Public Report

August 2011

Certified Public Accountants and Auditing Oversight Board

About the contents of this Public Report

This Public Report describes the activities of the Certified Public Accountants and Auditing Oversight Board (CPAAOB) during fiscal 2010 (from April 1, 2010, to March 31, 2011), and to better meet the needs of readers, it includes information on activities taken before and after fiscal 2010.

Contents

Summary

Examinations and Inspections

The Certified Public Accountants and Auditing Oversight Board (CPAAOB) reviewed and examined reports of quality control reviews by the Japanese Institute of Certified Public Accountants (JICPA). The CPAAOB conducted inspections of nine audit firms in FY2010 and based on the inspection results made recommendations concerning one audit firm to the Commissioner of the Financial Services Agency (FSA) on administrative penalties or any other measures.

The "Case Report: Deficiencies in Audit Quality Control Casebook of Findings in Inspections on Quality Control of Audits" was published in February 2008. This was reviewed by adding and deleting sample findings, etc., based on revisions of accounting standards and on cases confirmed in recent inspections conducted until FY2010. The revised version was published in July 2011.

Cooperation with Relevant Organizations in Other Countries

The CPAAOB attended the Eighth Meeting of the International Forum of Independent Audit Regulators (IFIAR) in September 2010 in Madrid.

The CPAAOB also participated in the IFIAR Inspection Workshop held at the Fifth Meeting in February 2011 in Washington DC.

1 Organization

1.1 *Certified Public Accountants and Auditing Oversight Board*

The Certified Public Accountants and Auditing Oversight Board (CPAAOB) is a council system government institution established by the Financial Services Agency (FSA), based on the Certified Public Accountants Act (CPA Act), and the Act for Establishment of the FSA(established April 2004).

The CPAAOB is comprised of a Chairperson and up to 9 Commissioners with understanding and knowledge of matters concerning CPAs who are appointed by the Prime Minister and approved by both Diet houses. Most of the Commissioners serve part-time, but one of them can serve full-time. They are appointed for a term of three years.

The Chairperson and Commissioners exercise authority independently, and excluding situations where there are legal reasons, that independence shall not be violated by their dismissal during their appointed terms.

Since April 1, 2010, the Board has been comprised of 10 Members: Chairperson Yoshimasa Tomosugi, full-time Commissioner Toshiro Hiromoto, and eight part-time Commissioners. This board is conducting CPAAOB activities during its third term (April 2010 to March 2013).（Please see Annex 1.）

The main work of the CPAAOB is as follows:

- Inspect CPAs, audit fiems, JICPA, and foreign audit firms, etc.[1]
- Implement the CPA examinations
- Deliberate matters concerning disciplinary actions against CPAs, audit firms, etc.

1.2 *Executive Bureau*

The CPAAOB has an Executive Bureau to handle its administrative duties (Article 41, Paragraph 1 of the CPA Act).

The Executive Bureau is comprised of the Office of Coordination and Examination and the Office of Monitoring and Inspection, under the Secretary-General of the Executive Bureau.

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[1] Signifying parties located in a foreign country, which do the work of audit attestation on the financial documents of foreign companies etc. which submit securities reports etc. in Japan.

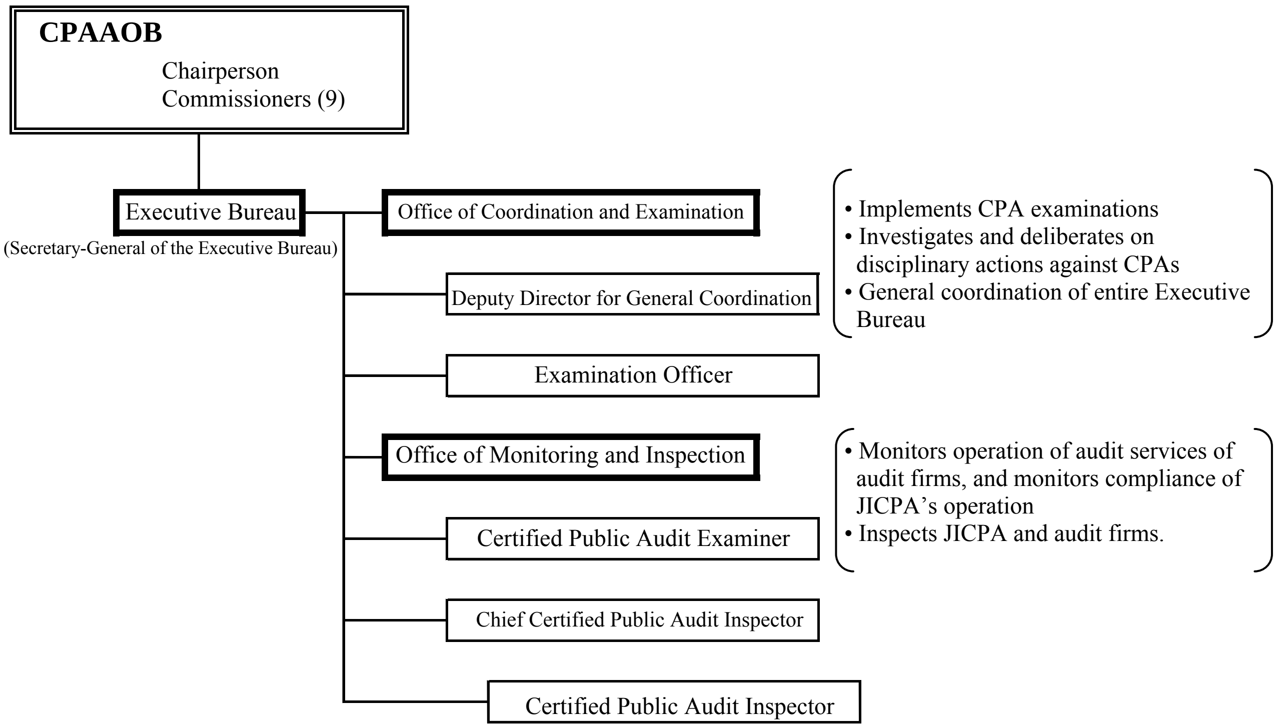
The Office of Coordination and Examination is in charge of implementing the CPA examinations, deliberating disciplinary actions against CPAs and audit firms, and general coordination of the Executive Bureau. The Office of Monitoring and Inspection is in charge of monitoring the operation of audit services provided by audit firms, monitoring the compliance of the operation of JICPA, and inspecting audit firms and foreign audit firms, and JICPA.

The Executive Bureau had 40 staff members when it was launched in April 2004. Its staff was steadily increased thereafter, to 14 in the Office of Coordination and Examination, and 44 in the Office of Monitoring and Inspection: for a total of 58 staff members on March 31, 2010.

Reference: Changes in the number of staff members (Fiscal year-end basis)

		FY2004	FY2005	FY2006	FY2007	FY2008	FY2009	FY2010
Office of Coordination and Examination		11	12	12	12	12	14	14
Office of Monitoring and Inspection		29	29	31	35	39	41	44
	Chief Inspectors	4	4	4	4	5	5	7
	Inspectors	18	18	20	24	26	28	28

Organization Chart of the CPAAOB



2 Examinations and Inspections

2.1 *Outline*

System

Under the CPA Act, the authorities relating to the following matters are delegated from the Commissioner of the FSA to the CPAAOB (Article 49-3-2, Paragraphs 1 and 2 of the CPA Act):

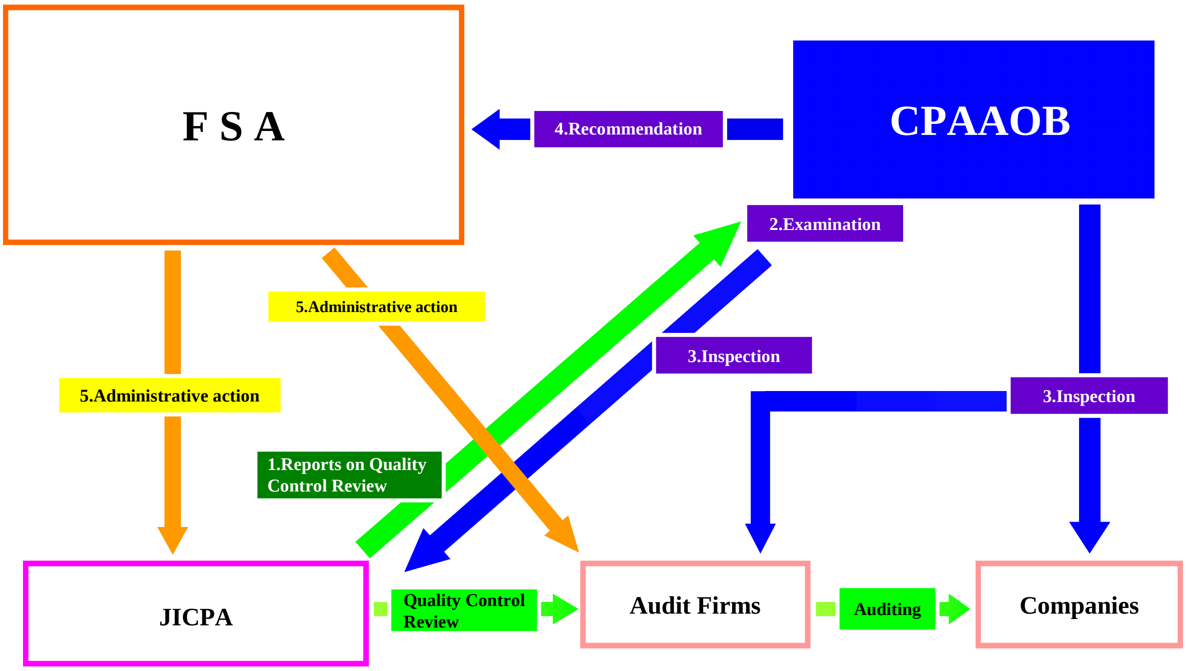
- Receipt of reports on results of JICPA's quality control review regarding the operation of audit and attestation services, as set forth in Article 2, Paragraph 1 of the CPA Act (Article 46-9-2, Paragraph 2 of the CPA Act);
- Request for information submission and conduct of inspections on the JICPA, CPAs and audit firms (limited to those actions performed in relation to the foregoing JICPA's quality control review) (Article 46-12, Paragraph 1 and Article 49-3, Paragraphs 1 and 2 of the CPA Act); and
- Request for information submission and conduct of inspections on foreign audit firms (Article 49-3-2, Paragraphs 1 and 2).

The CPAAOB examines JICPA's reports on quality control reviews[2] and exercises the authorities to request for information submission or to conduct inspections, when the CPAAOB finds it necessary and appropriate to do so from the standpoint of public interest or investor protection.

Based on the results of the above, the CPAAOB may make a recommendation to the Commissioner of the FSA regarding administrative actions or other measures, when the CPAAOB finds it necessary to do so.

[2] A quality control review is a review performed by the JICPA to assess the status of the operation of audit or attestation services. Specifically, with the aim of maintaining and improving the quality level of audit service as well as maintaining and enhancing social trust in audit, the JICPA reviews the status of quality control established by audit firms and offices of certified public accountants (hereinafter collectively referred to as "audit firms"), makes recommendations to remedy deficiencies, when finding it necessary, and receives from the reviewed audit firm the report on the status of the remedial action.

Outline of Examination and Inspection



1. Reports on Quality Control Review

The JICPA reviews and assesses, once every three years in principle (or once every two years, when the JICPA finds it necessary), an audit firms' compliance with laws, regulations, audit standards, and the JICPA's rules and other related regulations. The CPAAOB receives reports on the results of those reviews.

2. Examination

The CPAAOB examines JICPA's reports and ascertains (i) whether the quality control review system is appropriately operated by the JICPA as well as (ii) whether audit services are appropriately provided by audit firms.

The CPAAOB may request the submission of reports or other materials from the JICPA or audit firms, when the CPAAOB finds, in the course of examinations, it necessary to do so.

3. Inspection

Based on the results of examination, the CPAAOB conducts inspections of the JICPA, audit firms and any other related sites (such as those of audited companies), when the CPAAOB considers it necessary and appropriate in light of public interest or investor protection or when the CPAAOB considers it necessary to do so from the viewpoint of securing the appropriate operation of the JICPA.

4. Recommendation

Based on the results of examination or inspection, the CPAAOB may make a recommendation to the Commissioner of the FSA for administrative actions or any other measures for securing fair operation of audit services by audit firms or that of administrative operations of the JICPA, when the CPAAOB considers it necessary.

Note: Regarding requests for information submission and inspections on foreign audit firms refer to section 2.3.6 “Framework for Information Requirements and Inspections on Foreign Audit Firms, etc.”

2.2 *Basic Policies and Basic Plan for Examination and Inspection*

2.2.1 *Basic Policies for Examination and Inspection*

The CPAAOB established and published in June 2004 “To Ensure Reliability of Audits –Basic Policy for Examinations, etc.–” and announced the basic viewpoints and goals of its activities during the first term (from April 2004 to March 2007) as well as the basic guideline for examination and the framework for inspection.

In its second term (from April 2007 to March 2010), based on the results of examinations and inspections during the first term, the CPAAOB established and published in June 2007 “For Further Improvement of Audit Quality –Basic Policy for Examinations, etc.–”

In the third term (April 2010 to March 2013), based on the results of examinations and inspections during the first and second terms, the CPAAOB established and published “Basic Policies for Examination and Inspection –For Further Improvement of Audit Quality–” on June 25, 2010.

The third term’s basic policy is to carry out examinations and inspections with the following perspectives and goals.

- Perspectives

  In examinations and inspections implemented by the CPAAOB, one should always take a public-interest standpoint, from the people’s perspective, maximize use of the CPAAOB’s authority, and pay close attention to the adaptation of audit practice to laws and standards,etc. so as to actively work to ensure and enhance audit quality, and also to proactively respond to international trends, and provide information in Japan and overseas.

- Goal

  Examinations and inspections implemented by the CPAAOB do not focus directly on whether individual audit opinions themselves are suitable. Instead, the basic goal is to promote further improvement of the functions of quality control reviews by the JICPA, from a public-interest standpoint, and to ensure proper operation of audit firms and foreign audit firms.

2.2.2 *Basic Plan for Examinations and Inspections*

Based on the Basic Policies for Examination and Inspection mentioned above, the CPAAOB established the FY 2010 Basic Plan for Examinations and Inspections and published them on June 25, 2010.

The Basic Plan for Examinations states that, from the viewpoint of encouraging the appropriate establishment of audit quality control, the CPAAOB focuses on reviewing the establishment and management of the quality control systems of audit firms, such as those noted as having a wide range of deficiencies in quality control, or those for which voluntary remedial actions have to be implemented.

Also, the Plan mentions that with the aim of enhancing the function of quality control reviews by the JICPA and thereby securing effective implementation of remedial actions by audit firms, the CPAAOB reviews the appropriateness of JICPA's quality control review systems.

The Basic Plan for Inspections states that with respect to large audit firms the CPAAOB conducts their inspections as required, taking into consideration their roles in capital markets and international trends concerning audit supervision. The CPAAOB also inspects non-large audit firms that have a relatively large number of listed companies as their audit clients, as required.

Moreover, in relation to a small- or medium-sized audit firm, the quality control system tends to be insufficiently managed or remedial actions for the revealed deficiencies tend to be inadequately implemented. Therefore, the CPAAOB conducts inspection of those firms as required, based on the results of examination regarding the quality control review reports from the JICPA.

2.3 Examinations and Inspections

2.3.1 *Quality Control Reviews by the JICPA*

In FY 2010, the JICPA performed 99 quality control reviews of audit firms (53 audit firms, including 1 joint CPA office, and 46 CPAs). By March 31, 2011, 81 reports on those quality control reviews were submitted to the CPAAOB. (Note)
The status of quality control reviews is as follows.

(Note) The quality control review report (monthly report) consists of basically the following items:
- Quality control review report
- Recommendation for improvement report
- Response to recommendation for improvement report
- Quality control review documents (a set of documents collected and prepared to create quality control review reports and recommendation reports)

(i) Status of Implementation of Quality Control Reviews

Status of Implementation of Quality Control Reviews

Quality control reviews Month/Year conducted	2010						2011			Total
	Jul.	Aug.	Sep.	Oct.	Nov.	Dec.	Jan.	Feb.	Mar.	
Quality control reviews – Number of audit firms reviewed	15	17	0	20	21	15	9	2	0	99

(ii) Quality Control Review Reports

79 out of 81 cases, which were reported to the CPAAOB, included recommendations for remedy of deficiencies. The conclusions of those reports were as follows.

- Unqualified conclusion: 77 cases (40 audit firms and 37 CPAs)
- Qualified conclusion: 4 cases (1 audit firm and 3 CPAs)
- Negative conclusion (none)

Also, in FY 2010, the JICPA performed follow-up reviews[3] of 67 audit firms

[3] A “follow-up review” is a review conducted by the JICPA as part of its quality control review to assess the status of remedial action performed by an audit firm. Specifically, the JICPA assesses the status of remedial action by reviewing the status of (i) improvement of the quality control system, (ii) communication to auditors (including education and training of them), and (iii) remedial actions implemented in relation to the monitoring of the quality control system, etc., all of which are expected to be performed in accordance with the remedial plan described in the firm’s response to the JICPA in the course of the quality control review.

(53 audit firms, including 1 joint CPA office, and 14 CPAs). The results of 59 reviews, which were reported to the CPAAOB by March 31, 2011, were as follows.

- Remedial actions sufficiently completed: 54 cases (43 audit firms and 11 CPAs)
- Remedial actions insufficiently conducted: 5 cases (2 audit firms and 3 CPAs)

2.3.2 *Status of Examination of Quality Control Reviews*

(i) Scope and Perspectives for Examination

FY2010 examination has been performed regarding quality control reviews conducted by the JICPA in FY2009 and FY2010. The results of examination conducted regarding the FY2009 quality control reviews were as follows. As for the FY2010 quality control reviews, the CPAAOB received 81 reports on the cases by March 31, 2011, and their examinations are steadily in progress.

Quality Control Review Reports (FY2009) (No. of audit firms)

Category	Unqualified opinion		Qualified opinion		Negative opinion		Total
Audit firm	32	76.2%	10	23.8%	–	–	42
CPA	24	58.5%	17	41.5%	–	–	41
Total	56	67.5%	27	32.5%	–	–	83

Note: All of the above 83 cases included notes for improvement recommendation.

In the process of examination, the CPAAOB reviews reports on quality control review and assesses the results of interviews and those of requests for information submission for the purpose of ascertaining the following points:

- Appropriateness of JICPA's quality control reviews.
- Status of development and operation of quality control systems established for ensuring the quality of audit services in audit firms.
- Implementation of quality control by each audit firm in relation to the performance of respective engagement.

(ii) Information Submission

The FY 2010 Basic Plan for Examinations states that, from the viewpoint of encouraging appropriate establishment of audit quality control, the CPAAOB focuses on reviewing the establishment and management of the quality control systems of audit firms, such as those noted as having a wide range of deficiencies in quality control or those for which voluntary remedial actions have to be implemented. Based on this policy, the CPAAOB implemented the requests for information submission, as follows.

Status of Request for Information Submission (As of March 31, 2011)

		Number of audit firms subject to quality control review *1	Number of audit firms from which reports were submitted	Insufficient improvement *2
Information submission from audit firm		83	32	0
	Audit firm	41	16	0
	Sole practitioner	42	16	0

Note 1: Audit firms for which quality control reviews were conducted in fiscal 2009.

Note 2: Four of the audit firms which submitted information (one audit firm and three sole practitioners) had insufficient procedures for conducting audit operations. Their improvement situations will be checked later.

(iii) Deliberation

Based on the results of examinations of quality control reviews, the CPAAOB deliberates on conducting inspections of audit firms. Also, based on the results of inspections of audit firms, the CPAAOB deliberates on recommending administrative actions and other measures to the Commissioner of FSA.

In FY2010, the CPAAOB deliberated on the FY2009 quality control review (of 83 audit firms), and determined to conduct inspections of 9 audit firms. It also deliberated based on the results of these inspections, and a recommendation was made to the Commissioner of FSA regarding one audit firm (concerning the FY2008 quality control review).

The recent deliberation situation is as follows.

Recent Status of Deliberation (As of March 31, 2011)

	FY2009	FY2010
i. Deliberations completed (Note 1)	122 (Note 2)	83
ii. Decisions to conduct inspections of audit firms	7	9
iii. Decisions to recommend administrative actions and other measures to the Commissioner of FSA	1	1

Note 1: In principle, deliberations on the quality control review conducted in the previous

fiscal year

Note 2: Includes deliberations on the FY2007 quality control review.

2.3.3 *Status of Inspections*

Based on the “Basic Plan on Examination and Inspection, FY2010,” the CPAAOB conducted inspections on 9 audit firms in FY2010.

2.3.4 *Recommendations to the Commissioner of FSA*

Under Article 41-2 of the CPA Act, the CPAAOB made recommendations to the Commissioner of FSA for administrative actions or any other measures regarding the following audit firm, after deliberating the results of inspection conducted in FY 2010.

- July 13, 2010: Eisho Audit Firm

Note: The CEO and the partner in charge of quality control did not issue adequate instructions or assume sufficient supervision, as required by audit standards for maintaining the appropriateness of the quality control system. They did not repeatedly deliver clear and consistent messages to promote the internal culture recognizing that quality was essential in performing audit. Moreover, engagement quality control review and monitoring of the quality control system were not effectively conducted. In conclusion, its operation management was not appropriate to ensure the quality of audit performance and was, in fact, remarkably insufficient.

2.3.5 *Revision of the “Case Report: Deficiencies in Audit Quality Control”*

In July 2011, the CPAAOB published a revised version of the “Case Report: Deficiencies in Audit Quality Control,” published in February 2008. In the revised version, certain examples of issues were added or deleted to incorporate the issues identified in the inspections completed in FY2010 and to reflect the revisions of accounting standards, etc.

The CPAAOB intends to promote awareness of the importance of audit quality control through having meetings with related parties, etc.. The CPAAOB will also revise the above document every fiscal year, and add and delete the examples, as deemed necessary.（Please see Annex 2.）

2.3.6 *Framework for Information Requirements and Inspections on Foreign Audit Firms, etc.*

In relation to the supervision/inspection of foreign audit firms, the CPAAOB and the FSA published the “A Framework for Inspection/Supervision of Foreign Audit Firms, etc.” in

September 2009, based on the “Basic Plan on Examination and Inspection, FY2009.”

The CPAAOB published in January 2010, the “Basic Guidelines on Information Requirements and Inspection on Foreign Audit Firms etc. by the CPAAOB,” on the basis of “A Framework for Inspection/Supervision of Foreign Audit Firms, etc.” to provide the specific procedures and points to be considered regarding information requirements and inspection of foreign audit firms.

In the above framework and basic guidelines, it is stated that when (a) audit and public oversight systems in the firms’ home jurisdictions are equivalent to those of Japan, (b) necessary information can be provided from the foreign competent authorities through appropriate arrangements of information exchange, and (c) reciprocity is ensured, the CPAAOB will rely on information requirements and inspections conducted by the competent foreign authority and, in principle, will not conduct such actions on foreign audit firms itself.

Currently, the FSA and CPAAOB are having negotiations with the foreign competent authorities of various countries about the arrangement of mutual reliance and information sharing.

Reference: Notifications from the Foreign Audit Firms (as of March 31, 2011)

	Number of countries and regions	Number of firms
North America	2	7
Central & South America	2	2
Europe	11	34
Asia and Oceania	10	25
Middle East	1	1
Other	2	10
Total	28	79

3 Cooperation with Relevant Organizations in Other Countries

3.1 *Outline*

Sparked by a series of accounting scandals around the world, such as the Enron and WorldCom scandals, the importance of audit oversight has increased, and audit oversight institutions independent of the audit profession have been established in various countries, to ensure and enhance audit quality.

In this environment, the first plenary meeting of the International Forum of Independent Audit Regulators (IFIAR) (with 22 countries participating) was held in Tokyo in March 2007, and hosted by the CPAAOB. By March 31, 2011, IFIAR had eight meetings, and its membership has growth to 37 countries and regions. The Chairperson and the Full-time Commissioner of the CPAAOB have attended the meetings.

In order to improve the international audit quality, the CPAAOB is making efforts to establish and enhance cooperative relationships amongst foreign regulators.

3.2 International Forum of Independent Audit Regulators (IFIAR)

3.2.1 *Organization*

(i) Goals

IFIAR has the following goals.

i To share knowledge of the audit market environment and practical experience of independent audit regulatory activity with a focus on the inspections of auditors and audit firms;

ii To promote collaboration and consistency in regulatory activity; and

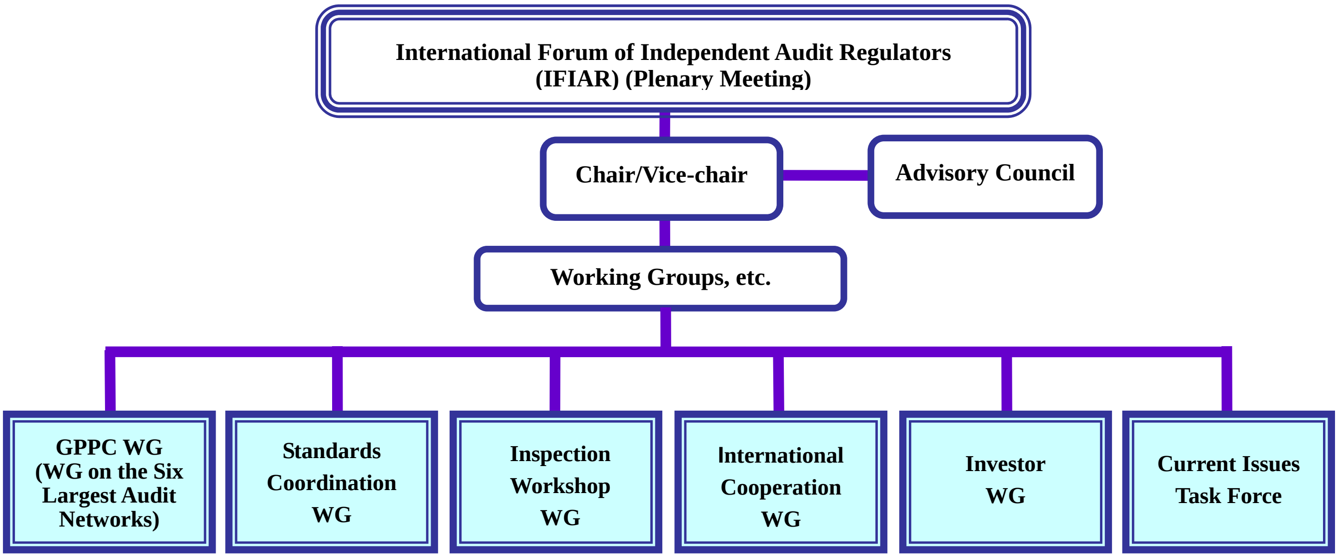
iii To provide a platform for dialogue with other organizations that have an interest in audit quality.

(ii) Organization

As of March 31, 2011, 37 countries and regions are members of IFIAR. Under its Chair and Vice-chair is placed the underlying organization, with five Working Groups (WG) and a Task Force (TF) (GPPC WG [WG on the Six Largest Audit Networks], Standards Coordination WG, Inspection Workshop WG, International Cooperation WG, Investor WG, and Current Issues TF).

There is also an Advisory Council which supports and advises the Chair and Vice-chair. The FSA/CPAAOB was elected as a member of this Council, which is comprised of six countries.

IFIAR organization chart



3.2.2 *Activities*

(i) Plenary Meeting

The eighth meeting was held in Madrid from September 27 to 29, 2010, hosted by ICAC (Instituto de Contabilidad y Auditoría de Cuentas). Chairperson Yoshimasa Tomosugi, Commissioner Toshiro Hiromoto attended the Meeting.

Independent audit regulators from 37 jurisdictions attended this Plenary Meeting. The International Organization of Securities Commissions (IOSCO), Public Interest Oversight Board (PIOB), Basel Committee on Banking Supervision (BCBS) and European Commission also participated as observers.

At the Plenary Meeting, a set of Core Principles for Independent Audit Regulators was discussed. There were also dialogues with investor representatives and the GPPC WG.

IFIAR past plenary meetings

- First meeting	March 22-23, 2007	Tokyo, Japan
- Second meeting	September 24-25, 2007	Toronto, Canada
- Third meeting	April 9-11, 2008	Oslo, Norway
- Fourth meeting	September 22-24, 2008	Cape Town, South Africa
- Fifth meeting	April 27-29, 2009	Basel, Switzerland
- Sixth meeting	September 14-16, 2009	Singapore
- Seventh meeting	March 22-24, 2010	Abu Dhabi, UAE
- Eighth meeting	September 27-29, 2010	Madrid, Spain
- Ninth meeting	April 11-13, 2011	Berlin, Germany

(ii) Inspection Workshop

Audit inspections remain a core area of focus for IFIAR. Therefore, aiming to share better practices and issues of inspections, and challenges in inspectors' skill training, IFIAR holds the Inspection Workshop, which is attended mainly by inspectors of the members.

The fifth Inspection Workshop was held in Washington DC in February 2011. Independent audit regulators of 30 jurisdictions participated in the Workshop.

This workshop had active exchanges of views and experience on the themes of audit issues based on a macroeconomic viewpoint after the financial crisis, the conduct of risk basis inspections, and how to apply appropriate professional skepticism. From the CPAAOB, a Chief Inspector contributed to the Workshop as a lecturer with introducing experience in CPAAOB and invited exchanging views and knowledge among participants.

IFIAR past inspection workshops

- First workshop	May 30-31, 2007	Amsterdam, the Netherlands
- Second workshop	January 29-30, 2008	Berlin, Germany
- Third workshop	February 11-13, 2009	Stockholm, Sweden
- Fourth workshop	February 9-12, 2009	Paris, France
- Fifth workshop	February 23-25, 2011	Washington DC, U.S.A.

3.3 Others

(i) Exchange of views with foreign authorities

In addition to participating in the IFIAR meetings, the CPAAOB is actively exchanging views and experience with audit regulators and other organizations of different countries on a bilateral basis.

In particular, based on the Certified Public Accountants Act, which has been enforced since April 2008, the CPAAOB and the FSA actively exchange views with authorities of various countries on how to implement the new system, including mutual reliance in inspections and supervision of foreign audit firms (refer to page 11, Chapter 2.3.6 Framework for Information Requirements and Inspections on Foreign Audit Firms, etc.)

(ii) Participation in seminars

The International Auditor Regulatory Institute was organized by the U.S. Public Company Accounting Oversight Board (PCAOB) in November, 2010. 71 representatives from 40 countries and regions participated in the Institute.

At the conference, the PCAOB introduced it's operations, such as inspections, standard setting, investigation procedures. There were also panel discussions on issues for inspections on audit firms by each country's supervisory institutions. The CPAAOB participated in the conference by sending an inspector as a panelist.

List of Members of Certified Public Accountants and Auditing Oversight Board (CPAAOB) (As of June 24, 2011)

Chairperson (full-time)	Yoshimasa Tomosugi	Former Professor WASEDA Graduate School of Accountancy
Commissioner (full-time)	Toshiro Hiromoto	Former Professor Graduate School of Commerce and Management Hitotsubashi University
Commissioner (part-time)	Yasuyoshi Ichikawa	Partner Deloitte Touche Tohmatsu LLC
Commissioner (part-time)	Mami Indo	Executive Officer & Head of Consulting Division Daiwa Institute of Research Ltd.
Commissioner (part-time)	Michiyoshi Sakamoto	Professor Keio University Graduate School of Business & Commerce
Commissioner (part-time)	Hisakatsu Sakurai	Professor Graduate School of Business Administration, Kobe University
Commissioner (part-time)	Yuko Tashima	Lawyer Outside Director Meiji Yasuda Life Insurance Company
Commissioner (part-time)	Naoko Nemoto	Managing Director Financial Services Ratings Standard & Poor’s
Commissioner (part-time)	Yasuyuki Fuchita	Executive Fellow Nomura Institute of Capital Markets Research
Commissioner (part-time)	Kazunori Yagi	Advisor Yokogawa Electric Corporation

Annex 2

Case Report：Deficiencies in Audit Quality Control

July 2011

Certified Public Accountants and Auditing Oversight Board

Introduction

Since its establishment in April 2004, the Certified Public Accountants and Auditing Oversight Board (CPAAOB) has been conducting inspections of Japanese audit firms from the viewpoint of enhancing the quality of audit in Japan and securing public interests.

In the course of those inspections, the CPAAOB identified various deficiencies in audit firms concerning their audit engagement performance as well as their quality control system, in the areas of, for instance, (i) leadership responsibilities for quality control, (ii) independence, (iii) audit files, (iv) engagement quality control review and (v) monitoring of quality control systems. To make those deficiencies publicly available, the CPAAOB has been issuing, since 2008, a Japanese version of the "Case Report: Deficiencies in Audit Quality Control" every year.

For this English version of "Case Report: Deficiencies in Audit Quality Control," we chose from the cases mentioned in our latest (2011) Japanese version those deficiencies, which are, in our analysis, assumed to be not peculiar to Japanese firms but to have some relevancy to foreign audit firms. In Part I of this English version, we introduce the deficiency cases concerning the firms' quality control system, and, in Part II, the deficiency cases concerning audit engagement performance.

We believe this English version of the report is beneficial for foreign audit firms, especially those having filed the notification required under the Certified Public Accountants Act of Japan with the Financial Services Agency, in making their continuous efforts to enhance the audit quality.

Chairperson of the CPAAOB
Yoshimasa Tomosugi

Part I Quality Control System

Management of Quality Control System

1. The CEO and the partner in charge of quality control did not issue instructions to maintain the appropriateness of the quality control system of the firm. They did not consider, from the viewpoint of reasonably securing the audit quality, how to allocate audit staff to each engagement and thus sufficient personnel was not allocated to each engagement. In addition, they assumed almost none of their obligations to issue necessary instructions concerning quality control or to supervise audit staff's performance, which were imposed under the relevant audit standards. Neither engagement quality control review nor ongoing evaluation of the quality control system was performed in an effective manner.

2. The main office of the firm did not properly monitor whether or not the local offices appropriately assumed the firm's internal procedures concerning the acceptance and continuance of audit engagements. The main office did not request the local offices to report the results of the ongoing evaluation of the quality control system conducted by them either.

Leadership Responsibilities for Quality Control

3. The CEO of the firm did not provide the partner in charge of quality control with specific instruction as to how the quality control system of the firm should be established and managed. In addition, the CEO did not appropriately supervise how the partner in charge of quality control assumed his responsibilities.

4. The operational responsibilities for the firm's system of quality control were assumed solely by the partner in charge of quality control and the firm did not allocate sufficient personnel to fulfill those responsibilities. The board of partners, which had the ultimate responsibility for the firm's system of quality control, did not appropriately supervise how the partner in charge of quality control assumed his/her responsibilities.

5. The firm did not clearly define the scope of responsibility to be assumed by each of the board of partners, the CEO, and the partner in charge of quality control, in connection with the firm's quality control system. None of them

performed proper oversight over the system. Those deficiencies led to defects in certain areas, such as the development of the firm's compliance system, information security, monitoring system, the establishment and notification of internal rules, and the retention of audit files.

Establishment of Internal Policies and Procedures

6. The internal rules of the firm did not reflect the recent amendments of related laws and regulations.

7. The most recent audit manual of the firm did not provide for the procedures dealing with the new accounting standard for measurement of inventories, which had to be implemented in relation to the fiscal years beginning on or after April 1, 2008.

8. The firm failed to distribute the firm's audit manual to some of the audit staff. In addition, the firm did not recognize such failure until revealed in the course of the on-site inspection.

9. The internal rules of the firm provided that, when a new employee joined the firm or when the firm's policies and procedures concerning its quality control system were amended, the partner in charge of quality control should explain those policies and procedures to the audit staff; however, the partner did not explain those policies and procedures to them in a timely manner.

Compliance with Professional Standards

10. A firm auditing the consolidated financial statements of a company concurrently provided the company with the service of "compiling the company's financial statements," by way of calculating the figures to be shown in the consolidated financial statements on the basis of the documents submitted from the company and providing those figures to it.

11. The CEO of the firm did not recognize that the consulting company, which was under the CEO's control through his ownership of the company's shares, fell into the category of the firm's "affiliated entity." Therefore the CEO did not notice that the fact that the firm audited a company and the affiliated company concurrently performed compiling of the financial statements of the same violated the regulations restricting concurrent provision of audit and

non-audit services.

12. The firm had no procedures to confirm whether or not the service provided by the firm violated the regulations restricting concurrent provision of the audit service and the non-audit service to a single client. Rather, the firm completely relied on each partner's judgment as to whether the service provided by him/her violated the above regulations.

Information Security

13. The firm failed to establish policies and procedures regarding information security.

14. As for the PCs rented by the firm to its audit staff, the firm did not establish policies and procedures concerning the password for them nor monitor whether or not the staff properly set up and amend the password in a timely manner. In addition, the firm failed to establish policies and procedures for the security of data saved on each PC and did not monitor whether or not the staff properly saved the data in a secured manner.

15. In relation to the PCs owned by the temporarily-employed staff and used by them for the firm's engagements, the firm did not implement appropriate measures for security password management or anti-virus protection.

Quality Control Review by the Japanese Institute of Certified Public Accountants (JICPA)

16. The firm confirmed in writing that it would perform sufficient and appropriate measures to remedy deficiencies identified in the course of JICPA's quality control review, such as communicating the identified deficiencies to the audit staff, strengthening monitoring over the quality control system and so on; however, the firm did not develop a detailed plan for implementing the remedial action or appropriately communicate the identified deficiencies to its staff.

17. The firm did not develop a detailed remedial action plan with regard to deficiencies identified in the course of JICPA's quality control review. The firm did not implement appropriate measures to confirm whether or not the remedy was appropriately in progress.

18. The firm did not substantially analyze the root causes of the deficiencies identified in the course of JICPA's quality control review and thus failed to develop remedial actions reflecting the root causes.

Independence

19. In confirming the independence of the partners and staff, the firm did not confirm their independence in relation to subsidiaries and other affiliated entities of the audited companies.

20. The firm failed to confirm the independence of audit assistants, who engaged in the input of the audited company's financial figures in the audit files.

21. In changing the assignment of a temporarily-employed audit staff, the firm did not confirm his/her independence in relation to the company newly assigned to him/her.

22. The engagement partner failed to confirm, with respect to each member of the engagement team, whether or not any event that might create threats to their independence had occurred after the annual confirmation of their independence.

23. The firm did not establish the procedures for confirming the independence of a person who joined the audit team subsequent to its initial formation, and thus failed to confirm his/her independence in relation to the engagement.

24. In confirming the independence of audit staff in relation to a new engagement by email, the firm mentioned only the name of the prospective client and failed to mention the names of those affiliated with the prospective client.

Human Resources

25. The firm failed to establish policies regarding how the quality of engagement performed by partners and staff was taken into consideration in their evaluation as well as the determination of their remuneration and promotion.

26. The firm's evaluation of the partners and staff was not performed in accordance with the firm's internal rules.

Acceptance and Continuance of Audit Engagements

27. The firm provided audit services to certain companies and schools without performing risk assessments, obtaining internal resolutions required under the firm's rules or executing written agreements.

28. While the firm identified certain problems in the course of considering whether to continue an existing engagement and finally decided to continue the engagement irrespective of existence of the problems, it failed to document how the problems were resolved.

29. Under the firm's rules, when accepting a new client, a partner was required to submit to the board of partners a report describing the outline of business and the financial status of the new client and thereafter obtain the board's approval. However, some of the engagement agreements were executed without obtaining the board's approval. In some cases completed versions of the reports were not submitted to the board in the process of obtaining the board's approval.

Audit Files

30. Although it was apparent from the audit files that the audit team had not appropriately conducted some of the necessary audit procedures, the reviewer issued no instructions to the team after the review of the files.

31. No descriptions were made in the audit files as to who conducted the relevant audit procedures or when and by whom the audit files were reviewed.

32. In relation to the retention of audit files, the following deficiencies were found:
    a) The firm had no detailed procedures for completing the assembly of final engagement files or keeping safe custody of the files;
    b) The firm failed to record the numbers, retention periods and other type of information relating to the retained files;
    c) The firm failed to record in the register some of the files retained by it; and
    d) The firm did not keep record of the disposal of files.

33. In relation to the custody of audit files, the following deficiencies were found:

a) During the on-site audit period, the audit team kept audit files in the lockers in the audited company without holding their keys under the team's control;

b) Audit files were retained by its partner in the cabinets at his/her office for personal business; and

c) The audit files were retained in unlocked cabinets.

Engagement Quality Control Review (EQCR)

34. A person involved in an audit engagement as an assistant subsequently acted as an engagement quality control reviewer of the same.

35. The internal rules of the firm provided that an engagement quality control review had to be conducted by the firm's review committee. However, for each engagement, the review was conducted without having a discussion among the committee members.

36. The firm had no policies or procedures for the review of an audit plan.

37. The firm did not review the audit plan regarding the client's financial statements or its internal control, either.

38. The audit plan and the audit report were reviewed on the same occasion.

39. The firm's internal rules required an audit team to have an EQCR partner review any matter related to the change of audit principle or going concern; however, a team issued an audit report, although the reviewer was yet to review the description relating to a change of software sales recognition or going- concern conditions.

40. The engagement partner issued the audit report before the EQCR partner's review was completed.

41. The firm did not record in an appropriate manner that the review procedure had been completed before the audit report was issued.

42. An engagement quality control reviewer failed to fill in the section titled "Results of Review" in the EQCR document.

43. The drafts of a financial statement and an audit report, which the EQCR partner claimed to have reviewed, were appropriately saved in the EQCR files and thus were unidentifiable.

44. The engagement partner issued the audit report before the matters indicated by the EQCR partner were completely resolved.

Ongoing Evaluation of Quality Control System

45. In relation to the ongoing evaluation of the quality control system, the firm did not establish specific procedures, document the results of the evaluation, or report to the CEO (or equivalent) the deficiencies identified as a result of the evaluation.

46. The firm did not perform ongoing evaluation of the process and decisions made in connection with the continuance of audit engagements.

Periodic Inspection of Completed Audit Engagements

47. With respect to periodic inspection of completed audit engagements, the firm did not specifically determine the timing of inspection, the inspection cycle or any other specific procedures.

48. The firm failed to communicate to the relevant engagement partner and the CEO deficiencies identified as a result of the periodic inspection.

49. In the course of periodic inspection, the person in charge only confirmed what procedures the audit team had conducted on a verbal basis and did not review any relevant audit files.

50. In relation to the deficiencies identified as a result of the periodic inspection, the firm did not assess the effects of those deficiencies or consider what remedial actions should be taken in relation to the relevant engagement or individual.

Joint Audit

51. While the auditor claimed that he confirmed the quality control system of the

joint auditor was managed in a manner sufficient to secure the quality of the joint audit, the auditor failed to document the above conclusion and the process for reaching it.

Part II Audit Engagement Performance

Audit Planning

1. The audit team calculated the audit materiality amount only based on their experience as auditors and did not consider materiality in terms of accounts or transactions.

2. The audit team changed the audit materiality but did not consider the necessity of change to an audit plan including the extent of procedures subject to audit sampling.

3. Audit procedures related to understanding the audit client's internal control were limited to inquiries with client management and statutory auditors and the audit team did not perform procedures such as observation, or review covering the assessment of internal control design.

4. The audit team failed to identify significant fraud risks at the entity level, significant fraud risks at the financial statement level, and risks that require special audit consideration. From this perspective the team failed to plan the audit procedures corresponding to those risks.

5. The audit team did not perform any procedures to assess the IT general control of the significant subsidiary.

6. Although the audit team could not use the results of their previous assessment of internal control designs, they did not consider the effect of the new accounting system that the client had implemented at the beginning of its financial year. They did not ascertain whether the accounts balances were appropriately carried forward to the beginning balances either.

7. While the audit team recognized the deficiencies related to the control of privileged ID for the client's accounting system, they failed to perform audit procedures corresponding to the deficiency.

8. In relation to an assessment of the Client's IT general control, the audit team concluded that there was no change and that the control level was good as a result of only inquiry procedures by relying upon the prior year's control assessment; it did not perform other procedures in addition to observation and

review of related documentation.

9. In relation to the client’s general control over the IT-based information system, the audit team failed to consider the accuracy of their calculation results made by the material spread sheet and user-developed program related to financial reporting. While they noted there was no design of control, they failed to perform alternative procedures for that.

10 . In relation to the valuation of delinquent accounts receivable and inventories, the audit team insisted that they considered the accuracy and completeness of the information generated from the Client’s IT system, but they failed to document the consideration process and conclusion in their working papers.

Audit Procedures regarding Control Risk of Subcontracted Services

11. The audit client subcontracts the computation-related procedures of its payroll process to a third party contractor. However, the audit team failed to consider the effect of its internal controls on the client’s financial statements.

12. The audit team used the outside contractor’s auditor’s report in order to ascertain the contractor’s design and the effectiveness of its internal control. However, the audit team failed to check whether there had been any changes to its internal control from the audit report date to the audit client financial year end.

13. The audit client outsources maintenance services of their IT system. However, the audit team did not obtain a copy of service contract or a detailed arrangement letter. The team failed to ascertain the effectiveness of the internal control of this outsourced service, too.

Fraud-related Procedures

14. The audit team did not perform the audit procedures to identify and understand the significant misstatement risk due to fraud, such as inquiring with the client management and statutory auditors regarding their understanding about those risks and their identification of actual fraud.

15. While the auditor's manual indicates a rebuttable assumption that there is a fraud risk with revenue recognition it also describes instances where the auditor need not identify fraud risk with the revenue recognition. For that reason the audit team failed to document their decision that they did not identify fraud risk with the client's revenue recognition and rationale behind it in their audit working papers.

16. In relation to the audit procedures corresponding to the risk of management override, the audit team failed to check the completeness of journal-entry data which had been booked on the general ledger.

Risk-related Audit Procedures

17. As procedures for assessing the effectiveness of daily and multiple controls relating to the revenue and the purchase processes, the audit team selected all sample items from transactions in the 4th quarter. Thus they failed to obtain audit evidence in order to assess the effectiveness of daily and multiple controls throughout the year.

Audit for Estimates

18. In relation to inventory valuation procedures, the audit team tested the data that the audit client prepared for the items whose net realizable value are lower than their book value and ascertained whether those valuation losses were appropriately booked or not. They failed to check the completeness of the data or to perform a further substantive test on a sample basis.

19. In relation to audit procedures for retirement benefit allowance, which the audit client calculated by using package software, the audit team failed to perform those procedures to ascertain the reliability of the software and perform a substantive test, such as vouching or calculation verification on a sample basis, in order to check the accuracy of the year-end allowance balance.

20. In relation to the long-term rate of return of pension assets, the client has not changed it since its adoption of a new accounting standard in terms of pension accounting. In these circumstances the audit team failed to consider the rationale of unchanged rate of return by checking the effect of actual returns for prior years to corresponding incomes, for example.

21. Although the leased assets balance exceeded the audit materiality, the team failed to consider the necessity of leased assets' impairment.

22. In relation to the grouping of assets so as to recognize the impairment loss of the client's fixed assets, the audit team obtained the client prepared materials but failed to ascertain the appropriateness of them. The team did not consider whether the client should recognize impairment loss or not on a consolidated group basis.

23. In relation to the audit of consolidated subsidiaries' accounts receivable with significant balance, the audit team failed to check whether there is any doubtful accounts or ascertain the appropriateness of reserve for doubtful receivables.

Consideration for Derecognition of Financial Asset

24. In relation to the transaction where the audit client transferred its accounts receivable to a third party, the audit team did not obtain the copy of the transfer agreement and failed to consider whether the transaction met the criteria for derecognition of a financial asset. Although the audit team did not have legal expertise, the team failed to obtain an opinion letter from an eligible legal specialist.

Revenue Recognition

25. The audit client engaged in subleasing of the real estate properties as its main business. The audit team performed only the vouching procedure for the revenue of the client and they did not perform further substantive procedures, such as the inspection of leased properties, or analytical procedures to pursuit the relevance between the revenue and the cost because the team did not assume fraud risk with the client's revenue recognition.

Confirmation Procedures

26. The audit team noted that there are problems with the collection of accounts receivable confirmations. For example, a large number of confirmations are not received from customers in accordance with set conditions. The team also recognized that there was a case of fraud caused by one of the client's

employees two months before the year-end. Irrespective of the above recognition, the audit team used the month-end date 3 months before the year-end as the confirmation balance.

27. The audit team circulated the confirmation of accounts receivable balance as of January 31, 2009 for most of the customers but as of January 20, 2009, for a part of the customers considering their monthly cut off date. However, in relation to the roll-forward procedures, they only checked the period from February 1, 2009, to March 31, 2009 (year end) but not for the period between January 21, 2009, and January 31, 2009.

28. In relation to the confirmation of completed constructions receivable, the audit team let the audit client deliver them and failed to control the processes for sending and receiving confirmations. The team did not consider the reliability of customer responses, either.

29. In relation to confirmation procedures, although the audit team received certain responses with no specific amounts filled in the form, they did not recirculate the confirmations in question or perform any alternative procedures, either.

Substantive Analytical Procedures

30. In relation to the substantive analytical procedures, the audit team failed to either develop an expectation at a sufficient level of precision or consider the amount of difference from an expectation that can be accepted without further investigation.

Substantive Procedures

31. While the audit client sold its material subsidiary company's shares at a price significantly higher than its net asset value, the audit team did not perform any procedures to check the appropriateness of the selling price or the recognized gain from the sale.

32. In relation to real estate properties with significant balance held as inventory by the client, the audit team failed to ascertain their existence and right of use by conducting substantive procedures, such as physical inspections and the review of the certified copy of register.

Audit of Consolidated Financial Statements

33. Although the audit team planned to visit certain subsidiaries, review their financial statements, and perform confirmation procedures, they did not prepare relevant audit programs. They actually did not perform the planned confirmation procedures but failed to document the changes to the audit plan in their working papers.

Related Party Transactions

34. In relation to the audit procedures of related party transactions, the audit team failed to perform the following procedures:
    a) Review of the investigation forms which the audit client requested and obtained from directors and their close family members regarding transactions between them;
    b) Inquiry with the CEOs on the alliance and joint venture relationships with other entities; and
    c) Review of the register of shareholders to identify key shareholders.

35. The team did not consider the client's internal control in terms of approval or records of the related party transactions, either.

Communication with Audit Committee

36. Although the audit team insisted that they communicated with the audit committee about the matters which the team noted as important from the perspective of the audit committee's performing its duties, the team failed to document such communication in the audit working papers.

Subsequent Events

37. The audit team planned to rely on other auditors' work for certain subsidiaries. However, they collected the reports in respect of subsequent events from other auditors after the audit report date without performing any alternative procedures before that date.

Financial Statement Disclosures

38. In relation to notes to the financial statements in respect of leases, investment securities, retirement benefits and deferred taxes, the audit team only compared the figures in the notes to the summary sheets prepared by the client and failed to verify the appropriateness of the client-prepared sheet.

Management Representation

39. The audit team only obtained a pdf copy file of the management representation letter from the audit client, not the original, when they submitted the auditor's report to the client.

Other Auditors' Work

40. In relation to the audits of overseas' subsidiaries, the audit team relied on other auditors' work. However, the team failed to ascertain whether or not the other auditors performed their audits in accordance with auditing standards that are virtually the same as the standards applied in Japan. They did not figure out the audit materiality amounts, either.

41. The audit team relied on other auditors' work for overseas subsidiaries and only checked the material impairment loss recognized in their financial statements, failing to consider the necessity of additional procedures, including the request for details-supporting documents from the auditors or inquiries with them.

Use of Specialists

42. In relation to the calculation of allowances for retirement benefits, the audit team utilized the actuary reports issued by the trust bank which the client outsourced. However, the team failed to consider its competency as an actuary specialist.

43. The audit team obtained and checked the opinion letter issued by an independent real estate valuation specialist whom the client used for its properties held as inventory. The team used the letter as audit evidence but failed to consider the capacity and the objectivity of the specialist.

Final Analysis

44. The audit team did not perform a final analysis of the financial statements as a whole at the last stage of their audit.

Assessment of Client Control over Litigation Risks

45. In relation to the client's control over litigation risks, the audit team failed to ascertain whether the client had an adequate department and whether there was a sufficient process to manage risks related to litigations and claims.

Going Concern

46. The audit team concluded that there is no significant uncertainty related to the client's going concern assumption as a result of their analytical procedures of the management-prepared business plan. However, the plan was prepared by the director in charge of accounting and was not duly approved by a party with proper authority, such as the board of directors.