II. Quality Control System

Implementation of Quality Control Operation

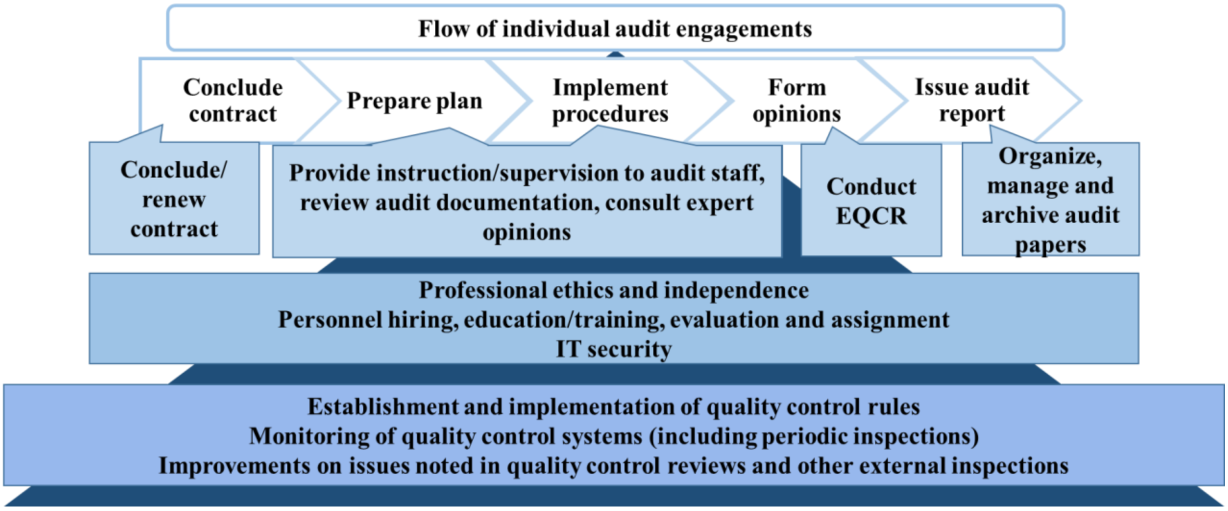
Outline

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>**

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.

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.

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

NEW

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.

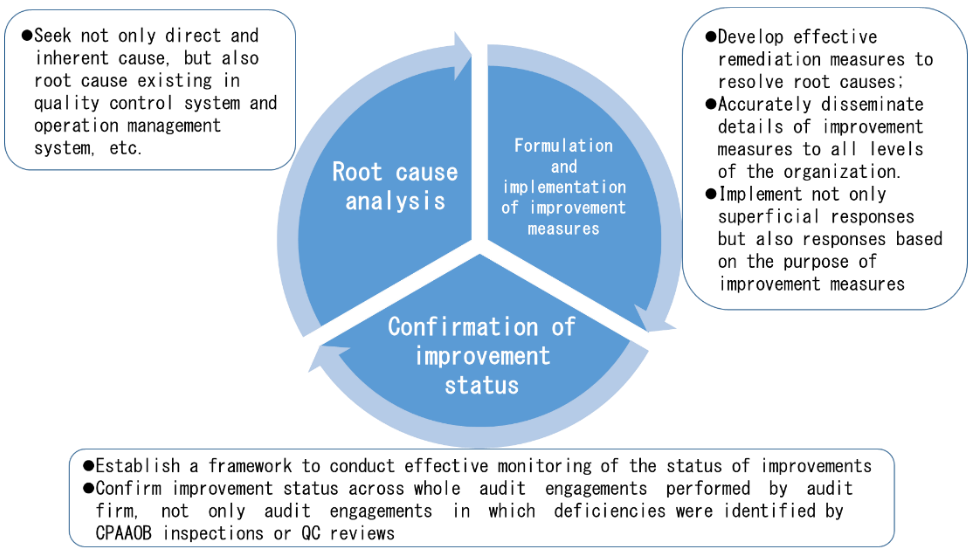
However, **when carrying out self-inspection of audit engagements targeted for inspection in QC reviews, the engagement partners and EQCRs merely conducted perfunctory checks of the items on the checklist and did not carry out checks that took into account the purpose for which each item had been instituted**. 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

Points of focus

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.

Outline of inspection results

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

<u>Points of focus</u>

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.

<u>Outline of inspection results</u>

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.

Expected response

Audit firms, **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**.

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 **to enhance the effectiveness of education and training** 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)

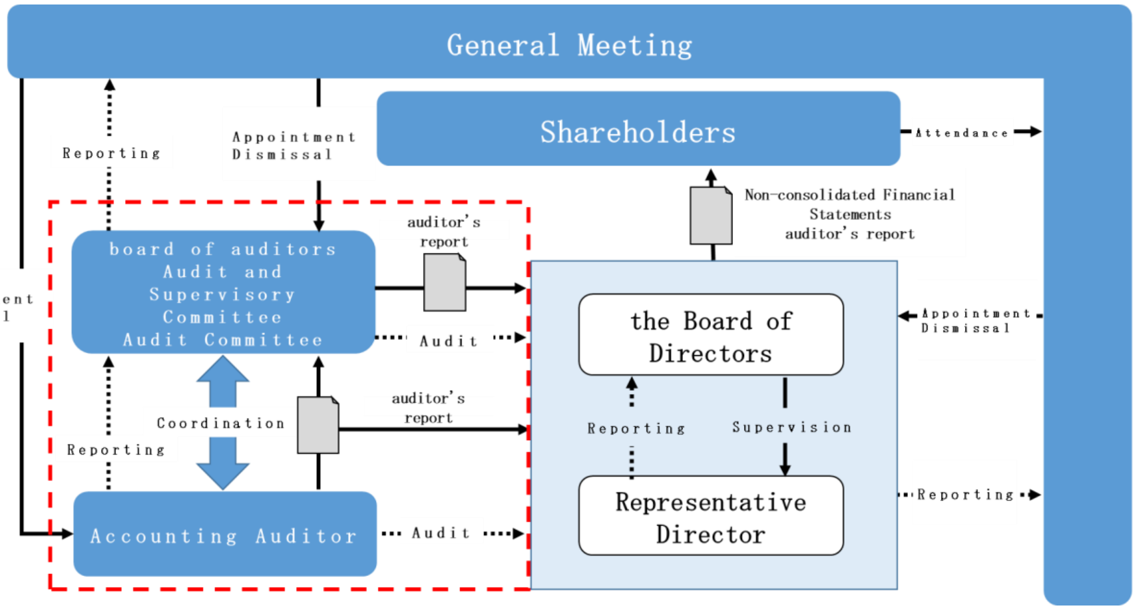
9. Cooperation with Company Auditors

(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.