

(Provisional Translation)

March 2007
Certified Public Accountants and Auditing Oversight Board

Regarding Quality Control of Audits by Small and Medium Scale Audit Firms (summary)

In November 2006, the Certified Public Accountants and Auditing Oversight Board (“the Board”) issued an interim report titled “Regarding Quality Control of Audits by Small Scale Audit Firms,” which was based upon accumulated cases concerning reviews, examinations and inspections of small scale audit firms. In addition, the Board, based upon “**The basic policy on examination and inspection, business year 2006 (July 2006 to June 2007)**”, has also examined and inspected medium scale audit firms as deemed necessary and appropriate to protect the public interest and investors. This report reflects the results of these examinations and inspections.

As summarized in this report, constructing and implementing appropriate management systems for quality control of audit engagements under constrained personnel resources are challenges for small and medium scale audit firms. The Board considers that it is necessary for small and medium scale audit firms, including individual firms, to continually endeavor to improve their system for ensuring and improving their audit quality under appropriate control. Furthermore, the Board expects that medium scale audit firms next in size following the big 4 audit firms which audit many listed companies will promptly improve their systematic management for quality control of audit engagements.

It should be noted that the above inspections did not make a general assessment of these audit firms, nor of the individual audit engagements inspected, but rather essentially reviewed the quality control of audits and identified deficiencies to be improved. The issues identified are to the extent examined and observed by the inspectors during the course of these inspections. Therefore, it does not necessarily mean that they are common issues reside in all small and medium scale audit firms, that the audit opinions expressed by each audit firm were inappropriate, and that all other aspects not mentioned in this report are appropriate.

1. The coverage of this report

This report categorizes “medium scale audit firms” as the 20 firms next in size following the big 4 audit firms in Japan¹ and “small scale audit firms” as all other audit firms. Such “medium scale audit firms” and “small scale audit firms,” including individual firms (individual certified public accountants) are referred to as “small and medium scale audit firms ” in this report.

¹ Ranking is based upon the number of full time certified public accountants as of end March 2005. The Board conducted examination and inspection of 17 firms as of February 2007.

The small and medium scale audit firms covered in this report are the 16 medium scale audit firms, 88 small scale audit firms and 128 individual audit firms of which the quality control review was conducted by the Japanese Institute of Certified Public Accountants (“JICPA”) in accounting year 2004 and 2005. In addition, the inspection results of one medium scale audit firm which was subject to the JICPA’s quality control review in accounting year 2006 is also reflected in this report.

2. Summary of small and medium scale audit firms (As of end March 2005)

There exists significant difference in the number of partners and staffs between the big 4 audit firms and the small and medium scale audit firms. For example, whereas the average number of full time certified public accountants at a big 4 audit firm is approximately 1,666 , that number at a small and medium scale audit firm is approximately 12 (medium scale 33, small scale 8).

Furthermore, by examining the number of audit engagements that are pursuant to the Securities and Exchange Act, small and medium scale audit firms still account for just less than 20% of all audit firms.

3. Quality control of audits by small and medium scale audit firms

The major problems regarding quality control of audits identified in the examination and inspection of small and medium scale audit firms are as follows:

(1) Management systems of audits

There exist firms with insufficient headquarter organizations and internal rules relating to these firms’ management and insufficient control of audit departments or regional offices which conduct audit engagements. At these firms, a situation was found where their managements were even more independent from their headquarters in decision of promotion and compensation of partners and staffs at the audit department or regional office level, compared to those of the Big 4.

(2) Professional ethics and independence

Although firms have generally put in place policies and procedures with respect to preserving independence and satisfying requirements based upon law and standards, cases were found where firms had problems in implementing the above such as insufficient confirmation of independence regarding all partners and staffs.

(3) Acceptance and retention of clients

Although firms have generally put in place policies and procedures with respect to entering into and renewing audit contracts, cases were found where specific guidelines or

review procedures have not been established. Furthermore, cases were found where application of the above was not appropriate such as those involve risk evaluation.

(4) Performance of audit engagements

Although firms have generally put in place audit manuals, cases were found where they have not been revised on a timely basis. Problems regarding individual audit procedures in each of the following areas were identified: “planning of audit plans based on risk,” “confirmation,” “manager confirmation letters” and “accounting estimates.” Especially, many problems regarding “planning of audit plans based on risk” and “confirmation” were identified.

Furthermore, at many firms insufficient documentation of their audit work was identified.

(5) Internal review of audit engagements

Regarding the internal review system, “a conference form” (for example, a conference consists of all partners of a firm and each audit engagement is discussed and approved by the conference) or “a review partner form” (a review is conducted by a designated partner other than the audit partner) is generally adopted. However, cases were found where not all audit engagements were submitted for review and audit opinions were expressed without review.

4. Quality control of audits by small and medium scale audit firms (summary)

Major problems common to small and medium scale audit firms which were found in the examination and inspection procedure are as follows:

(1) Management systems of audits

Due to a lack of effective headquarter departments and sufficient internal rules relating to the management of firms, cases were found where audit departments and regional offices were managed independently from their headquarters. Furthermore, cases were found where partners of an audit firm placed more priority on managing their own personal firms which provides non-audit services, creating impediments for the audit firm to appropriately manage audit engagements.

Since such management issues were identified at small and medium scale audit firms, the Board believes that developing effective management systems of audits under the leadership of the firms’ chief executive officers and quality control managers are necessary.

(2) Audit systems and internal review systems

Since the number of partners and staffs is small, it is difficult to organize sufficient and effective audit teams and internal review systems. Cases, therefore, were found where it

was difficult for those firms to organize audit teams adequate for large scale companies and to conduct sufficient internal review of an audit engagement.

(3) Lack of recognition of the importance of quality control of audits

There were chief executive officers with responsibility over quality control of audits who lacked recognition of the importance of quality control of audit engagements. There were also partners and staffs who had conducted audit engagements, but lacked recognition of fulfilling their responsibility as professionals fairly and with integrity.

5. Quality control of audits of individual firms

Individual firms that mainly engage in audit services are less than 30%. It is more difficult for them to establish and manage audit systems and internal review systems than small and medium scale audit firms.

With regard to carrying out audit engagements, problems were identified at many firms with respect to preparing audit manuals and planning audit plans based on risk. Furthermore, there were firms that seem to have little intent to deal with improving quality control of audits, since providing non-audit services are their principal service.

6. Inappropriate manners of audited companies

Regarding the audit of large scale companies audited by small scale audit firms or individual firms, cases were found where audited companies dealt with auditors in an inappropriate manner.

The audited companies need to once again recognize that they have a duty to appropriately disclose company information as preparers of financial statements.