality control throughout the audit firms, so it is important for the CEOs to demonstrate leadership in quality control. One characteristic trend identified in recent inspections is that the CEOs and the PICOQCs were "not aware of a lack of understanding among all audit team members, including themselves, of the current audit standards and the levels of quality control and audit procedures required by the standards." Another is that the CEOs and the PICOQCs "did not sufficiently understand the depth and methods of analysis of causes necessary for preventing deficiencies similar to the ones detected in the QC reviews, etc."

The root causes of deficiencies identified in the CPAAOB's inspections of small and medium-sized audit firms can be broadly categorized into the following three types:

・Cases related to a lack of awareness about quality control among CEOs and PICOQCs.
・Cases ascribable to changes in audit firms' management environment, such as mergers etc.
・Cases ascribable to audit firms' organizational climate

(1) Cases related to a lack of awareness about quality control among CEOs and PICOQCs

NEW

- The CEO and the PICOQC **did not conduct a fundamental analysis of the causes of deficiencies based on the recognition that the deficiencies identified in past quality control reviews did not include significant matters. Instead, they were convinced that if internal rules and checklists for remedial measures were prepared and the contents of these checklists were communicated through training programs and general meetings, audit engagements would be conducted in accordance with these rules, and audit quality would improve accordingly**.
  Furthermore, the CEO and the PICOQC **did not exercise leadership in improving audit quality**. For example, they did not recognize the need to verify the implementation of remedial measures implemented by persons in charge of EQC reviews and periodic inspections. In addition, engagement partners did not recognize the need to confirm the implementation of remedial measures on the audit frontline on their own responsibility. **As a result, awareness of maintaining and improving audit quality throughout the firm was weak**.
  Furthermore, the CEO and PICOQC did not recognize that professional staff, including themselves, lacked an understanding of the level of procedures required by the current audit standards. (With regard to root cause analysis regarding this example, also refer to [Small and medium-sized audit firms] [Case 1] on p.12)
- The CEO lacked awareness to design, implement and maintain of quality control systems that emphasize audit quality. For example, when evaluating partners, the CEO did not put more emphasis

on the quality of audit engagements for which partners were responsible for an engagement partners than the number of companies for which partners were responsible as engagement partners or engagement quality control reviewers (EQCRs) were responsible or the number of companies newly accepted new audit contracts which partners got.

- NEW Each partner, including the CEO, did not take a stance of critically examining the quality of individual audit engagements performed by other partners, and thus lacked awareness of the need to improve and enhance audit quality at the firm as a whole. As a result, **when reviewing audit documentation, examining audit engagements, conducting periodic inspections, and implementing remedial measures for issues pointed out in quality control reviews, they did not adequately fulfill their responsibilities and roles as partners for improving and enhancing audit quality at the firm as a whole**.
- The CEO gave top priority to releasing unqualified opinions until the filing due dates of the audit reports and did not exercise due care as a professional specialist. He also did not recognize the need to fulfill the roles and responsibilities as an audit firm expected by society in providing assurance to the reliability of financial statements. Other engagement partners, including the PICOQC, shared the CEO's thoughts and failed to check other engagement partners, including the CEO.
- NEW Under these circumstances, each partner, including the CEO, **did not proactively engage in audit engagements when performing individual audit engagements, and professional staff, including the CEO, did not recognize the lack of understanding of audit standards and the level of procedures required under current audit standards**. As a result, there was a lack of awareness of the importance of audit quality.
- The CEO did not appropriately evaluate the quality of individual audit engagements and the professional skills of professional staff, even though the most recent quality control review had identified relevant significant deficiencies. He had partners with insufficient understanding and knowledge of the quality levels required under current audit standards serve as engagement partners or engagement quality control reviewers (EQCRs) of listed companies for many years, and had not established an effective quality control system.
- NEW The CEO and the PICOQC **were convinced that an understanding of the level of procedures required by the current audit standards was sufficiently widespread within the firm through the hiring of CPAs who had worked at large-sized audit firms and through the training that the audit firm required them to attend**. Furthermore, **the PICOQC believed that partners and employees would appropriately use tools for improving audit quality,** such as forms for audit documentation and "self-inspection checklists," **as long as these tools were provided, and that there was no need to directly check the use of these tools**. As a result, the PICOQC did not take an attitude toward maintaining and improving audit quality.
- The PICOQC is replaced every two years, but the current PICOQC believes that his main role is to continue conducting periodic inspections, as his/her predecessor did. He/she therefore lacks awareness of the need to proactively get involved in quality control as a whole. Because of this,

he/she is not properly fulfilling his/her role of managing quality control. For example, he/she is not providing adequate instructions to staff involved in quality control. Furthermore, even though the CEO has been aware of this situation with quality control, he/she has not attempted to establish a more effective quality control system.

(2) Cases ascribable to changes in audit firms' management environment, such as mergers etc.

- The CEO did not sufficiently understand the required levels of the operations management system and quality control system suited to the audit firm's expanded size after the merger and assumed that post-merger quality control at the audit firm could be handled to a certain degree using the management methods employed before the merger. Accordingly, the CEO lacked awareness of the need to take prompt action to develop organized operations management system and quality control system. (With regard to root cause analysis regarding this example, also refer to [Small and medium-sized audit firms] [Case 2] on p.13)
- The audit firm had gone through a merger in recent years, but despite the need to implement integrated corporate management in respect of such matters as personnel evaluations, compensation, and the organization of engagement teams, the CEO was not aware of the importance of completing this process without delay.
- As the audit firm increased its audit engagements of listed and other companies, the audit engagement risk had been rising. However, the CEO failed to exercise leadership as a quality control manager in developing a quality control system, as indicated by a lack of commitment to conduct appropriate risk assessment of continuous and newly contracted audited companies.
- The number of audit engagements had increased every fiscal year and new audit contracts had recently been concluded with high-risk listed companies. However, only a small number of partners are serving as full-time audit team members, and the audit firm was dependent on part-time staff as assistants to engagement partners. As a result, the partners were preoccupied with the audit engagements that they are in charge of and failed to sufficiently involve themselves in quality control operation.

(3) Cases ascribable to audit firms' organizational climate

- Although the audit firm is small, its audit division has comprised two departments since its foundation, with audit engagements and financial and personnel affairs of each department independently managed. This has resulted in the development of an organizational culture that gives precedence to the independence of each department. Furthermore, only engagement partners work on a full-time basis, while all staff are certified public accountants and substantially all work part-time.

  Under these circumstances, the CEO and the PICOQC were not aware of a lack of understanding among all audit team members, including themselves, of the purposes of the current audit standards and the levels of quality control and audit procedures required by the current audit standards.

Moreover, they assumed that there was no issue with the current organizational structure that had been maintained since the firm's foundation, since no serious deficiencies had been detected in past QC reviews, etc. As a result, they were not aware of the need to achieve integrated operations management, including integrating the two departments within the audit division, or the need to develop an organized operations management system, including employing more full-time staff. (With regard to root cause analysis regarding this example, also refer to [Small and medium-sized audit firms] [Case 3] on p.13)

- The audit firm was pursuing operational improvements after being issued with a Business Improvement Order (improvement of operations management system) by the FSA and receiving recommendations for improvements several times in QC reviews.
  Amid this situation, each partner at the audit firm had been engaged in non-audit services at their own private firms, etc. to a considerable degree and generally lacked awareness of the maintenance and improvement of audit quality at the firm. Accordingly, they were not aware of the aforementioned order or recommendations for improvements being problems relating to the fundamentals of operations management. Moreover, the CEO and PICOQC lacked the awareness to develop an environment that would enable the quality control system to function effectively. For example, they did not demonstrate leadership in respect of improving audit quality. Furthermore, each partner at the firm lacked awareness of their position as partners in regard to operations management. For example, they were not aware of the need to monitor the state of quality improvements in individual audit engagements in which they were not involved. Thus, an organizational culture conducive to the maintenance and improvement of audit quality, in which partners keep each other in check, had not been fostered at the audit firm and it did not have system in which audits could be carried out systematically.
- The CEO thought that as long as the CEO, the person responsible for EQCR, and the PICOQC considered important matters for discussion, there was no need to share information with other partners. As such, the CEO did not strive to foster an organizational culture conducive to the maintenance and improvement of audit quality based on collaborative efforts by the all partners, including them, and thus did not develop system in which audits could be carried out organizationally.
- Partners at the audit firm had spent many years working on audit engagements for a particular listed audited company. Amid this situation, they demonstrated a lack of commitment to carefully discerning audit risk in light of such matters as the nature of audited company and its environment.
- The audit firm, which comprises a small number of partners and their assistants who have little experience of audit engagement at other audit firms, has maintained the management environment that has continued since its foundation. For many years, the firm has mainly audited several listed companies, and as a result, the ratio of fees received from those audited listed companies to the firm's overall revenue (fee dependency) is high.

Under these circumstances, the CEO, who concurrently serves as PICOQC, had placed top priority on maintaining the relationships with audited companies that had continued since before the firm's foundation and assumed that there was no issue with the performed audits and the firm's management because no changes had been made to the composition of audited companies. In addition, the CEO/PICOQC was not aware of the need to place emphasis on audit quality and the required qualifications for certified public accountants, such as professional ethics and independence. He was also not aware of the need to develop organized operations management and quality control systems. Moreover, as the autocratic management of the firm by the CEO/PICOQC had become entrenched, other partners were not aware of the need to perform their duties.

- The audit firm comprises two audit departments, and each department's audit engagements, and financial and personnel affairs are managed independently by the representative partner, head of each department. The organizational climate, which prioritizes independence of each audit department, has been fostered, such that the representative partner of each audit department is in effect appointed by the previous representative partner. The audit firm has designated the CEO as the person with the ultimate responsibility for quality control, but the CEO has not set forth a policy for achieving integrated quality control or demonstrated sufficient leadership in establishing an effective headquarters organization.
- The audit firm was established by partners who were colleagues at a large-sized audit firm. As the audit firm is comprised of a small number of partners, the CEO and PICOQC have a grasp of the capabilities of individual partners and are assuming that the partners are exercising their capabilities. In addition, since no significant deficiency has been pointed out to the audit firm in quality control reviews so far conducted, perception of the CEO and PICOQC is that the necessary minimum quality control system appropriate to the size of the audit firm has been developed. Accordingly, they were not sufficiently aware of the need to develop an organized quality control system.
- NEW The partners and employees of the audit firm were extremely lacking in awareness of the importance of integrity and trustworthiness as professionals. As a result, **the audit firm conducted inappropriate response in all individual audit engagements subject to inspection by the CPAAOB. The partners and employees thus lacked awareness of the need to perform their duties in compliance with laws and regulations, ethical rules, internal rules, etc. As a result, the CEO was unable to develop an organizational culture that emphasizes compliance with professional ethics**.

2. Response to the Audit Firm Governance Code

In light of the socio-economic conditions surrounding accounting audits, the Act for Partial Amendment of the Certified Public Accountants Act and the Financial Instruments and Exchange Act was enacted and promulgated in May 2022. The act introduced a registration system for audit firms that audit listed companies in order to ensure the reliability of accounting audits and to contribute to the further demonstration and improvement of the capabilities of CPAs. The related government orders were promulgated in January 2023 and came into effect in April of the same year. As a result, audit firms that audit listed companies are obliged to establish a framework for conducting operations in accordance with the Audit Firm Governance Code and a framework for conducting enhanced information disclosure.

The Audit Firm Governance Code was established in 2017. Based on the above laws and regulations, the Expert Review Committee on the Audit Firm Governance Code held discussions and revised the Audit Firm Governance Code in March 2023 to require effective disciplines suited to the scales and natures of audit firms. The purpose of the revision was to: (I) encourage small and medium-sized audit firms that conduct audits of listed companies to make arrangements suited to their acceptance of the code and disclose information to the public; and (ii) enhance disclosure in response to the globalization of audit firms.

The Audit Firm Governance Code has been formulated with organizational business administration in mind at audit firms that conduct audits of listed companies, etc., but it does not preclude other audit firms from voluntarily applying it. On this basis, each audit firm is required to take an autonomous approach based on its size and characteristics to implement the Audit Firm Governance Code and achieve effective organizational management.

In addition, we have published information about responses based on the size of audit firms in the form of the "2023 Monitoring Report". Please also refer to this report.

3. Responses to the Revision of Quality Control Standards

The Business Accounting Council of Japan published an opinion letter on the revision of quality control standards for audits ("Quality Control Standards") (November 16, 2024). The opinion letter included the introduction of a quality management system (a management method in which audit firms: (I) set quality objectives; (ii) identify and assess quality risks that hinder the achievement of quality objectives; (iii) define and implement policies or procedures to address the assessed quality risks; and (iv) make remediations based on root cause analysis if there are deficiencies), based on the revisions of international quality control standards such as "International Quality Management Standard 1" (Quality Management at Audit Firms - ISQM1), "International Quality Management Standard 2" (ISQM2), and "Quality Control for Financial Statement Audits" (ISA220). The revised quality control standards are required to be implemented from the audits of financial statements for fiscal years or accounting periods starting on or after July 1, 2023 (for audit firms other than large-scale audit firms under the Certified Public Accountants Act, for fiscal years or accounting periods starting on or after July 1, 2021).

In February 2023, the JICPA published Quality Control Standards Statement No. 1, Practical Guidance No. 3 (Q & A on Quality Control at Audit Firms and Audit Engagements, and Reviews of Audit Engagements) and Quality Control Standards Statement No. 1, Practical Guidance No. 4 (Tools for

Quality Control at Audit Firms) as practical guidelines necessary for applying the revised quality control standards.

In addition, we have published information about responses based on the size of audit firms in the form of the "2023 Monitoring Report". Please also refer to this report.

II. Quality Control System

Implementation of Quality Control Operation

Outline

The CPAAOB inspects whether measures developed by audit firms to ensure adequate operations and maintenance/enhancement of the QC system are appropriate to the size and characteristics of the firm.

Responses to requirements for QC systems under the audit standards vary from large-sized audit firms with several thousand members to relatively small-sized audit firms. Furthermore, many deficiencies identified thus far reflect the size and characteristics of each audit firm, and the background to the deficiency as well. Therefore, in "II. Quality Control System", examples of deficiencies identified in the CPAAOB inspections are categorized into "Large-sized audit firms" and "Mid-tier, and small and medium-sized audit firms," and introduced basically according to the provisions of "Quality Control for Audit Firms" (Quality Control Standards Statement No. 1).

Note that the examples of identified deficiencies include ones that could occur at any audit firm regardless of its size. Therefore, when examining system of quality control in your firm, please also refer to examples of deficiencies in the categories other than your firm belongs.

Relationship between quality control system and individual audit engagements

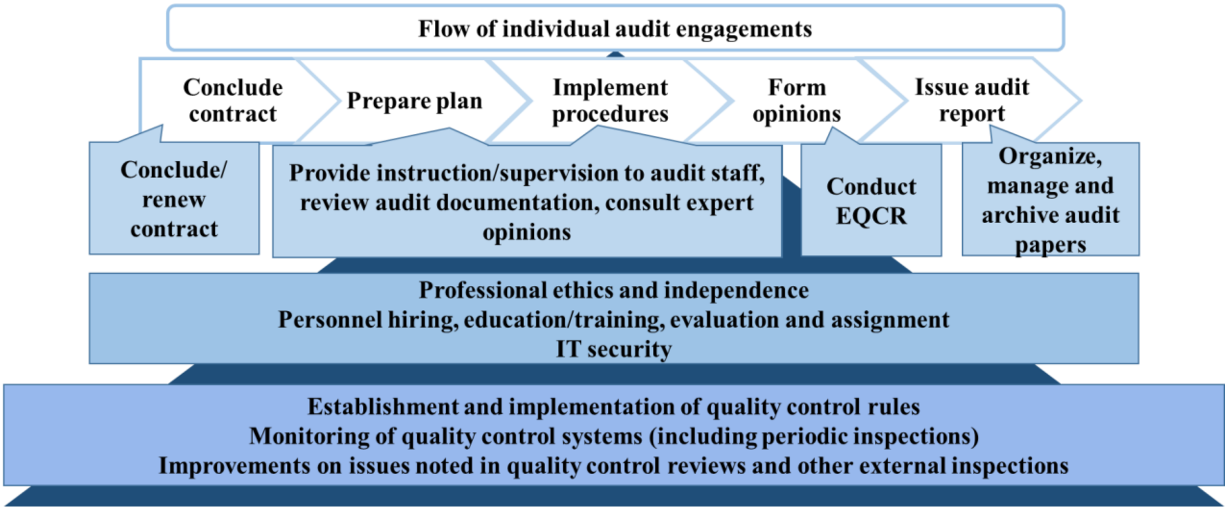
The Standard on Quality Control for Audits and Quality Control Standards Statements, etc. stipulate the quality control system required, and these have had a significant impact on the quality of individual audit engagements through the establishment and implementation of quality control system. The quality control system consists of elements pertaining to individual audit engagement processes and elements related to matters other than individual audit engagement processes.

The elements pertaining to individual audit engagement processes include assessments of contract risks, the supervision and review of audit documentation by engagement partners, the consultation of expert opinions, and EQCR, while among the elements not pertaining to individual audit engagement processes are professional ethics and independence and the hiring, education and training of human resources.

To ensure these systems function properly, audit firms establish and implement rules on quality control and monitor quality control systems (including periodic inspections), and make improvements regarding issues noted in quality control reviews and other external inspections.

The quality of individual audit engagements can be reasonably ensured when the aforementioned quality control system functions comprehensively and effectively in accordance with the scale and characteristics of each audit firm (see [Figure 2]).

[Figure 2] Reference Image: Relationship between Quality Control System and Individual Audit Engagements



Analysis of deficiencies that occurred

Regardless of the size of an audit firm, the purpose of establishing and implementing a QC system is that an audit firm reasonably ensures the quality of audit engagements as an organization.

However, some audit firms developed a QC system only as a formality. In such cases, the QC system is not implemented appropriately and does not work together organically for the improvement of individual audit engagements. Because of this, many cases where the QC system does not work as expected and causes deficiencies are identified.

At large-sized audit firms, although deficiencies related to the design of a QC system have seldom been identified in recent years, there are still many deficiencies in individual audit engagements. Therefore, it can be assumed that there are deficiencies in the operation of the QC system. Specifically, operation-related deficiencies have been identified in areas such as reviews of audit work papers, engagement quality control reviews and periodic inspections.

Furthermore, with regard to deficiencies in individual audit engagements that were identified by the CPAAOB inspections and quality control reviews in the past, adequate verification was not conducted as to whether improvement measures had taken hold and how effective they were. As a result, the same or similar deficiencies have been identified in other individual audit engagements. In such cases, it may be deemed that efforts to improve quality control operations are insufficient.

For example, there are cases in which deficiencies still have been identified in divisions, engagement teams, etc., because these divisions, engagement teams, etc., do not adequately understand, and hence do not sufficiently disseminate the purposes of measures formulated to improve deficiencies, resulting in that the anticipated effects of the improvement measures are not realized.

At Mid-tier audit firms and small and medium-sized audit firms, deficiencies have been identified in a broad range of areas in terms of both the establishment and implementation of the quality control system. In addition, same as at large-sized audit firms, inspections of individual audit engagements found cases where deficiencies, which had been identified in the past by the CPAAOB inspections and quality control reviews, etc., were not appropriately remediated. In many of those cases, the deficiencies were deemed to be attributable to the quality control system. Specifically, there were many cases where the quality control system was not appropriately established or implemented due to lack of awareness and knowledge of quality control operations on the part of the CEOs and the PICOQCs or where the CEOs and the PICOQCs did not sufficiently understand the level and method of in-depth analysis of causes necessary for preventing deficiencies similar to the ones identified in the quality control reviews, etc. There were also cases where deficiencies occurred because of a failure to allocate sufficient business resources to the establishment and implementation of the quality control system, which directly affects audit quality, or where the PICOQCs were not aware of the need to verify the effectiveness of quality control measures due to the assumption that partners would appropriately handle matters of quality control if informed of the need for the abovementioned activities through training, etc.

One cause of deficiencies that is unique to Mid-tier audit firms is the failure to strengthen the headquarters functions or otherwise improve quality control system functions sufficiently to suit the expansion of the size of the firms through merger or acceptance of new audit engagements. For example, there were cases in which, although persons in charge of each of the functions of the quality control system, including the EQC reviews and education/training, were appointed, they could not identify and remediate the deficiencies that are inherent in quality control operations and individual audit engagements due to a lack of sufficient manpower assigned to individual offices of the headquarters.

(Observed effective efforts)

There were cases such as the following of effective efforts having been made to strengthen the quality control of the firm as a whole:

In the area of quality control operations, a council has been established to identify the issues to be considered and integrate the administration of regional offices. This council comprises members of the quality control division at the headquarters as well as members from across the entire audit firm, including partners, managers, and senior staff involved in quality control at regional offices. Furthermore, the results of its consideration are shared with the board and partners meetings at regional offices to ensure that there is no variation in the responses over the regional offices.

Note that when such efforts are made, it is essential to pay adequate attention to their effectiveness, so it is important for the CEO and the PICOQC to actively commit.

<u>Expected response</u>

Based on the adequate awareness of the primary purpose of a quality control system, which is to reasonably ensure the quality of audit engagements, all audit firms are required to establish and implement such system effectively and efficiently, depending on the size and characteristics of each audit firm, so that the QC system can effectively work in individual audit engagements. Specifically, **<u>the CEO and PICOQC of audit firms</u>**

<u>should aware the purpose and importance of the quality control system, take the initiative in ensuring that whole personnel in a firm understand the primary purpose of the QC system, disseminate measures to improve the quality of audit throughout the entire organization, and verify their effects at all times</u>.

Note that the content and scope of quality control policies and procedures stipulated by an audit firm are affected by various factors, such as the size and composition of personnel at the firm, the characteristics of the management of organization, and whether the firm belongs to a global network. In light of this, the CEO and PICOQC of audit firms should establish appropriate QC system according to the size and characteristics of their firm and appropriately maintain the system by revising it as needed.

(Reference)

Main provisions serving as the basis grounds for deficiencies identified in quality control operation and relevant points to be noted are as follows.

Item	Main provisions that serve as the basis for the Identification	Relevant Points to Note
1. Initiatives to Improve Operation	Quality Control Standards Statement No. 1 paragraphs 15, 16, 31	➢ With regard to deficiencies pointed out in inspections, whether improvements are made only as a formality, for example, by merely announcing the matters to be improved and using improvement checklists. ➢ In cases where an improvement checklist, etc. is used, whether the status of improvement is checked in light of the purpose of the identifications.
2.Establishment/Implementation of Internal Rules and Compliance with Laws, Regulations, and Professional Standards	Quality Control Standards Statement No. 1 paragraphs 15, 16, 17, 18	➢ Whether the audit firm periodically checks whether there are any discrepancies between the internal rules it developed and their actual implementation. ➢ Whether the audit firm has developed a control system for appropriately recording and managing actual working hours of partners and employees. ➢ Whether the audit firm has established

Item	Main provisions that serve as the basis for the Identification	Relevant Points to Note
		security rules necessary for the use of Internet server services in the course of business, and whether it has considered security measures.
3. Professional Ethics and Independence	Quality Control Standards Statement No. 1 paragraphs 20, 21, 23, 24	➢ Whether the audit firm obtains confirmation letters concerning independence from all target persons at least once a year. ➢ Whether the audit firm conducts independence confirmation procedures when accepting or continuing audit engagements. ➢ Whether the audit firm has developed and implemented a control system for gathering information necessary for the independence confirmation procedures, such as a list of audited companies, in a timely and accurate manner. ➢ Whether the audit firm has established a policy and specific procedures concerning compliance with professional ethics, such as dependence on remuneration, restrictions on employment, confidentiality, and gift-giving and entertainment, and informed them to professional staff. ➢ Whether the audit firm has specified persons subject to rotation and has established criteria requiring safeguards to remove any factor that would hinder independence.
4. Acceptance and Continuance of Engagements	Quality Control Standards Statement No. 1 paragraphs 25, 26	➢ Whether specific procedures for evaluating contract risks have been established, and whether approval by the

Item	Main provisions that serve as the basis for the Identification	Relevant Points to Note
	Auditing Standards Statement No. 900 Paragraphs 9, 13	audit firm is made in a timely and appropriate manner. ➢ Whether the identified engagement risks have been appropriately reflected in the audit plans for individual audit engagements. ➢ Whether the audit firm has sufficiently examined whether or not it has the aptitude, ability and human resources to perform the newly accepted engagement. ➢ Whether the predecessor auditor provides information including information and circumstances relating to material misstatements in the financial statements in good faith and clearly in response to inquiries from the prospective auditor. ➢ Whether the prospective auditor makes inquiries of the predecessor auditor on matters required under auditing standards in order to determine whether or not to accept the engagement.
5. Recruitment, Education and Training; Evaluation and Assignment	Quality Control Standards Statement No. 1 paragraphs 28, F28-2, 29, 30	➢ Whether the audit firm continually provides education and training aimed at improving its audit quality control capabilities, and provides follow-up to personnel who have not completed the mandatory training. ➢ Whether the audit firm has established policies and procedures to fairly evaluate the competence (especially competence related to quality control) of professional staff and their compliance with professional ethics with regard to evaluation, remuneration and promotion,

Item	Main provisions that serve as the basis for the Identification	Relevant Points to Note
		and whether these policies and procedures are properly implemented. ➢ Whether, when assigning professional staff, the audit firm sufficiently evaluates the time, practical experience, and capabilities, etc. that each professional staff, including the engagement partner, can secure to perform their duties.
6. Audit Documentation	Quality Control Standards Statement No. 1 paragraphs 31, 44 Auditing Standards Statement No. 220 Paragraphs 14, 15, 16	➢ Whether the engagement partner reviews the audit documentation and holds discussions with the engagement team to confirm that sufficient appropriate audit evidence has been obtained to support the conclusions and audit opinion. ➢ Whether the audit firm has appropriately developed policies and procedures for the final assembly of the audit file, and ensures that the final assembly of the audit file is completed by the deadline. ➢ Whether the audit firm has adequate policies and procedures in place to ensure the confidentiality, safe custody, integrity, accessibility, and retrievability of audit documentation.
7. Engagement Quality Control Review	Quality Control Standards Statement No. 1 paragraphs 36, 37, 38	➢ Whether a person with the necessary experience and skills, etc. and who maintains objectivity and independence has been appointed as the EQC reviewer. ➢ Whether the EQC reviewer examines, based on the audit documentation, whether the evaluation of independence, the necessity of consultation with experts and the conclusion reached, and the significant judgments made by the

Item	Main provisions that serve as the basis for the Identification	Relevant Points to Note
		engagement team are supported by sufficient appropriate audit evidence.
8. Monitoring the Firm's Quality Control System	Quality Control Standards Statement No. 1 paragraph 47, 48, 49, 50	➢ Whether the audit firm appropriately grasps the status of establishment and implementation operation of the quality control system, and has established an inspection system to identify deficiencies. ➢ Whether the audit firm has had the person in charge of periodic inspection conduct an in-depth inspection of whether the audit evidence is sufficient and appropriate, by making inquiries of the professional staff and inspecting the audit documentation. ➢ Whether the audit firm evaluates the impact of deficiencies identified through ongoing monitoring and periodic inspections, instructs the relevant manager (s) to implement corrective measures, and checks the appropriateness of the measures.
9. Cooperation with Company Auditors	Auditing Standards Statement No. 260 Paragraphs 13, 14, 15, 16, 22	➢ Whether the engagement team clearly communicates with the company auditors, etc. about the auditor's responsibilities related to the audit, an overview of the scope and timing of the planned audit including the nature and the reasons of identified significant risks. ➢ Whether the engagement team provides audited companies with appropriate written explanations about the results of the CPAAOB inspections and quality control reviews. ➢ Whether important audit findings are

Item	Main provisions that serve as the basis for the Identification	Relevant Points to Note
		communicated to company auditors in a timely manner.

[Large-sized Audit Firms]

1. Efforts to Improve Operation

Points of focus

Although large-sized audit firms have established QC systems as a formality, it is assumed that there are certain deficiencies in the effectiveness of quality control, including the implementation of the system. Therefore, the CPAAOB inspects, in particular, whether the firm is making effective efforts to improve its operations, instead of those merely as a formality, against deficiencies identified in the previous CPAAOB inspection or QC review.

Specifically, the CPAAOB verifies the effectiveness of the firm's improvement efforts by checking the status of cause analysis of the deficiencies identified in the past and the status of the implementation of remediation based on it, and by examining individual audit engagements. In the case where issues are identified in the measures to improve operations, the CPAAOB examines the effectiveness of the remediation measures carried out by the firm through the process such as examining problems on the operation management system that are supposed to be the cause of issues.

Outline of inspection results

At large-sized audit firms, there are cases where remediation measures for deficiencies identified in the CPAAOB inspections and QC reviews are planned under the initiative of the QC division at the headquarters, and disseminate them to engagement teams through training and notifications so that each engagement team takes measures such as revising its actual audit procedures based on the risks of each audited company. Also, efforts under which main roles of quality control were relocated from the head office to audit service divisions closer to the audit frontline to further instill improvement measures are observed.

However, the CPAAOB inspection identified that organizational improvement measures were not necessarily sufficient at different levels within the firm, including divisions and partners. For example, cases in which cooperation between the head office and divisions was inadequate or in which efforts to make operational improvements had not sufficiently taken hold at divisions and regional offices where staff assignment is not flexible due to a lack of exchange of personnel with other divisions, etc.

Furthermore, cases in which there were lacks of organizational support from the head office and audit service divisions concerning the response to the important audit areas where no significant change had occurred, were identified.

Expected response

Large-sized audit firms employ several thousands of personnel and have multiple offices, including regional offices. Therefore, they usually have multiple departments, each consisting of several hundreds of personnel and managed by a department head etc. Therefore, **in order to disseminate improvement measures planned by headquarters to the entire organization and achieve sufficient effects as a response intended to improve operation,** it is deemed **that the entire firm, which means not only limited divisions such as the quality control division but also whole personnel including division heads etc., should understand the importance of quality control management and collaborate** so that expected effects can be achieved.

The CEOs in particular should take the initiative in encouraging all members, especially the engagement partners, who are in a position to lead the engagement teams, to improve operations, so that the intent of the improvement permeates the entire organization. Thereupon, the PICOQCs are required to plan and implement the timely and appropriate measures under the instructions of the CEO, while division heads are not required to only improve operations by themselves but to provide appropriate instructions and urge professional staff under their management to make appropriate responses.

Furthermore, the CEOs and PICOQCs, together with department heads, etc., **should establish an effective system to monitor improvement and promptly take appropriate remedial actions in case a problem related to the status of dissemination or effectiveness of improvement measures has been recognized as a result of verification**.

In carrying out measures to improve operations at large-sized audit firms, close attention should be paid so that the measures are not superficial, such as giving uniform instructions for remediating deficiencies throughout the entire firms. For this purpose, it is important to carry out moderated and effective measures, such as fully analyzing the tendency and causes of the identified deficiencies to specify the target areas for operational improvement (for example, certain departments and subordinate offices, audit items such as accounting estimates and response to fraud, and IPO-related audits), and focusing on effective improvement measures that suit such target areas.

Case 1: Verification of the status of improvement

NEW

①In order to improve the deficiencies identified in the previous CPAAOB inspection, the audit firm implemented measures such as familiarization training for partners and professional staff. In addition, through training for monitoring personnel, the audit firm worked to ensure thorough monitoring by communicating points to be noted for each of the major items subject to monitoring. However, the Quality Control Headquarters did not fully explain the information related to audit risks identified when selecting audit engagements to be monitored to some of the persons in charge

of monitoring, and did not examine in detail the reports from some of the persons in charge of monitoring. As a result, **the situation where the engagement team did not appropriately performed audit procedures was not adequately identified during the monitoring process**.
(Quality Control Standards Statement No. 1, paragraphs 15 and 16)

②Based on the results of past external inspections, the audit firm provided training to raise awareness of these results, and each department involved in quality control at the head office strengthened their efforts to accurately identify important audit areas and have engagement teams perform audit procedures with a focus on these areas.
However, with regard to responses to fraud risks and accounting estimates, **there was a lack of efforts to have engagement partners review, instruct and supervise thoroughly so that insufficient performance of procedures caused by lack of understanding of the level of audit procedures required under current auditing standards would not occur**.
(Quality Control Standards Statement No. 1, paragraphs 15 and 16)

Case 2: Collection of audit risk information

Quality control division is collecting information on responses to audit risks in individual audit engagements by sending a questionnaire concerning audit risks pertaining to audited companies to engagement teams. It is also encouraging improvements in responses to risks by providing engagement teams with instructions as necessary based on the information it has collected.
However, in effect, such collection is conducted as collecting same information throughout all audit engagements regardless of the degree of audit risk. Consequently, information corresponding to risks is not being collected.
(Quality Control Standards Statement No. 1, paragraphs 15 and 16)

2. Operation of the Quality Control System

Points of focus

At large-sized audit firms, although deficiencies related to the design of a QC system have seldom been identified in recent years, there are still deficiencies identified in individual audit engagements. The CPAAOB believes that, although the form (structure and procedures) of QC system is developed, there are deficiencies in the effectiveness of QC system including its implementation.

Therefore, the CPAAOB examines the existence of operational deficiencies of the QC system related to individual audit engagements from the perspective of whether the QC system that the audit firms established and implemented has failed to lead to ensuring and improving the audit quality that each engagement team implements, resulting in the failure to detect and prevent audit deficiencies.

Change of auditors at listed companies has been increasing in recent years. Also, as the number of companies aiming for IPO is trending upward, the number of new audit contracts pursuant to Article 193-2-1 of the Financial Instruments and Exchange Act is rising. In concluding new audit contracts with large companies, including listed ones, and new audit contracts pursuant to Article 193-2-1 of the Financial Instruments and Exchange Act, sufficient consideration should be given to the time for auditing, audit teams' human resources, the level of audit fees, etc., in order to rationally ensure audit quality.

Therefore, the CPAAOB inspects noting that whether audit firms sufficiently consider the time for auditing ,manpower and the level of audit fees with the viewpoint that verifies reasonableness of the evaluation of risks from the conclusion and renewal of audit contracts (below, "engagement undertaking risk") as well as the audit quality .

Outline of inspection results

In terms of the operation of QC systems, the CPAAOB has identified many deficiencies in areas such as reviews of audit work papers, EQC reviews and periodic inspections. Specifically, there were many cases where the engagement partners or equivalent who review audit work papers, the EQC reviewer and the persons in charge of periodic inspections had not fully understood the changes in the environment surrounding audited companies, the existing condition of the audited companies, or the audit procedures performed by the engagement teams, and failed to detect the deficiencies of individual audit engagements.

The CPAAOB has pointed out as the causes of such deficiencies that, although there were differences in awareness of audit quality and abilities of quality control among partners such as engagement partners and EQC reviewers, the QC department could not fully understand the differences and assign the appropriate engagement partners and EQC reviewers, and, in addition, the engagement teams did not proactively consider how to ensure audit quality as they relied on manuals and the headquarters' instructions.

(Observed effective efforts)

There were cases such as the following of effective efforts having been made:

The QC partners in the audit division confirm the views of the EQC reviewers concerning risks of material misstatement with audit engagements identified during the course of audit by engagement partners, and inform quality control review headquarters of areas deemed to be high risk. Furthermore, quality control review headquarters examines audit teams' responses to risks, and demands that audit teams undergo headquarters quality control reviews as necessary. Because this process is performed twice a year on a continuous basis, quality control review headquarters is able to act promptly in addressing high-risk areas in listed-company audit engagements.

Expected response

Engagement partners should understand that they are responsible for instructing and supervising engagement team members, considering their competency and experience, and leading them to conduct audit engagements sufficiently and appropriately, and should proactively engage in every phase from audit planning through the forming of opinions. Specifically, in the process of performing audits, they should understand the progress of audits and important matters through the review of audit work papers and discussions within the audit team. It is also necessary to form opinions at the final stage of the audit based on the audit evidence described in audit work papers.

Furthermore, **EQC reviewers** should confirm that audit engagements have been conducted sufficiently and appropriately**, for example, by evaluating audit procedures and audit evidence described in the audit documentation related to significant matters to ascertain that there were no issues in the process of forming audit opinion**.

The CEO and PICOQC should then establish the system which enables the engagement partners conducting reviews and EQC reviewers to carry out their roles appropriately.

Specifically, audit firms should assign appropriate engagement partners and EQC reviewers, considering each partner's awareness of required audit quality, abilities in QC and audit risk based on the audited company's business environment. In addition, for example, if a deficiency in operational improvements caused by an engagement partner has been detected, it would be adequate that the entire audit firm re-evaluates the ability in QC of the engagement partners and appropriately allocate them based on their ability and provide re-training to them.

Large-sized audit firms utilize contents such as electronic audit documentation systems, in which audit procedures are described, and checklists that are used in EQC reviews and periodic inspections in order to perform audits and related operations effectively and efficiently. In addition, they have established consultation and council systems at the headquarters, where difficult audit issues are discussed and advice or solutions are provided. While such a system is useful in maintaining audit quality at a certain level throughout the audit firm, it might lower the awareness of engagement teams to proactively consider audit quality.

The CEO and engagement teams, including engagement partners, should endeavor to appropriately

conduct audit engagements by fully understanding the benefits and limits of a system such as the above.

Case 1: Supervision of audit engagements and review of audit work papers

①The engagement partners were convinced that there was no issue with adopting the same audit responses as the previous fiscal year because there had been no significant changes in conditions at the audited company and that audit staff had been suitably performing procedures, so the partners did not provide instructions/supervision to audit staff to ensure that the audit procedures were properly performed and relating to the audit procedures performed by audit staff, they did not appropriately review the audit work papers from the viewpoint that whether audit staff had obtained sufficient and appropriate audit evidence according to the identified risks.
(Quality Control Standards Statement No. 1, paragraph 31; Auditing Standards Statement No. 220, paragraphs 14, 15 and 16)

②In an audit area where the engagement partners deemed the risk to be relatively low, based on their understanding of the company and business environment and their past audit experience, and in an audit area where the engagement partners were convinced from prior discussions, etc. with the audited company that there were no accounting issues, they thought that they should only confirm the correspondence between their assumption and the conclusion written in the audit work paper. Also, they trusted their audit staff excessively. Because of these issues, the engagement partners did not provide appropriate instructions/supervision and did not conduct reviews appropriately.
(Quality Control Standards Statement No. 1, paragraph 31; Auditing Standards Statement No. 220, paragraphs 14, 15, and16)

《Points to Note》

To suitably perform audit engagements within a limited time frame such as that for year-end audits, engagement partners are required to provide concrete instructions to the audit staff and supervise their performance appropriately.
The content, timing and scope of the audit work papers to be reviewed should also be suitably planned so that engagement partners, etc., appropriately review the audit work papers.

Case 2: Ensuring effective EQC review

①**As EQC reviewers focused mainly on checking information described in review documents prepared by engagement teams, they lacked awareness of the need to conduct a review based on audit documentation as to whether those teams planned and performed appropriate risk assessment procedures according to risks**.
As a result, EQC reviewers failed to point out deficiencies concerning procedures related to response to fraud risks in their reviews.
(Quality Control Standards Statement No. 1, paragraphs 36, 37, and A41; Auditing Standards

Statement No. 220, paragraphs 19 and 20)

NEW

②**The Quality Control headquarters did not re-examine the eligibility of the EQC reviewer according to the risks of audit engagements in which material risk information was newly identified in the middle of the fiscal year**.

(Quality Control Standards Statement No. 1, Paragraph 38)

Case 3: Effectiveness of periodic inspections

Although persons in charge for periodic inspections **confirmed the existence of audit work papers corresponding to a checklist, they lacked awareness of the need to conduct in-depth reviews concerning the adequacy of further audit procedures performed by engagement teams**. Because of this, they failed to conduct effective inspections. For example, deficiencies concerning accounting estimates and related-party transactions were not discovered.

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

《Points to Note》

It must be noted that, as with reviews conducted within the engagement team, it is necessary in EQC reviews and periodic inspections to assess whether the explanations offered by the engagement team are sufficiently and properly supported by audit evidence not only through oral communications but also through examining audit documentation.

It should also be noted that with regard to audit firms positioning the global review as the center of periodic inspection, whether the global review conducts inspections that correspond to requirements under audit standards in Japan should be ascertained, and if it is suspected that the global review does not, it should be ascertained whether it is necessary to take some kind of supplementary measures.

NEW

Case 4: Misstatements concerning qualifications as a certified public accountant in materials submitted outside of the firm;

The audit firm submitted to some audited companies audit contracts, audit plan statements, and audit results statements containing misstatements describing that persons who were not registered as CPAs engaged in audits of the audited companies were not registered as CPAs were not registered as CPAs were not registered as CPAs were not registered as CPAs as CPAs.

In addition, **the audit firm submitted an audit summary to the Director-General of the competent Local Finance Bureau containing an excessive number of CPAs or engagement hours**.

Furthermore, the audit firm provided incorrect information to an audited company concerning the number of CPAs that should be included in the "Composition of assistants to engagement partners" column of the securities report, and as a result, **the audited company overstated the number of CPAs in the securities report**.

(Quality Control Standards Statement No. 1, Paragraph 15; Auditing Standards Statement No. 220, Paragraph 7; Article 5, Paragraph 1 of the Cabinet Office Ordinance on Audit Certification of Financial Statements, etc.)

Case 5: Communication with company auditors, etc.

A component auditor of an audited company who belongs to the same network as the audit firm provided audit and non-audit services to the component of the audited company.

However, the audit staff lacked understanding of the audit standards, while engagement partners did not sufficiently review the summary report of the audit results submitted to the Audit & Supervisory Board. As a result, information on fees related to those services was not provided in writing to the audited company's Audit & Supervisory Board Members.

(Auditing Standards Statement No. 260, paragraphs 15 and 18)

《Points to Note》

It should be noted that when the audited company is a listed company, the engagement team and the network firm should make written communication with company auditors, etc. as to compliance with professional ethics rules regarding independence.

[Mid-tier Audit Firms and Small and Medium-sized Audit Firms]

1. Efforts to Improve Operation

Points of Focus

The CPAAOB performs inspections based on QC review reports, in principle. The CPAAOB inspection focuses on the status of improvement of deficiencies identified in the previous CPAAOB inspection or QC review. Specifically, the CPAAOB ascertains the status of cause analysis of past identified deficiencies as well as the status of measures to improve operations, such as those based on the cause analysis, and also ascertains the effectiveness of operational improvement of the audit firm through inspections of individual audit engagements. Furthermore, in the case where measures to improve operations are deemed problematic, the CPAAOB seeks to identify the operations management system issues that might be the cause of such insufficiency.

Outline of inspection results

As shown in the case example section below, at some audit firms, initiatives to improve the deficiencies identified in the QC review were not fully implemented, and over multiple deficiencies, improvement measures were not implemented or insufficient.

Possible causes of the above deem to be as follows:

- Although the PICOQC, etc., recognized the need to analyze the underlying causes for the items noted in the recommendations for improvements, he went no further than analyzing the direct specific causes, and did not sufficiently understand the necessity of, or the analysis methods for, analyzing the root causes to be found in the quality control and operations management systems;
- The audit firm lacked the attitude of seeking improvement throughout all audit engagements;
- The audit firm had not established system to effectively monitor the improvement of deficiencies; and
- The divisions had insufficient manpower to implement improvement measures correspond to the size of the audit firm.

Furthermore, in many cases, engagement partners responsible for reviewing audit documentation, EQC reviewers, and persons in charge of periodic inspections completed their work by superficially reviewing audit documentation and filling out checklists as a matter of formality because they did not sufficiently understand the purpose of their own tasks. In addition, the audit firm left the acquisition of audit engagement knowledge to the discretion of audit team members themselves instead of proactively maintaining and improving the aptitude and capabilities of the staff. Therefore, engagement teams did not sufficiently understand the audit standards and matters required by the standards, including Auditing Standards and the Auditing Standards Statement. As a result, in many cases, the same or similar deficiencies that were inherent in individual audit engagements were not identified, nor were operational improvements made in other engagements.

(Observed effective efforts)

The following effective efforts were observed at an audit firm where many deficiencies were identified in the QC review:

- The CEO directly ascertained the improvement of deficiencies in all audit engagements;
- The partners belonging to quality control department carried out monitoring of audit documentation before expressing audit opinion.
- A system that enables an early detection of audit issues was established, such as the implementation of a preliminary EQC review system;
- The identified deficiencies were understood and the improvement measures were disseminated through discussions in each engagement team; and
- A system under which an expert committee was set up for each discussion point, the members (inclusive of assistants to engagement partners) analyzed causes and discussed improvement measures, and conclusion was a provided to the firm's quality control division, was constructed.

Expected response

Audit firms must fully understand to what range and nature a deficiency should be improved, considering the reason why it was identified as a problem in the CPAAOB inspection or the QC review. Based on these understandings, audit firms should develop and implement appropriate improvement measures for the identified deficiency. **At the development stage of improvement measures, it is important that improvements of the identified deficiency are not developed as a mere formality, but that the root cause of the deficiency is analyzed before effective improvement measures are formulated to resolve the cause. At the implementation stage of the improvement measures, it is important that the contents of the measures are correctly understood throughout the organization. Audit firms should not only examine the individual audit engagement where the deficiency was identified, but also check whether other individual audit engagements had the same or similar situations as the identified deficiency, and fully examine whether the improvement measures developed have been properly implemented**. Thus, the firm must take measures to improve all audit engagements undertaken by the firm.

Case 1: Establishment and implementation of specific procedures for improvement

NEW

①The audit firm attributed the deficiencies identified in the quality control review to a) insufficient understanding of audit standards, b) insufficient understanding of the level required by audit standards, and c) lack of professional skepticism.

However, the audit firm **did not perform an analysis of the root causes** of a) to c).

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

②The audit firm's quality control rules do not prescribe the quality control committee's role regarding response to the matters identified in global reviews. As a result, the PICOQC assumed that it was not his/her own responsibility to respond to them, and therefore he/she did not consider what course of action to take.

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

③With regard to the root causes of the deficiencies identified in the CPAAOB inspection, the audit firm recognized engagement partners' insufficient involvement in audit work and implemented improvement measures in which engagement partners take the initiative in identifying and assessing audit risks. Moreover, the quality control division checked through periodic inspection how much the improvement measures had taken hold. In addition, the CEO continuously communicated the importance of engagement partners' involvement through communication with staff members.

However, due to a shortage of the manpower at the quality control division necessary for continuing those improvement measures and ensuring that they take hold, corrective actions taken in relation to the deficiencies identified were insufficient. Moreover, as engagement partners placed excessive trust in the formats of audit documentation revised in response to quality control reviews, awareness about the need for engagement partners' involvement in audit work did not sufficiently improve.

(Quality Control Standards Statement No. 1, paragraphs 31, A30, and A31; Auditing Standards Statement No. 220, paragraphs 14, 15, and 16)

Case 2: Dissemination of specific policies and procedures for improvement

The PICOQC fails to disseminate specific policies and procedures for improvement thoroughly. For example, the PICOQC included deficiencies identified in the QC review and improvement plans in the checklist designed for periodic inspection. However, the PICOQC did not explain to other members in the firm the reasons of the deficiencies and the purpose of the improvement plans. For part-time professional staff, only a postal mail describing the deficiencies was sent.

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

Case 3: Verification of improvement

①Ahead of a merger, the audit firm with the aim of finding out about the audit quality control system employed by the audit firm to be merged with, held meetings with the PIOCQC of that firm, reviewed the results of inspections by the CPAAOB, and so on.

However, while the PICOQC was aware that the audit firm to be merged with had had numerous deficiencies pointed out during CPAAOB inspections etc., he/she did not adequately assess whether the quality level of the firm was acceptable. For example, he/she did not specifically understand and analyze the nature and causes of the deficiencies.

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

②The audit firm prepared a checklist of improvements recommended in QC reviews , had the engagement teams perform self-inspections using the checklist in respect of audit engagements targeted for inspection in QC reviews, and had the EQCRs check the self-inspections afterwards. The firm also instructed the engagement teams to bear in mind the recommended improvements when performing audit engagements not targeted for inspection in QC reviews.

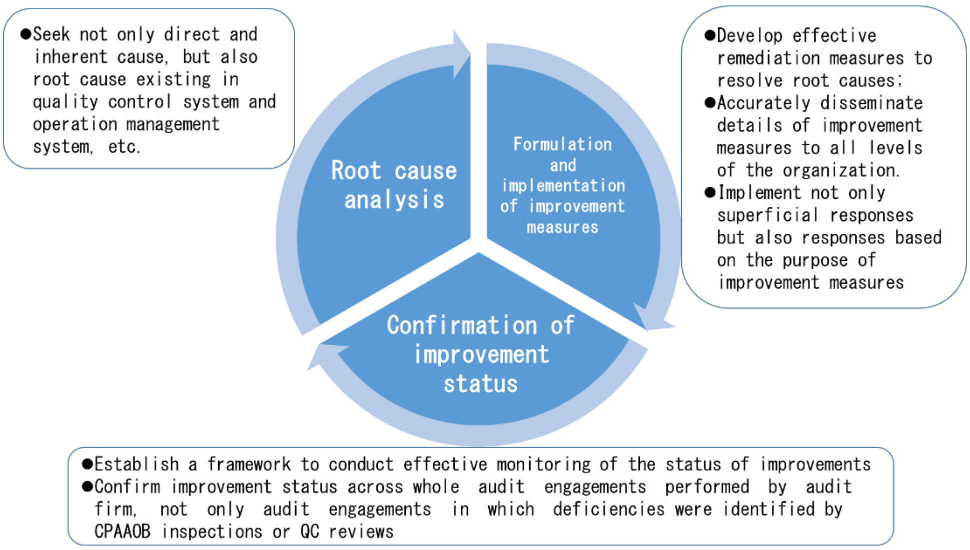
However, **when carrying out self-inspection of audit engagements targeted for inspection in QC reviews, the engagement partners and EQCRs merely conducted perfunctory checks of the items on the checklist and did not carry out checks that took into account the purpose for which each item had been instituted**. Moreover, **with regard to audit engagements not targeted for inspection in QC reviews, the quality control department only instructed the audit engagement teams to bear in mind the recommended improvements when carrying out, and did not check the implementation status of improvement measures**.

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

《Points to Note》

The above example cases indicate that the same or similar deficiencies as the deficiencies identified in the past CPAAOB inspections and QC reviews were found. These cases were occasioned by merely taking improvement measures as a formality, such as simply communicating the details of the matters to be improved or using improvement checklists without identifying the root cause of the deficiencies and resolving or improving the causes. Therefore, the PICOQC should note that it is necessary not only to communicate to the engagement teams the nature of the identified deficiencies but also to consider instructions in order to specifically reflect the issues into audit procedures. In addition, when using the improvement checklist or equivalent, it should be noted that the PICOQC and engagement partners need to inspect the improvement status in light of why the matter was identified as a deficiency as well as the scope of procedures that should be improved. (Refer to [Figure 3])

［Figure 3］ Reference image: Initiatives to improve operations



2. Establishment/Implementation of Internal Rules and Compliance with Laws, Regulations, and Professional Standards

(1) Establishment/Implementation of Internal Rules

Points of focus

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

- Whether the audit firm has internal rules in place to reasonably ensure audit quality, sufficiently taking into consideration the size and operations of their audit firm;
- Whether the audit firm works to ensure the adequacy of the internal rules, for example, by sufficiently confirming consistency between the rules when establishing or revising them, or by revising the internal rules according to revisions of laws, regulations, and professional standards, as needed;
- Whether the PICOQC or equivalent communicates the internal rules to professional staff (including part-time professional staff) and other personnel without omission, and ensures their familiarization with the rules, for example, by verbally explaining them as needed; and
- Whether the PICOQC or equivalent ensures compliance with the internal rules, for example, by understanding the status of professional staff's compliance with such rules in a timely manner, as needed.

Outline of inspection results

In the establishment and implementation of internal rules, as shown in the case example section below, deficiencies regarding establishment of internal rules related to organizational structure, independence, the provision of non-audit services, etc. were found. Also, deficiencies regarding implementation of internal rules related to contract management were found.

As for the causes of these deficiencies, there were cases in which there was a lack of sufficient understanding of the laws, regulations and standards applicable to audit firms and cases in which audit firms adopted the template of quality control rules ("Audit Quality Management Rules") provided by the JICPA without making any modification in accordance with the audit firm's actual circumstances. There were also cases in which audit firms assumed that it was unnecessary to revise the rules because no problem had occurred in the past.

(Observed effective efforts)

The following is an example of observed effective efforts made by an audit firm.

The audit firm promoted understanding of the relationship between the audit manual and the Auditing Standards Statement by noting the requirements indicated in relevant statements with respect to each provision of the audit manual. Using such audit manual, the audit firm provides education on the level of audit responses required by the audit standards.

Expected response

Audit firms need to **reconfirm that their internal rules are in compliance with the applicable laws, regulations and standards and they correspond to the actual status of each audit firm**s. Based on this reconfirmation, they should perform sufficient examination and review as to whether their operations are performed in accordance with the internal rules. They also need to establish operation management system that enables appropriate establishment, dissemination, and implementation of internal rules, for example, by establishing a workflow in accordance with the actual conditions of each firm.

Case 1: Establishment of internal rules (complaints and allegations)

NEW

With regard to the filing of complaints and allegations, the audit firm has stipulated in its quality control rules that information relating to fraud risk received from outside the firm should be accepted and addressed.

However, **the audit firm did not establish a contact point for receiving information related to fraud risk received from outside, and did not establish a specific system for responding to such information**.

(Quality Control Standards Statement No. 1, paragraphs 54, F54-2)

Case 2: Establishment of articles of incorporation and organizational rules

The CEO believed that the audit firm had not experienced any problems with administration since it had been established as a result of a merger in the past, so **they did not investigate whether new rules needed to be established or whether the statements in the current rules adequately took into account the size, circumstances, etc**. of the firm. As a result, the articles of incorporation only prescribed "important matters pertaining to the operations of the audit firm" as matters requiring deliberation and resolution at a general meeting of partners," and rules etc. did not give specific examples or guidelines concerning "important matters."

Furthermore, there were no organizational rules, and there were no provisions concerning the relationships of organizations involved in quality control, such as the quality control division and quality control review division, nor were there provisions concerning the purposes, roles, positioning, etc. of important meetings.

(Quality Control Standards Statement No. 1, paragraphs 17 and 18)

Case 3: Operation of the partners' meeting

NEW

The audit firm has a partners' meeting consisting of all partners to make decisions on important matters relating to management and operations.

However, the audit firm did not have a system in place for appropriate operation of the partners' meeting. For example, **the audit firm did not specifically stipulate in writing the matters to be resolved by the partners' meeting and the method of resolution, and it did not keep a record of the process of deliberation and content of resolutions on matters though it asserted that such matters had been resolved by the partners' meeting**.
(Article 34-13 of the Certified Public Accountants Act)

Case 4: Implementation of internal rules (conclusion of non-audit service contracts)

Although the CEO and PICOQC stipulated in the "Contract Management Policy" that the conclusion of a contract shall be notified to all partners and contract details shall be e examined when entering into a non-audit service contract with a client, neither notification nor examination was carried out when the majority of the non-audit service contracts were concluded.
(Quality Control Standards Statement No. 1, paragraphs 15 and 16)

Case 5: Implementation of internal rules (consultation)

The audit firm stipulates in its "Manual on Audits and Quality Control" that, when consulting on difficult or contentious matters with experts, engagement teams should describe the points and facts of the matter in the prescribed format.
However, the firm did not establish concrete policies or procedures for consultation. For example, the firm did not set out specific reporting procedures when engagement teams have identified a specific matter for which consultation is required. In addition, the firm did not specify any individuals within or outside the firm who had adequate expertise.
(Quality Control Standards Statement No. 1, paragraph 33 and F33-2)

《Points to Note》

The number of identified deficiencies in designing and implementing rules, such as the non-existence thereof, has decreased due to the enhancement of templates provided by the JICPA, etc. However, some cases concerning implementation of rules were found. For example, templates were used without being modified to suit the actual operating situation of the firm. Therefore, it is vital to check periodically whether or not there are any discrepancies between the internal rules developed by the audit firm and the actual status of implementation.

In addition to the above, the following deficiencies were identified:

- **The firm had failed to put in place a system for tallying and managing working hours of professional staff, which serve as the basis for developing audit plans.**
- **Regarding audit strategy to obtain audit evidence by conducting substantive procedure without conducting test of internal controls, the audit manual did not set out any guidelines on the requirements, nature, timing and extent of such substantive procedure.**

(2) Compliance with Laws, Regulations, and Professional Standards

Points of focus

A variety of restrictions and obligations, etc., are imposed on certified public accountants and audit firms by the 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 operation management system to ensure such compliance.

Outline of inspection results

From the perspective of compliance with laws, regulations, and professional standards, there were deficiencies in the rules for compliance with the prohibition of competition by partners, as well as in the rotation of key personnel in charge of audit engagements.

Causes of the deficiencies listed above include: the PICOQC or equivalent did not fully understand the applicable laws, regulations and professional standards or did not clearly and concretely stipulate practitioners and workflow regarding the tasks that necessitate verifying the status of compliance with laws, regulations and professional standards.

Expected response

An audit firm should be aware of their duties and responsibilities of certified public accountants at all times and should foster an organizational culture under which laws, regulations, and professional standards are observed. Moreover, an audit firm should establish an appropriate operations management system to ensure compliance with laws, regulations, and professional standards by identifying operations which necessitate checking the status of compliance with laws, regulations, and professional standards, and by assigning persons to be responsible for those operations.

Case 1: Prohibition on competitive work by partners

A certain partner affiliated with the audit firm had continued to provide services (audit services) that fall within the scope of the firm's engagements at his/her own audit office since before becoming a partner of the firm in violation of the Act, which prohibits engagement in competitive work by partners. In addition、the audit firm overlooked the fact that this partner was violating the Act.

(Article 34-14, paragraph 2 of the Act; Quality Control Standards Statement No. 1, paragraph 19)

Case 2: Rotation of major engagement team members

With regard to long-period involvement in audit work, the audit firm's quality control rules require that senior engagement team members (engagement partners, EQC reviewers, and other engagement team members responsible for making important decisions and judgments related to important matters of audit engagement) be replaced at intervals of seven years with regard to audit engagements for "large companies, etc." as defined under the Act and at intervals of 10 years with regard to audit engagements related to companies other than "large companies, etc."
However, the CEO, who concurrently serves as the PICOQC, did not sufficiently understand laws and regulations related to independence. As a result, **when partners performing audit engagements for large companies, etc. as assistants to engagement partners were involved in the audit work for equivalent or a longer period of time than engagement partners, the CEO/PICOQC did not consider whether such partners were other engagement team members responsible for making important decisions and judgments related to important matters of audit engagement**. Moreover, some engagement partners were violating the firm's policy concerning long-term involvement in audit engagements for companies other than large companies, etc. that was prescribed by the internal rules by continuing to be involved for more than 10 years.
(The Act, Article 24-3; Ordinance for Enforcement of the Certified Public Accountants Act, Article 9, paragraph 3; Guideline for Independence, Section 1, paragraph 139; Quality Control Standards Statement No. 1, paragraph 24)

Case 3: Inappropriate response to inspection

The audit firm submitted the inspection-related documentation to inspectors as if it had been prepared in a timely manner even though some partners and staff members had prepared some documents relating to quality management system after cut-off date of inspection or they had prepared some audit documents relating to individual audit engagement and inserted into the audit final file which had been completed and assembled before.
(The Act, Articles 26, 28-3, and 34-14-3)

Case 4: Inputting working hours of professional staff

NEW

Professional staff at the audit firm input working hours into the attendance management system. However, at this audit firm, there were numerous cases in which the working hours of professional staff, including those on statutory holidays, were not input into the attendance management system. In addition, there were numerous cases in which the number of working hours listed in the audit summary was insufficient and in which working hours on statutory holidays were input as working hours on working days. Despite these cases, **corrective measures were not taken to ensure the accuracy of input working hours for all professional staff, and the working hours of professional staff were not appropriately managed**.
(Quality Control Standards Statement No. 1, Paragraph 15; Auditing Standards Statement No. 220, Paragraph 7; Article 5, Paragraph 1 of the Cabinet Office Ordinance on Audit Certification of

Financial Statements, etc.)

Case 5: Misstatements concerning qualifications as a certified public accountant in materials submitted outside the firm

NEW

The audit firm submitted to some audited companies audit plan statements containing misstatement that an employees engaged in an audit of the audited company who were not registered as a CPAs was qualified as a CPAs.

In addition, **the audit firm issued business cards to persons who had not yet been registered as CPAs, stating that they were CPAs**.

(Quality Control Standards Statement No. 1, Paragraph 15; Auditing Standards Statement No. 220, Paragraph 7)

Case 6: Transactions with affiliated companies

NEW

The audit firm believed that there were no problems with its operations management system even though transactions with affiliated companies engaged in advisory and other services were not sufficiently discussed, based on the belief that affiliated companies were operated in an integrated manner. Therefore, **the audit firm did not consider the appropriateness of the compensation for services entrusted to it by affiliated companies, and the partners' meeting did not deliberate or resolve the conclusion of such services entrustment contracts**.

In addition, the audit firm did not record the compensation for such services as a deduction from personnel expenses of the audit firm, instead of recording it as revenue. Such accounting of the audit firm not was not in accordance with generally accepted accounting practices which prescribes total amount presentation in principle, prohibiting direct offsetting between expense items and revenue items.

(Articles 34-13, 34-15-2, and 34-15-3 of the Act)

《Points to Note》

In addition to the above cases, the following deficiencies have been identified.

- **The requirement that the majority of partners have been engaged in audit and attestation services for three (3) years or more after being registered as a certified public accountant has not been met.**
- **Internal rules did not establish procedures for identifying whether or not services that compete with audit firms are being conducted, or specific approval procedures related to competitive work.**
- **There is a discrepancy between the purpose of the audit firm stated in the Articles of Incorporation and the actual content of the audit firm's business.**
- **Notification concerning an amendment to the Articles of Incorporation has not been submitted by the statutory submission deadline.**
- **Transactions involving conflicts of interest are not approved.**
- **The audit firm did not calculate and manage the actual work hours of partners and employees, and did**

not establish a system for appropriately preparing audit summaries.

(3) Information Security

<u>Points of focus</u>

Professional staff, in the course of their daily duties, routinely carries paper documents and personal computers that contain or store confidential information of audited companies. They also use e-mail to communicate with the contact persons of the audited companies. Audit firms also store electronic audit documentation and electronic data before compilation in servers installed in and outside their offices. Therefore, audit firms are required to establish and implement 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 and implementation of information security systems, from the following perspectives:

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

<u>Outline of inspection results</u>

As shown in the case example section below, the deficiencies identified included: a failure to appropriately implement measures to prevent information leakage; a failure to establish internal rules on the use of internet server services for operation; a failure to appropriately apply rules on information security to part-time staff; and a failure to appropriately anonymize personal information described in audit documentation.

Causes of the identified deficiencies:

- ・The information security manager or equivalent established internal information security rules only as a formality, leaving the application of the rules to professional staff (including part-time professional staff) who use computers and other information devices;
- ・The information security manager or equivalent did not implement any measures to keep track of the operational status of the internal information security rules at their audit firms, being too confident in professional staff's compliance with the internal rules;
- ・Managers, etc., responsible for information management do not properly understand their own professional responsibilities, and do not establish rules suited to the actual use of information devices at the audit firm;

- Because priority was placed on executing tests of internal controls and substantive procedures, anonymization of personal information related to audit procedures was omitted; and
- As managers responsible for information management did not sufficiently understand or were not sufficiently aware of the importance of information security, they were not aware of the need to appropriately develop information security systems.

(Observed effective efforts)

The following are examples of observed effective efforts made by audit firms.

To reduce the risk of information leakage due to the loss of personal computers, the audit firm introduced a virtual desktop interface (VDI) using thin client terminals and used an external cloud storage service for exchange of data with audited companies (through the method of creating individual dedicated sites accessible only by engagement team members and audited companies within the storage account). When the external cloud storage service was introduced, the audit firm identified risks associated with its introduction and implemented its own new management measures as necessary with regard to risks not addressed by the external service provider.

Expected response

Although the opportunity to obtain enormous electronic data has increased due to the progress of digitization of confidential information of audited companies, many deficiencies for information security are still identified. Audit firms should fully understand the serious and adverse effects that information leakage would impose on the operation of the firm, and **carry out the establishment and implementation of appropriate information security systems in accordance with how information devices are being used** at each audit firm.

Note that the leakage of data as a result of external unauthorized access and external attacks aiming IT systems failure constitute a management risk for audit firms, and that **it is therefore necessary to ensure that cybersecurity is strengthened in conjunction with the developments in IT**.

Case 1: Establishment and implementation of internal information security rules

The information security manager of an audit firm did not fully understand the level and scope of information security measures required. He or she thus established a security policy and other internal rules, and performed information security checks just as a formality. As a result, the following deficiencies were observed:

- A security policy to prevent information leakage was in place. However, no policy or procedures for action to take in the event of information leakage were established;
- Stored data were not classified according to their crisis level; no backup or encrypted data were created for stored data; no ID codes or passwords were assigned to professional staff to protect critical electronic data from unauthorized access;

- The firm required all members to submit a “security policy compliance report,” but some members failed to submit this report; and
- **<u>The audit firm did not inform all partners and other staff of various rules, including the basic policy for information security. The audit firm did not provide periodic education/training concerning information security, either</u>**.

(Article 27 of the Act; Quality Control Standards Statement No. 1, paragraphs 15 and 16; Quality Control Standards Statement No. 1 Practical Guidelines No. 1 III-1, IV-2, and 5)

Case 2: Operation of internal information security rules for part-time professional staff

The PICOQC of the audit firm had stipulated in the “Information Security Regulations” to check whether data related to audit engagements is remaining on part-time professional staff’s own personal PCs when they use such PCs for audit engagements. However, the PICOQC merely used the “Checklist on Information Security” as a formality and did not actually ascertain whether there was remaining audit engagement data on the PC.

(Article 27 of the Act; Quality Control Standards Statement No. 1, paragraphs 15 and 16; Quality Control Standards Statement No. 1 Practical Guidelines No. 1 IV-2, IV-5, and V-2)

Case 3: Handling of personal information

NEW

In its Manual for Preparing Audit Documentation, the audit firm stipulated the following: a) In principle, vouchers containing personal information should not be stored as audit documentation; b) Measures should be taken to make it impossible to identify individuals when such vouchers are stored as audit documentation.

However, in audit documentation of multiple audit engagements at the audit firm, information that enables the identification of specific individuals, such as names, masking was not masked or other measures were not taken. **Therefore, <u>internal rules on the protection of personal information are not being appropriately implemented</u>**.

(Quality Control Standards Statement No. 1, paragraph 45; Auditing Standards Statement No. 220, paragraph 7)

《Points to Note》

It should be noted that, as described in Case 2, when a part-time professional staff uses his/her personal PC for audit engagements and work as well as a full-time employee, it is necessary to take the same level of security measures for a full-time employee.

In addition, there is a case in which an Internet server service provided by a major Internet-related company was being used as a file server in the absence of rules setting out necessary security measures for job-related use of the Internet server service in operations. It should be noted that the status of security measures should be examined when periodically evaluating service providers.

(4) Prevention of Insider Trading

Points of focus

If a CPA, who holds the important social mission of ensuring the reliability of the capital markets, partakes in insider trading using the insider information of an enterprise acquired in the course of his/her work, trust in CPA audit may be seriously damaged.

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 implementation of an anti-insider trading system, from the following perspectives:

- Whether the audit firm has internal rules in place that provide for effective procedures to prevent any of their members from participating in insider trading, and makes these procedures known to their members;
- Whether the audit firm appropriately takes the anti-insider trading measures set forth in its internal rules, and, whenever necessary, carries out monitoring, including confirmation of regulated securities transactions by its members.

Outline of inspection results

As shown in the case example section below, we observed cases where internal rules were prepared by using the template "Rules for Preventing Insider Trading" provided by the JICPA as a guide, but such rules were not followed.

Causes of identified deficiencies:

- The anti-insider trading manager or equivalent did not comprehensively understand the anti-insider trading measures to be performed under the internal rules; and
- The anti-insider trading manager or equivalent did not confirm whether members were actually compliant with the anti-insider trading rules, having too much confidence that members were appropriately observing the relevant rules.

Expected response

Audit firms should understand that the general public is increasing their awareness of negative effects of insider trading on capital markets and take even more effective measures to prevent such trading.

Specifically, audit firms **should take necessary responses** sufficiently referring to "Q&A Concerning Insider Trading" issued by the JICPA (September 2, 2008) and other relevant documents, **re-examine the status of establishment and implementation of the rules for preventing insider trading, and consider whether the strengthening of systems to prevent insider trading is required**.

Case: Submission of written pledges regarding anti-insider trading

The PICOQC requires the submission of a written pledge to comply with the "Rules for Preventing Insider Trading," which prohibits all members from buying/selling regulated securities issued by the audited companies to which services are provided. However, the written pledge was only required to be submitted at the time of hiring, and besides, any anti-insider trading measures such as monitoring all members for trading of regulated securities were not carried out subsequently.

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

《Points to Note》

In addition to the above cases, the following examples of deficiencies were identified in the establishment/implementation of internal rules for preventing insider trading:

- **The audit firm has not established internal rules comprehensively, only prohibiting transactions involving specified securities etc. of parties to which services are provided in The "Rules for Preventing Insider Trading" and prohibiting excessive entertainment and gifts in the "Code of Conduct and Ethics";**
- **Although it is specified in the "Rules for Preventing Insider Trading" that a list of companies to which services are provided shall be distributed to members in order to provide a warning about insider trading, the anti-insider trading manager did not distribute such list of audited companies to which services are provided; and**
- **Although members were instructed to submit written pledges to not buy/sell regulated securities issued by companies to which services are provided, in accordance with the "Rules for Preventing Insider Trading," written pledges from certain members who should submit the pledges have not been obtained, because the status of submission has not been confirmed.**

3. Professional Ethics and Independence

Points of Focus

In order for the audits performed by CPAs to be viewed as trustworthy by related parties, it is important that auditors maintain a fair and impartial attitude, not represent any special interests, and make fair judgments on the appropriateness of financial statements. To that end, audit firms are required to establish policies and procedures regarding compliance with professional ethics and independence requirements to objectively show that auditors maintain a fair and impartial attitude. In addition, the engagement partner is required to comply with such policies and procedures and to ensure that their assistants comply with them.

In consideration of the above, the CPAAOB inspects the professional ethics and independence of an audit firm from the following perspectives:

- Whether the audit firm obtains, at least once a year, a confirmation letter concerning compliance with policies and procedures for the maintenance of independence from all persons required to maintain independence; and whether appropriate verification procedures are performed according to the classifications of such applicable persons;
- Whether the audit firm performs the independence confirmation procedures set forth in its internal rules before acceptance and continuance of audit engagements, and when issuing the auditor's report, appropriately confirms that there was no change in the status of independence;
- Whether the audit firm has developed and implemented a system to appropriately and aptly collect the necessary information, including a list of audited companies, for judging whether persons subject to confirmation of independence are complying with the rules on independence when performing the confirmation procedure;
- Whether the audit firm establishes and communicates policies and specific procedures to ensure the observance of professional ethics, such as fee dependency, employment restrictions, duty of confidentiality and restrictions on gift-giving and entertainment, and whether the audit firm instructs the professional staff to follow these policies and procedures; and whether the professional staff follow the policies and procedures for the observance of professional ethics stipulated in the internal rules of the firm; and
- Whether the audit firm establishes and implements policies and procedures related to engagements associated with long periods of time to ensure compliance with the legal requirement of rotation.

Outline of inspection results

As shown in the case example section below, the deficiencies identified included: a failure to appropriately perform the procedure for confirming independence as prescribed under internal rules, with the conclusion on independence reached after only a perfunctory consideration; a failure to cover a comprehensive range of factors in the independence confirmation procedure; and a failure to develop rules in accordance with the revisions of laws, regulations, etc. concerning independence.

As for the causes of the deficiencies, in some cases, the PICOQC, etc. did not determine specific procedures for confirming independence (including the method for collecting the most up-to-date information on audited companies' subsidiaries, etc.) and the specific period of implementation or appoint the person in charge of the confirmation procedure. In other cases, the management of implementation was left entirely to the discretion of some particular persons in charge.

Expected response

Audit firms need to establish a system as soon as possible to implement procedures **to appropriately confirm their independence** so that the reliability of audits is ensured, since many deficiencies are still identified in matters concerning professional ethics and independence. Audit firms should carefully **consider actual conditions when determining what if any degree of collusion that impedes independence**.

(Revision of "Code of Ethics" and abolition of "Guidelines for Independence")

With the revision of the "Code of Ethics" in July 2022, the "Guidelines for Independence" were abolished and integrated into the "Code of Ethics," and the "Q & A (Practical Guidance) on the Code of Ethics" was published. The revised Code of Ethics came into effect on April 1, 2023, and matters concerning independence in audit engagements, etc. were applicable to audit engagements for fiscal years starting on or after April 1, 2023. Therefore, the provisions underlying deficiencies identified in the CPAAOB inspections conducted in Program Year 2022 or earlier were the same as those before the revision or repeal.

Case 1: Independence confirmation procedures for professional staff

As the audit firm did not sufficiently understand laws and regulations concerning independence, it used a checklist for confirming independence that did not appropriately reflect the revisions of the JICPA's Guideline for Independence. As a result, it did not perform a confirmation procedure adapted to the expansion of the scope of persons subject to regulation on independence beyond "major partners, etc. in charge" to include "persons in charge" in general. In addition, the audit firm did not define "persons in charge" who are subject to regulation on independence under its quality control rules. Thus the audit firm failed to develop quality control rules in accordance with the revisions of the Guideline for Independence.

(Quality Control Standards Statement No. 1, paragraphs 20 and 21; Guideline for Independence, Section 1, paragraphs 150 and 150-4)

Case 2: Confirmation of independence when accepting new audit engagements

NEW

The audit firm performs procedures to confirm the independence of members who conduct a preliminary investigation of new audit engagement before conducting the preliminary investigation, and performs procedures to confirm the independence of other members of the engagement team before commencing audit engagements.

However, **with regard to confirmation of independence, the audit firm did not establish internal rules setting out specific procedures such as who should be subject to the checks and when they should be implemented**, so for some audit engagements, **procedures to confirm independence before conducting a preliminary investigation or before starting audit engagements were not performed**.

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

Case 3: Incomplete list of audited companies and their subsidiaries

When performing the procedure for confirming independence to a partners and other staff, the audit firm prepared a list of companies subject to regulation on independence and then appended this list to the independence checklist. However, the audit firm neglected to include multiple companies subject to regulation on this list, as the firm had not checked the comprehensiveness of such list. Furthermore, when performing the procedure for confirming independence, even though the responses obtained from partners and other staff contained oversights in the checks, the firm failed to adequately ascertain the reasons for this and thus failed to sufficiently confirm the status of compliance with rules regarding independence.

(Quality Control Standards Statement No. 1, paragraphs 20 and 21)

Case 4: System for obtaining information about group firms

NEW

The audit firm performed non-audit services (financial due diligence, etc.) entrusted to it by affiliated companies, etc. These services were outsourced by affiliated companies, etc.

However, **with regard to the acceptance of non-audit engagements by the audit firm, the audit firm did not establish policies and procedures for maintaining independence**, and did not establish specific procedures for: a) examination of whether concurrent provision of non-audit services constituted prohibited work, etc. (i.e., whether there was a capital relationship between the client of the non-audit services and the audited company, the nature of the non-audit services, etc.); b) examination of safeguards to be applied when providing non-audit services; c) approval by the engagement partner and the PICOQC.

(Quality Control Standards Statement No. 1, paragraphs 20 and 21)

Case 5: Calculation of fee dependency

The fees received from an audited company accounted for more than 15% of the audit firm’s total fees for two consecutive years, so the audit firm as a safeguard requested a CPA who was not a member of the audit firm to conduct a review after expressing the audit opinion. The audit fees from the audited company and the total audit fees from that company’s consolidated subsidiaries were included in the numerator when calculating the degree of fee dependency from the audited company.

However, the audit firm had not established standards for determining “cases in which fees account for a certain percentage” and “cases in which the fees significantly exceed 15%” in its Interpretive Guidance for Professional Ethics, and had not considered whether these cases applied to the audited company. The audit firm had also not made judgements of related companies, etc., in keeping with the Interpretive Guidance for Professional Ethics, and had not considered whether there were any related companies, etc., that should be taken into consideration when calculating the degree of fee dependency.

(Guideline for Independence, Section 1, paragraphs 27, 220 and 222; Interpretive Guidance for Professional Ethics Q1 and Q13)

Case 6: Involvement period of engagement partners

NEW

After being involved as an engagement partner, the CEO attended meetings to report audit results to representative directors etc. of some audited companies during periods when he / she was no longer involved as an engagement partner due to the number of years he / she had been continuously involved.

However, despite being aware of this fact, **the person in charge of independence did not consider the CEO's attendance at such meetings from the perspective of independence**.

(Quality Control Standards Statement No. 1, paragraphs 20)

Case 7: Maintaining professional ethics and independence

The audit firm has continuously received from an audited company "special audit fees," which were not deemed to be equivalent to compensation for audit services, apart from audit fees prescribed under audit contracts, and it has continuously given gift certificates to audited company's executives. The abovementioned "special audit fees" are deemed to be equivalent to "special economic profits" under the Act. As a result, the audit firm is providing audit services to "a company or any other person in which the audit firm has a substantial interest," a practice prohibited under the same act. As for the provision of gift certificates by the audit firm, the firm is providing "gifts that are beyond the limits that are tolerable under social norms" to clients receiving assurance services, a practice that is prohibited under the Code of Ethics that has been established by the JICPA.

(Act, Articles 1-2 and 34-11; Order for Enforcement of the Certified Public Accountants Act, Articles 7 and 15; JICPA Rules, Article 50 and 52; Code of Ethics, Articles 13 and 26, note 22; Guideline for Independence, Section 1, paragraph 230)

Case 8: Payment of commission for referral to assurance services

The audit firm paid to staff members a set percentage of the assurance service contract sum as an allowance by way of commission for referral to assurance services when the referral resulted in the conclusion of a contract. The firm also outsourced new customer cultivation and referral services to an external business partner and paid them commission for referral to assurance services.

However, the payment of such commission violates the Code of Ethics prohibiting payment of commission referral to assurance services.
(Code of Ethics, Article 23)

《Points to Note》

In addition to the above, examples of deficiencies in professional ethics and independence include the following:

・The firm included the income of personnel's own private firms, etc., such as remuneration partners received as company directors, as a part of the basis for calculating the degree of fee dependency of the firm, even though the firm did not consider whether or not that remuneration as company directors constituted remuneration for services as professional experts.

・The firm had neither set out policies and procedures regarding the long-term involvement of engagement team members, nor prescribed standards for those subject to periodic rotation or when safeguards are required to defuse the situation that may create threats to independence.

4. Acceptance and Continuance of Engagements

(1) Assessment of Risk Associated with Acceptance and Continuance of Engagements

Points of focus

In order to reasonably ensure audit quality, in principle, audit firms need to carefully assess engagement risks by collecting information regarding the integrity, etc., of the audited company 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 audited companies, or if a judgment as to whether audit engagement should be accepted, etc., is made based on an incorrect understanding of the audit performance system, it might result in a situation where auditors cannot fully execute their responsibilities. It is, therefore, evidently required that careful judgment based on properly collected, sufficient information is carried out in accepting or continuing audit engagements.

Therefore, before acceptance and continuance of engagements, audit firms must consider the following matters:

- Whether there are engagement risks, including questions regarding the integrity of the top management of the audited company (note that interviewing top management is an effective way of assessing their integrity);
- Whether it is possible for the audit firm to allocate the necessary and appropriate personnel and time, and to perform audit procedures according to engagement risks;
- Whether the audit firm retains professional staff having sufficient knowledge, experience, capabilities and competence required to deal with the specified engagement risks appropriately; and
- Whether the audit firm could comply with regulations related to professional ethics.

Regarding the examination of integrity of the top management of the audited company involved in particular, audit firms are required to obtain the information deemed necessary in light of the situation when accepting engagements or continuing existing engagements. Also, in the case of accepting or continuing engagements despite the fact that problems were identified, documenting how the firm resolved such problems is required.

The audit firm should establish policies and procedures for the acceptance and continuance of audit engagements, which include the evaluation of risks relating to the acceptance and continuance of the audit engagement considering the risks of fraud. The policies and procedures should also require that the adequacy of the evaluation be reviewed by an appropriate department or person outside the engagement team, according to the degree of risk upon acceptance or continuation of engagements.

In consideration of the above, the CPAAOB conducts inspections from the following perspectives concerning the acceptance and continuance of engagements at audit firms:

- Whether specific procedures for assessing engagement risks have been established, and whether engagement risks have been appropriately assessed;

- ▸ Whether identified engagement risks have been properly reflected in the audit plans for individual audit engagements;
- ▸ Whether, when the audit performance system is being put together, adequate consideration is given to whether the audit firm has the aptitude, ability, and human resources necessary to perform the new audit engagement; and
- ▸ Whether engagement risks are being assessed and approvals within the audit firm are being conferred in a timely and appropriate manner.

Outline of inspection results

Acceptance and continuance of audit engagements are core management decisions at audit firms. However, as shown in the case example section below, when accepting or continuing audit engagements, information obtained by the prospective engagement partner (i.e., the integrity of the audited company involved, risk information on the audited company, etc.) from the preliminary investigation and handover of audit engagements, etc. was not shared among persons authorized to approve the acceptance and continuance of engagements (partners' meetings, etc.). As a result, appropriate risk assessment was not performed. In another case, insufficient consideration was given to the audit resources required to conclude engagements. Other deficiencies included a failure to conduct appropriate risk assessment despite having identified situations in which there was significant doubt about the going concern assumptions or the business rationale of transactions was in doubt.

Causes for the deficiencies:

- ・The prospective engagement partners gave greater priority to quickly concluding audit contracts and quickly getting started on the engagement than to carrying out careful risk assessments and resolving issues in a timely and appropriate manner;
- ・The prospective engagement partner did not have sufficient experience to make appropriate decisions regarding management fraud, audit of internal control, accounting estimates or other matters. Therefore, he/she failed to properly identify and assess engagement acceptance risks based on facts found in a preliminary investigation or information provided by the predecessor auditor; and
- ・When discussing a proposed engagement, the partners did not recognize how important it was for the audit firm to assess the risks associated with the proposed engagement based on information gathered by the predecessor auditor, and the partners other than the prospective engagement partner were reluctant to examine critically as to whether or not the engagement should be accepted.

(Observed effective efforts)

The following are examples of an effective effort observed in an audit firm.

- ▪ Since the company from which the acceptance of engagement was being considered was a high-risk company where sales fraud had been identified in the previous fiscal year, it was necessary in risk evaluation of the engagement acceptance to carefully determine the status of internal control relating to prevention of fraud. Under such circumstances, the prospective engagement partner not only obtained information from internal personnel such as the management, but also gathered detailed and objective information in order to corroborate the management's insists, such as by interviewing external experts who were directly involved in the fraud prevention measures of the company, in order to fully understand the internal systems and progress related to the actual establishment of internal control.

- The audit firm established a division dedicated to IPO within the head office organization in order to develop an environment to enable companies aiming for IPO to receive appropriate audit services. The dedicated IPO division is responsible for exercising functions such as serving as a contact point for requests for consultation from companies aiming for IPO, ensuring audit quality by supporting engagement teams, and preparing and implementing training programs for personnel responsible for IPO-related audit.

Expected response

Audit firms should pay sufficient attention to the fact that acceptance and continuance of audit engagements are core management decisions at audit firms. They should then re-examine the design and implementation status of policies and procedures for acceptance and continuance of audit engagements from **the perspective of determining whether engagements are accepted or rejected after identifying engagement risks and considering measures to address them as an audit firm, based on information obtained through preliminary investigations and handover of audit engagements, such as the integrity of the audited company and risk information on the company involved**..

Note that in recent years there have been many cases of audited companies switching their auditors from large-sized audit firms to mid-tier audit firms or small and medium-sized audit firms. In particular, if the background etc. to the replacement of auditors indicates that the audit engagement risk associated with the audited company is high, more caution needs to be exercised.

As the number of companies aiming for IPO is trending upward, the number of new contracts pursuant to Article 193-2-1 of the Financial Instruments and Exchange Act is rising. On the other hand, it is important to maintain audit quality in order to ensure appropriate disclosure of financial reports by companies aiming for IPO. Therefore, when concluding new contracts for audits related to IPO, it is necessary to carefully consider whether audits of appropriate quality can be performed.

Companies subject to consideration regarding the conclusion of new contracts for audits related to IPO often face challenges in terms of developing internal control and management systems, and therefore, attention should be paid to the following points in particular.

- Carefully evaluate the integrity of audited companies' management.
- Consider whether or not it is possible to conduct audits suited to audited companies' contract risks by securing the necessary and appropriate amount of audit manpower and time.
- Secure audit team members possessing the knowledge, experience and capabilities, necessary for conducting audits, including expertise regarding IPO-related operations.

Moreover, from the viewpoint of developing a system to continuously provide IPO-related audits, it is necessary to develop an organizational system that makes it possible to train personnel responsible for IPO-related audit and to collect and accumulate knowledge and knowhow regarding IPO-related operations and to improve quality control.

Case 1: Risk assessment procedures when accepting new audit engagements

①The prospective engagement partner had assessed the contract risk as high after ascertaining that in previous audits, the submission of audit reports had been delayed due to vulnerabilities in the audited company's management systems relating to accounting, etc. After that, inquiring with the predecessor auditor and confirming that there were no problems with the integrity of key management of the company, the prospective engagement partner submitted the matter to partners meeting to discuss the advisability of acceptance of a new audit engagement.

However, the prospective engagement partner had not had a meeting with key management of the company and the partners meeting failed to adequately assess the integrity of key management of the company, it approved the new contract with the audited company based solely on the outcome of the inquiry made to the predecessor auditor.

(Quality Control Standards Statement No. 1, paragraphs 25 and 26)

②The prospective engagement partner underwent a review related to the conclusion of a new audit contract based on the audit firm's rules when he/she concluded a new audit contract.

However, **although a new audited company conducted business acquisition transactions which required careful consideration of business rationale, the prospective engagement partner did not sufficiently consider the business rationale of those transactions or the integrity of the management**. The partner in charge of the EQC review was not aware of the need to conduct an in-depth review of the conclusion of a new audit contract and therefore overlooked the above situation and approved the audit contract.

(Quality Control Standards Statement No. 1, paragraphs 25, 26, and F26-2)

③Despite planning to rely on the audit results from the auditor of an foreign significant component, the prospective engagement partner requested the PICOQC to approve the engagement on the grounds that no issues with group audits had been identified, even though the independence of the component auditor had not been confirmed. Furthermore, even though materials attached to the request to approve the engagement stated that the auditor of the foreign significant component was scheduled to be changed, the PICQCC approved the engagement without checking whether the prospective engagement partner had confirmed the independence of the incoming auditor.

(Auditing Standards Statement No. 600, paragraphs 11, 19, A11, and A37)

《Points to Note》

In addition to the above, there were cases where engagements were approved before the audit firm had completed required procedures such as obtaining answers from predecessor auditors in response to inquiries. There were also cases where appointments as accounting auditor were accepted based on the belief that if, even after accepting the appointment, the results of performing the necessary engagement risk assessment procedures revealed problems, the acceptance could be easily withdrawn.

Furthermore, in the case of a merger with another audit firm, some audit firms did not fully consider the adequacy of audit procedures performed by the audit firm it was to merge with in the past years including audit procedures for details of a material asset and liability items that the audited company recorded, although they understood important matters regarding these accounts that should be examined upon acceptance of the audit engagements. It should be noted that when audit firms merge, appropriate risk assessment procedures need to be performed after completing required procedures such as audit engagement acceptance procedures.

It should be remembered that the methods for obtaining information on the integrity of the client must be examined with reference to the following from Quality Control Standards Statement No. 1, paragraph A17.

- **Communications with existing or previous providers of professional accountancy and audit-related services to the client s**
- **Inquiry of other firm personnel or third parties such as financial institutions, legal experts and industry peers**
- **Background searches of relevant databases in and outside of the audit firm**

Case 2: Risk assessment procedures at the time of renewal of audit contracts

The engagement team became aware of significant matters, including significant deficiency in internal controls, note about going concern assumption, and doubt about the business rationale of the transaction with a major shareholder. The engagement team assess the transactions of dubious rationality with the major shareholder as the circumstances that indicated the risk of material misstatement due to fraud.

However, when renewing the audit contract with the audited company, **the audit firm failed to sufficiently consider procedures to ensure audit quality, even though the firm was aware that these significant matters would cause significant difficulty in ensuring the quality of audit engagements**.

(Quality Control Standards Statement No. 1, paragraphs 24, 25, 26, and F26-2; Auditing Standards Statement No. 220, paragraph 11 and F11-2)

《Points to Note》

In addition to the above, there were cases in which, despite it being recognized when assessing contract risks in continuing audit contracts that management had not provided necessary information during the previous year's audit, the integrity of management of the audited company was not considered from the viewpoint of inappropriate limitation in the scope of work, such as a limitation on the scope of the audit,

and cases in which the integrity of management of the audited company was not considered based on responses being taken to address the disclosures of significant deficiencies in entity level controls and process level controls, even though such deficiencies were identified.

It should be noted that, not only on accepting but also on continuing audit contracts, decisions should only be made after identifying engagement risks on the basis of information ascertained and considering response measures to address these risks.

Case 3: Ensuring the necessary audit days

In estimating the expected audit days for the purpose of accepting new audit engagement, the prospective engagement partner **did not consider if the expected audit days were adequate in comparison with predecessor auditor's audit days**. The prospective engagement partner also **did not report to the basis of its estimation- to the partners' meeting, the body that approves the acceptance of audit engagement**.

Despite the fact that the audit fee estimate presented by the prospective engagement partner was substantially lower than the audit fees charged by the predecessor auditor, the partners' meeting overlooked the fact that the prospective engagement partner had not considered whether the expected audit days were adequate in comparison with predecessor's audit days.

(Quality Control Standards Statement No. 1, paragraphs 25 and 26; Auditing Standards Statement No. 220, paragraph 11)

Case 4: Risk assessment procedures when accepting amendment audit engagement

Since an amendment audit engagement-covering multiple fiscal years was accepted shortly before the audit report deadline, borrowing audit documentation from the predecessor auditor, evaluating the adequacy of the predecessor auditor's audit procedures, and performing supplemental procedures as needed were difficult. Despite this fact, time and human resources needed for the audit were not sufficiently analyzed when accepting the engagement

(Quality Control Standards Statement No. 1, paragraphs 25 and 26; Auditing Standards Statement No. 220, paragraph 11)

《Points to Note》

Recent years have seen more than a few instances of listed companies being prompted by the discovery of inappropriate accounting to submit amendment reports of annual securities reports and, as is the case with ordinary financial statement audits, appropriate quality control of amendment audits must be ensured from the decision on whether to accept an engagement until submission of the audit report. When corrections of financial statements covering multiple fiscal years are anticipated, it is necessary to carefully consider the adequacy of the planned number of audit days because the auditor may need more time to obtain sufficient and appropriate audit evidence than in cases of normal audit engagement.

(2) Communication between the predecessor auditor and the prospective auditor

Points of focus

In cases where auditors change, the information collected and obtained by the predecessor auditor in the course of performing audit engagements in the past is extremely important. The predecessor audit firm and the prospective incoming audit firm should follow appropriate procedures to hand over the engagement from the predecessor auditor to the incoming auditor so that the prospective auditor can obtain the useful information to determine whether it can accept the proposed audit engagement and perform the audit.

In consideration of the above, the CPAAOB inspects whether an audit firm uses appropriate procedures for handing over an audit engagement to another audit firm, mainly from the following perspectives:

- Whether the predecessor auditor communicates in a timely and adequate manner in order to provide the prospective auditor with useful information that can be used when the prospective auditor makes a judgment as to whether the audit engagement should be accepted and when the successor auditor conducts an audit.

  Whether the predecessor auditor responds honestly and clearly to inquiries made by the prospective auditor. Especially in the case where the predecessor auditor is aware of information or circumstances concerning material misstatements in the financial statements that affected or could affect the audit opinion, whether the predecessor auditor provides such information to the prospective auditor;
- Whether the prospective auditor makes inquiries required under the audit standards to the predecessor auditor, including the reason for the replacement of the audit firm, and the status of measures against fraud risks, to determine whether or not to accept the engagement;
- Whether the prospective auditor and the predecessor auditor mutually confirm and respectively create and store detailed records of the processes performed for the handover of the engagement;
- Whether the audit firm confirms that the handover is properly conducted, by having the engagement team report the status of the handover to an appropriate department or a person who does not belong to the engagement team; and
- Whether in cases where the conclusion of audit contract has been canceled or an existing contract has been terminated in response to illegal conduct, the predecessor auditor, pursuant to a request from the prospective auditor, provides the prospective auditor with all facts and information concerning confirmed and suspected illegal or suspicious conduct that the predecessor auditor deems that the prospective auditor needs to know prior to determining whether an audit engagement can be accepted.

Outline of inspection results

Deficiencies were observed in some audit firms regarding inappropriate inquiry made by prospective auditor or failure by predecessor auditors to properly communicate their own awareness regarding the

integrity of management when handing over to the prospective auditor.
Causes of the deficiencies include: the partner who would take charge of the engagement prioritized quick acceptance and quick commencement of the audit engagement rather than performing careful risk assessment, solving any identified problems or performing procedures required by the audit firm in an adequate and timely fashion. There were also cases in which the PICOQC assumed that, if rules were put in place around the termination of audit contracts and the handover of audit engagements, the engagement team would comply with those rules and apply them appropriately.

Expected response
The predecessor auditor needs to understand that it is essential **to provide information relating to the audit risks of the audited company, etc., obtained in the course of performing audit engagements to the prospective auditor in a clear and sufficient manner**.
In addition, **the prospective auditor needs to establish a system in which the information relating to audit risks of the audited company, etc., obtained from the predecessor auditor in the process of communications between auditors, etc., which should be properly documented and fully used in the audit**.
Similarly, when an engagement is handed over within the same audit firm, information related to audit risks needs to be properly conveyed. In particular, important audit-related matters such as fraud risk, should be fully and clearly communicated from the predecessor engagement team to the successor engagement team.

Case: Provision of information to the prospective auditor

When handing over an audit engagement, the audit firm communicated to the prospective auditor its awareness that there were no particular problems with the integrity of the management.
However, although the engagement partner at the audit firm had, in the application to withdraw from the audit engagement prepared as part of the firm's internal procedure for withdrawing, explained that there were significant matters with the integrity of the management, the engagement partner did not accurately communicate this awareness regarding the integrity of the management during the handover to the prospective auditor. Furthermore, the quality control department at the audit firm had not established procedures for identifying discrepancies between the minutes of the audit engagement handover meeting and the application to withdraw from the audit engagement.
(Quality Control Standards Statement No. 1, paragraphs 27 and 60; Auditing Standards Statement No. 900, paragraph 13)

《Points to Note》

In addition to the above, there were cases where the prospective engagement partner did not ask questions to the predecessor auditor, and cases where, due to a sharp increase in new audit engagements accompanying business expansion, consideration in accordance with the internal rules developed by the

audit firm was not completed by the deadline when taking over audit engagements.

Furthermore, it was revealed ex-post facto at some firms that the application of accounting policies was inappropriate as a result of being handed over audit engagements without fully examining the appropriateness of the accounting policies of the audited company, on the grounds that the predecessor auditor was a large-sized audit firm. Therefore, it should be noted that it is necessary to maintain a cautious stance upon handover and to not rely too much on the predecessor auditor.

5. Recruitment, Education and Training; Evaluation and Assignment

(1) Recruitment, Education and Training

Points of focus

During its inspections, the CPAAOB investigates, from the following perspectives, whether the audit firm has established and is following policies and procedures concerning the recruitment of audit team members:

- Whether specific policies and procedures concerning recruitment have been established, and whether they are being properly implemented as prescribed.

Furthermore, auditors, as professional experts, are expected to always strive to develop their expertise and accumulate knowledge that can be obtained through practical experience, etc. The CPAAOB inspects education and training provided at each audit firm from the following perspectives:

- Whether the audit firm develops and provides education/training programs that sufficiently take into account the knowledge, experience, competence and capabilities of the professional staff;
- Whether the audit firm provides education/training programs designed to maintain and improve the audit competence and capabilities of the professional staff; this may include, for example, accurately identifying areas where professional staff tend to have less understanding and providing training focusing on these areas; and
- Whether the engagement partner provides instruction and supervision to professional staff so that they can fully utilize and exercise the knowledge and awareness acquired in the training in audit field work.

Outline of inspection results

As shown in the case examples below, when recruiting professional staff, emphasis was placed on the administration of the audit division rather than the administration of the audit firm as a whole, so recruitment was sometimes unsuited to the audit firm as a whole.

Furthermore, deficiencies in education and training for professional staff were observed, with some firms not providing effective training programs and others failing to provide opportunities for education and training in areas that require special knowledge, such as the auditing of financial institutions.

Other deficiencies included a failure to have staff members who have not participated in mandatory training programs do so within the period prescribed by each audit firm despite having identified those persons.

The causes of these deficiencies included a lack of commitment to establishing an appropriate education and training system. For example, in some cases, the PICOQC, etc. depended entirely on engagement partners' instructions and supervision in audit field work in encouraging staff members to acquire engagement-related knowledge. In other cases, the PICOQC was not aware of the need to check whether staff members have participated in mandatory training programs.

There were also cases in which audit firms lacked commitment to maintaining and improving audit quality by ensuring that audit team members have a certain level of engagement-related knowledge as a whole, as they left the improvement of skills to the discretion of individual audit practitioner, including part-time staff.

(Observed effective efforts)

The following is an example of observed effective efforts made by an audit firm.

- NEW The audit firm has set the required number of credits of training about fraud risk at 12 per year, higher than the necessary minimum of 6 credits per year prescribed by the JICPA, under its rules on training, as it believes that learning widely about examples of fraud at other audited companies helps to enhance "the ability to detect fraud" given the limited number of audit engagements performed for listed companies by the audit firm, etc.
- At training sessions to inform personnel of deficiencies identified in CPAAOB inspections and QC reviews, the audit firm informed personnel of specific areas highlighted and areas where improvements were required by presenting as much of the content of the audit documentation as possible.
- Staff who have not taken the mandatory training courses designated by the audit firm are obliged to take a test concerning the course content so that the firm is able to check the extent of their knowledge of audit engagements and the like.
- NEW The audit firm recognizes that part-time professional staff account for a high proportion of professional staff, and is strengthening its recruitment of full-time professional staff and converting part-time professional staff to full-time professional staff as improvement measures. In addition, the firm is giving careful consideration to renewing contracts with part-time professional staff who engaged in for fewer days.

<u>Expected response</u>

Audit firms, **<u>when recruiting audit staff, should appropriately estimate the necessary number of personnel in light of factors such as the current audit workload, the number of new audit contracts expected to be concluded, and the number of staff members expected to leave the firm in the future</u>**.

Furthermore, when providing education and training for audit teams, firms must maintain and improve the skills of engagement team members (including part-time and non-qualified engagement team members) by accurately identifying the areas of audit where they lack sufficient understanding and by preparing and implementing training programs that give due consideration to their respective knowledge, skills and experiences. Moreover, it is necessary to implement effective measures to ensure staff members' participation in mandatory training programs, such as conducting follow-up checks as to whether they have appropriately participated in the mandatory training programs designated by each audit firm. It is also important **<u>to enhance the effectiveness of education and training</u>** through reviews of audit documentation, etc. so **that knowledge and perspectives acquired through training programs can be fully put to use in audit field work**.

Case 1: Recruitment of staff

Due to the circumstances surrounding its establishment, the audit firm is divided into two divisions, and in one of the divisions **insufficient time is made available for audit documentation review, engagement quality control review, and quality-control-related tasks, as engagement partners are busy with performing audit procedures for the accounts they are in charge of**. Despite this situation, the CEO makes decisions regarding the hiring of professional staff based on the P/L of each division, and is failing to optimize recruitment for the firm as a whole.

(Quality Control Standards Statement No. 1, paragraphs 17, 28, and A20)

Case 2: Effectiveness of training

① The audit firm's quality control rules stipulate that opportunities for necessary training and appropriate opportunities for fraud-related education and exercises should be provided to all audit team members. Its anti-insider trading rules obligate all partners and other staff members to participate in the training program concerning anti-insider trading efforts designated by the audit firm.

However, **although an accounting fraud case has occurred at an audited company, the audit firm has not provided opportunities for fraud-related training and exercises by implementing fraud-related training on its own, and so on**. Moreover, the audit firm has not designated a training program concerning anti-insider trading efforts in which partners and other staff members should participate as prescribed by its anti-insider trading rules.

(Quality Control Standards Statement No. 1, paragraphs 28 and F28-2)

② The audit firm obliged all partners and professional staff members to earn at least 40 credits per year from continuing professional education (CPE) programs offered by the JICPA, and also held two periodic training sessions per year of its own, along with other ad hoc training courses as needed. However, although the PICOQC was aware that partners and professional staff members lacked an understanding of audit standards and of the level of procedures required under current audit standards, **they failed to prepare and implement training programs that took into account the causes, based on a sufficient analysis of deficiencies identified in QC reviews**.

(Quality Control Standards Statement No. 1, paragraphs 28 and A22)

Case 3: Education and training of part-time professional staff

The PICOQC and the person in charge of training believed that because most of the part-time staff had experience of audits at large-sized audit firms, there were no problems with their ability, and therefore did not provide training on audit standards.

(Quality Control Standards Statement No. 1, paragraphs 28, A21, and A22)

《Points to Note》

In addition to the above, example cases of deficiencies include the following:

- **Audit firms left the maintenance and improvement of knowledge, competence/capabilities to individual effort of each professional staff. They only monitored the achievement status of practitioners' CPE (continuing professional education) enrollment obligations, and did not develop an education and training fully considered on audit experience, the audit engagements, and audit standards that were newly introduced;**
- **Audit firms did not continuously conduct education and training to improve the audit quality control capabilities for engagement partners. It resulted in many deficiencies identified in certain individual audit engagements; and**
- **Audit firms did not conduct follow-up checks on the status of training with regard to persons who have not participated in mandatory training programs.**

In many cases, where deficiencies were identified in individual audit engagements, there was insufficient understanding of audit standards resulting from deficiencies in the education/training for professional staff. Audit firms are required to maintain and improve the competence/capabilities of audit teams through education and training in order to properly perform audit engagements.

(2) Evaluation, Compensation, and Promotion

Points of focus

Audit firms are expected to design appropriate policies and procedures for compensation, performance evaluation, and promotion of personnel 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 professional staff, from the following perspectives:

- ▶ How the audit firm reflects the attitude of placing high priority on audit quality in the policies and procedures relating to personnel affairs;
- ▶ Whether the audit firm has designed and properly followed its policies and procedures for performance evaluation, compensation and promotion of personnel with which the competence and capabilities (especially quality control capabilities) of professional staff and their compliance with professional ethics are fairly evaluated and appropriately rewarded.

Outline of inspection results

Some audit firms did not evaluate audit team members based on professional skills (quality control-related skills in particular) and compliance with professional ethics.

As for the background factors of the above deficiency, at some audit firms, the CEO evaluated audit team members and determined their compensation based on subjective evaluation. There were also audit firms which assumed that the quality of audit engagements did not significantly differ from partner to partner or which believed that it was important not to differentiate between partners in terms of evaluation.

(Observed effective efforts)

The following is an example of observed effective efforts made by an audit firm.

As a way of placing emphasis on audit quality, the audit firm adopted as many as 12 evaluation items related to quality control, including the level of understanding of audit procedures and accounting standards, among all 17 evaluation items of partners set by the firm.

Expected response

Audit firms need to **establish and implement policies and procedures in order to evaluate professional competence and capabilities, particularly those of quality control, and compliance with professional ethics of members**, taking into consideration the size, personnel structure and other relevant factors of the audit firm.

In addition, audit firms should properly evaluate professional staff's efforts to improve and maintain their competence and capabilities as well as their compliance with professional ethics, and appropriately reflect the results of the evaluation in compensation, promotion, and composition of engagement teams, in order to fully reward such efforts.

Case 1: Policies and procedures for evaluating partners

NEW

The audit firm stipulated that evaluations and compensation for partners were determined based on factors such as the length of the period since the appointment as a partner office, the quality control of audit engagements performed, and the partner's performance.

However, the audit firm did not establish specific evaluation standards for each evaluation item, nor did it clarify how each evaluation item would be reflected in partners' remuneration. As a result, the audit firm **did not have a system in which the evaluation of audit quality, etc. would be reflected in determining partners' remuneration**.

(Quality Control Standards Statement No. 1, Items 15, 17, 28, A5, A20, and A24)

Case 2: Evaluation of partners

The audit firm evaluates partners based on the table of personnel evaluation prescribed by the operational rules on personnel evaluation. Personnel evaluation is conducted on a five-grade scale with respect to each evaluation item. Overall evaluation is conducted based on the total points calculated according to the weightings assigned to the evaluation items. The audit firm proclaims to reflect its emphasis on the quality of audit engagements in personnel evaluation by giving higher weightings to the evaluation items related to the quality. Compensation plans for partners are prepared by the CEO based on the results of personnel evaluation and are determined through consultation at a partners' meeting.

However, actually, the audit firm **did not give consideration to audit quality when evaluating partners. For example, its evaluation assigned the same points and the same grade to each and every partner with respect to every evaluation item for two straight fiscal years**.
(Quality Control Standards Statement No. 1, paragraphs 17, 28, A20, and A24)

Case 3: Evaluation of part-time professional staff

All partners at the audit firm were to carry out evaluations of part-time professional staff and, based on the results of these evaluations by partners, to decide through discussions at the partners' meeting the compensation of part-time professional staff engaged in audits.
However, the CEO and the PICOQC had not clarified specific assessment items, the assessment methods and the quality control items to be emphasized in making assessments when deciding on the compensation of part-time professional staff, and had not developed an effective system for evaluating them.
(Quality Control Standards Statement No. 1, paragraphs 28, 29 and 30)

《Points to Note》

In addition to the above, there are cases in which audit firms have not sufficiently monitored some audit engagements involving certain partners whose quality control capabilities, etc. are concerned at their evaluations. In some cases, deficiencies regarding the operation of partners' meetings were identified. For example, there was a case in which the CEO made the decision instead of leaving the decision to a partners' meeting, although internal rules on quality control stipulate that the compensation for audit team members should be decided at a partners' meeting. Another deficiency identified was a failure to set clear standards regarding the relationship between the evaluation results of factors that should be considered when evaluating partners and the grade of the base salary and the payment conditions of evaluation-based compensation.
There were also cases in which, although part-time audit staff were subject to the same standard of personnel evaluation as full-time staff, the results of the personnel evaluation of part-time audit staff were not sufficiently reflected in promotions/demotions or the composition of engagement teams out of concern that audit engagements could be impeded because part-time staff might quit their jobs if treated strictly.
Evaluation, compensation, promotion, etc., are vivid illustrations of the CEO's management policies, and they also have a major impact on an audit firm's climate. The importance of this must be given due consideration when seeking to formulate appropriate policies and procedures and implement them.

(3) Assignment

Points of focus

When assigning professional staff to audit engagements, audit firms must select audit practitioners who have the knowledge, competence/capabilities and experience necessary to properly perform the audits, considering the business and characteristics of the audited companies, and who can take sufficient time for the assigned engagements.

In consideration of the above, in the inspections, the CPAAOB reviews the assignment of professional staff to engagements, including their appropriateness, from the following perspectives:

- ▶ Whether the audit firm has assignment policies and procedures to ensure that professional staff (including engagement partners)with the required competence and capabilities are assigned to individual audit engagements;
- ▶ Whether, when assigning audit practitioners (including engagement partners), sufficient examinations are made for each audit practitioners regarding the time that can be spent on assigned audit engagements, understanding professional standards and laws, practical experience, abilities, etc.; and
- ▶ Whether, if a merger etc. has occurred, audit teams members (including engagement partners) are being appropriately assigned, regardless of their affiliation prior to the merger, from the standpoint of forming appropriate engagement teams for the audit firm as a whole.

Outline of inspection results

Deficiencies were observed in assignments, including cases where the assignment of an engagement partner and the composition of an engagement team were not appropriately conducted based on audit risks. Causes for the identified deficiencies were as follows:

- ・The audit firm failed to appropriately conduct risk assessment based on the actual status of audited companies, or compose an engagement team based on risk assessment;
- ・Audit firms appoint engagement partners mainly based on which audit department the partners belong to, without due consideration for their quality control skills;
- ・The audit firm gave priority to acquiring new audit engagements without due consideration to the audit practitioners competence/capabilities and experience, or the performance capability of the audit firm as a whole; and
- ・The audit firm did not correctly understand the QC competence of engagement partners and how much time they could spend on audit engagements.

(Observed effective efforts)

The following is an example of observed effective efforts made by an audit firm.

- ▶ Following a merger, the audit firm has appointed partners in charge of individual audit engagements in a way that ensures that, after the expiry of each rotation period, each engagement partner and the partner in charge of the EQC review is replaced by a person who was affiliated with a different pre-merger audit firm so that the firm is able to promote integrated operation.

- The audit firm ascertained the operational workload of each partner by means of a comparative analysis of actual engagement performance against the annual engagement plan drawn up by each partner, and revised assignment of responsibility if necessary.

Expected response

Audit firms need **to assign audit practitioners who have the professional knowledge, practical experience, and abilities, etc., required in accordance with the size, risk and business of audited companies, and to establish a system for properly carrying out engagements to ensure that the engagement team can spend sufficient time on audit engagements, for example, by monitoring the work load.** Note that if a merger etc. has occurred, an integrated response is required for the audit firm as a whole.

Case 1: Assignment of engagement partner

①When appointing engagement partners, **the audit firm did not identify the engagement partners' workload and level of involvement in each audit engagement , resulting in failure to conduct appropriate monitoring as to whether sufficient time was secured for engagement partners to perform their duties**.
(Quality Control Standards Statement No. 1, paragraphs 29 and A26)

NEW

②When accepting or continuing audit engagements, the audit firm identified audit engagements assessed as having high audit risk as high-risk audit engagements, and in consideration of the results of the risk assessment, determined the most suitable engagement partner and partner in charge of engagement quality control, and subject them to audit quality monitoring by the quality control division.
However, the audit firm **did not reconsider the assignment of engagement partners of some of the audit engagements selected as high-risk audit engagements from the perspective of identified audit risks, and did not select them as engagements subject to audit quality monitoring by the quality control division**.
(Quality Control Standards Statement No. 1, paragraphs 15 and 16)

③When appointing engagement partners, the CEO of the audit firm is supposed to take into account not only restrictions on the number of years of involvement, but also factors such as the level of difficulty of audit engagement and the results of quality-related personnel evaluations.
However, even though factors such as the size of business and degree of internationalization of audited companies and the working hours of each partner differed by each audit division, the CEO appointed engagement partners within each audit division, which had been independent audit firms prior to the merger, and **did not consider audit risk for the firm as a whole and whether enough time could be secured to complete engagements**.
(Quality Control Standards Statement No. 1, paragraphs 17, 30, A26, and A27)

Case 2: Composition of engagement team

Although the PICOQC was aware of issues in the composition of engagement teams in certain audit engagements of a regional office, he/she left audit responses including composition of engagement teams to regional office entirely and did not provide any instruction for improvement as headquarter audit division. This led to insufficient monitoring by the audit division in head office for the composition of engagement teams at the regional office.

(Quality Control Standards Statement No. 1, paragraphs 15, 29, and 30)

《Points to Note》

It is important for audit firms to conduct appropriate risk assessment in line with the actual situation of audited companies, and to compose engagement teams based on the results of such risk assessment. When forming an engagement team, the audit firm shall give due consideration to the quality control capabilities of engagement partners, and shall bear in mind that monitoring by the head office is important for ensuring audit quality.

6. Audit Documentation

(1) Preparation of Audit Documentation and Supervision/Review by Superior

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 the generally accepted auditing standards. Thus, the audit documentation serves as evidence to directly and specifically demonstrate the audit procedures performed by the auditor.

On the other hand, especially in the case of audit procedures concerning significant or material matters, if the procedures performed were not recorded in the audit documentation, evidence other than the audit documentation (for example, oral explanations by an engagement team member who performed the procedures) cannot serve as solid and reliable evidence of the work performed by the auditor, or its conclusion. Auditors, as professionals, must pay full attention to this matter.

In consideration of the above, the CPAAOB inspects the status of the preparation of audit documentation and supervision/review by superiors from the following perspectives:

- Whether the audit firm has prescribed the information and techniques required for audits and informed audit teams of them;
- Whether engagement partners, during the process of conducting an audit, properly supervise the audit engagement by monitoring the progress of the audit engagement, finding out about important matters, etc. through the review of audit documentation and discussions with engagement teams;

- Whether professional staff prepare audit documentation in such a way to sufficiently and appropriately describe the types of audit procedures performed in accordance with generally accepted auditing standards , the nature, the timing and scope of audit procedures, the grounds for judgments, the conclusions reached, and other information;
- Whether more experienced members of the audit team appropriately review the audit documentation prepared by less experienced members; and
- Whether the engagement partner reviews the audit documentation and has discussions with the engagement team to confirm that sufficient and appropriate audit evidence has been obtained to support the reached conclusions and audit opinion.

Outline of inspection results

Concerning the preparation of audit documentation and supervision/review by superiors, many deficiencies, such as not documenting audit procedures performed by engagement teams and the basis for auditor's conclusion, were identified. Such deficiencies indicate that engagement teams did not perform appropriate audit procedures. . Furthermore, as a result of the failure of the engagement partner to review from the perspective of whether the audit procedures performed were appropriate and such procedures were sufficiently and appropriately documented, deficiencies in audit documentation were identified.

Causes for the identified deficiencies were as follows:

- As the CEO and the PICOQC place excessive trust in engagement partners, they assume that if the quality control policy and procedures are prescribed by the quality control rules, the partners will appropriately review audit documentation and provide instructions to and supervise their assistants and other staff;
- The professional staff did not fully understand the important role of the audit documentation at the time when the audit firm conducts quality control related tasks or explains their audits to external parties;
- Engagement partners did not consider the need to supervise assistants or review audit documentation and left the audit procedures to audit assistants because they misunderstood that there was a shared awareness among the engagement team about audited company's issues and audit procedures to be performed, since the partner always accompanied on site audits and understood the situation; and
- The engagement partner did not sufficiently understand audit procedures through review of audit documentation and concluded his/her understanding by simply hearing oral explanation or equivalent from the assistants.

(Observed effective efforts)

The following case constitutes an effective effort observed at an audit firm.

- The audit firm has divided up audit engagement processes granularly into detailed work tasks and documented the content, timing, workload, persons in charge, etc., of each work task, making it possible to carefully manage the progress of audit engagements by engagement partners, and it is conducting suitable and timely reviews of audit documentation as well as providing supervision and instructions to assistants to engagement partners.
- NEW By providing guidance about how to document the performed audit procedures and obtained audit evidence, the audit firm ensured that audit teams were informed of the level of audit procedures to be performed for individual audit engagements, as well as the required status of audit documentation, including the conclusions reached by practitioners and the basis for reaching their conclusions.

Expected response

Some firms did not prepare audit documentation so that the audit procedures performed for individual audit engagements could be clearly identified. There were also many cases where the processes to reach an important conclusion could not be understood from the audit documentation. Therefore, audit firms should ensure that the professional staff is fully aware of the following items:

- All procedures should be recorded clearly in the audit documentation, while confirming their adequacy and completeness; and
- Professional staff must check that the audit procedures are consistent with the audit plan that was established, and describe the audit procedures performed, the results of the audit procedures and the audit evidence obtained in the audit documentation. In addition, the audit documentation must also include the conclusions reached by audit practitioners as well as the basis of professional judgments for reaching such conclusions.

Engagement partners must realize that their review of audit documentation is a good opportunity to educate and train professional staff with communicating the level of audit procedures to be performed for individual audit engagements as well as the required status of audit documentation, including the conclusions reached by professional staff and the basis for reaching those conclusions. Keeping this in mind, it is important for engagement partners **to fully verify whether the conclusions reached by the engagement team are supported by the obtained audit evidence, and instructor supervise the team as necessary**.

Case 1: Preparation of audit documentation

The assistants to the engagement partner were not fully aware of the need to appropriately prepare audit documentation, as they lacked an understanding of audit standards relating to audit documentation. Accordingly, the assistants recorded only the results of audit procedures in the audit documentation regarding inventory, and failed to fully record the nature, timing and scope of the audit procedures performed to obtain sufficient and audit evidence.

(Auditing Standards Statement No. 230, paragraphs 7 and 8)

Case 2: Review of audit documentation

①The engagement partner himself prepared audit documentation and reviewed audit documentation prepared by other engagement partners and assistants to engagement partners.

Because preparing the audit documentation for which he was responsible was time-consuming and **sufficient time had not been allotted him for reviewing audit documentation, however, the engagement partner did not adequately confirm if other engagement partners and assistants to engagement partners had carried out suitable audit procedures in dealing with risks and if they had obtained sufficient appropriate audit evidence**.

(Quality Control Standards Statement No. 1, paragraphs 31 and A31; Auditing Standards Statement No. 220, paragraphs 15 and 16)

②Engagement partners lacked their understanding of procedures required by current audit standards and did not have adequate stance to reflect an understanding of the business of the audited company in audit plans and to verify the sufficiency of audit evidence and audit documentation. Furthermore, engagement partners were not sufficiently critical because their assistants to engagement partners had audit experience at large-sized audit firms and had been engaged in current audit engagements for a long time, and they were not aware of the need to mutually check the audit documentation prepared by other partners. Therefore, engagement partners did not sufficiently confirm whether appropriate audit procedures corresponding to risks had been performed and did not sufficiently confirm whether sufficient appropriate audit evidence had been obtained by reviewing audit documentation, etc.

(Quality Control Standards Statement No. 1, paragraphs 31, A30, and A31; Auditing Standards Statement No. 220, paragraphs 15 and 16)

Case 3: Instructions to and supervision of assistants to engagement partner

NEW

Engagement partners did not sufficiently identify and assess fraud risks in accordance with the audited company's business and its business environment and did not sufficiently plan procedures to respond to audit risks, and did not appropriately instruct or supervise audit procedures performed by assistants to engagement partners. Engagement partners also **did not conduct in-depth reviews of audit documentation from the perspective of whether management's assertions about accounting estimates were critically examined and whether sufficient appropriate audit evidence commensurate with the identified risks of material misstatement had been obtained**.

(Quality Control Standards Statement No. 1, paragraphs 31; Auditing Standards Statement No. 220, paragraphs 14, F14-2, 15, F15-2, and 16)

《Points to Note》

Engagement partners should note that they are required to appropriately assess audit procedures that were

performed through review of audit documentation, concerning the relevance of audit procedures performed by assistants to engagement partners, and whether the conclusion that was reached was supported by sufficient appropriate audit evidence.

In particular, there are cases where those responsible for reviews focused on examining the appropriateness of accounting by the audited company and neglected to ascertain whether the audit procedures performed met the levels required under audit standards. It is important in reviews to re-examine whether the levels of audit procedures performed by assistants to engagement partners conform to the current audit standards.

(2) Final assembly of audit files and control and retention of audit documentation

Points of focus

After the date of the auditor's report, and within the due period, auditors should assemble the audit documentation within the audit file, and complete the administrative procedures for the final assembly of the audit file. The audit firm should pay sufficient attention to the status of final assembly of the audit file and the control and retention of the audit documentation.

In consideration of the above, the CPAAOB inspects audit firms for final assembly of the audit file and control and retention of the audit documentation from the following perspectives:

- Whether the audit firm has established appropriate policies and procedures for the final assembly of the audit file;
- Whether the audit firm completed the final assembly of the audit file by the due date, by appropriately applying the policies and procedures mentioned above;
- Whether the audit firm ensures the traceability of any correction made after the final registration of the audit documentation and the reason and process for the correction, from the perspective of reliability of audit documentation;
- Whether the audit firm has policies and procedures properly in place for audit documentation so that confidentiality, safe custody, integrity, accessibility, and retrievability are ensured; and
- Whether the audit firm secures the confidentiality, safe custody, integrity, accessibility, and retrievability of audit documentation by appropriately applying the policies and procedures mentioned above.

Outline of inspection results

The audit firms had not established specific procedures to complete the assembly of final engagement files and control them. Some firms registered audit documents as the final assembly despite the fact that they had not completed important audit procedures, while some firms did not control audit documentation by making inventory list. Furthermore, there were cases in which taking audit documentation out of offices was not managed, and cases in which periodic inventory of audit documentation was not carried out, because policies and procedures relating to management of taking

out audit documentation and to inventory had not been prescribed.
The main causes of the identified deficiencies included lack of awareness in the control of audit documentation, as well as the lack of understanding among professional staff regarding the importance of audit documentation at the time when the audit firm conducts quality control related tasks or explains their audit to external parties.

(Observed effective efforts)
The following is an example of observed effective efforts made by an audit firm.
From the viewpoint of ensuring the confidentiality, safe custody, information integrity, accessibility, and retrievability of audit documentation, the audit firm converted audit documentation into an electronic format using audit software available in the market in light of its own resources.

Expected response
Audit firms need **to ensure the confidentiality, safe custody, integrity, accessibility, and retrievability of audit documentation**.
In order for the above to occur, each audit firm must once again recognize the importance of the control and retention of audit documentation and re-examine the condition of the final assembly of the audit file and the control and retention of the audit documentation, under the initiative of controllers such as the PICOQC. Audit firms must also ensure the completion of the final assembly of the audit file after the date of the auditor's report and within the due period, and implement all possible measures to prevent loss of audit evidence, leakage of confidential information, or any other damage, resulting from the loss of or damage to audit documentation.

Case: Assembly of the final audit file

①The audit firm prescribed policies and procedures for assembly of the final audit files in its quality control rules and stipulated a deadline by which assembly of the final audit files had to be completed. However, the audit firm did not confirm if assembly of the final audit files had been completed by the deadline by the engagement partner.
(Quality Control Standards Statement No. 1, paragraph 44)

NEW

②The audit firm established policies and procedures for the final assembly of the audit file and a deadline for completing the final assembly of the audit file in its quality control rules. In addition, if it became necessary to amend existing audit documentation or add new audit documentation after the deadline for completing the audit file documentation, the audit firm required to document (a) the specific reason for the amendment or addition, (b) the person who made the amendment or addition and the date of making the amendment or addition, and (c) the person who reviewed the amendment or addition and the date of reviewing, and developed a standard audit documentation format for this purpose.

However, the engagement partner **did not retain part of the audit documentation in the audit file, and even though some of the audit documentation had been amended after the deadline for completion of the documentation, the specific reasons for the need for amendments, etc. were not documented as prescribed**.
(Quality Control Standards Statement No. 1, paragraph 44; Auditing Standards Statement No. 230, paragraph 13)

《Points to Note》

In addition to the above, there are cases in which audit firms had not set out specific provisions on such matters as procedures and persons responsible for the final assembly of audit files, cases in which only the audited companies' names, the fiscal years and the total number of audit files were managed, with the contents of audit documentation stored in the audit files left unknown, and cases in which audit documentation had not been properly carried forward , despite the fact that the adequacy of the audited company's accounting policies had been examined in previous fiscal years in individual audit engagements.

7. Engagement Quality Control Review

Points of focus

In principle, audit firms should establish policies and procedures for reviews in order to objectively evaluate the audit procedures performed, the significant audit judgments and opinions made by the engagement teams throughout all audit engagements.

The CPAAOB inspects the appropriateness of review performed by the EQC reviewer from the following perspectives:

- Whether a person with the necessary experience and ability to perform the duties is appointed as the EQC reviewer, and whether they maintain objectivity and independence;
- Whether the EQC reviewer reviews the audit planning, significant audit judgments, and expressions of audit opinion in a timely manner;
- Regarding significant judgments and audit opinions made by the engagement team, whether the EQC reviewer discusses with the engagement partner, reviews audit documentation, evaluates audit opinions, and examines the appropriateness of financial statements and the draft of audit report, etc.;
- Whether the EQC reviewer examines the appropriateness of the evaluation of the engagement team members' independence, the necessity of consultation with experts and the conclusion reached, and whether the important judgments made by the engagement team were supported by sufficient and appropriate audit evidence, by reviewing the audit documentation; and
- Whether it has been appropriately documented that the procedures required by the audit firm's EQCR policies have been implemented, that the EQCR was completed before date of the auditor's report, and that there were no items deemed improper among the significant audit judgements and conclusions made by the engagement team.

Outline of inspection results

There were cases of deficiencies as follows. In the adequacy of EQC reviewers, where an EQC reviewer with abilities corresponding to the audit risk was not appointed. Ineffectiveness of the review process was also observed in cases of deficiencies, for example, the EQC reviewer did not conduct the review from a viewpoint that the EQC reviewer evaluates the appropriateness and sufficiency of the audit evidence and its judgment process related to significant matters objectively and failed to find deficiencies in the important audit procedures. Furthermore, there were also many cases where deficiencies were identified in the operation of EQC reviews as a result of analyzing the cause of deficiencies of individual audit engagements.

Causes of the identified deficiencies include the following issues:

- Due to reasons such as limitations in the personnel composition of the audit firm, an EQC reviewer with sufficient knowledge and experience corresponding to the audit risk as well as having spent enough time on reviews, was not assigned;

- In an audit firm where a small number of partners operate the business, the EQC reviewer did not spend sufficient time for the review putting a priority on the audit engagements he/she was in charge of;
- Although the audit firm did not have a sufficient number of partners or other staff members with sufficient knowledge and experience to perform the EQC review, the PICOQC did not examine whether persons with sufficient qualifications to serve as EQC reviewers had been hired or fostered. In addition, due to excessive trust placed in the EQC reviewer, the PICOQC did not aware of the need to develop an adequate review system;
- The EQC reviewer merely examined the same deficiencies as the ones identified in the CPAAOB inspections or the quality control reviews while neglecting to examine the responses to similar deficiencies;
- As the engagement team did not pass on to the EQC reviewer (including in cases outsourced to an external EQC reviewer), in writing or by any other appropriate means, information regarding the condition of the audited company and the consideration of significant matters, the engagement team and the EQC reviewer did not share the recognition of risk and other audit matters; and
- The EQC reviewer assumed, from the daily communications with the engagement team, that the audit procedures performed by the team were sufficient and appropriate. Thus, the EQC reviewer did not examine the important judgments made by the engagement team and the sufficiency and appropriateness of their audit procedures through audit work papers. In addition, the EQC reviewer lacked awareness to critically examining engagement teams' opinions.

(Observed effective efforts)

The following is an example of an effective effort observed in an audit firm.

Besides the normal opinion engagement quality control review, the audit firm carried out preliminary engagement quality control reviews concerning important accounting estimates, such as the recoverability of deferred tax assets, at an early stage during the end-of-term audit, when the work of the engagement team and the EQC reviewer did not become hectic. As a result, engagement quality control reviews were performed with plenty of time and profound perspectives instead of being performed precipitously right before formulating audit opinions.

<u>Expected response</u>

When reviewing the audit planning, the EQC reviewer should review the risk assessment conducted and risk-related audit procedures planned by engagement teams from an objective perspective while taking into account not only audited companies' business activities and business performance trends but also business risks related to their business objectives and strategies.

In addition, **<u>when reviewing the forming of audit opinions, the EQC reviewer should not only discuss matters important for the forming of opinions with engagement partners but also review audit documentation related to important judgments in order to examine whether the conclusions</u>**

<u>reached by engagement teams are supported by sufficient and appropriate audit evidence</u>. At small and medium-sized audit firms in particular, partners who serve as EQC reviewers are usually very busy because the firms are operated by a small number of partners. As a result, in some cases, as partners placed priority on their own audit engagements, it became difficult for them to conduct appropriate reviews. Therefore, audit firms are required to take actions to enhance the review system after reaffirming the importance of the EQC.

Case 1: Eligibility of the EQC reviewer

The audit firm's quality control policies stipulates that a person appointed to the post of EQC reviewer must have more than five years of practical audit experience after becoming qualified as a certified public accountant. However, while the firm was facing a shortage of persons with such practical audit experience, it placed the top priority on complying with the legally mandated rotation rules. As a result, with regard to audit engagements related to all large-sized companies, etc., the firm appointed a partner with less than five years of experience after becoming qualified as a certified public accountant as an EQC reviewer without considering the appointee's eligibility.

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

Case 2: Ensuring the effectiveness of EQCR

①The EQC reviewer and members of the review board operated by the collegial system did not sufficiently review audit documentation. In the case of the EQC reviewer, the reason for failing to conduct a sufficient review was that he/she did not adequately understand the need to objectively consider key audit judgments based on audit documentation. In the case of the members of the review board, the reason was that, because they assumed that the EQC reviewer had sufficiently reviewed audit documentation, they determined that engagement teams had obtained sufficient and appropriate audit evidence as a result of reading the items described in the EQC review request form prepared by the teams and checking the audit procedures performed and audited companies' assertions based on oral explanations from the teams. Moreover, the EQC review division head did not take steps to make sure that the EQC reviewer and members of the review board reviewed audit documentation relating to important judgements and conclusions when conducting the EQC review due to the assumption that they had considered the key audit judgements based on audit documentation.

(Quality Control Standards Statement No. 1, paragraphs 36, 37 and A41; Auditing Standards Statement No. 220, paragraphs 19 and 20)

②Regarding EQC reviews, the audit firm stipulated in its quality control policy that if any material misstatements due to fraud emerged, the adequacy of the amended audit plan, and the sufficiency and appropriateness of audit evidence obtained should be reviewed at a partners' meeting.

However, a review at a partners' meeting was not carried out when conducting an audit on amended financial statements arising from a material misstatement due to fraud.
(Quality Control Standards Statement No. 1, paragraphs 36 and 37)

③As only one person was in charge of conducting the EQC reviews for almost all of the audit firm's listed audited companies, he/she was unable to make sufficient time available for each review when several reviews coincided. Accordingly, **the EQC reviewer judged that understanding the engagement teams' explanation of key audit matters would be sufficient, and completed the review by concluding that there were no problems with the key judgments and conclusions of the engagement team, without sufficiently reviewing the relevant audit documentation**.
(Quality Control Standards Statement No. 1, paragraphs 36 and 37)

Case 3: Examination in the Financial Instruments and Exchange Act Audit

The engagement team did not inform the audited company that, at the time the audited company submitted its financial statements to EDINET, **the response to consultations from the department in charge and the review of audit engagements had not been completed, and the firm was not in a position to make an official expression of its opinion**; this led to the situation where the engagement team submitted the financial statements to EDINET that appeared as if the opinion had already been expressed, despite the fact that the EQC reviews had not been completed and the audited company's audit opinion was not yet expressed.
(Quality Control Standards Statement No. 1, paragraphs 14 and 41; Auditing Standards Statement No. 220, paragraphs 17)

《Points to Note》

The EQC reviewer needs to verify not only whether the accounting processes were suitable but also whether sufficient and appropriate audit evidence was obtained, and to make objective evaluations of engagement teams' explanations based on recorded facts by reviewing audit documentation.
Sending the necessary audit documentation in advance and other such steps are particularly necessary when a head office EQC reviewer located remotely, etc., carries out reviews of regional offices via a videoconferencing system, etc.
The audit firm must also ensure that, even if it consigns an EQCR to a CPA outside the audit firm, the steps required to be taken are the same as assigning internal personnel to EQCR.
Furthermore, if the date of the audit report based on the Financial Instruments and Exchange Act is the same as the date on which the financial statements, etc. is submitted to EDINET, it is necessary to ensure sufficient communication with the audited company so that the financial statements, etc. is not submitted to EDINET before the examination is completed.

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

Points of focus

The monitoring of the QC system plays an important role in ensuring and improving audit quality as a process to voluntarily identify and understand issues relating to the QC system and to remediate such issues. For this reason, audit firms are required to perform ongoing monitoring of the QC system to ensure the appropriate establishment and implementation of policies and procedures relating to the QC system; and to perform periodic inspections of completed audit engagements in a specified period for each engagement partner.

Furthermore, to confirm that an appropriate and adequate QC system has been established and is being implemented effectively, it is essential to accept statements of objection and doubt concerning violations of laws, regulations, and professional standards as well as breaches etc. of the QC system from inside and outside the audit firm. It is also necessary to conduct investigations based on this information, to take appropriate corrective action, as required, in the same way as in the case of deficiencies identified during ongoing monitoring and evaluations of the QC system.

In consideration of the above, the CPAAOB inspects whether monitoring of the QC system is effectively functioning from the following perspectives, in view of the importance of functions of QC system monitoring:

- Whether the audit firm assigns a person with sufficient and appropriate experience as the person responsible for the monitoring of the system of quality control, and vests the assigned person with sufficient authority;
- Whether the audit firm sets up monitoring system which appropriately understands the status of the establishment and implementation of a quality control system and identifies dificiencies; and
- Whether the audit firm evaluates the impact of deficiencies identified in the process of ongoing monitoring, and takes appropriate improvement measures in accordance with the results of such evaluation.

The CPAAOB also inspects the implementation status of periodic inspections of audit engagements at audit firms from the following perspectives:

- Whether the audit firm ensures that the person in charge of periodic inspections performed in-depth inspections to confirm whether the audit evidence was sufficient and appropriate, for example, by making inquiries to audit teams and reviewing audit documentation, not only by superficial inspection using the checklist, etc.;
- Whether the audit firm selects target engagements for periodic inspections by sufficiently taking into account deficiencies in the audit procedures identified during the QC review, the CPAAOB's inspection or other occasions;
- Whether the audit firm analyzes the impact of deficiencies identified as a result of inspections, has the relevant engagement partner take improvement measures, and verifies the appropriateness of such measures; and

- Whether the audit firm analyzes the deficiencies identified as a result of inspections, and communicates the result of the analysis throughout the firm.

The CPAAOB inspects Statements of objection and doubt from the following perspectives:

- Whether an appropriate system for a statements of objection and doubt has been established;
- Whether proper investigation is conducted based on the accepted statements; and
- Whether appropriate corrective action is taken in response to the results of investigations of statements of objection and doubt.

Outline of inspection results

As shown in the case example section below, there were some cases where the persons responsible for implementing ongoing monitoring and periodic inspection (including external persons responsible for those activities) conducted reviews based on checklists, etc. merely as a matter of formality and in which the PICOQC did not give those persons pre-inspection instructions or conduct post-inspection monitoring of them. There were also many deficiencies concerning the operation of the quality control system, such as a failure to appropriately detect deficiencies regarding individual audit engagements in periodic inspections because the person in charge of inspection merely received explanations from engagement teams and failed to spend sufficient time on inspections.

The primary cause of those deficiencies was the audit firm's failure to allocate sufficient time and manpower to inspections due to a lack of sufficient understanding of the importance of monitoring the quality control system.

(Observed effective efforts)

The following is an example of observed effective efforts made by an audit firm.

From the viewpoint of securing audit quality, the audit firm selects engagements subject to periodic inspection so that each engagement partner's work is inspected at a frequency of around twice every three years.

Expected response

Audit firms are **required to establish and implement an organizational system that adequately performs the primary function of quality control monitoring, which is to enable audit firms themselves to discover and understand problems related to the system of quality control and voluntarily implement remediation measures**. Specifically, audit firms should give due consideration to the need to carefully select individual audit engagements and identify the necessary inspection items in light of the economic environment, the business condition of audited companies, and the results of the previous CPAAOB inspection or the quality control review. They also need to establish a system which ensures that qualified persons inspections conduct periodic inspections, rather than merely conducting superficial inspections based on the checklist, and to develop an environment to check the adequacy of the corrective measures taken against the deficiencies identified through inspections.

It should also be kept in mind that even when a CPA from outside the audit firm has been appointed as the person responsible for implementing periodic inspections, it is necessary to check whether the primary monitoring function is sufficiently exercised, just as it is when a person within the audit firm has been appointed to that post.
Furthermore, it is necessary to establish and implement a system which enables that statements of objection and doubt are recognized in a timely fashion, with appropriate investigations conducted as necessary. For example, one possible way to do that is to establish a system for receiving information from whistleblowers inside and outside the audit firm.

Case 1: Effectiveness of ongoing monitoring

The person responsible for ongoing monitoring of the quality control system only checked on the existence of relevant documents (rules, etc.) based on the ongoing monitoring checklist and the like, and **did not perform in-depth inspections of the content of the relevant documents**. As a consequence, the person failed to point out multiple deficiencies in the quality control system identified by CPAAOB inspections, including those relating to the establishment and implementation of internal rules.
(Quality Control Standards Statement No. 1, paragraph 47)

Case 2: Effectiveness of periodic inspection

①**The persons in charge of periodic inspections merely conducted superficial checks based on the checklist without setting forth specific viewpoints of inspection and did not spend sufficient time on those checks. This resulted in a failure to conduct in-depth inspection from the viewpoint of whether engagement teams obtained sufficient and appropriate audit evidence**. Moreover, despite being aware that the time spent on inspections was short compared with the volume of the checklist and that the number of deficiencies identified was smaller than that of deficiencies identified in the quality control review, etc., the PICOQC did not evaluate the effectiveness of periodic inspections. In addition, the PICOQC did not develop a system to ensure the implementation of effective periodic inspections, for example by increasing the number of persons in charge of periodic inspections.
(Quality Control Standards Statement No. 1, paragraphs 47 and 48)

② The PICOQC just post a list of deficiencies detected during periodic inspections and the improvement measures required on a noticeboard in the office, so these matters were not communicated adequately. Furthermore, the descriptions of the required improvement measures only covered the procedures that needed to be followed to address the identified deficiencies. **They were not based on the causes of the deficiencies**.
Furthermore, confirmation of the status of improvements was limited to engagements subject to periodic inspections, and the status of improvements with another engagements was not confirmed.

(Quality Control Standards Statement No. 1, paragraphs 49 and 50)

《Points to Note》

In addition to the above, there were cases where persons were selected to carry out periodic inspection without consideration for their abilities with regard to audit quality, where a system was being implemented in a manner leading to collusion, e.g., the majority of partners were selected to carry out periodic inspection and they carried out inspection among themselves, and where audit engagements of specific engagement partners were not targeted for periodic inspection.

Other cases included a failure to develop an effective system for monitoring the quality control. For example, the monitoring of the quality control system was conducted solely by the CEO in some cases, while the frequency of periodic inspection of each audit engagements was too low in other cases.

From the perspective of analyzing deficiencies identified in the quality control review and preventing / discovering the identified deficiencies in advance, it is important to evaluate again whether periodic inspections were not limited to formal confirmation of the existence of audit documentation based on checklists, but were implemented effectively.

Case 3: Statements of objection and doubt

Even though the representative partners received information about fraud at an audited company via a hotline, they did not inform the PICOQC of the information they had obtained.

Furthermore, even though the “Audit Quality Management Rules” stipulated that engagement partners in charge of audited companies should report how they considered whistleblowing from internal and external parties to the division in charge of quality control in writing, they did not make such reports.

(Quality Control Standards Statement No. 1, paragraph F54-2)

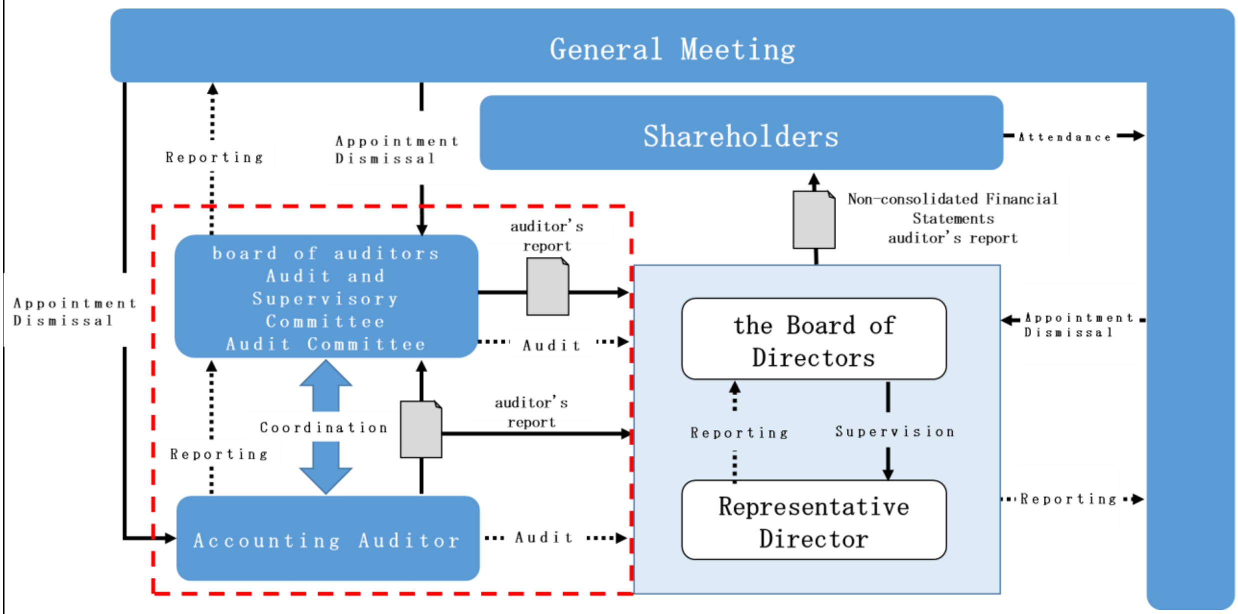
9. Cooperation with Company Auditors

(1) Communication between Accounting Auditors and Company Auditors

Points of focus

Accounting auditors and company auditors 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 through actively exchanging information and opinions, for example, they should share information identified during audits in a timely manner, or company auditors should understand the status of QC of audits undertaken by accounting auditors. (Refer to [Figure 4])

［Figure 4］ Reference image: Relationship between Company Auditors and Accounting Auditors



Source: Prepared by the CPAAOB based on data published by the JICPA

Given the importance of the aforementioned collaboration between the accounting auditors and company auditors, the CPAAOB inspects whether policies and procedures on communication with company auditors, and on responses when fraud, etc., is discovered, have been suitably stipulated, and whether implementation system of such policies and procedures has been established, from the following perspectives:

- Whether suitable provisions, requiring timely communication with company auditors at each phase of audits (planning, conducting, and reporting) and share of necessary information for enhancing both sides' audit work, have been stipulated;
- Whether a procedure in which, for example, basic forms and model sentences are prepared, has been put in place so that suitable explanations of the results of CPAAOB inspections and the results of quality control reviews are reported to audited companies in writing; and

- Whether policies and procedures have been suitably stipulated to ensure compliance by professional personnel with guidelines on dealing with violations of law.

Inspection of communications with company auditors are carried out from the following perspectives:

- Whether communication with company auditors concerning the accounting auditor's responsibilities, the scope of the planned audit, and an overview of its timing is clearly being carried out ;
- Whether explanations of the results of CPAAOB inspections and quality control reviews are suitably provided in writing to audited companies ;
- Whether information on audits is being properly obtained from company auditors ;
- Whether issues that are discovered during accounting audits and deemed to be important are conveyed in a timely manner to company auditors, etc. responsible for overseeing the financial reporting process; and
- Whether accounting auditors and company auditors cooperate and engage in effective two-way communication.

Outline of inspection results

As the need for collaboration between accounting auditors and company auditors has been widely accepted among relevant persons, efforts have been made to develop and maintain an environment to facilitate communication between them. As a result, periodic communication has been promoted, although the depth of collaboration may vary case by case.

Audit firms are following the principle of reporting the results of the CPAAOB inspection or the quality control review to company auditors in writing in a timely manner. On the other hand, as shown in the example case section below, due to a lack of understanding of the items requiring communication, there were some cases in which communication was inadequate or in which audit firms, despite having received notification of the results of the quality control review from the JICPA, did not communicate the results to company auditors.

Expected response

The necessity and importance of cooperation between accounting auditors and company auditors has been recently emphasized again in response to the occurrence of fraudulent corporate financial reporting cases. The audit standards state, "the auditor must ensure appropriate cooperation, through consultation or otherwise, with company auditors at each stage of the audit."

Auditing Standards Statement No. 260 ("Communication with Company Auditors) revised in February 2019 specifically seeks to enhance communication on particularly important matters when conducting audits, and it concretely manifests provisions on communication with company auditors, e.g., specifically describing the details to be conveyed to company auditors, regarding the results of quality control reviews and CPAAOB inspections and disciplinary actions taken by regulatory authorities and

JICPA, as well as the methods by which this information is to be conveyed, as part of explanations of the establishment and implementation of accounting auditors' quality control systems (Note 1, Note 2).
Accounting auditors need to improve the effectiveness of audits through information sharing with company auditors about every stage of the audit – from the audit planning to the implementation of audit procedures and the formation of an auditor's opinion – and circumstances identified in the process, exchange views on audit quality control issues highlighted in the results of CPAAOB inspections and quality control reviews, and actively promote collaboration with company auditors. **This collaboration will help ensure and improve audit quality as well as enhance/strengthen corporate governance at audited companies**.
The Revised Accounting Standards of 2018 required that key audit matters ("KAM") be included in auditor's reports. KAM are to be determined from among those matters discussed between accounting auditors and company auditors and the introduction of KAM has made in-depth communication between accounting auditors and company auditors all the more important.
Furthermore, Auditing Standards Statement No. 701 ("Reporting on KAM in Accounting Auditors' Audit Reports") released in February 2019 stipulated the items that auditors are to communicate company auditors, on KAM, while the Auditing Standards Statement No. 260 ("Communications with Company Auditors") was revised in February 2019 to address KAM. It is thus necessary to understand these standards as well.
Audit firms need **to build systems to support engagement teams so that engagement teams can suitably pursue effective two-way communication with company auditors**.

(Note 1) Disclosure of the results of the CPAAOB inspection to a third party needs the advance approval of the CPAAOB, in principle. However, no advance approval of the CPAAOB is necessary if the disclosure is made to those charged with the governance or equivalent of the audited company and the disclosed information is "whether or not there were deficiencies in the establishment or implementation of the quality control system of the audit firm and the outline of such deficiencies" or "whether or not there were deficiencies related to the engagement for the audited company and the outline of such deficiencies."
(Please refer to "III. Handling of Inspection Results" in the "Basic Policy for Inspections Performed by the Certified Public Accountants and Auditing Oversight Board" published on the CPAAOB's website)
(Note 2) In principle, any disclosure, including whether or not the audit firm is being inspected by the CPAAOB, is not permitted during the inspection.

Case: Communication with company auditors

① The engagement partner did not sufficiently understand the audit standards pertaining to communication with company auditors and thus **did not convey to company auditors the contents of and the steps taken in response to the "Quality Control Review Report" and the "Follow-**

up Review Report" received from JICPA, that are very useful for company auditors when selecting accounting auditors.
(Auditing Standards Statement No. 220, paragraph 11, and No. 260, paragraphs 16 and A31)

NEW

②Although the engagement team identified fraud risks in revenue recognition related to the business conducted by a significant component in the group audit and performed audit procedures to address them as significant risks, the team **did not report to the company auditors of the audited company that the risk was considered to be a significant risk related to the component, and did not appropriately communicate with the company auditors**.
(Auditing Standards Statement No. 260, paragraphs 13)

③The engagement team **did not communicate sufficiently with the company auditors, as it failed to provide reports on the following matters** :

・The auditor's response to significant risks
・The draft of the written representations from management
・Outline of audit tasks regarding the financial information of components
・Usage plan for the work of internal auditors

(Auditing Standards Statement No. 260, paragraph 13 and 14; No. 600, paragraph 48; and No. 610, paragraph 16)

④The engagement team did not provide the company auditors with written communication regarding the audit firm's fees for non-audit and audit services provided for the audited company and components dominated by the audited company.
(Auditing Standards Statement No. 260, paragraphs 15 and 19)

《Points to Note》

Auditors need to ensure that communication must be maintained with company auditors on the scope of the planned audit, the overall timing, the nature of significant risks and the reasons they were identified.
When communicating verbally with company auditors, auditors must ensure to note in the audit documentation when, with whom, and on what topics this communication took place.
When conducting both a Financial Instruments and Exchange Act audit and a Companies Act audit on an audited company, the scope of the audit and the date of the audit report differ. Therefore, it is necessary to communicate with company auditors on matters required in the Auditing Standards Statement such as the draft of management confirmation and the results of the internal control audit, even at the final stage of the Financial Instruments and Exchange Act audit.

(2) Response to Detection 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 audited company, the auditor is obligated to notify company auditors thereof so as to encourage the audited company to implement voluntary corrective action (see Article 193-3 of the Financial Instruments and Exchange Act). In light of the importance of such notice for ensuring the appropriateness of financial statements, the CPAAOB inspects the status of how the audit firm responded to the detection of fraud or non-compliance.

Outline of inspection results

(Observed effective efforts)

The following is an example of an effective effort observed in an audit firm.

Thoroughgoing efforts are being made to familiarize partners, etc., e.g., examples of notifications to be sent to company auditors of audited companies when facts of a non-compliance have been discovered are being presented.

Additionally, as a result of the audit firm having provided notice to an audited company in accordance with Financial Instruments and Exchange Act Article 193-3 about matters that could adversely impact the appropriateness of financial documents, the company revised its quarterly report and sought to reinforce its systems for suitable disclosure.

Expected response

It should be kept in mind that **in the event of detecting any deficiency during an audit that may affect the appropriateness of financial statements, audit firms should respond to such deficiency by facilitating audited companies to make corrections, including considering whether to give notice under Article 193-3 of Financial Instruments and Exchange Act**.

A support system for engagement teams must also be established so that experts are able to provide appropriate opinions when audit judgments about fraud or non-compliance are made.

Please refer to "Practical Guidelines for Audits of Financial Statements Included in Amendment Reports" (revised in January 2023), Auditing Standards Statement 560, Practical Guidelines No. 2, published by the JICPA, for points to be noted in order for auditors to take appropriate actions in audits of amended financial statements included in amendment reports for financial statements, interim reports, and quarterly reports.

Impact of COVID-19 and International Situations on Audit Engagements and Response

Points of focus

Due to the rapid expansion of the COVID-19 infections from around March 2020 in Japan, account book-closing work has been delayed, mainly at companies whose fiscal year end in March. Accordingly, with regard to audit engagements, constraints on the implementation of audits have arisen in a broad range of activities, including observation of inventory checks, balance confirmation, and conducting group audits related to foreign subsidiaries, raising concerns about delays in audit engagements and the impact on audit opinions. In the field of "audits related to accounting estimates," it has become difficult to make projections regarding the timing of the ending of COVID-19, among other factors.

Under these circumstances, in and after March 2020, the JICPA published "Audit Considerations Relating to COVID-19," while the Accounting Standards Board of Japan ("ASBJ") published "Response to COVID-19 (Views on the Impact of COVID-19 on Accounting Estimates)."

Furthermore, the JICPA published "Audit Responses in Light of the Current International Situation in Ukraine" in February 2022.

In light of the above, the CPAAOB inspects audit responses to the impact of COVID-19 and international situations from the following perspectives.

- ▶ Whether the audit firm has established appropriate operations management and quality control systems, for example by reorganizing the audit implementation system.
- ▶ Whether the audit firm is appropriately dealing with the impact on audit procedures and other elements of individual audit engagements in reference to the notices on audit considerations published by the JICPA.

Outline of inspection results

Concerning the operations management system, there were cases in which the CEO informed staff members of the basic policy for responding to the COVID-19 pandemic, such as protecting staff members from infection risk and sincerely performing the firm's social missions, and cases in which support was provided with regard to working arrangements and the development of a remote work environment.

Concerning the quality control system, there were cases in which the quality control division informed staff members of the notices on audit considerations published by the JICPA in light of the impact of COVID-19 and cases in which the quality control division understood audit-related challenges faced by engagement teams and new risks detected, provided guidance on how to respond to those challenges and risks, and supported engagement teams as necessary. Some audit firms made audit responses in light of the guidance on audit implementation that had been provided by global networks with which they were in partnership.

In individual audit engagements, the following responses based on the notices on audit considerations published by the JICPA were made.

- A case in which an audit firm revised the audit schedule and changed the date of submission of an audit report in order to deal with delays in the progress in the account book-closing work of audited companies' groups, including foreign components.
- A case in which an audit firm remotely observed inventory checks using a video camera because of the restrictions on the entry of auditors into audited companies' factories and other facilities.
- A case in which regarding the balance of account payable by business clients from which written replies could not be obtained at the time of balance checking, replies obtained via email were used as audit evidence as an alternative measure.
- A case in which an audit firm, when conducting group audits, increased the frequency of communication with component auditors and audited companies' top management in light of the restrictions on work done by component auditors.
- A case in which audit reference materials were provided by an audited company to an audit firm in the PDF format because of the restrictions on on-site audits of audited companies and in which the audit firm ascertained the authenticity of the audit reference materials later, when an on-site audit was conducted, by checking them against the original documents.
- A case in which an audit firm, when conducting an audit of accounting estimates, considered requiring appropriate disclosure of additional information in light of the possible impact on financial statements of the assumptions set by the management of the audited company with regard to the timing of the end of the pandemic.

Regarding individual audit engagements, there were cases in which the engagement team did not confirm the consistency of the management's assumptions regarding the COVID-19 containment period and the additional information regarding the estimation of future cash flows for impairment of long-lived assets, despite being aware of the difference between the two. There were also cases in which the engagement team did not consider the significant assumptions used by the management in evaluating investments and loans for affiliates, believing that the business plan would be achievable once the COVID-19 situation was under control.

(Observed effective efforts)

The following is an example of an effective effort observed in an audit firm.

- During office renovations, the firm installed multiple conference rooms equipped with large monitors, cameras and speaker microphones for online meetings, there by putting in place the infrastructure required to undertake remote audits and web-conferencing efficiently and effectively.
- NEW In order to support engagement teams' appropriate consideration of audit issues arising from the spread of COVID-19 and changes in the international situation, the quality control division prepares a standard audit documentation format that summarizes audit issues based on audit points to be noted published by the JICPA, and audit documentation using this format is required.

Expected response

With regard to the operations management system, it is important to formulate a basic policy for responding to COVID-19 that gives consideration to protecting staff members from infection risk and fulfilling the audit firm's social missions at the same time and to inform all staff members of the basic policy. Moreover, it is necessary to determine a policy on working arrangements for staff members adapted to the level of the COVID-19 pandemic (e.g. decisions on the percentage of staff members working in the office and on whether or not to permit business trips) and to develop infrastructure for efficiently conducting audits, such as introducing a web conference system, in order to enable the remote work arrangement, which has taken hold under the COVID-19 pandemic, to function effectively.

As for the quality control system, it is essential to inform all audit firms' staff members, in an appropriate and timely manner, of the notices on considerations published by the JICPA and the Accounting Standards Board of Japan in light of the impact of COVID-19 and International Situations. **The quality control division, etc. should collect information from engagement teams with regard to audit risks and constraints on audit implementation that have arisen at audited companies and provide organized support as necessary**.

With regard to individual audit engagements, it is necessary to obtain sufficient and appropriate audit evidence after identifying, in a timely manner, the impact of the COVID-19 pandemic and International Situations on audited companies' business activities and business performance and the presence or absence of constraints on audit implementation, giving consideration to the presence or absence of changes in internal control due to the expansion of telework, and appropriately evaluating audit risks. In particular, in the field of "audits related to accounting estimates," while it is not appropriate to tolerate top management's overly optimistic estimates, it is necessary to keep in mind that it is also not appropriate to make overly pessimistic projections far from reality and judge the top management's accounting estimates as material misstatements. It is also necessary to give consideration to the need to take more care than usual to communicate with audited companies' top management and company auditors, etc. in an appropriate and timely manner.

Ⅲ．Individual Audit Engagements

Audit Engagement Performance

Summary

Examples of deficiencies in individual audit engagements identified during the CPAAOB's inspections broadly cover audit planning through to the formulating of auditor's opinions.

This section, "III. Individual Audit Engagements," lists example cases of identified deficiencies in accordance with the structure of the Auditing Standards Statement. In particular, the section begins with "The Auditor's Responsibilities Relating to Fraud in Financial Statement Audits" not only because the Fraud Risk Response Standard requires careful response when addressing fraud risks in audits but also because, as seen in recent incidents, accounting fraud has been attracting attention from society at large. For the same reasons, the number of example cases has been enhanced.

Furthermore, with regard to "Audit of Internal Control over Financial Reporting," which is subject to audit standards different from the ones that are applicable to audits of financial statements, example cases and other items, including specifics related to the "use of the work of internal auditors" (Auditing Standards Statement No. 610), are described in a separate sub-section. The number of example cases has also been enhanced.

As in "II. Quality Control System," each subsection describes the "points to note" in performing audit procedures as a reference, in addition to the "points of focus" in inspection and example cases of identified deficiencies.

Furthermore, cases that have continued to appear since being identified in previous program years and frequently identified cases are presented with the mark: **FREQUENT**

Analysis of deficiencies

Deficiencies identified in individual audit engagements result from some form of failures of satisfying requirements of audit standards or standards of the Auditing Standards Statement ("requirement(s)").

Reflecting the situation surrounding engagement teams and audited companies, various factors were described as the causes of deficiencies. In recent cases, the following three causes were identified relatively frequently:

- Insufficient consideration for suitability of further audit procedures to audit risk and the sufficiency and appropriateness of audit evidence;
- Lack of an attitude of professional skepticism required of an auditor; and
- Insufficient knowledge of requirements of audit standards and the Auditing Standards Statement.

(1) Cases of inadequate consideration of the suitability of risk-related audit procedures to audit risk and the sufficiency and appropriateness of audit evidence

Auditors are required to identify and assess the risk of a material misstatement based on their understanding of companies and business environments and to design and perform procedures for addressing the assessed risk of material misstatement. However, many cases were observed in which it could not be ascertained that sufficient and appropriate audit evidence had been obtained through the audit procedures. This deficiency resulted from the fact that engagement teams did not adequately consider the audit procedures and audit evidence at the following two stages:

1) Risk assessment at the audit planning stage

In some cases, the auditors did not plan audit procedures for addressing risks that should in principle have been assumed at the assertion level (refer to "1. The Auditor's Responsibilities Relating to Fraud in Financial Statement Audits"(2) and "2. Risk Assessment and Response to Assessed Risks"(2), and "5. Group Audit" Case 1) due to the insufficiency of their own risk assessment.

There were also many cases in which although risks were appropriately identified, sufficient and appropriate audit evidence was not obtained because risk-related audit procedures performed under a detailed audit plan did not sufficiently conform to the specifics of the identified risks (refer to "1. The Auditor's Responsibilities Relating to Fraud in Financial Statement Audits"(3) and "2. Risk Assessment and Response to Assessed Risks"(3)).

When performing audit procedures, auditors are required under the audit standards to design and perform procedures to address the risks identified through risk assessment. Specifically, the nature, timing and extent of specific risk-related audit procedures should be determined based on the professional judgment of engagement teams in view of the situation of audited companies. In particular, it is required that risk-related audit procedures at the assertion level be designed under a detailed audit plan.

2) Evaluation of obtained audit evidences

Auditor have to conclude whether sufficient and appropriate audit evidences have been obtained. If not, he/she needs to perform additional audit procedures. In principle, whether sufficiency and appropriateness of obtained audit evidence should be checked through means such as a review by superiors, but there were cases in which the obtained audit evidence was not sufficiently evaluated (refer to "1. The Auditor's Responsibilities Relating to Fraud in Financial Statement Audits"(3) and "3. Audit Evidence")

With regard to risks of material misstatement at the assertion level, auditors should note that they are required to obtain more suitable and attestable, or more audit evidences if any, compared to cases where no risk of fraud is identified for the assertion.

(2) Lack of an attitude of professional skepticism required of an auditor

Auditors are required to make professional judgments and maintain professional skepticism throughout the processes of planning and performing audits. However, there were cases in which, although the auditors understood the management's assumptions and accounting treatments, they failed to perform the procedures for verifying the reasonableness of the management's assertions such as the feasibility of business plans used in accounting estimates based on objective evaluation due to a lack of professional skepticism (refer to "4. Auditing Accounting Estimates" (1)).

Auditors need to continuously pay attention to the possibility of material misstatement due to fraud and retain a professional skepticism throughout the entire audit process, regardless of the auditors' past experience concerning the reliability and sincerity of management, directors and company auditors.

(3) Insufficient knowledge of requirements of audit standards and the Auditing Standards Statement

As described below, there were many cases of deficiencies due to a lack of knowledge concerning the matters required by the audit standards and the Auditing Standards Statement.

- Cases regarding to fraud risk, in which the engagement team did not consider the possibility that unusual transactions were conducted for the purpose of producing fraudulent financial reports (see "1. The Auditor’s Responsibilities Relating to Fraud in an Audit of Financial Statements" (3)).
- Cases in responding to assessed risks, in which substantive procedures were not performed for significant account balances, or substantive procedures were not performed for part of the population (see "2. Risk Assessment and Response to Assessed Risks" (3)).
- Cases in which the reliability of basic data was not evaluated in the substantive analytical procedures (refer to "3. Audit Evidence" (3)), or in which sufficient and appropriate evidence was not obtained when the difference between the booked value and the estimated value was larger than the tolerable level of difference (refer to "3. Audit Evidence" (3)).
- Cases in an audit sampling, in which the engagement team did not examine the appropriateness of audit evidence obtained through alternative procedures, and among the transactions in the population, transactions from January to March were not given the opportunity to be selected (see "3. Audit Evidence (1)").
- Cases in which accounting estimates for the previous fiscal year were not reviewed (See "4. Auditing Accounting Estimates" (1)) or in which the reliability, etc. of data used as basis of the accounting estimate was not assessed (See "4. Auditing of Accounting Estimates" (8))
- Cases in which the specific procedures to be performed by component auditors in order to address significant risks related to group financial statements were not understood or considered in group audits (refer to "5. Group Audit," Case 5), in which the appropriateness of risk-related audit procedures was not evaluated (refer to "5. Group Audit," Case 9), or in which the matters reported by component auditors were not evaluated (refer to "5. Group Audit," Case 9).
- Cases in which experts' competence, capabilities and objectivity were not evaluated when experts' work was used (refer to "6. Using the Work of Auditor’s experts").
- Cases in which, in audits of internal controls over financial reporting, the adequacy of the scope of internal control was not examined (refer to "7. Audit of Internal Control over Financial Reporting" (1)) or in which the impact of the identified material misstatements on the audit of internal controls was not examined (refer to "7. Audit of Internal Control over Financial Reporting" (3)).
- Cases in which the nature of each KAM, the reason for deciding on it, and the appropriateness of the description relating to the audit response were not examined (refer to "8. Key Audit Matters (KAM)").

When performing audit procedures, if the engagement team does not sufficiently understand the requirements, and requirements are not satisfied in the audit procedures performed, the primary purpose cannot be achieved with the performed procedures and it results in a deficiency at audit procedures.

Expected response

Engagement teams are required to sufficiently exert professional skepticism in all audit aspects, as well as to update and expand the required knowledge such as audit standards. Based on this, they necessitate to respond to individual audit engagements from the perspective of whether sufficient audit plans are formulated according to misstatement risks, and whether the audit procedures planned are performed according to the requirements of standards of audit, such as the Auditing Standards Statement, in order to reduce audit risk to a reasonably low level.

There continue to be many cases where engagement teams argue “deficiency in audit documentation” when identifying deficiencies in individual audit engagements. This argument means that the team actually performed audit procedures but neglected to document them.

In this regard, unless the argument by the engagement team is objectively proven by audit documentation, etc., it cannot be determined that the audit procedures were completed before issuance of the audit opinion. Therefore, close attention should be paid so that such cases are treated the same as when audit procedures were not performed.

Audit firms are required to ensure and improve the quality of individual audit engagements through QC systems to prevent the occurrence of deficiencies that were identified in individual audit engagements.

In order for the penetration and establishment of measures over an entire firm, it may need to establish a system that monitors each engagement team’s understanding of improvement measures, as well as the implementation status of improvement measures by each engagement team. When improving audit engagements, not only additionally establishing new quality control system, but also the use of existing systems including periodic inspections and QC reviews is effective. Each audit firm is required to take efforts for effective and efficient improvement for audit quality in a way that suits the characteristics of each firm.

Regardless of the size of the audit firm, some deficiencies in individual audit engagements are caused by engagement partners whose understanding of the concept of the risk-based approach are insufficient. In such case, it is necessary to note that audit firms are required to respond with organizational and adequate measures, such as re-education of partners and appropriate assignment.

According to the Auditing Standards Statement No. 260, etc., deficiencies in individual audit engagements identified by the CPAAOB's inspections need to be explained to those in charge of governance of the audited company that was subject to the inspection. Therefore, each engagement team needs to strive for exact understanding of the deficiencies so that it can explain the deficiencies that were identified in the inspection to the audited company.

Furthermore, it is necessary for not only the engagement teams that were subject to inspection but also other engagement teams to refer to the deficiencies identified in the CPAAOB’s inspections, QC reviews, and periodic inspections within the firm so that they are able to examine/review their audit work appropriately.

(Reference)

Regarding deficiencies identified in individual audit engagements, the provisions on criteria and points to note relating to frequently identified deficiencies are shown below.

Deficiency	Provisions Often Serving as Criteria for Identification	Relevant Points to Note
1. The Auditor's Responsibilities Relating to Fraud in Financial Statement Audits	Auditing Standards Statement No. 240 Paragraphs 25, 29, 31	➢ Whether the engagement team easily assumes that fraud risks exist solely in areas where risks are evaluated particularly high. ➢ Whether the engagement team plans and performs audit procedures corresponding to assumed fraud risks. ➢ Whether, in examining the business rationality of significant transactions, the engagement team assesses and examines the entire picture of a series of related transactions.
2. Risk Assessment and Response to Assessed Risks	Auditing Standards Statement No. 330 Paragraphs 5, 17	➢ Whether the engagement team plans the nature, timing, and extent of risk-related audit procedures, in accordance with the assessed risks of material misstatement at the assertion level. ➢ Whether the engagement team designs and implements substantive procedures for important transaction types, account balances, and notes, etc., regardless of the degree of the assessed risks of material misstatement.
3. Audit Evidence	Auditing Standards Statement No. 500 Paragraphs 7, 8, 9; No. 520, Paragraph 4; No. 530, Paragraphs 6 and 7; No. 550, Paragraphs 12 and 13; No. 570, Paragraph 15	➢ Whether the engagement team evaluates the competence, capabilities and objectivity of experts employed by the management, and examines the appropriateness of the experts' work. ➢ Whether the engagement team examines the reliability of data prepared by the audited company. ➢ Whether, when performing substantive analytical procedures, the engagement team examines the reliability of the data, the accuracy of the

Deficiency	Provisions Often Serving as Criteria for Identification	Relevant Points to Note
		expected values, and reason of any differences that exceed the acceptable level. ➢ Whether, when performing audit sampling, the engagement team examines the validity of the sample selection method and sample size. ➢ Whether, when testing items selected by specific sampling, the engagement team obtains sufficient and appropriate audit evidence for the remainder of the population. ➢ Whether the engagement team comprehensively identifies related party relationships and transactions.
4. Auditing Accounting Estimates	Auditing Standards Statement No. 540 Paragraphs 8, 12, 14 No. 500, Paragraph 8	➢ Whether the engagement team reviews prior period accounting estimates. ➢ Whether the engagement team examines the appropriateness of rules established by the audited company, such as inventory valuation rules and the grouping for impairment judgement of fixed assets. ➢ Whether the engagement team examines the reliability of data prepared by the audited company when examining accounting estimates. ➢ Whether the engagement team examines the audited company's assertions such as the achievability of its business plan based on concrete evidence.
5. Group Audit	Auditing Standards Statement No. 600 Paragraphs 8, 30, 31, 41	➢ Whether the engagement team considers multiple financial indicators according to the group's characteristics and circumstances when assessing individual financial significance. ➢ Whether the engagement team is appropriately involved in tasks undertaken by component auditors. ➢ Whether appropriateness, completeness and accuracy on consolidated journal entries are

Deficiency	Provisions Often Serving as Criteria for Identification	Relevant Points to Note
		evaluated. ➢ Whether the engagement team evaluates the appropriateness of tasks undertaken by component auditors.
6. Using the Work of Auditor's Experts	Auditing Standards Statement No. 620 Paragraph 8	➢ Whether the engagement team evaluates the competence, capabilities and objectivity of experts.
7. Audit of Internal Control over Financial Reporting	Auditing Standards Statement No. 265 Paragraph 6 Audit and Assurance Practice Committee Statement No. 82, Paragraphs 44, 100, 112	➢ Whether the engagement team examines the adequacy of the scope of internal controls set by management, based on the audited company's business environment and business characteristics. ➢ Whether the engagement team examines consistency between the scope of risk assessment in financial statement and that of effectiveness evaluation of internal controls conducted by management. ➢ Whether the engagement team examines the impacts on internal control audits when misstatements are found during the course of the financial statement audit.
8. Key Audit Matters (KAM)	Auditing Standards Statement No. 701 Paragraph 12	➢ Whether the engagement team examines the appropriateness of the descriptions of the nature of each KAM and the reason for deciding on it. ➢ Whether the engagement team appropriately describes the audit procedures carried out as an audit response to the KAM.

1. The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements

Points of focus

Users of financial statements are increasingly paying more attention to fraud that may result in material misstatement of financial statements. Considering this, the CPAAOB inspects the auditor's response to fraud risks in an audit of financial statement from the following perspectives:

- ▶ Whether the engagement team maintains professional skepticism throughout the audit, and exercises such skepticism so as not to overlook any circumstances that indicate the possibility of a material misstatement due to fraud, when assessing the risks of material misstatement due to fraud, responding to such risks, and evaluating audit evidence that has been obtained;
- ▶ Whether the engagement team discusses the possibility of material misstatement due to fraud; and whether the engagement team places emphasis on where and how material misstatement due to fraud may occur in financial statements, including how fraud is committed, without assuming the reliability and integrity of the audited company's top management, directors, and company auditors;
- ▶ Whether the engagement team evaluates whether the information obtained from other performed risk assessment procedures and related activities indicates the presence of fraud risk factors and takes such risks, if any, into account when identifying and assessing the risk of a material misstatement due to fraud at two levels, i.e. the financial statement level and the assertion level; whether the engagement team makes judgements as to which types of revenue, sales transactions or assertions may give rise to fraud risks; and, when making such judgments, whether the engagement team conducts sufficient consideration in light of the audited companies' business processes, without easily assuming that fraud risks are limited to areas where particularly high risks are considered to exist;
- ▶ Whether the engagement team obtains audit evidence more relevant, reliable and/or quantity of audit evidence, for the risks of material misstatement due to fraud at the assessed assertion level than in cases where no risk of fraud has been identified;
- ▶ Whether the engagement team evaluates if a misstatement, in the case that one is identified, is indicative of fraud; recognizes that, when such misstatement is determined to be indicative of fraud, an instance of fraud is unlikely to be an isolated occurrence; and pays extra attention to the relationship with other aspects of the audit, particularly evaluating the reliability of statements by the management, and reviews and modifies its audit plan as needed after evaluating the implications of such misstatement;
- ▶ Whether the engagement team makes inquiries of and asks for explanations from the management when it identifies any circumstances that indicate the possibility of a material misstatement due to fraud during the audit, and performs additional audit procedures; and modifies its risk assessment and planned responses to audit risk to include audit procedures that are specifically responsive to the types of possible fraud if it determines that any suspected material misstatement due to fraud

exists; and

- Whether the engagement team adequately communicates with company auditors who supervise the execution of duties by directors, if it determines that suspected material misstatements due to fraud exists or suspects fraud involving the management.

Outline of inspection results

There were cases of significant deficiencies regarding audit procedures related to fraud risks in the audit of financial statements. In some cases, the engagement team overlooked indications of fraud, although the risk of a material misstatement due to fraud could have been identified at the stages of audit planning and performance. In other cases, the audit team determined a misstatement to be due to error without sufficient examination although the situation raised suspicions about the possible management's involvement in fraud.

Other cases were also observed in which: the engagement team failed to assess the risk of a material misstatement due to fraud in view of changes at the audited company; the engagement team identified the risk of a material misstatement due to fraud only in areas where particularly high risks were considered to exist and determined without due consideration that there was no risk of a material misstatement due to fraud in other areas; the engagement team did not examine the presence or absence of risk of a material misstatement due to fraud with regard to items other than revenue recognition; the engagement team did not sufficiently perform further audit procedures, although it identified the risk of a material misstatement due to fraud with regard to revenue recognition; the engagement team performed only perfunctory risk-related audit procedures in order to address risks related to management override; the engagement team did not carefully assess fraud risks, although it identified transactions with related parties and unusual transactions.

(Observed effective efforts)

The following is an example of an effective effort observed in an audit firm.

- The audited company ran a manufacturing business and had multiple regional sales subsidiaries. These sales subsidiaries only sold products purchased from the parent company to customers, and they used a sales management system shared in common with the parent company to recognize revenue.

  Because of the commonality in revenue types and transaction formats between the parent company and its sales subsidiaries, the group engagement team conducted a centralized risk assessment and proposed further audit procedures to address fraud risks pertaining to revenue recognition by the audited corporate group inclusive of the parent company and key sales subsidiaries that constitute significant components
- An audited company (private tutoring school), upon establishing preventive internal control over fictitious revenue recognition with no track record of classes, considered obtaining signatures from the students and their parents upon attending class as external evidence of the transactions, but was

reluctant to do so on the grounds that it was bothering. Against this situation, the engagement team, saying that external evidence of the transaction was fundamental, convinced the audited company to appropriately develop the internal control.

Expected response

Conventionally, auditors have been required to maintain professional skepticism. Since the Fraud Risk Response Standard emphasizes the maintenance and exercise of professional skepticism, auditors should **pay attention to the fact that they are expected to maintain professional skepticism in all processes of auditing and exercise it when examining the risk of a material misstatement due to fraud**.

In particular, all auditors must recognize anew that the reliability of audit has once again been called into question following recent cases of fraudulent accounting.

Therefore, when preparing audit plans, in order to examine if there are fraud risk factors, auditors are required to understand major fraud cases published as well as general and industry-specific business practices that may be used for fraud, obtain information through interviews with managers and other employees, and carefully examine whether the information obtained indicates the presence of fraud risk factors through discussions within the engagement team.

Furthermore, auditors should consider identified fraud risk factors and identify and assess the risk of a material misstatement due to fraud at two levels, i.e. at the level of the financial statement as a whole, and at the assertion level. When identifying and assessing fraud risks related to revenue recognition, auditors should **consider where and how material misstatements due to fraud may occur in financial statements in light of their understanding of the audited company and its business processes, without easily assuming that fraud risks are limited to areas where particularly high risks are considered to exist**.

In responding to the assessed risk of a material misstatement due to fraud, auditors should always keep in mind the possibility that a material misstatement due to fraud could occur and prepare overall responses appropriate to the risk of a material misstatement due to fraud at the level of the financial statement as a whole and further audit procedures for addressing the risk of a material misstatement at the assertion level.

In performing the procedures to address the risk of a material misstatement due to fraud, auditors should keep in mind **that they are required to obtain more relevant and stronger audit evidence in greater quantity with regard to assertions regarding the identified fraud risks than with regard to assertions over which no fraud risk has been identified**.

If auditors have identified circumstances that indicate the possibility of a material misstatement due to fraud during the process of audit procedure, they should make inquiries of and ask for explanations from the management, and they should perform additional audit procedures in order to determine whether the suspected material misstatement due to fraud exists. In cases where there are suspicions about a possible material misstatement due to fraud, such as when the management's explanations are considered to be not reasonable, it is necessary to keep in mind the need to modify their risk assessment and designed further audit procedures and perform audit procedures that are specifically relevant to the type of fraud that may be assumed.

(1) Discussion among the engagement team, risk assessment procedures, and related activities

Case: Understanding of fraud cases at audited companies and the industries to which they belong

The audited company engages in construction business and applies the percentage-of-completion method to the booking of sales. As a fraud risk scenario, the engagement team considered possible fraud due to the manipulation of the total construction cost and the progress in construction as of the date of the account book closing.

However, the engagement team did not consider the need to identify risks related to the "fraudulent practice of indicating the cost of a construction project as the cost of another project," many cases which have been published as examples of fraud, in discussions within the team.

In addition, although the engagement team identified cases of such fraud in past fiscal years during the process of auditing at the end of each fiscal year, it did not consider the need to review its risk assessment.

(Auditing Standards Statement No. 240, paragraphs 14, F15-2, and No. 330, paragraph 24) [Mid-tier, and small and medium-sized audit firms]

《Points to Note》

The engagement team needs to sufficiently perform risk assessment with an understanding of the audited company's nature of business, the industry-specific business practices, and previous fraud instances. The team then needs to develop an appropriate audit plan responsive to the identified risks related to the assertions, so as to perform sufficient and appropriate further audit procedures.

In addition, it is necessary to maintain and exercise professional skepticism in identifying fraud risk factors, including incentives or pressure to commit fraud, or events or situations which create opportunities to do so; as well as in assessing the risks of material misstatement due to fraud.

There were also cases in which the discussion held within the engagement team was merely perfunctory. For example, the risks indicated by example cases of fraud thus far published were not discussed in relation to audited companies. In some cases, as inquiries asked of the management about fraud and communication with the management and company auditors were merely perfunctory, the engagement team failed to reflect the information obtained through those processes in its risk assessment.

(2) Identifying and assessing risk of material misstatement due to fraud

Case: Identifying and assessing fraud risks in revenue recognition

NEW

①The audited company is engaged in business A and B. In both businesses, transactions for which the price per each transaction is relatively small account for the majority of all transactions. However, in business B, transactions for which the price per transaction is high occur several times a year.

In light of these circumstances, the engagement team assessed that the transactions in Business B involving price of money per transaction had a high fraud risk, and planned and performed audit procedures such as cross-checking with cash-receipt vouchers and checking the status of system development, in addition to cross-checking with order and acceptance vouchers. In addition, the engagement team assessed that there was a fraud risk of fictitious recording in overall sales excluding transactions involving large price per transaction, and responded by expanding the number of transactions subject to detailed testing compared to cases where no fraud risk had been identified.

However, although the engagement team assessed that transactions with large price per transaction had high fraud risks, and that overall sales excluding such transactions also had fraud risks of fictitious sales, the engagement team **did not sufficiently consider these fraud risks from the perspective of specifically what kind of methods would be used to commit fraud**.

(Auditing Standards Statement No. 240, paragraphs 25) [Large-sized audit firms]

FREQUENT

②The audited company ran a home furnishings wholesale business. The engagement team identified the risk of fraudulent sales being booked in respect of transactions carried out using a miscellaneous account or new account that were not based on orders.

However, although the engagement team used transactions within a period of 10 business days before and after the closing date of the fiscal year as the sample population, based on the assumption that channel stuffing is generally more prone to taking place during this period, the team **did not examine whether the period in question was appropriate in light of the audited company's likelihood of fraud risks**. Moreover, regarding the risk of booking fraudulent sales using a miscellaneous account or new account, the engagement team **did not examine such matters as the specific individuals committing fraud or the means via which fraud might be committed, nor did the team fully examine which types of sales transactions or assertions may give rise to fraud risks**.

(Auditing Standards Statement No. 240, paragraph 25) [Mid-tier, and small and medium-sized audit firms]

NEW

③With regard to an audited company manufacturing and selling fire protection and extinguishing products, the engagement team found that the sales division manager was under pressure to meet budget targets, which increased its motivation to commit fraud in the last month of the fiscal year. The team also found that there were opportunities to commit fraud during the shipment suspension period, when fraudential shipment orders from the sales division to the factory were unlikely to be detected.

Based on the consideration of these fraud risk factors, the engagement team assumed a fraud risk scenario in which "the sales division manager or his / her subordinate under his / her instructions records sales by giving false shipping instructions to the person in charge at the factory during the

shipping suspension period for product sales transactions exceeding an amount that was clearly determined to be an insignificant misstatement." However, because there were no transactions exceeding an amount that was clearly determined to be an insignificant misstatement during the shipping suspension period, the team did not perform procedures to respond to the fraud risks. However, the engagement team **did not adequately consider the possibility of fraud in transactions that occurred before the period of suspending shipments at the year-end and in transactions below the amount of the apparently immaterial misstatement that occurred during the period of suspending shipments**.
(Auditing Standards Statement No. 240, paragraph 25, 46) [Mid-tier, and small and medium-sized audit firms]

④The engagement team identified the "risk of employees engaging in the practice of early sales booking by booking sales regarding transactions that do not meet the booking requirements" given the possibility that employees of the audited company might commit fraud in order to achieve the budgeted sales figure because of the severe order-receiving situation.
However, the engagement team did not sufficiently evaluate the risk of a material misstatement due to fraud related to revenue recognition. For example, the engagement team did not identify the risk of fraud being committed by the management merely because of the assumption that the management was strict about rules and that their sense of values was not such that they would justify fraud, nor did it take into account motivations and opportunities for the management to commit fraud.
(Auditing Standards Statement No. 240, paragraph 25) [Mid-tier, and small and medium-sized audit firms]

FREQUENT

⑤The audited company engages in wholesale sales of beverages and retail sales using vending machines. Regarding wholesales sales, the engagement team identified the risk of sales being overstated through a fraudulent practice. On the other hand, regarding sales through vending machines, which account for around 40% of the audited company's overall sales, although the engagement team recognized the presence of a possible motivation for overstating sales, it did not identify the risk of a material misstatement due to fraud for the following reasons: that it was difficult to commit fraud to overstate sales to a large degree given the need to book a large number of small-value cash sales transactions; and that if sales were overstated to a large degree, the anomaly could be easily detected through audit procedures.
However, the engagement team **did not sufficiently evaluate the risk of a material misstatement due to fraud related to sales through vending machines. For example, it did not take into account the possibility of the management falsifying financial data**.
(Auditing Standards Statement No. 240, paragraph 25) [Large-sized audit firms]

FREQUENT

⑥The audited company is operating a large chain of drugstores and pharmacies.

With regard to sales at drugstores and pharmacies, the engagement team identified the risk of sales being fraudulently booked without going through the enterprise system through the direct entry of fictitious sales data into the accounting system. On the other hand, sales booked through the enterprise system represented sales of products to general customers and were comprised of small-value transactions, and the journal entry of sales was automatically implemented based on sales data recorded by store registers incorporating the point of sales system (POS registers), leaving little room for human intervention. Therefore, the engagement team did not identify fraud risks. It should be noted that when evaluating the status of design of internal control over store sales, the engagement team recognized the possibility that sales data recorded by POS registers might be modified during the process of being booked in the accounting system via the enterprise system.

However, **when identifying and assessing the risk of a material misstatement due to fraud related to revenue recognition, the engagement team did not consider the possibility of fraud being committed through the modification of sales data booked via the enterprise system**.

(Auditing Standards Statement No. 240, paragraph 25) [Mid-tier, and small and medium-sized audit firms]

《Points to Note》

As shown in the above example case section, many cases were observed in which: although the audited company engaged in multiple businesses, the engagement team did not identify and assess fraud risks in accordance with those businesses' respective types of revenue and transactions; in which the engagement team identified fraud risks only in areas where higher risks were considered to exist (e.g., fraud committed during a limited period of time, such as the last month of the fiscal year, fraud committed by the use of a miscellaneous account or new account, or fraud committed by employees), while assuming the absence of fraud risks in other areas without conducting sufficient evaluation in light of possible incentives and opportunities for committing fraud.

When identifying and assessing the risks of material misstatement due to fraud, the engagement team shall, based on a presumption that there are risks of fraud in revenue recognition, evaluate which types of revenue, sales transactions or assertions give rise to such risks. When making such judgment, it is necessary to pay attention to the following points.

- **When the audited company engages in multiple businesses within the consolidated group, it is necessary to identify and assess fraud risks in accordance with those businesses' respective types of revenue and transactions.**
- **When considering fraud risk scenarios, it is necessary to evaluate where in the financial statement and how a material misstatement due to fraud may occur based on an understanding of the audited company and its business processes.**
- **When the risk of material misstatement due to fraud has been identified, it is necessary to understand the audited company's internal control, including control activities related to the identified risk.**

- **When fraud risks related to revenue recognition have not been identified, it is necessary to conduct sufficient examination and to describe the reason for judging that there is no fraud risk in audit documentation.**
- **It is essential to identify and assess the risk of a material misstatement due to fraud at two levels, i.e. at the level of the financial statement as a whole and at the assertion level, after sufficiently examining risks related to management override.**

(3) Response to assessed risk of material misstatement due to fraud

Case 1: Response to fraud risks in revenue recognition

NEW

①The audited company provided financial support services such as investments, loans, and debt guarantees for medical institutions, as well as services such as providing guidance on management, administration, and operation of medical institutions it supported.
The engagement team identified as a fraud risk relating to revenue recognition the possibility that the audited company could use its financial support services to influence the companies it supported and thereby receive unduly excessive compensation. In addition, from the perspective of evaluating the reasonableness of the amount of compensation for service agreements, the engagement team set the amount of compensation deemed appropriate by management at a reasonable amount, and performed procedures to compare this amount with the actual amount of compensation.
However, although the engagement team identified the possibility of receiving unduly excessive remuneration as a fraud risk, the engagement team set the amount of remuneration deemed appropriate by management as a reasonable amount of remuneration based only on its understanding in light of discussions with management. **<u>In evaluating the reasonableness of the amount of remuneration, the engagement team did not obtain audit evidence that was more relevant or more convincing than in cases where no fraud risk had been identified.</u>**
(Auditing Standards Statement No. 240, paragraph 29) [Mid-tier, and small and medium-sized audit firms]

FREQUENT

②The engagement team identified a risk of material misstatement due to fraud in the cutoff of revenue, extracted samples from sales transactions one week before and after the year-end, and cross-checked these against shipping slips, receipts, etc.
However, the engagement team **<u>did not examine whether extracting samples from the transactions one week before and after the last day of the fiscal year was a sufficient audit procedure for addressing the fraud risks</u>**.
(Auditing Standards Statement No. 240, paragraph 29) [Mid-tier, and small and medium-sized audit firms]

FREQUENT

③The audited company engages in construction business and applies the percentage-of-completion method to the booking of sales.

Regarding projects to which the percentage-of-completion method was applied, the engagement team assumed the following fraud risk scenarios because of the pressure to achieve budget targets: (i) that the management would increase the profit/loss ratio by fraudulently understating the total estimated cost; and (ii) that employees would overstate the rate of progress by booking fictitious costs.

To identify projects in which there was the possibility that either of the above scenarios could come true, the engagement team selected (i) projects in which the profit/loss ratio was higher at the end of the fiscal year than at the end of the third quarter and (ii) projects in which the rate of progress was higher at the end of the fiscal year than at the end of the third quarter, checked the validity of the reasons given for the increases by inquiring with the audited company and by reading the company's internal documents, and ultimately concluded that there was no project in which fraud might have been committed.

However, the procedures performed by the engagement team were not relevant to the assumed fraud risks. For example, although the risk of the management or employees committing fraud due to the pressure to achieve budget targets was assumed, the engagement team did not take into account the status of achievement of budget targets when selecting projects involving the possibility of fraud. In addition, when checking the validity of the reasons given for the increases in the profit/loss ratio and the rate of progress in the selected projects, the engagement team merely identified the reasons by inquiring with the audited company and by reading the company's internal documents but did not evaluate relevant external evidence. As a result, **the procedures performed by the engagement team were not sufficient to conclude that there was no project in which fraud might have been committed**.

(Auditing Standards Statement No. 240, paragraph 29) [Large-sized audit firms]

④The engagement team identified fraud risks in sales of game machines and the like and assumed a fraud scenario involving fictitious and early booking of sales by means of the forgery of order forms and other supporting documents by sales staff, along with the falsification of shipments by moving products to a warehouse secured by the audited company.

When, amid this situation, the engagement team conducted journal entry tests as a procedure to address the aforementioned fraud risks, the team confirmed that for all 161 journal entries for the year relating to product sales, the journal entry data showed that the corresponding account was accounts receivable, the summary was sales of system equipment, and the booked date was the last day of the month. As a result, the team concluded that there were no inappropriate or atypical journal entries and no material misstatements due to fraud in respect of sales of game machines and the like.

However, when the engagement team checked of the aforementioned journal entry data, the team did not plan and perform further audit procedures responsive to the identified fraud risks, as the team did not take into account the fact there was a low possibility of being able to identify the forgery of supporting documents or falsification of shipments by inspecting only the journal entry

data.
(Auditing Standards Statement No. 240, paragraph29) [Mid-tier, and small and medium-sized audit firms]

FREQUENT

⑤ The audited company engages in the business of manufacturing measurement and control equipment, mainly electricity meters, and applies the arrival of shipment standard to the booking of sales.
With regard to the period attribution of sales at the audited company, the engagement team identified the risk of a material misstatement due to fraud, and citing the possibility of the company deliberately manipulating the timing of booking of sales around the end of the fiscal year, it selected samples from among sales data booked around the end of the fiscal year and conducted a test of detail.
However, when evaluating the period attribution of sales, **the engagement team merely checked sales data against order sheets but did not perform substantive procedures to obtain stronger audit evidence, such as checking sales data against customers' acknowledgements of receipt that confirm the fact of arrival of shipment**.
(Auditing Standards Statement No. 240, paragraph 29) [Mid-tier, and small and medium-sized audit firms]

⑥ With regard to revenue recognition concerning the audited company's wholesale business, the engagement team identified the risk that, when entering order receipt information, they might deliberately enter earlier requested dates of delivery than those indicated in order sheets for the purpose of moving forward to the current fiscal year the timing of the booking of sales transactions that shipment was scheduled for the next fiscal year.
To address the above fraud risk, the engagement team performed procedures to evaluate the exercise of internal control related to the order-receiving process.
However, when performing the procedures to evaluate the exercise of internal control related to the order-receiving process, the engagement team designed and performed procedures under which the sample population size and the degree of use of internal auditors' work were similar to the ones under the procedures to be performed in cases where fraud risks had not been identified. As a result, the engagement team did not obtain stronger audit evidence or a larger quantity of evidence, as required in cases where fraud risks had been identified.
(Auditing Standards Statement No. 240, paragraph 29, and No. 330, paragraph 7) [Large-sized audit firms]

《Points to Note》

There were many cases related to risk assessment regarding revenue recognition and further audit procedures. For example, in one case, the engagement team did not perform sufficient further audit

procedures due to the failure to sufficiently perform risk assessment regarding revenue recognition based on an understanding of the audited company's business and its business environment, including its type of business and the characteristics of its sales transactions, and due to the failure to develop appropriate audit procedures. In another case, the engagement team did not perform sufficient further audit procedures due to the failure to conduct specific deliberations on what risks existed with regard to each assertion and to develop appropriate audit procedures despite having identified the risk of material misstatement due to fraud. In some cases, although the engagement team assumed fraud risk scenarios, it did not conduct sufficient evaluation, as it concluded that the assumed fraud risks had not materialized after merely performing analytical procedures, such as comparison with the previous fiscal year, for example. In other cases, the engagement team merely cross-checked books against evidence as a matter of formality and overlooked an abnormal profit ratio and terms of contracts that were inconsistent with reality. There were also cases in which the engagement team, when evaluating the estimated total cost under the percentage-of-completion method, merely inquired with the management and cross-checked books against internal management data prepared by the audited company.

For revenue recognition, Auditing Standards Statement No. 240, paragraph 25 stipulates "When identifying and assessing the risks of material misstatement due to fraud, the auditor shall, based on a presumption that there are risks of fraud in revenue recognition, evaluate which types of revenue, revenue transactions or assertions give rise to such risks," while paragraph 29 prescribes "Auditors are required to obtain audit evidence, which is more relevant or reliable, or greater in quantity, for risk of material misstatement due to fraud at the assessed assertion level than in cases where no risk of fraud is identified for the assertion." Particular attention should be paid in implementing further audit procedure.

Case 2: Journal entries test

FREQUENT

①When conducting journal entries tests, the engagement team focused on manual journal entries for any sums above an amount deemed negligible trivial, journal entries including specific keywords such as those where the summary column contained the word "CEO," and transactions involving infrequently used accounts where the value of the transaction was at least 10% of performance materiality.

However, the engagement team **<u>only analyzed changes in accounting in respect of the manual journal entries and did not examine them in light of fraud risks. Nor did the team examine the reasonableness of limiting consideration to specific keywords such as "CEO" or of the quantitative materiality of the journal entry frequency and selection criteria</u>**.

(Auditing Standards Statement No. 240, paragraph 31) [Mid-tier, and small and medium-sized audit firms]

NEW

FREQUENT

②When conducting a journal entry test as a procedure to address the risk of management override, the engagement team excluded from the journal entry test automatic journal entries that were automatically generated by batch processing based on data in the business system, on the understanding that there was little room for generating fraudulent journal entries.

However, **when excluding automatic journal entries from the journal entry tests, the engagement team did not adequately consider the possibility that fraudulent automatic journal entries could be generated by inputting fraudulent data into the business system or by directly correcting data using a privileged ID in the business system**.

(Auditing Standards Statement No. 240, paragraph 31) [Mid-tier, and small and medium-sized audit firms]

《Points to Note》

There were many cases where professional skepticism was not exercised. For example, some engagement teams did not perform procedures to address fraud risks for journal entries selected for fraud risks on the grounds that the journal entries were not problematic based on their understanding of the content of the journal entries. In addition, with regard to procedures to address risks related to management override of internal controls, some engagement teams performed journal entry tests by setting sampling conditions merely as a formality without fully considering fraud risks, based on the understanding of the audited company's business environment and business processes related to journal entry and adjustment.

The engagement team shall keep in mind that it needs to design and implement effective audit procedures in response to the degree of said risks after understanding that management is in a position to falsify accounting records and prepare fraudulent financial statements by overriding effectively operating internal control.

Furthermore, the engagement team also needs to obtain sufficient appropriate audit evidence with respect to the completeness of journal data used for journal entry testing.

Case 3: Business rationale for significant transactions

NEW

①The engagement team had determined that the transactions for the five accounts receivables of the audited company (whose fiscal year ended in March) were unusual because the receivables had become delinquent beyond the due date for payment and it was considering changing the collection conditions and collection methods.

In addition, the engagement team received an explanation from the audited company regarding the recoverability of the above accounts receivable at the time of the first and second quarterly reviews for the current fiscal year. Subsequently, contrary to the explanation given at the time of the second quarterly review, the audited company explained that "all of the above accounts receivable were deposited in the accounts of customers in the audited company's name and recovered in November and December of the current fiscal year." Therefore, the engagement team confirmed that the receivables had been deposited in these accounts.

However, although the engagement team **determined that it was unusual to repeatedly consider changing the collection conditions and collection method for the above trade receivables after**

sales were recorded, the engagement team did not consider whether this situation indicated the possibility of fraudulent financial reporting, for example, by not being aware of the reason for considering changing the payment conditions and payment method from those at the time of the transaction.
(Auditing Standards Statement No. 240, paragraphs 11, F11-2 and 31) [Large-sized audit firms]

NEW

②The engagement team was aware that six outsourcing costs of the audited company (whose fiscal year ended in March) had not been paid for a long time. In addition, in February of the current fiscal year, the audited company explained to the team that it had "received a complaint from a customer about the delivered goods, and reduced or planned to reduce the outsourcing costs in consultation with the outsourced manufacturer of the delivered goods," and the team recognized that the reduction of each outsourcing cost had been accounted for as of March 31, the end of the current fiscal year.
With regard to the above claims, the engagement team received an explanation from the audited company that "Each claim was not significant in terms of the amount of money for all related sales transactions, and the business of the client was not hindered and the impact was not significant. Each claim could not be handled by the contractor, so it was accepted by the audited company and handled by the sales representative." The team also obtained and reviewed the related request for approval (approved between late January and early February of the current fiscal year) and the detailed report (prepared and confirmed on March 31, the end of the current fiscal year). The team also obtained a delivery slip that stated the amount after the reduction and confirmed whether the amount had been reduced and the amount.
However, the engagement team **did not fully understand the details of the claims made by customers and the reasons why outsources were unable to respond, and it did not obtain sufficient audit evidence to support the audited company's assertions. As such, the engagement team did not evaluate whether these reductions in outsourcing costs indicated the possibility that these reductions had been made for the purpose of producing fraudulent financial reports**.
(Auditing Standards Statement No. 240, paragraph 31; No. 550, paragraph 5) [Large-sized audit firms]

《Points to Note》

Indicators that may suggest that significant transactions that are outside the normal course of business for the audited company, or that otherwise appear to be unusual, may have been entered into to engage in fraudulent financial reporting or to conceal misappropriation of assets include（Auditing Standards Statement No. 240, paragraph A46）:

- **The form of such transactions appears extremely complex (e.g., transactions involve multiple subsidiaries of audited companies within a consolidated group or multiple third parties not having usual trading relationships);**
- **The management has not discussed the nature of and accounting for such transactions with company auditors of the audited company, and there is inadequate documentation;**
- **The management places more emphasis on the need for a particular accounting treatment than on the underlying economic reality of the transactions;**
- **Transactions that involve non-consolidated related parties, including special-purpose companies, have not been properly reviewed or approved by company auditors of the audited company; and**
- **The transactions involve previously unidentified related parties or parties that do not have the substance or the financial strength to support the transactions without assistance from the audited company.**

If the engagement team identifies any of the above mentioned indications in the course of the audit, and as result of assessing them it discovers circumstances that indicate material misstatement due to fraud, the engagement team needs to ask the management for explanation and needs to keep in mind that the team should implement additional audit procedures in order to judge whether there are suspected material misstatement due to fraud.

Furthermore, there are some cases where, in conducting fraudulent accounting treatment, the audited company obscured accounting treatments by carrying out complicated transactions with several business partners. Therefore, in examining the business rationality of significant transactions, it is important for the engagement team to not only evaluate individual transactions but also assess and examine the entire picture of a series of related transactions by paying attention to the timing and conditions of such transactions.

Case 4: Response to fraud risks in transactions with related parties

FREQUENT

①In examining a loan that may be relevant to a related party, the engagement team directly confirmed with the original borrower and considered the valuation of the assets pledged by the borrower as collateral.

However, the team **did not carry out audit procedures, such as obtaining a full understanding of the flow of capital and the reasonableness of the loan transaction with an eye to possible fraud, by taking into account the fact that the objective of the original loan was unclear**.

(Auditing Standards Statement No. 240, paragraphs F11- 2 and 31; No. 550, paragraph 22) [Mid-tier, and small and medium-sized audit firms]

②During the current term, the audited company rehired employees that it had transferred to a specific group company in the past, but also concluded new contracts with these employees that would see them dispatched to the same group company. By doing this, the audited company booked large profits. The engagement team identified these contracts as unusual transactions, and identified them as constituting circumstances indicating signs of material misstatement due to fraud. As a result of inquiring about the matter with directors of the audited company, the team was told that the company would generally not be taking similar actions in the future, but that such action might be taken on an emergency basis to prevent a company in the corporate group from falling into a crisis situation.

However, the engagement team did not adequately consider the economic rationality of these unusual transactions.

(Auditing Standards Statement No. 240, paragraphs F11- 2, 32-2, and F35-2) [Large-sized audit firms]

③The audited company sold the land on which its head office and distribution center were located and the buildings on the sites to a company of which the audited company's shareholder, Shareholder A, was the representative director. The audited company booked the sale as gains on the sale of fixed assets.

When reviewing the contract of sale for the aforementioned transaction and confirming that the proceeds from the sale had been received, the engagement team identified circumstances indicating material misstatement due to fraud, as the team identified the payment of a guarantee deposit not specified in the contract of sale and a discount equivalent to consumption tax.

However, the engagement team did not evaluate whether or not this equated to a significant risk, even though the team had identified the transaction as an unusual transaction and a significant transaction, and had also identified circumstances indicating material misstatement due to fraud. Moreover, although the engagement team had identified circumstances indicating material misstatement due to fraud, the team only communicated with the management and company auditors, and did not plan and perform additional audit procedures in respect of the transaction. Nor did the engagement team obtain sufficient and appropriate audit evidence relating to the question of whether the suspected material misstatement due to fraud existed.

(Auditing Standards Statement No. 240, paragraphs F1-2 and F35-2; No. 315, paragraph 27) [Mid-tier, and small and medium-sized audit firms]

《Points to Note》

According to Auditing Standards Statement No. 550, paragraph 11, discussions within the engagement team “shall include specific consideration of the susceptibility of the financial statements to material misstatement due to fraud or error that could result from the audited company’s related party relationships and transactions.” In auditing related party transactions, the engagement team needs to consider the risks of material misstatement due to fraud.

In entrepreneurial companies in particular, owner-managers are often so strongly influential that internal control may not function over related party transactions. Understanding these characteristics of companies, the engagement team needs to obtain sufficient appropriate audit evidence in performing risk assessment procedures and responses to audit risk in connection with related party transactions.

(4) Evaluation of audit evidence

Case 1: Responses to circumstances that indicate the possibility of a material misstatement due to fraud

NEW

The audited company reported to the engagement team that it had discovered that two employees in Division A had placed an oral order for construction work without permission. The internal investigation into this matter had not been completed by the date of the audit report, and the full picture of the situation had not been clarified as of the same date. However, the audited company interviewed its business partners concerning the construction work in which two employees were involved, and as a result, it identified the omission of expenses and inventory related to this matter. Under these situation where the internal investigation by the audited company had not completed before forming audit opinion, the engagement team interviewed the Director and CFO about this matter. As a result, the engagement team was able to confirm that the division where the oral order without prior consent was placed was limited to division A. In addition, given the scale of the construction work that the two employees were in charge of, the engagement team determined that it was unlikely that there would be an impact that exceeded the materiality threshold, and that the qualitative factors contributing to the fraud were not material. In addition, the above expenses and the amount of inventory not recorded were treated as an uncorrected misstatement.

However, **despite the fact that the whole picture of this matter was still unknown, the engagement team only asked questions of the Director and CFO and did not sufficiently evaluate whether the omission of expenses and inventories related to this matter indicated indications of material misstatement due to fraud**.

(Auditing Standards Statement No. 240, paragraph 32-2, and F32-3) [Mid-tier, and small and medium-sized audit firms]

《Points to Note》

In the above cases, professional skepticism was not exercised even though there were suspected circumstances that indicated indications of material misstatement due to fraud.

In addition to the above, there were cases in which professional skepticism was not exercised, such as a case in which a material misstatement due to fraud was determined without sufficient evaluation, despite there being a strong indication of a material misstatement due to fraud, and a case in which management did not examine the content of a contradictory explanation on the sales recording, despite identifying it as a situation suggesting a material misstatement due to fraud.

Case 2: Evaluation of identified misstatement due to fraud during the audit

The audited company established an investigative committee headed by an external auditor and conducted an in-house investigation because it was found during the inventory-taking process that fictitious inventories due to fraudulent cost transfer were booked.

As a result of the investigation, the investigative committee concluded that Division A implemented the fraudulent cost transfer under the initiative of the head of the division. As for the method of fraud, the investigative committee determined that Division A had instructed the order-placing division to place an order with a construction number different from the original number.

In order to identify transactions affected by the cost transfer, the investigative committee selected transactions worth 100,000 yen or higher from among the acceptance data and checked the construction numbers indicated in the quotation against the construction number at the time of order placement, and it determined that fraudulent cost transfer occurred in cases where the two numbers were different.

Moreover, regarding divisions other than Division A, the investigative committee also conducted a similar investigation with respect to transactions worth 3 million yen or higher and confirmed that there was no case of fraudulent cost transfer.

Regarding the completeness of the investigation's coverage of transactions affected by fraudulent cost transfer, the engagement team read the report prepared by the investigative committee and determined that the committee's investigation method was appropriate.

However, the engagement team did not check the completeness of the acceptance data when considering whether the investigative committee had exhaustively selected transactions affected by fraudulent cost.

Moreover, when examining the presence or absence of fraudulent cost transfer at divisions other than Division A, the engagement team did not consider the reasonableness of subjecting only transactions worth 3 million yen or higher to investigation or the possibility that cost transfer might have been implemented through a similar method at other consolidated subsidiaries.

(Auditing Standards Statement No. 240, paragraph F35-2) [Mid-tier, and small and medium-sized audit firms]

《Points to Note》

There were deficiencies in procedures for fraud-related risks, including failure to sufficiently assess whether the misstatement identified during the audit fell under an indication of fraud, failure to assess the possibility of the identified misstatement occurring in the audited company as a whole, and failure to reconsider risk assessment if circumstances that may indicate the possibility of a material misstatement due to fraud were identified.

If the engagement team identifies the suspected material misstatement due to fraud, the team needs to revise its planned risk assessment and further audit procedure, and implement audit procedures that directly respond to the situation of possible fraud, including sufficient evaluation of the suspected material misstatement due to fraud, in order to obtain sufficient appropriate audit evidence regarding the suspicion.

Furthermore, if the engagement team has identified fraud, or obtained information that indicates the possibility of fraud, the team must, in order to convey to the person responsible for preventing and detecting fraud relating to that responsibility, inform the appropriate level of management of such matters

on a timely basis. The team also needs to inform the company auditors of such matters. In addition, if the engagement team suspects that management are involved or are on suspicion of being involved in fraud, the team must report this to the company auditors and hold consultations with the company auditors concerning the nature, timing and extent of the audit procedures required to complete the audit. The team also needs to demand that management take appropriate measures to correct problems. In addition, if fraud has been identified, when auditors express disclaimer of opinion in the auditor's report based on the Companies Act;, and expressing an unqualified opinion in the subsequent auditor's report based on the Financial Instruments and Exchange Act, auditors must carefully judge whether sufficient and appropriate audit evidence has been obtained, such as whether sufficient audit procedures have been carried out in response to the identified fraud risks.

2. Risk Assessment and Response to Assessed Risks

Points of focus

The CPAAOB performs inspections of risk assessment and response to assessed risks from the following perspectives:

- Whether the engagement team performs appropriate identification and assessment of the risks of material misstatement in the financial statements as a whole and at the assertion level when it develops an audit plan, considering the audited company and its environment, business risks and internal control of the audited company, instead of merely completing templates provided by the audit firm or the JICPA;
- Whether the engagement team makes appropriate judgment, when it identifies significant risks, in light of matters that are required by the Auditing Standards Statement to be taken into account; and whether the team understands internal control relevant to significant risks;
- Whether the engagement team develops an overall response required by the Auditing Standards Statement in accordance with the assessed risks of material misstatement in the financial statements as a whole, and plans the nature, timing, and extent of procedures in response to the audit risks, taking into account the materiality, in accordance with the assessed risks of material misstatement at the assertion level;
- Whether the engagement team makes appropriate responses, when a misstatement is identified as the audit progresses, such as judging whether it is necessary to revise the overall audit strategy and detailed audit plans, and evaluating the impact of the uncorrected misstatement; and
- Whether the engagement team develops an audit plan suited to the contractor and IT use status considering the influence of the contractor and IT used by the audited company for the audit.

Outline of inspection results

With regard to risk assessment and response to the assessed risks, there were many cases in which the engagement team did not appropriately design and perform further audit procedures as a result of the failure to make appropriate risk assessment.

For example, there were cases in which: the engagement team did not assess the audited company's accounting policy; the engagement team did not understand and assess internal control concerning important businesses; or the engagement team did not understand and assess the internal control of service organizations over important business processes. There were also cases in which: deficiencies occurred with regard to the nature, timing and extent of substantive procedures performed at the end of the term as a result of the failure to appropriately consider revising the audit plan when the audited company's business environment and financial results deteriorated, or when misstatements were identified over the course of the audit process; or deficiencies occurred with respect to the test of the operating effectiveness and substantive procedures due to the failure to design appropriate further audit procedures to address the assessed risks.

Moreover, there were still engagement partners and audit assistants who did not fully understand the concept of a risk-based approach. As a result, there were several cases where the engagement team merely completed templates, such as the "audit tool" and the "documentation sample forms" provided by the audit firm or the JICPA, and did not perform appropriate risk assessment. There were also cases where the nature, timing and extent of the procedures actually taken in response to the assessed risks did not respond to the risks since the engagement team did not evaluate the adequacy of the assessed risks and procedures in the audit plan developed by using audit tools.
Other cases of deficiency included ones in which: the engagement team did not perform substantive procedures despite having identified the risk of material misstatement on the grounds that the analysis of changes in accounting found no irregularities; or the absence of notes regarding important transactions with related parties was overlooked at an audited company engaging in a large volume of various types of transactions with relevant parties due to a lack of particular awareness about risks even though risk assessment should have been conducted more carefully than usual from the viewpoint of exhaustively identifying transactions with related parties. There were also cases in which: the effects of the identified misstatement on the results of the test of internal control and on the substantive procedures were not considered; the engagement team lacked sufficient understanding of the overview of the audited company's information systems and of the company's general IT controls.

(Observed effective efforts)
The following is an example of observed effective efforts made by an audit firm.
The audited company is not only actively engaging in corporate acquisitions in order to achieve business growth but is also eagerly starting new businesses. With regard to new businesses, the company expects long-term growth in some cases and earns profits by selling businesses that started to show commercial promise. In addition, the company opts for business closure or selloff immediately once it has judged that it is difficult to continue operating new businesses. This reflects the significant effects that the management's decisions and judgments have had on the company's financial statements.
The engagement team understands the above situation and has requested to have a meeting with the management each month. In the meeting, the engagement team strives to grasp changes in the company's situation and in its business environment in an appropriate and timely manner by checking the management's present assessment of the results of corporate acquisitions and new businesses and by receiving detailed explanations about the matters determined by and reported to the board of directors directly from the management.

Expected response
Professional staff should **pay due attention as professional experts and exercise professional skepticism**. They should fully understand the audited company and its environment and assess risks through such understanding, and should carefully identify and assess risks by referring to this Case Report and the Audit Recommendations issued by the JICPA, based on a full understanding of the intent

of Auditing Standards Report No.315, etc. In addition, when developing responses to audit risk, they should carefully consider whether the procedures respond to the assessed risks and whether the procedures enable sufficient appropriate audit evidence to be obtained, including not only the types of procedure, but also the timing and the extent of the procedures. In order to do so, they should **make sure sufficient hours are spent for not only substantive procedures but also for the audit plans**.

Furthermore, some professional staff still do not recognize the importance of audit planning and have no understanding of the need, in audit plans, to link material misstatement risks and details of the procedures responsive to the assessed risks (the nature, timing and extent of the procedures).

Engagement teams must **reconfirm the concept of the risk-based approach and the positioning of the audit plan in the current audit, and review the audit plan that they developed, according to the situation**.

Once again, an audit firm where deficiencies were identified in risk assessment and responses to the assessed risks **must consider appropriate responses, such as re-educating professional staff who have failed to catch up with the current audit standards and responding in terms of the assignment of engagement teams**.

(1) Audit planning

Case 1: Formulation of audit planning

The engagement team had selected net income before income taxes as the indicator to be used in deciding materiality in the previous fiscal year, but as a net loss was expected to be booked for the current fiscal year, due to the impact of COVID-19, the engagement team selected an average of net income before income taxes for the past three fiscal years as the indicator for the current fiscal year. As a result, the materiality for the current fiscal year was higher than the materiality for the previous fiscal year.

However, with regard to the audited company's full-year results for the current fiscal year, in examining the going concern assumptions and evaluating such matters as fixed assets, investments in and loans to subsidiaries and associates, and deferred tax assets due to the impact of COVID-19, the engagement team **did not conduct a full evaluation, including comparison with the previous fiscal year's materiality, when deciding on materiality, despite circumstances creating an increased audit risk**.

(Auditing Standards Statement No. 320, paragraph 9 and A2) [Mid-tier, and small and medium-sized audit firms]

《Points to Note》

In addition to the aforementioned cases, there were also cases in which indicators affecting economic decision-making by users of financial statements were not fully evaluated; for example, with regard to indicators used in deciding materiality, in a situation in which the audited company had booked fictitious profits in past years, the engagement team used sales and net assets—indicators that do not take profits

into consideration—rather than types of profit and loss, such as net income before income taxes or operating profit.

Case 2: Changes to planning decisions during the course of the audit

NEW

The audited company included franchise sales in the sales account because they were insignificant in the previous term. On the other hand, in light of the increase of sales in the current period, the audited company accounted for them as a separate account, the franchise sales account.

When developing the audit plan at the beginning of the fiscal year, the engagement team identified risks of material misstatement at the assertion level using account balances at the end of the previous fiscal year, and determined that it was not necessary to revise the audit plan developed at the beginning of the fiscal year because there had been no material changes in the understanding of the company and its environment at the end of the fiscal year.

However, the engagement team **did not consider the need to revise the plan in light of changes in the audited company and its environment**. For example, the engagement team did not consider the need to identify risks of material misstatement even though the amount of franchise sales booked the current period exceeded the materiality threshold.

(Auditing Standards Statement No. 300, paragraph 9 and No.315, paragraph 24 and 25) [Mid-tier, and small and medium-sized audit firms]

《Points to Note》

There were cases of deficiencies in audit planning in which adequate evaluation was not carried out, including cases in which when considering whether the identified risk of material misstatement was a significant risk, there was no adequate evaluation of whether it was a fraud risk, or of whether it related to a significant transaction with a related party, or whether it was a transaction outside the audited company's normal course of business. (Auditing Standards Statement No. 315, paragraph 27)

In addition, there were cases where the engagement team only followed audit procedures for past years in a perfunctory way and did not appropriately prepare a detailed audit plan covering such matters as the nature, timing, and extent of audit procedures to be performed by engagement team members.

The engagement team shall carefully consider not only the nature of audit procedures, but also their timing and extent, to ascertain whether the established audit procedures respond to the assessed risks and whether sufficient and appropriate audit evidence can be obtained from those audit procedures.

(2) Identification and assessment of the risk of material misstatement through understanding the audited company and its environment

Case 1: Understanding the audited company and its environment, including the audited company's internal control

①The audited company mainly provided consulting, system development, and system maintenance services related to management and accounting. In revenue recognition from the services provided, the audited company adopted an accounting treatment in light of the 5-step model for revenue recognition (I) identifying contracts, ii) identifying performance obligations, iii) determining transaction prices, iv) allocating transaction prices, and v) recognizing revenue from satisfying performance obligations, as set forth in the Revenue Recognition Accounting Standard.

The engagement team understood the audited company's accounting treatment in the past fiscal years in light of these 5-step model. For "⑤ recognizing revenue from satisfying performance obligations," the team verified the appropriateness of the timing of satisfying performance obligations for each service type. The team also understood that there had been no significant changes in the audited company's business in the current fiscal year.

However, the engagement team **did not verify the appropriateness of the matters considered by the audited company in applying the above accounting treatment, based on actual contract details**.

(Auditing Standards Statement No. 315, paragraph 10) [Mid-tier, and small and medium-sized audit firms]

②The engagement team identified a risk of material misstatement in existence and completeness assertions for sales by all the audited company's multiple businesses.

However, the engagement team **did not perform procedures to understand the internal controls for the bricks-and-mortar retailing business**, even though sales from the business far exceeded the performance materiality.

(Auditing Standards Statement No. 315, paragraph 10 and 12) [Mid-tier, and small and medium-sized audit firms]

《Points to Note》

As shown in the aforementioned examples of deficiencies identified, there are the case that the engagement team did not assess the audited company accounting policies and the case that the engagement team did not understand the internal control of the important business which the audited company engaged in other than its mainstay business. The engagement team needs to assess, by understanding the audited company and its environment, whether the company's accounting policies are suitable for that business and whether it conforms to the applicable financial reporting framework and to the accounting policies applicable in the industry to which the company belongs. Because there are cases that fraudulent financial reporting is made in businesses other than the audited company's main business, when identifying and assessing the risk of material misstatement at the assertion-level, the engagement team needs to consider the types of transactions and relevant internal controls differences between each businesses.

In addition, there are also cases in which the engagement team had an understanding of the businesses of each significant components in the group audit but not of businesses or distribution channels at a group level, as well as cases in which the risks of material misstatement were not identified and assessed for each type of transaction, despite the possibility of differences arising in effective procedures and the nature of

audit evidence that ought to be obtained due to differences in the types of transactions even within the same account, since the risks of material misstatement had not been examined for each operational process.

Case 2: Identifying and assessing the risks of material misstatement

An audited company engaged in information and telecommunications business was listed during the interim period and revised its earnings forecasts downward in multiple times before the end of the fiscal year. Given this situation, the engagement team determined that the audited company was under pressure to overstate its profits, and identified as fraud risks in overstatement of sales and software (excessive capitalization of expenses).

However, **while the engagement team identified fraud risks regarding sales and software, it did not consider the need to identify the risk of misstatement in completeness and cutoff assertions for cost, despite assuming that the audited company might fraudulently overstate its profits**.

(Auditing Standards Statement No. 315, paragraph 25) [Large-sized audit firms]

《Points to Note》

In identifying and assessing the risks of material misstatement, the engagement team needs to exercise professional skepticism and sufficiently understand the audited company and its environment, and thereby perform risk assessment.

"Although the concept that the risks of material misstatement are comprised of two components, i.e. inherent risk and i.e. control risk, is not changed in Auditing Standards Statement No.315, which was revised in June 2021, it should be noted that Auditing Standards Statement No.315 before the revision allowed inherent risk and control risk to be assessed separately or together, while the revised Auditing Standards Statement No.315 requires inherent risk and control risk to be assessed separately (see Auditing Standards Statement No.315, paragraph 5)."

In assessing inherent risk, it should also be noted that the revised Auditing Standards Statement No. 315 requires the engagement team to consider how and to what extent "inherent risk factors" (i.e., characteristics of events or conditions that affect susceptibility to misstatement, whether due to fraud or error, of an assertion about a class of transactions, account balances or disclosure, before, consideration of controls) affect the susceptibility to misstatement in related assertions.

Case 3: Understanding of the audited company's internal controls related to significant risks

One of the audited company's main businesses was to earn revenue through providing its customers with rights to use its intellectual property.

The engagement team considered the business included risks to record sales based on fictitious contracts and sales in advance, and identified them as significant risks.

However, the engagement team **did not perform the procedures to understand what sort of control activities were performed to address the above-mentioned significant risks** although the engagement team understood the overview of transactions relating to the business. (Auditing Standards Statement No. 315, paragraph 28) [Mid-tier, and small and medium-sized audit firms]

《Points to Note》

In terms of identified significant risks, an auditor must understand the internal controls, including control activities relating to the risk. Further, when relying on internal controls to address significant risks, an auditor is required to perform tests of operating effectiveness of related controls during the audit for the current year.

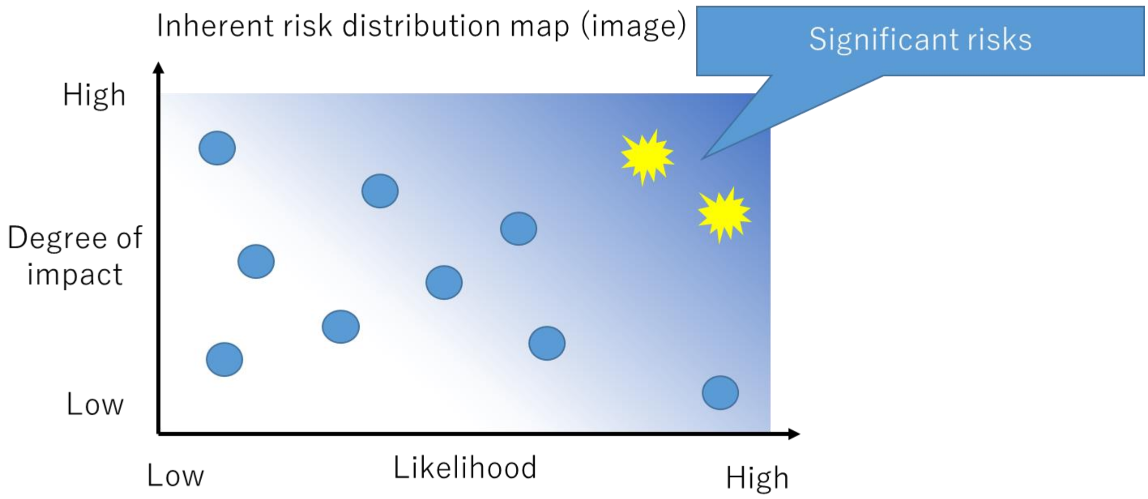
It should also be noted that significant risks, which were defined as "identified and assessed risks of material misstatement which the auditor considers to require special audit consideration" in the Auditing Standards Report No.315 before the revision, are identified as the following risks of material misstatement in the revised Auditing Standards Statement No.315 (see Figure 5).

(I) Risks of material misstatement assessed to exist in the areas of highest inherent risk based on the degree to which inherent risk factors affect a combination of the likelihood of a misstatement occurring and the magnitude of the potential misstatement (quantitative and qualitative impact)

(ii) Risks of material misstatement that are determined to be treated as significant risks in accordance with the requirements of other audit standard reports

- **Risks assessed as risks of material misstatement due to fraud.**
- **Risks related to management override of controls;**
- **Significant related party transactions outside the entity's normal course of business;**

［Figure 5］ Reference image: Distribution of inherent risk



Source: Prepared by the CPAAOB based on data published by the JICPA

(3) The auditor's responses to assessed risks

Case 1: Audit procedures for risks of material misstatements

NEW FREQUENT ①The engagement team identified risks of material misstatement with regard to sales of some businesses among sales reported by the audited company on its non-consolidated financial statements. Based on its understanding that the design and operation of internal controls for the sales of these businesses were effective, the engagement team performed confirmation procedures for confirmed the balance of receivables with the end of the previous month of the fiscal year end as the record date, and roll-forward procedures for the remaining period, as well as performed procedures to respond to fraud risks with respect to sales reported in the fiscal year end.

However, although the engagement team identified risks of material misstatement of sales for this business, the engagement team **did not perform substantive procedures for sales recorded before the month before the end of the fiscal year**.

(Auditing Standards Statement No. 330, paragraph 17 and No.500, paragraph 5) [Mid-tier, and small and medium-sized audit firms]

NEW FREQUENT ②The engagement team identified golf club membership held by the audited company as a significant account balance, and identified the reasonableness of the valuation of the membership as a material misstatement risk. The engagement team also evaluated the audited company's design and operation of internal controls related to the valuation of the membership. On the other hand, the engagement team omitted substantive procedures for the valuation of the membership on the grounds that the book value of each issue did not exceed the amount of materiality, and concluded that no misstatement had been recognized.

However, with regard to the reasonableness of the valuation of golf membership, the engagement team **only evaluated the design and operation of internal controls while identifying the risks of material misstatement, and did not perform substantive procedures**.

(Auditing Standards Statement No. 330, paragraph 17) [Mid-tier, and small and medium-sized audit firms]

NEW ③The audited company deemed that the company split was a transaction under common control and had each succeeding company succeed to the assets and liabilities attributable to the split company (the audited company) at the time of the company split at their book values.

Given these circumstances, the engagement team identified significant risks associated with the company split in light of the atypical nature of the transaction and the materiality of the amount involved, and performed the following procedures to address these risks.

・Inspection of the agreement concerning the company split;

・Checking compliance with relevant accounting standards;

・Check that the balance of the journal entries related to the company split is consistent between the split company and each succeeding company.

・Inspection of the trial balance prepared by the audited company with respect to the assets and liabilities succeeded to by each succeeding company;

However, **although the engagement team identified significant risks in the company split,** the engagement team **<u>did not examine the consistency between the assets and liabilities succeeded to by each succeeding company in the company split and the business of each succeeding company</u>**.

(Auditing Standards Statement No. 330, paragraph 20) [Mid-tier, and small and medium-sized audit firms]

《Points to Note》

As pointed out in the above examples, there were many cases in which audit procedures suited to the identified and assessed risks of material misstatement were not performed, as well as cases in which substantive procedures to address the assessed risks of material misstatement on an individual basis were not performed despite the assessed risks of material misstatement being determined to be significant risks. In designing audit procedures responsive to the assessed risks of material misstatement, auditors need to take into account the particular characteristics of the relevant class of transactions, account balances and notes, etc., as well as relevant internal controls, and design audit procedures that ensure that sufficient appropriate audit evidence suited to the assessed risks of material misstatement at the assertion level can be obtained.

There are also instances in which auditors do not identify all of the risks of material misstatement or in which there are inherent limitations to internal control, including management override, so it should be remembered that substantive procedures must be designed and performed for important transaction types, account balances, and notes, etc., regardless of the degree of the assessed risks of material misstatement.

Case 2: Adequacy of presentation and disclosure

①While the audited company adopted the percentage-of-completion basis as its revenue recognition standard, it did not disclose important accounting estimates in the company's annual securities report.

Amid this situation, the engagement team understood that judgments by management influenced the estimate of the total cost of construction on a percentage-of-completion basis, and that estimates of such matters as the details of tasks, work-hours, and raw material prices entailed some uncertainty. However, in judging the need for disclosures regarding important accounting estimates, the engagement team did not evaluate whether or not these were items that risked having a material impact on the financial statements of the audited company in the following fiscal year, nor did the team evaluate the size of the quantitative impact on the following fiscal year's financial statements or the likelihood of such an impact occurring.

(Auditing Standards Statement No. 330, paragraph 23) [Mid-tier, and small and medium-sized audit firms]

② The engagement team identified the risk of material misstatement with regard to segment information.

However, the engagement team did not evaluate whether segment information conformed to the accounting standards concerning segment information, etc. Moreover, it merely checked segment information against the basic reference materials prepared by the audited company and failed to perform sufficient substantive procedures.

(Auditing Standards Statement No. 330, paragraphs 17 and 23 and No. 501, paragraph 12) [Mid-tier, and small and medium-sized audit firms) [Mid-tier, and small and medium-sized audit firms]

《Points to Note》

In addition to the above, numerous deficiencies in the audit procedures for presentation and disclosure included: a case where the engagement team did not sufficiently verify the overall presentation of the financial statements, including disclosures, prepared by the audited company, and overlooked important misstatements in the notes on the consolidated statement of changes in net assets, the consolidated statement of comprehensive income, and notes on significant subsequent events; a case where the engagement team did not plan and perform audit procedures to assess compliance with accounting standards, etc. in the notes on revenue recognition; and a case where the engagement team did not examine the completeness of the data used as the basis for calculating fair value, such as by overlooking that capital expenditures necessary for continuing leasing business were not included in the audited company's materials used as the basis for calculating fair value in the notes on leased property.

Engagement teams should plan and perform audit procedures to examine whether the overall presentation of financial statements, including related disclosures, complies with the applicable financial reporting framework. They shall note that disclosure of related parties, in particular, needs to provide appropriate information so that users of financial statements can understand the impact of transactions between companies and related parties or the existence of related parties on financial statements.

(4) Audit considerations relating to an audited company using a service organization

Case 1: Obtaining an understanding of the services provided by a service organization, including internal control

The audited company outsourced the administration and investment of plan assets to multiple life insurance companies and trust banks. In this situation, the engagement team **lacked sufficient understanding of the services provided by them, the importance of those services, and the effects of those services on the audited company's internal controls related to audit**. As a result, the engagement team did not identify and assess the risk of material misstatement related to plan assets.

(Auditing Standards Statement No. 402, paragraphs 8 to 10) [Mid-tier, and small and medium-sized audit firms]

Case 2: Audit evidence regarding the effectiveness of internal controls in the service organization

The audited company uses a network system developed by a service organization as an IT system for its important business operation processes. The audited company had obtained the assurance report on a description of the service organization's system, the suitability of the design of controls, the application of the controls to the service, and the operating effectiveness of controls.

However, the engagement team only evaluated this report obtained by the audited company and **did not perform assessment of the service, such as assessment of the adequacy of the assessment procedures taken by the auditor of the service organization**.

(Auditing Standards Statement No. 402, paragraph 16) [Mid-tier, and small and medium-sized audit firms]

《Points to Note》

In addition to the above cases of deficiency, there were cases in which, although the management of inventory, including shipment and acceptance of goods, was outsourced to a warehousing company, the engagement team lacked sufficient understanding of the services provided by the service organization and relevant internal controls.

If the audited company uses the services of one or more service organizations, the engagement team shall understand how the audited company uses the services provided by a service organization in the audited company's operations. Meanwhile, when understanding the internal control related to auditing, the engagement team shall assess the design and operating effectiveness of relevant controls at the audited company that relate to the services provided by the service organization. Note that these are required to be performed not only in financial statement audits but also in audits of internal control over financial reporting.

Since the migration of systems to the cloud has been progressing recently, audit firms must often judge which of the audited company (user entity) and the service organization is responsible for the internal control over the underlying operations for the financial reporting, depending on the contents and the mode of service that the service organization provides for the audited company. Audit firms need to fully understand the contents of services provided by service organizations and their importance, and their impact on the internal control over financial reporting.

(5) Evaluation of misstatements identified during the audit

Case: Consideration of identified misstatements

①The engagement team ascertained that the understatement of loss on valuation of shares of subsidiaries and associates in the 'non-consolidated and consolidated financial statement for the prior period, which were included in comparative information, was recognized in the current period and that the uncorrected misstatement in the previous fiscal year was corrected in the current term. However, the engagement team did not evaluate the effect of the misstatement in the previous fiscal year on audit of internal control over financial reporting. In addition, it did not include "uncorrected misstatement included in comparative information" or "effect of the undermining of comparative information as a result of correction made in the figures for the current term" among the matters to be confirmed in the management representation letter for confirmation. Moreover, the engagement team did not report to the board of auditors the effect of the uncorrected misstatement related to past fiscal years on the relevant classes of transactions, account balances, or disclosures, and the non-consolidated and consolidated financial statement as a whole.

(Auditing Standards Statement No. 265, paragraph 6, and No. 450, paragraphs 5 and 10; Audit and Assurance Practice Committee Statement No. 82, paragraphs 188 and 195) [Mid-tier, and small and medium-sized audit firms]

NEW ②The audited company disclosed the "amount of inventories recognized as expense" in the notes on inventories in the consolidated financial statement for the previous term and the current period.

In response, the engagement team stated in the audit documentation that the amount disclosed in the previous period was incorrect.

However, the engagement team did not sufficiently understand that comparative information was included as an integral part of the financial statements for the current fiscal year, so the team did not confirm the difference between the misstated amount and the amount that should have been stated, and **did not evaluate whether the misstatement was material as an uncorrected misstatement**.

(Auditing Standards Statement No. 300, paragraph 23, and No. 450, paragraphs 10) [Mid-tier, and small and medium-sized audit firms]

《Points to Note》

There were numerous cases where auditors did not evaluate the results of test of internal control and the impact on substantive procedures although auditors shall judge whether the overall audit strategy or detailed audit plans should be revised when the nature and circumstance of the identified misstatements may indicate the possibility of other misstatements, and there is possibility that the aggregation of other misstatements might become a material misstatement.

Moreover, auditors need to determine whether identified misstatements would be material, either individually or in aggregate, if they are not corrected. However, there were cases where auditors did not evaluate the impact of uncorrected misstatements of past fiscal years on the financial statements as a whole. Note that it is necessary to state in the list of uncorrected misstatements attached to the written representation (1) uncorrected misstatements included in comparative information or (2) effect of comparative information as a result of correction (or elimination) of the figures for the current term, when auditors discovered uncorrected misstatements for the prior years, and management determined that they were not material and have corrected (or eliminated) them in the current term.

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

Case 1: Formulation of a plan for auditing IT use

NEW

①With regard to general controls over IT systems used for construction management and financial management at a consolidated subsidiary of the audited company, the engagement team identified as a deficiency that there were no differences in the authority settings for each user and that all users were granted the same authority. Furthermore, although the engagement team determined that the deficiency was minor as a result of performing risk assessment procedures, the engagement team designed an audit plan and performed audit procedures on the assumption that it was impossible to rely on general controls over the IT systems. Specifically, as substantive procedures, the scope of detailed tests of construction sales by comparing vouchers was expanded.

However, the engagement team **did not identify in detail what risks would arise from the deficiencies in general controls related to the IT systems, did not appropriately assess the risks of material misstatement in light of the impact of the deficiencies, and did not consider the necessity of additional substantive procedures to address the risks**.

(Auditing Standards Statement No. 315, paragraphs 20 and 30) [Large-sized audit firms]

②The audited company identified the application controls of information technology relating to sales processes included restrictions to non-registered customers' usage in the sales management system and the issuance of vouchers prior to shipping registration, and evaluated the design and operating effectiveness of the key aspect of the controls.

The engagement team evaluated sales processes, and determined that application controls in information technology that should be examined as part of financial statement audits and internal control audits were absent, and only evaluated the design and operating effectiveness of manual internal controls.

However, the engagement team did not understand how the audited company dealt with IT-related risks, and did evaluate whether it was possible for only manual internal controls other than the application controls in information technology to prevent and detect risks of misstatement on a timely basis.

(Auditing Standards Statement No. 315, paragraph 20; Audit and Assurance Practice Committee Statement No. 82, paragraph 144, IT Committee Practical Guidance No. 6, paragraph 29) [Mid-tier, and small and medium-sized audit firms]

Case 2: Evaluating of deficiencies in General IT control

The audited company identified and assessed controls on program changes as part of general IT controls for logistics system. The company stipulated that information system work request forms, program test plans, transition plan to production environment, etc., must be prepared and approved at each stage – from detailed system design to testing to transition to a full-scale environment – as controls on program changes.

The engagement team identified deficiencies in these controls because the aforementioned necessary documentation was not prepared at each stage of these controls, but it concluded that IT controls were on the whole effective by identifying and assessing the preparation of information system development management charts and email approval as alternative controls.

However, the engagement team overlooked the fact that the information covered under control activities in which deficiencies had been identified was not listed in the information system development management chart to be prepared for managing progress in program development. The engagement team also did not confirm the specific operational methods for leaving traces of email approval and otherwise did not obtain sufficient appropriate audit evidence relating to the effectiveness of general IT controls.

(Audit and Assurance Practice Committee Statement No. 82, paragraph 185; IT Committee Practical Guidance No. 6, paragraph 46) [Mid-tier, and small and medium-sized audit firms]

《Points to Note》

In addition to the above example cases, there were also cases in which the engagement team lacked sufficient understanding of the specifics of programs related to cost calculation and information systems using IT, including the method of generating master data used by the programs, when evaluating the development of business processes for cost calculation.

Business enterprises use information systems for their business operations. Through understanding the status, characteristics and operation of the information systems of the audited company, the engagement team can properly identify and assess the risks of material misstatements resulting from those systems. There were some cases in which the audit firm judged that the potential material misstatement risk was low without understanding the general structure of those IT systems. When developing an audit plan, audit firms should understand the IT-related environment of the audited company, and identify IT systems that should be included in the assessment for risks of material misstatement.

Moreover, when understanding the general structure of IT systems of an audited company at a group audit, auditors shall be careful not to omit significant components. In addition, auditors need to develop an appropriate audit plan by considering how the accounting policies and the control environment of the audited company, including the year-end closing process, are reflected in or associated with the IT systems. Furthermore, when using various lists generated by the audited company's information system for the tests of controls or substantive procedures, the engagement team shall evaluate the accuracy and completeness of the information. Depending on the degree of IT use by the audited company, the engagement team may need the support of IT specialists and incur considerable time to complete the audit. Therefore, the engagement team should note that it needs to develop an audit plan for the above procedures at an early phase.

The revised Auditing Standards Report No.315 expands the scope of IT-related statements and includes in

the appendix some considerations for understanding IT and for understanding IT general controls.

3. Audit Evidence

Points of focus

Auditors should assess information obtained as audit evidence considering its relevance and reliability. The CPAAOB inspects whether audit procedures designed by the engagement team are properly performed and whether sufficient appropriate audit evidence to draw reasonable conclusions on which to base the auditor's opinion is obtained from the following perspectives:

- Whether the engagement team obtains appropriate audit evidence responsive to the assessed risks of material misstatement at the assertion level, rather than only focusing on the quantitative sufficiency of audit evidence;
- Whether the engagement team performs further in-depth procedures to audit risk to reduce audit risk to an acceptably low level for significant risks;
- Whether the engagement team performs appropriate audit procedures in individual situations as tests of controls and substantive procedures; and
- Whether the engagement team assesses whether the information prepared by the audited company and information prepared by the management's experts is sufficiently reliable.

Outline of inspection results

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

The engagement team did not assess whether the audit evidence obtained through the audit procedures was adequate to identify risks of misstatement;

The engagement team identified significant risks but did not perform substantive procedures that responded individually to the risks;

The engagement team identified inconsistencies and irregularities with other audit evidence but did not determine the necessity of additional audit procedures;

The procedures performed by the engagement team as substantive analytical procedures did not meet the requirements for substantive procedures since the engagement team only performed annual comparisons and monthly fluctuation analyses, and they did not assess the reliability of the data used by the auditor to estimate booked amounts and ratios, and whether the engagement team's estimate was precise enough to identify misstatements which could lead material misstatements;

In using audit sampling for audit procedures, the engagement team did not examine whether the sample size it had determined was adequate to reduce sampling risk to an acceptably low level;

Audit evidence was not obtained on all of the specific items selected when sampling was carried out by selecting specific items;

When testing specific items selected, the engagement team did not examine whether it was necessary to obtain additional audit evidence for the remaining balance; and

When using information prepared by the audited company, the engagement team did not evaluate whether the information had sufficient reliability for audit purposes.
For more information in responses to audit risk for revenue recognition, also see items “(2) Identifying and assessing risks of material misstatement due to fraud” and “(3) Response to assessed risks of material misstatement due to fraud” in “1. The Auditor’s Responsibilities Relating to Fraud in Financial Statement Audits.”

(Observed effective efforts)
The following is an example of observed effective efforts made by an audit firm.
The engagement team reviewed audit plans before the end of each fiscal year, and the results of the review are shared at a meeting held before the end of the fiscal year and attended by all team members. At that meeting, the engagement team checks once again each of the audit procedures planned to be performed in year-end audits with regard to each material accounts, and the engagement partner conducts a detailed review of the specifics of the audit procedures before the performance of year-end audits.

Expected response
The engagement team needs to assess appropriately whether they have obtained sufficient appropriate audit evidence to respond to identified risks. Particularly, **for significant risks, the engagement team shall perform substantive procedures corresponding to each of those risks individually**.
Many examples of identified deficiencies in relation to obtaining sufficient appropriate audit evidence resulted from the engagement team’s failure to appropriately perform risk assessment and design further procedures, and the team’s lack of in-depth understanding of the audited company’s business for the fiscal year subject to audit (See paragraph titled “Expected response,” in “2. Risk Assessment and Response to Assessed Risks”).
In many other cases, the engagement team appropriately performed risk assessment and designed further procedures to respond to the assessed risk but the engagement partners neither gave specific directions nor exercised specific supervision. Staffs of the engagement team therefore performed only conventional audit procedures, leading to a lack of organic coordination between the audit plan and actual audit procedures. Thus, when auditing the audited company, the engagement team should, through the audit period, obtain a deep understanding of the audited company and its business environment and sufficiently discuss the risk assessment and audit procedures to be performed. The engagement team should also comprehensively evaluate the sufficiency and appropriateness of audit evidence obtained as a result of performing audit procedures through the review of audit documentation.

(1) Matters common to audit evidence

Case 1: Sufficient appropriate audit evidence

NEW ①The audit evidence corresponding to the risk of material misstatement

With regard to the fact that the audited company, which is engaged in the land sales business, recorded sales for land sales transactions as of the year-end closing date, the engagement team determined that there was no problem with the attribution of the period for the Transaction because, although the receipt of the sales proceeds and the registration of the transfer of ownership for the Transaction were both made after the year-end closing date, setting the date of transfer of ownership and the date of delivery on the year-end closing date was based on the buyer's request, and the parties concerned had agreed to it.

However, the engagement team **only confirmed the agreement between the parties that the delivery date would be the year-end closing date, and did not examine the reasonableness of the agreement or whether the delivery had actually occurred**.

(Auditing Standards Statement No. 330, paragraph 5) [Large-sized audit firms]

②Dual-purpose test

FREQUENT

The engagement team claimed to have performed dual-purpose tests doubling as substantive procedures in the form of examination of 25 sample cases conducted as test of controls related to raw material cost included in manufacturing costs.

However, the engagement team **merely stated in audit documentation the fact of having checked the presence or absence of approval as a test of controls, but information on monetary value was not covered by the test, while substantive procedures were not performed. In addition, the engagement team did not sufficiently evaluate the sufficiency on sample size of the 25 sample cases randomly selected, nor did it design and perform substantive procedures for the period between January and March, which was not covered by the test of controls**.

(Auditing Standards Statement No. 500, paragraphs 5 and 9, and No. 530, paragraphs 6 to 8) [Mid-tier, and small and medium-sized audit firms]

③Observation of physical inventory counting

Although the engagement team observed physical inventory counting, it merely observed inventory counting procedures and performed test counts but failed to perform the procedures to check the completeness of the physical inventory count records and the accuracy of cutoff of shipping and receipt. As a result, the engagement team did not obtain sufficient and appropriate audit evidence regarding the completeness and accuracy of the physical inventory count records.

(Auditing Standards Statement No. 500, paragraph 5 and No. 501, paragraph 3) [Large-sized audit firms]

《Points to Note》

Generally, inquiries without other procedures neither proves that there is no risks of material misstatement at the assertion level, nor provides sufficient audit evidences as to the effectiveness of internal controls ; however, there were cases where the engagement team completed audit procedures by inquiries only. The

engagement team needs to perform procedures corresponding to assessed risks to corroborate the evidence obtained through inquiry. That applies not only to audit procedures for significant risks but also to audit procedures corresponding to the risks of material misstatement identified.

In addition, auditors plan substantive analytical procedures, tests of details, or a combination of both as audit procedures for assessed risk, depending on the conditions, but the degree of required responses to audit risks differs depending on the significance of assessed risk.

In some cases, although the engagement team performed multiple audit procedures, it did not consider whether the audit evidence obtained through the audit procedures designed under the audit plan was sufficient in terms of quality and quantity, with the result that sufficient audit evidence to reduce the degree of audit risk to an acceptably low level on the whole was not obtained.

The engagement team should not perform planned audit procedures for formality, but comprehensively assess the events identified during the audit and the sufficiency as well as the appropriateness of audit evidence obtained through multiple audit procedures. Furthermore, when implementing tests of controls to be performed concurrently with substantive procedures (dual-purpose tests), the engagement team must remember to evaluate whether procedures designed to obtain sufficient appropriate audit evidence satisfying the purposes of the respective audit procedures have been designed and implemented.

Case 2: Information to be used as audit evidence

①Relevance and reliability of information

The audited company engages in the business of providing economic information to customers. It prepares and updates the list of customers based on written applications for subscriptions and notices of cancellation that indicate fixed monthly fees and books sales on a monthly basis based on the list of customers.

Although the engagement team selected samples from the list of customers as a substantive procedure corresponding to the occurrence of sales, it merely checked sales data against written applications received at the start of transactions and failed to consider the need to obtain audit evidence for ascertaining that the contracts for those transactions were still in effect by verifying the fact of payment, for example.

(Auditing Standards Statement No. 500, paragraph 6) [Large-sized audit firms]

②Work of management's experts

FREQUENT

When evaluating the book value of shares in an insolvent subsidiary, the audited company obtained a real estate appraisal report for land and buildings owned by the subsidiary and calculated the net asset value of the shares, taking into account the market valuation of the real estate.

Amid this situation, the engagement team evaluated the competence, capabilities and objectivity of the experts used by management to prepare the appraisal report, which is information used as audit evidence, and obtained an understanding of the experts' work before reviewing the appraisal report.

However, the engagement team **did not sufficiently evaluate the appropriateness of the appraisal**

report as audit evidence, as the team did not verify the calculation methods or the source data employed by the experts used by management.
(Auditing Standards Statement No. 500, paragraph 7) [Mid-tier, and small and medium-sized audit firms]

FREQUENT

③Reliability of information produced by companies (i)
Regarding the end-of-period inventory valuation, the audited company booked valuation losses on inventory by multiplying the balance of inventory by the percentage by which the selling price fell short of the cost. These valuation losses on inventory were calculated automatically in the audited company's system and output as an inventory table.
When examining the valuation losses booked on inventory, the engagement team reconciled them to the valuation losses on inventory in the inventory table.
However, the team **did not obtain sufficient and appropriate audit evidence, as it did not examine the accuracy of the inventory table**.
(Auditing Standards Statement No. 500, paragraph 8) [Mid-tier, and small and medium-sized audited companies]

NEW

FREQUENT

④Reliability of information produced by companies (ii)
When performing audit procedures for the valuation of accounts receivable and goodwill, the engagement team examined the existence of receivables in arrears and indications of impairment of goodwill based on materials prepared by the audited company.
However, **when using materials prepared by the audited company as audit evidence, the engagement team did not verify the accuracy and completeness of the materials**.
(Auditing Standards Statement No. 500, paragraph 8) [Mid-tier, and small and medium-sized audit firms]

《Points to Note》

When designing and performing audit procedures, auditors should keep in mind that they should take into account the relevance and reliability of information used as audit evidence.
In addition, when using information prepared by experts (e.g., pension actuaries, real estate appraisers, and attorneys) employed by the management as audit evidence, auditors should keep in mind that they should evaluate the competence, capabilities and objectivity of the experts, to understand the experts' work, and to evaluate the adequacy of the experts' work used as audit evidence in light of relevant assertions.
Meanwhile, audited companies often make accounting estimates based on information prepared by themselves, including reference data regarding valuation losses that lists book values and net sales prices by inventory and reference data regarding indications of impairment that lists book values of fixed assets and operating profits/losses by asset group, and data regarding estimated construction profits/losses by construction project and the balance of construction-in-progress expenditures under the percentage-of-

completion method, and reference data regarding construction loss provisions. There are still many cases in which information prepared by audited companies as the basis of accounting estimates is used as audit evidence in the audit of accounting estimates without its accuracy and completeness being verified. When performing audit procedures using information prepared by audited companies, engagement teams must obtain audit evidence concerning the accuracy and completeness of the information and sufficiently examine the reliability of the information obtained by evaluating whether the information is sufficiently accurate and detailed.

Case 3: Timing of substantive procedures

① Performing substantive procedures at an interim date

The engagement team checked the balance of accounts payable as of the end of February as a substantive procedure regarding accounts payable. However, although changes that exceeded the materiality had occurred in the balance with respect to multiple suppliers, the engagement team merely vouched one arbitrarily selected transaction with each supplier in March and failed to design and perform sufficient substantive procedures for the remaining period.

(Auditing Standards Statement No. 330, paragraphs 21) [Mid-tier, and small and medium-sized audit firms]

②Performing physical inventory counting on a date other than the closing date of the term

The audited company adopted physical inventory cycle counting, with different interim count dates applied to inventory taking at different business locations.

The engagement team selected multiple locations for observation of physical inventory counting and performed audit procedures with respect to changes in inventory at some of those locations between the interim count date and the closing date of the fiscal year.

However, the engagement team did not identify the balance of inventory as of the count date or the changes in the balance between the count date and the closing date of the fiscal year at locations not covered by the examination of changes in the balance of inventory. As a result, the engagement team did not design and perform audit procedures to obtain sufficient and appropriate audit evidence with regard to changes in the balance of inventory between count date and the closing date.

(Auditing Standards Statement 501, paragraph 4) [Mid-tier, and small and medium-sized audit firms]

《Points to Note》

It should be kept in mind that, when performing substantive procedures with regard to balance sheet items with a date before the closing date of the term as the reference date, it is necessary to perform additional substantive procedures for the remaining period in order to provide rational grounds for an extended application of the results of the performed substantive procedures to the remaining period.

It should also be kept in mind that, when using audit sampling for substantive procedures with regard to income statement items, it is necessary to select items for the sample in such a way that each sampling unit

in the population during the period has a chance of selection because the entire data for the whole of that period becomes the sampling population.

(2) External Confirmation

Case 1: Reliability of responses to confirmation request

NEW

The engagement team identified fraud risks in accounts receivable, recognizing that the audited company had receivables that had been in arrears for a long time beyond the payment deadline and that transaction agreements for these receivables had not yet been concluded. In addition, the engagement team e-mailed confirmation letters to the companies where the receivables had been in arrears to confirm their balances, collected them, and compared the e-mail address domain of the confirmed respondents with the website domain of the companies where the receivables had been confirmed.

However, the engagement team **did not consider the need for additional procedures even though there was a partial mismatch between the email address domain of the confirmed respondent and the website domain of the confirmed company**.

(Auditing Standards Statement No. 505, paragraphs 6) [Large-sized audit firms]

《Points to Note》

External confirmation procedures generally provide strong audit evidence to auditors. However, if auditors have suspicion of the reliability of the responses, such as receipt of the replies via facsimile, email or obtaining the replies via an audited company, it is necessary to perform an audit procedure to ascertain the reliability of the replies and mitigate the risks of manipulation and fraud.

Especially, in the case of confirmation with the external legal counsel, the engagement team needs to confirm the facts that caused the litigation or claim, when it arose or how long it continued, its status, the likelihood of losses arising therefrom, and an estimate of expected loss.

Additionally, in the case where the payment of compensation due to litigation, etc., is likely to impact the audited company's financial statements materially, the engagement team should examine the appropriateness and effectiveness of the audited company's litigation risk management framework.

Case 2: Alternative audit procedures

In confirming the balances of accounts receivable as of the balance sheet date, the engagement team conducted alternative procedures for confirmations not received through examination cash receipts. However, among the amounts confirmed with respect to major business partners from which responses had not been received, the engagement team only verified the collection of receivables through several collections made in the following month of the balance sheet date but did not examine more than 80% of balances exceeding the materiality, which should have been confirmed.

(Auditing Standards Statement No. 505, paragraph 11) [Mid-tier, and small and medium-sized audit firms]

《Points to Note》

If an engagement team is unable to obtain responses to its confirmation requests, it needs to perform alternative audit procedures. At the same time, the team should carefully evaluate whether the audit evidence obtained through alternative procedures is adequate and appropriate in view of the risks of material misstatement.

Case 3: Exception in relation to confirmation

NEW

The engagement team sent out a confirmation letter as part of its audit procedures for the audited company's accounts payable.

The engagement team determined that there was no problem with one of the confirmation exceptions because it was able to confirm, through the audited company's explanation and review of the reconciliation prepared by the audited company, that the confirmation exception resulted from the assignment of part of the accounts receivable to the audited company.

However, the engagement team **did not examine specific supporting materials such as documents which indicated the assignment of receivables in the investigation of the confirmation exceptions, and did not obtain sufficient appropriate audit evidence for the confirmation exceptions**.

(Auditing Standards Statement No. 505, paragraphs 13 and 15) [Mid-tier, and small and medium-sized audit firms]

《Points to Note》

Exceptions arising from responses to external confirmation might indicate misstatements in financial statements or potential misstatements. Based on this, the engagement team should investigate the exception between the confirmed and stated amounts, and obtain corroborative audit evidence such as specific supporting documents.

If the engagement team determines whether the exceptions corresponds to a misstatement as a result of cause analysis of exceptions, and identifies a misstatement, the team also needs to evaluate the effectiveness of internal control and its impact on the financial statements.

Case 4: Evaluation of reply received

The engagement team identified the risk of material misstatement in the existence of inventory, and regarding the inventories under the custody and control of a third party, it requested confirmation from all entities entrusted with storing those inventories as to inventory balances

However, the engagement team reconciled only some of the inventory balance data provided by the third party to the system data and neglected to reconcile all of the inventory balance date on the confirmation responses from third party. As a result, the engagement team did not obtain audit

evidence concerning the existence of inventory.
(Auditing Standards Statement No. 505, paragraph 15) [Mid-tier, and small and medium-sized audit firms]

《Points to Note》

As in the above cases, there are cases where audit evidence has not been obtained for the entire confirmed amount even though the balance has been confirmed as a specific item due to the importance of the amount. With regard to the main examples of audit sampling, refer to "(4) Audit sampling and testing specific items".

(3) Substantive analytical procedures

Case 1: Performing substantive analytical procedures

FREQUENT

①For the audited company, which operated a payment agency business, the engagement team performed a substantive analytical procedure for cost of sales, developing expectation for cost of sales by multiplying sales for the current term by the cost of sales rate for the previous term.
However, the audit team **did not consider whether it was appropriate to calculate the developed expectation by multiplying by the cost of sales rate for the previous term, even though the cost of sales included costs arising from the settlement amount, costs arising from the number of settlements, costs arising separately without being linked to sales, and sales that did not give rise to cost of sales**.
(Auditing Standards Statement No. 520, paragraph 4) [Large-sized audit firms]

②The engagement team performed substantive analytical procedures for the audited company's labor costs. Specifically, the engagement team subdivided the recorded amounts for each account, which provide a breakdown of labor costs, into categories –cost of products manufactured, R&D expenses, and selling, general and administrative expenses other than R&D expenses – and then developed expectation based on the assumption that the ratio of each category to total labor costs had not changed from the previous term.
However, the engagement team did not ascertain the number of personnel in R&D organizations and non-R&D back-office organizations in the previous and current terms. Accordingly, the appropriateness of the assumption that the ratio of R&D expenses and selling, general and administrative expenses other than R&D expenses to the recorded amounts of each account into which personnel expenses are subdivided remained unchanged from the previous fiscal year was not sufficiently evaluated.
(Auditing Standards Statement No. 520, paragraph 4) [Mid-tier, and small and medium-sized audit firms]

《Points to Note》

When designing and performing substantive analytical procedures, there were still cases where the requirements of substantive procedures were met in form, but the reliability of data and the accuracy of estimates, which were necessary for reducing audit risk to a minimum acceptable level, were not examined. For example, the engagement team used the results of the previous fiscal year and earnings forecasts as estimates without reasonable grounds. The engagement team should give due consideration to the nature and relevance of the information, and consider the possibility of material misstatement regarding the difference between the auditor's expectation and the amount reported.

Case 2: Investigation of results of substantive analytical procedures

FREQUENT

In substantive analytical procedures for cost of sales, the engagement team identified that the difference between the expenditure items listed as cost of sales and the expectation of the auditor exceeded the acceptable difference.

However, the engagement team **merely inquired the difference with the audited company and obtained a response, and did not obtain audit evidence to corroborate the audited company's response**.

(Auditing Standards Statement No. 520, paragraph 6) [Mid-tier, and small and medium-sized audit firms]

《Points to Note》

In some cases, the engagement team only performed an inquiry to obtain qualitative reasons regarding the nature of differences when investigating the differences between the amounts recorded on financial statements and the auditor's expectation. The team did not perform a quantitative investigation and analysis by each cause and did not obtain specific audit evidence to support the qualitative reasons. In substantive analytical procedures, the engagement team needs to investigate differences from expectations and reasons for inconsistencies with other related information considering that the differences subject to further investigations may turn out to be material misstatements.

(4) Audit sampling and testing specific items

Case 1: Planning of audit sampling

FREQUENT

①The engagement team planned audit sampling as tests of details for the value of goods purchased by the audited company. The team performed dual-purpose tests doubling as substantive procedures in the form of cross-checking supporting documents for 25 cases to evaluate the operation of internal control in respect of the value of goods purchased between April and September, and cross-checked supporting documents for the value of goods purchased between March 16 and March 30 for 24 cases.

However, the engagement team **limited the period under the substantive procedures relating to the value of goods purchased and therefore did not select samples in a way each sampling unit in the population has a chance selection**.

(Auditing Standards Statement No. 530, paragraphs 7) [Mid-tier, and small and medium-sized audit firms]

NEW ②In order to verify the audited company's sales, the engagement team cross-checked samples selected through audit sampling against relevant vouchers.

However, the engagement team could not compare some sales transactions in the sample with external evidence such as order forms and acceptance notifications because the audited company did not possess such evidence. Despite this situation, the engagement team **did not examine the appropriateness of audit evidence obtained through alternative procedures**.

(Auditing Standards Statement No. 530, paragraph 10) [Large-sized audit firms]

《Points to Note》

When designing audit sampling, the engagement team needs to consider the purposes of audit and the most suitable combination of audit procedures to achieve those purposes, in consideration of the characteristics of the population from which samples are to be selected.

In deciding the number of samples, it is necessary to note that the way of determination thereof for tests of operating effectiveness of internal control differs from that for tests of details, in general. Therefore, when using the number of samples, which was for the tests of controls, also for the tests of details as in the above example case, it is necessary to examine whether the number of samples is sufficient for tests of details.

With audit sampling, samples should be selected in a way that provides opportunities for all items within the population to be selected; therefore, it is necessary to pay attention to the completeness of the population for selection.

Note that if misstatements are discovered in some selected items in a population using sampling, it is necessary to estimate the total amount of misstatement in the population as a whole.

Case 2: Selecting specific items

The engagement team identified risks of material misstatement (including in regard to existence and completeness) in respect of the cost of sales (value of goods purchased) and performed cutoff tests using data for transactions near the closing date of the term and also performed balance confirmation procedures regarding accounts payable as of the closing date of the term.

However, the engagement team did not obtain sufficient and appropriate audit evidence regarding the cost of sales (value of goods purchased), as the team only performed tests of details for transactions near the closing date of the term that were subject to the cutoff and the accounts payable balances subject to confirmation procedures, and did not perform tests of details in respect of the remaining transactions after these had been excluded.

(Auditing Standards Statement No. 500, paragraphs 9 and A55) [Mid-tier, and small and medium-sized audit firms]

《Points to Note》

As the above case shows, numerous deficiencies are still being observed. These include the failure to consider whether additional procedures should be considered for the remaining part of the population after some selected items in the population have been tested.

Testing some selected items in a population, which involves extracting specific items from transaction types or account balances, is an effective method for obtaining audit evidence, as it allows for the examination of atypical transactions, high-risk items, and monetary materiality, as well as the acquisition of information about the nature of transactions. Unlike audit sampling, however, it needs to be kept in mind that audit evidence is not provided concerning the remaining part of the population, namely the components of the population that are not extracted as samples.

(5) Related parties

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

FREQUENT

In examining whether or not there were any related parties and related party transactions, the engagement team stated that it confirmed that there were no related parties of which the audited company or engagement team were not aware by inquiring with the audited company and reviewing the minutes of various meetings.

However, the engagement team did not conduct sufficient risk assessment procedures in respect of the completeness of related parties and related party transactions, as the team **evaluated the content of the responses to its inquiries without understanding the internal controls established by the management**. Moreover, the engagement team **did not obtain sufficient and appropriate audit evidence in respect of the completeness of related parties, as the team did not confirm the names of related parties and their relationship to the audited company** when the audited company replied only that there were related parties.

(Auditing Standards Statement No. 550, paragraphs 12 and 13) [Mid-tier, and small and medium-sized audit firms]

《Points to Note》

As the above case shows, there were cases where the engagement team did not examine related parties and transactions with related parties completely. If the management has implemented an internal control for identifying related party transactions and approving significant transactions, the engagement team needs to understand the internal control and perform other appropriate risk assessment procedures as deemed appropriate.

Further, the following examples of failure are found for the disclosure of related party transactions:

- **The audited company did not appropriately disclose the terms and conditions while the audited company provided non-interest bearing loans and guarantee without any charge; and**
- **The engagement team did not sufficiently examine the terms and conditions of transactions that were disclosed as arm's length transactions.**

The engagement team should carefully evaluate whether identified relationships with related parties and related party transactions have been properly accounted for and disclosed in accordance with the applicable financial reporting framework.

For information on cases related to identification and assessment of the risks of material misstatement and audit procedures responsive to the assessed risk regarding related party transactions, including the consideration of fraud risk required in the Auditing Standards Statement No. 240, also see “1. The Auditor’s Responsibilities Relating to Fraud in Financial Statement Audits”.

Case 2: Identification of significant related party transactions outside the audited company’s normal course of business

NEW

The audited company acquired a new business in order to strengthen its revenue base, and under the business acquisition agreement relating to this case, the customer of the product was limited to one company, and the product was stored in an external warehouse designated by the customer.

The engagement team determined that the transaction, which was intended to enter a new business, was a significant transaction outside the audited company's normal course of business, and through interviews with the management, the engagement team obtained an understanding of the distribution channel for the Business and the economic rationale of the business model for the Business.

However, the engagement team **did not recognize that the customer to whom the products relating to the business were sold was a related party of the audited company and did not accurately understand the particularities of the business.** In addition, **regarding the reasonableness of the business acquisition, the engagement team did not critically examine and assess whether the business acquisition implied the possibility that the transaction had been carried out for fraudulent financial reporting or to conceal the misappropriation of assets**.

(Auditing Standards Statement No. 550, paragraph 22) [Mid-tier, and small and medium-sized audit firms]

《Points to Note》

Related party transactions sometimes carry higher risks of material misstatement of financial statements than third party transactions. Therefore, as a precondition for audit procedures, the engagement team needs to comprehensively understand the audited company’s related parties and its relationships with them. The engagement team needs to be aware that if it discovers significant transactions with related parties outside the audited company’s normal course of business, it must treat them as a significant risk.

Furthermore, with regard to significant transactions with related parties outside the audited company’s normal course of business, the engagement team needs to carefully consider not only whether they have been disclosed, but also whether their business rationality, or lack thereof, points to the possibility that they have been conducted for the purpose of producing fraudulent financial statements, and whether the

transaction terms are consistent with the explanations by management.

(6) Going concern

Case: Evaluation of management's assessment of going concern assumptions

FREQUENT

Although there were events or conditions casting significant doubt on the going concern assumptions, such as a negative cash flow from sales activities, the audited company determined that there was no material uncertainty regarding its going concern assumptions, as the company had implemented cost reductions and other measures to eliminate the events or conditions in the doubt.

Amid this situation, the engagement team examined the consistency of the statement of cash receipts and disbursement prepared by the audited company with the budget and maximum credit line.

However, the engagement team did not sufficiently examine the reliability of basic data in the budget prepared by the audited company, nor the evidence for the audited company's assumptions forming the basis for the preparation of the budget. Moreover, with regard to additional borrowing in the statement of cash receipts and disbursement, the engagement team did not conduct a detailed examination of the feasibility of additional borrowing in excess of the maximum credit line. (Auditing Standards Statement No. 570, paragraphs15) [Mid-tier, and small and medium-sized audit firms]

《Points to Note》

Early signs of significant events or conditions that may damage the continuity of business operations are likely to appear in business activities, so the engagement team should carefully ascertain any events or conditions that would cast significant doubt on the going concern assumption. Furthermore, when there are events or conditions that might cast significant doubt on the going concern assumption of the audited company, the engagement team should consider the potential need to revise the evaluation as to the risks of material misstatement and nature, timing and scope of further audit procedures.

In addition, the engagement team needs to comprehensively evaluate the circumstances of the audited company and to consider based on concrete audit evidence whether management's plans for future actions in relation to its going concern assessment were effective and feasible.

(7) Subsequent events

Case 1: Examination of events that occurred between the date of the financial statements and the date of the auditor's report

The audited company executed an agreement to extend the due date of the significant loan that was approximately 20% of the audited company's total assets, and publicly disclosed the information.

However, the engagement team failed to consider whether the due date extension was a subsequent event that would require revisions in the audited company's financial statements or affect the audited company's financial statements in the following year and thereafter.

(Auditing Standards Statement No. 560, paragraph 7) [Mid-tier, and small and medium-sized audit firms]

《**Points to Note**》

In many cases, engagement teams performed audit procedures related to subsequent events only by making inquiries with the management. The engagement teams need to perform audit procedures regarding subsequent events for the period between the balance-sheet date and the date of the auditor's report, including at least (Refer to Auditing Standards Statement No. 560, paragraph 6):

- **Understanding the procedures performed by the management to identify subsequent events;**
- **Inquiries with the management;**
- **Inspection of the minutes of board of directors meetings; and**
- **Review of the latest subsequent monthly financial statements, if available.**

Case 2: Examination of facts learned by an auditor after financial statements were released

The audited company excessively eliminated the amount of deferred tax assets by mistake with regard to the journal entry of the eliminations of intercompany balances when preparing a consolidated financial statement based on the Companies Act.

The engagement team expressed an unqualified opinion in the auditor's report based on the Companies Act while overlooking the excessive elimination. However, later, when the consolidated financial statement was published, the engagement team identified the excessive elimination and submitted the auditor's report regarding a corrected financial statement.

Still, when preparing the corrected auditor's report, the engagement team did not consider whether the error overlooked in the pre-correction auditor's report should be included as a matter for emphasis or as other matter.

(Auditing Standards Statement No. 560, paragraph 15) [Mid-tier, and small and medium-sized audit firms]

《**Points to Note**》

In addition to the above example cases, if, after the date of the auditor's report but before the date the financial statements are issued, a fact becomes known to the auditor that, had it been known to the auditor at the date of the auditor's report, may have caused the auditor to amend the auditor's report, the auditor shall implement the following procedures (Auditing Standards Statement No. 560, paragraph 13):

- **Discuss the matter with management**
- **Determine if financial statement revisions or disclosures in financial statements are required**
- **If the financial statements need to be revised or there need to be disclosures in the financial statements, ask management how they plan to handle the matter in the financial statements.**

4. Auditing Accounting Estimates

Points of focus

The CPAAOB inspects audit firms regarding auditing accounting estimates from the following perspectives:

- Whether, considering the degree of estimation uncertainty, the engagement team appropriately identifies and assesses the risks of material misstatement in the accounting estimates, and performs appropriate audit procedures to address such risks, particularly considering the reasonableness of management’s assumptions;
- Whether the engagement team identifies any indication of possible management bias, considering the risks of material misstatement due to fraud, and performs further audit procedures responsive to the management bias if any; and
- Whether, in the case that the engagement team identifies significant risks in accounting estimates, the engagement team performs an evaluation required under Auditing Standards Statement No. 540, paragraph 14 in addition to the planned audit procedure.

Outline of inspection results

There are many cases in which a lack of professional skepticism by the engagement team in auditing accounting estimates leads the engagement team to be content with understanding management's assumption and the accounting processes and not objectively evaluate management's insists on, for instance, the appropriateness of inventory valuation rules, the impairment of fixed assets, and the recoverability of deferred tax assets that determines the feasibility of the business plan used in making accounting estimates, and not carry out procedures for verifying the rationality of these insists.
Further, required audit procedures were often not performed, due to the lack of understanding of requirements under Auditing Standards Statement No. 540.

(Observed effective efforts)

The following case can be cited as an effective effort observed to improve procedures for auditing accounting estimates.
The engagement team unambiguously communicates to management at the audit planning stage its policy of not accepting management’s assumption that are not clearly supported when examining the audited company's business plan.

Expected response

Accounting estimates are accompanied by uncertainty, and the risks of material misstatement associated with them depend on the degree of the uncertainty. Thus, auditors should examine the estimation uncertainty—including the nature and method of accounting estimates, associated internal control, indications of management bias—and should identify and assess the risks of material misstatement.

Auditors should also perform appropriate audit procedures relevant to the risk of identified and evaluated material misstatements, and **verify the reasonableness of the management's estimates from a critical standpoint** as professionals.

With regard to the impact of COVID-19 on the audit of accounting estimates and how to respond to the impact, refer to "II. Quality Control System: Impact of COVID-19 and International Situations on Audit Engagements and Response."

(Amendments to Auditing Standards Statement 540 "Auditing of Accounting Estimates")
Although the Auditing Standards Report No. 540 "Audit of Accounting Estimates" was revised in January 2021, it is be applied to the audit of financial statements for the fiscal year ending March 31, 2023. Therefore, the provisions, on which deficiencies identified in the CPAAOB's inspections before the 2022 business year are based, remain unchanged.

(1) Matters common to auditing accounting estimates

Case 1: Reasonableness of management's assumptions

NEW FREQUENT

①The audited company did not recognize an impairment loss on fixed assets of a consolidated subsidiary, because the value in use, which was based on discounted future cash flows according to the business plan of the subsidiary, exceeded the book value of the fixed assets as a result of an impairment test conducted in accordance with International Financial Reporting Standards.

On the other hand, regarding the management's assumptions implied in the business plan of the subsidiary, which were used in estimating discounted future cash flows in the impairment test, the engagement team inquired with management and reviewed market forecasts and new vehicle unit sales forecasts published by an external market research company.

However, with regard to the increase in sales in the business plan, the engagement team **did not examine the reasonableness of specific sales growth factors (including the method of estimates and the basic data actually selected and used by management) or the reasonableness of management's assumption that the cost of sales ratio would continue to decrease**. In addition, the engagement team did not examine the reasonableness of the discount rate used for calculating discounted future cash flows in the above mentioned impairment test.

(Auditing Standards Statement No. 540, paragraph 7, 9 and 12) [Mid-tier, and small and medium-sized audit firms]

NEW

②Regarding to the advance payment to the non-consolidated subsidiary that had capital deficit, for which the audited company did not record an allowance for doubtful accounts, the engagement team reviewed the operating profit plan (hereinafter referred to as the "profit plan") and repayment plan (hereinafter referred to as the "repayment plan") of non-consolidated subsidiary. Based on this review, the engagement team determined that it was appropriate to classify the advance payment as recoverable general receivables, based on the assumption that the operating profit in the profit plan would be fully used to repay the advance payment and that the same amount would continue to be repaid until the repayment is completed.

However, the engagement team **did not retrospective review on the estimated figures such as sales and operating profit by comparing the projected amount to the actual amount for the current year, regarding the estimation uncertainty. In addition, the engagement team did not examine the reasonableness of the profit plan or the management's assumptions underlying the repayment plan (i.e., the assumption that the entire amount of operating profit in the profit plan would be used to repay the advance payment and the assumption that repayment of the same amount would continue until repayment is completed).**

(Auditing Standards Statement No. 540, paragraph 7, 9 and 12) [Mid-tier, and small and medium-sized audit firms]

NEW

FREQUENT

③ In valuing the investment in subsidiaries and associates of wholly owned non-consolidated subsidiary Company A, the audited company recognized that the net assets of Company A declined by less than 50% of the acquisition cost. And the audited company examined the necessity of write-downs based on Company A's business plan for the next fiscal year and thereafter, and determined that the audited company did not need to write-down of the investment in subsidiaries and associates on the grounds that although Company A's net assets would not recover to the acquisition cost in five years, the acquisition cost included excess earning power, and that the excess earning power had not been impaired.

With regard to the audited company's valuation of the investment, the engagement team understood that Company A would continue generating a certain level of profits from subleasing a real estate, which Company A leased from a third party outside the group, to the audited company, and deemed it appropriate that the audited company did not need to recognize write-down on the investment.

However, the engagement team **did not examine the reasonableness of the audited company's assertion that the excess earning power was not impaired. For example, the engagement team did not compare the actual results with the business plan of Company A, which the audited company developed upon acquisition of Company A’s shares, or did not analyze or examine the differences between the plan and the actual results**.

(Auditing Standards Statement No. 540, paragraph 12) [Large-sized audit firms]

《Points to Note》

Other than the examples above, it is necessary to also review the grouping of impairment of long-lived assets to determine whether the rules set by management match the actual situation of the company and whether the rules that were considered in prior fiscal years still match the actual state of the company when there were changes in the company or the environment surrounding the company. However, there are some cases where the engagement team accepted such management's assumptions without examining them in

detail, and simply checked whether the estimate amount was calculated in accordance with management's assumptions.

When examining accounting estimates, including the evaluation of investments in and loans to subsidiaries and associates, impairment of fixed assets and recoverability of deferred tax assets, engagement teams often evaluate the reasonableness and other aspects of business plans prepared by the management. However, there were many cases in which the engagement team did not sufficiently and appropriately examine the reasonableness of the business plan from a critical standpoint as professionals. For example, the engagement team evaluated the business plan qualitatively only through interviews with the management without checking the details of the business plan based on concrete evidence. Engagement teams should keep in mind that they should carefully consider business plans. For example, they should examine the consistency between business plans and the business environments as understood by themselves, compare the plans with past actual results, check specific measures that form the basis of numerical projections contained in the plans, such as revenue growth and cost reduction, and examine the feasibility of the measures.

In particular, when significant risk has occurred with regard to accounting estimates, engagement teams must evaluate the following (Auditing Standards Statement No. 540, paragraph 14):

- **The methodology taken by management to consider an alternative assumption/result and their reasons for not using such alternative assumption/result; or the process of examining the estimation uncertainty in the case that management did not consider an alternative assumption/result;**
- **The reasonableness of management’s material assumptions; and**
- **Management’s intent and capability to abide by their principles, in terms of the reasonableness of the management’s material assumptions or the appropriateness of the applied reporting framework.**

Case 2: Review of the method of management's accounting estimates

NEW

FREQUENT

①When examining impairment of fixed assets, the audited company grouped assets on a divisional basis, allocated corporate expenses to each asset group, and calculated the profit / loss from operating activities of each asset group.

The basis for allocating head office expenses of the audited company in the previous fiscal year and in the current year, as in management accounting, is as follows:

Previous year: Apply to each division the portion of corporate expenses at the amount that is calculated based on the actual sales of each division multiplying by a certain percentage. Thereafter, allocate the remaining corporate expenses after deducting the portion of corporate expenses according to the percentage of the income of each division.

Current year: Allocate corporate expenses as a percentage of each division's budgeted income to the total budgeted income of all divisions.

As an audit procedure to test the appropriateness of the allocation basis for corporate expenses, the engagement team conducted interviews with management, reviewed materials summarizing the audited company's policy on the application of accounting for impairment of fixed assets, and reviewed divisional income statements generated from the accounting system so that the engagement team could gain understanding on the content and the allocation basis of corporate expenses.

However, the engagement team **did not examine whether the change in the allocation basis for corporate expenses from the previous year was appropriate in light of changes in the circumstances at the audited company in the current year**.

(Auditing Standards Statement No. 540, paragraph 7, 11 and 12) [Mid-tier, and small and medium-sized audit firms]

NEW

FREQUENT

②When identifying and valuing the intangible assets of a company acquired in the current fiscal year, the audited company did not record customer-related intangible assets in the consolidated financial statements, as the audited company noted that (a) only customer-related intangible assets were identified as intangible assets and (b) such customer-related assets were immaterial in the intangible asset valuation report obtained from an external expert.

The engagement team reviewed the intangible asset valuation report prepared by the external expert and noted that the amount of customer-related assets in the report was immaterial.

However, even though the engagement team used an intangible asset valuation report prepared by the external expert that the management used, **the engagement team did not understand the information, which the external expert utilized to identify intangible assets, or the method which the external expert applied to value the identified customer-related intangible assets, therefore the engagement team did not evaluate the appropriateness of the report as audit evidence**.

(Auditing Standards Statement No. 500, paragraph 7 and No. 540, paragraph 12) [Mid-tier, and small and medium-sized audit firms]

《Points to Note》

With regard to accounting estimation methods applied by the management, it is necessary to evaluate the following points: whether the management appropriately applied the requirements of the accounting standards related to the accounting estimate; whether the methods for making accounting estimate are appropriate in light of the purpose of the accounting standards; whether the method for making accounting estimate has been applied consistently; and, whether changes, if any, in accounting estimates or in the method for making them from the prior period are appropriate in the circumstances at the time.

Furthermore, engagement teams should keep in mind that, testing how management made the accounting estimate may involve the following(refer to Auditing Standards Statement No. 540, paragraph A68):

- **Examination as to the accuracy, completeness and relevance of the basic data used for accounting estimates, and whether the accounting estimates are made appropriately with the basic data and management's assumptions;**

・**Examination as to the source of information, the relevance, and reliability of external data or information (including information from external experts used by management);**

・**Examination as to the consistency of information for accounting estimates and the recalculation thereof; and**

・**Examination of management's review and approval for accounting estimates.**

Case 3: Review of prior period accounting estimates

NEW

FREQUENT

Company B, a consolidated subsidiary of the audited company, continued to record operating losses. However, in examining the recognition of impairment losses on fixed assets in the current year, the audited company determined that the audited company did not need to recognize impairment losses on fixed assets, as the undiscounted future cash flows according to the business plan exceeded the book value of fixed assets. The audited company expected that Company B's would turn to operating profit, as the overall fixed costs would decrease compared to the current year due to reduction of personnel expenses by securing personnel and promoting employee retention, and as well as the reduction of the fixed costs other than personnel expenses.

With regard to management's assumptions regarding Company B's fixed-cost reductions, the engagement team inquired with management to understand the management's assumptions. In addition, the engagement team understood that increase in personnel expenses in the current year was due to a temporary factor, and compared the planned figures for the next year with the actual figures for the current year, and determined that the management's assumptions were not unreasonable.

However, the engagement team **did not specifically understand the nature and reason for the difference between the planned figures and actual figures, while, Company B**'s **continued to record operating loss and the actual figures of operating profit or loss for the current year fell short of the planned figures. In addition, the engagement. The team did not assess the possibility of management bias or the degree of uncertainty included in management's estimate of fixed assets**.

(Auditing Standards Statement No. 540, paragraph 7, 8 and 12) [Mid-tier, and small and medium-sized audit firms]

《Points to Note》

In some cases, when reviewing the audited company's accounting estimates, the engagement team only ascertained the amount of deviation between the value estimated in the previous period and the outcome in the current period and the reason therefor, and did not consider the background of the deviation in evaluating the management's estimate for the current period. The team needs to note that reviewing the accounting estimates for the previous period is required in order to identify possible management bias and evaluate the degree of the estimation uncertainty.

It should be noted that the existence of a difference between outcome of accounting estimate and estimated

amounts in the previous year's financial statements does not necessarily indicate a misstatement in the previous year's financial statements. However, it is possible to make a reasonable basis that the audited company could estimate close to the actual amount, if management used certain information available when estimating, as well as information reasonably expected to be obtained or considered when preparing the financial statements. In such a case, the auditor needs to consider that the difference could increase misstatements in the previous year's financial statements.

(2) Evaluation of shares in subsidiaries and affiliates

Case 1: Examination of excess earning power in the valuation of shares

The audited company obtained shares in an equity method affiliated company in anticipation of excess profitability, and, when valuing the shares, examined whether or not there would be any damage to excess profitability by comparing the business plan at the time of acquiring the shares with the actual figures. Specifically, although the actual profit of the equity method affiliated company in the fourth quarter was lower than the plan, the audited company determined on the basis of the business plan revised at the end of the fiscal year in light of actual performance that there was no need to write down shares in affiliates, as the root cause was a lag due to the delayed progress of the business plan.

Amid this situation, the engagement team confirmed that the cause of actual performance falling below the plan was the lag, and, after examining the feasibility of the revised business plan, deemed the audited company's assertion that no write-down was required to be valid.

However, the engagement team **did not sufficiently examine the impact on the initially anticipated excess profitability of the situation in which the revised business plan had been revised downwards from the business plan at the time of acquisition**.

(Auditing Standards Statement No. 540, paragraph 11 and 12) [[Large-sized audit firms]

《Points to Note》

In addition to the aforementioned examples of identified deficiencies, there were cases in which the engagement team did not quantitatively examine the reasonableness of the management's assumption that business performance would substantially improve, even though the subsidiary's net asset value was less than 50% of its acquisition value (refer to (1) Matters common to auditing accounting estimates, Case 1 ③), or in which the engagement team did not examine the reasonableness of the audited company's judgment regarding the evaluation of shares in a subsidiary with poor business performance, even though the value of the shares, which was estimated to be likely to recover in roughly five years based on the subsidiary's business plan, failed to reach the book value and remained at around 50% of the book value; or in which the engagement team did not consider the need for a write-down of shares held by the subsidiary in an insolvent subsidiary of its own, and thus did not appropriately value the net asset value of shares in the subsidiary.

When the net asset value of shares in subsidiaries and affiliates whose market value is considered to be

very difficult to be identified has fallen by around 50% compared with the acquisition value, it is necessary to assume that the net asset has declined significantly and book a reasonable amount of impairment losses. The same treatment of asset impairment is applicable to the evaluation of shares in recently acquired subsidiaries and affiliates, and therefore, it is necessary to carefully examine the possibility of a decline in the net asset, including examining the discrepancy between the initial business plan and the actual results.

(3) Valuation of receivables

Case 1: Review of recognition and measurement

The audited company booked an allowance for bad debts based on past default rates to prepare for losses due to debt default. Specifically, it categorized claims as either (1) those for which no more than one year had passed since they fell into arrears or (2) those for which more than one year but no more than three years had passed since they fell into arrears, and then calculated the allowance for bad debts using the three-year-average default rate computed as follows for each of the categories (1) and (2).

With regard to (1), it computed the past default rate using the balance of receivables as the denominator and the amount of defaults in the following year as the numerator, while with regard to (2), it computed the past default rate using the balance of receivables as the denominator and the amount of defaults in the following two years as the numerator. Furthermore, the audited company re-categorized receivables for which three years had passed since they fell into arrears as bankruptcy/rehabilitation receivables, and booked an allowance for bad debts for the entire amount of the bankruptcy/rehabilitation receivables.

However, the engagement team did not adequately consider whether the above-mentioned period categories and default-rate calculations, which the audited company used to estimate future losses from defaults on receivables, were consistent with actual losses by the audited company incurred as a result of defaults.

(Auditing Standards Statement No. 540, paragraph 7 and 14) [Large-sized audit firms]

《Points to Note》

In addition to the above example cases, there were cases in which the engagement team did not sufficiently examine the reasonableness of the estimation method of taking into account the uncertainties according to the period during which receivables were scheduled to be recovered (refer to (1) Matters common to auditing accounting estimates, Case 2 ①), or in which, regarding assets scheduled to be seized, the engagement team did not examine the reasonableness of the amount of assets that the audited company asserted could be recovered. When evaluating debt claims in cases where some assets are planned to be seized, it is necessary not only to identify the assets to be seized but also to sufficiently examine the feasibility of seizure and the estimated amount of assets that may be disposed of.

As for the method of evaluating receivables with default possibility, if it is difficult to obtain data that helps judge the debtor's ability to pay, one example option is using a simplified method of provisioning 50% of

the balance of receivables after the deduction of the estimated disposal value of the collateral in the term that the receivables are determined for the first time to have a default possibility. With regard to individually material receivables with default possibility, it should be kept in mind that it is necessary to obtain as much data as possible and to sufficiently examine whether the audited company conducted an appropriate estimation at the time of evaluation.

Case 2: Self-assessment of loans (appropriateness of borrower category)

When auditing a tier-2 regional bank, the engagement team did not examine the audited company's decision-making as to borrower category as follows:

a) While the engagement team considered that the "Reasonable and Highly Achievable Plan" prepared by a debtor was unachievable, the team agreed with the financial institution's decision to classify the debtor as category "requires attention." The engagement team did not perform audit procedures for the inconsistency above.

b) While recognizing that a debtor had substantially negative assets with an unrealized loss, the financial institution did not adjust the debtor's financial profile (including an adjustment based on the unrealized loss). However, the engagement team acknowledged the unrealized loss but did not examine the appropriateness of the financial institution's decision.

c) Despite the fact that a huge loss incurred by A Co. was covered by B Co., the audited financial institution did not treat the two companies as a group in its self-assessment process. However, the engagement team did not examine the appropriateness of not treating the two companies as a single group and assign to a single borrower category or review the financial condition of the two companies as a borrower group.

(Auditing Standards Statement No. 540, paragraph 14)[Large-sized audit firms]

《Points to Note》

In auditing a deposit-taking financial institution, it is often the case that the audited company's evaluation of loans is identified as a significant risk, and the audit plan is designed based on the internal controls. In that case, it is necessary to perform tests on the operating effectiveness of controls, in addition to substantive procedures. Re-performance, in addition to inspection of records and documents, is considered effective in the tests of operating effectiveness of controls regarding the allowance for doubtful accounts. Extracting a borrower as a sample and re-performing self-assessment on it can cover both the tests of operating effectiveness and of details. However, it is important to fully consider that even when using identical information, procedures vary based on the purpose of these tests.

(4) Inventory valuation

Case: Review of the method used for management's accounting estimates

NEW

FREQUENT

With regard to the valuation of products and raw materials, the audited company had an accounting policy that the audited company write-down book values to zero due to decline in profitability, on the condition that the products, of which were expected to be hold for more than three years in the future, were unlikely to be sold (condition 1) and raw materials expected to be disposed of (condition 2). Also, the audited company determined that raw materials that were not subject to condition 2 would not have a decline in profitability, as such raw materials would not degrade physically and the audited company would need to hold a wide variety of raw materials.

The engagement team noted that the audited company evaluated products and raw materials in accordance with the above policy.

However, the engagement team **did not evaluate whether the aforementioned valuation method for products and raw materials of the audited company was appropriate to determine declines in the profitability of products and raw materials**.

(Auditing Standards Statement No. 540, paragraphs 7) [Mid-tier, and small and medium-sized audit firms]

《Points to Note》

In addition to the above example cases, there were cases in which: the engagement team did not sufficiently examine the reasonableness of the management's assumption that it was unnecessary to book valuation losses on retained inventory whose sales results were sluggish because those assets had not physically deteriorated and that sales activity was continuing; the engagement team did not examine the reasonableness of the audited company's assumption that with regard to current sales products and inventories held for the purpose of maintenance, valuation losses would not occur because they would not be sold at prices below their book values; the engagement team did not examine the reasonableness of the audited company's applying a uniform valuation loss rate to retained inventory according to the period of retention; or the engagement team did not sufficiently examine the reliability of calculation data regarding valuation losses prepared by the audited company.

Also, audited companies have inventories with special characteristics, such as real estate inventories for sale and development projects in progress, which are different in value and difficult to calculate an objective value for. It is necessary to keep in mind that these special inventories, in general, should not be excluded from the scope of reduction in book value due to a decline in profitability.

(5) Impairment of long-lived assets

Case 1: Consideration of cash-generating units

In performing impairment tests of fixed assets in consolidated financial statements, the audited company grouped its bricks-and-mortar store assets on the basis of the organizational units responsible for businesses under a particular brand (hereinafter referred to as "brand units").

Amid this situation, the engagement team did not undertake any particular examination of the cash-generating units, as the audited company grouped its store assets on the basis of brand units every fiscal year and there had been no change during the current fiscal year.

However, the engagement team **did not examine the appropriateness of the audited company**

grouping its store assets on the basis of brand units, even though the audited company published figures for the number of stores opened and closed in its monthly overview of sales and grouped those store assets on the basis of independent store units in those figures.
(Auditing Standards Statement No. 540, paragraphs 11) [Large-sized audit firms]

《Points to Note》

In addition to the above example cases, there were cases in which: the engagement team overlooked the discrepancy between the asset grouping and the reality; the engagement team did not examine the appropriateness of the classification of shared assets; or the engagement team merely checked the amount of profits/losses or cash flow generated from operating activities that was calculated by the audited company and the status of idle assets and failed to examine the appropriateness and completeness of the asset grouping. There are also cases in which, when the impairment loss of fixed assets after a change in grouping was not recognized, the engagement team did not exercise professional skepticism and sufficiently examine whether this change might have been an indication of fraud, and cases in which the engagement team did not fully examine the reasonableness of a change in a grouping in light of accounting standards, etc., when impairment has not been recognized in a given cash-generating unit because of a regrouping of fixed assets traditionally belonging to a single cash-generating unit into multiple generating units.
Cash-generating units should, as a principle, be a unit generating cash flows generally independent of those of other assets or cash-generating units. Therefore, the engagement team should examine the appropriateness of the policy to determine cash-generating units when the audited company monitors operating performance in smaller units than the cash-generating units determined by the audited company.

Case 2: Review of indications of impairment

FREQUENT

①As to new stores in business less than two years from the beginning of the fiscal year following their opening, the audited company determined that operating losses incurred or likely to be incurred on a continuous basis would be excluded from the assessment of indications of impairment, except that some significant change in the environment exists, because its new stores tend to suffer operating losses immediately after opening due to the nature of the business.
However, when examining the company’s assessment of the indications of impairment for the new stores, the engagement team **did not consider whether the new store’s operating losses represented a significant downward deviation from the business plan formulated when the store was opened**, although there are stores for which impairment losses are recognized just after their first two years in business.
(Auditing Standards Statement No. 540, paragraphs 12 and 14) [Large-sized audit firms]

NEW

FREQUENT

②When determining the indications of impairment of long-lived assets, the audited company set the minimum unit generating cash flows (hereinafter referred to as the "minimum unit asset group") for each business unit of the audited company and for each consolidated subsidiary. When aggregating the "profit (loss) from operating activities" for each minimum unit asset group, the audited company allocated corporate expenses incurred at corporate department, including accounting department, human resources department, and IT promotion department, to each minimum unit asset group at the amount that equivalent to management fee, while the audited company did not allocate the remaining amount after deducting the expenses equivalent to management fees to each minimum unit asset group.

The engagement team understood the audited company's allocation of corporate expenses, evaluated design effectiveness of internal controls relating to indications of impairment of fixed assets, and evaluated the reliability of information on the divisional income statement. And the engagement team examined the consistency between the assessment materials for indications of impairment and the divisional income statement, and evaluated the reasonableness of the assessment materials for indications of impairment prepared by the audited company. As a result, the engagement team determined that the audited company had appropriately identified indications of impairment.

However, the engagement team **did not evaluate the appropriateness of the audited company not allocating the amount remaining after deducting expenses equivalent to management fees out of the corporate expenses to the related minimum unit asset group**.

(Auditing Standards Statement No. 540, paragraph 11) [Mid-tier, and small and medium-sized audit firms]

《Points to Note》

In addition to the above examples, there were cases in which: the engagement team did not assess indications of impairment using profits/losses generated from operating activities when it had identified both those profits/losses and cash flow generated from operating activities; or the engagement team assessed indications of impairment based on the estimated figures before the end of the term and neglected to conduct assessment based on the actual figures at the end of the term although it recognized a significant deterioration in the actual figures compared with the estimated figures. With those cases in mind, engagement teams need to carefully examine indications of impairment.

Further, as a principle, when an asset or a cash-generating unit becomes idle, it means a change that will reduce the recoverable amount of such asset or cash-generating unit significantly in the scope and method that the asset, etc., is used. Therefore, when examining the indications of impairment of idle assets, the engagement team needs to carefully examine the reasonableness of the amount of time that has passed since the assets became idle. For example, in the case where an asset just fell into the idle state, the engagement team should examine whether the duration can be treated as time necessary to determine the future use of the asset.

NEW

FREQUENT

Case 3: Review of recognition and measurement of impairment

In examining impairment of long-lived assets, the audited company identified indications of impairment on asset groups related to business locations where operating income after corporate expenses was negative for two consecutive years. In addition, since undiscounted future cash flows were negative, the audited company measured impairment loss. Furthermore, in measuring impairment loss, no impairment loss was recorded for land, as the simple appraisal value based on the property tax appraisal value exceeded the book value of land. On the other hand, the audited company recorded the entire book value of depreciable assets such as buildings as impairment loss. The engagement team determined that the above method and amount of impairment loss on non-current assets by the audited company was appropriate.

However, with regard to the measurement of impairment loss on land, the engagement team **did not evaluate the reasonableness of management's assumption that the appraisal value based on the property tax appraisal value would be the net selling value**, and with regard to the measurement of impairment loss on depreciable assets such as buildings, the engagement team did not evaluate the reasonableness of management's assumption that the net selling value was zero and the entire book value was impaired.

(Auditing Standards Statement No. 540, paragraph 11 and 12) [Large-sized audit firms]

《Points to Note》

In addition to the above examples, there were cases in which: the engagement team merely inquired with the audited company about the business plan that formed the basis of the calculation of future cash flows and failed to examine the reasonableness of the plan based on specific supporting data; the engagement team examined only sales in the business plan and failed to examine cost of sales/selling costs, and general and administrative expenses; the engagement team did not examine the reasonableness of the process of determining the main asset of each asset group and the remaining economic life of the main asset, which form the basis of the estimation period of future cash flow; capital investment and repair costs necessary for maintaining the present value were not included in future cashflows, or were included, but not fully examined; after-tax discount rates were used even though future cash flows were pre-tax figures; the appropriateness of the discount rates used was not examined; or the recognition of impairment losses was assessed on the basis of profits/losses generated from operating activities rather than undiscounted future cash flows.

In addition, there are cases involving the use of real estate appraisal reports in which the engagement team did not examine the appropriateness of continuing to use real estate appraisal reports obtained in previous year's audit as audit evidence for the current fiscal year, cases in which real estate appraisal reports were used without evaluating the capabilities, competence and objectivity of the real estate appraiser used by the management, and cases in which the engagement team did not examine the reasonableness of not deducting the estimated disposal cost from the real estate appraisal value in calculating the net selling value.

The audited company must largely rely on projected future cash flows to decide whether to recognize and measure impairment loss. Therefore, when verifying the management's insists on the necessity to recognize impairment loss, the engagement team should note that it is necessary to carefully examine components of

the projected future cash flows, including the remaining economic life used to calculate the utility value of assets, and the business plan that is the basis of projection, and the reasonableness of the business plan. Additionally, when the audited company adopted net selling value as the asset's recoverable value, the engagement team should carefully examine the basis of calculating the net selling value.

(6) Valuation of goodwill

Case 1: Review of amortization period of goodwill

For an acquisition completed in the current period, the audited company accounted for the difference between the net assets of the purchased company and the acquisition costs as goodwill.

In this regard, the engagement team ascertained that the amortization period of five years determined by the audited company was appropriate only on the basis that the period did not exceed 20 years. Therefore, the team did not examine the appropriateness of the goodwill amortization period by verification of the period during which the subject goodwill would remain effective and the reasonable period of return on the investment.

(Auditing Standards Statement No. 540, paragraphs 11 and 12) [Mid-tier, and small and medium-sized audit firms]

《Points to Note》

The acquirer must estimate a reasonable period as the goodwill amortization period for each business combination based on the expected duration that the goodwill will remain effective, while the accounting standard also allows reference to a reasonable period for the recovery of the investment as a basis for the calculation of the value of the business combination. With this understanding, the engagement team should pay attention to the necessity to verify the appropriateness of the amortization period applied by the audited company.

Case 2: Indications of goodwill impairment

FREQUENT

①Although a consolidated subsidiary for which goodwill was recognized recorded operating loss after amortization of goodwill in the current fiscal year, the engagement team judged that the audited company's assertion that there were no indications of impairment was appropriate because the subsidiary had recorded operating profit in the previous fiscal year.

However, the engagement team **did not sufficiently examine the presence or absence of indications of impairment. For example, it did not compare the business plan at the time of the acquisition of shares in the subsidiary with the actual results**.

(Auditing Standards Statement No. 540, paragraphs 11 and 12) [Large-sized audit firms]

NEW

FREQUENT

②The audited company did not recognize an impairment loss for the goodwill, which the audited company recognized in the business combination conducted in the current year, as the audited company deemed that the value in use calculated based on discounted future cash flows according to the business plan of the acquired company exceeded the book value of the cash-generating units, including goodwill as a result of an impairment test on the goodwill in accordance with International Financial Reporting Standards.

With regard to management's assumptions in the business plan of the acquired company used for estimating discounted future cash flows, the engagement team identified sales growth rate only as a significant assumption, and performed substantive procedures for sales growth rate.

However, the engagement team **did not examine the reasonableness of assumptions other than the sales growth rate**, even though the business plan used for the audited company's impairment test assumed that the operating profit rate would continue to rise every period and that the number of employees hired would exceed the most recent actual number. In addition, while the engagement team **only compared the sales growth rate, which it identified as a significant assumption, with market forecasts in related fields published by an external organization and sales growth rates of other companies in the same industry, etc. it did not examine the reasonableness of sales growth factors specific to the acquired company (including the management's estimation method and basic data used), and did not sufficiently examine the reasonableness of assumptions used by the management**.

(Auditing Standards Statement No. 540, paragraph 7, 9 and 12) [Mid-tier, and small and medium-sized audit firms]

《Points to Note》

As can be seen from the above examples, if the value allocated to goodwill and other intangible assets is relatively high, it may be determined that there is an indication of impairment in the year of the business combination as well. Therefore, if a large amount of goodwill has occurred, engagement teams should also sufficiently examine whether there are indications of impairment in the year of occurrence of goodwill.

In addition to the above examples, there were cases in which the engagement team did not understand the management's assumptions regarding the valuation of goodwill for a group composed of several consolidated subsidiaries, relating to such matters as the breakdown of sums for individual companies in the group and the quantitative impact of measures (refer to (1) Matters common to auditing accounting estimates, Case 1, ①), and cases in which the engagement team did not sufficiently examine the feasibility of business plans. For example, in one such case, a business plan formulated at the time of acquisition failed to proceed as expected and the actual profit/loss figure fell significantly short of the target under the business plan, and as a result the business plan was revised and the difference between the recoverable value based on the revised business plan and the book value of goodwill was booked as impairment loss. However, when reviewing the revised business plan, the engagement team did not examine the revenues by type and examined only some portions of the revenues. Moreover, there were cases in which the engagement team did not sufficiently examine the inconsistency in the management's assumptions regarding accounting treatments. For example, in one such case, although the audited company booked impairment losses related to shares in a subsidiary in the non-consolidated financial statement, the engagement team did not examine

the impairment of the corresponding goodwill on a consolidated basis. Engagement teams should keep in mind the need to evaluate from a broad perspective whether the identified events have been comprehensively reflected in accounting.

In addition, in fiscal years when there has been a change in auditor, if the balance at the beginning of the fiscal year includes important goodwill or intangible assets, engagement teams should keep in mind the need to understand the management's assumptions forming the basis of the allocation of acquisition costs, in order to identify and evaluate the risk of material misstatement in regard to goodwill, etc.

(7) Recoverability of deferred tax assets

Case 1: Review of company classification

A consolidated subsidiary of the audited company booked a large tax loss in the current year. The audited company claimed that this was due to the impact of a drop in sales as a result of temporary factors, and that it would be easy for the audited company to reduce the management consulting fees which the audited company was receiving from the subsidiary.

Because of this, the audited company compared the total amount of taxable income of the audited company and the subsidiary with the amount of the tax loss, and classified the subsidiary as Category 2 in the ASBJ Guidance No. 26 “Implementation Guidance on Recoverability of Deferred Tax Assets” on the grounds that a “significant tax loss” had not arisen.

In response, the engagement team described in the audit documentation that the tax loss had arisen due to temporary causes and that the subsidiary was paying a large amount of management consulting fees to the audited company.

However, despite the fact that the taxable income for the next term as forecast in the subsidiary’s business plan was smaller than the tax loss, the engagement team did not examine whether, for the current year, it met the criteria for stating that a “significant tax loss” had not occurred.

(Auditing Standards Statement No. 540, paragraphs 7 and 11) [Large-sized audit firms]

《Points to Note》

In relation to the company classification specified in the ASBJ Guidance No. 26 “Implementation Guidance on Recoverability of Deferred Tax Assets”, the engagement team needs to remain conservative and carefully check the company classification in light of relevant accounting standards.

Regarding “taxable income excluding that arising from temporary causes” for categories 2 and 3 in the Implementation Guidance, the engagement team needs to examine whether “that arising from temporary causes.” was actually temporary or not with particularly careful manner.

Case 2: Estimation of taxable income

NEW

FREQUENT

The audited company determined that Company C, a consolidated subsidiary, was classified as Category 3 under ASBJ Guidance No. 26 “Implementation Guidance on Recoverability of Deferred Tax Assets” on Recoverability of Deferred Tax Assets, and recognized deferred tax assets within the limit of taxable income according to Company C’s medium-term management plan. The audited company determined that the future taxable income of Company C would be the amount of income before income tax in the medium-term management plan, making estimated tax adjustment, assuming the operating income would be the same amount as income before income tax in the medium-term management plan. Since the period of the medium-term management plan of Company C was three years, the audited company estimated income before income tax for the fourth and fifth years at the same amount as in the final year of the medium-term management plan.

When examining the recoverability of Company C's deferred tax assets, the engagement team confirmed that the amount of income before income tax used to calculate the estimate of future taxable income was consistent with the amount of operating income in Company C's medium-term management plan.

However, **in evaluating the recoverability of deferred tax assets, the engagement team did not examine: (i) the reasonableness of Company C's medium-term management plan; (ii) the reasonableness of the audited company's assumption that operating income and income before income tax in Company C's medium-term management plan would be same amount; and (iii) the reasonableness of setting Company C's estimate of income before income tax for the fourth and fifth years at the same amount as the estimate for the final year of the medium-term management plan**.

(Auditing Standards Statement No. 540, paragraph 12) [Mid-tier, and small and medium-sized audit firms]

《**Points to Note**》

In reviewing the recoverability of deferred tax assets, the engagement team often examines the reasonableness and other aspects of the business plan prepared by the audited company's management for estimation of taxable income. There are cases where the engagement team judges that the estimation is conservative and achievability is high based solely on the fact that management calculated the estimation by multiplying the business plan by achievement rates in past years, without critically reviewing the business plan itself.

If the audited company posts deferred tax assets based on the sufficiency of taxable income before adjustment for temporary differences etc. backed by its earnings capability, the business plan, a basis for taxable income before adjustment for temporary differences etc., should in principle be approved by the board of directors. Further, in the case of material adjustments between the business plan and taxable income, the engagement team needs to perform audit procedures to secure the feasibility of taxable income, including verification of the reasonableness of adjustments from profits in the business plan to taxable income.

Case 3: Review of scheduling

FREQUENT

The audited company booked the full amount of an allowance for doubtful accounts for loans etc. to its poorly performing subsidiaries. The audited company determined that the deferred tax assets relating to the deductible temporary difference of the allowance for doubtful accounts were recoverable because they planned to waive their receivables in the future. The engagement team obtained a confirmation letter in the name of the representative director stating that the receivables would be waived at some unspecified point in the future for the liquidation or rehabilitation of the subsidiary, and therefore assessed that the audited company's accounting procedures for posting deferred tax assets relating to the allowance for doubtful accounts to be appropriate.

However, the engagement team **did not examine the reasonableness of the management assumption that the debt waiver would take place based on the facts that the representative director's stated that the debt waiver would take place at some unspecified time and additional loans had been made in the current fiscal year**.

(Auditing Standards Statement No. 540, paragraph 12) [Mid-tier, and small and medium-sized audit firms]

《Points to Note》

In addition to the above examples, in many cases, the engagement team did not appropriately or sufficiently examine the feasibility of the schedule for tax deduction of temporary difference in the future. For example, there is inconsistency between the assumption for valuation of securities and allowance for doubtful accounts and the planned period for tax deduction of relevant temporary differences in the future. The engagement team needs to exercise due care when examining the reasonableness of the schedule for tax deduction of deductible temporary differences arising from the valuation of investments in affiliated companies in particular, because complicated conditions such as organizational restructuring may often be involved.

In addition, in examining the deferred tax liabilities arising from undistributed profits of subsidiaries, there are cases in which the engagement team did not sufficiently examine the audited company's policy of not having subsidiaries pay dividends as a rule, and cases in which the engagement team did not sufficiently verify whether the dividend policy of foreign subsidiaries had been officially approved by an authorized decision-making body, etc.

Case 4: Review of the impact of business combinations

The audited company classified its consolidated subsidiary as Category 4 in ASBJ Guidance No. 26"Implementation Guidance on Recoverability of Deferred Tax Assets" because it had a significant tax loss, and it planned to merge with the subsidiary in the next fiscal year. Based on the post-merger taxable income, the audited company determined that the tax loss was recoverable and recorded deferred tax assets corresponding to the tax loss.

However, when examining the recoverability of deferred tax assets, the engagement team overlooked that this accounting treatment did not comply with ASBJ Guidance No. 10, which stipulates that the impact of the business combination cannot be taken into account until the actual business combination takes place, and that this impact is to be reflected from the year of the business combination.

(Auditing Standards Statement No. 540, paragraphs 11 and 12; ASBJ Guidance No. 10, paragraph 75) [Mid-tier, and small and medium-sized audit firms]

《Points to Note》

As pointed out in the examples above, the recoverability of deferred tax assets is judged by taxable income before the addition/subtraction of temporary differences based on the profitability of the acquiring company, and it is important to note that the impact of the business combination is to be reflected after the fiscal year in which the business combination takes place.

(8) Retirement benefit obligations

Case: Reliability of basic data

NEW

FREQUENT

The audited company provided the pension actuary engaged in the computation of retirement benefit obligations with the actuarial assumptions (discount rate, retirement rate, expected salary increase rate, etc.) and personnel data (salary, age, years of service, etc.) of each employee used in the computation of the retirement benefit obligations. The audited company booked provisions for retirement benefits in non-consolidated financial statements based on the computation results of the pension actuary.

The engagement team sent a confirmation letter concerning the computation results of retirement benefit obligations to the pension actuary, and confirmed that the amount in the reply on the confirmation letter matched the amount of retirement benefit obligations recognized by the audited company. In addition, the engagement team confirmed that the number of employees included in the pension actuary's computation matched the audited company's internal data.

However, the engagement team **did not examine the accuracy of the personnel data (salary, age, years of service, etc. of each employee) provided by the audited company to the pension actuary, and did not examine whether the assumptions used by the pension actuary in computing retirement benefit obligations conformed to the applicable financial reporting framework**.

(Auditing Standards Statement No. 500, paragraph 8, and No. 540, paragraph 12) [Mid-tier, and small and medium-sized audit firms]

《Points to Note》

When estimating retirement benefit obligations, it is necessary for auditors to examine the relevance, completeness, and accuracy of the underlying data of the audited company upon using the service of the management's expert.

In addition, considering actuarial assumptions such as the discount rate could influence the computation results for retirement benefit obligations greatly, the engagement team should be aware of the importance of examining the appropriateness of the actuarial assumptions used by the audited company.

(9) Asset retirement obligations

Case 1: Look back review of accounting estimates in the previous fiscal year

NEW

FREQUENT

Of the leased stores, the audited company booked asset retirement obligations for properties for which restoration obligations were contractually owed, at the amount calculated by multiplying the past unit price of restoration expenses per square meter leased by the number of square meters leased. The audited company re-estimated the cost of restoring stores that had been decided to close by the Board of Directors and booked additional asset retirement obligations. The audited company also reversed asset retirement obligations for stores that had already been closed on the grounds that the actual cost of restoring them to their original state fell short of the amount booked as asset retirement obligations.

The engagement team understood the method used by the audited company to estimate asset retirement obligations, and examined that the method had been applied consistently since the previous fiscal year. The engagement team also evaluated the design and operation of internal controls relating to asset retirement obligations, performed a detailed substantive test relating to the recording of asset retirement obligations relating to newly opened stores, and examined the appropriateness of the amount of asset retirement obligations recorded by the audited company.

However, the engagement team **did not evaluate the reason for discrepancy between the estimated amount of asset retirement obligations for the previous year and the actual amount fixed in the current year**, nor **the reason for difference between the estimated amount of asset retirement obligations for the previous year and the re-estimated amount made in the current year**.

Furthermore, the engagement team did not perform substantive procedures for the additional amount of asset retirement obligations booked relating to stores that the audited company had decided to close.

(Auditing Standards Statement No. 540, paragraph 8 and 11) [Mid-tier, and small and medium-sized audit firms]

Case 2: Appropriateness when reasonable estimates cannot be obtained

FREQUENT

The audited company rents properties under restoration obligations, and of these, it booked asset retirement obligations for unprofitable stores for which impairment losses had been booked on the grounds that it is likely that the properties will be vacated when the terms of the leases expire, and that it is therefore possible to reasonably estimate the timing of performing restoration obligations. In the case of profitable stores and the company's head office, on the other hand, it has not booked asset retirement obligations on the grounds that it is difficult to reasonably estimate the timing of performaning restoration obligations because there are no current plans to close stores or relocate the head office. This is despite the fact that stores have been closed and the head office has been relocated in the past.

In response, the engagement team identified the completeness of asset retirement obligations as a significant risk, but it did not perform any procedures to verify in detail past performance of restoration obligations other than having the audited company's explanation that the reasons for closes in the past were that stores had been unprofitable or that the floor areas of the stores were too small. Furthermore, the engagement team **did not obtain sufficient appropriate audit evidence concerning the reasonableness of the audited company's explanation that it was difficult to reasonably estimate the timing of performaning restoration obligations for profitable stores and the head office**.

(Auditing Standards Statement No. 330, paragraph 20; No. 540, paragraphs 11 and 12) [Mid-tier, and small and medium-sized audit firms]

《Points to Note》

Even if the amount of asset retirement obligations is not determined because the timing of performaning restoration obligations or the method of retirement is unclear, asset retirement obligations can be reasonably estimated if information to reasonably estimate the scope and probability of the timing of performance is available. Cases in which asset retirement obligations cannot be reasonably estimated are limited to cases in which the amount cannot be reasonably estimated even after all evidence available as of the balance sheet date is taken into consideration to make the best estimate. Therefore, the engagement team should keep in mind that when an audited company asserts that asset retirement obligations cannot be reasonably estimated, the team is required to carefully examine the reasonableness of such assertion, including the availability of information used for estimating asset retirement obligations.

(10) Others

Case 1: Provisions for loss on order received

FREQUENT

If a loss was forecast after comparing the value of a received order against the projected cost, the audited company would book provisions for loss on order received.

Amid this situation, the engagement team performed a risk assessment procedure focused on cases where the audited company had booked provisions for loss on order received at the end of the previous fiscal year by comparing the actual profit or loss realized during the current fiscal year against the provisions for loss on order received at the end of the previous fiscal year, and examined the difference. In respect of the provisions for loss on order received booked at the end of the current fiscal year, the engagement team observed the documents prepared by the audited company regarding the booking of provisions for loss on order received. Then, for an arbitrarily selected sample, the team vouched the projected cost with the revised cost projection data prepared by the audited company.

However, the following deficiencies were identified in the audit procedures performed by the engagement team:

a) Regarding cases where provisions for loss on order received had not been booked at the end of the previous fiscal year, the engagement team **did not sufficiently examine the completeness of the booking of provisions for loss on order received**, as the team did not examine whether or not there were any cases involving losses during the current fiscal year.

b) Amid a situation in which there were cases of loss during the current fiscal year and even though there were other cases in which losses were expected for items with the same name and for the same customer, the engagement team merely vouched figures with the revised cost projection data prepared by the audited company, however, the team **did not examine the reasonableness of specific assumptions used by the audited company, nor did the team examine the realizability of cost reductions**.

(Auditing Standards Statement No. 540, paragraph 8 and 12) [Mid-tier, and small and medium-sized audit firms]

Case 2: Consideration of estimates of total cost of construction on a percentage-of-completion basis

NEW

FREQUENT

A consolidated subsidiary of the audited company applied the percentage-of-completion method as the basis for revenue recognition pertaining to software development for customers. Sales were calculated by multiplying total contract revenue by the progress rate (the ratio of actual incurred costs as of the balance sheet date to estimated total cost of construction).

As an audit procedure for revenue on a percentage-of-completion basis for this consolidated subsidiary, which is a significant component, the engagement team confirmed that the estimated total cost of construction used for calculating the progress rate matched the estimated total cost of construction estimated in advance in the document for the estimate prepared by the audited company. However, the engagement team **only examined that the estimated total cost of construction was consistent with the amount in the document for the estimate prepared by the audited company and examined the internal approval status, and did not obtain an understanding of the detailed estimation method used by the audited company**.

(Auditing Standards Statement No. 540, paragraph 12) [Mid-tier, and small and medium-sized audit firms]

《Points to Note》

In addition to the above example cases, there were cases in which, although losses were booked in the current fiscal year with regard to construction contracts for which provisions for construction losses had not been booked in the previous fiscal year, the engagement team did not take into account the impact of the booking of those losses on the management's estimates, or in which the engagement team did not consider whether the management's assumption regarding the projection period of loss occurrence reflects reality.

The engagement team should keep in mind that they should obtain sufficient and appropriate audit evidence through the following procedures: appropriately identifying events which are expected to lead to the occurrence of expenses or losses in the future while taking into account the estimation uncertainty related to construction contracts; examining the reasonableness of underlying data related to the management's estimates and the management's assumptions; and reviewing accounting estimates in the previous fiscal year.

5. Group Audit

Points of focus

Recent fraud cases identified at domestic and foreign subsidiaries have increasingly drawn the attention of financial statement users. The CPAAOB inspects audit firms from the following perspectives:

- Whether the group engagement team appropriately assesses risks associated with the group financial statements and develops overall audit strategy and a detailed audit plan;
- Whether the group engagement team identifies significant components appropriately, including consideration of components with significant risks related to the group financial statements based on the nature and circumstance of each component, and does not simply make judgments based on whether the component is individually financially important;
- Whether the group engagement team appropriately understands the component auditors, gets involved in their procedures, and evaluates the appropriateness of such procedures performed;
- Whether the group engagement team appropriately communicates with the component auditors in situations that may influence the work of the component auditors during group audit, such as when a fraudulent material misstatement in relation to the group financial statements is identified; and
- Whether the group engagement team evaluates the component auditors' reports, requests additional audit procedures if necessary, or performs the audit procedures, thereby obtaining sufficient appropriate audit evidence; and whether the engagement team, in response to the component auditors' reporting of an uncorrected misstatement, appropriately assesses the impact of such misstatement over the group financial statements.

Outline of inspection results

In many cases, group engagement teams utilized on the audit results of component auditors putting too much reliance on them without fully evaluating them. There were also cases in which individual financial materiality was determined solely on the basis of the financial indicator of revenue when identifying significant components. There were also cases in which adequate risk assessment was not performed when identifying significant components, such as cases in which qualitative impacts such as the possibility of significant risks relating to group financial statements were not taken into account. There were also cases in which communication with component auditors was inadequate, such as cases in which risks were not appropriately communicated to component auditors. There were also cases in which the identification of significant risks relating to group financial statements and the adequacy of audit procedures to address these risks were not sufficiently considered. There were also cases in which consolidated journal entries were not examined.

(Observed effective efforts)

The following is examples of effective efforts aimed at ensuring and improving group audit quality.

- The quality control department prepares a list of discussion points to advance understanding of the group audit and implementation of the necessary responses. More specifically, the group engagement team can make it clear what should be done in the group audit by being presented available materials that describe in detail issues pertaining to group audits – tasks to be performed throughout the year, how to prepare audit documentation, methods for communicating with component auditors, etc. – and the responses thereto.
- A dedicated section was established within the audit business department to support and oversight engagement teams that conducted group audits on a global basis. Specifically, the dedicated section gathered information through questionnaire surveys of the engagement teams and interviews with the group engagement team with a significant component in emerging countries.
- The PICOQC emphasized through training that it was necessary to consider not only quantitative materiality such as value-based but also qualitative materiality, such as the existence of significant risk, when selecting significant components, in view of cases where an issue occurred in a component other than a significant component, resulting in restatement of the financial statements.
- The audit business department prepared, in cooperation with the advisory department, a checklist that summarized the key points in controlling foreign group companies. The group engagement team uses this checklist to improve its understanding of the audited company's consolidated financial reporting processes and risk management environment for new foreign group companies.

Expected response

The group engagement team is required to evaluate the work of the component auditors it uses, always bearing in mind that responsibility for issuing appropriate auditor’s reports in audit engagements of group financial statements lies with the auditor expressing an opinion.

Group audit requires the group engagement team to sufficiently communicate with the component auditors about the types, timing and scope of audit procedures, as well as findings concerning the audit procedures performed for component financial information, and to obtain sufficient appropriate audit evidence about component financial information and consolidation processes so as to express opinions about whether the group financial statements have been prepared in accordance with the applicable financial reporting framework. Therefore, **the group engagement team needs to develop an appropriate audit plan, perform audit procedures, and evaluate whether sufficient appropriate audit evidence has been obtained to gain a basis for forming an opinion on group financial statements**.

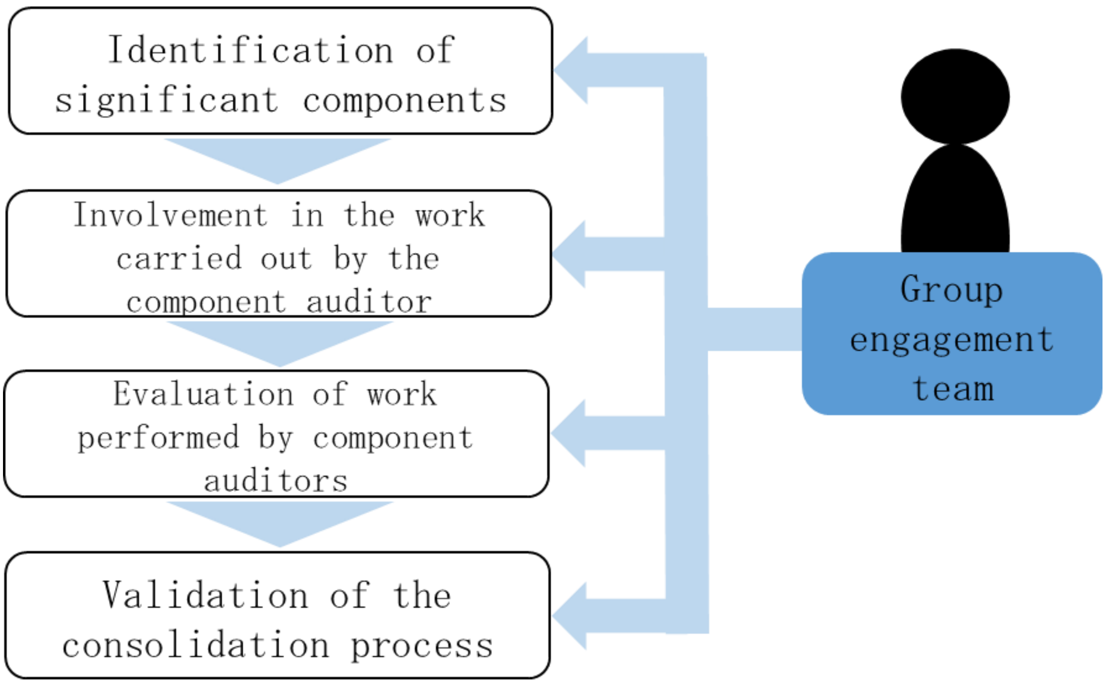
In particular, **when there are significant foreign components, the group engagement team is required to ascertain the circumstances of such key foreign business locations, communicate sufficiently with component auditors, and then appropriately identify the existing risks**.

To perform group audit appropriately, the group engagement team, in addition to the knowledge and experience required for general audit practice, is required to be equipped with additional capability to cope with any situations, such as language skills to instruct the component auditors in overseas countries and knowledge of the financial reporting framework of specific countries.

To achieve the above, audit firms should carefully assign engagement partners and other professionals to ensure and improve the quality of group audit.

In the case where the foreign component auditors are arranged in a multi-layered and complex structure, especially when involving an foreign component auditor outside the group auditor's network, audit firms should develop frameworks to provide instructions and support in relation to the group engagement team's instructions to and supervision of the foreign component auditors, evaluation of reports prepared by the foreign component auditors, and understanding of the audited company's management control over new affiliate companies added through acquisition, etc.

［Figure 6］ Reference image: Outline of responses required by the group engagement team



Regarding the impact of COVID-19 on group audits and response to the impact, refer to "II. Quality Control System: Impact of COVID-19 and International Situations on Audit Engagements and Response."

Case 1: Significant components

FREQUENT

①As a financial indicator used to identify components with individual financial significance, the engagement team used income before income taxes of a business plan that used in calculating materiality for the audit of the group financial statements as a whole. As Company A's income before income taxes as a percentage of the group financial statements was below a certain percentage, the engagement team did not identify Company A as a component with individual financial significance.

At the same time, as a fraud had occurred at Company A during the fiscal year, the engagement team identified fraud risks in overstatement of accounts associated with the fraud. The team also identified Company A as a significant component with significant risks related to group financial statements, and performed substantive procedures.

However, the engagement team **did not obtain sufficient and appropriate audit evidence to form the basis for expressing an opinion on the group financial statements, as the team did not perform any substantive procedures relating to Company A's accounts other than the aforementioned fraud risk-related audit procedures, even though Company A's revenue, cost of sales, and bonds and borrowings accounted for a relatively high share of accounts in the group financial statements**.

(Auditing Standards Statement No. 600, paragraphs 11 and 17) [Mid-tier, and small and medium-sized audit firms]

②The group engagement team did not consider the following, despite the fact that foreign subsidiaries Company B and Company C, neither of which deemed a significant component, recorded operating losses for both the previous fiscal year and the current fiscal year, though both of them hold fixed assets that exceed the materiality for the group audit as a whole.

a) The group engagement team only obtained a response from the component auditor that there was no risk of impairment of fixed assets and, **without obtaining sufficient information about the company and its business environments such as Company B’s future business plan, it determined that the financial statements of the component did not include significant risks**.

b) Although the group engagement team had not sufficiently evaluated cost-cutting elements, the key factors for improving profit/loss, when evaluating Company C's business plan in which operating profits was forecast in the next fiscal year, the group engagement team determined that this component’s financial statements did not include significant risks.

(Auditing Standards Statement No. 600, paragraphs 8 and 17) [Mid-tier, and small and medium-sized audit firms]

《Points to Note》

When determining significant components, it is necessary to take into account financial indicators used for assessing individual financial significance, not only revenue but also other items such as assets, liabilities, cash flows or earnings indicated in group financial statements, depending on the group's characteristics and circumstances. It is also necessary to make judgements in accordance with the specific characteristics and circumstances of components. For example, in addition to individual financial significance, qualitative significance, such as the possibility that components have significant risks related to group financial statements, should also be taken into account.

Case 2: Understanding the Component Auditor

The engagement team sent a letter of inquiry concerning quality control to the auditors of foreign components that had not been identified as significant components and requested a reply, in addition to requesting a report concerning the results of the audits and subsequent events, in order to understand those auditors.

However, the engagement team did not sufficiently perform the procedures to understand component auditors. For example, it did not obtain a reply to the letter of inquiry concerning quality control from multiple component auditors whom it asked to perform audits for the first time in the current fiscal year.

(Auditing Standards Statement No. 600, paragraph 18) [Mid-tier, and small and medium-sized audit firms]

《**Points to Note**》

The group engagement team should keep in mind that, when asking a component auditor to perform work related to the component's financial information, it should understand if there are any issues pertaining to the component auditor's independence, whether the component auditor has the skills of a professional expert, and whether it can involve itself in the work of the component auditor. When consigning the audit of components' financial statements prepared in accordance with the Japanese accounting standards to the auditors of foreign components, it is necessary to evaluate whether those auditors have the knowledge necessary for them when performing audits.

Case 3: Materiality

The group engagement team uniformly applied the upper limit given in the audit manual in determining the component materiality, and decided that the component materiality for all components were to be slightly below the materiality for the audit of group financial statements as a whole.

Although an employee fraud had been uncovered in the previous fiscal year at a subsidiary that was determined as a significant component of the audited company, the group engagement team did not consider whether it was necessary to set a different component materiality to such component in keeping with the circumstances of individual components, including those where fraud had been identified.

(Auditing Standards Statement No. 600, paragraph 20) [Mid-tier, and small and medium-sized audit firms]

《**Points to Note**》

To reduce the possibility that the total uncorrected and undiscovered misstatements in the group financial statements exceed group materiality to a minimum acceptable level, component materiality shall be set lower than the group materiality. The group engagement team needs to sufficiently understand the audited

company group and its business environment in deciding component materiality. If any change occurs in the business environment, the team needs to appropriately consider its effects and consider the adequacy of component materiality to perform appropriate audit procedures to response audit risks for each component. In addition to the above example cases, there were cases in which the group engagement team did not evaluate the appropriateness of the performance materiality, as exemplified by a failure to request component auditors to report on the performance materiality that they had determined.

Case 4: Deciding audit procedures to be performed for the financial information of components

Regarding procedures for responding to the significant risk regarding foreign subsidiaries of the audited company, the group engagement team made a request to the component auditors in the audit instructions, and received reports from them.

However, the group engagement team instructed the component auditors to perform agreed-upon procedures rather than audit procedures and failed to examine whether the agreed-upon procedures were sufficient as audit procedures to address the significant risks. As a result, it did not obtain sufficient and appropriate audit evidence with regard to the significant risks.

(Auditing Standards Statement No. 600, paragraphs 17, 25, and 26) [Mid-tier, and small and medium-sized audit firms]

《Points to Note》

The group engagement team should consider whether audit procedures to be performed have been planned appropriately for both significant components and other components, respectively.

Case 5: Involvement in audit procedures undertaken by component auditors

NEW

FREQUENT

①With regard to a foreign subsidiary that was a significant component, the engagement team identified a risk of "understatement of execution budget" used for the estimate calculation of the percentage-of-completion method of accounting as a significant risk related to group financial statements.

However, the engagement team **did not discuss with the component auditor the risk of "understatement of execution budget" used for the estimate calculation of the percentage-of-completion method of accounting, which the engagement team identified as a significant risk in group financial statements**.

(Auditing Standards Statement No. 600, paragraphs 29) [Mid-tier, and small and medium-sized audit firms]

FREQUENT

②Through discussions with the auditors of significant components, the group engagement team confirmed that the component auditors had identified the risk of management override and fraud risks in revenue recognition.

However, the group engagement team did not perform the following procedures, even though the team identified these risks as significant risks in the group financial statements.

a) **With regard to the fraud risks in revenue recognition, the engagement team merely gained an understanding of the relevant assertions and was not sufficiently involved in risk assessment by the component auditors; for example, the team did not obtain the details of the risks in the concrete**.

b) **With regard to the risk of management override, the group engagement team did not fully evaluate the appropriateness of audit procedures to address the risk; for example, the team did not ascertain the selection criteria for journal entry tests performed by the component auditors as audit procedures to address the risk**.

(Auditing Standards Statement No. 600, paragraph 29 and 30) [Large-sized audit firms]

《Points to Note》

With regard to significant risks in group financial statements, there was a case where the group engagement team did not get involved in the component auditor's risk assessments and did not assess the appropriateness of audit procedures to address the significant risks.

To address significant risks in group financial statements, the group engagement team needs to engage in appropriate communication with component auditors and assess the sufficiency and appropriateness of audit procedures planned by the component auditors.

Case 6: Consolidation process

①With regard to components' financial information included in the consolidation reporting package prepared by significant components, the engagement team had the policy of relying on the results of audits performed by component auditors for the examination of specified account balances concerning significant risks related to the group financial statements, while examining other financial information on its own.

However, with regard to the following financial information which was quantitatively material and for which the engagement team had decided to examine on its own, it merely ascertained the absence of unusual changes through trend analysis and other means, and failed to perform substantive procedures.

- The period-end balance of inventory purchased by the components from the consolidated group companies, which form the basis of journal entries concerning the elimination of unrealized profits/losses on inventory.
- The detailed data on changes in the balance of the components' tangible fixed assets, which form the basis of "expenditure due to the purchase of tangible fixed assets" subject to disclosure in the consolidated cash flow statement.

(Auditing Standards Statement No. 600, paragraphs 23 and 32) [Mid-tier, and small and medium-sized audit firms]

②The audited company prepared its consolidated financial statements in accordance with IFRS (International Financial Reporting Standards). Furthermore, the audited company's foreign components followed local accounting standards when preparing their own financial statements. The audited company consolidated the foreign components' certain accounts into its consolidated financial statement without adjusting accounting treatments to conform to IFRS. The component auditors reported to the group engagement team that different accounting treatments were required under the local accounting standards and IFRS with regard to certain accounts.

However, the group engagement team did not sufficiently consider whether it was necessary to adjust accounting treatments based on the accounting standards adopted by the components to conform to IFRS, which was adopted for the consolidated financial statements.

(Auditing Standards Statement No. 600, paragraph 34) [Large-sized audit firms]

③The audited company adjusted the financial statements of a consolidated subsidiary due to material discrepancies in accounting records relating to inter-company transactions between consolidated companies resulting from the difference between the closing date for the consolidated subsidiary and the consolidated closing date.

Amid this situation, the group engagement team confirmed that the audited company had adjusted the financial statements using the same debit and credit accounts as those used in the previous year. Although the engagement team identified the risk of material misstatement in the adjustments and recognized that the adjusted amount represented a significant increase from the previous fiscal year, it did not sufficiently examine the basis of the reason for the adjustments and the adjusted amount.

(Auditing Standards Statement No. 600, paragraphs 16 and 36) [Large-sized audit firms]

NEW

FREQUENT

④When a consolidated subsidiary, Company A carried out an initial public offering of shares at the time of listing, Company A received capital injection from the non-controlling shareholder of Company A. As a result, the audited company's equity ratio in Company A decreased. The audited company accounted for the decrease in the equity ratio as an increase in non-controlling interests for the entire payment amount in the consolidated financial statements.

However, the group engagement team overlooked the erroneous accounting treatment made by the audited company for a decrease in the parent company's interest due to a capital increase at market value by the consolidated subsidiary, and **did not appropriately verify the accounting treatment made by the audited company**.

(Auditing Standards Statement No. 600, paragraph 32 and 33) [Mid-tier, and small and medium-sized audit firms]

《Points to Note》

There were cases in which: when examining consolidated journal entries, the group engagement team

merely made comparisons with the previous period's balances and observed documents prepared by the audited company, and did not perform substantive procedures; or, due to a lack of a sufficient understanding of the audited company and its business environment at the group level to serve as the basis for risk assessment of group financial statements, the engagement team did not examine whether unrealized profits were fully eliminated even though complex inter-company transactions had occurred.
There were also cases in which the group engagement team did not examine whether financial information for components reported by component auditors had been reflected in group financial statements.
The group engagement team shall understand the group, its components and their environment, as well as the consolidation process, including group-wide controls. The group engagement team shall plan and implement the types, timing and scope of audit procedures to address the risks of material misstatement in the group financial statements arising from the consolidation process, and shall evaluate the appropriateness and completeness of adjustments and reclassifications for consolidation.

Case 7: Subsequent events

The engagement team requested the component auditors of multiple foreign components to prepare and submit reports on subsequent events.
However, as of the date of the auditor's report under the Companies Act, the engagement team did not receive a report on subsequent events from any of those component auditors, and as a result, it did not perform planned procedures.
(Auditing Standards Statement No. 600, paragraph 37) [Mid-tier, and small and medium-sized audit firms]

《Points to Note》

Group engagement team or component auditors need to perform procedures designed in order to identify events which may occur between the period end of the components' financial information and the date of the auditor's report on the group financial statements and which may require a revision of the group financial statements or may become subject to disclosure in the group financial statements.

Case 8: Communication with component auditors

①The audit engagement team sent the component auditors of significant components written instructions regarding the audit of financial information for their components and obtained responses from the component auditors, but did not communicate adequately with the component auditors in regard to the following points.

・The audit engagement team did not communicate with the component auditors regarding the threshold for accumulating identified misstatements, below which was clearly trivial in respect of the group financial statements.

・Although the group engagement team had identified a significant risks in the group financial statements of the components (fraud risks related to revenue recognition and risk of management override), the team did not communicate with the component auditors these risks.

・The group engagement team did not comprehensively communicate the list of related parties with the component auditors, as the team informed them of the audited company's subsidiaries and affiliates as related parties, but did not inform of its major shareholders and executives as related parties.

・The group engagement team did not request the component auditors to report any indications of bias among the components' management, material weaknesses in internal controls over financial reporting identified in the components, and any other important matters that the component auditors had reported or planned to report to those charged with governance of the components.

(Auditing Standards Statement No. 600, paragraph 39 and 40) [Mid-tier, and small and medium-sized audit firms]

②The group engagement team understood that the audited company and an foreign subsidiary that was a significant component both recognized revenues based on customer’s acceptance inspection basis because installation work was involved when selling products, and it identified a risk of fraud in product sales of pretending to have conducted customer’s acceptance inspection and then recognizing revenue.

However, the group engagement team communicated with the component auditors only that there was a significant risk of material misstatement due to fraud in revenue recognition, but did not specifically communicate the risk of fraud identified with respect to the customer’s acceptance inspection basis.

(Auditing Standards Statement No. 600, paragraph 39)[Mid-tier, and small and medium-sized audit firms]

《Points to Note》

Group engagement teams must communicate with component auditors significant risks relating to group financial statements that would affect the work of the component auditors. Furthermore, group engagement teams must request component auditors to inform them in a timely manner whether significant risks relating to group financial statements other than those communicated by the group engagement team exist and of the response to these risks.

However, as shown above, there were cases in which the group engagement team did not appropriately communicate with component auditors such risks. There were also cases in which: the team did not communicate with the component auditors component materiality; or, even though component auditors reported significant risks to the group engagement team, the team did not sufficiently examine those risks constituted significant risks in respect of the group financial statements; or the timing of obtaining information, including audit plans, from component auditors was too late; or the group engagement team

merely presented a list of affiliated companies to component auditors and did not present a list of related parties identified by the audited company that included executives. Group engagement teams need to engage in effective two-way communication with component auditors.

Case 9: Sufficiency and appropriateness of audit evidence obtained

FREQUENT

①In an interview held with the component auditors of a significant component while conducting an on-site visit, the group engagement team was reported that they had not identified any abnormalities in journal entry testing. In addition, the group engagement team received a response to its audit instructions stating that there were no matters to report regarding journal entry testing.

However, the group engagement team **did not understand the specific risk scenarios by which the component auditor had concluded that there were no matters to report regarding journal entry testing and the results of procedures, and hence the group engagement team did not evaluate the sufficiency and appropriateness of the procedures performed by the component auditor**.

In addition, the group engagement team received a response to its audit instructions from the component auditor of the significant component stating that the bank confirmation form had not been returned, but it did not obtain sufficient appropriate audit evidence on the audit procedures the component auditor had subsequently performed and on the conclusion of the procedures.

(Auditing Standards Statement No. 600, paragraphs 41 and 43) [Large-sized audit firms]

②The group engagement team instructed the component auditors of significant components to implement audits and used the audit results. However, although the group engagement team **received from the component auditors the reports on the presence of deficiencies of internal control that had been identified as a result of the evaluation of internal control audits, it did not evaluate those deficiencies. It also failed to consider whether or not additional procedures were necessary**.

(Auditing Standards Statement No. 600, paragraph 41) [Mid-tier, and small and medium-sized audit firms]

③Regarding the financial information for two significant components, the group engagement team sought a quality review for the purpose of expressing an opinion regarding the audited company's group financial statements before completing its review of audit working paper relating to the accounts with risks of material misstatement, including significant risks in respect of the group financial statements. Thus, the group engagement team did not obtain sufficient and appropriate audit evidence before expressing an audit opinion on the audited company's group financial statements.

(Auditing Standards Statement No. 600, paragraph 43) [Mid-tier, and small and medium-sized audit firms]

《Points to Note》

Group engagement teams should evaluate whether or not sufficient and appropriate audit evidence has been obtained through the audit procedures performed with regard to the consolidation processes and the work done by themselves and component auditors with regard to financial information concerning the components in order to form the basis for expressing opinions regarding group financial statements.

However, as shown in the above, there were cases in which: the group engagement team did not receive reports on the results of the audit procedures performed by component auditors in a timely manner; the group engagement team merely obtained information on the results of audit procedures from component auditors and failed to appropriately evaluate the sufficiency and appropriateness of the audit evidence obtained with regard to significant risks; or although deficiencies regarding components' internal control were identified, the group engagement team did not evaluate them. Notably, even if the component auditor is in the same network as the group engagement team, the group engagement team still needs to evaluate the reports received from the component auditor.

6. Using the work of Auditor's experts

Points of focus

The auditor may make use of experts to obtain sufficient appropriate audit evidence if the auditor needs expertise in areas other than accounting or auditing. The CPAAOB inspects whether the experts used by the engagement team are equipped with the necessary qualifications, competency and objectivity in light of the purposes of auditing financial statements and whether the auditor evaluates the appropriateness of the experts' work.

Outline of inspection results

In using the work of others such as auditor's experts, there were cases in which the engagement team had overly trusted the result of the work of others and relied on it without sufficient evaluation.

There were cases where the engagement team did not sufficiently communicate with the experts on the scope and purpose of work to be used, or did not sufficiently assess the appropriateness of the work of experts used by the auditor.

Expected response

Engagement teams should always keep in mind that they are responsible for issuing appropriate auditor's report on the financial statements they audit, and they should therefore evaluate the adequacy of the experts' work they intend to use.

When using experts' work, the auditor should determine the necessity of use, assess the qualifications of the experts, competency and objectivity of them, and evaluate the appropriateness of the experts' work for its audit purposes. In using the experts' work, **the engagement team needs to sufficiently consult with the experts on the purpose and scope of work to be used, without leaving everything to the experts, in order to obtain sufficient appropriate audit evidence conforming to the audit purpose**.

Case 1: Competence, capabilities and objectivity of auditor's expert

FREQUENT

The engagement team used the auditor's expert to evaluate retirement benefit obligations and service cost calculated by the audited company, but it **did not sufficiently understand the external expert's area of expertise and evaluate the external expert's competence, capabilities and objectivity**.

(Auditing Standards Statement No. 620, paragraphs 8 and 9) [Mid-tier, and small and medium-sized audit firms]

Case 2: Agreement with auditor's experts

With regard to some real estate inventories for sale that had been valued by the audited company based on real estate appraisal, the engagement team requested a review of the real-estate appraisal report from an internal expert.

However, the engagement team did not give appropriate instructions to the selected expert by clarifying the specific tasks requested, including the nature, scope and objectives, and thus the engagement team and the expert were not in agreement with each other regarding their roles and responsibilities.

(Auditing Standards Statements No. 620, paragraph 10) [Large-sized audit firms]

《Points to Note》

When using the work of auditor's experts in areas of expertise other than accounting and auditing, engagement teams should not leave matters entirely to them but should discuss with them to determine the scope of work for which their services are used, evaluate their competence, capabilities and objectivity and assess whether their work is appropriate in light of auditing purposes.

In addition to the above cases, there were also cases in which, although the evaluation method adopted by an expert was different from the one designated by the engagement team, the team did not examine the appropriateness of the work done by the expert.

For the requirements applicable when engagement teams undertake consultation on difficult or contentious matters of accounting or auditing, the engagement teams shall refer to paragraph 17 of Auditing Standards Statement No. 220 ("Quality Control for an Audit of Financial Statements"). For points to note in the case where audit evidence is based on the work of experts used by the audited company's management, refer to the section "3. Audit Evidence".

7. Audit of Internal Control over Financial Reporting

Points of focus

CPAAOB performs inspections of audit of internal control over financial reporting from the following perspectives:

- Whether the engagement team develops an audit plan in consideration of materiality, with an understanding—based on the audited company's business environment and business characteristics—of the design and operation of internal control and assessment thereof by the management;
- Whether the engagement team evaluates the way the management decides the scope of assessment as well as its reasonableness; and particularly in the case that the management prepares an internal control report that excluded some part of the processes that could not be assessed, the engagement team should examine the reasonableness of the management's exclusion of the scope and the effects of the exclusion on the financial statement audit;
- Whether the engagement team appropriately assesses the deficiencies identified by the management; especially in evaluating the degree of control deficiencies, does the team examine the potential impact of the deficiencies and the possibility of the occurrence of a material misstatement by taking into consideration the quantitative and qualitative effect on the overall internal controls over financial reporting of the audited company;
- Whether, in the course of an internal control over financial reporting audit, the engagement team reports the deficiencies detected by the auditors to the appropriate person in a timely manner and examines the possibility of the deficiencies being a material weakness;
- Whether, if the engagement team has discovered a material weakness, the team reports this to the management and demands that the management remediates it, and examines progress made in remediating the deficiencies in a timely manner; and
- Whether the engagement team examines the impact on internal control over financial reporting audit by the misstatements found during the course of the financial statements audit.

Outline of inspection results

In some cases, the engagement team, without enough professional skepticism, relied on the results of the audited companies' internal control assessment, without evaluating the adequacy of the scope of internal control assessment, the internal auditors' capability and objectivity, the appropriateness of samples, assessment method and so on.

Some engagement teams only responded in form to changes of the business environment of the audited company such as those of significant business locations or units because of acquisition and commencement of new business or other. Other engagement teams did not examine the appropriateness of management using the previous year's results of the evaluation for IT general controls. Other engagement teams did not examine whether the identified deficiencies could constitute material weakness. The other engagement teams did not obtain enough audit evidence to evaluate the remedial actions against the relevant material weakness.

Expected response

An auditor shall form and express its opinion based on the audit evidence obtained, on whether internal control report prepared by management present fairly, in all material respects, the evaluation results of the effectiveness of internal controls in accordance with generally accepted standards for the assessment of internal controls.

To that end, in consideration of materiality, auditors **should adequately understand management's design and operation status of internal controls as well as assessment results and should carry out financial statement audit and internal control audit in an integrated manner from the perspective of effective and efficient audits**.

Meanwhile, the purpose of the internal control reporting system under the Financial Instruments and Exchange Act is to ensure disclosure reliability through managements' assessment of their internal controls over financial reporting and by audits of their assessment. Therefore, auditors **should provide insights into design of internal controls based on the audited company's background, including its size and business structure to the audited company**.

To meet the expectations mentioned above, auditors need to examine the scope, timing and appropriateness of audit procedures to evaluate the adequacy of the scope of internal control assessment, the approach of internal control assessment, and the assessment of the significance of internal control deficiencies. They should not perform procedures uniformly and routinely without sufficient consideration.

Careful assessment should be performed concerning whether sufficient appropriate audit evidence was obtained particularly on the audited company's business locations/units deemed to have relatively high risks, such as processes newly added to be assessed.

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

Case 1: Selection of significant accounts of significant relevance to operational objectives

FREQUENT

The audited company (a labor-intensive consulting firm) considered sales, accounts receivable, and inventories as significant accounts for the audited company's business objectives and included them in the scope of internal control assessment.

However, the engagement team **did not assess whether payroll, which was larger in amount than inventories according to the characteristics of the audited company's business, should be included in the scope of internal control assessment**.

(Auditing Standards for Internal Controls over Financial Reporting Statement No. 1, paragraphs 98 and 100) [Mid-tier, and small and medium-sized audit firms]

《**Points to Note**》

"Significant accounts for operational objective (three accounts: sales, accounts receivable and inventories)" are just examples, described in the Practice Standards for Management Assessment and Audit concerning Internal Control over Financial Reporting. It is necessary to note that significant accounts should be appropriately selected in consideration of the audited company's type of industry, business environment and business characteristics. In the event of changes in the audited company's business activities and profit structure, in particular, significant accounts need to be carefully selected.

In addition to the above example case, net sales are often used as an indicator for selecting significant business locations or units. However, it must be noted that using a different or additional indicator may be more appropriate depending on the environment or nature of the business of the audited company.

Case 2: Identifying significant business processes

FREQUENT

①The engagement team had identified significant risks regarding revenue recognition for the audited company's overseas subsidiaries, but **did not consider whether there was a reasonable reason for the audited company not to include the subsidiaries' sales process in the scope of internal control assessment**.

(Auditing Standards for Internal Controls over Financial Reporting Statement No. 1, paragraph 112) [Mid-tier, and small and medium-sized audit firms]

②The audited company used an ERP system composed of sales management, procurement and inventory management, production management, project management, financial accounting, management accounting, and personnel management modules.

Amid this situation, the engagement team evaluated the design of IT general controls relating to the system, but did not evaluate the operation IT general controls relating to it. Moreover, in evaluating business processes, the team evaluated only the operation of manual internal controls and did not evaluate the operation of IT application controls.

However, although the system was a key system widely related to business processes and financial reporting, the engagement team did not evaluate the appropriateness of not to test the operation of system's IT general controls and its IT application controls.

(Auditing Standards Statement No. 315, paragraphs 17 and 20; Auditing Standards for Internal Controls over Financial Reporting Statement No. 1, paragraph 144) [Mid-tier, and small and medium-sized audit firms]

《**Points to Note**》

Business processes, related to the accounts with significant risks, should be usually selected for internal control assessment by the management because of their characteristics. If such business processes are not selected, the engagement team should note that it is required to discuss again with the management regarding the management's method of deciding the scope of assessment as well as the basis of the decision,

and carefully evaluate the reasonableness of exclusion of these processes from the scope of assessment.

If the engagement team considers that the business processes selected by the management for assessment are not appropriate, the engagement team needs to request the management to take additional actions, including reconsidering the business processes to be assessed, depending on the degree of impact on financial reporting.

If some processes are included in business processes through which accounts that are substantially related to the company's business objectives for significant business locations or units are generated, but are excluded from management assessment because of their limited relevance to material businesses or operations and small impact on financial reporting, the engagement team should carefully evaluate the reason for their exclusion from assessment, etc.

(2) Approach of Assessment of Internal Control

Case 1: Sampling

①In assessing the operation of internal controls over revenue recognition, the engagement team used the audited company's tests of controls, but did not examine the appropriateness of the selection method and sample size the audited company had extracted.

(Auditing Standards Statement No. 500, paragraph 9; Auditing Standards for Internal Controls over Financial Reporting Statement No. 1, paragraphs 153 and 154) [Mid-tier, and small and medium-sized audit firms]

②In assessing the operation of internal controls associated with business processes of significant business locations or units, the audited company selected samples only from certain months from the entire population that covered 12 months.

However, the engagement team did not evaluate whether the management's sample selection method has provided a reasonable basis for conclusion about the entire 12-month population.

(Auditing Standards for Internal Controls over Financial Reporting Statement No. 1, paragraphs 153 and 158) [Mid-tier, and small and medium-sized audit firms]

Case 2: Assessment of design and operation of internal controls

①The engagement team identified fraud risks of manipulating cut-off of revenue recognition in respect of sales relating to the condominium management business of the audited company's consolidated subsidiary.

However, although the engagement team performed procedures to evaluate the operation of internal controls in respect of business processes relating to sales associated with the condominium management business by vouching the table of approval stamps for selected samples, the team **did not appropriately evaluate the operation of internal controls, as this data contained no date information and the engagement team only vouched the amounts, without checking the appropriateness of the timing of revenue recognition**.

(Auditing Standards Statement No. 330, paragraphs 7, 9 and A22) [Mid-tier, and small and medium-sized audit firms]

NEW

②In its assessment of internal controls over financial reporting, the audited company selected an overseas subsidiary as a significant business location, and identified the internal controls of its sales, purchase, and inventory management business processes as in-scope processes subject to management assessment.
However, the engagement team **did only evaluated the effectiveness of internal controls of sales process but not evaluate the effectiveness of internal controls of purchase and inventory management processes**.
(Auditing Standards for Internal Controls over Financial Reporting Statement No. 1, paragraphs 66) [Mid-tier, and small and medium-sized audit firms]

③As part of its sales management process, the audited company performed master registration and processed orders received, shipments, cash collection and clearing corresponding receivables, etc. Through its ERP system, which was interfaced with the accounting system once a month to allow the accounting of sales, accounts receivable, etc. to be posted
However, the engagement team did not consider whether automated application controls of the interface linking the EPR system with the accounting system needed to be included in the scope of internal control audit.
(Audit Standards Committee Statement No. 315, paragraph 17; IT Committee Practical Guideline No. 6, paragraph 31; Practice Standards for Management Assessment and Audit concerning Internal Control over Financial Reporting III. 3 (4)) [Mid-tier, and small and medium-sized audit firms]

《Points to Note》

In addition to the above examples, there are cases in which only the results of control activities, such as whether seals were affixed, were included in the audit working paper, cases in which an alternative sample was not selected when a sample that was inappropriate for audit procedures was recognized, cases in which the evaluation of IT general controls (program changes, responses to system failures, access controls, etc.) was inadequate, and cases in which only the IT application controls of the old system were evaluated and the IT application controls of the new system were not evaluated when a system change was made. The engagement team also needs to fully understand the purpose of Auditing Standards Statement No. 530 ("Audit Sampling") and select appropriate samples for sampling in the procedures for evaluating the operation of internal controls. In addition, the engagement team needs to evaluate internal controls that appropriately address the identified risks of material misstatement when evaluating the design and operation of internal controls. Furthermore, the engagement team needs to plan and implement appropriate responses to IT-related risks based on a full understanding of IT Committee Practical Guidance No. 6 (or Auditing Standards Statement No. 315 ("Practical Guidance No. 1" under the 2021

Auditing Standards Statement No. 315)) when evaluating IT-related internal controls. When evaluating internal controls, the engagement team also needs to pay attention to changes in the business activities and profit structure of the audited company, without being influenced by past audit experience.

For points to be noted when conducting a dual-purpose test, see "3. Audit Evidence (1) Matters common to audit evidence".

On top of that, although the financial closing and reporting process is one of the business processes that are extremely important in terms of the reliability of financial reporting, it should be noted that audit procedures must be performed with sufficient care in order to examine the design and operation of internal controls associated with of the process because the frequency of performance of the controls is relatively low compared to those for other business processes related to daily transactions.

Case 3: Timing of assessment procedures

①The engagement team did not obtain sufficient and appropriate audit evidence to express an audit opinion regarding the audit based on the Companies Act, as the team performed audit procedures regarding the audited company's IT application controls relating to individually evaluated financial closing and reporting processes such as various allowances, taxes and tax effects, and business processes such as automatic journal entries after the date of the auditor's report under the Companies Act, but before the date of the auditor's report under the Financial Instruments and Exchange Act.
(Auditing Standards Statement No. 330, paragraph25) [Mid-tier, and small and medium-sized audit firms]

②The engagement team evaluated process-level controls by obtaining management assessment result verified using the transactions in the first quarter as samples. In assessing the result, the engagement team made inquiries and observed relevant documents of management samples, and subsequently obtained the documents from the audited company confirming whether or not any material changes to internal controls were made after the year-end closing date. Considering the above, the engagement team assessed the status of design and operation of process-level controls as effective. However, the engagement team did not consider what additional procedures should be performed for the rest of the fiscal year in order to assess whether the assessment results of internal controls verified using the transactions in the first quarter as samples remained effective as of the year-end closing date.
(Auditing Standards Statement No. 330, paragraph 11; Auditing Standards for Internal Controls over Financial Reporting Statement No. 1, paragraph 160) [Mid-tier, and small and medium-sized audit firms]

《Points to Note》

If the engagement team plans to rely on related internal controls that it assumes to be effective in deciding

the nature, timing and extent of substantive procedures in the financial statement audit, it should preferably perform procedures for assessing operation of internal controls prior to performing key substantive procedures. The same can be said for the assessment of the effectiveness of the company-level controls and IT general controls that support the process-level controls as well as the subject controls including IT application controls.

Furthermore, there was a case where the engagement team performed tests of controls during the interim period, and with regard to the period after that, performed roll-forward procedures subsequent to the date of the financial statements. However, the roll-forward procedures were not completed by the date of the auditor's report under the Companies Act. See Auditing Standards Statement No. 330, paragraph A32 for the relevant factors in obtaining additional audit evidence for performing roll-forward procedures.

Case 4: Management's use of assessment results of prior years

In management's assessment of IT general controls over sales systems used at significant business locations or units, the audited company used the results of prior years' assessment for certain internal controls.

However, the engagement team did not examine whether it was appropriate for the management to use the results of prior years' assessment, according to the Practice Standards for Management Assessment and Audit concerning Internal Control over Financial Reporting.

(Practice Standards for Management Assessment and Audit concerning Internal Control over Financial Reporting II. 3 (3) (v) D (Note)) [Mid-tier, and small and medium-sized audit firms]

《Points to Note》

When the management continuously uses the results of previous year's assessment of operating effectiveness in assessing IT general control items, the engagement team should note that it is necessary to examine whether the items have particularly material impact on the reliability of financial reporting, whether there had been any material changes in effectiveness of the design from the previous year, whether the results of previous year's assessment of operation were effective, and whether operating effectiveness has been assessed once every several accounting periods

(3) Assessment of Deficiencies

Case 1: Assessment of deficiencies in design and operation of internal control

With regard to the audited company's IT system for receiving and placing orders and its cost accounting system, the engagement team discovered that management functions such as the setting of IDs and passwords for each user were absent, and deemed this to be a deficiency in IT general controls.

However, the team did not consider the impact of this deficiency in IT general controls on IT application controls and the audit of financial statements.

(Auditing Standards Statement No. 315, paragraph 30; IT Committee Practical Guideline No. 6, paragraph 53) [Mid-tier, and small and medium-sized audit firms]

Case 2: Determination of material weaknesses

The engagement team identified numerous deficiencies from the process-level controls over financial closing and reporting process during the substantive testing of the financial statement audit, and also identified multiple disclosure errors in the securities report for the previous fiscal year caused by internal control deficiencies. Although these deficiencies had not been remediated as of the year-end closing date because the engagement team had identified these deficiencies after that day, the engagement team concluded by holding meetings with the internal audit department of the audited company that these did not constitute material weakness.

However, the engagement team did not examine specifically how management had assessed the deficiencies, and it did not consider from the viewpoint of quantitative and qualitative significance whether these deficiencies constituted material weakness individually or in aggregate.

(Auditing Standards Statement No. 330, paragraph 16; Auditing Standards for Internal Controls over Financial Reporting Statement No. 1, paragraphs 187 and 205) [Mid-tier, and small and medium-sized audit firms]

Case 3: Assessment of internal control over misstatement

FREQUENT

Regarding misstatements related to inventories discovered in the course of financial statements audit of a component, the group engagement team considered reasonable the component auditor's assessment that those were not significant deficiencies because: the misstatements had been corrected; the misstatements were not deemed as significant although these were caused by the deficiencies in internal controls; and the component's management had immediately taken remedial actions of deficiencies.

However, the evaluation procedures for deficiencies carried out by the group engagement team included the following deficiencies.

- **The internal controls that had deficiencies were not specified**.
- **The account items affected by the deficiencies and the likelihood of occurrence of the deficiencies were not examined to determine whether the deficiencies were deemed as a material weakness**.
- **The details of the remedial actions taken by the component's management were not understood**.
- **It was not confirmed how these deficiencies had been assessed in the management assessment**.

(Auditing Standards Statement No. 265, paragraphs 6 and 7; Auditing Standards for Internal Controls over Financial Reporting Statement No. 1, paragraph 44) [Mid-tier, and small and medium-sized audit firms]

《**Points to Note**》

Deficiencies in an internal control can be classified into deficiencies in design and deficiencies in operating effectiveness. Deficiencies in design include the absence of internal control and failure of the existing internal control to fulfill the objectives of the internal control, while deficiencies in operating effectiveness consist of failure to perform the internal control as designed, the existence of many errors in performing internal control and a poor understanding of the nature and objectives of the internal control by the person who performs the internal control.

When finding a deficiency in internal control, the engagement team is required to: confirm which classification it falls under; take into account its quantitative and qualitative materiality and existence of compensating controls; calculate the potential quantitative impact of the deficiency discovered; and examine which accounts will be affected by such deficiency and to what extent, and the likelihood of occurrence of material misstatement. The team needs to pay attention to the fact that it is required to carefully judge if the deficiency discovered falls under material weaknesses.

Further, it should be noted that, if the misstatement identified by the auditor was due to ineffective internal controls, it may imply the possibility of other misstatements.

(4) Use of the work of internal auditors

Case: Extent of using the work of internal auditors

①The engagement team partially relied upon audit results from internal auditors concerning the audited company's IT general controls for its accounting system and construction system, which were ERP system (controls relating to program and data access controls, program change, program development, and computer operation).

However, **when deciding whether the work performed by the internal auditors was appropriate in light of the objectives of the financial statements audit, the team did not consider objectivity. Furthermore**, the team **did not conduct investigations to determine whether specific tasks performed by the internal auditors were appropriate in light of the audit objectives**.

(Auditing Standards Statement No. 610, paragraphs 11 and 19) [Large-sized audit firms]

NEW

②Based on the premise that the work of the audited company's internal auditor would be used in tests of the operation of internal controls, the engagement team re-performed all tests of the operation performed by the internal auditor.

However, the engagement team **did not perform procedures to understand the cause and potential impact of the multiple deviations from internal controls discovered by the internal auditors**.

(Auditing Standards Statement No. 330, paragraph 16, No. 610, paragraph 13 and 19) [Mid-tier, and small and medium-sized audit firms]

《Points to Note》

In many cases, engagement teams use the work performed by the audited company's internal auditors from the perspectives of effectiveness and efficiency of audit. However, on such occasions, it is necessary to examine if the objectivity and capability of the internal auditors are maintained and if the quality of assessment by the internal auditors is high enough to be used as audit evidence.

When using the work of internal auditors, etc., the engagement team must remember to examine: the degree of risk addressed by the internal controls intended to be used; the nature and significance of the internal controls; the operation status of the internal controls; the degree of judgment necessary to evaluate the operation; and the quality of the work of the internal auditors, etc.

8. Key Audit Matters (KAM)

Points of focus

KAM are required to be included in auditor's reports for listed companies, starting with financial statements audits for the fiscal year ended March 31, 2021. The CPAAOB inspects audit procedures relating to the contents of such matters as the process of deciding on the KAM and the audit response from the following perspectives:

- ▶ Whether, in its audit of financial statements for the current fiscal year, the engagement team chooses matters that the team, as professional experts, deems particularly important as KAM, following an appropriate process that includes communication with those charged with governance, etc.
- ▶ Whether, if there are notes relating to KAM in the financial statements, the engagement team appropriately specifies reference to those notes, and appropriately describes the contents of each KAM and the reasons for deciding on it.
- ▶ Whether the engagement team appropriately describes in the auditor's report the audit procedures it carried out as an audit response to the KAM.
- ▶ Whether the engagement team appropriately communicates with those charged with governance, etc. regarding the matters the team has chosen as KAM.

Outline of inspection results

The examples identified included cases in which the engagement team referred inappropriately to notes relating to KAM in the financial statements; or cases in which, of the audit responses described in the KAM, the team failed to perform some substantive procedures or procedures to assess the design and operation of internal controls; or cases in which, where the same matters—e.g. impairment of fixed assets—had been decide as KAM for all the audited company's multiple subsidiaries, the team did not verify whether all component auditors had performed the audit responses described in the KAM.

(Observed effective efforts)

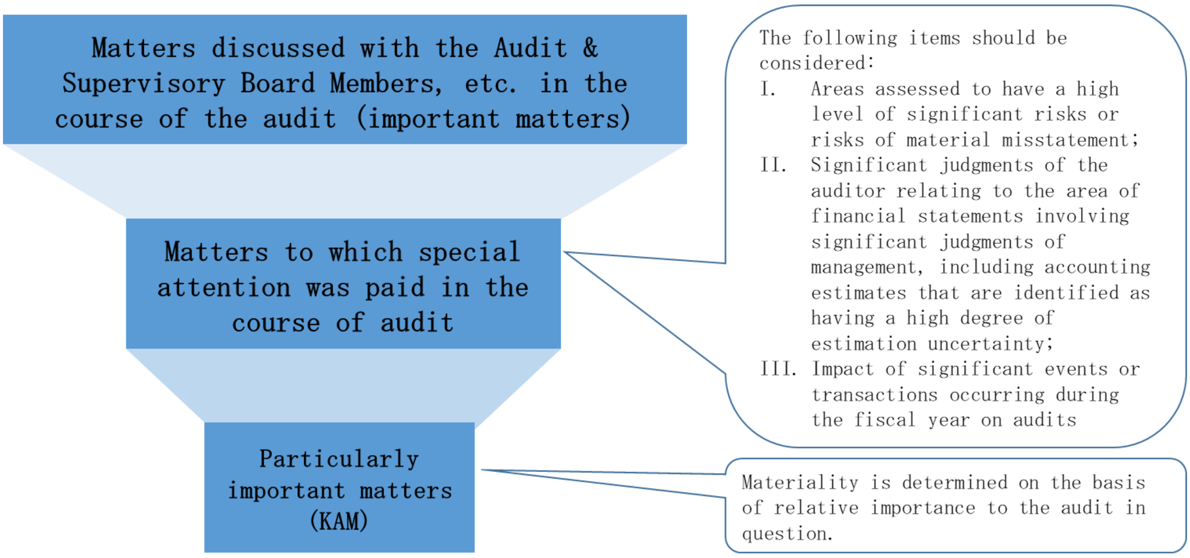
The following cases can be presented as an effective effort observed to improve the appropriateness of the content of KAM descriptions.

- ・ The audit firm established a dedicated KAM team within the quality control department, which provided engagement teams with comprehensive support such as preparing templates for consideration of KAM, developing and circulating examples of KAM description and manuals showing how to complete the templates, and providing KAM-related training.
- ・ The audit firm put in place a KAM review system, under which reviews are carried out by a reviewer other than the EQC reviewer and made individual reviews by EQC reviewers mandatory.
- ・ Regarding key discussion points, the audit firm introduced mandatory requirements to consult experts and to undergo a senior review.

Expected response

The purpose of KAM reports is to increase the value of auditor's report as a medium of information by increasing the transparency of the audits conducted. In addition, KAM reports can increase the transparency of audits by providing the envisaged users of financial statements with additional information that is useful in understanding the matters deemed by auditors, as professional experts, to be particularly important in their audit of the current fiscal year's financial statements. Therefore, auditors are required to take appropriate actions based on a full understanding of the purpose of KAM's reporting so as not to lead to KAM becoming boilerplate or losing substance. See [Figure 7] for the process of determining KAM.

[Figure 7] Reference image: KAM Determination Process



Source: Prepared by the CPAAOB based on data published by the JICPA

When deciding on KAM, engagement teams are required to proactively communicate with the audited company's management and those charged with governance. Moreover, engagement teams should note that the descriptions of each KAM and the reason for deciding on it described in the auditor's report are directly related to the company's specific situation by specifying the areas and amounts which the KAM targets. Furthermore, regarding the auditor's response described in the auditor's report, engagement teams should describe as specifically as possible the details of their procedures or audit approach suitable for the factors described as reasons for deciding on the KAM.

With regard to appropriate KAM descriptions, refer also to such documents as Auditing Standards Statement No.700 Practical Guidance No. 1, "Q&A on Auditor's Reports (Practical Guidance)" published by the JICPA.

Case 1: Description of the KAM and the reason for deciding on it

In considering the KAM for the audit of the consolidated financial statements, the engagement team decided to report the recoverability of deferred tax assets for the audited company's non-consolidated financial statements.

However, in the auditor’s report on the consolidated financial statements submitted to the audited company, the engagement team specified the value of deferred tax assets given in the consolidated financial statements after referring to the note in the consolidated financial statements regarding deferred taxes accounting, but without disclosing the scope of deferred tax assets covered by the KAM, thereby resulting in a description which implies that the KAM would cover the examination of the recoverability of entire deferred tax assets recorded in the consolidated financial statement. Thus, the engagement team did not sufficiently consider the appropriateness of the description of KAM and the reason for deciding on it for the consolidated financial statements.
(Auditing Standards Statement No. 701, paragraphs 12 and A47) [Mid-tier, and small and medium-sized audit firms]

Case 2: Descriptions relating to audit responses

NEW

In its auditor’s report on the audited company's consolidated financial statements, the engagement team described impairment of long-lived assets as KAM, and stated that it had performed audit procedures such as examining the grouping method through inspection of company materials by the Board of Directors, etc., inspecting evidences such as real estate appraisal reports to identify indications of impairment, and inspecting business plans for businesses with indications of impairment.
However, **although the engagement team did not actually inspect the real estate appraisal report and other supporting materials, the engagement team stated that it did so.**
(Auditing Standards Statement No. 701, paragraphs 12 and A46) [Mid-tier, and small and medium-sized audit firms]

IV. Others

Notification of inspection results

(1) Letter of notification of inspection results

The notification of the results of the CPAAOB inspection is made through the provision of a document (a letter of notification of inspection results) to the CEO of the inspected audit firm.

The main contents of the letter of notification of inspection results are as follows:

> 1. Matters of particular note
> 2. Viewpoints of inspection
> 3. Status of measures to ensure appropriateness of implementation of business processes designed by the audit firm in order to maintain and improve the quality control system (quality control system)
> 4. Status of implementation of audit engagements (individual audit engagements)

(2) Specifics described in "Matters of particular note"

Of the items of the letter of notification of inspection results, "Matters of particular note" sorts out deficiencies which have been identified in inspection and which are considered to be important. This is comprised of three items, i.e., operations management system, quality control system, and individual audit engagements, with an overall assessment to be given according to the statuses of the three items. An overall assessment of the inspected audit firm's business administration is described at the beginning of "Matters of particular note" in the letter of notification of inspection results, as shown below.

In "(1) Operations management system" of "Matters of particular note," the root causes analyzed by the CPAAOB (refer to "I. Operations Management System, 1. Operations Management System and Root Cause Analysis") with regard to deficiencies identified in inspection are described. In addition, the direction of future improvement considered by the CPAAOB is indicated in the case of some audit firms.

> 1. Matters of particular note
>
> As a result of the inspection of the audit firm, with regard to the business administration of the firm, it is deemed, within the scope of the inspection, that …, as described below.
>
> (1) Operations management system
> … (issues related to governance and business administration are described)
>
> (2) Quality control system
> … (deficiencies and other matters related to the quality control system are described)
>
> (3) Individual audit engagements
> … (deficiencies and other matters related to audit engagement are described)

The presentation of overall assessment started with inspections launched in Program Year 2016 in order to accurately convey the CPAAOB's assessment to audit firms and help corporate auditors, etc. of audited companies to which inspection results are disclosed by the audit firms appropriately understand the audit firms' level of quality control.

(3) Grades of overall assessment

Overall assessment is presented in the following five grades based on the statuses of the inspected audit firm's operations management system, quality control system, and individual audit engagements.

"Good (Overall assessment grade: 1)"

The grade that is given in cases where business administration is considered to be good, such as when few deficiencies have been identified with regard to the statuses of the operations management system, quality control system, and individual audit engagements.

"Generally good despite the presence of some points requiring improvement (Overall assessment grade: 2)"

The grade that is given in cases where business administration is considered to be generally good despite the presence of some points requiring improvement, such as when no serious problem has been identified although some deficiencies have been identified with regard to the statuses of the operations management system, quality control system, or individual audit engagements.

"Not good due to the presence of significant points requiring improvement (Overall assessment grade: 3)"

The grade that is given in cases where business administration is not considered to be good, such as when there are significant problems that require improvement with regard to the statuses of the operations management system, quality control system, or individual audit engagements.

"Not good and requiring prompt improvement in the status of the operations management system, etc. (Overall assessment grade: 4)"

The grade that is given in cases where business administration is considered to be not good and to require particularly prompt improvement.

"Considerably inadequate (Overall assessment grade: 5)"

The grade that is given in cases where serious deficiencies have been identified with regard to the statuses of the quality control system and individual audit engagements and where voluntary improvement is not expected to be made.

It should be noted that the CPAAOB requires the submission of reports from audit firms to which the assessment grade "Not good and requiring prompt improvement in the status of the operations management system, etc." has been given at the same time as the notification of the inspection results and urges them to make prompt improvement. With regard to audit firms to which the assessment grade "Considerably inadequate" has been given, the CPAAOB recommends that the Commissioner of the Financial Services Agency should take administrative actions or implement other measures.

(4) Communicating "Matters of particular note" to corporate auditors, etc. of audited companies

Audit firms are required to communicate "Matters of particular note" described in the letter of notification of inspection results and the audit firms' handling of those matters to corporate auditors, etc. of all audited companies (Auditing Standards Statement No. 260, paragraphs 16 and A31-2).
In addition, audit firms are required to communicate the specifics of deficiencies identified in the inspection of individual audit engagements and the audit firms' handling of the deficiencies to corporate auditors, etc. of the audited companies whose audit engagements were selected for the inspection.
From the viewpoint of accurately communicating inspection results, the CPAAOB has asked audit firms to communicate "Matters of particular note" without any modification to corporate auditors, etc. of audited firms, starting with inspections launched in Program Year 2016.
Moreover, from the viewpoint of helping corporate auditors, etc. of audited companies understand the level of their audit firms' business administration through comparison with other audit firms in terms of inspection results, the CPAAOB publishes data on the distribution of overall assessment grades in the "Monitoring Report."

(5) Regarding treatment of inspection results, etc.

When inspected audit firms disclose the contents of the letter of notification of inspection results to third-party entities, they need to obtain prior consent from the CPAAOB. Recently, there have been many cases in which an audit firm applied with the CPAAOB for prior consent to disclosure of inspection results, etc. based on a request from an audited company's directors, from corporate auditors and directors (including outside directors) of the audited company's parent company, or from a company that may potentially be audited (e.g., a company considering appointing an independent auditor).
However, in consideration of the fact that audit and corporate auditors, etc. of audited companies make use of inspection results and promote communication with audit firms, prior consent is not required in the case of (4) above or when submitting the letter of notification of inspection results to JICPA in accordance with the rules on the treatment of the letter of notification of inspection results set forth in the JICPA Quality Control Committee Operating Rules.

It is desirable that the results of the CPAAOB inspection, etc. be used not only by corporate auditors, etc. of audited companies but also by directors, etc. of audited companies and by companies that may potentially be audited in order to check the statuses of the design and operation of independent auditors' quality control systems.

Certified Public Accountants and Auditing Oversight Board

https://www.fsa.go.jp/cpaaob/english/index.html