Ⅲ． Individual Audit Engagements

Audit Engagement Performance

Summary

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

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

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

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

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

Analysis of deficiencies

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

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

・Insufficient consideration for suitability of further audit procedures to audit risk and the sufficiency and appropriateness of audit evidence;

・Lack of an attitude of professional skepticism required of an auditor; and

・Insufficient knowledge of requirements of audit standards and the Auditing Standards Statement.

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

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

1) Risk assessment at the audit planning stage

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

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

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

2) Evaluation of obtained audit evidences

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

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

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

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

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

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

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

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

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

Expected response

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

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

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

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

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

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

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

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

(Reference)

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

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

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

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

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

Points of focus

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

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

exists; and

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

Outline of inspection results

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

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

(Observed effective efforts)

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

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

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

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

Expected response

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

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

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

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

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

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

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

further audit procedures and perform audit procedures that are specifically relevant to the type of fraud that may be assumed.

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

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

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

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

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

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

《Points to Note》

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

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

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

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

Case: Identifying and assessing fraud risks in revenue recognition

NEW

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

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

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

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

FREQUENT

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

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

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

NEW

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

Based on the consideration of these fraud risk factors, the engagement team assumed a fraud risk scenario in which "the sales division manager or his / her subordinate under his / her instructions records sales by giving false shipping instructions to the person in charge at the factory during the shipping suspension period for product sales transactions exceeding an amount that was clearly determined to be an insignificant misstatement." However, because there were no transactions exceeding an amount that was clearly determined to be an insignificant misstatement during the shipping suspension period, the team did not perform procedures to respond to the fraud risks. However, the engagement team **did not adequately consider the possibility of fraud in transactions that occurred before the period of suspending shipments at the year-end and in transactions below the amount of the apparently immaterial misstatement that occurred during the period of suspending shipments**.

(Auditing Standards Statement No. 240, paragraph 25, 46) [Mid-tier, and small and medium-sized audit firms]

④The engagement team identified the "risk of employees engaging in the practice of early sales booking by booking sales regarding transactions that do not meet the booking requirements" given the possibility that employees of the audited company might commit fraud in order to achieve the budgeted sales figure because of the severe order-receiving situation.

However, the engagement team did not sufficiently evaluate the risk of a material misstatement due to fraud related to revenue recognition. For example, the engagement team did not identify the risk of fraud being committed by the management merely because of the assumption that the management was strict about rules and that their sense of values was not such that they would justify fraud, nor did it take into account motivations and opportunities for the management to commit fraud.

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

FREQUENT

⑤The audited company engages in wholesale sales of beverages and retail sales using vending machines. Regarding wholesales sales, the engagement team identified the risk of sales being overstated through a fraudulent practice. On the other hand, regarding sales through vending machines, which account for around 40% of the audited company's overall sales, although the engagement team recognized the presence of a possible motivation for overstating sales, it did not identify the risk of a material misstatement due to fraud for the following reasons: that it was difficult to commit fraud to overstate sales to a large degree given the need to book a large number of small-value cash sales transactions; and that if sales were overstated to a large degree, the anomaly could be easily detected through audit procedures.

However, the engagement team **did not sufficiently evaluate the risk of a material misstatement due to fraud related to sales through vending machines. For example, it did not take into account the possibility of the management falsifying financial data**.

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

FREQUENT

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

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

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

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

《Points to Note》

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

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

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

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

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

Case 1: Response to fraud risks in revenue recognition

NEW

①The audited company provided financial support services such as investments, loans, and debt guarantees for medical institutions, as well as services such as providing guidance on management, administration, and operation of medical institutions it supported.

The engagement team identified as a fraud risk relating to revenue recognition the possibility that the audited company could use its financial support services to influence the companies it supported and thereby receive unduly excessive compensation. In addition, from the perspective of evaluating the reasonableness of the amount of compensation for service agreements, the engagement team set the amount of compensation deemed appropriate by management at a reasonable amount, and performed procedures to compare this amount with the actual amount of compensation.

However, although the engagement team identified the possibility of receiving unduly excessive remuneration as a fraud risk, the engagement team set the amount of remuneration deemed appropriate by management as a reasonable amount of remuneration based only on its understanding in light of discussions with management. **In evaluating the reasonableness of the amount of remuneration, the engagement team did not obtain audit evidence that was more relevant or more convincing than in cases where no fraud risk had been identified.**

(Auditing Standards Statement No. 240, paragraph 29) [Mid-tier, and small and medium-sized audit firms]

FREQUENT

②The engagement team identified a risk of material misstatement due to fraud in the cutoff of revenue, extracted samples from sales transactions one week before and after the year-end, and cross-checked these against shipping slips, receipts, etc.

However, the engagement team **did not examine whether extracting samples from the transactions one week before and after the last day of the fiscal year was a sufficient audit procedure for addressing the fraud risks**.

(Auditing Standards Statement No. 240, paragraph 29) [Mid-tier, and small and medium-sized audit firms]

FREQUENT

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

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

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

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

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

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

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

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

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

FREQUENT

⑤ The audited company engages in the business of manufacturing measurement and control equipment, mainly electricity meters, and applies the arrival of shipment standard to the booking of sales.

With regard to the period attribution of sales at the audited company, the engagement team identified the risk of a material misstatement due to fraud, and citing the possibility of the company deliberately manipulating the timing of booking of sales around the end of the fiscal year, it selected samples from among sales data booked around the end of the fiscal year and conducted a test of detail.

However, when evaluating the period attribution of sales, **the engagement team merely checked sales data against order sheets but did not perform substantive procedures to obtain stronger audit evidence, such as checking sales data against customers' acknowledgements of receipt that confirm the fact of arrival of shipment**.

(Auditing Standards Statement No. 240, paragraph 29) [Mid-tier, and small and medium-sized audit firms]

⑥ With regard to revenue recognition concerning the audited company's wholesale business, the engagement team identified the risk that, when entering order receipt information, they might deliberately enter earlier requested dates of delivery than those indicated in order sheets for the purpose of moving forward to the current fiscal year the timing of the booking of sales transactions that shipment was scheduled for the next fiscal year.

To address the above fraud risk, the engagement team performed procedures to evaluate the exercise of internal control related to the order-receiving process.

However, when performing the procedures to evaluate the exercise of internal control related to the order-receiving process, the engagement team designed and performed procedures under which the sample population size and the degree of use of internal auditors' work were similar to the ones under the procedures to be performed in cases where fraud risks had not been identified. As a result, the engagement team did not obtain stronger audit evidence or a larger quantity of evidence, as required in cases where fraud risks had been identified.

(Auditing Standards Statement No. 240, paragraph 29, and No. 330, paragraph 7) [Large-sized audit firms]

《Points to Note》

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

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

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

Case 2: Journal entries test

FREQUENT

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

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

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

NEW

FREQUENT

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

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

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

《Points to Note》

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

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

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

Case 3: Business rationale for significant transactions

NEW

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

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

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

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

NEW

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

《Points to Note》

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

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

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

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

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

FREQUENT

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

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

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

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

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

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

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

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

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

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

《Points to Note》

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

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

(4) Evaluation of audit evidence

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

NEW

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

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

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

《Points to Note》

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

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

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

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

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

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

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

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

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

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

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

《Points to Note》

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

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

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

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

2. Risk Assessment and Response to Assessed Risks

Points of focus

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

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

Outline of inspection results

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

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

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

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

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

of Auditing Standards Report No.315, etc. In addition, when developing responses to audit risk, they should carefully consider whether the procedures respond to the assessed risks and whether the procedures enable sufficient appropriate audit evidence to be obtained, including not only the types of procedure, but also the timing and the extent of the procedures. In order to do so, they should **make sure sufficient hours are spent for not only substantive procedures but also for the audit plans**.
Furthermore, some professional staff still do not recognize the importance of audit planning and have no understanding of the need, in audit plans, to link material misstatement risks and details of the procedures responsive to the assessed risks (the nature, timing and extent of the procedures).
Engagement teams must **reconfirm the concept of the risk-based approach and the positioning of the audit plan in the current audit, and review the audit plan that they developed, according to the situation**.
Once again, an audit firm where deficiencies were identified in risk assessment and responses to the assessed risks **must consider appropriate responses, such as re-educating professional staff who have failed to catch up with the current audit standards and responding in terms of the assignment of engagement teams**.

(1) Audit planning

Case 1: Formulation of audit planning

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

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

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

《Points to Note》

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

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

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

NEW

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

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

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

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

《Points to Note》

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

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

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

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

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

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

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

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

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

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

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

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

《Points to Note》

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

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

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

Case 2: Identifying and assessing the risks of material misstatement

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

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

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

《Points to Note》

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

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

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

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

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

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

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

《Points to Note》

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

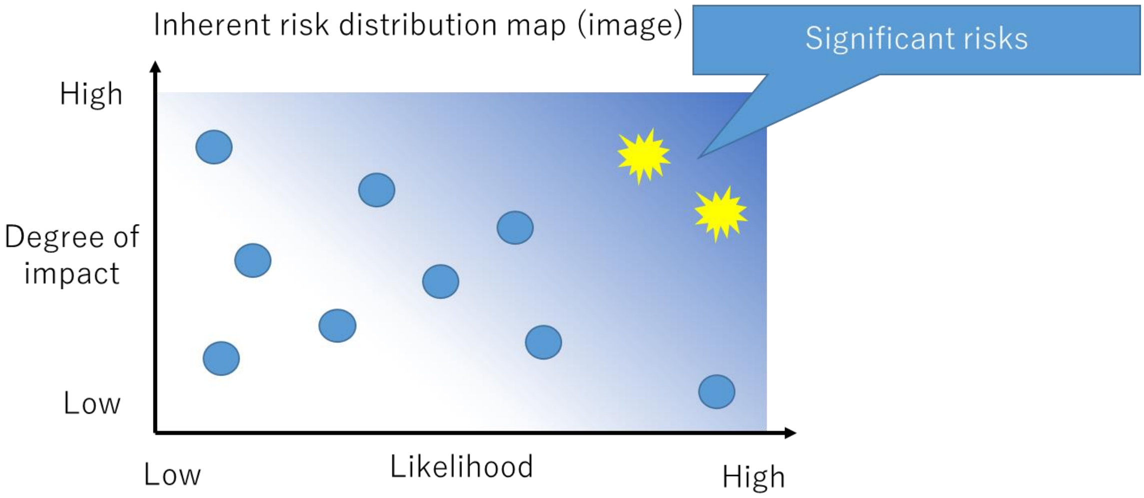
It should also be noted that significant risks, which were defined as "identified and assessed risks of material misstatement which the auditor considers to require special audit consideration" in the Auditing Standards Report No.315 before the revision, are identified as the following risks of material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

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

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

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

［Figure 5］ Reference image: Distribution of inherent risk



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

(3) The auditor's responses to assessed risks

Case 1: Audit procedures for risks of material misstatements

NEW

FREQUENT

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

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

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

NEW

FREQUENT

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

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

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

NEW

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

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

・Inspection of the agreement concerning the company split;

・Checking compliance with relevant accounting standards;

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

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

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

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

《Points to Note》

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

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

Case 2: Adequacy of presentation and disclosure

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

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

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

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

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

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

《Points to Note》

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

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

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

Case 1: Obtaining an understanding of the services provided by a service organization, including internal control

The audited company outsourced the administration and investment of plan assets to multiple life insurance companies and trust banks. In this situation, the engagement team **lacked sufficient understanding of the services provided by them, the importance of those services, and the effects of those services on the audited company's internal controls related to audit**. As a result, the engagement team did not identify and assess the risk of material misstatement related to plan assets.

(Auditing Standards Statement No. 402, paragraphs 8 to 10) [Mid-tier, and small and medium-sized audit firms]

Case 2: Audit evidence regarding the effectiveness of internal controls in the service organization

The audited company uses a network system developed by a service organization as an IT system for its important business operation processes. The audited company had obtained the assurance report on a description of the service organization's system, the suitability of the design of controls, the application of the controls to the service, and the operating effectiveness of controls.

However, the engagement team only evaluated this report obtained by the audited company and **did not perform assessment of the service, such as assessment of the adequacy of the assessment procedures taken by the auditor of the service organization**.

(Auditing Standards Statement No. 402, paragraph 16) [Mid-tier, and small and medium-sized audit firms]

《Points to Note》

In addition to the above cases of deficiency, there were cases in which, although the management of inventory, including shipment and acceptance of goods, was outsourced to a warehousing company, the engagement team lacked sufficient understanding of the services provided by the service organization and relevant internal controls.

If the audited company uses the services of one or more service organizations, the engagement team shall understand how the audited company uses the services provided by a service organization in the audited company's operations. Meanwhile, when understanding the internal control related to auditing, the engagement team shall assess the design and operating effectiveness of relevant controls at the audited company that relate to the services provided by the service organization. Note that these are required to be performed not only in financial statement audits but also in audits of internal control over financial reporting.

Since the migration of systems to the cloud has been progressing recently, audit firms must often judge which of the audited company (user entity) and the service organization is responsible for the internal control over the underlying operations for the financial reporting, depending on the contents and the mode of service that the service organization provides for the audited company. Audit firms need to fully understand the contents of services provided by service organizations and their importance, and their impact on the internal control over financial reporting.

(5) Evaluation of misstatements identified during the audit

Case: Consideration of identified misstatements

①The engagement team ascertained that the understatement of loss on valuation of shares of subsidiaries and associates in the 'non-consolidated and consolidated financial statement for the prior period, which were included in comparative information, was recognized in the current period and that the uncorrected misstatement in the previous fiscal year was corrected in the current term. However, the engagement team did not evaluate the effect of the misstatement in the previous fiscal year on audit of internal control over financial reporting. In addition, it did not include "uncorrected misstatement included in comparative information" or "effect of the undermining of comparative information as a result of correction made in the figures for the current term" among the matters to be confirmed in the management representation letter for confirmation. Moreover, the engagement team did not report to the board of auditors the effect of the uncorrected misstatement related to past fiscal years on the relevant classes of transactions, account balances, or disclosures, and the non-consolidated and consolidated financial statement as a whole.

(Auditing Standards Statement No. 265, paragraph 6, and No. 450, paragraphs 5 and 10; Audit and Assurance Practice Committee Statement No. 82, paragraphs 188 and 195) [Mid-tier, and small and medium-sized audit firms]

NEW ②The audited company disclosed the "amount of inventories recognized as expense" in the notes on inventories in the consolidated financial statement for the previous term and the current period.

In response, the engagement team stated in the audit documentation that the amount disclosed in the previous period was incorrect.

However, the engagement team did not sufficiently understand that comparative information was included as an integral part of the financial statements for the current fiscal year, so the team did not confirm the difference between the misstated amount and the amount that should have been stated, and **did not evaluate whether the misstatement was material as an uncorrected misstatement**.

(Auditing Standards Statement No. 300, paragraph 23, and No. 450, paragraphs 10) [Mid-tier, and small and medium-sized audit firms]

《Points to Note》

There were numerous cases where auditors did not evaluate the results of test of internal control and the impact on substantive procedures although auditors shall judge whether the overall audit strategy or detailed audit plans should be revised when the nature and circumstance of the identified misstatements may indicate the possibility of other misstatements, and there is possibility that the aggregation of other misstatements might become a material misstatement.

Moreover, auditors need to determine whether identified misstatements would be material, either individually or in aggregate, if they are not corrected. However, there were cases where auditors did not evaluate the impact of uncorrected misstatements of past fiscal years on the financial statements as a whole.

Note that it is necessary to state in the list of uncorrected misstatements attached to the written representation (1) uncorrected misstatements included in comparative information or (2) effect of comparative information as a result of correction (or elimination) of the figures for the current term, when auditors discovered uncorrected misstatements for the prior years, and management determined that they were not material and have corrected (or eliminated) them in the current term.

(6) Identifying and assessing the risks of material misstatement due to the information system and procedures responsive to assessed risks

Case 1: Formulation of a plan for auditing IT use

NEW

①With regard to general controls over IT systems used for construction management and financial management at a consolidated subsidiary of the audited company, the engagement team identified as a deficiency that there were no differences in the authority settings for each user and that all users were granted the same authority. Furthermore, although the engagement team determined that the deficiency was minor as a result of performing risk assessment procedures, the engagement team designed an audit plan and performed audit procedures on the assumption that it was impossible to rely on general controls over the IT systems. Specifically, as substantive procedures, the scope of detailed tests of construction sales by comparing vouchers was expanded.

However, the engagement team **did not identify in detail what risks would arise from the deficiencies in general controls related to the IT systems, did not appropriately assess the risks of material misstatement in light of the impact of the deficiencies, and did not consider the necessity of additional substantive procedures to address the risks**.

(Auditing Standards Statement No. 315, paragraphs 20 and 30) [Large-sized audit firms]

②The audited company identified the application controls of information technology relating to sales processes included restrictions to non-registered customers' usage in the sales management system and the issuance of vouchers prior to shipping registration, and evaluated the design and operating effectiveness of the key aspect of the controls.

The engagement team evaluated sales processes, and determined that application controls in information technology that should be examined as part of financial statement audits and internal control audits were absent, and only evaluated the design and operating effectiveness of manual internal controls.

However, the engagement team did not understand how the audited company dealt with IT-related risks, and did evaluate whether it was possible for only manual internal controls other than the application controls in information technology to prevent and detect risks of misstatement on a timely basis.

(Auditing Standards Statement No. 315, paragraph 20; Audit and Assurance Practice Committee Statement No. 82, paragraph 144, IT Committee Practical Guidance No. 6, paragraph 29) [Mid-tier, and small and medium-sized audit firms]

Case 2: Evaluating of deficiencies in General IT control

The audited company identified and assessed controls on program changes as part of general IT controls for logistics system. The company stipulated that information system work request forms, program test plans, transition plan to production environment, etc., must be prepared and approved at each stage – from detailed system design to testing to transition to a full-scale environment – as controls on program changes.

The engagement team identified deficiencies in these controls because the aforementioned necessary documentation was not prepared at each stage of these controls, but it concluded that IT controls were on the whole effective by identifying and assessing the preparation of information system development management charts and email approval as alternative controls.

However, the engagement team overlooked the fact that the information covered under control activities in which deficiencies had been identified was not listed in the information system development management chart to be prepared for managing progress in program development. The engagement team also did not confirm the specific operational methods for leaving traces of email approval and otherwise did not obtain sufficient appropriate audit evidence relating to the effectiveness of general IT controls.

(Audit and Assurance Practice Committee Statement No. 82, paragraph 185; IT Committee Practical Guidance No. 6, paragraph 46) [Mid-tier, and small and medium-sized audit firms]

《Points to Note》

In addition to the above example cases, there were also cases in which the engagement team lacked sufficient understanding of the specifics of programs related to cost calculation and information systems using IT, including the method of generating master data used by the programs, when evaluating the development of business processes for cost calculation.

Business enterprises use information systems for their business operations. Through understanding the status, characteristics and operation of the information systems of the audited company, the engagement team can properly identify and assess the risks of material misstatements resulting from those systems. There were some cases in which the audit firm judged that the potential material misstatement risk was low without understanding the general structure of those IT systems. When developing an audit plan, audit firms should understand the IT-related environment of the audited company, and identify IT systems that should be included in the assessment for risks of material misstatement.

Moreover, when understanding the general structure of IT systems of an audited company at a group audit, auditors shall be careful not to omit significant components. In addition, auditors need to develop an appropriate audit plan by considering how the accounting policies and the control environment of the audited company, including the year-end closing process, are reflected in or associated with the IT systems. Furthermore, when using various lists generated by the audited company's information system for the tests of controls or substantive procedures, the engagement team shall evaluate the accuracy and completeness of the information. Depending on the degree of IT use by the audited company, the engagement team may need the support of IT specialists and incur considerable time to complete the audit. Therefore, the engagement team should note that it needs to develop an audit plan for the above procedures at an early phase.

The revised Auditing Standards Report No.315 expands the scope of IT-related statements and includes in

the appendix some considerations for understanding IT and for understanding IT general controls.

3. Audit Evidence

Points of focus

Auditors should assess information obtained as audit evidence considering its relevance and reliability. The CPAAOB inspects whether audit procedures designed by the engagement team are properly performed and whether sufficient appropriate audit evidence to draw reasonable conclusions on which to base the auditor's opinion is obtained from the following perspectives:

- Whether the engagement team obtains appropriate audit evidence responsive to the assessed risks of material misstatement at the assertion level, rather than only focusing on the quantitative sufficiency of audit evidence;
- Whether the engagement team performs further in-depth procedures to audit risk to reduce audit risk to an acceptably low level for significant risks;
- Whether the engagement team performs appropriate audit procedures in individual situations as tests of controls and substantive procedures; and
- Whether the engagement team assesses whether the information prepared by the audited company and information prepared by the management's experts is sufficiently reliable.

Outline of inspection results

The following examples of identified deficiencies, as pointed out in past years, are also frequent in the current program year:

The engagement team did not assess whether the audit evidence obtained through the audit procedures was adequate to identify risks of misstatement;

The engagement team identified significant risks but did not perform substantive procedures that responded individually to the risks;

The engagement team identified inconsistencies and irregularities with other audit evidence but did not determine the necessity of additional audit procedures;

The procedures performed by the engagement team as substantive analytical procedures did not meet the requirements for substantive procedures since the engagement team only performed annual comparisons and monthly fluctuation analyses, and they did not assess the reliability of the data used by the auditor to estimate booked amounts and ratios, and whether the engagement team's estimate was precise enough to identify misstatements which could lead material misstatements;

In using audit sampling for audit procedures, the engagement team did not examine whether the sample size it had determined was adequate to reduce sampling risk to an acceptably low level;

Audit evidence was not obtained on all of the specific items selected when sampling was carried out by selecting specific items;

When testing specific items selected, the engagement team did not examine whether it was necessary to obtain additional audit evidence for the remaining balance; and

When using information prepared by the audited company, the engagement team did not evaluate whether the information had sufficient reliability for audit purposes.
For more information in responses to audit risk for revenue recognition, also see items “(2) Identifying and assessing risks of material misstatement due to fraud” and “(3) Response to assessed risks of material misstatement due to fraud” in “1. The Auditor’s Responsibilities Relating to Fraud in Financial Statement Audits.”

(Observed effective efforts)
The following is an example of observed effective efforts made by an audit firm.
The engagement team reviewed audit plans before the end of each fiscal year, and the results of the review are shared at a meeting held before the end of the fiscal year and attended by all team members. At that meeting, the engagement team checks once again each of the audit procedures planned to be performed in year-end audits with regard to each material accounts, and the engagement partner conducts a detailed review of the specifics of the audit procedures before the performance of year-end audits.

Expected response
The engagement team needs to assess appropriately whether they have obtained sufficient appropriate audit evidence to respond to identified risks. Particularly, **for significant risks, the engagement team shall perform substantive procedures corresponding to each of those risks individually**.
Many examples of identified deficiencies in relation to obtaining sufficient appropriate audit evidence resulted from the engagement team’s failure to appropriately perform risk assessment and design further procedures, and the team’s lack of in-depth understanding of the audited company’s business for the fiscal year subject to audit (See paragraph titled “Expected response,” in “2. Risk Assessment and Response to Assessed Risks”).
In many other cases, the engagement team appropriately performed risk assessment and designed further procedures to respond to the assessed risk but the engagement partners neither gave specific directions nor exercised specific supervision. Staffs of the engagement team therefore performed only conventional audit procedures, leading to a lack of organic coordination between the audit plan and actual audit procedures. Thus, when auditing the audited company, the engagement team should, through the audit period, obtain a deep understanding of the audited company and its business environment and sufficiently discuss the risk assessment and audit procedures to be performed. The engagement team should also comprehensively evaluate the sufficiency and appropriateness of audit evidence obtained as a result of performing audit procedures through the review of audit documentation.

(1) Matters common to audit evidence

Case 1: Sufficient appropriate audit evidence

NEW

①The audit evidence corresponding to the risk of material misstatement

With regard to the fact that the audited company, which is engaged in the land sales business, recorded sales for land sales transactions as of the year-end closing date, the engagement team determined that there was no problem with the attribution of the period for the Transaction because, although the receipt of the sales proceeds and the registration of the transfer of ownership for the Transaction were both made after the year-end closing date, setting the date of transfer of ownership and the date of delivery on the year-end closing date was based on the buyer's request, and the parties concerned had agreed to it.

However, the engagement team **only confirmed the agreement between the parties that the delivery date would be the year-end closing date, and did not examine the reasonableness of the agreement or whether the delivery had actually occurred**.

(Auditing Standards Statement No. 330, paragraph 5) [Large-sized audit firms]

②Dual-purpose test

FREQUENT

The engagement team claimed to have performed dual-purpose tests doubling as substantive procedures in the form of examination of 25 sample cases conducted as test of controls related to raw material cost included in manufacturing costs.

However, the engagement team **merely stated in audit documentation the fact of having checked the presence or absence of approval as a test of controls, but information on monetary value was not covered by the test, while substantive procedures were not performed. In addition, the engagement team did not sufficiently evaluate the sufficiency on sample size of the 25 sample cases randomly selected, nor did it design and perform substantive procedures for the period between January and March, which was not covered by the test of controls**.

(Auditing Standards Statement No. 500, paragraphs 5 and 9, and No. 530, paragraphs 6 to 8) [Mid-tier, and small and medium-sized audit firms]

③Observation of physical inventory counting

Although the engagement team observed physical inventory counting, it merely observed inventory counting procedures and performed test counts but failed to perform the procedures to check the completeness of the physical inventory count records and the accuracy of cutoff of shipping and receipt. As a result, the engagement team did not obtain sufficient and appropriate audit evidence regarding the completeness and accuracy of the physical inventory count records.

(Auditing Standards Statement No. 500, paragraph 5 and No. 501, paragraph 3) [Large-sized audit firms]

《Points to Note》

Generally, inquiries without other procedures neither proves that there is no risks of material misstatement at the assertion level, nor provides sufficient audit evidences as to the effectiveness of internal controls ; however, there were cases where the engagement team completed audit procedures by inquiries only. The

engagement team needs to perform procedures corresponding to assessed risks to corroborate the evidence obtained through inquiry. That applies not only to audit procedures for significant risks but also to audit procedures corresponding to the risks of material misstatement identified.

In addition, auditors plan substantive analytical procedures, tests of details, or a combination of both as audit procedures for assessed risk, depending on the conditions, but the degree of required responses to audit risks differs depending on the significance of assessed risk.

In some cases, although the engagement team performed multiple audit procedures, it did not consider whether the audit evidence obtained through the audit procedures designed under the audit plan was sufficient in terms of quality and quantity, with the result that sufficient audit evidence to reduce the degree of audit risk to an acceptably low level on the whole was not obtained.

The engagement team should not perform planned audit procedures for formality, but comprehensively assess the events identified during the audit and the sufficiency as well as the appropriateness of audit evidence obtained through multiple audit procedures. Furthermore, when implementing tests of controls to be performed concurrently with substantive procedures (dual-purpose tests), the engagement team must remember to evaluate whether procedures designed to obtain sufficient appropriate audit evidence satisfying the purposes of the respective audit procedures have been designed and implemented.

Case 2: Information to be used as audit evidence

①Relevance and reliability of information

The audited company engages in the business of providing economic information to customers. It prepares and updates the list of customers based on written applications for subscriptions and notices of cancellation that indicate fixed monthly fees and books sales on a monthly basis based on the list of customers.

Although the engagement team selected samples from the list of customers as a substantive procedure corresponding to the occurrence of sales, it merely checked sales data against written applications received at the start of transactions and failed to consider the need to obtain audit evidence for ascertaining that the contracts for those transactions were still in effect by verifying the fact of payment, for example.

(Auditing Standards Statement No. 500, paragraph 6) [Large-sized audit firms]

②Work of management's experts

FREQUENT

When evaluating the book value of shares in an insolvent subsidiary, the audited company obtained a real estate appraisal report for land and buildings owned by the subsidiary and calculated the net asset value of the shares, taking into account the market valuation of the real estate.

Amid this situation, the engagement team evaluated the competence, capabilities and objectivity of the experts used by management to prepare the appraisal report, which is information used as audit evidence, and obtained an understanding of the experts' work before reviewing the appraisal report.

However, the engagement team **did not sufficiently evaluate the appropriateness of the appraisal**

<u>report as audit evidence, as the team did not verify the calculation methods or the source data employed by the experts used by management</u>.
(Auditing Standards Statement No. 500, paragraph 7) [Mid-tier, and small and medium-sized audit firms]

③Reliability of information produced by companies (i)

FREQUENT

Regarding the end-of-period inventory valuation, the audited company booked valuation losses on inventory by multiplying the balance of inventory by the percentage by which the selling price fell short of the cost. These valuation losses on inventory were calculated automatically in the audited company's system and output as an inventory table.
When examining the valuation losses booked on inventory, the engagement team reconciled them to the valuation losses on inventory in the inventory table.
However, the team **<u>did not obtain sufficient and appropriate audit evidence, as it did not examine the accuracy of the inventory table</u>**.
(Auditing Standards Statement No. 500, paragraph 8) [Mid-tier, and small and medium-sized audited companies]

④Reliability of information produced by companies (ii)

NEW

FREQUENT

When performing audit procedures for the valuation of accounts receivable and goodwill, the engagement team examined the existence of receivables in arrears and indications of impairment of goodwill based on materials prepared by the audited company.
However, **<u>when using materials prepared by the audited company as audit evidence, the engagement team did not verify the accuracy and completeness of the materials</u>**.
(Auditing Standards Statement No. 500, paragraph 8) [Mid-tier, and small and medium-sized audit firms]

《Points to Note》

When designing and performing audit procedures, auditors should keep in mind that they should take into account the relevance and reliability of information used as audit evidence.
In addition, when using information prepared by experts (e.g., pension actuaries, real estate appraisers, and attorneys) employed by the management as audit evidence, auditors should keep in mind that they should evaluate the competence, capabilities and objectivity of the experts, to understand the experts' work, and to evaluate the adequacy of the experts' work used as audit evidence in light of relevant assertions.
Meanwhile, audited companies often make accounting estimates based on information prepared by themselves, including reference data regarding valuation losses that lists book values and net sales prices by inventory and reference data regarding indications of impairment that lists book values of fixed assets and operating profits/losses by asset group, and data regarding estimated construction profits/losses by construction project and the balance of construction-in-progress expenditures under the percentage-of-

completion method, and reference data regarding construction loss provisions. There are still many cases in which information prepared by audited companies as the basis of accounting estimates is used as audit evidence in the audit of accounting estimates without its accuracy and completeness being verified. When performing audit procedures using information prepared by audited companies, engagement teams must obtain audit evidence concerning the accuracy and completeness of the information and sufficiently examine the reliability of the information obtained by evaluating whether the information is sufficiently accurate and detailed.

Case 3: Timing of substantive procedures

① Performing substantive procedures at an interim date

The engagement team checked the balance of accounts payable as of the end of February as a substantive procedure regarding accounts payable. However, although changes that exceeded the materiality had occurred in the balance with respect to multiple suppliers, the engagement team merely vouched one arbitrarily selected transaction with each supplier in March and failed to design and perform sufficient substantive procedures for the remaining period.

(Auditing Standards Statement No. 330, paragraphs 21) [Mid-tier, and small and medium-sized audit firms]

②Performing physical inventory counting on a date other than the closing date of the term

The audited company adopted physical inventory cycle counting, with different interim count dates applied to inventory taking at different business locations.

The engagement team selected multiple locations for observation of physical inventory counting and performed audit procedures with respect to changes in inventory at some of those locations between the interim count date and the closing date of the fiscal year.

However, the engagement team did not identify the balance of inventory as of the count date or the changes in the balance between the count date and the closing date of the fiscal year at locations not covered by the examination of changes in the balance of inventory. As a result, the engagement team did not design and perform audit procedures to obtain sufficient and appropriate audit evidence with regard to changes in the balance of inventory between count date and the closing date.

(Auditing Standards Statement 501, paragraph 4) [Mid-tier, and small and medium-sized audit firms]

《Points to Note》

It should be kept in mind that, when performing substantive procedures with regard to balance sheet items with a date before the closing date of the term as the reference date, it is necessary to perform additional substantive procedures for the remaining period in order to provide rational grounds for an extended application of the results of the performed substantive procedures to the remaining period.

It should also be kept in mind that, when using audit sampling for substantive procedures with regard to income statement items, it is necessary to select items for the sample in such a way that each sampling unit

in the population during the period has a chance of selection because the entire data for the whole of that period becomes the sampling population.

(2) External Confirmation

Case 1: Reliability of responses to confirmation request

NEW

The engagement team identified fraud risks in accounts receivable, recognizing that the audited company had receivables that had been in arrears for a long time beyond the payment deadline and that transaction agreements for these receivables had not yet been concluded. In addition, the engagement team e-mailed confirmation letters to the companies where the receivables had been in arrears to confirm their balances, collected them, and compared the e-mail address domain of the confirmed respondents with the website domain of the companies where the receivables had been confirmed.

However, the engagement team **did not consider the need for additional procedures even though there was a partial mismatch between the email address domain of the confirmed respondent and the website domain of the confirmed company**.

(Auditing Standards Statement No. 505, paragraphs 6) [Large-sized audit firms]

《Points to Note》

External confirmation procedures generally provide strong audit evidence to auditors. However, if auditors have suspicion of the reliability of the responses, such as receipt of the replies via facsimile, email or obtaining the replies via an audited company, it is necessary to perform an audit procedure to ascertain the reliability of the replies and mitigate the risks of manipulation and fraud.

Especially, in the case of confirmation with the external legal counsel, the engagement team needs to confirm the facts that caused the litigation or claim, when it arose or how long it continued, its status, the likelihood of losses arising therefrom, and an estimate of expected loss.

Additionally, in the case where the payment of compensation due to litigation, etc., is likely to impact the audited company's financial statements materially, the engagement team should examine the appropriateness and effectiveness of the audited company's litigation risk management framework.

Case 2: Alternative audit procedures

In confirming the balances of accounts receivable as of the balance sheet date, the engagement team conducted alternative procedures for confirmations not received through examination cash receipts. However, among the amounts confirmed with respect to major business partners from which responses had not been received, the engagement team only verified the collection of receivables through several collections made in the following month of the balance sheet date but did not examine more than 80% of balances exceeding the materiality, which should have been confirmed.

(Auditing Standards Statement No. 505, paragraph 11) [Mid-tier, and small and medium-sized audit firms]

《Points to Note》

If an engagement team is unable to obtain responses to its confirmation requests, it needs to perform alternative audit procedures. At the same time, the team should carefully evaluate whether the audit evidence obtained through alternative procedures is adequate and appropriate in view of the risks of material misstatement.

Case 3: Exception in relation to confirmation

NEW

The engagement team sent out a confirmation letter as part of its audit procedures for the audited company's accounts payable.

The engagement team determined that there was no problem with one of the confirmation exceptions because it was able to confirm, through the audited company's explanation and review of the reconciliation prepared by the audited company, that the confirmation exception resulted from the assignment of part of the accounts receivable to the audited company.

However, the engagement team **did not examine specific supporting materials such as documents which indicated the assignment of receivables in the investigation of the confirmation exceptions, and did not obtain sufficient appropriate audit evidence for the confirmation exceptions**.

(Auditing Standards Statement No. 505, paragraphs 13 and 15) [Mid-tier, and small and medium-sized audit firms]

《Points to Note》

Exceptions arising from responses to external confirmation might indicate misstatements in financial statements or potential misstatements. Based on this, the engagement team should investigate the exception between the confirmed and stated amounts, and obtain corroborative audit evidence such as specific supporting documents.

If the engagement team determines whether the exceptions corresponds to a misstatement as a result of cause analysis of exceptions, and identifies a misstatement, the team also needs to evaluate the effectiveness of internal control and its impact on the financial statements.

Case 4: Evaluation of reply received

The engagement team identified the risk of material misstatement in the existence of inventory, and regarding the inventories under the custody and control of a third party, it requested confirmation from all entities entrusted with storing those inventories as to inventory balances

However, the engagement team reconciled only some of the inventory balance data provided by the third party to the system data and neglected to reconcile all of the inventory balance date on the confirmation responses from third party. As a result, the engagement team did not obtain audit evidence concerning the existence of inventory.

(Auditing Standards Statement No. 505, paragraph 15) [Mid-tier, and small and medium-sized audit firms]

《Points to Note》

As in the above cases, there are cases where audit evidence has not been obtained for the entire confirmed amount even though the balance has been confirmed as a specific item due to the importance of the amount. With regard to the main examples of audit sampling, refer to "(4) Audit sampling and testing specific items".

(3) Substantive analytical procedures

Case 1: Performing substantive analytical procedures

FREQUENT

①For the audited company, which operated a payment agency business, the engagement team performed a substantive analytical procedure for cost of sales, developing expectation for cost of sales by multiplying sales for the current term by the cost of sales rate for the previous term.

However, the audit team **did not consider whether it was appropriate to calculate the developed expectation by multiplying by the cost of sales rate for the previous term, even though the cost of sales included costs arising from the settlement amount, costs arising from the number of settlements, costs arising separately without being linked to sales, and sales that did not give rise to cost of sales**.

(Auditing Standards Statement No. 520, paragraph 4) [Large-sized audit firms]

②The engagement team performed substantive analytical procedures for the audited company's labor costs. Specifically, the engagement team subdivided the recorded amounts for each account, which provide a breakdown of labor costs, into categories –cost of products manufactured, R&D expenses, and selling, general and administrative expenses other than R&D expenses – and then developed expectation based on the assumption that the ratio of each category to total labor costs had not changed from the previous term.

However, the engagement team did not ascertain the number of personnel in R&D organizations and non-R&D back-office organizations in the previous and current terms. Accordingly, the appropriateness of the assumption that the ratio of R&D expenses and selling, general and administrative expenses other than R&D expenses to the recorded amounts of each account into which personnel expenses are subdivided remained unchanged from the previous fiscal year was not sufficiently evaluated.

(Auditing Standards Statement No. 520, paragraph 4) [Mid-tier, and small and medium-sized audit firms]

《Points to Note》

When designing and performing substantive analytical procedures, there were still cases where the requirements of substantive procedures were met in form, but the reliability of data and the accuracy of estimates, which were necessary for reducing audit risk to a minimum acceptable level, were not examined. For example, the engagement team used the results of the previous fiscal year and earnings forecasts as estimates without reasonable grounds. The engagement team should give due consideration to the nature and relevance of the information, and consider the possibility of material misstatement regarding the difference between the auditor's expectation and the amount reported.

Case 2: Investigation of results of substantive analytical procedures

FREQUENT

In substantive analytical procedures for cost of sales, the engagement team identified that the difference between the expenditure items listed as cost of sales and the expectation of the auditor exceeded the acceptable difference.

However, the engagement team **merely inquired the difference with the audited company and obtained a response, and did not obtain audit evidence to corroborate the audited company's response**.

(Auditing Standards Statement No. 520, paragraph 6) [Mid-tier, and small and medium-sized audit firms]

《Points to Note》

In some cases, the engagement team only performed an inquiry to obtain qualitative reasons regarding the nature of differences when investigating the differences between the amounts recorded on financial statements and the auditor's expectation. The team did not perform a quantitative investigation and analysis by each cause and did not obtain specific audit evidence to support the qualitative reasons. In substantive analytical procedures, the engagement team needs to investigate differences from expectations and reasons for inconsistencies with other related information considering that the differences subject to further investigations may turn out to be material misstatements.

(4) Audit sampling and testing specific items

Case 1: Planning of audit sampling

FREQUENT

①The engagement team planned audit sampling as tests of details for the value of goods purchased by the audited company. The team performed dual-purpose tests doubling as substantive procedures in the form of cross-checking supporting documents for 25 cases to evaluate the operation of internal control in respect of the value of goods purchased between April and September, and cross-checked supporting documents for the value of goods purchased between March 16 and March 30 for 24 cases.

However, the engagement team **limited the period under the substantive procedures relating to the value of goods purchased and therefore did not select samples in a way each sampling unit in the population has a chance selection**.

(Auditing Standards Statement No. 530, paragraphs 7) [Mid-tier, and small and medium-sized audit firms]

NEW ②In order to verify the audited company's sales, the engagement team cross-checked samples selected through audit sampling against relevant vouchers.
However, the engagement team could not compare some sales transactions in the sample with external evidence such as order forms and acceptance notifications because the audited company did not possess such evidence. Despite this situation, the engagement team **did not examine the appropriateness of audit evidence obtained through alternative procedures**.
(Auditing Standards Statement No. 530, paragraph 10) [Large-sized audit firms]

《Points to Note》

When designing audit sampling, the engagement team needs to consider the purposes of audit and the most suitable combination of audit procedures to achieve those purposes, in consideration of the characteristics of the population from which samples are to be selected.
In deciding the number of samples, it is necessary to note that the way of determination thereof for tests of operating effectiveness of internal control differs from that for tests of details, in general. Therefore, when using the number of samples, which was for the tests of controls, also for the tests of details as in the above example case, it is necessary to examine whether the number of samples is sufficient for tests of details.
With audit sampling, samples should be selected in a way that provides opportunities for all items within the population to be selected; therefore, it is necessary to pay attention to the completeness of the population for selection.
Note that if misstatements are discovered in some selected items in a population using sampling, it is necessary to estimate the total amount of misstatement in the population as a whole.

Case 2: Selecting specific items

The engagement team identified risks of material misstatement (including in regard to existence and completeness) in respect of the cost of sales (value of goods purchased) and performed cutoff tests using data for transactions near the closing date of the term and also performed balance confirmation procedures regarding accounts payable as of the closing date of the term.
However, the engagement team did not obtain sufficient and appropriate audit evidence regarding the cost of sales (value of goods purchased), as the team only performed tests of details for transactions near the closing date of the term that were subject to the cutoff and the accounts payable balances subject to confirmation procedures, and did not perform tests of details in respect of the remaining transactions after these had been excluded.
(Auditing Standards Statement No. 500, paragraphs 9 and A55) [Mid-tier, and small and medium-sized audit firms]

《Points to Note》

As the above case shows, numerous deficiencies are still being observed. These include the failure to consider whether additional procedures should be considered for the remaining part of the population after some selected items in the population have been tested.

Testing some selected items in a population, which involves extracting specific items from transaction types or account balances, is an effective method for obtaining audit evidence, as it allows for the examination of atypical transactions, high-risk items, and monetary materiality, as well as the acquisition of information about the nature of transactions. Unlike audit sampling, however, it needs to be kept in mind that audit evidence is not provided concerning the remaining part of the population, namely the components of the population that are not extracted as samples.

(5) Related parties

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

FREQUENT

In examining whether or not there were any related parties and related party transactions, the engagement team stated that it confirmed that there were no related parties of which the audited company or engagement team were not aware by inquiring with the audited company and reviewing the minutes of various meetings.

However, the engagement team did not conduct sufficient risk assessment procedures in respect of the completeness of related parties and related party transactions, as the team **evaluated the content of the responses to its inquiries without understanding the internal controls established by the management**. Moreover, the engagement team **did not obtain sufficient and appropriate audit evidence in respect of the completeness of related parties, as the team did not confirm the names of related parties and their relationship to the audited company** when the audited company replied only that there were related parties.

(Auditing Standards Statement No. 550, paragraphs 12 and 13) [Mid-tier, and small and medium-sized audit firms]

《Points to Note》

As the above case shows, there were cases where the engagement team did not examine related parties and transactions with related parties completely. If the management has implemented an internal control for identifying related party transactions and approving significant transactions, the engagement team needs to understand the internal control and perform other appropriate risk assessment procedures as deemed appropriate.

Further, the following examples of failure are found for the disclosure of related party transactions:

- **The audited company did not appropriately disclose the terms and conditions while the audited company provided non-interest bearing loans and guarantee without any charge; and**
- **The engagement team did not sufficiently examine the terms and conditions of transactions that were disclosed as arm's length transactions.**

The engagement team should carefully evaluate whether identified relationships with related parties and related party transactions have been properly accounted for and disclosed in accordance with the applicable financial reporting framework.

For information on cases related to identification and assessment of the risks of material misstatement and audit procedures responsive to the assessed risk regarding related party transactions, including the consideration of fraud risk required in the Auditing Standards Statement No. 240, also see "1. The Auditor's Responsibilities Relating to Fraud in Financial Statement Audits".

Case 2: Identification of significant related party transactions outside the audited company's normal course of business

NEW

The audited company acquired a new business in order to strengthen its revenue base, and under the business acquisition agreement relating to this case, the customer of the product was limited to one company, and the product was stored in an external warehouse designated by the customer.

The engagement team determined that the transaction, which was intended to enter a new business, was a significant transaction outside the audited company's normal course of business, and through interviews with the management, the engagement team obtained an understanding of the distribution channel for the Business and the economic rationale of the business model for the Business.

However, the engagement team **did not recognize that the customer to whom the products relating to the business were sold was a related party of the audited company and did not accurately understand the particularities of the business.** In addition, **regarding the reasonableness of the business acquisition, the engagement team did not critically examine and assess whether the business acquisition implied the possibility that the transaction had been carried out for fraudulent financial reporting or to conceal the misappropriation of assets**.

(Auditing Standards Statement No. 550, paragraph 22) [Mid-tier, and small and medium-sized audit firms]

《Points to Note》

Related party transactions sometimes carry higher risks of material misstatement of financial statements than third party transactions. Therefore, as a precondition for audit procedures, the engagement team needs to comprehensively understand the audited company's related parties and its relationships with them. The engagement team needs to be aware that if it discovers significant transactions with related parties outside the audited company's normal course of business, it must treat them as a significant risk.

Furthermore, with regard to significant transactions with related parties outside the audited company's normal course of business, the engagement team needs to carefully consider not only whether they have been disclosed, but also whether their business rationality, or lack thereof, points to the possibility that they have been conducted for the purpose of producing fraudulent financial statements, and whether the

transaction terms are consistent with the explanations by management.

(6) Going concern

Case: Evaluation of management's assessment of going concern assumptions

FREQUENT

Although there were events or conditions casting significant doubt on the going concern assumptions, such as a negative cash flow from sales activities, the audited company determined that there was no material uncertainty regarding its going concern assumptions, as the company had implemented cost reductions and other measures to eliminate the events or conditions in the doubt.

Amid this situation, the engagement team examined the consistency of the statement of cash receipts and disbursement prepared by the audited company with the budget and maximum credit line.

However, the engagement team did not sufficiently examine the reliability of basic data in the budget prepared by the audited company, nor the evidence for the audited company's assumptions forming the basis for the preparation of the budget. Moreover, with regard to additional borrowing in the statement of cash receipts and disbursement, the engagement team did not conduct a detailed examination of the feasibility of additional borrowing in excess of the maximum credit line. (Auditing Standards Statement No. 570, paragraphs15) [Mid-tier, and small and medium-sized audit firms]

《Points to Note》

Early signs of significant events or conditions that may damage the continuity of business operations are likely to appear in business activities, so the engagement team should carefully ascertain any events or conditions that would cast significant doubt on the going concern assumption. Furthermore, when there are events or conditions that might cast significant doubt on the going concern assumption of the audited company, the engagement team should consider the potential need to revise the evaluation as to the risks of material misstatement and nature, timing and scope of further audit procedures.

In addition, the engagement team needs to comprehensively evaluate the circumstances of the audited company and to consider based on concrete audit evidence whether management’s plans for future actions in relation to its going concern assessment were effective and feasible.

(7) Subsequent events

Case 1: Examination of events that occurred between the date of the financial statements and the date of the auditor's report

The audited company executed an agreement to extend the due date of the significant loan that was approximately 20% of the audited company’s total assets, and publicly disclosed the information.

However, the engagement team failed to consider whether the due date extension was a subsequent event that would require revisions in the audited company’s financial statements or affect the audited company’s financial statements in the following year and thereafter.

(Auditing Standards Statement No. 560, paragraph 7) [Mid-tier, and small and medium-sized audit firms]

《Points to Note》

In many cases, engagement teams performed audit procedures related to subsequent events only by making inquiries with the management. The engagement teams need to perform audit procedures regarding subsequent events for the period between the balance-sheet date and the date of the auditor's report, including at least (Refer to Auditing Standards Statement No. 560, paragraph 6):

- **Understanding the procedures performed by the management to identify subsequent events;**
- **Inquiries with the management;**
- **Inspection of the minutes of board of directors meetings; and**
- **Review of the latest subsequent monthly financial statements, if available.**

Case 2: Examination of facts learned by an auditor after financial statements were released

The audited company excessively eliminated the amount of deferred tax assets by mistake with regard to the journal entry of the eliminations of intercompany balances when preparing a consolidated financial statement based on the Companies Act.

The engagement team expressed an unqualified opinion in the auditor's report based on the Companies Act while overlooking the excessive elimination. However, later, when the consolidated financial statement was published, the engagement team identified the excessive elimination and submitted the auditor's report regarding a corrected financial statement.

Still, when preparing the corrected auditor's report, the engagement team did not consider whether the error overlooked in the pre-correction auditor's report should be included as a matter for emphasis or as other matter.

(Auditing Standards Statement No. 560, paragraph 15) [Mid-tier, and small and medium-sized audit firms]

《Points to Note》

In addition to the above example cases, if, after the date of the auditor's report but before the date the financial statements are issued, a fact becomes known to the auditor that, had it been known to the auditor at the date of the auditor's report, may have caused the auditor to amend the auditor's report, the auditor shall implement the following procedures (Auditing Standards Statement No. 560, paragraph 13):

- **Discuss the matter with management**
- **Determine if financial statement revisions or disclosures in financial statements are required**
- **If the financial statements need to be revised or there need to be disclosures in the financial statements, ask management how they plan to handle the matter in the financial statements.**

4. Auditing Accounting Estimates

Points of focus

The CPAAOB inspects audit firms regarding auditing accounting estimates from the following perspectives:

- Whether, considering the degree of estimation uncertainty, the engagement team appropriately identifies and assesses the risks of material misstatement in the accounting estimates, and performs appropriate audit procedures to address such risks, particularly considering the reasonableness of management's assumptions;
- Whether the engagement team identifies any indication of possible management bias, considering the risks of material misstatement due to fraud, and performs further audit procedures responsive to the management bias if any; and
- Whether, in the case that the engagement team identifies significant risks in accounting estimates, the engagement team performs an evaluation required under Auditing Standards Statement No. 540, paragraph 14 in addition to the planned audit procedure.

Outline of inspection results

There are many cases in which a lack of professional skepticism by the engagement team in auditing accounting estimates leads the engagement team to be content with understanding management's assumption and the accounting processes and not objectively evaluate management's insists on, for instance, the appropriateness of inventory valuation rules, the impairment of fixed assets, and the recoverability of deferred tax assets that determines the feasibility of the business plan used in making accounting estimates, and not carry out procedures for verifying the rationality of these insists.
Further, required audit procedures were often not performed, due to the lack of understanding of requirements under Auditing Standards Statement No. 540.

(Observed effective efforts)

The following case can be cited as an effective effort observed to improve procedures for auditing accounting estimates.
The engagement team unambiguously communicates to management at the audit planning stage its policy of not accepting management's assumption that are not clearly supported when examining the audited company's business plan.

Expected response

Accounting estimates are accompanied by uncertainty, and the risks of material misstatement associated with them depend on the degree of the uncertainty. Thus, auditors should examine the estimation uncertainty—including the nature and method of accounting estimates, associated internal control, indications of management bias—and should identify and assess the risks of material misstatement.

Auditors should also perform appropriate audit procedures relevant to the risk of identified and evaluated material misstatements, and **verify the reasonableness of the management's estimates from a critical standpoint** as professionals.

With regard to the impact of COVID-19 on the audit of accounting estimates and how to respond to the impact, refer to "II. Quality Control System: Impact of COVID-19 and International Situations on Audit Engagements and Response."

(Amendments to Auditing Standards Statement 540 "Auditing of Accounting Estimates")
Although the Auditing Standards Report No. 540 "Audit of Accounting Estimates" was revised in January 2021, it is be applied to the audit of financial statements for the fiscal year ending March 31, 2023. Therefore, the provisions, on which deficiencies identified in the CPAAOB's inspections before the 2022 business year are based, remain unchanged.

(1) Matters common to auditing accounting estimates

Case 1: Reasonableness of management's assumptions

NEW

FREQUENT

①The audited company did not recognize an impairment loss on fixed assets of a consolidated subsidiary, because the value in use, which was based on discounted future cash flows according to the business plan of the subsidiary, exceeded the book value of the fixed assets as a result of an impairment test conducted in accordance with International Financial Reporting Standards.
On the other hand, regarding the management's assumptions implied in the business plan of the subsidiary, which were used in estimating discounted future cash flows in the impairment test, the engagement team inquired with management and reviewed market forecasts and new vehicle unit sales forecasts published by an external market research company.
However, with regard to the increase in sales in the business plan, the engagement team **did not examine the reasonableness of specific sales growth factors (including the method of estimates and the basic data actually selected and used by management) or the reasonableness of management's assumption that the cost of sales ratio would continue to decrease**. In addition, the engagement team did not examine the reasonableness of the discount rate used for calculating discounted future cash flows in the above mentioned impairment test.
(Auditing Standards Statement No. 540, paragraph 7, 9 and 12) [Mid-tier, and small and medium-sized audit firms]

NEW

②Regarding to the advance payment to the non-consolidated subsidiary that had capital deficit, for which the audited company did not record an allowance for doubtful accounts, the engagement team reviewed the operating profit plan (hereinafter referred to as the "profit plan") and repayment plan (hereinafter referred to as the "repayment plan") of non-consolidated subsidiary. Based on this review, the engagement team determined that it was appropriate to classify the advance payment as recoverable general receivables, based on the assumption that the operating profit in the profit plan would be fully used to repay the advance payment and that the same amount would continue to be repaid until the repayment is completed.

However, the engagement team **did not retrospective review on the estimated figures such as sales and operating profit by comparing the projected amount to the actual amount for the current year, regarding the estimation uncertainty. In addition, the engagement team did not examine the reasonableness of the profit plan or the management's assumptions underlying the repayment plan (i.e., the assumption that the entire amount of operating profit in the profit plan would be used to repay the advance payment and the assumption that repayment of the same amount would continue until repayment is completed).**

(Auditing Standards Statement No. 540, paragraph 7, 9 and 12) [Mid-tier, and small and medium-sized audit firms]

NEW

FREQUENT

③ In valuing the investment in subsidiaries and associates of wholly owned non-consolidated subsidiary Company A, the audited company recognized that the net assets of Company A declined by less than 50% of the acquisition cost. And the audited company examined the necessity of write-downs based on Company A's business plan for the next fiscal year and thereafter, and determined that the audited company did not need to write-down of the investment in subsidiaries and associates on the grounds that although Company A's net assets would not recover to the acquisition cost in five years, the acquisition cost included excess earning power, and that the excess earning power had not been impaired.

With regard to the audited company's valuation of the investment, the engagement team understood that Company A would continue generating a certain level of profits from subleasing a real estate, which Company A leased from a third party outside the group, to the audited company, and deemed it appropriate that the audited company did not need to recognize write-down on the investment.

However, the engagement team **did not examine the reasonableness of the audited company's assertion that the excess earning power was not impaired. For example, the engagement team did not compare the actual results with the business plan of Company A, which the audited company developed upon acquisition of Company A’s shares, or did not analyze or examine the differences between the plan and the actual results**.

(Auditing Standards Statement No. 540, paragraph 12) [Large-sized audit firms]

《Points to Note》

Other than the examples above, it is necessary to also review the grouping of impairment of long-lived assets to determine whether the rules set by management match the actual situation of the company and whether the rules that were considered in prior fiscal years still match the actual state of the company when there were changes in the company or the environment surrounding the company. However, there are some cases where the engagement team accepted such management's assumptions without examining them in

detail, and simply checked whether the estimate amount was calculated in accordance with management's assumptions.

When examining accounting estimates, including the evaluation of investments in and loans to subsidiaries and associates, impairment of fixed assets and recoverability of deferred tax assets, engagement teams often evaluate the reasonableness and other aspects of business plans prepared by the management. However, there were many cases in which the engagement team did not sufficiently and appropriately examine the reasonableness of the business plan from a critical standpoint as professionals. For example, the engagement team evaluated the business plan qualitatively only through interviews with the management without checking the details of the business plan based on concrete evidence. Engagement teams should keep in mind that they should carefully consider business plans. For example, they should examine the consistency between business plans and the business environments as understood by themselves, compare the plans with past actual results, check specific measures that form the basis of numerical projections contained in the plans, such as revenue growth and cost reduction, and examine the feasibility of the measures.

In particular, when significant risk has occurred with regard to accounting estimates, engagement teams must evaluate the following (Auditing Standards Statement No. 540, paragraph 14):

- **The methodology taken by management to consider an alternative assumption/result and their reasons for not using such alternative assumption/result; or the process of examining the estimation uncertainty in the case that management did not consider an alternative assumption/result;**
- **The reasonableness of management's material assumptions; and**
- **Management's intent and capability to abide by their principles, in terms of the reasonableness of the management's material assumptions or the appropriateness of the applied reporting framework.**

Case 2: Review of the method of management's accounting estimates

NEW

FREQUENT

①When examining impairment of fixed assets, the audited company grouped assets on a divisional basis, allocated corporate expenses to each asset group, and calculated the profit / loss from operating activities of each asset group.

The basis for allocating head office expenses of the audited company in the previous fiscal year and in the current year, as in management accounting, is as follows:

Previous year: Apply to each division the portion of corporate expenses at the amount that is calculated based on the actual sales of each division multiplying by a certain percentage. Thereafter, allocate the remaining corporate expenses after deducting the portion of corporate expenses according to the percentage of the income of each division.

Current year: Allocate corporate expenses as a percentage of each division's budgeted income to the total budgeted income of all divisions.

As an audit procedure to test the appropriateness of the allocation basis for corporate expenses, the engagement team conducted interviews with management, reviewed materials summarizing the audited company's policy on the application of accounting for impairment of fixed assets, and reviewed divisional income statements generated from the accounting system so that the engagement team could gain understanding on the content and the allocation basis of corporate expenses.

However, the engagement team **did not examine whether the change in the allocation basis for corporate expenses from the previous year was appropriate in light of changes in the circumstances at the audited company in the current year**.

(Auditing Standards Statement No. 540, paragraph 7, 11 and 12) [Mid-tier, and small and medium-sized audit firms]

NEW

FREQUENT

②When identifying and valuing the intangible assets of a company acquired in the current fiscal year, the audited company did not record customer-related intangible assets in the consolidated financial statements, as the audited company noted that (a) only customer-related intangible assets were identified as intangible assets and (b) such customer-related assets were immaterial in the intangible asset valuation report obtained from an external expert.

The engagement team reviewed the intangible asset valuation report prepared by the external expert and noted that the amount of customer-related assets in the report was immaterial.

However, even though the engagement team used an intangible asset valuation report prepared by the external expert that the management used, **the engagement team did not understand the information, which the external expert utilized to identify intangible assets, or the method which the external expert applied to value the identified customer-related intangible assets, therefore the engagement team did not evaluate the appropriateness of the report as audit evidence**.

(Auditing Standards Statement No. 500, paragraph 7 and No. 540, paragraph 12) [Mid-tier, and small and medium-sized audit firms]

《Points to Note》

With regard to accounting estimation methods applied by the management, it is necessary to evaluate the following points: whether the management appropriately applied the requirements of the accounting standards related to the accounting estimate; whether the methods for making accounting estimate are appropriate in light of the purpose of the accounting standards; whether the method for making accounting estimate has been applied consistently; and, whether changes, if any, in accounting estimates or in the method for making them from the prior period are appropriate in the circumstances at the time.

Furthermore, engagement teams should keep in mind that, testing how management made the accounting estimate may involve the following(refer to Auditing Standards Statement No. 540, paragraph A68):

- **Examination as to the accuracy, completeness and relevance of the basic data used for accounting estimates, and whether the accounting estimates are made appropriately with the basic data and management's assumptions;**

- **Examination as to the source of information, the relevance, and reliability of external data or information (including information from external experts used by management);**
- **Examination as to the consistency of information for accounting estimates and the recalculation thereof; and**
- **Examination of management's review and approval for accounting estimates.**

Case 3: Review of prior period accounting estimates

NEW

FREQUENT

Company B, a consolidated subsidiary of the audited company, continued to record operating losses. However, in examining the recognition of impairment losses on fixed assets in the current year, the audited company determined that the audited company did not need to recognize impairment losses on fixed assets, as the undiscounted future cash flows according to the business plan exceeded the book value of fixed assets. The audited company expected that Company B's would turn to operating profit, as the overall fixed costs would decrease compared to the current year due to reduction of personnel expenses by securing personnel and promoting employee retention, and as well as the reduction of the fixed costs other than personnel expenses.

With regard to management's assumptions regarding Company B's fixed-cost reductions, the engagement team inquired with management to understand the management's assumptions. In addition, the engagement team understood that increase in personnel expenses in the current year was due to a temporary factor, and compared the planned figures for the next year with the actual figures for the current year, and determined that the management's assumptions were not unreasonable.

However, the engagement team **did not specifically understand the nature and reason for the difference between the planned figures and actual figures, while, Company B**'s **continued to record operating loss and the actual figures of operating profit or loss for the current year fell short of the planned figures. In addition, the engagement. The team did not assess the possibility of management bias or the degree of uncertainty included in management's estimate of fixed assets**.

(Auditing Standards Statement No. 540, paragraph 7, 8 and 12) [Mid-tier, and small and medium-sized audit firms]

《Points to Note》

In some cases, when reviewing the audited company's accounting estimates, the engagement team only ascertained the amount of deviation between the value estimated in the previous period and the outcome in the current period and the reason therefor, and did not consider the background of the deviation in evaluating the management's estimate for the current period. The team needs to note that reviewing the accounting estimates for the previous period is required in order to identify possible management bias and evaluate the degree of the estimation uncertainty.

It should be noted that the existence of a difference between outcome of accounting estimate and estimated

amounts in the previous year's financial statements does not necessarily indicate a misstatement in the previous year's financial statements. However, it is possible to make a reasonable basis that the audited company could estimate close to the actual amount, if management used certain information available when estimating, as well as information reasonably expected to be obtained or considered when preparing the financial statements. In such a case, the auditor needs to consider that the difference could increase misstatements in the previous year's financial statements.

(2) Evaluation of shares in subsidiaries and affiliates

Case 1: Examination of excess earning power in the valuation of shares

The audited company obtained shares in an equity method affiliated company in anticipation of excess profitability, and, when valuing the shares, examined whether or not there would be any damage to excess profitability by comparing the business plan at the time of acquiring the shares with the actual figures. Specifically, although the actual profit of the equity method affiliated company in the fourth quarter was lower than the plan, the audited company determined on the basis of the business plan revised at the end of the fiscal year in light of actual performance that there was no need to write down shares in affiliates, as the root cause was a lag due to the delayed progress of the business plan.

Amid this situation, the engagement team confirmed that the cause of actual performance falling below the plan was the lag, and, after examining the feasibility of the revised business plan, deemed the audited company's assertion that no write-down was required to be valid.

However, the engagement team **did not sufficiently examine the impact on the initially anticipated excess profitability of the situation in which the revised business plan had been revised downwards from the business plan at the time of acquisition**.

(Auditing Standards Statement No. 540, paragraph 11 and 12) [[Large-sized audit firms]

《Points to Note》

In addition to the aforementioned examples of identified deficiencies, there were cases in which the engagement team did not quantitatively examine the reasonableness of the management's assumption that business performance would substantially improve, even though the subsidiary's net asset value was less than 50% of its acquisition value (refer to (1) Matters common to auditing accounting estimates, Case 1 ③), or in which the engagement team did not examine the reasonableness of the audited company's judgment regarding the evaluation of shares in a subsidiary with poor business performance, even though the value of the shares, which was estimated to be likely to recover in roughly five years based on the subsidiary's business plan, failed to reach the book value and remained at around 50% of the book value; or in which the engagement team did not consider the need for a write-down of shares held by the subsidiary in an insolvent subsidiary of its own, and thus did not appropriately value the net asset value of shares in the subsidiary.

When the net asset value of shares in subsidiaries and affiliates whose market value is considered to be

very difficult to be identified has fallen by around 50% compared with the acquisition value, it is necessary to assume that the net asset has declined significantly and book a reasonable amount of impairment losses. The same treatment of asset impairment is applicable to the evaluation of shares in recently acquired subsidiaries and affiliates, and therefore, it is necessary to carefully examine the possibility of a decline in the net asset, including examining the discrepancy between the initial business plan and the actual results.

(3) Valuation of receivables

Case 1: Review of recognition and measurement

The audited company booked an allowance for bad debts based on past default rates to prepare for losses due to debt default. Specifically, it categorized claims as either (1) those for which no more than one year had passed since they fell into arrears or (2) those for which more than one year but no more than three years had passed since they fell into arrears, and then calculated the allowance for bad debts using the three-year-average default rate computed as follows for each of the categories (1) and (2).

With regard to (1), it computed the past default rate using the balance of receivables as the denominator and the amount of defaults in the following year as the numerator, while with regard to (2), it computed the past default rate using the balance of receivables as the denominator and the amount of defaults in the following two years as the numerator. Furthermore, the audited company re-categorized receivables for which three years had passed since they fell into arrears as bankruptcy/rehabilitation receivables, and booked an allowance for bad debts for the entire amount of the bankruptcy/rehabilitation receivables.

However, the engagement team did not adequately consider whether the above-mentioned period categories and default-rate calculations, which the audited company used to estimate future losses from defaults on receivables, were consistent with actual losses by the audited company incurred as a result of defaults.

(Auditing Standards Statement No. 540, paragraph 7 and 14) [Large-sized audit firms]

《Points to Note》

In addition to the above example cases, there were cases in which the engagement team did not sufficiently examine the reasonableness of the estimation method of taking into account the uncertainties according to the period during which receivables were scheduled to be recovered (refer to (1) Matters common to auditing accounting estimates, Case 2 ①), or in which, regarding assets scheduled to be seized, the engagement team did not examine the reasonableness of the amount of assets that the audited company asserted could be recovered. When evaluating debt claims in cases where some assets are planned to be seized, it is necessary not only to identify the assets to be seized but also to sufficiently examine the feasibility of seizure and the estimated amount of assets that may be disposed of.

As for the method of evaluating receivables with default possibility, if it is difficult to obtain data that helps judge the debtor's ability to pay, one example option is using a simplified method of provisioning 50% of

the balance of receivables after the deduction of the estimated disposal value of the collateral in the term that the receivables are determined for the first time to have a default possibility. With regard to individually material receivables with default possibility, it should be kept in mind that it is necessary to obtain as much data as possible and to sufficiently examine whether the audited company conducted an appropriate estimation at the time of evaluation.

Case 2: Self-assessment of loans (appropriateness of borrower category)

When auditing a tier-2 regional bank, the engagement team did not examine the audited company's decision-making as to borrower category as follows:

a) While the engagement team considered that the "Reasonable and Highly Achievable Plan" prepared by a debtor was unachievable, the team agreed with the financial institution's decision to classify the debtor as category "requires attention." The engagement team did not perform audit procedures for the inconsistency above.

b) While recognizing that a debtor had substantially negative assets with an unrealized loss, the financial institution did not adjust the debtor's financial profile (including an adjustment based on the unrealized loss). However, the engagement team acknowledged the unrealized loss but did not examine the appropriateness of the financial institution's decision.

c) Despite the fact that a huge loss incurred by A Co. was covered by B Co., the audited financial institution did not treat the two companies as a group in its self-assessment process. However, the engagement team did not examine the appropriateness of not treating the two companies as a single group and assign to a single borrower category or review the financial condition of the two companies as a borrower group.

(Auditing Standards Statement No. 540, paragraph 14)[Large-sized audit firms]

《Points to Note》

In auditing a deposit-taking financial institution, it is often the case that the audited company's evaluation of loans is identified as a significant risk, and the audit plan is designed based on the internal controls. In that case, it is necessary to perform tests on the operating effectiveness of controls, in addition to substantive procedures. Re-performance, in addition to inspection of records and documents, is considered effective in the tests of operating effectiveness of controls regarding the allowance for doubtful accounts.
Extracting a borrower as a sample and re-performing self-assessment on it can cover both the tests of operating effectiveness and of details. However, it is important to fully consider that even when using identical information, procedures vary based on the purpose of these tests.

(4) Inventory valuation

Case: Review of the method used for management's accounting estimates

NEW

FREQUENT

With regard to the valuation of products and raw materials, the audited company had an accounting policy that the audited company write-down book values to zero due to decline in profitability, on the condition that the products, of which were expected to be hold for more than three years in the future, were unlikely to be sold (condition 1) and raw materials expected to be disposed of (condition 2). Also, the audited company determined that raw materials that were not subject to condition 2 would not have a decline in profitability, as such raw materials would not degrade physically and the audited company would need to hold a wide variety of raw materials.

The engagement team noted that the audited company evaluated products and raw materials in accordance with the above policy.

However, the engagement team **did not evaluate whether the aforementioned valuation method for products and raw materials of the audited company was appropriate to determine declines in the profitability of products and raw materials**.

(Auditing Standards Statement No. 540, paragraphs 7) [Mid-tier, and small and medium-sized audit firms]

《Points to Note》

In addition to the above example cases, there were cases in which: the engagement team did not sufficiently examine the reasonableness of the management's assumption that it was unnecessary to book valuation losses on retained inventory whose sales results were sluggish because those assets had not physically deteriorated and that sales activity was continuing; the engagement team did not examine the reasonableness of the audited company's assumption that with regard to current sales products and inventories held for the purpose of maintenance, valuation losses would not occur because they would not be sold at prices below their book values; the engagement team did not examine the reasonableness of the audited company's applying a uniform valuation loss rate to retained inventory according to the period of retention; or the engagement team did not sufficiently examine the reliability of calculation data regarding valuation losses prepared by the audited company.

Also, audited companies have inventories with special characteristics, such as real estate inventories for sale and development projects in progress, which are different in value and difficult to calculate an objective value for. It is necessary to keep in mind that these special inventories, in general, should not be excluded from the scope of reduction in book value due to a decline in profitability.

(5) Impairment of long-lived assets

Case 1: Consideration of cash-generating units

In performing impairment tests of fixed assets in consolidated financial statements, the audited company grouped its bricks-and-mortar store assets on the basis of the organizational units responsible for businesses under a particular brand (hereinafter referred to as "brand units").

Amid this situation, the engagement team did not undertake any particular examination of the cash-generating units, as the audited company grouped its store assets on the basis of brand units every fiscal year and there had been no change during the current fiscal year.

However, the engagement team **did not examine the appropriateness of the audited company**

grouping its store assets on the basis of brand units, even though the audited company published figures for the number of stores opened and closed in its monthly overview of sales and grouped those store assets on the basis of independent store units in those figures.
(Auditing Standards Statement No. 540, paragraphs 11) [Large-sized audit firms]

《Points to Note》

In addition to the above example cases, there were cases in which: the engagement team overlooked the discrepancy between the asset grouping and the reality; the engagement team did not examine the appropriateness of the classification of shared assets; or the engagement team merely checked the amount of profits/losses or cash flow generated from operating activities that was calculated by the audited company and the status of idle assets and failed to examine the appropriateness and completeness of the asset grouping. There are also cases in which, when the impairment loss of fixed assets after a change in grouping was not recognized, the engagement team did not exercise professional skepticism and sufficiently examine whether this change might have been an indication of fraud, and cases in which the engagement team did not fully examine the reasonableness of a change in a grouping in light of accounting standards, etc., when impairment has not been recognized in a given cash-generating unit because of a regrouping of fixed assets traditionally belonging to a single cash-generating unit into multiple generating units.
Cash-generating units should, as a principle, be a unit generating cash flows generally independent of those of other assets or cash-generating units. Therefore, the engagement team should examine the appropriateness of the policy to determine cash-generating units when the audited company monitors operating performance in smaller units than the cash-generating units determined by the audited company.

Case 2: Review of indications of impairment

FREQUENT

①As to new stores in business less than two years from the beginning of the fiscal year following their opening, the audited company determined that operating losses incurred or likely to be incurred on a continuous basis would be excluded from the assessment of indications of impairment, except that some significant change in the environment exists, because its new stores tend to suffer operating losses immediately after opening due to the nature of the business.
However, when examining the company's assessment of the indications of impairment for the new stores, the engagement team **did not consider whether the new store's operating losses represented a significant downward deviation from the business plan formulated when the store was opened**, although there are stores for which impairment losses are recognized just after their first two years in business.
(Auditing Standards Statement No. 540, paragraphs 12 and 14) [Large-sized audit firms]

NEW

FREQUENT

②When determining the indications of impairment of long-lived assets, the audited company set the minimum unit generating cash flows (hereinafter referred to as the "minimum unit asset group") for each business unit of the audited company and for each consolidated subsidiary. When aggregating the "profit (loss) from operating activities" for each minimum unit asset group, the audited company allocated corporate expenses incurred at corporate department, including accounting department, human resources department, and IT promotion department, to each minimum unit asset group at the amount that equivalent to management fee, while the audited company did not allocate the remaining amount after deducting the expenses equivalent to management fees to each minimum unit asset group.

The engagement team understood the audited company's allocation of corporate expenses, evaluated design effectiveness of internal controls relating to indications of impairment of fixed assets, and evaluated the reliability of information on the divisional income statement. And the engagement team examined the consistency between the assessment materials for indications of impairment and the divisional income statement, and evaluated the reasonableness of the assessment materials for indications of impairment prepared by the audited company. As a result, the engagement team determined that the audited company had appropriately identified indications of impairment.

However, the engagement team **did not evaluate the appropriateness of the audited company not allocating the amount remaining after deducting expenses equivalent to management fees out of the corporate expenses to the related minimum unit asset group**.

(Auditing Standards Statement No. 540, paragraph 11) [Mid-tier, and small and medium-sized audit firms]

《Points to Note》

In addition to the above examples, there were cases in which: the engagement team did not assess indications of impairment using profits/losses generated from operating activities when it had identified both those profits/losses and cash flow generated from operating activities; or the engagement team assessed indications of impairment based on the estimated figures before the end of the term and neglected to conduct assessment based on the actual figures at the end of the term although it recognized a significant deterioration in the actual figures compared with the estimated figures. With those cases in mind, engagement teams need to carefully examine indications of impairment.

Further, as a principle, when an asset or a cash-generating unit becomes idle, it means a change that will reduce the recoverable amount of such asset or cash-generating unit significantly in the scope and method that the asset, etc., is used. Therefore, when examining the indications of impairment of idle assets, the engagement team needs to carefully examine the reasonableness of the amount of time that has passed since the assets became idle. For example, in the case where an asset just fell into the idle state, the engagement team should examine whether the duration can be treated as time necessary to determine the future use of the asset.

NEW

Case 3: Review of recognition and measurement of impairment

FREQUENT

In examining impairment of long-lived assets, the audited company identified indications of impairment on asset groups related to business locations where operating income after corporate expenses was negative for two consecutive years. In addition, since undiscounted future cash flows were negative, the audited company measured impairment loss. Furthermore, in measuring impairment loss, no impairment loss was recorded for land, as the simple appraisal value based on the property tax appraisal value exceeded the book value of land. On the other hand, the audited company recorded the entire book value of depreciable assets such as buildings as impairment loss. The engagement team determined that the above method and amount of impairment loss on non-current assets by the audited company was appropriate.

However, with regard to the measurement of impairment loss on land, the engagement team **<u>did not evaluate the reasonableness of management's assumption that the appraisal value based on the property tax appraisal value would be the net selling value</u>**, and with regard to the measurement of impairment loss on depreciable assets such as buildings, the engagement team did not evaluate the reasonableness of management's assumption that the net selling value was zero and the entire book value was impaired.

(Auditing Standards Statement No. 540, paragraph 11 and 12) [Large-sized audit firms]

《Points to Note》

In addition to the above examples, there were cases in which: the engagement team merely inquired with the audited company about the business plan that formed the basis of the calculation of future cash flows and failed to examine the reasonableness of the plan based on specific supporting data; the engagement team examined only sales in the business plan and failed to examine cost of sales/selling costs, and general and administrative expenses; the engagement team did not examine the reasonableness of the process of determining the main asset of each asset group and the remaining economic life of the main asset, which form the basis of the estimation period of future cash flow; capital investment and repair costs necessary for maintaining the present value were not included in future cashflows, or were included, but not fully examined; after-tax discount rates were used even though future cash flows were pre-tax figures; the appropriateness of the discount rates used was not examined; or the recognition of impairment losses was assessed on the basis of profits/losses generated from operating activities rather than undiscounted future cash flows.

In addition, there are cases involving the use of real estate appraisal reports in which the engagement team did not examine the appropriateness of continuing to use real estate appraisal reports obtained in previous year's audit as audit evidence for the current fiscal year, cases in which real estate appraisal reports were used without evaluating the capabilities, competence and objectivity of the real estate appraiser used by the management, and cases in which the engagement team did not examine the reasonableness of not deducting the estimated disposal cost from the real estate appraisal value in calculating the net selling value.

The audited company must largely rely on projected future cash flows to decide whether to recognize and measure impairment loss. Therefore, when verifying the management's insists on the necessity to recognize impairment loss, the engagement team should note that it is necessary to carefully examine components of

the projected future cash flows, including the remaining economic life used to calculate the utility value of assets, and the business plan that is the basis of projection, and the reasonableness of the business plan. Additionally, when the audited company adopted net selling value as the asset's recoverable value, the engagement team should carefully examine the basis of calculating the net selling value.

(6) Valuation of goodwill

Case 1: Review of amortization period of goodwill

For an acquisition completed in the current period, the audited company accounted for the difference between the net assets of the purchased company and the acquisition costs as goodwill.

In this regard, the engagement team ascertained that the amortization period of five years determined by the audited company was appropriate only on the basis that the period did not exceed 20 years. Therefore, the team did not examine the appropriateness of the goodwill amortization period by verification of the period during which the subject goodwill would remain effective and the reasonable period of return on the investment.

(Auditing Standards Statement No. 540, paragraphs 11 and 12) [Mid-tier, and small and medium-sized audit firms]

《Points to Note》

The acquirer must estimate a reasonable period as the goodwill amortization period for each business combination based on the expected duration that the goodwill will remain effective, while the accounting standard also allows reference to a reasonable period for the recovery of the investment as a basis for the calculation of the value of the business combination. With this understanding, the engagement team should pay attention to the necessity to verify the appropriateness of the amortization period applied by the audited company.

Case 2: Indications of goodwill impairment

FREQUENT

①Although a consolidated subsidiary for which goodwill was recognized recorded operating loss after amortization of goodwill in the current fiscal year, the engagement team judged that the audited company's assertion that there were no indications of impairment was appropriate because the subsidiary had recorded operating profit in the previous fiscal year.

However, the engagement team **did not sufficiently examine the presence or absence of indications of impairment. For example, it did not compare the business plan at the time of the acquisition of shares in the subsidiary with the actual results**.

(Auditing Standards Statement No. 540, paragraphs 11 and 12) [Large-sized audit firms]

NEW

FREQUENT

②The audited company did not recognize an impairment loss for the goodwill, which the audited company recognized in the business combination conducted in the current year, as the audited company deemed that the value in use calculated based on discounted future cash flows according to the business plan of the acquired company exceeded the book value of the cash-generating units, including goodwill as a result of an impairment test on the goodwill in accordance with International Financial Reporting Standards.

With regard to management's assumptions in the business plan of the acquired company used for estimating discounted future cash flows, the engagement team identified sales growth rate only as a significant assumption, and performed substantive procedures for sales growth rate.

However, the engagement team **did not examine the reasonableness of assumptions other than the sales growth rate**, even though the business plan used for the audited company's impairment test assumed that the operating profit rate would continue to rise every period and that the number of employees hired would exceed the most recent actual number. In addition, while the engagement team **only compared the sales growth rate, which it identified as a significant assumption, with market forecasts in related fields published by an external organization and sales growth rates of other companies in the same industry, etc. it did not examine the reasonableness of sales growth factors specific to the acquired company (including the management's estimation method and basic data used), and did not sufficiently examine the reasonableness of assumptions used by the management**.

(Auditing Standards Statement No. 540, paragraph 7, 9 and 12) [Mid-tier, and small and medium-sized audit firms]

《Points to Note》

As can be seen from the above examples, if the value allocated to goodwill and other intangible assets is relatively high, it may be determined that there is an indication of impairment in the year of the business combination as well. Therefore, if a large amount of goodwill has occurred, engagement teams should also sufficiently examine whether there are indications of impairment in the year of occurrence of goodwill.

In addition to the above examples, there were cases in which the engagement team did not understand the management's assumptions regarding the valuation of goodwill for a group composed of several consolidated subsidiaries, relating to such matters as the breakdown of sums for individual companies in the group and the quantitative impact of measures (refer to (1) Matters common to auditing accounting estimates, Case 1, ①), and cases in which the engagement team did not sufficiently examine the feasibility of business plans. For example, in one such case, a business plan formulated at the time of acquisition failed to proceed as expected and the actual profit/loss figure fell significantly short of the target under the business plan, and as a result the business plan was revised and the difference between the recoverable value based on the revised business plan and the book value of goodwill was booked as impairment loss. However, when reviewing the revised business plan, the engagement team did not examine the revenues by type and examined only some portions of the revenues. Moreover, there were cases in which the engagement team did not sufficiently examine the inconsistency in the management's assumptions regarding accounting treatments. For example, in one such case, although the audited company booked impairment losses related to shares in a subsidiary in the non-consolidated financial statement, the engagement team did not examine

the impairment of the corresponding goodwill on a consolidated basis. Engagement teams should keep in mind the need to evaluate from a broad perspective whether the identified events have been comprehensively reflected in accounting.

In addition, in fiscal years when there has been a change in auditor, if the balance at the beginning of the fiscal year includes important goodwill or intangible assets, engagement teams should keep in mind the need to understand the management's assumptions forming the basis of the allocation of acquisition costs, in order to identify and evaluate the risk of material misstatement in regard to goodwill, etc.

(7) Recoverability of deferred tax assets

Case 1: Review of company classification

A consolidated subsidiary of the audited company booked a large tax loss in the current year. The audited company claimed that this was due to the impact of a drop in sales as a result of temporary factors, and that it would be easy for the audited company to reduce the management consulting fees which the audited company was receiving from the subsidiary.

Because of this, the audited company compared the total amount of taxable income of the audited company and the subsidiary with the amount of the tax loss, and classified the subsidiary as Category 2 in the ASBJ Guidance No. 26 “Implementation Guidance on Recoverability of Deferred Tax Assets” on the grounds that a “significant tax loss” had not arisen.

In response, the engagement team described in the audit documentation that the tax loss had arisen due to temporary causes and that the subsidiary was paying a large amount of management consulting fees to the audited company.

However, despite the fact that the taxable income for the next term as forecast in the subsidiary’s business plan was smaller than the tax loss, the engagement team did not examine whether, for the current year, it met the criteria for stating that a “significant tax loss” had not occurred.

(Auditing Standards Statement No. 540, paragraphs 7 and 11) [Large-sized audit firms]

《Points to Note》

In relation to the company classification specified in the ASBJ Guidance No. 26 “Implementation Guidance on Recoverability of Deferred Tax Assets”, the engagement team needs to remain conservative and carefully check the company classification in light of relevant accounting standards.

Regarding “taxable income excluding that arising from temporary causes” for categories 2 and 3 in the Implementation Guidance, the engagement team needs to examine whether “that arising from temporary causes.” was actually temporary or not with particularly careful manner.

Case 2: Estimation of taxable income

NEW

FREQUENT

The audited company determined that Company C, a consolidated subsidiary, was classified as Category 3 under ASBJ Guidance No. 26 “Implementation Guidance on Recoverability of Deferred Tax Assets” on Recoverability of Deferred Tax Assets, and recognized deferred tax assets within the limit of taxable income according to Company C's medium-term management plan. The audited company determined that the future taxable income of Company C would be the amount of income before income tax in the medium-term management plan, making estimated tax adjustment, assuming the operating income would be the same amount as income before income tax in the medium-term management plan. Since the period of the medium-term management plan of Company C was three years, the audited company estimated income before income tax for the fourth and fifth years at the same amount as in the final year of the medium-term management plan.

When examining the recoverability of Company C's deferred tax assets, the engagement team confirmed that the amount of income before income tax used to calculate the estimate of future taxable income was consistent with the amount of operating income in Company C's medium-term management plan.

However, **in evaluating the recoverability of deferred tax assets, the engagement team did not examine: (i) the reasonableness of Company C's medium-term management plan; (ii) the reasonableness of the audited company's assumption that operating income and income before income tax in Company C's medium-term management plan would be same amount; and (iii) the reasonableness of setting Company C's estimate of income before income tax for the fourth and fifth years at the same amount as the estimate for the final year of the medium-term management plan**.

(Auditing Standards Statement No. 540, paragraph 12) [Mid-tier, and small and medium-sized audit firms]

《Points to Note》

In reviewing the recoverability of deferred tax assets, the engagement team often examines the reasonableness and other aspects of the business plan prepared by the audited company's management for estimation of taxable income. There are cases where the engagement team judges that the estimation is conservative and achievability is high based solely on the fact that management calculated the estimation by multiplying the business plan by achievement rates in past years, without critically reviewing the business plan itself.

If the audited company posts deferred tax assets based on the sufficiency of taxable income before adjustment for temporary differences etc. backed by its earnings capability, the business plan, a basis for taxable income before adjustment for temporary differences etc., should in principle be approved by the board of directors. Further, in the case of material adjustments between the business plan and taxable income, the engagement team needs to perform audit procedures to secure the feasibility of taxable income, including verification of the reasonableness of adjustments from profits in the business plan to taxable income.

Case 3: Review of scheduling

FREQUENT

The audited company booked the full amount of an allowance for doubtful accounts for loans etc. to its poorly performing subsidiaries. The audited company determined that the deferred tax assets relating to the deductible temporary difference of the allowance for doubtful accounts were recoverable because they planned to waive their receivables in the future. The engagement team obtained a confirmation letter in the name of the representative director stating that the receivables would be waived at some unspecified point in the future for the liquidation or rehabilitation of the subsidiary, and therefore assessed that the audited company's accounting procedures for posting deferred tax assets relating to the allowance for doubtful accounts to be appropriate.

However, the engagement team **did not examine the reasonableness of the management assumption that the debt waiver would take place based on the facts that the representative director's stated that the debt waiver would take place at some unspecified time and additional loans had been made in the current fiscal year**.

(Auditing Standards Statement No. 540, paragraph 12) [Mid-tier, and small and medium-sized audit firms]

《Points to Note》

In addition to the above examples, in many cases, the engagement team did not appropriately or sufficiently examine the feasibility of the schedule for tax deduction of temporary difference in the future. For example, there is inconsistency between the assumption for valuation of securities and allowance for doubtful accounts and the planned period for tax deduction of relevant temporary differences in the future. The engagement team needs to exercise due care when examining the reasonableness of the schedule for tax deduction of deductible temporary differences arising from the valuation of investments in affiliated companies in particular, because complicated conditions such as organizational restructuring may often be involved.

In addition, in examining the deferred tax liabilities arising from undistributed profits of subsidiaries, there are cases in which the engagement team did not sufficiently examine the audited company's policy of not having subsidiaries pay dividends as a rule, and cases in which the engagement team did not sufficiently verify whether the dividend policy of foreign subsidiaries had been officially approved by an authorized decision-making body, etc.

Case 4: Review of the impact of business combinations

The audited company classified its consolidated subsidiary as Category 4 in ASBJ Guidance No. 26"Implementation Guidance on Recoverability of Deferred Tax Assets" because it had a significant tax loss, and it planned to merge with the subsidiary in the next fiscal year. Based on the post-merger taxable income, the audited company determined that the tax loss was recoverable and recorded deferred tax assets corresponding to the tax loss.

However, when examining the recoverability of deferred tax assets, the engagement team overlooked that this accounting treatment did not comply with ASBJ Guidance No. 10, which stipulates that the impact of the business combination cannot be taken into account until the actual business combination takes place, and that this impact is to be reflected from the year of the business combination.

(Auditing Standards Statement No. 540, paragraphs 11 and 12; ASBJ Guidance No. 10, paragraph 75) [Mid-tier, and small and medium-sized audit firms]

《Points to Note》

As pointed out in the examples above, the recoverability of deferred tax assets is judged by taxable income before the addition/subtraction of temporary differences based on the profitability of the acquiring company, and it is important to note that the impact of the business combination is to be reflected after the fiscal year in which the business combination takes place.

(8) Retirement benefit obligations

Case: Reliability of basic data

NEW

FREQUENT

The audited company provided the pension actuary engaged in the computation of retirement benefit obligations with the actuarial assumptions (discount rate, retirement rate, expected salary increase rate, etc.) and personnel data (salary, age, years of service, etc.) of each employee used in the computation of the retirement benefit obligations. The audited company booked provisions for retirement benefits in non-consolidated financial statements based on the computation results of the pension actuary.

The engagement team sent a confirmation letter concerning the computation results of retirement benefit obligations to the pension actuary, and confirmed that the amount in the reply on the confirmation letter matched the amount of retirement benefit obligations recognized by the audited company. In addition, the engagement team confirmed that the number of employees included in the pension actuary's computation matched the audited company's internal data.

However, the engagement team **did not examine the accuracy of the personnel data (salary, age, years of service, etc. of each employee) provided by the audited company to the pension actuary, and did not examine whether the assumptions used by the pension actuary in computing retirement benefit obligations conformed to the applicable financial reporting framework**.

(Auditing Standards Statement No. 500, paragraph 8, and No. 540, paragraph 12) [Mid-tier, and small and medium-sized audit firms]

《Points to Note》

When estimating retirement benefit obligations, it is necessary for auditors to examine the relevance, completeness, and accuracy of the underlying data of the audited company upon using the service of the management’s expert.

In addition, considering actuarial assumptions such as the discount rate could influence the computation results for retirement benefit obligations greatly, the engagement team should be aware of the importance of examining the appropriateness of the actuarial assumptions used by the audited company.

(9) Asset retirement obligations

Case 1: Look back review of accounting estimates in the previous fiscal year

NEW

FREQUENT

Of the leased stores, the audited company booked asset retirement obligations for properties for which restoration obligations were contractually owed, at the amount calculated by multiplying the past unit price of restoration expenses per square meter leased by the number of square meters leased. The audited company re-estimated the cost of restoring stores that had been decided to close by the Board of Directors and booked additional asset retirement obligations. The audited company also reversed asset retirement obligations for stores that had already been closed on the grounds that the actual cost of restoring them to their original state fell short of the amount booked as asset retirement obligations.

The engagement team understood the method used by the audited company to estimate asset retirement obligations, and examined that the method had been applied consistently since the previous fiscal year. The engagement team also evaluated the design and operation of internal controls relating to asset retirement obligations, performed a detailed substantive test relating to the recording of asset retirement obligations relating to newly opened stores, and examined the appropriateness of the amount of asset retirement obligations recorded by the audited company.

However, the engagement team **did not evaluate the reason for discrepancy between the estimated amount of asset retirement obligations for the previous year and the actual amount fixed in the current year**, nor **the reason for difference between the estimated amount of asset retirement obligations for the previous year and the re-estimated amount made in the current year**.

Furthermore, the engagement team did not perform substantive procedures for the additional amount of asset retirement obligations booked relating to stores that the audited company had decided to close.

(Auditing Standards Statement No. 540, paragraph 8 and 11) [Mid-tier, and small and medium-sized audit firms]

Case 2: Appropriateness when reasonable estimates cannot be obtained

FREQUENT

The audited company rents properties under restoration obligations, and of these, it booked asset retirement obligations for unprofitable stores for which impairment losses had been booked on the grounds that it is likely that the properties will be vacated when the terms of the leases expire, and that it is therefore possible to reasonably estimate the timing of performing restoration obligations. In the case of profitable stores and the company’s head office, on the other hand, it has not booked asset retirement obligations on the grounds that it is difficult to reasonably estimate the timing of performaning restoration obligations because there are no current plans to close stores or relocate the head office. This is despite the fact that stores have been closed and the head office has been relocated in the past.

In response, the engagement team identified the completeness of asset retirement obligations as a significant risk, but it did not perform any procedures to verify in detail past performance of restoration obligations other than having the audited company's explanation that the reasons for closes in the past were that stores had been unprofitable or that the floor areas of the stores were too small. Furthermore, the engagement team **did not obtain sufficient appropriate audit evidence concerning the reasonableness of the audited company's explanation that it was difficult to reasonably estimate the timing of performaning restoration obligations for profitable stores and the head office**.

(Auditing Standards Statement No. 330, paragraph 20; No. 540, paragraphs 11 and 12) [Mid-tier, and small and medium-sized audit firms]

《Points to Note》

Even if the amount of asset retirement obligations is not determined because the timing of performaning restoration obligations or the method of retirement is unclear, asset retirement obligations can be reasonably estimated if information to reasonably estimate the scope and probability of the timing of performance is available. Cases in which asset retirement obligations cannot be reasonably estimated are limited to cases in which the amount cannot be reasonably estimated even after all evidence available as of the balance sheet date is taken into consideration to make the best estimate. Therefore, the engagement team should keep in mind that when an audited company asserts that asset retirement obligations cannot be reasonably estimated, the team is required to carefully examine the reasonableness of such assertion, including the availability of information used for estimating asset retirement obligations.

(10) Others

Case 1: Provisions for loss on order received

FREQUENT

If a loss was forecast after comparing the value of a received order against the projected cost, the audited company would book provisions for loss on order received.

Amid this situation, the engagement team performed a risk assessment procedure focused on cases where the audited company had booked provisions for loss on order received at the end of the previous fiscal year by comparing the actual profit or loss realized during the current fiscal year against the provisions for loss on order received at the end of the previous fiscal year, and examined the difference. In respect of the provisions for loss on order received booked at the end of the current fiscal year, the engagement team observed the documents prepared by the audited company regarding the booking of provisions for loss on order received. Then, for an arbitrarily selected sample, the team vouched the projected cost with the revised cost projection data prepared by the audited company.

However, the following deficiencies were identified in the audit procedures performed by the engagement team:

a) Regarding cases where provisions for loss on order received had not been booked at the end of the previous fiscal year, the engagement team **did not sufficiently examine the completeness of the booking of provisions for loss on order received**, as the team did not examine whether or not there were any cases involving losses during the current fiscal year.

b) Amid a situation in which there were cases of loss during the current fiscal year and even though there were other cases in which losses were expected for items with the same name and for the same customer, the engagement team merely vouched figures with the revised cost projection data prepared by the audited company, however, the team **did not examine the reasonableness of specific assumptions used by the audited company, nor did the team examine the realizability of cost reductions**.

(Auditing Standards Statement No. 540, paragraph 8 and 12) [Mid-tier, and small and medium-sized audit firms]

Case 2: Consideration of estimates of total cost of construction on a percentage-of-completion basis

NEW

FREQUENT

A consolidated subsidiary of the audited company applied the percentage-of-completion method as the basis for revenue recognition pertaining to software development for customers. Sales were calculated by multiplying total contract revenue by the progress rate (the ratio of actual incurred costs as of the balance sheet date to estimated total cost of construction).

As an audit procedure for revenue on a percentage-of-completion basis for this consolidated subsidiary, which is a significant component, the engagement team confirmed that the estimated total cost of construction used for calculating the progress rate matched the estimated total cost of construction estimated in advance in the document for the estimate prepared by the audited company. However, the engagement team **only examined that the estimated total cost of construction was consistent with the amount in the document for the estimate prepared by the audited company and examined the internal approval status, and did not obtain an understanding of the detailed estimation method used by the audited company**.

(Auditing Standards Statement No. 540, paragraph 12) [Mid-tier, and small and medium-sized audit firms]

《Points to Note》

In addition to the above example cases, there were cases in which, although losses were booked in the current fiscal year with regard to construction contracts for which provisions for construction losses had not been booked in the previous fiscal year, the engagement team did not take into account the impact of the booking of those losses on the management's estimates, or in which the engagement team did not consider whether the management's assumption regarding the projection period of loss occurrence reflects reality.

The engagement team should keep in mind that they should obtain sufficient and appropriate audit evidence through the following procedures: appropriately identifying events which are expected to lead to the occurrence of expenses or losses in the future while taking into account the estimation uncertainty related to construction contracts; examining the reasonableness of underlying data related to the management's estimates and the management's assumptions; and reviewing accounting estimates in the previous fiscal year.

5. Group Audit

Points of focus

Recent fraud cases identified at domestic and foreign subsidiaries have increasingly drawn the attention of financial statement users. The CPAAOB inspects audit firms from the following perspectives:

- Whether the group engagement team appropriately assesses risks associated with the group financial statements and develops overall audit strategy and a detailed audit plan;
- Whether the group engagement team identifies significant components appropriately, including consideration of components with significant risks related to the group financial statements based on the nature and circumstance of each component, and does not simply make judgments based on whether the component is individually financially important;
- Whether the group engagement team appropriately understands the component auditors, gets involved in their procedures, and evaluates the appropriateness of such procedures performed;
- Whether the group engagement team appropriately communicates with the component auditors in situations that may influence the work of the component auditors during group audit, such as when a fraudulent material misstatement in relation to the group financial statements is identified; and
- Whether the group engagement team evaluates the component auditors' reports, requests additional audit procedures if necessary, or performs the audit procedures, thereby obtaining sufficient appropriate audit evidence; and whether the engagement team, in response to the component auditors' reporting of an uncorrected misstatement, appropriately assesses the impact of such misstatement over the group financial statements.

Outline of inspection results

In many cases, group engagement teams utilized on the audit results of component auditors putting too much reliance on them without fully evaluating them. There were also cases in which individual financial materiality was determined solely on the basis of the financial indicator of revenue when identifying significant components. There were also cases in which adequate risk assessment was not performed when identifying significant components, such as cases in which qualitative impacts such as the possibility of significant risks relating to group financial statements were not taken into account. There were also cases in which communication with component auditors was inadequate, such as cases in which risks were not appropriately communicated to component auditors. There were also cases in which the identification of significant risks relating to group financial statements and the adequacy of audit procedures to address these risks were not sufficiently considered. There were also cases in which consolidated journal entries were not examined.

(Observed effective efforts)

The following is examples of effective efforts aimed at ensuring and improving group audit quality.

- The quality control department prepares a list of discussion points to advance understanding of the group audit and implementation of the necessary responses. More specifically, the group engagement team can make it clear what should be done in the group audit by being presented available materials that describe in detail issues pertaining to group audits – tasks to be performed throughout the year, how to prepare audit documentation, methods for communicating with component auditors, etc. – and the responses thereto.
- A dedicated section was established within the audit business department to support and oversight engagement teams that conducted group audits on a global basis. Specifically, the dedicated section gathered information through questionnaire surveys of the engagement teams and interviews with the group engagement team with a significant component in emerging countries.
- The PICOQC emphasized through training that it was necessary to consider not only quantitative materiality such as value-based but also qualitative materiality, such as the existence of significant risk, when selecting significant components, in view of cases where an issue occurred in a component other than a significant component, resulting in restatement of the financial statements.
- The audit business department prepared, in cooperation with the advisory department, a checklist that summarized the key points in controlling foreign group companies. The group engagement team uses this checklist to improve its understanding of the audited company's consolidated financial reporting processes and risk management environment for new foreign group companies.

Expected response

The group engagement team is required to evaluate the work of the component auditors it uses, always bearing in mind that responsibility for issuing appropriate auditor's reports in audit engagements of group financial statements lies with the auditor expressing an opinion.

Group audit requires the group engagement team to sufficiently communicate with the component auditors about the types, timing and scope of audit procedures, as well as findings concerning the audit procedures performed for component financial information, and to obtain sufficient appropriate audit evidence about component financial information and consolidation processes so as to express opinions about whether the group financial statements have been prepared in accordance with the applicable financial reporting framework. Therefore, **the group engagement team needs to develop an appropriate audit plan, perform audit procedures, and evaluate whether sufficient appropriate audit evidence has been obtained to gain a basis for forming an opinion on group financial statements**.

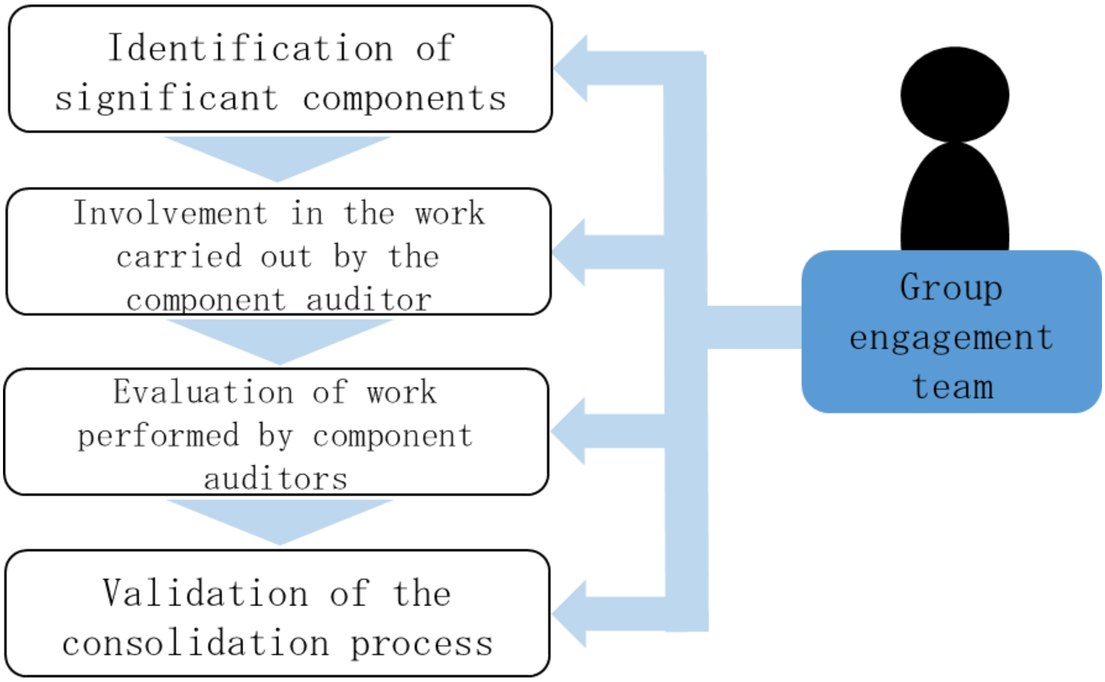
In particular, **when there are significant foreign components, the group engagement team is required to ascertain the circumstances of such key foreign business locations, communicate sufficiently with component auditors, and then appropriately identify the existing risks**.

To perform group audit appropriately, the group engagement team, in addition to the knowledge and experience required for general audit practice, is required to be equipped with additional capability to cope with any situations, such as language skills to instruct the component auditors in overseas countries and knowledge of the financial reporting framework of specific countries.

To achieve the above, audit firms should carefully assign engagement partners and other professionals to ensure and improve the quality of group audit.

In the case where the foreign component auditors are arranged in a multi-layered and complex structure, especially when involving an foreign component auditor outside the group auditor's network, audit firms should develop frameworks to provide instructions and support in relation to the group engagement team's instructions to and supervision of the foreign component auditors, evaluation of reports prepared by the foreign component auditors, and understanding of the audited company's management control over new affiliate companies added through acquisition, etc.

［Figure 6］ Reference image: Outline of responses required by the group engagement team



Regarding the impact of COVID-19 on group audits and response to the impact, refer to "II. Quality Control System: Impact of COVID-19 and International Situations on Audit Engagements and Response."

Case 1: Significant components

FREQUENT

①As a financial indicator used to identify components with individual financial significance, the engagement team used income before income taxes of a business plan that used in calculating materiality for the audit of the group financial statements as a whole. As Company A's income before income taxes as a percentage of the group financial statements was below a certain percentage, the engagement team did not identify Company A as a component with individual financial significance.

At the same time, as a fraud had occurred at Company A during the fiscal year, the engagement team identified fraud risks in overstatement of accounts associated with the fraud. The team also identified Company A as a significant component with significant risks related to group financial statements, and performed substantive procedures.

However, the engagement team **did not obtain sufficient and appropriate audit evidence to form the basis for expressing an opinion on the group financial statements, as the team did not perform any substantive procedures relating to Company A's accounts other than the aforementioned fraud risk-related audit procedures, even though Company A's revenue, cost of sales, and bonds and borrowings accounted for a relatively high share of accounts in the group financial statements**.

(Auditing Standards Statement No. 600, paragraphs 11 and 17) [Mid-tier, and small and medium-sized audit firms]

②The group engagement team did not consider the following, despite the fact that foreign subsidiaries Company B and Company C, neither of which deemed a significant component, recorded operating losses for both the previous fiscal year and the current fiscal year, though both of them hold fixed assets that exceed the materiality for the group audit as a whole.

a) The group engagement team only obtained a response from the component auditor that there was no risk of impairment of fixed assets and, **without obtaining sufficient information about the company and its business environments such as Company B’s future business plan, it determined that the financial statements of the component did not include significant risks**.

b) Although the group engagement team had not sufficiently evaluated cost-cutting elements, the key factors for improving profit/loss, when evaluating Company C's business plan in which operating profits was forecast in the next fiscal year, the group engagement team determined that this component’s financial statements did not include significant risks.

(Auditing Standards Statement No. 600, paragraphs 8 and 17) [Mid-tier, and small and medium-sized audit firms]

《Points to Note》

When determining significant components, it is necessary to take into account financial indicators used for assessing individual financial significance, not only revenue but also other items such as assets, liabilities, cash flows or earnings indicated in group financial statements, depending on the group's characteristics and circumstances. It is also necessary to make judgements in accordance with the specific characteristics and circumstances of components. For example, in addition to individual financial significance, qualitative significance, such as the possibility that components have significant risks related to group financial statements, should also be taken into account.

Case 2: Understanding the Component Auditor

The engagement team sent a letter of inquiry concerning quality control to the auditors of foreign components that had not been identified as significant components and requested a reply, in addition to requesting a report concerning the results of the audits and subsequent events, in order to understand those auditors.

However, the engagement team did not sufficiently perform the procedures to understand component auditors. For example, it did not obtain a reply to the letter of inquiry concerning quality control from multiple component auditors whom it asked to perform audits for the first time in the current fiscal year.

(Auditing Standards Statement No. 600, paragraph 18) [Mid-tier, and small and medium-sized audit firms]

《Points to Note》

The group engagement team should keep in mind that, when asking a component auditor to perform work related to the component's financial information, it should understand if there are any issues pertaining to the component auditor's independence, whether the component auditor has the skills of a professional expert, and whether it can involve itself in the work of the component auditor. When consigning the audit of components' financial statements prepared in accordance with the Japanese accounting standards to the auditors of foreign components, it is necessary to evaluate whether those auditors have the knowledge necessary for them when performing audits.

Case 3: Materiality

The group engagement team uniformly applied the upper limit given in the audit manual in determining the component materiality, and decided that the component materiality for all components were to be slightly below the materiality for the audit of group financial statements as a whole.

Although an employee fraud had been uncovered in the previous fiscal year at a subsidiary that was determined as a significant component of the audited company, the group engagement team did not consider whether it was necessary to set a different component materiality to such component in keeping with the circumstances of individual components, including those where fraud had been identified.

(Auditing Standards Statement No. 600, paragraph 20) [Mid-tier, and small and medium-sized audit firms]

《Points to Note》

To reduce the possibility that the total uncorrected and undiscovered misstatements in the group financial statements exceed group materiality to a minimum acceptable level, component materiality shall be set lower than the group materiality. The group engagement team needs to sufficiently understand the audited

company group and its business environment in deciding component materiality. If any change occurs in the business environment, the team needs to appropriately consider its effects and consider the adequacy of component materiality to perform appropriate audit procedures to response audit risks for each component. In addition to the above example cases, there were cases in which the group engagement team did not evaluate the appropriateness of the performance materiality, as exemplified by a failure to request component auditors to report on the performance materiality that they had determined.

Case 4: Deciding audit procedures to be performed for the financial information of components

Regarding procedures for responding to the significant risk regarding foreign subsidiaries of the audited company, the group engagement team made a request to the component auditors in the audit instructions, and received reports from them.

However, the group engagement team instructed the component auditors to perform agreed-upon procedures rather than audit procedures and failed to examine whether the agreed-upon procedures were sufficient as audit procedures to address the significant risks. As a result, it did not obtain sufficient and appropriate audit evidence with regard to the significant risks.

(Auditing Standards Statement No. 600, paragraphs 17, 25, and 26) [Mid-tier, and small and medium-sized audit firms]

《Points to Note》

The group engagement team should consider whether audit procedures to be performed have been planned appropriately for both significant components and other components, respectively.

Case 5: Involvement in audit procedures undertaken by component auditors

NEW

FREQUENT

①With regard to a foreign subsidiary that was a significant component, the engagement team identified a risk of "understatement of execution budget" used for the estimate calculation of the percentage-of-completion method of accounting as a significant risk related to group financial statements.

However, the engagement team **did not discuss with the component auditor the risk of "understatement of execution budget" used for the estimate calculation of the percentage-of-completion method of accounting, which the engagement team identified as a significant risk in group financial statements**.

(Auditing Standards Statement No. 600, paragraphs 29) [Mid-tier, and small and medium-sized audit firms]

FREQUENT

②Through discussions with the auditors of significant components, the group engagement team confirmed that the component auditors had identified the risk of management override and fraud risks in revenue recognition.

However, the group engagement team did not perform the following procedures, even though the team identified these risks as significant risks in the group financial statements.

a) **<u>With regard to the fraud risks in revenue recognition, the engagement team merely gained an understanding of the relevant assertions and was not sufficiently involved in risk assessment by the component auditors; for example, the team did not obtain the details of the risks in the concrete</u>**.

b) **<u>With regard to the risk of management override, the group engagement team did not fully evaluate the appropriateness of audit procedures to address the risk; for example, the team did not ascertain the selection criteria for journal entry tests performed by the component auditors as audit procedures to address the risk</u>**.

(Auditing Standards Statement No. 600, paragraph 29 and 30) [Large-sized audit firms]

《Points to Note》

With regard to significant risks in group financial statements, there was a case where the group engagement team did not get involved in the component auditor's risk assessments and did not assess the appropriateness of audit procedures to address the significant risks.

To address significant risks in group financial statements, the group engagement team needs to engage in appropriate communication with component auditors and assess the sufficiency and appropriateness of audit procedures planned by the component auditors.

Case 6: Consolidation process

①With regard to components' financial information included in the consolidation reporting package prepared by significant components, the engagement team had the policy of relying on the results of audits performed by component auditors for the examination of specified account balances concerning significant risks related to the group financial statements, while examining other financial information on its own.

However, with regard to the following financial information which was quantitatively material and for which the engagement team had decided to examine on its own, it merely ascertained the absence of unusual changes through trend analysis and other means, and failed to perform substantive procedures.

- The period-end balance of inventory purchased by the components from the consolidated group companies, which form the basis of journal entries concerning the elimination of unrealized profits/losses on inventory.
- The detailed data on changes in the balance of the components' tangible fixed assets, which form the basis of "expenditure due to the purchase of tangible fixed assets" subject to disclosure in the consolidated cash flow statement.

(Auditing Standards Statement No. 600, paragraphs 23 and 32) [Mid-tier, and small and medium-sized audit firms]

②The audited company prepared its consolidated financial statements in accordance with IFRS (International Financial Reporting Standards). Furthermore, the audited company's foreign components followed local accounting standards when preparing their own financial statements. The audited company consolidated the foreign components' certain accounts into its consolidated financial statement without adjusting accounting treatments to conform to IFRS. The component auditors reported to the group engagement team that different accounting treatments were required under the local accounting standards and IFRS with regard to certain accounts.

However, the group engagement team did not sufficiently consider whether it was necessary to adjust accounting treatments based on the accounting standards adopted by the components to conform to IFRS, which was adopted for the consolidated financial statements.

(Auditing Standards Statement No. 600, paragraph 34) [Large-sized audit firms]

③The audited company adjusted the financial statements of a consolidated subsidiary due to material discrepancies in accounting records relating to inter-company transactions between consolidated companies resulting from the difference between the closing date for the consolidated subsidiary and the consolidated closing date.

Amid this situation, the group engagement team confirmed that the audited company had adjusted the financial statements using the same debit and credit accounts as those used in the previous year. Although the engagement team identified the risk of material misstatement in the adjustments and recognized that the adjusted amount represented a significant increase from the previous fiscal year, it did not sufficiently examine the basis of the reason for the adjustments and the adjusted amount.

(Auditing Standards Statement No. 600, paragraphs 16 and 36) [Large-sized audit firms]

NEW

FREQUENT

④When a consolidated subsidiary, Company A carried out an initial public offering of shares at the time of listing, Company A received capital injection from the non-controlling shareholder of Company A. As a result, the audited company's equity ratio in Company A decreased. The audited company accounted for the decrease in the equity ratio as an increase in non-controlling interests for the entire payment amount in the consolidated financial statements.

However, the group engagement team overlooked the erroneous accounting treatment made by the audited company for a decrease in the parent company's interest due to a capital increase at market value by the consolidated subsidiary, and **did not appropriately verify the accounting treatment made by the audited company**.

(Auditing Standards Statement No. 600, paragraph 32 and 33) [Mid-tier, and small and medium-sized audit firms]

《Points to Note》

There were cases in which: when examining consolidated journal entries, the group engagement team

merely made comparisons with the previous period's balances and observed documents prepared by the audited company, and did not perform substantive procedures; or, due to a lack of a sufficient understanding of the audited company and its business environment at the group level to serve as the basis for risk assessment of group financial statements, the engagement team did not examine whether unrealized profits were fully eliminated even though complex inter-company transactions had occurred. There were also cases in which the group engagement team did not examine whether financial information for components reported by component auditors had been reflected in group financial statements.

The group engagement team shall understand the group, its components and their environment, as well as the consolidation process, including group-wide controls. The group engagement team shall plan and implement the types, timing and scope of audit procedures to address the risks of material misstatement in the group financial statements arising from the consolidation process, and shall evaluate the appropriateness and completeness of adjustments and reclassifications for consolidation.

Case 7: Subsequent events

The engagement team requested the component auditors of multiple foreign components to prepare and submit reports on subsequent events.

However, as of the date of the auditor's report under the Companies Act, the engagement team did not receive a report on subsequent events from any of those component auditors, and as a result, it did not perform planned procedures.

(Auditing Standards Statement No. 600, paragraph 37) [Mid-tier, and small and medium-sized audit firms]

《Points to Note》

Group engagement team or component auditors need to perform procedures designed in order to identify events which may occur between the period end of the components' financial information and the date of the auditor's report on the group financial statements and which may require a revision of the group financial statements or may become subject to disclosure in the group financial statements.

Case 8: Communication with component auditors

①The audit engagement team sent the component auditors of significant components written instructions regarding the audit of financial information for their components and obtained responses from the component auditors, but did not communicate adequately with the component auditors in regard to the following points.

・The audit engagement team did not communicate with the component auditors regarding the threshold for accumulating identified misstatements, below which was clearly trivial in respect of the group financial statements.

・Although the group engagement team had identified a significant risks in the group financial statements of the components (fraud risks related to revenue recognition and risk of management override), the team did not communicate with the component auditors these risks.
・The group engagement team did not comprehensively communicate the list of related parties with the component auditors, as the team informed them of the audited company's subsidiaries and affiliates as related parties, but did not inform of its major shareholders and executives as related parties.
・The group engagement team did not request the component auditors to report any indications of bias among the components' management, material weaknesses in internal controls over financial reporting identified in the components, and any other important matters that the component auditors had reported or planned to report to those charged with governance of the components.

(Auditing Standards Statement No. 600, paragraph 39 and 40) [Mid-tier, and small and medium-sized audit firms]

②The group engagement team understood that the audited company and an foreign subsidiary that was a significant component both recognized revenues based on customer’s acceptance inspection basis because installation work was involved when selling products, and it identified a risk of fraud in product sales of pretending to have conducted customer’s acceptance inspection and then recognizing revenue.

However, the group engagement team communicated with the component auditors only that there was a significant risk of material misstatement due to fraud in revenue recognition, but did not specifically communicate the risk of fraud identified with respect to the customer’s acceptance inspection basis.

(Auditing Standards Statement No. 600, paragraph 39)[Mid-tier, and small and medium-sized audit firms]

《Points to Note》

Group engagement teams must communicate with component auditors significant risks relating to group financial statements that would affect the work of the component auditors. Furthermore, group engagement teams must request component auditors to inform them in a timely manner whether significant risks relating to group financial statements other than those communicated by the group engagement team exist and of the response to these risks.

However, as shown above, there were cases in which the group engagement team did not appropriately communicate with component auditors such risks. There were also cases in which: the team did not communicate with the component auditors component materiality; or, even though component auditors reported significant risks to the group engagement team, the team did not sufficiently examine those risks constituted significant risks in respect of the group financial statements; or the timing of obtaining information, including audit plans, from component auditors was too late; or the group engagement team

merely presented a list of affiliated companies to component auditors and did not present a list of related parties identified by the audited company that included executives. Group engagement teams need to engage in effective two-way communication with component auditors.

Case 9: Sufficiency and appropriateness of audit evidence obtained

FREQUENT

①In an interview held with the component auditors of a significant component while conducting an on-site visit, the group engagement team was reported that they had not identified any abnormalities in journal entry testing. In addition, the group engagement team received a response to its audit instructions stating that there were no matters to report regarding journal entry testing.

However, the group engagement team **did not understand the specific risk scenarios by which the component auditor had concluded that there were no matters to report regarding journal entry testing and the results of procedures, and hence the group engagement team did not evaluate the sufficiency and appropriateness of the procedures performed by the component auditor**.

In addition, the group engagement team received a response to its audit instructions from the component auditor of the significant component stating that the bank confirmation form had not been returned, but it did not obtain sufficient appropriate audit evidence on the audit procedures the component auditor had subsequently performed and on the conclusion of the procedures.

(Auditing Standards Statement No. 600, paragraphs 41 and 43) [Large-sized audit firms]

②The group engagement team instructed the component auditors of significant components to implement audits and used the audit results. However, although the group engagement team **received from the component auditors the reports on the presence of deficiencies of internal control that had been identified as a result of the evaluation of internal control audits, it did not evaluate those deficiencies. It also failed to consider whether or not additional procedures were necessary**.

(Auditing Standards Statement No. 600, paragraph 41) [Mid-tier, and small and medium-sized audit firms]

③Regarding the financial information for two significant components, the group engagement team sought a quality review for the purpose of expressing an opinion regarding the audited company's group financial statements before completing its review of audit working paper relating to the accounts with risks of material misstatement, including significant risks in respect of the group financial statements. Thus, the group engagement team did not obtain sufficient and appropriate audit evidence before expressing an audit opinion on the audited company's group financial statements.

(Auditing Standards Statement No. 600, paragraph 43) [Mid-tier, and small and medium-sized audit firms]

《Points to Note》

Group engagement teams should evaluate whether or not sufficient and appropriate audit evidence has been obtained through the audit procedures performed with regard to the consolidation processes and the work done by themselves and component auditors with regard to financial information concerning the components in order to form the basis for expressing opinions regarding group financial statements.

However, as shown in the above, there were cases in which: the group engagement team did not receive reports on the results of the audit procedures performed by component auditors in a timely manner; the group engagement team merely obtained information on the results of audit procedures from component auditors and failed to appropriately evaluate the sufficiency and appropriateness of the audit evidence obtained with regard to significant risks; or although deficiencies regarding components' internal control were identified, the group engagement team did not evaluate them. Notably, even if the component auditor is in the same network as the group engagement team, the group engagement team still needs to evaluate the reports received from the component auditor.

6. Using the work of Auditor's experts

Points of focus

The auditor may make use of experts to obtain sufficient appropriate audit evidence if the auditor needs expertise in areas other than accounting or auditing. The CPAAOB inspects whether the experts used by the engagement team are equipped with the necessary qualifications, competency and objectivity in light of the purposes of auditing financial statements and whether the auditor evaluates the appropriateness of the experts' work.

Outline of inspection results

In using the work of others such as auditor's experts, there were cases in which the engagement team had overly trusted the result of the work of others and relied on it without sufficient evaluation.
There were cases where the engagement team did not sufficiently communicate with the experts on the scope and purpose of work to be used, or did not sufficiently assess the appropriateness of the work of experts used by the auditor.

Expected response

Engagement teams should always keep in mind that they are responsible for issuing appropriate auditor's report on the financial statements they audit, and they should therefore evaluate the adequacy of the experts' work they intend to use.
When using experts' work, the auditor should determine the necessity of use, assess the qualifications of the experts, competency and objectivity of them, and evaluate the appropriateness of the experts' work for its audit purposes. In using the experts' work, **the engagement team needs to sufficiently consult with the experts on the purpose and scope of work to be used, without leaving everything to the experts, in order to obtain sufficient appropriate audit evidence conforming to the audit purpose**.

Case 1: Competence, capabilities and objectivity of auditor's expert

FREQUENT

The engagement team used the auditor's expert to evaluate retirement benefit obligations and service cost calculated by the audited company, but it **did not sufficiently understand the external expert's area of expertise and evaluate the external expert's competence, capabilities and objectivity**.

(Auditing Standards Statement No. 620, paragraphs 8 and 9) [Mid-tier, and small and medium-sized audit firms]

Case 2: Agreement with auditor's experts

With regard to some real estate inventories for sale that had been valued by the audited company based on real estate appraisal, the engagement team requested a review of the real-estate appraisal report from an internal expert.

However, the engagement team did not give appropriate instructions to the selected expert by clarifying the specific tasks requested, including the nature, scope and objectives, and thus the engagement team and the expert were not in agreement with each other regarding their roles and responsibilities.

(Auditing Standards Statements No. 620, paragraph 10) [Large-sized audit firms]

《Points to Note》

When using the work of auditor's experts in areas of expertise other than accounting and auditing, engagement teams should not leave matters entirely to them but should discuss with them to determine the scope of work for which their services are used, evaluate their competence, capabilities and objectivity and assess whether their work is appropriate in light of auditing purposes.

In addition to the above cases, there were also cases in which, although the evaluation method adopted by an expert was different from the one designated by the engagement team, the team did not examine the appropriateness of the work done by the expert.

For the requirements applicable when engagement teams undertake consultation on difficult or contentious matters of accounting or auditing, the engagement teams shall refer to paragraph 17 of Auditing Standards Statement No. 220 ("Quality Control for an Audit of Financial Statements"). For points to note in the case where audit evidence is based on the work of experts used by the audited company's management, refer to the section "3. Audit Evidence".

7. Audit of Internal Control over Financial Reporting

Points of focus

CPAAOB performs inspections of audit of internal control over financial reporting from the following perspectives:

- Whether the engagement team develops an audit plan in consideration of materiality, with an understanding—based on the audited company's business environment and business characteristics—of the design and operation of internal control and assessment thereof by the management;
- Whether the engagement team evaluates the way the management decides the scope of assessment as well as its reasonableness; and particularly in the case that the management prepares an internal control report that excluded some part of the processes that could not be assessed, the engagement team should examine the reasonableness of the management's exclusion of the scope and the effects of the exclusion on the financial statement audit;
- Whether the engagement team appropriately assesses the deficiencies identified by the management; especially in evaluating the degree of control deficiencies, does the team examine the potential impact of the deficiencies and the possibility of the occurrence of a material misstatement by taking into consideration the quantitative and qualitative effect on the overall internal controls over financial reporting of the audited company;
- Whether, in the course of an internal control over financial reporting audit, the engagement team reports the deficiencies detected by the auditors to the appropriate person in a timely manner and examines the possibility of the deficiencies being a material weakness;
- Whether, if the engagement team has discovered a material weakness, the team reports this to the management and demands that the management remediates it, and examines progress made in remediating the deficiencies in a timely manner; and
- Whether the engagement team examines the impact on internal control over financial reporting audit by the misstatements found during the course of the financial statements audit.

Outline of inspection results

In some cases, the engagement team, without enough professional skepticism, relied on the results of the audited companies' internal control assessment, without evaluating the adequacy of the scope of internal control assessment, the internal auditors' capability and objectivity, the appropriateness of samples, assessment method and so on.

Some engagement teams only responded in form to changes of the business environment of the audited company such as those of significant business locations or units because of acquisition and commencement of new business or other. Other engagement teams did not examine the appropriateness of management using the previous year's results of the evaluation for IT general controls. Other engagement teams did not examine whether the identified deficiencies could constitute material weakness. The other engagement teams did not obtain enough audit evidence to evaluate the remedial actions against the relevant material weakness.

Expected response

An auditor shall form and express its opinion based on the audit evidence obtained, on whether internal control report prepared by management present fairly, in all material respects, the evaluation results of the effectiveness of internal controls in accordance with generally accepted standards for the assessment of internal controls.

To that end, in consideration of materiality, auditors **should adequately understand management's design and operation status of internal controls as well as assessment results and should carry out financial statement audit and internal control audit in an integrated manner from the perspective of effective and efficient audits**.

Meanwhile, the purpose of the internal control reporting system under the Financial Instruments and Exchange Act is to ensure disclosure reliability through managements' assessment of their internal controls over financial reporting and by audits of their assessment. Therefore, auditors **should provide insights into design of internal controls based on the audited company's background, including its size and business structure to the audited company**.

To meet the expectations mentioned above, auditors need to examine the scope, timing and appropriateness of audit procedures to evaluate the adequacy of the scope of internal control assessment, the approach of internal control assessment, and the assessment of the significance of internal control deficiencies. They should not perform procedures uniformly and routinely without sufficient consideration.

Careful assessment should be performed concerning whether sufficient appropriate audit evidence was obtained particularly on the audited company's business locations/units deemed to have relatively high risks, such as processes newly added to be assessed.

(1) Evaluation of the Scope of Assessment of Internal Control

Case 1: Selection of significant accounts of significant relevance to operational objectives

FREQUENT

The audited company (a labor-intensive consulting firm) considered sales, accounts receivable, and inventories as significant accounts for the audited company's business objectives and included them in the scope of internal control assessment.

However, the engagement team **did not assess whether payroll, which was larger in amount than inventories according to the characteristics of the audited company's business, should be included in the scope of internal control assessment**.

(Auditing Standards for Internal Controls over Financial Reporting Statement No. 1, paragraphs 98 and 100) [Mid-tier, and small and medium-sized audit firms]

《**Points to Note**》

"Significant accounts for operational objective (three accounts: sales, accounts receivable and inventories)" are just examples, described in the Practice Standards for Management Assessment and Audit concerning Internal Control over Financial Reporting. It is necessary to note that significant accounts should be appropriately selected in consideration of the audited company's type of industry, business environment and business characteristics. In the event of changes in the audited company's business activities and profit structure, in particular, significant accounts need to be carefully selected.

In addition to the above example case, net sales are often used as an indicator for selecting significant business locations or units. However, it must be noted that using a different or additional indicator may be more appropriate depending on the environment or nature of the business of the audited company.

Case 2: Identifying significant business processes

FREQUENT

①The engagement team had identified significant risks regarding revenue recognition for the audited company's overseas subsidiaries, but **did not consider whether there was a reasonable reason for the audited company not to include the subsidiaries' sales process in the scope of internal control assessment**.
(Auditing Standards for Internal Controls over Financial Reporting Statement No. 1, paragraph 112) [Mid-tier, and small and medium-sized audit firms]

②The audited company used an ERP system composed of sales management, procurement and inventory management, production management, project management, financial accounting, management accounting, and personnel management modules.
Amid this situation, the engagement team evaluated the design of IT general controls relating to the system, but did not evaluate the operation IT general controls relating to it. Moreover, in evaluating business processes, the team evaluated only the operation of manual internal controls and did not evaluate the operation of IT application controls.
However, although the system was a key system widely related to business processes and financial reporting, the engagement team did not evaluate the appropriateness of not to test the operation of system's IT general controls and its IT application controls.
(Auditing Standards Statement No. 315, paragraphs 17 and 20; Auditing Standards for Internal Controls over Financial Reporting Statement No. 1, paragraph 144) [Mid-tier, and small and medium-sized audit firms]

《**Points to Note**》

Business processes, related to the accounts with significant risks, should be usually selected for internal control assessment by the management because of their characteristics. If such business processes are not selected, the engagement team should note that it is required to discuss again with the management regarding the management's method of deciding the scope of assessment as well as the basis of the decision,

and carefully evaluate the reasonableness of exclusion of these processes from the scope of assessment.

If the engagement team considers that the business processes selected by the management for assessment are not appropriate, the engagement team needs to request the management to take additional actions, including reconsidering the business processes to be assessed, depending on the degree of impact on financial reporting.

If some processes are included in business processes through which accounts that are substantially related to the company's business objectives for significant business locations or units are generated, but are excluded from management assessment because of their limited relevance to material businesses or operations and small impact on financial reporting, the engagement team should carefully evaluate the reason for their exclusion from assessment, etc.

(2) Approach of Assessment of Internal Control

Case 1: Sampling

①In assessing the operation of internal controls over revenue recognition, the engagement team used the audited company's tests of controls, but did not examine the appropriateness of the selection method and sample size the audited company had extracted.

(Auditing Standards Statement No. 500, paragraph 9; Auditing Standards for Internal Controls over Financial Reporting Statement No. 1, paragraphs 153 and 154) [Mid-tier, and small and medium-sized audit firms]

②In assessing the operation of internal controls associated with business processes of significant business locations or units, the audited company selected samples only from certain months from the entire population that covered 12 months.

However, the engagement team did not evaluate whether the management's sample selection method has provided a reasonable basis for conclusion about the entire 12-month population.

(Auditing Standards for Internal Controls over Financial Reporting Statement No. 1, paragraphs 153 and 158) [Mid-tier, and small and medium-sized audit firms]

Case 2: Assessment of design and operation of internal controls

①The engagement team identified fraud risks of manipulating cut-off of revenue recognition in respect of sales relating to the condominium management business of the audited company's consolidated subsidiary.

However, although the engagement team performed procedures to evaluate the operation of internal controls in respect of business processes relating to sales associated with the condominium management business by vouching the table of approval stamps for selected samples, the team **did not appropriately evaluate the operation of internal controls, as this data contained no date information and the engagement team only vouched the amounts, without checking the appropriateness of the timing of revenue recognition**.

(Auditing Standards Statement No. 330, paragraphs 7, 9 and A22) [Mid-tier, and small and medium-sized audit firms]

NEW

②In its assessment of internal controls over financial reporting, the audited company selected an overseas subsidiary as a significant business location, and identified the internal controls of its sales, purchase, and inventory management business processes as in-scope processes subject to management assessment.

However, the engagement team **did only evaluated the effectiveness of internal controls of sales process but not evaluate the effectiveness of internal controls of purchase and inventory management processes**.

(Auditing Standards for Internal Controls over Financial Reporting Statement No. 1, paragraphs 66) [Mid-tier, and small and medium-sized audit firms]

③As part of its sales management process, the audited company performed master registration and processed orders received, shipments, cash collection and clearing corresponding receivables, etc. Through its ERP system, which was interfaced with the accounting system once a month to allow the accounting of sales, accounts receivable, etc. to be posted

However, the engagement team did not consider whether automated application controls of the interface linking the EPR system with the accounting system needed to be included in the scope of internal control audit.

(Audit Standards Committee Statement No. 315, paragraph 17; IT Committee Practical Guideline No. 6, paragraph 31; Practice Standards for Management Assessment and Audit concerning Internal Control over Financial Reporting III. 3 (4)) [Mid-tier, and small and medium-sized audit firms]

《Points to Note》

In addition to the above examples, there are cases in which only the results of control activities, such as whether seals were affixed, were included in the audit working paper, cases in which an alternative sample was not selected when a sample that was inappropriate for audit procedures was recognized, cases in which the evaluation of IT general controls (program changes, responses to system failures, access controls, etc.) was inadequate, and cases in which only the IT application controls of the old system were evaluated and the IT application controls of the new system were not evaluated when a system change was made. The engagement team also needs to fully understand the purpose of Auditing Standards Statement No. 530 ("Audit Sampling") and select appropriate samples for sampling in the procedures for evaluating the operation of internal controls. In addition, the engagement team needs to evaluate internal controls that appropriately address the identified risks of material misstatement when evaluating the design and operation of internal controls. Furthermore, the engagement team needs to plan and implement appropriate responses to IT-related risks based on a full understanding of IT Committee Practical Guidance No. 6 (or Auditing Standards Statement No. 315 ("Practical Guidance No. 1" under the 2021

Auditing Standards Statement No. 315)) when evaluating IT-related internal controls. When evaluating internal controls, the engagement team also needs to pay attention to changes in the business activities and profit structure of the audited company, without being influenced by past audit experience.

For points to be noted when conducting a dual-purpose test, see "3. Audit Evidence (1) Matters common to audit evidence".

On top of that, although the financial closing and reporting process is one of the business processes that are extremely important in terms of the reliability of financial reporting, it should be noted that audit procedures must be performed with sufficient care in order to examine the design and operation of internal controls associated with of the process because the frequency of performance of the controls is relatively low compared to those for other business processes related to daily transactions.

Case 3: Timing of assessment procedures

①The engagement team did not obtain sufficient and appropriate audit evidence to express an audit opinion regarding the audit based on the Companies Act, as the team performed audit procedures regarding the audited company's IT application controls relating to individually evaluated financial closing and reporting processes such as various allowances, taxes and tax effects, and business processes such as automatic journal entries after the date of the auditor's report under the Companies Act, but before the date of the auditor's report under the Financial Instruments and Exchange Act.
(Auditing Standards Statement No. 330, paragraph25) [Mid-tier, and small and medium-sized audit firms]

②The engagement team evaluated process-level controls by obtaining management assessment result verified using the transactions in the first quarter as samples. In assessing the result, the engagement team made inquiries and observed relevant documents of management samples, and subsequently obtained the documents from the audited company confirming whether or not any material changes to internal controls were made after the year-end closing date. Considering the above, the engagement team assessed the status of design and operation of process-level controls as effective. However, the engagement team did not consider what additional procedures should be performed for the rest of the fiscal year in order to assess whether the assessment results of internal controls verified using the transactions in the first quarter as samples remained effective as of the year-end closing date.
(Auditing Standards Statement No. 330, paragraph 11; Auditing Standards for Internal Controls over Financial Reporting Statement No. 1, paragraph 160) [Mid-tier, and small and medium-sized audit firms]

《Points to Note》

If the engagement team plans to rely on related internal controls that it assumes to be effective in deciding

the nature, timing and extent of substantive procedures in the financial statement audit, it should preferably perform procedures for assessing operation of internal controls prior to performing key substantive procedures. The same can be said for the assessment of the effectiveness of the company-level controls and IT general controls that support the process-level controls as well as the subject controls including IT application controls.

Furthermore, there was a case where the engagement team performed tests of controls during the interim period, and with regard to the period after that, performed roll-forward procedures subsequent to the date of the financial statements. However, the roll-forward procedures were not completed by the date of the auditor's report under the Companies Act. See Auditing Standards Statement No. 330, paragraph A32 for the relevant factors in obtaining additional audit evidence for performing roll-forward procedures.

Case 4: Management's use of assessment results of prior years

In management's assessment of IT general controls over sales systems used at significant business locations or units, the audited company used the results of prior years' assessment for certain internal controls.

However, the engagement team did not examine whether it was appropriate for the management to use the results of prior years' assessment, according to the Practice Standards for Management Assessment and Audit concerning Internal Control over Financial Reporting.

(Practice Standards for Management Assessment and Audit concerning Internal Control over Financial Reporting II. 3 (3) (v) D (Note)) [Mid-tier, and small and medium-sized audit firms]

《Points to Note》

When the management continuously uses the results of previous year's assessment of operating effectiveness in assessing IT general control items, the engagement team should note that it is necessary to examine whether the items have particularly material impact on the reliability of financial reporting, whether there had been any material changes in effectiveness of the design from the previous year, whether the results of previous year's assessment of operation were effective, and whether operating effectiveness has been assessed once every several accounting periods

(3) Assessment of Deficiencies

Case 1: Assessment of deficiencies in design and operation of internal control

With regard to the audited company's IT system for receiving and placing orders and its cost accounting system, the engagement team discovered that management functions such as the setting of IDs and passwords for each user were absent, and deemed this to be a deficiency in IT general controls.

However, the team did not consider the impact of this deficiency in IT general controls on IT application controls and the audit of financial statements.

(Auditing Standards Statement No. 315, paragraph 30; IT Committee Practical Guideline No. 6, paragraph 53) [Mid-tier, and small and medium-sized audit firms]

Case 2: Determination of material weaknesses

The engagement team identified numerous deficiencies from the process-level controls over financial closing and reporting process during the substantive testing of the financial statement audit, and also identified multiple disclosure errors in the securities report for the previous fiscal year caused by internal control deficiencies. Although these deficiencies had not been remediated as of the year-end closing date because the engagement team had identified these deficiencies after that day, the engagement team concluded by holding meetings with the internal audit department of the audited company that these did not constitute material weakness.

However, the engagement team did not examine specifically how management had assessed the deficiencies, and it did not consider from the viewpoint of quantitative and qualitative significance whether these deficiencies constituted material weakness individually or in aggregate.

(Auditing Standards Statement No. 330, paragraph 16; Auditing Standards for Internal Controls over Financial Reporting Statement No. 1, paragraphs 187 and 205) [Mid-tier, and small and medium-sized audit firms]

Case 3: Assessment of internal control over misstatement

FREQUENT

Regarding misstatements related to inventories discovered in the course of financial statements audit of a component, the group engagement team considered reasonable the component auditor's assessment that those were not significant deficiencies because: the misstatements had been corrected; the misstatements were not deemed as significant although these were caused by the deficiencies in internal controls; and the component's management had immediately taken remedial actions of deficiencies.

However, the evaluation procedures for deficiencies carried out by the group engagement team included the following deficiencies.

- **The internal controls that had deficiencies were not specified**.
- **The account items affected by the deficiencies and the likelihood of occurrence of the deficiencies were not examined to determine whether the deficiencies were deemed as a material weakness**.
- **The details of the remedial actions taken by the component's management were not understood**.
- **It was not confirmed how these deficiencies had been assessed in the management assessment**.

(Auditing Standards Statement No. 265, paragraphs 6 and 7; Auditing Standards for Internal Controls over Financial Reporting Statement No. 1, paragraph 44) [Mid-tier, and small and medium-sized audit firms]

《**Points to Note**》

Deficiencies in an internal control can be classified into deficiencies in design and deficiencies in operating effectiveness. Deficiencies in design include the absence of internal control and failure of the existing internal control to fulfill the objectives of the internal control, while deficiencies in operating effectiveness consist of failure to perform the internal control as designed, the existence of many errors in performing internal control and a poor understanding of the nature and objectives of the internal control by the person who performs the internal control.

When finding a deficiency in internal control, the engagement team is required to: confirm which classification it falls under; take into account its quantitative and qualitative materiality and existence of compensating controls; calculate the potential quantitative impact of the deficiency discovered; and examine which accounts will be affected by such deficiency and to what extent, and the likelihood of occurrence of material misstatement. The team needs to pay attention to the fact that it is required to carefully judge if the deficiency discovered falls under material weaknesses.

Further, it should be noted that, if the misstatement identified by the auditor was due to ineffective internal controls, it may imply the possibility of other misstatements.

(4) Use of the work of internal auditors

Case: Extent of using the work of internal auditors

①The engagement team partially relied upon audit results from internal auditors concerning the audited company's IT general controls for its accounting system and construction system, which were ERP system (controls relating to program and data access controls, program change, program development, and computer operation).

However, **when deciding whether the work performed by the internal auditors was appropriate in light of the objectives of the financial statements audit, the team did not consider objectivity. Furthermore**, the team **did not conduct investigations to determine whether specific tasks performed by the internal auditors were appropriate in light of the audit objectives**.

(Auditing Standards Statement No. 610, paragraphs 11 and 19) [Large-sized audit firms]

NEW ②Based on the premise that the work of the audited company's internal auditor would be used in tests of the operation of internal controls, the engagement team re-performed all tests of the operation performed by the internal auditor.

However, the engagement team **did not perform procedures to understand the cause and potential impact of the multiple deviations from internal controls discovered by the internal auditors**.

(Auditing Standards Statement No. 330, paragraph 16, No. 610, paragraph 13 and 19) [Mid-tier, and small and medium-sized audit firms]

《Points to Note》

In many cases, engagement teams use the work performed by the audited company's internal auditors from the perspectives of effectiveness and efficiency of audit. However, on such occasions, it is necessary to examine if the objectivity and capability of the internal auditors are maintained and if the quality of assessment by the internal auditors is high enough to be used as audit evidence.

When using the work of internal auditors, etc., the engagement team must remember to examine: the degree of risk addressed by the internal controls intended to be used; the nature and significance of the internal controls; the operation status of the internal controls; the degree of judgment necessary to evaluate the operation; and the quality of the work of the internal auditors, etc.

8. Key Audit Matters (KAM)

Points of focus

KAM are required to be included in auditor's reports for listed companies, starting with financial statements audits for the fiscal year ended March 31, 2021. The CPAAOB inspects audit procedures relating to the contents of such matters as the process of deciding on the KAM and the audit response from the following perspectives:

- ▶ Whether, in its audit of financial statements for the current fiscal year, the engagement team chooses matters that the team, as professional experts, deems particularly important as KAM, following an appropriate process that includes communication with those charged with governance, etc.
- ▶ Whether, if there are notes relating to KAM in the financial statements, the engagement team appropriately specifies reference to those notes, and appropriately describes the contents of each KAM and the reasons for deciding on it.
- ▶ Whether the engagement team appropriately describes in the auditor's report the audit procedures it carried out as an audit response to the KAM.
- ▶ Whether the engagement team appropriately communicates with those charged with governance, etc. regarding the matters the team has chosen as KAM.

Outline of inspection results

The examples identified included cases in which the engagement team referred inappropriately to notes relating to KAM in the financial statements; or cases in which, of the audit responses described in the KAM, the team failed to perform some substantive procedures or procedures to assess the design and operation of internal controls; or cases in which, where the same matters—e.g. impairment of fixed assets—had been decide as KAM for all the audited company's multiple subsidiaries, the team did not verify whether all component auditors had performed the audit responses described in the KAM.

(Observed effective efforts)

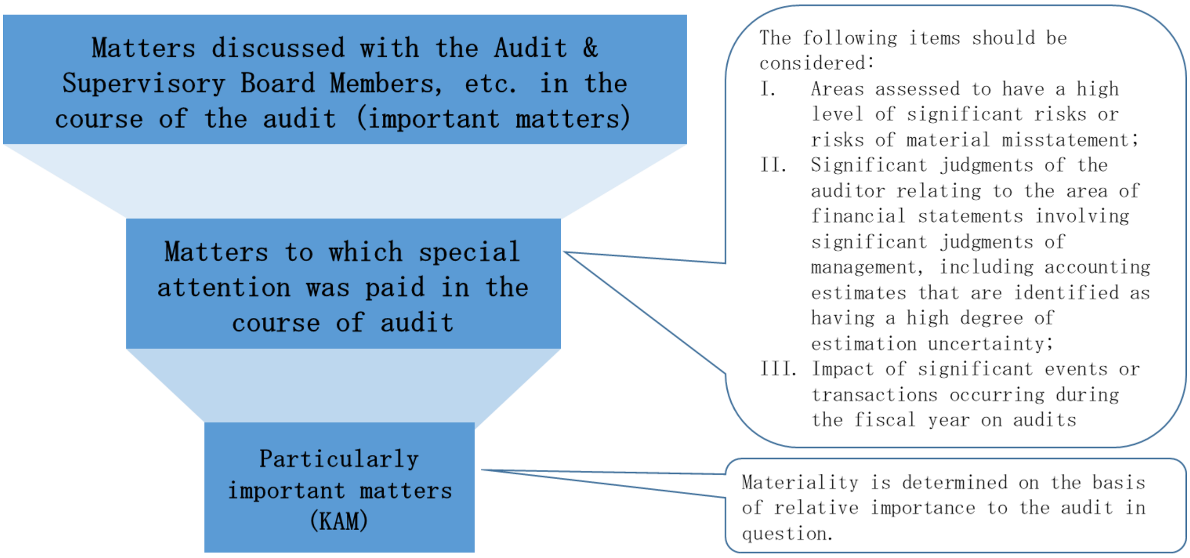
The following cases can be presented as an effective effort observed to improve the appropriateness of the content of KAM descriptions.

- ・ The audit firm established a dedicated KAM team within the quality control department, which provided engagement teams with comprehensive support such as preparing templates for consideration of KAM, developing and circulating examples of KAM description and manuals showing how to complete the templates, and providing KAM-related training.
- ・ The audit firm put in place a KAM review system, under which reviews are carried out by a reviewer other than the EQC reviewer and made individual reviews by EQC reviewers mandatory.
- ・ Regarding key discussion points, the audit firm introduced mandatory requirements to consult experts and to undergo a senior review.

Expected response

The purpose of KAM reports is to increase the value of auditor's report as a medium of information by increasing the transparency of the audits conducted. In addition, KAM reports can increase the transparency of audits by providing the envisaged users of financial statements with additional information that is useful in understanding the matters deemed by auditors, as professional experts, to be particularly important in their audit of the current fiscal year's financial statements. Therefore, auditors are required to take appropriate actions based on a full understanding of the purpose of KAM's reporting so as not to lead to KAM becoming boilerplate or losing substance. See [Figure 7] for the process of determining KAM.

［Figure 7］Reference image: KAM Determination Process



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

When deciding on KAM, engagement teams are required to proactively communicate with the audited company's management and those charged with governance. Moreover, engagement teams should note that the descriptions of each KAM and the reason for deciding on it described in the auditor's report are directly related to the company's specific situation by specifying the areas and amounts which the KAM targets. Furthermore, regarding the auditor's response described in the auditor's report, engagement teams should describe as specifically as possible the details of their procedures or audit approach suitable for the factors described as reasons for deciding on the KAM.

With regard to appropriate KAM descriptions, refer also to such documents as Auditing Standards Statement No.700 Practical Guidance No. 1, "Q&A on Auditor's Reports (Practical Guidance)" published by the JICPA.

Case 1: Description of the KAM and the reason for deciding on it

In considering the KAM for the audit of the consolidated financial statements, the engagement team decided to report the recoverability of deferred tax assets for the audited company's non-consolidated financial statements.

However, in the auditor’s report on the consolidated financial statements submitted to the audited company, the engagement team specified the value of deferred tax assets given in the consolidated financial statements after referring to the note in the consolidated financial statements regarding deferred taxes accounting, but without disclosing the scope of deferred tax assets covered by the KAM, thereby resulting in a description which implies that the KAM would cover the examination of the recoverability of entire deferred tax assets recorded in the consolidated financial statement. Thus, the engagement team did not sufficiently consider the appropriateness of the description of KAM and the reason for deciding on it for the consolidated financial statements.
(Auditing Standards Statement No. 701, paragraphs 12 and A47) [Mid-tier, and small and medium-sized audit firms]

Case 2: Descriptions relating to audit responses

NEW

In its auditor’s report on the audited company's consolidated financial statements, the engagement team described impairment of long-lived assets as KAM, and stated that it had performed audit procedures such as examining the grouping method through inspection of company materials by the Board of Directors, etc., inspecting evidences such as real estate appraisal reports to identify indications of impairment, and inspecting business plans for businesses with indications of impairment.
However, **although the engagement team did not actually inspect the real estate appraisal report and other supporting materials, the engagement team stated that it did so.**
(Auditing Standards Statement No. 701, paragraphs 12 and A46) [Mid-tier, and small and medium-sized audit firms]